INCOME TAX OUTLINE --- SPRING 2012

**Introduction**

1. General
   1. 1986 Act is so unique (and was able to pass) b/c it lowered rates (Reagan) **and** there was base broadening (removed a lot of tax expenditures)
   2. Tax evasion means purposely avoiding legal obligations
   3. Tax avoidance is perfectly legal
      1. **Learned Hand**- “there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible … nobody owes any public duty to pay more taxes than the law demands”
2. Principle Goals of Taxation:
   1. Raise revenue for public goods
      1. Products that individuals don’t have incentives to purchase on their own
   2. Provides incentives to shape behavior (e.g. “sin taxes”)
   3. Distribute tax duties more “fairly” (e.g. progressive tax rates)
   4. Promote economic growth
      1. Use tax cuts to promote spending, etc.
3. Significance of Federal Taxes
   1. Income taxes constituted 60% of federal revenue in 2009
   2. There are always 3 parties involved (the 2 parties directly involved + the US Treasury/Taxpayers)
   3. You can think of any tax preference as a subsidy in a sense (tax expenditures)
4. Taxes in the News
   1. State of the Union 🡪 theme of econ inequality and how IRC can address this
   2. “Buffet Rule”: effective tax rate of 30% for millionaires [currently there is a significantly lower rate for capital gains than for wage income]
   3. PROF: can’t simplify the IRC and still use it to do all sorts of things that politicians want
   4. Romney’s effective tax rate is 13.9% (b/c of capital gains); while Gingrich’s is 31% b/c he makes his money as a speaker
5. Basic Income Tax Terminology
   1. Treasury Regs
      1. Fill in the holes of the IRC
      2. Are not laws from Congress—that are made through agency rule-making procedure
   2. Calculating taxable income
      1. **§ 61** – Gross Income
         1. Foundational code section; comes from the 16th Am, which allows taxation of income
         2. “All income from whatever source derived”
            1. Start with a very large notion of gross income

Watch for exceptions

* + - 1. “Included, but not limited to…” [non-exhaustive examples]
         1. Compensation for services

Wages

Doesn’t say anything about the form of the compensation (ie. cash, etc.)

**Treas. Reg. § 1.61-1(a); 1.61-2(d)(1)**

(a) Income doesn’t have to be limited to cash

Form of income for services doesn’t matter (could be gum)

(d) Compensation paid other than in cash

If compensation is property, calculate income as FMV of property (ie. FMV of the gum, etc.)

* + - * 1. Gross income derived from business
        2. Gains from dealings in property
        3. Interest
        4. Rents
        5. Royalties
        6. Dividends
        7. Alimony & separate maintenance payments
        8. Annuities
        9. Income from **life insurance** & endowments contracts
        10. Pensions
        11. Income from discharge of indebtedness

As a general idea, pay taxes on settlement with creditor as income (b/c you are economically better off)

But after exceptions, this isn’t how it ends up working

* + - * 1. Distributive share of partnership GI
        2. Income in respect of decedent
        3. Income from an interest in an estate or trust
    1. **§ 62** – Adjusted Gross Income (AGI)
       1. Subtract some things from GI to get AGI **[“Above the line deductions”]**
          1. **The “line” is AGI**
          2. Typically business-related expenses

EX: $2 spent on flyers is immediately deductible as an ordinary & necessary business expense under **§ 162**. $5 spent on more t-shirt inventory would not be immediately deductible b/c it is capitalized to inventory (have to wait to deduct until it becomes COGS).

* + - 1. (1) Trade & business deductions
         1. Re: business income, only tax net income [gross income minus expenses]

Exception: stuff TP does as an EE does not count as this kind of deduction

EX: if you are a solo practitioner, you CAN use this deduction b/c you bear the cost of travel, but an EE gets reimbursed for these expenses (& the ER gets to deduct for the expenses)

* + - 1. (2) Certain trade & business deductions of EEs
         1. (A) Reimbursed expenses of EEs
         2. (B) Certain expenses of performing artists
      2. (3) Losses from sale or exchange of property
      3. (7) Retirement savings
         1. Allowed by **§ 219**
      4. (10) Alimony
         1. Allowed by **§ 215**
      5. (15) Moving expenses
         1. Allowed by **§ 217**
      6. (17) Interest on education loans
         1. Allowed by **§ 221**
      7. (18) Higher education expenses
         1. Allowed by **§ 222**
      8. (19) Health savings accounts
         1. Allowed by **§ 223**
      9. Above the line deductions are good b/c they lower AGI and therefore reduce the ratios used other places in the IRC
         1. You can always take above the line, you can’t always take below the line deductions (come with strings)
    1. **§ 63** – Taxable Income defined
       1. (a) IRC says gross income, but taxable income means AGI minus deductions forthcoming in this chapter
       2. “Itemized deductions” or “below the line deductions” [**to get from AGI to taxable income**]
          1. e.g. personal and dependency exemptions & the greater of standard deductions OR itemized deductions
          2. Alternative to these itemized deductions is the standard deduction: people may not qualify for the itemized deductions, so get standard deduction instead (wouldn’t be fair otherwise)

People need to think about whether itemized deductions would add up to be more than the standardized deductions

E.g. home mortgage interest deduction is an itemized deduction

* + 1. **§ 67** – 2-percent floor on miscellaneous itemized deductions
       1. (a) General rule: for an individual, the misc. item. ded. for any taxable year is allowed only to the extent that the **aggregate** of such deductions exceeds 2% of **AGI**.
       2. (b) Misc. item. deductions **are any** itemized deductions **that are NOT on this list**:
          1. (1) Interest - **§ 163**
          2. (2) Taxes - **§ 164**
          3. (3) **§ 165(a)** deductions for losses described in paras (2) or (3) of **§ 165(c)** or for losses under **§ 165(d)**

ie. casualty losses; gambling losses

* + - * 1. (4) Charity-related - **§ 170** & **§ 642(c)**
        2. (5) Medical/dental expenses - **§ 213**
        3. (6) Impairment-related work expenses deductions
        4. (7) Estate tax - **§ 691(c)**
        5. (8) Deduction allowable w.r.t. personal property used in a short sale
        6. (9) Claim of right - **§ 1341**
        7. (10) Annuity payments ceasing before investment is recovered - **§ 72(b)(3)**
        8. (11) Amortizable bond premium - **§ 171**
        9. (12) Cooperative housing corps - **§ 216**
    1. GET CALCULATION CHART FROM SLIDE
  1. “Above the Line” v. “Below the Line” [continued]
     1. Below the Line Deductions are contingent upon:
        1. (1) Whether **§ 67**’s 2% of AGI floor applies
           1. (a) Restriction on miscellaneous itemized deductions only [aggregate of each misc. itemized deduction has to exceed 2% of AGI in order for deductions to be used]

Example of **§ 67**’s misc. item. ded. is unreimbursed EE expenses (ie. unapproved travel) 🡪 dubious expenses that are given harsh treatment [tax code picks up on the skepticism of company refusing to reimburse these expenses]

Misc. item. deductions are a subset of item. deductions

* + - * 1. (b) “Other than” – anything NOT on this list is what is miscellaneous [aka the list is not subject to the 2% floor]
      1. (2) Whether sum of all itemized deductions is greater than the standardized deduction [See **Schedule A** for itemized deductions]
         1. Take standard deduction instead if it is worth more (for admin ease and parity)
         2. Why have a standard deduction or personal exemption?

Personal exemption: for each dependent, you get a $ amount deduction based on the expenses associated

For equity/fairness reasons

* + 1. Exclusions are better than deductions/credits
       1. Exclusions are excluded from gross income right off the bat, whereas deductions have limitations
       2. Deductions are a function of your top MTR
          1. Deductions are an upside down subsidy b/c as you move up the income ladder, you get more of a benefit
       3. Deductions & exclusions are functionally equivalent when it comes to valuing them (assuming you can take the full deduction)
          1. Whether you exclude them from the big # or deduct them, they are both going to be determined by the TP’s top MTR
          2. AGI is an important #

1. Definition Quiz
   1. Difference between stocks & bonds
      1. Risk: stock (equity) signifies ownership in a company; bond (debt) is a loan to issuer
   2. Depreciation
      1. “Loss of value over time”
         1. But for tax purposes, this is a term of art
            1. Wear and tear over time, or **loss of income-producing capacity** of capital goods, such as plant and equipment
   3. Tax Expenditure
      1. Indirect government spending through the use of tax preferences (deductions, credits, deferrals, etc.)
         1. The spending of the government through NOT taxing & foregoing that tax revenue
            1. Home mortgage interest deduction is one of the biggest expenditures
   4. Implicit Tax
      1. Costs, such as lower rates of return or higher prices, borne by participants in untaxed or favorably taxed markets
   5. Imputed Income
      1. Income not received in monetary form and thus not typically subject to taxation (e.g. unpaid housework)
         1. PROF: in the abstract, we ought to tax this b/c there is an economic benefit from mowing your own lawn, etc. – but this is impossible administratively
         2. This is important re: gender inequality and how the tax code plays a role
2. Progressive Marginal Tax Rates
   1. **§ 1(c)** 2007 Marginal Tax Rates & Brackets
      1. 6 brackets w/ marginal tax rates
         1. Pay more on a marginal level depending on how much you make [average to get the effective rate – don’t just look at the top marginal rate]
         2. Total tax liability / total taxable income = effective tax rate [average]
            1. But top marginal tax rate is important for tax planning purposes
3. Deductions v. Credits
   1. PROF: difference is huge
   2. Deduction = take off of calculating taxable income [comes off gross income or AGI]
      1. Value to person depends on what bracket you are in (top marginal rate]
         1. A $100 deduction for a person at top MTR of 35% saves TP $35
            1. More complicated when the deduction is more than the income that is in the top tax bracket
   3. Credit = take off of tax liability [at the end]
      1. Dollar for dollar benefit for each person
         1. If credit is $100, TP benefits $100
   4. TP should generally prefer the credit
      1. But if you don’t have any tax liability, a credit may not be any good unless it is a refundable tax credit
         1. NOTE: earned income tax credit is the most important refundable credit – it is a social welfare transfer policy
      2. A credit is independent of the TP’s top MTR (NOT connected)
   5. Progressive MTRs
      1. For a credit, it will come off the bottom off of the tax liability
      2. For a deduction, it will come off the taxable income that is taxed at the top rate
4. Haig-Simons Economic Definition of Income
   1. Robert Haig (1920)
      1. “Income is the money value of the net **accretion** of one’s economic power between two points in time”
   2. Henry Simons (1939) [went a step further]
      1. “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in question”
   3. Income = Consumption + Accumulation [change in wealth/savings over a specific time period]
      1. The USES to which you can put economic power matter in defining income
         1. Ask if the TP is better off
      2. This is the ideal baseline, but deviate from this to the legal definition (but the two go hand-in-hand)
      3. Emphasis on personal, voluntary consumption
      4. You can either consume income or you can save it
5. Time Value of Money
   1. A dollar today is worth more than a dollar tomorrow
      1. B/c of interest
         1. The price someone else pays you to be able to use your money for a specified period of time
         2. Price is a notion of opportunity cost (you can’t use the money if you are lending it out)
            1. Interest captures this opportunity cost [today’s dollar can be invested immediately to earn interest]

Conversely, if one owes a dollar tomorrow (say taxes), it is worth less than a dollar owed today

* 1. Tax Incentives [assuming same MTR]
     1. You want to defer paying taxes
     2. You want to defer gain until tomorrow and accelerate losses today
        1. You want to speed losses in order to decrease your taxable income and therefore tax liability
  2. PV = FV/(1+i)n
  3. Gov’t will charge you interest in deficiency cases (when your tax plan is illegitimate)

1. Justice Holmes
   1. “The life of the law has not been logic, it has been experience”
   2. Deviate from the H-S definition for many real life reasons
      1. It is about the layering of tax policy over time **[3 legs of tax policy stool]**
         1. Equity/fairness
            1. Vertical equity = embedded in notion of progressivity [those who make more should pay more]
            2. Horizontal equity = fairness b/w two people who make the same income
         2. Efficiency
            1. Economic efficiency =
            2. Some argue that taxes distort decision-making (shapes people in a direction that doesn’t make the pie larger, which is inefficient)
         3. Administration
            1. Is it feasible? How can we try to tax things like in-kind benefits?

**Some Characteristics of Gross Income**

1. Noncash Benefits
   1. In-Kind (Generally)
      1. Defined: anything of value (not in cash) received by a TP, generally in an ER/EE context for services provided/goods produced (NOT gifts)
         1. Example: gum for baby-sitter; meals for wait staff; free use of ER facilities; ER-provided parking; use of company car; prizes/windfalls
         2. Shows that substance often trumps form [if it looks like income, it should be taxed as such]
      2. EE in a 35% tax bracket would prefer $66 of desirable tax-free fringe benefits over $100 of ordinary cash compensation b/c after tax, the $100 is only worth $65
         1. ER would also prefer this b/c of the tax benefit—this would be a deductible business expense. Also, the cost to the ER may be less than the value to the EE ($66 instead of $100)
            1. ER could be indifferent so long as the parking costs ER no more than $100 pre tax

Would want to know ER’s top MTR

Would create happy ERs at US Treas/other TP’s expense

* + 1. Others who benefit from fringe benefits:
       1. 3rd party provider of the ER-provided tax-free benefit
          1. ie. manager of parking garage
       2. Society at large
          1. Could structure this for environmental reasons (ie. use tax benefits to encourage public transit)
       3. Customer/Consumer of this product
          1. ER could lower labor costs if EE is willing to take this benefit 🡪 lower costs to customer
    2. Think of it as a spectrum: [one extreme] additional compensation that is includable in income 🡪 [other extreme] for the benefit of the ER, which is excluded b/c it is essential for the performance of EE’s job/forced personal consumption
  1. Meals & Lodging Provided to Employees
     1. ***Benaglia v. Commissioner***
        1. Procedure: Board of Tax Appeals [precursor to U.S. Tax Court]
           1. Modern 🡪 can go two routes:

Tax Court

If you decline to pay the tax, can petition tax court

District Court

Have to pay tax first and then sue for a refund

* + - 1. Facts:
         1. Π/TP: hotel mgr who got meals & lodging at hotel as part of compensation (ER-provided benefit)

Π didn’t include the value of these in his income

* + - * 1. IRS’ argument: Π is better off from these benefits so he should have included them in his tax returns. It would have cost Π $4000 to live elsewhere
        2. Π’s argument: he had to live there b/c he was on-call 24/7 for the convenience of the ER [thus not voluntary personal consumption]

Forced personal consumption would NOT fit H-S definition of income

* + - 1. Arguments
         1. Valuation Problems

(1) Holding: exclude all benefit

Seems TP generous

PROF: courts will sometimes wash its hands when there is a valuation problem (either exclude or include ALL, often no in between)

(2) Tax alternate costs of room/board

(3) Tax marginal cost to ER

(4) Tax TP’s subjective value

(5) Tax at full FMV

* + - * 1. Liquidity Problem

The benefit TP got was not liquid (couldn’t just write a check)

* + - * 1. Forced Personal Consumption

**§ 119(a)** codifies this after this case

Intent of the parties is irrelevant, but adopted “convenience of the ER” language

Under this **§**, same result in Benaglia

This is an exclusion from gross income, NOT a deduction [“before the line” – not above or below]

* + - 1. Majority
         1. HELD: for Π/TP

NOT income b/c it was provided for the convenience of the ER (not intended as compensation)

“Even if it would relieve TP of an expense that he would pay otherwise”

Despite the fact that this was negotiated compensation, the dominant fact is that this was imposed upon the TP

* + - 1. Dissent
         1. TP benefitted from these benefits, even though there is a convenience to the ER (H-S defense)
         2. Focuses on monetary benefits in addition to convenience to ER (this is overly tax generous)
      2. Court doesn’t mention the subjective value to the TP
         1. Maybe TP doesn’t want to live in a hotel? This is the valuation problem

Valuation problem:

Cost of the room to normal customers (FMV) = $8k

Cost to hotel = ?

Subjective value to TP = ?

Alternative living arrangements = $4k

* + - * 1. Court punts b/c of the valuation problem and decides not to tax the TP at all

Policy argument that to tax this would be punitive?

Respect for voluntary decisions

Institutional competence argument that court shouldn’t be the one to draw these valuation lines?

* + - 1. PROF: too TP generous 🡪 court gave away too much by not taxing anything; could have come up with an ad hoc valuation method
         1. What about the benefits to his spouse?
      2. Modern read of this case: intentions of parties matter less now and the convenience/compulsion aspect is more important (we care about whether TP has a choice re: compensation)
    1. **§ 119(a)** Meals & Lodging Furnished for the Convenience of the ER
       1. Codifies the holding of ***Benaglia***
       2. **(a)** There shall be **excluded from gross income** of an **EE** (not ICs, etc.) the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his ER **for the convenience of the ER**, but only if—
          1. **(1)** In the case of **meals**, the meals are **furnished** on the **business premises** of the ER, or
          2. **(2)** In the case of **lodging**, the EE is **required** to accept such lodging on the business premises of his ER as a **condition of his employment**

Congress makes a distinction b/c it thinks that lodging is more important

* + - 1. **(b)** Special rules
         1. **(1)** Provisions of employment K or state statute are not determinative
         2. **(2)** Certain factors not taken into account w.r.t. meals

The fact that the EE may accept or decline such meals shall **not** be taken into account

* + - * 1. **(3)** Certain fixed charges for meals
        2. **(4)** Meals furnished to EEs on business premises where meals of most EEs are otherwise excludable
      1. Applies to EEs (not ICs, etc.)
      2. Application to ***Benaglia*** facts:
         1. Would turn on evidentiary issues whether it met these factors

Benaglia WOULD fit in this section – agree with Court

* + - * 1. Congress agrees with Benaglia that these things should be excluded
        2. This would be a business expense for ER that hotel would write off
      1. PROF: **§ 119** Would generally not apply to a computer programmer
      2. Spectrum of convenience to ER/benefit to EE?
    1. Example 1
       1. EE (Alice) agrees to ER’s (Unitek) new payment of $1k/monthly rent & salary = $4k
       2. ER would agree b/c has nothing to lose (can deduct full $5k of “compensation”)
          1. The rest of the TPs have to pick up his burden
          2. Incentive for both sides b/c ER can make EE happier
       3. Splitting the tax savings-- \* tax savings can be shared if structured the right way
          1. ER is giving EE a tax benefit 🡪 ER could claw some of that tax savings back by reducing EE’s salary

Key variables in determining savings:

EE & ER’s top MTRs

ER’s compensation costs would go down 🡪 should weigh this against the lower business cost deduction that results (would have to play with the #s)

* + - 1. Congress’ giving tax free treatment to ER provided benefits creates incentives (form v. substance)
         1. EE’s income stays the same but her tax liability goes down
    1. Example 2
       1. ER buys $10k insurance policy for EE w/ payout of $50k in 40 years
          1. Possible tax implications [2 options]

(1) Tax EE on $10k now [year 1]

Must include/tax $40k in year 40

(2) Tax EE on $50k in year 40 [deferral]

Time value of money (pay nothing now)

EE would prefer this option assuming that MTRs stay the same

ER would not want to defer deduction until year 40 (would argue for time value of money treatment)—that policy is worth more than the $10k it initially paid out

(3) Econ precise [H-S] method 🡪 Tax $10k today and tax the growth every year [until reach $50k]

Come up with an increment of how the 10k grows to 50k over the years

This can be difficult if there are no banking records (valuation problem)

Symmetry: ER can deduct whatever EE is forced to include in gross income

* + - 1. Tax Symmetry/Consistency in IRC
         1. EE & ER should mirror each other
         2. ER deduction for compensation when EE can spend it however EE wants

Match compensation to deduction

* + - * 1. Insurance in this EX is part of the EE package

ER would mirror EE

Can deduct $10k right away in option (1)

Option (2)—per symmetry, ER should only be able to deduct in year 40 (but would argue for present value treatment)

* 1. Other ER-Provided Fringe Benefits
     1. **§ 132** Certain Fringe Benefits
        1. (a) **Exclusion from GI**—gross income shall **not** include any fringe benefits which qualifies as a—
           1. (1) No-additional-cost service;

ie. ER incurs no additional cost

* + - * 1. (2) Qualified EE discount;
        2. (3) Working condition fringe;
        3. (4) De minimus fringe;
        4. (5) Qualified transportation fringe;
        5. (6) Qualified moving expense reimbursement;
        6. (7) Qualified retirement planning services; or
        7. (8) Qualified military base realignment and closure fringe
      1. Exclusion (TP friendly) from gross income of any fringe benefits:
         1. Definitive/exhaustive list of 8--unlike **§ 67**, which is written in reverse):
      2. Further Restrictions
         1. **§ 132 (b)(1)** No addt’l cost service must be offered for sale in ER’s normal course of business

E.g. Airline EEs can fly standby for free

But if you work for an airline that also owns a dept store, airline EE can’t deduct benefits from the store

**§ 132 (c)(4)** this rule applies to qualified EE discounts

* + - * 1. **§ 132(j)(1)** Non-discrimination

(a)(1) & (2) exclusions of no addt’l cost services & qualified EE discounts apply to highly-compensated EEs only if no discrimination

Don’t want ERs to save benefits only for the highly compensated (but don’t have to be available to the ENTIRE workforce)- this is a fairness argument

* + - 1. Origins: problems of valuation, enforcement and political acceptance
         1. This draws a line to stop the bleeding of fringe benefit exclusions, but why deny EE a benefit if there is no cost to the ER—this would be econ waste.
    1. Problems
       1. (1) **§ 132(d)** Working Condition Fringe Benefit. EE is an associate at a big firm. Firm pays all membership fees at local clubs. EE joins a country club.
          1. H-S [**§ 132** is an exception to this notion]: EE should be taxed on the FMV of this benefit
          2. **§ 132(d)**: Working Condition Fringe defined [closest match for this benefit]

Any property/services to an EE of an ER, to the extent that if the EE had paid for these himself, such payment would be an allowable deduction under **§ 162**

**§ 162** = ordinary & necessary business expenses

Apply: ask how much of the use is business and how much is personal [the fact that the firm pays for it is not conclusive]. If EE is using it for a lot of personal uses, it shouldn’t be excluded. If it is used primarily for client recruitment, etc., he would be able to deduct it as a solo practitioner, so it should be deductible here, as well.

PROF: depends—probably includable in GI until we know more facts, but could argue symmetry between this EE and solo practitioners?

We need to know how often he goes to the club, how many clients he has recruited from it, etc.

(d) is murky—we are not so certain whether you can exclude this under this **§**

* + - * 1. NOTE: “Working Condition” Fringe & Driving Mr. Daschle

Daschle- former Senator who lost his nomination to leader of HHS b/c he didn’t report income from the car and driver his firm have him for many years [form of tax evasion—paid $130k in past taxes & penalties]

* + - 1. (2) **§ 132(j)(4)** On Premises Gym. EE is counsel at Corp which has an on-site gym open to all EEs during business hours. Lisa uses gym daily.
         1. **§ 132(j)(4)** On premises gyms & other athletic facilities

Gross income doesn’t include value derived from these

See IRC limitations on the type of facilities that count

Ie. has to be operated by the ER

**§ 132** was meant to stop the bleeding and restrict this benefit – proponents of this code section were prob. businesses that already had these on-premises gyms

* + 1. **§ 125** Cafeteria Plans
       1. **(a)** **In general**—Except as provided in (b), **no amount shall be included in the GI** of a participant in a cafeteria plan solely because under the plan, the participant may choose among the benefits of the plan
       2. **(b)** Exception for highly compensated participants and key EEs
       3. **(d)** Cafeteria plan defined
          1. All participants must be EEs
          2. Must be a written plan
          3. The participants may choose among 2 or more benefits consisting of cash and qualified benefits
       4. EE may choose between (1) non-cash/non-taxable benefit; or (2) taxable cash
          1. Constructive receipt: choosing reveals a preference (that the benefit is worth at least as much as the cash, so the benefit should be taxed)

**§ 125** undermines this ideal of constructive receipt

* + - 1. EX: “Use it or lose it” caveat for dental/eye care plans
         1. How IRC creates tax friction (for TPs to make these kinds of choices early on)
         2. Econ inefficiency problem: if TP is forced to anticipate and guess wrong, he is out of luck
         3. Tries to make people more cognizant of tax plan
         4. IU has gone away from the use it or lose it – went to the maximum benefit plan instead
    1. Frequent Flier Plans
       1. Personal use of FF credit accumulated from business travel/expense? [business use would not be a problem]
          1. IRS Announcement 2002-10 IRB 621 officially said that IRS is not going after FF miles
          2. But if you are using FF for personal consumption, then it is income & you ought to be taxed on it per H-S

IRS didn’t worry about this until it grew over time

* + 1. ***Haverly v. US***
       1. Under H-S, should be taxable income
       2. Principal gets textbooks for free
          1. Doesn’t include them as income, but then donates them and tries to take a charitable deduction
    2. **§ 106:** ER-Provided Health Insurance
       1. “Except as otherwise provided in this **§**, GI of an EE doesn’t include ER-provided coverage under an accident or health plan”
          1. Another example of in-kind income
       2. (A) Leading tax expenditure (2nd in spending after dividends and long-term capital gains)
          1. Indirect gov’t spending

Stan Surrey (scholar): as you poke holes in the H-S income tax base, the gov’t is spending money in the form of subsidy

This spending can be characterized as exclusions, deductions, or changes in rates

* + - * 1. $126 billion for exclusions in 2009

“Divided American welfare state”

Private/public structure

* + - 1. (B) **§ 162(l):** Similar benefit for self employed
      2. (C) If you are neither self employed NOR have ER-provided health insurance:
         1. You pay out of pocket/out of luck generally speaking

Big expenditures are deductible (7%), though [?]

* + - 1. Who benefits?
         1. Helps the EEs who are getting this kind of health insurance
         2. Also helps ERs b/c helps them attract EEs
         3. Also helps 3rd parties who are supplying these benefits (health insurance companies)
         4. Also helps societies at large. Pooling the risk into a greater insurance pool is better.
      2. Who loses?
         1. Low wage/working poor whose ERs don’t provide health bens
         2. Revenue loss from these expenditures (major hole in our H-S/legal def of income base)
  1. Economic Effects of ER-Provided Benefits
     1. “**Deadweight Loss**”
        1. IRC can distort TP decision making (which can lead to social/econ waste)
           1. Pushes people to do things they wouldn’t otherwise do
        2. EX: ER-provided parking
           1. Hypo data

ER’s cost = $50

EE’s subjective value = $40 [if it cost EE more, he would take the bus instead]

* + - * 1. (A) World w/o taxes

EE would choose $50 cash over free parking (no waste)

* + - * 1. (B) World w/ taxes [assume EE’s MTR is 40%]

Cash is taxable; parking is a tax-free fringe ben

(i) Cash option

$20 tax ($50 x 40%) = $30 after tax ben

(ii) Fringe benefit option

$0 tax = $40 net ben

$10 waste/deadweight loss b/c ER pays $50 for a $40 ben to EE

Not good, but EEs will want this

We don’t want EEs to choose this b/c it is inefficient, not good for society, makes the pie smaller [but they will anyway]

* + - * 1. Behavior responses

Increased single driving; reduced demand for public transport; increased traffic, congestion, pollution, etc.

Is commuting a purely personal choice? Congress/IRC thinks it is a personal choice, but if you have to get to work maybe the cost of getting there should be deductible?

* + - 1. We can get around this waste if we tax the benefit/get rid of the exclusion of tax-free parking
         1. The **tax treatment/exclusion is the driver of the distortion**

If you tax the parking, the value to the EE would go down and the EE would choose the cash (thus not waste)

The taxed parking would be worth $24 to the EE, which is less than $30

The ER would prob not provide the parking option now, which means no waste

* + - * 1. NOTE: if we are wrong about the assumption of the EE’s value of the parking, there may be no distortion
  1. Other In-Kind/Non-Cash Benefits 🡪 **Prizes**
     1. ***Turner v. Commissioner***
        1. Facts
           1. TPs won cruise tix; traded (2) 1st class tix for (4) lower class tix
           2. Tax Commissioner disagreed w/ how TP valued the tix

TP valued them at $520; Commissioner valued them at $2200

* + - 1. Issue: How do you value something that TP would not have been able to buy on his own salary
      2. Held: Court splits the difference in the two values ($1400) b/c:
         1. These people are of modest means who would not have bought these $2000 tix on their own, so can’t value them at $2200. But $520 is too low.
      3. PROF: this is highly subjective; court considers subjective intent
         1. Problematic that this is random – hard to advise client on how much to pay in taxes (predictability problem)
         2. TPs got a windfall here under H-S notion—the Q is all about the value
  1. Problem
     1. (1) Fringe Benefits 🡪 Tax implications of a $100 gift certificate given to the associate from a big firm at the end of the year
        1. **§ 132(e)**: argue that it falls under the de minimus fringe exemption
           1. Elements:

Frequency [only 1x year here]

Size [so small to be admin impractical]

* + - * 1. Valuation issue

Subjective value v. market value

What if you were given a $100 gift card to a choc shop and you’re allergic to choc?

* + - * 1. Liquidity issue
        2. This is a very narrow gift—realm of personal, voluntary consumption is limited here
      1. **Treas. Reg. 1.132-6(c) & 1.132-6(e)(1)**
         1. Holiday gifts of small amounts are generally excludable under **§ 132(e)**
         2. But arguments on both sides, here)
    1. (2) When & how much taxable income for the (un)lucky baseball fan. Did Murphy have taxable income when he caught the Barry Bonds homerun ball? When he sold it?
       1. Realization concept: mere ownership & possession do not lead to taxation. There has to be a subsequent, secondary transaction in which he Murphy realizes the transaction. A sale triggers the realization event.
          1. Valuation Problem: Argument for not taxing him now b/c we don’t know the value of the ball until its sale
          2. Liquidity Problem: He didn’t find a bag of cash, which favors delaying taxation until he sells the ball
       2. **Treas. Reg. 1.61-14** [IRC p. 542]
          1. Misc. Items of Gross Income

“Treasure Trove”

Under this reg., Murphy has a treasure trove when he catches the ball (which would constitute gross income)

Could argue that he has GI right when he catches the ball, but Congress says that it is income only upon realization

* + 1. (3) If Murphy had given the ball to Bonds for nothing in exchange?
       1. Gift treatment: Bonds gets to exclude the gift, no deduction for the giver
          1. But if Bonds sells it, will prob have to pay taxes on the realization
    2. (4) If Murphy got $5k of tix in exchange for the ball
       1. PROF: should be taxed on $5k under H-S, BUT could argue that Murphy didn’t bargain for this
          1. Liquidity problem & is $5k the right value? Similar to cruise tix case where court split the difference
       2. TP argument: would trade these seats for cheaper ones, etc. Argue about the subjective value under ***Turner*** case principles

1. Imputed Income
   1. Generally
      1. Imputed Income = H-S economic income not received in monetary form and thus not typically taxed b/c it is an implicit transaction with oneself providing a benefit otherwise attainable only through paid market
         1. Imputed = lack of a visible market transaction b/w two parties (that you would otherwise find in the market)
            1. Think of the TP as being two parts of one TP [one person is both the renter on one hand and the landlord on the other]
      2. Examples
         1. Services: repairing your own car; own childcare; growing your own food; just about anything you do for yourself
         2. Property:
            1. Owner-occupied housing;
            2. The ownership of any consumer durable (ie. owning a washing machine so you don’t have to go to the Laundromat)

Consumer durable = good that provides value over a period of time

* + 1. There are economic inefficiencies that come from not taxing imputed income (making the pie smaller)
       1. Distinction b/w economic & taxable income is important b/c it distorts individual decisions and as result there is a misallocation of scarce social resources
  1. Services
     1. **Example 1**: James [MTR = 40%] wants to paint his house. Tanya is a house painter. James earns $20/hour pre-tax [the tax system will distort decision making]. Post-tax, James earns $12/hour. Tanya charges $15/hr for her services.
        1. James’ incentive is thus to paint the house himself assuming he and Tanya are equally efficient
           1. If James hires Tanya, he has to pay with after-tax $-- so he has to work more than one hour to pay for one hour of Tanya’s services
           2. If James paints the house himself, imputed income from the services is untaxed
        2. Econ Effects
           1. James will paint the house himself—there IS a deadweight loss of $5

The value of James’ service to society is $20/hour, and he is now doing something that is valued at $15/hr

This distortion is not just caused by the tax rate—the non-taxation of imputed income contributes

* + - * 1. Distortion is driven by two things:

Non-tax of imputed income; and

Tax rate/lack of deduction

* + - * 1. Economists: time is a resource and should be used as efficiently as possible to make the pie bigger
      1. Eliminate the distortion/solve the problem by?
         1. Let James deduct the cost to him for getting this service from the market [more feasible but prob. won’t do this b/c it’s a commercial transaction]; OR
         2. Tax him on his imputed income
    1. **Example 2**: Stay at home parent re-enters workforce to earn $40k as a secondary earner. Incurs childcare and total households costs of $30k as a result.
       1. On a econ/pre-tax basis, this makes sense b/c pre-tax $10k is real gain
       2. BUT assuming the family’s MTR is 35%, the after tax result for the secondary earner is net $26k (so this is a losing proposition after paying $30k in childcare)
          1. \*Strong disincentive for a secondary earner to rejoin the formal labor market [IRC reproduces traditional gender roles]
          2. **Drivers**:

Progressive rate structure [that the $40k is taxed at the 35% MTR]; AND

Non-taxation of imputed income from the household services of the secondary worker staying at home

* + - 1. Solution?
         1. Childcare tax credit

Not an upside down subsidy

Portion of what you pay in childcare can lower your tax bill, which can address this distortion

* + - * 1. Tax the imputed income of household work

Would remove the disincentive of returning to the formal labor force (the tax system would apply equally)

PROF: not suggesting that we do this

* + 1. The implications of NOT taxing is what is important in the service area of imputed income
  1. Property
     1. Owner-Occupied Homes
        1. The real tax benefit from owning your own home is that you are not taxed on the imputed income aka the rental value of that home. The ownership of the home provides the tax benefit.
           1. Under H-S, this should be taxed but it is admin impossible to do

For a time, UK taxed people on the rental value of their owner-occupied housing

* + - * 1. The tax benefit is NOT the home mortgage interest deduction [this just puts you on par with the homeowner who has the cash to buy the house outright w/o a mortgage]

You do NOT need cash to get the benefit of owning your own home

* + - 1. The right to use property has an economic value
         1. Right to use property w/o paying “rent” is an economic benefit
      2. Examples
         1. (1) A hires a lawyer. A lets lawyer stay in A’s guesthouse rent-free while working on A’s estate plan [ER-provided housing, but NOT for the convenience of the ER like in ***Benaglia***]

Tax consequences: this clearly should be part of lawyer’s gross income, b/c it looks like compensation

Otherwise, lawyer would have to pay for a hotel, etc. out of his income

* + - * 1. (2) John buys $200k home with cash [house has a rental value of $10k]. Heather buys a similar home with $200k debt [interest rate = 5%]

The econ. benefits are somewhat the same

John

Econ. H-S income is $10k annually

Taxable income is $0k b/c we don’t tax imputed income

No mortgage

Heather

Econ. H-S income is $0k annually

Rental value of home (10k) [-] mortgage interest (10k) = $0

Taxable income is $(-)10k

Rental value (10k) is NOT taxed

Mortgage interest payment is a $10k deduction

Now, J & H are in the same boat (in a sense)

The difference between both of their econ. income and taxable income is $10k

J still has a $10k benefit from owning his own home (even though he doesn’t get the mortgage interest deduction that H gets)

NOTE: the real benefit to home ownership is the non-taxation of imputed income from “rent”, NOT the mortgage interest deduction, even though this deduction is what is visible

* + - 1. Homeowners (with & w/o mortgages) are better off than renters
         1. Example: Owner uses $100k to buy owner-occupied housing; Renter uses $100k to invest in rental property identical to Owner’s, and continues to rent her own apartment. O & R have identical H-S econ. income, BUT from tax POV:

O has $10k imputed rental value not taxed, but R has taxable rental income of $10k and still must pay her own rent with after tax dollars to her own landlord

O takes advantage of the lack of the observable market transaction; R does have an observable market transaction w/ a 3rd party aka her tenant)

R has an incentive to become more like O [tax encourages more and more people to buy their own homes]

Deadweight loss- maybe there is too much money going into residential housing and not enough into manufacturing, etc.

NOTE: R may be able to deduct maintenance costs, depreciation, etc., as a LL [but O’s tax incentives would erode these]

* + - 1. WI: pulled off taxation of imputed income of owner/occupied housing for a while
  1. Leisure
     1. Less like property & services and more an extension of the valuation problem
     2. “Enslaving the beachcomber”—misallocation of resources if a lawyer becomes a beachcomber
        1. But maybe the high taxes on wages incentivizes this?
     3. **Example**: Dick is offered $12/hr pre-tax to work on Saturday, but he values his weekend leisure at $10/hr. Whether he works on Sat. will depend on his MTR.
        1. MTR = 25%
           1. After tax income = $9
           2. He will stay at home b/c he values his leisure more

Distortionary effect of MTR and deadweight loss (we prefer him to work)

* + - 1. MTR = 10%
         1. After tax income = $10.80
         2. He will be more likely to work (toss-up)
      2. To remove distortion 🡪 tax Dick’s leisure time or make a deduction for just weekend income
         1. Figure out where the decision is actually occurring (discouraging top bracket, weekend work?)
    1. Optimal taxation
       1. Some scholars recommend lower tax rates after the highest bracket (b/c high rates push people into leisure)
       2. PROF: the untaxed leisure value is the real problem. NOT just the MTR.
       3. H-S econ definition includes the psychic benefits from leisure (not just cash)

1. Windfalls & Gifts
   1. Windfalls/Punitive Damages
      1. ***Glenshaw Glass***
         1. Held: Punitive damages are included in income b/c of a focus on the uses of income
            1. “Undeniable accessions to wealth, clearly realized, and over which the TPs have complete dominion”
            2. Compensatory damages are clearly income b/c they represent lost profits and the profits would have been taxed
            3. But does not overrule the holding in ***Macomber***

But the analytical and constitutional logic of Macomber is no longer good

* + - 1. TP’s argument:
         1. ***Eisner v. Macomber***: constitutionally (16th Am), the sources of income matter [windfalls are not income, only taxable income if you earn it through labor/wages/investments]
      2. IRS/Maj
         1. ***Macomber*** definition of income should be expanded; we don’t care about the sources of income, we are about its uses.
         2. It is about the economic power of income/greater ability to pay—we don’t care where the money came from [embracing H-S]

No question of liquidity or valuation. This company can use this money to consume or invest [the TP was better off]

* + 1. Modern examples
       1. You fall over a bag of money on the street
          1. Taxable once it is reduced to your undisputed dominion [this is part of gross income]
       2. You win $20k from Ryan Seacrest
          1. Taxable and part of gross income (esp. if its cash)

TP can make a subjective valuation argument if the winnings are tix that he doesn’t want, etc.

* + - 1. Your uncle gives you $10k for doing well in law school
         1. H-S econ income: this should not be different than the 1st two examples. You are clearly better off and you have clear accession to it.
         2. BUT not taxed under **§ 102** and ***Duberstein*** [gift giving in the family context is not something we want to squash]
  1. Gifts
     1. Options for taxing gifts in the family context [before **§ 102**]
        1. Donor deduction & donee inclusion in GI
           1. H-S way of doing things (b/c donee benefits from the gift]
           2. Pros: track changes in wealth accurately [the donee is the person who is better off]
           3. Cons: donor is usually in a higher tax bracket, so this causes a potential net revenue loss for IRS; might chill intra-family giving; giving as a form of consumption [uncle may want to help his niece, so should not be deducted for uncle—family unit is crucial]
        2. No donor deduction & donee inclusion
           1. Don’t want to do this b/c we only want one layer of tax in this situation
           2. Pros: accounts for the donor’s consumption power in giving AND the donee’s increase in wealth [this is why H-S would have likes this]
           3. Cons: double layer of taxation; chilling effect
        3. \*No donor deduction & donee exclusion
           1. Codified in **§ 102**
           2. Pros: ignores intra-family transfers (donor pays with after tax dollars); treats family as a single tax unit
           3. Cons: donee gets untaxed income even though he is better off (contrary to H-S)

But as a policy goal, willing to override H-S to encourage intra-family giving

Requires tax law to scrutinize transfers to make sure it is truly intra-family type giving

* + - 1. Donor deduction & donee exclusion
         1. Double benefit that will hurt IRS revenue [most pro-TP POV b/c both parties win for tax purposes
         2. PROF: this is off the table b/c it would create a gaping hole
    1. **§ 102(a)** Gifts & Inheritances
       1. Excludes gift property value from donee’s income
          1. This is an exclusion, not a deduction/credit, etc.

**§ 102(b)** Limitation: e.g. if you inherit a house, the FMV of the house is not in your gross income, but the annual rental income you get from it IS included in GI

W/o this limitation, too much tax revenue would be lost

Another example of how (a) & (b) work together: gifting of stocks

You get 100 shares of Apple from Uncle as a gift, you are not taxed on the transfer, BUT dividends you get from the stock are part of taxable income

* + - 1. Why? One layer of tax for intra-family type giving (aka the right type of giving)
         1. Once you leave the family context, things are more complicated
         2. Policy: encourage giving w/o giving away the IRS farm (even though, from the H-S POV, the donee IS better off and there is some consumptive value in giving)
    1. ***Duberstein*** [1960]
       1. Facts: Duberstein gave Berman valuable info that helped Berman’s business. Berman then gave Duberstein a Cadillac.
          1. “Lagniappe”= something given over and above what is purchased or earned (aka a tip)
       2. Issue: are business gifts taxable?
          1. IRS: there are no gifts in the business context (wants bright-line rule); taxable b/c it is a recompense for past or future service
       3. Held: Too much business b/w these two people for this to be detached, so this is NOT a gift (taxable)
          1. Donor’s intent is key
          2. **“Detached & disinterested generosity”**

There was no legal obligation here on Berman’s part

This is an evidentiary/fact specific issue, so doesn’t want to go with IRS’ bright-line rule

* + - 1. Distinguished from/compared with ***Stanton***
         1. Two cases together show that it is the facts that matter (don’t go with the IRS bright-line rule)

The court does NOT entertain the rule that there can NEVER be a gift in the business context

* + - * 1. Discretionary standard in which courts held the IRS police the line b/w compensation and legally excludable gifts under **§ 102**
        2. Congressional response is **§ 102(c)** EE gifts

Even though Duberstein was not an EE

Makes the transfer in ***Stanton*** taxable (looks like compensation)

The original case said that this transfer was not taxable

There are de minimus caveats

Ask whether the ER tried to deduct it as a business expense in order to determine whether you pass the de minimus threshold (ie. wedding gift)

This is a way to get at the donor’s intent (which is key)

If ER deducts it, symmetry says that EE should include it in income [matching principle]

Also want to know the value of the [wedding] gift (ie. cash or a gift the couple didn’t want that has a liquidity issue?)

Admin rules re: what constitutes de minimus

PROF: when your ER of 20 years gives EE a gold watch, looks like compensation

* + 1. **§ 274(b)(1)**
       1. Avoids problem of “double dipping,” where donor deducts and donee excludes
       2. Has a de minimus threshold
       3. No deduction allowed under **§ 162** (ordinary & necessary business expenses) or **§ 212** (any other expenses of producing income) if the thing you are using is available under **§ 102**
          1. **§§ 162 & 212** are paired together b/c shores up ER/EE earned income plus side income you may earn

ie. if this gift is excludable by the recipient under **§ 102**, you cannot deduct it under **§ 162** or **§ 212** as a donor

* + - 1. Creates dueling tax incentives
         1. In the business context, the donor wants to deduct the transfer as a business expense, but the donee wants it to be a gift that is excludable under **§ 102**

But can’t have both

* + - 1. This **§** is a form of “surrogate taxation”
         1. If we permit the recipient to exclude under **§ 102**, we deny the **§ 162** deduction to the giver

In this way, we are taxing the giver for the benefit the recipient gets

If it is a true, disinterested gift, the giver is paying a layer of tax by not getting a deduction

* + 1. NOTE: Oprah’s car giveaway
       1. Taxable prize, NOT a gift
          1. Pontiac got to deduct the free cars as a business expense/marketing
          2. **§ 102** doesn’t apply b/c this is not detached & disinterested generosity under ***Duberstein*** & **§ 67**’s b/c Oprah is just the conduit for Pontiac’s marketing
       2. If Oprah has paid the taxes on the cars for her audience, the audience would have to pay tax on THAT tax amount as well
       3. Options:
          1. TP could have sold the car and paid the $5k tax liability

TPs are still $25k better off if the car was worth $30k

Could argue that the tax value isn’t the sticker price, but the price on resale

Don’t let the tax tail wag the deal dog

* + - * 1. TP could turn down the gift
        2. If TP sold the car for more than $30k, then he should pay tax on that upper amount
      1. If audience-member gave car to her mother (intra family giving):
         1. Daughter includes the value of the car & pays tax, then gives the car to her Mom. Mom gets the car tax-free (this is whole point of **§ 102**). Daughter does not get a deduction for giving it to her Mom.

If the daughter is in a higher tax bracket, this helps the treasury

* + 1. Examples
       1. You invite your ER to your wedding and he gives you a gift, of course it falls under **§ 102**. The problem arises if your ER tries to double dip and deduct it as a business expense.
          1. Allowing double dipping would create a double tax benefit and a huge hole in the tax base
          2. If the donee doesn’t want this gift? Could give it back

But if ER has already filed his deduction you have to get them to reverse it

**§ 102(c) EE gifts**

Tax treatment of the giver may make it dispositive

* + 1. ***Harris***
       1. Appeal of criminal tax conviction
       2. Excludable gifts or payments for “services rendered”?
       3. What is the appropriate taxable unit?
          1. Outside of the family unit – mistress/lover?
  1. Other Transfers
     1. Scholarships
        1. Under H-S/horizontal equity, should pay tax on scholarships b/c the recipient is better off
           1. But policy goal overrides this to allow certain uses of scholarships to be treated like gifts
           2. This is gift-like treatment for something that is clearly income

Carve out in **§ 117**

* + - 1. **§ 117(a)** General Exclusion
         1. “Qualified scholarship” – go to **(b)(1)**

“Qualified tuition related expenses” – go to **(b)(2)(A)**

applies only to the above paragraph [may mean something else elsewhere in the IRC]

* + - * 1. (a) & (b) together tell us what kinds of scholarships this exclusion applies to

Benefit = scholarship used for tuition, fees, books IS excludable

NOT excludable if you use the scholarship for personal consumption

* + - 1. **§ 117(c)** Required Service
         1. Exclusion doesn’t apply if you get the scholarship only b/c you’re doing some teaching (this would be included in GI)

Taxing the part of the scholarship that is the compensatory part, NOT the tuition part (which would be hard to value)

* + - 1. **§ 117(d)** Qualified Tuition Deduction
         1. The amount of any tuition reduction given to an EE of an educational institution
         2. **§ 132(h)**: ER-provided fringe benefits

Tuition reduction is a big fringe benefit for EEs of educational institutions

* + - 1. Example:
         1. X is a grad student and TA at a Univ. He receives $5k/class as a TA, and a $10k tuition reduction.

$5k is included in GI under **§ 117(c)** and $10k is excluded under **§ 117(b)**

This creates horizontal equity when X is compared to an adjunct professor with equal pay who doesn’t have the scholarship component

Would NOT be fair if compared to a private institution

* + 1. **§ 1014:** Transfers at Death
       1. “Life’s Last Tax Loophole”
          1. Assets transferred to heirs at death have a basis of the FMV at the time of the transfer

For loss property, probably an incentive for TP to sell it and take advantage of the loss in his older age/before death

But for gain property, there is a disincentive for the TP to sell before death b/c there is a tax bite lurking (esp. if TP has owned it for a very long time and TP is near death)

At TP’s death, the unrealized gain sitting in the asset disappears—asset’s basis gets stepped up to FMV for the heirs

PROF: this “Stepped Up Basis” creates huge potential revenue losses

“Lock-in Effect” – this also encourages TP to lock-in and hold on to stocks/land that have grown substantially, so heirs can get the untaxed growth

TP would have had to sell the stock to realize this gain/be taxed on the growth in value

* + - 1. Policy Rationale
         1. Every coin/stamp collector argue that they don’t know the basis for their collections, so for admin reasons, it is fair to use the stepped up basis and use TP death as the time to put the value on the assets (argument for keeping **§ 1014**)

But empirically, the major concern for this section is people gifting GOOG stock, etc.

* + - * 1. Politics

This section has been on the radar of tax reformers

* + - 1. Exceptions
         1. **§ 1014(c)**
         2. **§ 1014(e)**

Goofy fact patterns Congress had in mind

* + - 1. This section leads to large untaxed gains
  1. Gain/Loss Property as a Gift
     1. Capacious notion of gross income under **§ 61**, including **(a)(3)🡪** gains derived from dealings in property [but sources of income matter]
        1. SUMMARY
           1. First step is **§ 102** (non-taxable gift), then if the gift is not cash—look to see if it has a gain/loss
           2. To determine gain, need a realization event (sale or disposition)

**§ 1011**: need to determine adjusted basis

**Gain = Amount Realized (A/R) less Adjusted Basis (A/B)**

* + - * 1. To determine loss:

**Loss = Adjusted Basis (A/B) less Amount Realized (A/R)**

Because the basis is greater when you have loss on an asset

In general, this type of loss is a good thing b/c it will lower your taxable income

TPs want to find tax losses that aren’t real economic losses

Ie. Father could sell stock to his minor children to create a tax loss on his books (but he would still have control over it)—but IRC doesn’t allow this shifting of loss b/w related parties

* + 1. Analysis of “Gains/Losses” from Property Dealings
       1. **§ 1001**: Determination of amount of and recognition of gain or loss. Compare the A/R to the A/B of the thing just sold to determine gain.
          1. **(a)** Computation of gain/loss: Gain is “excess of amount realized over adjusted basis”

Gain = from sale or other disposition

“Other disposition” – ie. X trades GOOG stock for coin collection [X may have a gain here if he bought the stock low]

“Amount realized” – go to **(b)**

**(b)** Amount realized is the total FMV of what you’re getting in the trade (not the gain)

“Gain” – go to **§ 1011**

**§ 1011(a)**- adjusted as provided in **§1016**

Adjusted basis … shall be the basis determined under **§ 1012**

**§ 1012**- Generally, basis is what you paid for the property initially

But **§ 1016** provides for adjustments to this basis.

Basis adjustments under **§ 1016**

Basis may go up if there is a capital improvement to the property

Ie. if you spend $10k to add square footage to a $100k warehouse, the new basis would be $110k

Basis may go down due to depreciation

Ie. use of the warehouse is depreciating every year

\*Basis can fluctuate

* + - 1. **§ 1015:**  Basis of Property Acquired by Gifts & Transfers in Trust
         1. Generally, donee will take basis of donor when gift is transferred [codification in ***Taft v. Bowers***]

Congress uses this transfer basis rule for gain property

* + - * 1. Except: if such transferred original basis is greater than the FMV of the property at the time of the gift (loss property), then the basis is FMV for determining loss

This is an attempt by Congress to ward off the use of losses (but is swatting a fly with a battering ram)

Now, most people will take the loss themselves and gift the proceeds [this is a major constraint for loss property]

Creates a double standard

**Transfer basis for gain**

**FMV basis for loss**

* + - * 1. PROF: this double standard creates a blind spot

Example: Property w/ cost basis of $1k. FMV at time of gift transfer is $700. Donee then sells property for:

(a) $600

Under 2nd ½ of **§ 1015**, donee takes loss of $100 (instead of more favorable $400)

This is exactly what Congress had in mind b/c this property had a built-in loss

(b) $1100

A/R [$1100] – A/B [Cost basis of $1000]

Gain is limited to $100

(c) $800 [this is the blind spot]

A/R = $800 [less than basis but greater than FMV]

Don’t know which rule to use? Gap between $700 and $100 where there is no gain or loss

**Treas. Reg. 1.1015-1(a)**

Explains blind spot where IRC can’t “get” people (ie. where there is no gain/loss)

Congress’ myopia re: losses created this blind spot

How could this section be re-written to eliminate this blind spot?

The issue is that it is one big run-on sentence

Per Prof. Popkin, a clearer **§ 1015**:

(a) Except as provided in para (b), if the property was acquired by gift after [date], the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift.

(b) If the basis provided for in (a) is greater than the FMV of the property at the time of the gift (aka loss property), then:

(i) Solely for the purpose of determining whether the acquirer has a loss, [This is how to eliminate the double standard]

(ii) The basis shall be FMV

* + 1. GAIN Property as Gift
       1. ***Taft v. Bowers***
          1. Facts

Gift of stock intra family

Father buys stock for $1k in 1916; gives them as a legit gift to daughter in 1923. Daughter is not taxed on upon receipt of this.

The asset has appreciated $1000k in these 7 years.

Daughter sells the stock for $5k in 1923.

She (TP) only wants to pay tax on the $3k

IRS argues that she should pay tax on $4k (full amount of gain since 1916)

* + - * 1. Issue: What is the basis of the stock when daughter got the gift?
        2. Policy Options:

(1) Treat the gift as a realization event – donor has realized amount, donee takes with FMV

Then donor would realize the $1k gain at that time and pay tax on it. Then donee would pay the tax on the $3k when she sells the stock.

\*\*(2) No realization until final sale

Make sure that the recipient of the stock takes the basis of the donor (transfer/carryover basis)

Daughter should be taxed on the $4k

(3) Realization at sale, but allocate gain among donor and donee

This is challenging b/c it is hard administratively (hard to find out how to allocate to the original donor)

* + - * 1. Held: Option 2

Gifting is not a good time to have a realization event (goes with **§ 102** rationale), but can’t let these gains disappear

Donee assumes the position of the donor – takes the same basis in the stock that the donor had (ie. the original purchase price of $1k, here)

PROF: this makes good policy rationale

**§ 1015(a)**

Codifies this holding

General rule: donee will take the basis of the donor when the gift is transferred

Except if the original basis is greater than FMV (property that has a built-in loss), THEN the basis is the FMV

Creates **“double standard”** 🡪 One basis for gain (transfer basis); another basis for loss (FMV)

Congress was so worried about losses that it came up with his Draconian rule

Ie. if you buy stock at $500, the basis is $500 even if the current FMV is $400

* + 1. Loss Gifts to Related Parties
       1. **§ 267(a)(1)**
          1. Go to **(b)**
          2. Then **(c)(4)**
       2. This is a broad disallowance to prevent the exploitation of losses among related parties
  1. SUMMARY Example re: Transfers of Gift Property
     1. A gives her son 100 shares of stock. She paid $5k for it, but it’s worth $25k at transfer.
        1. (A) If the gift is made when A is still alive, tax implications:
           1. **§ 102(a)**: actual transfer is tax free as a gift, BUT it is gain property (and no realization), so look to 1st ½ of **§ 1015(a)**

Basis for son is $5k (transfer/carryover basis)

Unrealized gain is still there, so when the son sells the stock, this $20k gain will be realized

* + - 1. (B) If transfers is made upon A’s death, tax implications:
         1. **§ 102(a)**: no taxability upon receipt, but:

Son’s basis in the property is stepped up to $25k [FMV at transfer] per **§ 1014(a)(1)**

$20k of unrealized gain will never be taxed/realized b/c of this loophole

* + - 1. Dividends that come to the son from the stock 🡪 son has to pay tax b/c this is ordinary income
         1. **§ 102** does not apply to this income that comes subsequent to the gifts

1. Recovery of Capital
   1. Key Terms
      1. Realized Amount
         1. What you get upon disposition of property
      2. Cost Basis
         1. Value when you acquire a property
            1. When you buy land as an investment, you use your after-tax income that you probably earned through wages
         2. Basis helps us keep track of what amount from the investment has already been taxed (the excess amount is the true gain)
            1. Your basis reflects your investment in the property
      3. Adjusted Basis
         1. Can adjust basis upward if you spend $ to add a wing to your warehouse, etc. or adjust basis downward if the warehouse depreciates in its income-producing capacity
            1. A signifier of your after-tax investment in property

Basis is usually not static

But IS static in some assets (ie. stock- which does not depreciate for tax purposes)

* + 1. Recognized Gain/Loss
       1. Loss when A/B is greater than A/R
          1. You have not recovered all of the after tax dollars/basis you originally invested (this is why we allow a loss deduction)
       2. Loss can be deductible by individual TPs depending on the asset’s use:
          1. Assets to produce income: loss generally deductible
          2. Assets used for personal use: only casualty losses deductible [**§ 165(c)**]
          3. \*IRC distinguishes b/w business and personal use
  1. ***Inaja Land Co.***
     1. Facts: TP bought land for $61k, but eventually settled with the city for a $50k easement b/c the city was polluting the land (after it built an aqueduct]
        1. Note: an easement is a right of passage across land
     2. Tax issue: is the $50k settlement taxable income or recovery of capital?
        1. IRS: This is taxable b/c it is a benefit under H-S
           1. Compensation for loss of present & future “ordinary income”
        2. TP: Benefit is a non-taxable return of capital. It is not practical to value this easement b/c it is only a portion of the entire property
           1. Should reduce their basis in the land, and it is not gain b/c it doesn’t go over the basis
     3. Held: for TP
        1. Benefit from selling this easement is recovery of capital
        2. Court does a **§ 1001** analysis
           1. TP gets $50k, but the hard part is determining the basis for this easement [hard to apportion the A/B from the easement—this is a valuation problem]
           2. “Apportionment [of the value of the easement] with reasonable accuracy of the amount received not being possible … it can not be determined that TP has, in fact, realized gain in any amount”
        3. **“Basis First” Rule**
           1. For valuation problems, take away basis first

A form of deferral and all of the benefits that come with deferral (time value of money, etc.) – NOT exclusion

* + 1. PROF: this is a very pro-TP case
       1. BUT the TP will have to pay tax when he eventually sells the property [there will be some realized amount and there will be a lower basis—deferral]
  1. Examples re: ***Inaja***& sale of easements
     1. (A) TP owns 10-acre plot of homogenous land w/ basis of $60. If TP sold 1/10 of the land for $10, no admin problem.
        1. **§ 1001**: A/R is $10; basis is $6 [$60/10]; taxable gain is $4
        2. Basis for the remaining 9 acres should be $54, b/c $6 of the basis has already been recovered
        3. This is NOT the ***Inaja*** problem
        4. If the remaining property is later sold for $54, the taxable gain would be $0 [b/c A/R is $54 AND the new A/B is $54]
           1. Pay tax up front (no deferral—doesn’t benefit from the time value of money)
     2. (B) [***Inaja***] A owns 10-acre land w/ $60 basis. He sells an easement for $10.
        1. 1st step in **§ 1001** analysis: A/R is $10
        2. 2nd step: A/B apportioned to easement?
           1. Under ***Inaja***, there is a valuation problem here (unclear what A/B of property right is)🡪 So the basis first rule says that the $10 will be treated as non-taxable recovery of capital from the entire property

So no immediate gain on this transaction

$10 A/R applies against $60 total basis

New A/B of entire property = $50

If you then sell the rest of the land around the easement for $54 🡪 the A/R is $54, A/B is $50, taxable gain is $4

This shows the benefit of pro-TP deferral [pay the tax later instead of upon the initial sale of the easement]

* + - 1. This example is preferable over example (A) b/c of the time value of money
  1. Insurance
     1. Generally
        1. Insurance is a form of risk spreading and wealth transfer
           1. Insurance companies invest the money you pay them. This money gains interest.
           2. Incentive for insurance companies to widen the base of insureds in order to spread/pool the risk
           3. When there is a pay-out, there is a “winner” & a “loser”

Winner = beneficiary

Loser = other insured payors

\*Money is being moved around/wealth transfer

* + - 1. Tax issues: separating “pure” insurance from savings, or “inside buildup”
         1. “Inside Buildup”

Component of insurance contract that is kind of like a savings account

There is a return, and this return ought to be taxed b/c it is similar to someone putting money in a savings account and earning interest on it [horizontal equity concern]

**BUT this savings component is NOT taxed**

Valuation problem b/c it is intertwined with the mortality component

Social concerns

Congress agrees that fire & death are not great times for the IRS to show up

Realization concept

We don’t tax mere appreciation; we wait until a realization event [we already turn out back on the unrealized gains in stocks]

* + - 1. One layer of tax 🡪 we generally only want to tax wealth transfers once
         1. IRC ensures that payors use after-tax $ to pay the premiums for insurance by not allowing TP a deduction for them

Thus, the beneficiaries should not have to pay taxed on pay-outs (exclusion)

This is similar to gifts & **§ 102**

* + 1. **§ 101(a)** Life Insurance
       1. Exclusion to beneficiary for receipt of insurance proceeds
          1. Social policy reasons & single layer of tax, even if there is clearly an accession of wealth

**No deduction** for the premiums that were paid earlier

Savings element is also generally excluded from GI

B/c had to disentangle from the mortality element AND we turn our back on unrealized gains in other areas, too

* + - 1. “Proceeds of life insurance … EXCEPT as otherwise provided (see sections), GI does not include amounts receivable under life insurance contracts if the amount is paid for the death of the insured”
  1. Annuities
     1. Generally
        1. Often a retirement vehicle
        2. Contract providing TP future payments in return for an upfront fixed sum
           1. This is a pooling of risk (b/c some people won’t live long enough to receive all of their payments)
     2. **§ 72**
        1. **(a)** Gross income includes any amount received as an annuity
           1. But what about the after tax dollars TP spent upfront? You have some basis when you buy this contract for future payments.

Attribute basis to this purchase of an annuity b/c it is an investment. You don’t really sell the investment, like land in a **§ 1001** analysis, but the logic is similar.

Therefore, not all of the annuity payments should be part of GI

* + - 1. **(b)** Exclusion ratio for portion that is recovery of capital
         1. Pro Rata option for the exclusion

For the ratio, compare the initial basis (investment under the K) to the total amount expected to receive from the payment.

This % will be excluded from GI. The other part of the income from the annuity will be included in GI.

* + - * 1. Congress does NOT go with:

Inaja, basis-first option b/c too pro-TP in context of annuities b/c TP may die while still exhausting basis and IRS would get no income; or

Amortized loan b/c it is too complicated

* + 1. Example
       1. TP buys annuity at year 0 for $8k. Annuity expected pay out $1k annually for the next 10 years. TP receives $1k at end of year 1.
          1. **§ 72(b)(1)** 🡪 take $8k (investment) divided by $10k (total expected gain over ten years) to get exclusion ratio of 80% (8/10)

But when we do this pro rata exclusion, we are ignoring the time value of money

We have punted on the this issue, b/c the expected return is really less than $10k

This is Pro-TP, too, b/c Congress is giving away the time value of money benefit

* + - * 1. SO 🡪 $800/year is excluded as recovery of basis and $200/year is taxable [to total the $1k/year payments]

Compromise, but still pro-TP

* 1. Gambling Gains/Losses
     1. **§ 165(d)**
        1. Take all gambling winnings and put them in one basket. Can only deduct gambling losses from that basket—“basketing”
           1. Gambling losses are only deductible up to the “extent of gains”

This is an example of “netting” or “basketing” in tax law

Prohibits the use of gambling losses to shelter other income (ie. wage income). Basketing also happens elsewhere in IRC

* + - * 1. Taxes the net gambling gain

No net loss from the basket is deducible

* + 1. Why this treatment?
       1. Gambling is a form of consumption under H-S
          1. Congress says that this looks too much like voluntary personal consumption, so should not be deductible from tax base
       2. Don’t want to subsidize gambling?
       3. Allow basketing as a compromise so IRS can get income from gains but still give TPs limited loss deductions
  1. Non-Taxable Compensation for Loss
     1. ***Clark v. Commissioner*** (1939)
        1. Kind of an intro into annual v. transactional accounting
        2. Facts:
           1. Due to bad tax atty advice, TP pays more than he is legally obliged to pay for the year 1932

This loss was NOT deductible (can’t file an amended return)

If TP could have amended or if this had happened all in 1932, this would be an issue

* + - * 1. Few years later, mistake is uncovered and tax atty pays the TP the amount of overpayment (close to $20k)

It is important that the error and the repayment happened in different tax years (even though they were part of the same transaction)

* + - 1. Issue: Whether this payment from the tax atty was compensation for a non-deductible loss OR taxable income?
      2. Held: for TP
         1. This is “compensation for loss that impaired TP’s capital”

Compensation is not income, but recovery of capital [non-deductible loss, so exclude recovery from tax]

* + - * 1. It is important that this was a non-deductible loss b/c had it been deductible, TP would have gotten a tax benefit and this wouldn’t be a problem

Conceptually, if we don’t allow TP a deduction for the loss, there is something akin to basis going on here—when TP was compensated for this loss, he was just recovering his basis (this is what the court is trying to get at when it mentions basis)

* + - 1. Notes:
         1. Tax treatment of a TP’s tax refund?

You had too much withheld, this is NOT an accession to wealth 🡪 not taxed

This is similar to ***Clark***

* + - * 1. Instead of focusing on accounting years, could focus instead on the transaction surrounding this bad tax advice

But we have to have annual accounting in the real world (even though the notion of transactional accounting is important and the ***Clark*** holding makes sense under trans accounting)

* + - 1. Relativism of horizontal equity
         1. Clark is better off when compared to whom?

Have to think about this re: fairness, even though the ***Clark*** holding makes sense given our basic tax principles

* + - * 1. Example 1

Three TPs, all of whom have the same taxable income (so ought to be treated alike)

Year 1: Only C hired a good tax preparer. A and B got bad tax advice to the tune of $5k.

After tax, A & B are worse off than C

Year 2: A is able to track down his bad counsel and gets $5k recovery.

A & C are not on par and are better off than B

Should A be taxed on this $5k repayment?

Under ***Clark***, NO

This tax treatment puts A in the same place as C (But A & C are under-taxed in relation to B)

Court has to make a choice re: to whom they want to make A equal to re: horizontal equity [Court picked C]

If Court had chosen B as the baseline instead, then A would have been overtaxed when compared to C

PROF: the horizontal equity argument of ***Clark*** is not foolproof (is it fair to compare TP A to C or B?)

But if the transactional accounting concept is paramount, the ***Clark*** is correctly decided

* + - * 1. Example 2

Instead of A getting $5k as repayment (to make him whole), what if A got an extra $3k (for total of $8k)

First $5k would be a non-taxed recovery of capital and additional $3k would be taxable

This $3k would be a clear accession to wealth (better even than C)

* + - 1. ***Old Colony***
         1. If your ER pays your taxes for you, that is an accession to wealth

1. Annual Accounting & Its Consequences
   1. Early Case Law
      1. ***Burnet v. US/Sanford & Brooks Co.*** [1931]
         1. Rule: We have to have a fixed accounting year
            1. PROF: this leads to a lot of unfairness b/c it is so inflexible
         2. Facts:
            1. TP is a dredging company that has a K with US gov’t. While working on the K over a span of years, the company operates at a loss in all years but one [~180k of expenses in trying to fulfill the K]
            2. When the K was abandoned, the company sues the gov’t for breach

Company wins settlement of $192k as recovery

This contains $176k in expenses under the K that exceeded receipts + $16k in interest

No dispute that the interest should be treated as income

* + - 1. Issue: tax treatment of “compensation for losses” 🡪 what year should the ~$180k be treated as GI
         1. TP: argues the $180k should be included in the past years as losses on the K, so NO income
         2. IRS: argues that it should be GI for 1920 b/c of annual accounting
      2. Held: triumph (admin need) of fixed annual accounting
         1. Can’t argue that this is a recoupment of loss to offset later earnings 🡪 rejects TP’s flexible transactional accounting argument
         2. Tax law does not look back, we look at fixed accounting years
         3. Rationale

Practicality- we have to draw a line and we choose to do it on an annual basis [it would be a nightmare to use transactional accounting b/c would have to allocate the cost of overhead among transactions)

* + - 1. PROF: but doesn’t tax law look back for some purposes?
         1. **§ 1001** analysis looks back to determine basis
    1. **§ 441:** Period for computing taxable income
       1. Codifies ***Burnet*** holding
          1. Establishes the importance of annual tax accounting
       2. **(a)** Gist is that there is some deference to how businesses keep books (ie. the year does not have to be the calendar year)
       3. **(g)** No books kept; no accounting period [default to calendar year]
       4. NOTE: **§ 446(b)** Exceptions – accounting method should “clearly reflect income”
          1. Trying to get a clear reflection of income w/ these accounting rules [see harshness of Oil Co. v. Utility Co.]
    2. NOTE: there is potential inequity in sticking strictly to **§ 441** & ***Burnet***
       1. Example: two companies [one oil and one utility] with same MTR
          1. Utility Co. makes $20/year, but the Oil Co. has more volatility. But at the end of 5 years, both have the same income.

Oil Co. will pay a ton of taxes in year 3 only. Utility Co. pays taxes every year.

Inequity of different taxes but same total income

* + - 1. Fix this rigidity problem of the annual accounting year with **§ 172** Net Operating Losses
  1. **§ 172**: Net Operating Losses
     1. Softens the harshness of CL default rule of fixed annual accounting
     2. **§ 172(a)** Grants a deduction for business operating losses
        1. An amount equal to the aggregate of the NOL carryovers to such a year plus NOL carrybacks to such a year
           1. Add up the carryovers of a certain year and the carrybacks of a certain year to determine the deduction amount

Can use **§ 172** both ways

* + 1. **§ 172(b)** Can shift NOLs around
       1. **(i)** Go back 2 taxable years [preceding the taxable year of the loss]
          1. Note: lends some finality
       2. **(ii)** Go forward 20 taxable years [from the taxable year of the loss]
          1. Note: hard for companies to predict 20 years out (this is good to avoid exploitation of this provision)

But in a sense, these numbers are arbitrary (Congress things 23 years is a good average span)

* + 1. **§ 172(a)** & **(b)** together allow for a smoothing/averaging of income over time
       1. Discrepancy due to the differences in income volatility of utility/oil companies would be spread out using this, which is more fair
    2. **§ 172(c): NOL defined** – means the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d)
    3. Policy rationales for allowing businesses this smoothing
       1. Equitable as between different income streams
       2. Incentive effects: risk taking & new ventures
       3. No longer gaming revenue streams
       4. Cushions the impact of the business cycle
    4. If you have a NOL, carry-backs have to be used first
       1. 2012 Example: apply NOLs to 2010, then leftover to 2011. If there is any left over, it can be carried forward for 20 more years.
    5. NOL Problem
       1. Company (est. 1999) gets 10-year contract, but has loss of $30k in 1999. In 2000, Company has net income of $30k attributable to sales.
          1. 1999: NOL of $30k
          2. 2000: Carry over the $30k 1999 loss
          3. \*So no tax liability in either year
    6. NOTE: remember that MTRs change over time, so think about this when allocating NOLs using **§ 172**
       1. Congress had to draw a line at the annual accounting year – can’t have a lifetime income tax even though this would even out your average income
  1. Claim of Right
     1. Use these (3) cases for the elements of claim of right
     2. ***North American Oil Co.*** [1932]
        1. Facts: Property dispute over ownership rights to the land where the oil is (this becomes a claim of right dispute for tax purposes)
           1. 1916: Receivership started

Earned

* + - * 1. 1917: Company received some profits that came in via the receivership (but dispute is still outstanding)

TP received the money with the chance of losing it later

* + - * 1. 1922: Dispute is resolved; now we know that it is income
      1. Issue: What is it income [1916, 1917, or 1922]?
         1. TP: wants income to be included in 1916 b/c the 1916 tax rate was really low (was higher in 1917 due to WWI)

Argues that they had the money to use in 1917, but the litigation as looming and was not resolved until 1922

* + - 1. Held: It is income in 1917 b/c that was when it was paid
         1. There needs to be some finality
         2. PROF: TP has the cash to use as it sees fit
    1. ***Lewis*** [1951]
       1. Facts: EE got a really big bonus but later found out that he was only entitled to ½ of it, so he was forced to pay a portion back
          1. 1944: EE earned the $
          2. 1946: EE paid it back
          3. \*Dramatic change in rate structures b/w the years
       2. Issue: Does EE get a tax deduction when he returns his portion? When is it income?
          1. General rule is that TP would include in GI the year earned and deduct it the year paid back
       3. Held: TP should be taxed on earnings received without restriction as to its use
       4. **§ 1341(a)(1)-(4)** is the congressional response to this case
       5. Note: what happens to Lewis’s ER?
          1. Matching principle

If Lewis included the bonus income in the earlier year (1944), we assume that the ER deducted it in 1944 as compensation expense

If Lewis has to repay some of the bonus later and gets a deduction for it (in 1946), the ER would have to include the repayment in its income in 1946

* + 1. NOTE: Potential Options re: Claim of Right
       1. Exclude until all uncertainty is resolved
          1. Undermines H-S notion of econ income; potential for tremendous deferral (hugely pro-TP)
       2. Retrospectively determine right year
          1. Potential closure problem for past years; too much uncertainty
       3. Use current info as “correctly” as possible
          1. Admin problems/impracticality even though this is the econ accurate method
       4. **\*“Follow the money”- “claim of right”** [this is option we go with]
          1. If you have control/dominion w/o restriction or future liability, then it ought to be a claim of right/included in income
          2. Practical and generally fair; important to remember ***Lewis*** – important to the evolution of this doctrine
    2. **§ 1341(a)(1)-(4):** Congressional Response to ***Lewis***
       1. Follows the mechanics of ***Lewis***
       2. Deduction for repayment; happens in the year the money has to be given back
          1. Restrictive b/c it addresses the ***Lewis*** fact pattern (has to be an initial unrestricted use of something and then you are giving it back)—narrowly tailored

But also addresses rate variations

* + - 1. **(a)(1)**: If item was included in GI for prior tax year b/c TP had unrestricted right to it; and
         1. **(1)** & **(2)** set up ***Lewis***
      2. **(a)(3)**: Deduction amount has to exceed $3k
      3. If **(a)(1)-(3)** are fulfilled, the tax imposed has to be the lesser of **(4)** & **(5)** in the subsequent year
         1. Tax for the latter year will be the lesser of:

**(a)(4)**: Tax w/ deduction [like ***Lewis***], or

**(a)(5)**: Tax w/o deduction reduced by tax owed in earlier year

\*TP wins either way, b/c can choose and thus take advantage of the rate swing

* + 1. **§ 1341** Problems
       1. (A) Year 1, 35% bracket TP has claim of right to $20k income. $7k of tax on that income. Year 2, TP is in 25% bracket and must return entire funds.
          1. Under **§ 1341(a)(4)**, deduction of $20k is worth $5k savings due to the rigidity of annual accounting and ***Burnet*** rule b/c TP is now in the 25% bracket [this would not be a direct recovery]
          2. BUT under **§ 1341(a)(5)**, IRC permits TP $7k of savings b/c this is how much he owed in the earlier year – forget the deduction he could take this year, which would have only been $5k [gives TP a choice]
       2. (B) Year 1, 25% bracket TP has claim of right to $20k of income. $5k tax on that income. Year 2, TP is in 35% bracket and must return funds. In year 2, could take a deduction of $20k & $7k savings.
          1. **§ 1341** permits TP to take full $7k savings (b/c allows TP to choose)

This section is very pro-TP

* + - 1. \*The critical question is what happened in the earlier year; on what premise did TP take/not take the deduction?
         1. This is how we know if the later event is fundamentally inconsistent
    1. ***Glenshaw Glass*** [revisited]
       1. Undeniable accessions to wealth;
       2. Clearly realized;
       3. Over which TP has complete dominion and control
  1. Tax Benefit Rule
     1. Allows us to use flexible transactional accounting in some cases
     2. Exclusionary Aspect
        1. ***Dobson v. Commissioner***
           1. Demonstrates the exclusionary aspect of the “Tax Benefit Rule” 🡪 could call this the “No Tax Benefit Rule”
           2. Facts: TP sells stock in Year 1 at a loss, but can’t make use of loss deduction (for some reason- thus no tax benefit from the loss)

Year 2, TP determines that the Year 1 loss was due to broker malfeasance, and recovers loss from the broker

* + - * 1. Issue: Problem re: the fixed annual accounting year b/c the loss and recovery happened in two different years [not being able to use the loss as a deduction in the previous year creates this problem]

TP: argues for a more transactional type of accounting even though under **§ 441**, TP should recognize this recovery as part of GI in year 2

* + - * 1. Held: agrees with TP

Excludes recovery from GI

* + - * 1. Application of the concept of basis

Even though **§ 1001** doesn’t apply b/c this is not an exchange of property, this non-deductible loss is a signifier of after-tax dollars [no gain/loss upon recovery]

* + - 1. **§ 111** Recovery of Tax Benefit Capital
         1. Kind of codifies ***Dobson***/partial codification of the exclusionary aspect of the TB Rule
         2. An exclusion

Attributable to a recovery in a particular year

But only to the extent that the amount of the recovery could have been deducted in the prior year but wasn’t

***Dobson*** facts: match this transaction very tightly (amount of loss = amount of recovery)

To the extent that TP could not make use of his loss for whatever reason

* + - * 1. This is a relaxation of the rigid default rule

Permits transactional accounting when you have one-on-one correspondence between a non-deductible loss and excluded recovery

Meant to make the TP whole (matching)

* + - * 1. Technically deals with rate variance, but only from zero MTR to a positive MTR in a later year
      1. Problems
         1. (1) Year 1, TP has business losses & $1k of bad debt losses, which go undeducted. Year 2, TP recovers $1k of bad debt losses.

Entire $1k is excludable under **§ 111** (undermines annual accounting)

* + - * 1. (2) Year 1, TP has $700 of income and $1k of bad debt losses; only $300 of the losses goes undeducted. Year 2, TP recovers $1k of bad debt losses.

$300 is excludable (he already made use of $700 of the $1k deduction)

Think of this as basis

* + 1. Inclusionary Aspect
       1. ***Hillsboro National Bank v. Comm.*** (1983)
          1. “Tax benefit rule will ‘cancel out’ any earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based”
       2. Examples:
          1. (1)[Converse of ***Dobson*** facts]

Year 1, TP makes contingent donation of property and takes a deduction. Year 3, property is returned to TP.

TP made use of the deduction in the prior year, so in year 3 he must include in his income the amount of the earlier deduction

What about relief from rate variation?

**§ 1341** won’t apply & **§ 111** doesn’t give relief either, b/c doesn’t deal with rate variation

Could use transactional accounting logic depending on case law

PROF: possibly no rate variation relief in this type of inclusionary fact pattern [don’t want to go too far- this could be a huge benefit to the TP, depending]

***Alice Phelan Sullivan v. U.S.*** [1967]

If property comes back, clearly includable in income

When you make a gift of property, there is a lurking valuation problem

Basis: this TP bought land for a lower price/basis (probably). When TP donated it, the value is (a probably much higher) FMV (not basis)

This means that the land likely has unrealized gain for which TP is now no longer responsible

PROF: this is kind of a give-away (counterintuitive to our dealings in property)

* + - * 1. (2) Year 1, write off/deduct bad debt loss b/c of deadbeat client. This premise becomes inconsistent when TP receives the payment from THAT client in Year 2.

Transactional accounting—nexus b/w what TP is deducting and what he getting a recovery for

* + - * 1. (3) Calendar-year TP makes deductible rent payment on 12/15 for 30-day business lease.

Rent payment is deductible as a business expense.

(A) If on 1/10 of the next year, a fire destroys the rental property:

Fire has nothing to do with the premise on which you took the deduction (not fundamentally inconsistent, so nothing happens to your deduction)

(B) But if instead on 1/10, you decide to use the property for personal instead of business use, this would be fundamentally inconsistent with your previously taken deduction and under ***Hillsboro***, there would have to be some kind of inclusion to make up for the previous deduction.

* + - * 1. (3)
  1. Cash v. Accrual Accounting
     1. Generally
        1. Cash Method
           1. Generally, income/deduction counted when received/paid in cash or “cash equivalent”
        2. Accrual Method
           1. More economically accurate
           2. Income/deduction counted when earned/obligation incurred, regardless of when paid
        3. Principal Difference
           1. Accrual must take face value of promise
           2. Cash is easier to administer, but accrual is more accurate
     2. Example
        1. Accountant (A) does work for Lawyer (L)
           1. (1) Service performed on 12/5/03
           2. (2) L received bill on 12/8/03
           3. (3) L pays bill on 1/10/04
           4. If A and L use the cash method, income to A in ’04 b/c that is when A gets payment. Deductible to L in ’04.
           5. If A and L use accrual method, A counts as income in ’03 and L gets deduction in ’03 [b/c that is when he receives the bill]

1. Recoveries for Personal & Business Injuries
   1. Taxation of Tort Recoveries
      1. **§ 104**: Compensation for injuries or sickness
         1. **(a)(2)** **Exclusion** for damages received for personal or physical injuries [making a person whole—so not including in taxable income is a good thing]
            1. Don’t care how it is structured
            2. Not excluded [from **§ 61** GI]

Punitive damages

Compensation for non-physical injuries (e.g. libel & emotional distress)

* + - * 1. Excluded [from **§ 61** GI]

Medical expenses [that are not deducted under **§ 213**]

W/o this cross reference to **§ 213**, there would be a double tax benefit b/c TP could deduct the expenses when they are spent AND then later exclude the tort damages/recovery when received [this shouldn’t be allowed] – see #3 below

Lost wages

But making someone whole ex ante doesn’t justify this, b/c wages would normally be taxed absent the injuries

Possible rationale for tax exclusion for wage replacement under **§ 104(a)(2)**

Opaqueness: tort settlements are not transparent – may not know which part of settlement is attributable to wages

Undercompensation for recovery

Idea that recoveries don’t really make you whole

Possible double-tax on lump sum awards

Time value of money issue and what about attorneys’ fees?

* + - 1. Looks like a broad exclusion for tort recovery, but may not be in reality
      2. Except in the case of deductions allowed under **§ 213** [be careful]
         1. **§ 104** references **§ 213:** medical, dental expenses, etc.

**§ 213(a)** Only allow expenses if they are more than 7.5% of AGI

* + 1. Policy reasons for this exclusion
       1. Tort recoveries are meant to make a person whole, so bring person back to ex ante status quo by not taxing this recovery
          1. Fairness argument; but this is a horizontal equity argument (but you made the TP whole when compared to whom?)

This is fair when TP is compared with someone never in an accident, but not when compared to someone who was in an accident but didn’t recover anything [unless they got a deduction for all medical expenses]

PROF: the right baseline is probably the person who never was in an accident, but it is important to remember that we are leaving someone out in the process

* + 1. ***Murphy v. US*** (2006)
       1. Held: **§ 104(a)(2)** is unconstitutional
          1. But vacated within the same year
    2. Taxing Recoveries Problems
       1. (1) T sees C (T’s wife) injured by drunk driver. C sues and recovers $100k for physical injury, $50k for medical expenses and $1mm for punitive damages. T also sues and recovers $10k for psych bills and $100k for loss of consortium.
          1. C’s $100k for physical injuries is clearly excludable
          2. C’s $50k for medical expenses is excludable unless they were deducted under **§ 213**
          3. C’s $1mm is not excluded b/c punitive damages are included in income
          4. T’s $10k for psych bills

PROF: could make a good argument that this is excludable under **§ 104** b/c it is tied to the actual tort injury of C

What about **§ 213**?

Medical expenses can be pretty general

Could have psych bills under **§ 213**, and if these are tied directly to the accident, they should be a **§ 213**-type expense

* + - * 1. T’s $100k for loss of consortium

PROF: legislative history shows that Congress had this in mind with **§ 104** – thought this ought to be excludable

* + 1. NOTE: When IRC uses “personal,” it just means not business

1. Income from Discharge of Indebtedness
   1. Anatomy of a Loan
      1. Conceptually, under an income tax base, a loan is not income b/c there is a countervailing liability & the TP is not better off under H-S
         1. Borrower: proceeds are not income & repayment is not deductible. Interest may be deductible (given the context).
            1. Loan increases assets but also increases liabilities
            2. \*As long as this is a legitimate loan that the borrower intends to pay back
         2. Lender: Loan is not deductible and repayment is not income. Interest is taxable income.
            1. Loan decreases/increases assets [cash goes out but A/Rs go up]
            2. \*At this level, as long as it is a legitimate loan, it doesn’t matter who the lender is (bank, parents, friends, etc.)

But this matters if there is cancellation of the loan/debt

* + 1. Income = consumption + change in wealth
       1. If we shifted to a consumption tax, as opposed to an income tax, this analysis would be different
  1. Cancellation of Debt Income [COD]
     1. ***Us v. Kirby Lumber*** (1931)
        1. Facts: Kirby issues some bonds [gives out IOUs]. Kirby later repurchases the debt back for a lower price [difference of $138k].
           1. Kirby may have bought some of the bonds back b/c they feared having too much debt [fear of default]. Also, the market went down [bond interest rates changes, etc.], so it was a good business decision to buy the bonds back
           2. This resulted in come cancellation/discharge of debt b/c Kirby was able to buy the bonds back at a lower rate
        2. Issue: How do we treat this cancellation of debt (COD) income?
           1. There are Treas. Regs. on point
        3. Held: COD ought to be income b/c Kirby is better off by $138k
           1. Increase in net worth; TP has “realized within the year an accession of income”
           2. Codified in **§ 61(a)(12)**

COD/discharge of debt included in gross income

Policy

But is this a good time to tax?

Generally, although not in this case, when we see a COD, the TP is not in the best financial position

Liquidity problem (TP may not even have the cash)

SO, Congress recognizes exceptions to the general rule that COD is clearly income with **§ 108**

* + 1. Exceptions to COD Income [**§ 108(a)(1), (b)** & **§ 1017**]
       1. **§ 108**
          1. Exclusion
          2. **(a)** Says that before you apply **§ 61(a)(12)**, look at the listed exclusions:

TPs in Ch. 11 BK;

Insolvent TPs;

Solvent farmers [qualified farm indebtedness];

Corporations that incur debt to purchase real estate (real estate developers)

Discharge due to principle residence indebtedness

Readjustments to mortgages b/c people were underwater. Technically, these readjustments should be taxed as GI, but not a good time to be taxed

* + - * 1. **(b)** TP has to use any other favorable tax treatment under IRC before using this exclusion [ie. carryovers, NOLs, etc.]

This means that a TP can’t hold onto his losses and keep taxable GI [gov’t can get the revenue back later even though it is giving exclusions now]

**(b)(2)** Order reduction

**(b)(2)(A)**: NOLs [first b/c they are the most valuable to the TP]

**(b)(2)(E)**: Basis of property of the TP can be reduced

* + - * 1. Cross reference to **§ 1017**

General Rule: if an amount is excluded from GI under **§ 108(a)** and any portion of such amount is to be applied to reduce basis under **§ 108(b)(2)(E)**, then such portion shall applied to reduce the basis in the taxable year following the taxable year in which the discharge occurs.

By forcing the TP to make adjustment to basis under **§ 1017**, this is deferral (even though **§ 108** gives this up-front exclusion)

Time value of money benefit

When TP sells this property or takes depreciation deductions, gov’t will claw back the money

* + - * 1. **(f)(2)**: Student loan forgiveness
        2. **(e)(5)**: Purchase price reduction
        3. **(a)(1)(E), (h)**: Mortgage forgiveness
    1. COD Income Problem
       1. A borrows $150k from J (not related). Later, A is insolvent but has assets: (1) $100k cash & (2) $40k business equipment [A/B = $60k]. A’s insolvency = $10k [b/c assets = $140k & liability = $150k].
          1. If J accepts ½ (ie. repayment of $75k to cancel debt):

On first blush, there is $75k of COD income, but b/c of the insolvency context, some of it can be excludable

**§ 108(a)(3)**: exclude $10k [extent of insolvency] & the rest is COD income under **§ 61(a)(12)**

When **§ 108** applies, other favorable tax treatment has to be applied first

Use basis to determine the depreciation deduction for the business equipment

\*Congress can get some of this $10k exclusion back later: A will have a new A/B in the equipment 🡪 $50k [per **§ 108(b)(2)(E)** & **§ 1017(b)(2)**]

TP wants a lot of basis in a property b/c then the TP is taxed less when he sells the property

Also, want basis in depreciable property b/c the more basis you have upfront, the more depreciation deductions you get

* + 1. Child Support & Other Obligations
       1. Should failure to make legally required child support payments lead to COD income?
          1. Is the “deadbeat” parent better off than a similarly-situated TP who honors his obligations? Clearly yes.
          2. If the ex-spouse can’t get the deadbeat to pay, maybe the taxman can?
  1. Transfers of Property Subject to Debt
     1. Terms
        1. Basis
        2. Depreciation
           1. **§ 167(a)**: Exhaustion, wear & tear of income-producing asset is deductible [machines/buildings don’t last forever]
           2. Policy

If you have a net income tax, the proper definition has to allow for some depreciation of the income-producing asset

There are economic incentives lurking here

* + - * 1. Calculating amount of depreciation deduction:

Straight-line method

(Cost – salvage value)/useful life

$60 cost; $0 salvage value; 5-yr useful life

$12/yr depreciation deduction

Example 1: Year 1, TP buys an oven for $5k (5-yr useful life). After 2 years of straight-line depreciation, the oven is sold for $4k.

A/R is $4k

A/B is $3k [depreciate the asset]

Gain of $1k

TP has over-depreciated the asset and the government is getting it back [recaptured some of the deductions that were given upfront]

Example 2: If TP above buys the oven with debt of $5k, does it matter (for purposes of determining basis in the asset), if the debt was non recourse (ie. TP is not personally liable and recourse is probably to the property)?

TP’s basis in the oven is the full $5k

Fundamental assumption that this is a legit loan, so it does not matter that this is non recourse, b/c TP is going to pay the loan back with after tax dollars [so TP ought to get basis in the asset that is equal to the loan]

We need basis in this b/c we need some way to calculate the wear & tear on this over time [and so we can get an idea when TP sells the asset]

If TP used her savings to buy the $5k oven, her basis would obviously be $5k. So the loan gives her the same basis treatment.

* + - 1. Sales
         1. What are the gross sales proceeds when property subject to debt is sold? (Ie. what is the A/R on the transaction?)
         2. Example

S sells property to J:

(a) For $400k cash & J’s assumption of recourse debt of $100k

Gross proceeds to S = $500k

(b) For $400k cash & J’s assumption of nonrecourse debt of $100k [borrower is not personally liable]

Gross proceeds to S = still $500k

* + - * 1. Distinction b/w personal liability for a loan and nonrecourse:

If the value of the property increases, the loan stays fixed. S would enjoy the benefits of this upside/growth in value, and S would want to pay off the nonrecourse debt

BUT if the asset declines in value (suppose even lower than the amount of nonrecourse debt), S does NOT have an incentive to pay the loan off. S would have an incentive to walk away from the loan and let the bank take the collateral (b/c the bank took the risk when it made this nonrecourse loan)

* + - 1. Debt
    1. Debt Included in Basis
       1. ***Crane v. Commissioner*** (1947)
          1. Facts:

1932: TP inherits property subject to a $250k nonrecourse mortgage [critical that TP is not personally liable for the debt]

Inheritance triggers **§ 1014** [when TP inherits the property, she gets it at its FMV—which is the stepped-up basis of $250k]

1932-38: TP takes depreciation deductions tied to this property [approx. $30k]

All of these deductions taken up front are a big benefit to her [gov’t tries to get these back later]

PROF: IRS won the tax shelter battle, but maybe lost the war?

1938: TP sells property for $2.5k and the buyer assumes the nonrecourse debt

TP may have just been paying the interest payments on the loan for 6 years

TP gets the econ benefit of getting rid of the debt & the additional $2.5k is “boot”

TP is not being relieved of the debt by the bank/lender, so this is not discharge of debt

Just a shift of the debt obligation to someone who assumes it with full consent

With this shift, there is an econ benefit in the transaction

* + - * 1. Issue: How to (consistently) treat the debt; parties disagree on whether “property” includes the debt

How to determine cost basis & A/R on property transferred subject to nonrecourse debt

* + - * 1. Arguments:

TP

Legal argument: (1) TP’s initial property rights in the property at the time of inheritance was her equity in it [equity was $0, so her basis was $0]

The term “property” means “equity”, NOT “debt” [so debt ought to be ignored, in a sense].

The bank had the equity when TP inherited the property

BUT can only take depreciation deductions if you have some basis

(2) So TP says that she never would have taken these $30k in depreciation deductions – but oops, the statute of limitations have run on these

(3) At sale, TP’s A/R is only $2.5k, her A/B is still $0, so her realized gain is only $2.5k

TP admitted that she had a gain of $2.5k

Government

Legal argument: “property” = value of asset including debt

So at sale, TP’s A/B is $220k

TP was right to take the $30k depreciation deductions b/c her original basis at time of inheritance was $250k

Symmetry: if we include the debt in TP’s basis upfront [b/c it was a legit debt that gov’t thought TP would pay back], we have to be consistent and make sure that we also include the assumption of the debt by the buyer as also being included in TP’s A/R on the sale of the property

A/R = $252.5k [$2.5k cash plus $250k mortgage]

**Realized gain = $32.5k** [gov’t recaptures the $30k in depreciation deductions, which is consistent]

Having someone else assume TP’s loan liability is as if she was discharged from it [accession to wealth]

* + - * 1. Held: for IRS

Property = value [not equity]

Debt is to be included in basis and A/R for symmetry

Statutory authority: **§§ 1014, 1016 & 1001**

IRC does not look at the equity/pure ownership aspect of property

* + - * 1. Alternative – if we went with TP’s argument [ie. equity matters and no basis upfront], how would it work?

Can’t have a negative basis, so can’t give TP a depreciation deduction

How would TP get basis over time? Could give basis as TP paid principle on the loan and built equity monthly, but this would be very difficult administratively.

PROF: challenges of calculating depreciation deductions with equity as basis

* + - * 1. FN 37 [57 in our CB]: problems when the debt is greater than FMV of the property

Maybe this isn’t legit debt? Court punts on this

* + - * 1. Implications of ***Crane***

IRS position permits early depreciation deduction for the sale of later “recapture”

This is pro-TP b/c of the time value of money (and character of income at recapture)

Depreciation deductions reduce ordinary income, but when you dispose of property, you may get capital gains tax preference

***Crane*** fuels future tax shelters

Advantages of nonrecourse debt in questionable tax transactions:

Limited economic risk (bank takes the risk)

Borrower can walk away

Allowed for inflated depreciable basis

Borrower can take out a loan that is bigger than the FMV of the property (which makes the debt look less legit—if not legit, shouldn’t be added to basis to allow for deductions)

FN 37 suggested possible avoidance of “recapture”

* + - 1. ***Commissioner v. Tufts*** (1983)
         1. Facts:

1970: TPs bought an apt complex w/ 1.85 mm of nonrecourse debt

1970-72: TPs claim $400k in depreciation deductions, so A/B should be $1.4mm [benefit of $400k to TPs upfront]

1972: TP sells apartments for assumption of debt. FMV of apartments is under $1.4mm.

This is the ***Crane*** FN 37 problem [FMV of property is lower than debt amount]

* + - * 1. Issue: Does ***Crane*** apply in this case? Ie. What is the A/R on this transaction, where property is given up that has a debt that exceeds its FMV?
        2. Arguments:

TP

FMV of apts = extent of TP liability

Benefit (A/R) = ~1.4 mm

The A/R is key

A/B = $1.45 mm (so this triggers a loss of $50k on the transaction)

Argument: who cares about what the loan says

Gov’t

A/R = full amount of outstanding debt, NOT FMV of property

A/R = $1.85 mm

A/B = $1.45 mm, which triggers a GAIN of $400k

This $400k equals the amount of the deductions previously taken

* + - * 1. Held: For gov’t 🡪 Symmetry & transactional consistency means treating debt consistently for depreciable basis AND for A/R

Addresses ***Crane’s*** FN 37 🡪 does A/R include debt even when FMV is less than the debt? YES

But if the spread b/w the loan amount and FMV gets too disparate, question the legitimacy of the loan

* + - * 1. Concurrence (O’Connor):

Bifurcate this transaction into the loan agreement and the property transaction

(1) Property transaction

Loss on the sale; BUT

(2) Loan agreement

COD income

$400k

Note mentions that bifurcation does actually occur in recourse transactions (so nonrecourse v. recourse matters in this context)

O’Connor comes to the same figure as the majority

* + - 1. ***Crane’s*** Progeny & Legitimate Debt
         1. Prof: IRS did the right thing in ***Crane*** & ***Tufts***, but led to a tax benefit of deferral for the TPs

IRS really had no choice [IRS getting excessive depreciation back gives TP the time value of money]

Rule makes sense – if there is no econ loss, there ought to be no tax loss

Ought to be skeptical when there is a divergence

* + - * 1. ***Estate of Frankin*** (9th Cir. 1976)

Sale/leaseback deal: TP buys hotel w/ nonrecourse debt that is much greater than the FMV of the hotel

Key that the loan came from the seller

We don’t think that TP will ever pay the loan back b/c it is so far removed from the value

Held: spread was so wide that the debt lacked economic substance and was unlikely to be repaid, so not legitimate 🡪 so debt is not included in basis

We cannot stick to ***Crane*** every time b/c context matters

* + - * 1. ***Pleasant Summit Land Corp*** (3d Cir. 1988)

Nonrecourse loan exceeded value of the property, but it was a third-party lender, which distinguishes it from ***Estate of Franklin***

Sounds like the TP probably will pay this back—verification of this b/c of who the lender is

Held: nonrecourse debt that is greater than the FMV shall be included in basis, but only to the extent of FMV

***Estate of Franklin*** & ***Pleasant Summit Land Corp*** show a circuit split

* + - * 1. Examples

Tax Shelter -- Clicker sale for $1mm. A sold B a tax shelter via nonrecourse debt that is widely disparate from the FMV of the clicker. B can use the depreciable deductions to shield her other income. If B walks away from the loan, the bank will get the clicker back but not the $1mm.

***Estate of Franklin*** stops this

TP uses $5k cash and $1mm nonrecourse debt to buy a resort = $400k. Basis?

***Crane***shouldn’t apply

Under ***Crane***, basis would be $1,005,000 (full debt included)

Under ***Franklin***, the cost basis would be only $5k

Under ***Pleasant Summit***, $405k cost basis

* + - 1. Congressional Response to Tax Shelters
         1. **§ 465**

The “At-Risk” Rules:

Disallow deductions for “losses” of an investment that is greater than the amount put “at risk”

Attack leverage (debt) used in tax shelters

“Qualified nonrecourse financing” exception

* + - * 1. **§ 469**

Passive activity loss rules:

Limit deductions from passive activity losses

TP doesn’t “materially participate”

Treas. Reg. **§ 1.469-5T**

Netting against “passive activity income”

Another example of basketing/netting

1. Interest on State & Local Bonds
   1. **§ 103** & capture of tax benefits
      1. Exclusion of the interest component that comes from state and local bonds (ie. if you buy an IN state bond that pays X interest, that interest is excluded from your gross income)
         1. Policy: this saves money for local gov’ts, but this lowered interest rate gets priced into the bonds [if you know you don’t have to pay taxes on a bond, you will accept a lower amount of return—this is an implicit/putative tax that the TP pays]
         2. Incidence of tax benefits: sharing may be dispersed (like many fringe benefits)
            1. Nominally, Congress wants state/local gov’ts to be able to raise money cheaply (nominal benefit to the TP, but it helps the state gov’t)

But it is clawed back by high bracket TPs

* 1. We know what the implicit tax is by comparing the tax free bonds with similar, taxed bonds
     1. Things of equal risk
     2. A lot of this will turn on the MTR of the investor
        1. How to take advantage of an exclusion is based on your MTR
           1. NOW the different bracket of TPs will have different benefits based on their MTRs (benefit for more than state/local gov’ts)
  2. To attract TPs in lower brackets, bonds have to have a slightly higher return to be attractive (higher TPs benefit from this)
     1. But gov’ts still benefit from this exclusion
        1. But benefit less due to the progressive rate structure [some of the benefits have to be shared now, doesn’t all go to the state/local gov’t—unless the bond market can be segmented by MTR]

1. Gain on Sale of a Home
   1. Dollar limits b/c we have to cap it – so as not to be unlimited
   2. **§ 121**: limited exclusion of gain from sale of principle residence
      1. **(b)** Dollar limit on exclusion
         1. So TPs can’t sell McMansions and shelter a whole lot of income
      2. **(c)** Prof likes this section
2. Special Rate for Dividends
   1. A dividend is a distribution made by a corp. to its SHs
   2. For tax purposes, certain qualified dividends are given special treatment (quasi-capital gain treatment)
      1. This is important b/c capital gains are taxed at a lower rate than ordinary income
         1. Policy
            1. Mitigates the double taxation of corporate income (argument that this is not fair, so give the preferential rate)

**Timing Issues**

1. Timing Generally
   1. Timing matters:
      1. (1) Possible variation of MTR due to:
         1. Volatile income streams (ie. high MTR one year and low another for a company)
         2. Legislative changes
      2. (2) Time value of money
         1. Opportunity cost of money (benefits of tax deferral)
2. Gains & Losses from Investments in Property
   1. Leasehold Improvements
      1. ***Helvering v. Bruun***
         1. Facts
            1. 1915: Starts lease for 99 years. Bruun is the landlord/lessor/TP
            2. 1929: Tenant builds new building on the land (w/ a 50-year life)
            3. 1933: Tenant abandons lease
            4. 1979: End of new building’s expected life
            5. 2014: Expected expiration of lease
         2. Issue: Should LL recognize income equal to the building’s value when the lease reverts back to LL in 1933? [Not should the LL recognize income, but when]
            1. IRS: This is income when the lease reverts back to the LL in 1933 b.c of Treas. Regs.
            2. LL/TP: This improvement is capital appreciation not income because it is not separate or derived from capital; income upon final disposition

Uses constitutional argument from ***Macomber***

* + - 1. Held: for IRS/Gov’t
         1. Value of improvement is taxable to LL at moment of abandonment [TP is taxed on the FMV]

Realization of gain doesn’t need to be in cash derived from a complete transaction/sale to be a taxable gain

PROF: undermining liquidity prong here

This is a clear accession to wealth for the LL so it ought to be income to him when the lease reverts back to LL

This chips away at ***Macomber*** – we care about uses more than sources

* + - * 1. This takes place in the 1930s (Great Depression) – valuation issues of the building & the court is cognizant of this
      1. PROF: do we want to discourage this type of behavior?
         1. Congress responded to this case by enacting **§ 109**

Not a great time to tax (greater social policy)

If Congress had only intervened with **§ 109**, TP would have gotten a huge windfall of complete exclusion [**§ 1019** mitigates this with A/B]

* + - * 1. But under H-S, ***Bruun*** is right b/c this is a clear accession to wealth re: the building
      1. Irony when compared to ***Macomber***:
         1. ***Bruun*** undermines the ***Macomber*** constitutional holding but the ***Bruun***holding doesn’t hold up in the end (***Macomber*** holding is still good re: realization requirement)

The precise holding in ***Bruun*** is overruled in **§§ 109 & 1019**

* + 1. **§ 109**: Tax Treatment of Leasehold Improvements
       1. Exactly like the ***Bruun*** fact pattern
       2. When a LL receives property back that has improvements, it is not income
          1. Overrules ***Bruun***
          2. “GI does not include income provided by …”

Looking at just **§ 109**, looks like a huge windfall to the TP in ***Bruun***-like fact patterns

But, there is a countervailing basis adjustment in **§ 1019**

* + - 1. This looks like just an exclusion, but becomes a deferral when combined with **§ 1019**
    1. **§ 1019**
       1. “Neither the basis nor the basis adjusted basis be diminished…”
          1. Directly references **§ 109**
          2. In the **§ 109** context, when the LL gets the property back with leasehold improvements –

**§ 1019** says that LL can’t adjust basis in this context [thus TP can’t take depreciation deductions]

This matters b/c gov’t turns this exclusion benefit into a deferral through adjustments of basis

Gov’t doesn’t want LL to be able to take a stepped-up basis in FMV of the returned property

* + 1. Illustrations
       1. (A) If you don’t have a basis upfront, you can’t have a depreciation deduction (under **§§ 109/1019** analysis).
          1. In the excel example, the nominal amounts paid in taxes are the same under ***Bruun*** analysis and **§§ 109/1019** analysis. But the deferral (**§§ 109/1019**) example is better for the TP b/c of the present value calculation/time value of money. [Ie. same aggregate net income and tax over the total time period under both regimes, but cash flow is different

***Bruun***: taxed all upfront [~19k in tax]

Congress response – defer taxes over time [~13k in tax]

Get net present value

* + - * 1. Basis adjustment is critical re: whether it is an exclusion or deferral
      1. (B) Does this deferral benefit only work if you are able to use all of the depreciation deductions … ie. can TP still benefit if he sells along the way?
         1. Selling the property early terminates the benefit of deferral to the TP re: the time value of money (but TP still gets the benefit to the extent of time the land is kept)
         2. When you sell, your gain is determined by comparing A/R to A/B

As long as you are making the right basis adjustments, there will still be the benefit of deferral (may not be as much, though, if the sale is early on)

* + - * 1. Look at the rental value over period of time, discount it back to determine the rental cash flows (to determine fair price)

Tax treatment under ***Bruun***—basis goes down with depreciation deduction, but only get this until you sell the property. Sale for $34k at end of year 3 is taxed. A/B is $35k, but A/R is $34k (loss on sale). The resulting tax upon sale is $(-)300 [b/c taxes were paid upfront]

Tax treatment under **§ 109/1019**—get no basis or income upfront

Rental income is $7k, and the end of year 4 there is a sale for $34k. At disposition, there is still a gain of $34k b/c A/R is $34k and A/B is $0.

Deferring most of the tax to the end lowers net present value of taxes owed

The 3rd party who buys the property for $34k will have a basis of $34k

* + - 1. (C) Year 1, LL has a prior investment in land of $15k. Leases land to tenant. Year 2, tenant builds a building. LL recovers the land with the building in year 3. The value of the building is only $20k. Ten years later, LL sells land and building for $35k (assume value of land has not changed).
         1. When is LL taxed under **§§ 109 & 1019**?

A/R = $35k. TP doesn’t have a basis adjustment for the year 3 improvements/reversion under **§ 1019**, so TP basis will be $15k.

$20k gain for TP will be taxed

1. Realization
   1. Generally
      1. Realization is a deviation from H-S definition, b/c if you believe in H-S economic notion of income, there would be no realization requirement
         1. Would come up with some gain (may be presumptive) at the end of every year, give TP an A/R and tax on the gain every year
         2. To be a fair net income system, would also have to do the same thing for losses (even if you didn’t sell to realize the loss, paper loss would have to be accounted for—this is what mark to market says)
         3. Realization is a necessary but not sufficient condition for taxable income
         4. After ***Bruun***, **§§ 109 & 1019**, we have now changed depreciation into a tool of economic policy [it is frontloaded to encourage businesses to buy more capital goods]
            1. Whereas depreciation used to be a measurement of value under H-S
      2. An admin requirement after ***Cottage Savings***, but there is still some econ substance
         1. Look for a change in TP’s asset that is sufficiently definite and objective to warrant a taxable event [e.g. sale, exchange or disposition]
            1. Change in value of asset or qualifying transfer
   2. ***Eisner v. Macomber***
      1. NOTE: really gets at the timing issue; this was clearly appreciation in the asset over time
      2. Facts:
         1. TP has 2200 shares of stock with par value of $100
         2. Corp. declared 50% stock dividend, so TP got an additional 1100 shares
            1. When a dividend is issued, the price of the company’s stock normally should drop. Company may sometimes want the stock price to drop so as not to price out buyers.
      3. Issues: are these stock dividends income?
         1. More precisely:
            1. Econ issue: whether the stock dividend is an accession to wealth for the TP?
            2. Constitutional issue: when can TP’s prior increase to wealth be taxed?
            3. Legal issue: did TP’s receipt of dividends serve as a realization of her prior increase in wealth?
      4. Held [Maj per Pitney]: Stock dividends are not income/payment of them is not a taxable event [**§ 305** non recognition provision]
         1. No accession to wealth b/c it is the same pie, just sliced into more pieces
            1. Do not tax mere appreciation
         2. Realization requirement [still good law]
            1. Distribution of tax dividend does not trigger an even to tax the TP’s past appreciation
         3. Constitutional issue: source of income matters; this income doesn’t derive from the typical sources, ie. labor under the 16th Am [no longer good law]
         4. Legal issue: liquidity problem; TP is still vested in this company, so her property in the new dividends is still subject to the business risks of the corporate governance/market
            1. Ie. if you don’t get cash, you are still along for the rise and this is not the right time to tax you (the core issue is risk)
      5. Economics of stock dividends
         1. Functionally the same thing as asking the SHs to cut their current shares in half with scissors – shows that there is no accession to wealth
      6. PROF: Brandeis blew this case when he said that stock dividends are functionally equivalent to cash dividends that come w/ the right to repurchase more stock
         1. Prof says that this doesn’t make sense b/c TP here never had the option to take the cash dividend
            1. The method matters—they should not be treated the same re: tax [the intermediate step of receiving cash changes a lot]
            2. TP has a choice when he gets cash [***Benaglia*** principle of forced personal consumption in receiving stock dividends]; cash gives a TP dominion, control, and choice

This goes to the horizontal equity question

Fair compared to whom—the TP who gets cash dividends?

Another example: cafeteria plans under **§ 132**

* + 1. If the gov’t had won & Brandeis’ opinion was the majority:
       1. Chilling effect for corporations’ issuance of dividends
          1. Companies now want to issue stock dividends in order to lower stock price so more people can afford them—why would we want to chill this?
       2. Brandeis would advise a company (his client) to stop issuing stock b/c all you are doing is issuing your SHs tax bills. Brandeis would lobby Congress to change the law to eliminate this chilling effect on stock dividends.
    2. NOTE: If all SHs get cash dividends & Macomber uses this cash to buy more stock, she does get more of the “pizza” (ie. more equity in the company)
       1. Her new basis in this new stock would be the purchase price, which is her after tax investment
          1. This is distinguishable from the stock split that actually happened in this case

If Macomber gets more stock via dividends, her new basis depends

Allocate this basis properly in order to account for the fact that TP should not get complete FMV b/c there has to be some accounting for the circumstances in which she got it

* 1. Principle rationales for realization requirement in ***Macomber***:
     1. (1) Liquidity – unfair to tax w/o cash [paper profit does not equal cash]
     2. (2) Administration – valuation problems (in which year should the appreciation be taxed?)
     3. (3) No change in investment/risk – TP hasn’t yet “cashed out”; TP has not eliminated her business risk
        1. Possible disposition events: sale; settled debt
           1. Gifting is not a realization event
           2. If you are able to cash out your investment, that ought to be a good time to tax
        2. The economic risk rationale is key
     4. (4) [added below by ***Woodsam***]
  2. Potential drawbacks/adverse results from the realization requirement:
     1. (1) Fairness – horizontal equity
        1. TPs who get their income from unrealized gains are treated differently from people who get their income from a salary
           1. TPs with unrealized gains benefit from the time value of money
     2. (2) Inefficiency – distorting investment choices; unnecessary “subsidy” for savings
        1. People go more into vehicles that have unrealized gains than they would have otherwise (subsidy = deferral)
     3. (3) Administration – definitional challenges
        1. When is it a realization event? What is a “disposition”?
           1. This may not be easy – see ***Woodsam***
  3. Alternatives to the realization requirement:
     1. (1) We could take the Netherland’s approach
        1. Tax on the presumed value of appreciation (taxed on the imputed return w/o regard to the receipt)
           1. Imputes realization w/o actually having it
     2. (2) Mark to market
        1. Zuckerberg tax?
           1. See article
        2. Certain group of high income tax payers should not be able to take advantage of the realization requirement advantage and should have to use the mark to market approach
  4. Examples:
     1. (A) If ***Macomber*** TP had gotten cash instead of stock but still didn’t increase in wealth, this case would come out differently.
        1. Now TP has something severed from the capital (but we don’t care about this after ***Glenshaw Glass***)
        2. The cash would not be subject to the business risk and it would be liquid (so could pay taxes on it)
        3. No valuation problem
           1. Valuation problem with the stock dividends is that we don’t know if the price accurately recognizes the TP’s appreciation over time (this makes it a hard argument that the dividend event should trigger a realization event)
        4. PROF: cash would trigger a realization even & would be taxed
     2. (B) Year 1, J inherits a book collection with FMV = $10k. Year 2, he gets it appraised and it has a FMV = $12k. Year 3, he transfers the collection to K to pay an outstanding debt.
        1. Year 1- gift under **§ 102**; stepped up basis under **§ 1014** of $10k
        2. Year 2- nothing happens b/c mere appreciation (no realization)
        3. Year 3- depends on the value of the debt to K 🡪
           1. If the debt = $15k and J pays off the debt in full of $15k

**§ 1001** analysis – J’s A/R is $15k (this is a realization event)

A/R ($15k) – Basis ($10k) = $5k taxable gain

* + - * 1. If the debt = $15k and collection is only worth $12k when given to K

This is a realization event (collection is used to pay the debt in part). Discharge of debt is $3k.

**§ 1001** – A/R is $12k

Basis is still $10k, so $2k gain on this transfer

PLUS $3k of COD income for J

* + - 1. If K agrees that the collection is worth $15k (even if FMV is $12k), there is NO COD for J.
  1. **§ 305**
     1. Non-recognition provision
        1. Codifies ***Macomber*** holding that a stock dividend is not a proxy for taxing
     2. If **(a)** applies, then the basis adjustment rules of **§ 307** apply [ie. the A/B of the “old” stock is spread out over all the shares]
        1. This is how we have deferred the taxing of the stock dividend [when you start selling some of them, the gain will be taxed then]

1. Limits of Realization
   1. ***Woodsam Assoc. v. Comm.*** [1952]
      1. Legacy: adds 4th rationale for realization requirement 🡪 formalism of **§ 1001** matters [meaning of “disposition”]
      2. Facts
         1. 1922: Wood buys property for ~300k
         2. 1931: Wood mortgages property (nonrecourse) for $400k
            1. Wood refinances using the property as collateral (takes a mortgage consolidation that is in excess of what she paid for the land)
         3. 1934: Creates a corporation and transfers this property to it
            1. The corporation is a legal entity. Takes shares back in return.
            2. **§ 351** allows corp. to have the transferred/same basis as Wood
         4. 1943: Foreclosure/final disposition
      3. Issue: Taxable gain in 1943 upon foreclosure? Yes, there is an A/R but the argument is over what happens to A/B and whether it increased when the property was mortgaged
         1. TP argument: mortgaging property = cashing out (ie. constructive sale), so there should have been a gain in 1931 and a new stepped-up basis to the value of the property starting in 1931 [of $400k]
            1. Problem for gov’t is that it can’t go back to 1931 to get these taxes
         2. IRS argument: getting a loan on this property in 1932 is not a disposition, hence not a realization event. It is loan proceeds—TP was still the owner.
      4. Held: for IRS
         1. This is just a loan & the property is collateral [mere borrowing is not a realization event]
            1. Look to **§ 1001** meaning of disposition
            2. TP remained owner, thus no disposition
         2. PROF: this is an odd position for the gov’t to take b/c normally the gov’t wants to recognize income/taxable gain right away
            1. Here, they were forced to deal with this individual case
            2. IRS won the battle but lost the war – b/c TP can keep deferring the unrealized gain while still getting the benefit of the cash now
      5. Apply these facts to our policy rationales for realization events:
         1. (1) No liquidity problem here
            1. TP did have cash to pay the tax (came from the loan itself)
         2. (2) No real valuation problem here
            1. Some 3rd party lender looked at this property & decided to give $400l nonrecourse loan based on that collateral, so someone did due diligence and came up with a number

A bank would do this b/c they had some notion of the value of the property [matters that it was NR b/c bank could charge a higher interest rate]

* + - 1. (3) Good argument that there was a change in risk exposure [and this this was a realization event]
         1. Losses will not fall completely on the TP b/c it is a nonrecourse loan
         2. The upside is that if the property value continues to rise, the TP will probably continue making her loan payments [she maintains the upside risk just by servicing the loan properly]

But if the value of the property dips below the loan amount, TP’s econ incentives are to walk away [she has thus contained her downside risk—she has essentially taken a loan with a “put option”]

“Put option” is a right to sell something in the future at a specified price

Very pro-TP

* + - * 1. But court argues that there is an administrative argument here

If this was a realization event (if court had gone the other way), a lot more scrutiny would be necessary to make sure that there was realization on certain loans, and this would be too hard to administer

So instead add a FOURTH realization requirement: (4) adherence to legal formalism of **§ 1001**

* 1. SEE PROBLEM ON SLIDE ON CLASS #18
  2. ***Woodsam*** & ***Crane*** problem
     1. Year 1, E buys apt building for $400k ($100k cash + $300k NR mortgage). Year 4, property appreciates to $1mm & E borrows (NR) an additional $600k (onto existing mortgage). Year 5, E sells property: receives $100k cash and buyer assumes $900k mortgage
        1. **§ 1001** analysis: basis for apt = $400k [***Crane*** principle, allows debt to be added to basis initially]
        2. Appreciation in year 4 is a non-taxable event
        3. Additional $600k mortgage taken in year 4 would not be added to basis b/c this is not a realization event under ***Woodsam*** [PROF: this looks like a cash-out event, but it’s not per ***Woodsam*** and b/c TP is taking advantage of unrealized/untaxed gain]
        4. Year 5:
           1. A/R = $1mm [b/c cash + $900k assumed mortgage b/c it was initially built into basis per ***Crane*** symmetry]
           2. A/B = $400k [b/c the NR mortgage was built into basis]

Additional $600k loan was not added to basis b/c of ***Woodsam*** & b/c it was a loan (aka untaxed/unrealized gain, thus shouldn’t be included in basis)

* + - * 1. Gain = $600k
      1. Note: not COD going on here, b/c COD only happens when creditor says that debtor can pay creditor less

1. Realized Losses
   1. ***Cottage Savings v. Commissioner*** (1991)
      1. Facts:
         1. Cottage Savings is a savings & loan assoc.
         2. In this transaction, CS is swapping mortgages to realize a tax loss (while not recognizing an accounting loss)
            1. Due to interest rate market going up in 1970s, which led to losses in mortgages in CS’s portfolio
         3. ***Memo R-49***
            1. Issued by regulatory body
            2. Relaxed accounting rules to these S&Ls wouldn’t go BK
            3. Encourages the S&Ls to do these swaps to take advantage of the tax losses

Nudged the S&Ls to do these swaps to take advantage of the tax losses

The value of the swaps (A/R) is much less than the A/B (will recognize a loss)

* + 1. Issues
       1. 1st: Is this swap a realization event?
          1. IRS argument: swap is not a realization event and suggests a substantive econ test

For this swap to be a realization event, the two things being swapped have to be “materially different” [both parties agree on this]

To determine material difference, the IRS argues the need to get to the subjective value between the swappers [Court thinks this is a hard test—admin nightmare]

* + - * 1. TP argument: Yes, swap is a realization event b/c mortgages were materially different
    1. Held: Swap is a realization event b/c assets were materially different
       1. Agree that the legal standard is “material difference”
          1. To define this standard, looks to corporate reorganization case law
       2. Rationale:
          1. Test for “materially different”: look to see if there are legally distinct (different) entitlements

Highly formalistic difference re: differences in legal entitlement

Go back to notion of what realization is about

To Maj—the principle goal of realization is not to deal with risk; concerned with administrability

* + 1. Difference from ***Macomber***
       1. ***Cottage Savings*** says that realization is merely an administrative out that makes it easier to run the tax system
       2. Hammers home the fourth rationale created in ***Woodsam***
    2. Legacy
       1. Can easily trigger a realization event after this case (hair trigger)
          1. All TP has to do to trigger realization is to swap legally distinct property
          2. People can exploit this to cherry pick losses (freedom from the looseness re: taking advantages of losses)

Later, capital loss statutes limit this cherry picking

* + - 1. Benefits of this formalistic system:
         1. Certainty (administrability; predictability)
      2. Drawbacks of this formalistic system:
         1. Legal form over economic substance

Disconnect/fairness issue when compared to the other areas where econ substance is emphasized

* + - * 1. Easy to trigger realization—gives TP almost control to trigger losses

Will hold on to their gains to keep benefit of deferral

This may lead to unfairness from gov’t POV

But there are limits, in that losses themselves have limits (see more in capital gains & losses)

* + 1. NOTE: losses dictated under **§ 165**
  1. Capital Losses
     1. **§ 1211**
        1. Corps’ capital losses are limited to gains per **§ 1211(a)**
           1. Another example of “basketing”/”netting”
        2. Individuals also limited to gains, but excesses can be applied against ordinary income up to $3k per **§ 1211(b)**
     2. Policy rationale
        1. Prevents cherry-picking of losses
           1. IRS: if TP wants to take losses, has to take some gains this year, too
  2. Realized Gains Problem
     1. H & K are individual, independent dealers of cotton. They each buy lots of cotton and put it in storage. Toward the end of the year, the price of cotton has fallen; each has unrealized losses on stored cotton. They want to hold on to inventory and realize the losses.
        1. To do this, they could just trade warehouse receipts [exchange legal entitlements under ***Cottage Savings***]
           1. This would trigger a tax loss

PROF: this is an exploitation of tax losses [b/c there is no substantive economic transaction]

1. Intro to Non-recognition
   1. Basics
      1. “Lock-In Effect”
         1. Example: A owns property X w/ FMV = $100k & A/B = $50k. A would like to change investments and buy property Z with a FMV = $100k. A may be deterred from making this decision b/c sale would trigger gain of $50k [A/R = $100k & A/B = $50k, so gain = $50k—which is a huge tax bite].
            1. This taxable gain “locks” A into this investment in a sense. She may be further deterred from taking this new investment opportunity if she is older in age b/c of **§ 1014**, which says that there is a stepped up basis at bequest (which will exacerbate the lock-in effect)
         2. How to mitigate the “lock-in effect”?
            1. **§ 1013**: exchange of like-kind basis can defer tax (grant non-recognition treatment to this kind of swap)
            2. Besides **§1013**, long-term capital gain is taxed at a lower/preferential rate in order to mitigate the lock-in effect
            3. Could also get rid of realization (use mark-to-market system that taxes appreciation every year)

B/c one of the drivers of the lock-in effect is realization

* + - * 1. Could excuse/defer tax when TPs case out of investment and use that cash to invest in new investment

But if you go so far as to excuse taxes on reinvestment of all savings/roll-over of investment, income tax would only be based on consumption (instead of now, which is based on savings and personal consumption)

* 1. **§ 1031:** “Like Kind Exchange”
     1. Non-recognition provision [new category]
        1. Recognition is a 2nd-order question (after realization)
     2. No gain/loss will be recognized …
        1. **§ 1001(a)** def of gain
        2. **§ 1001(c)** recognition of gain/loss
           1. Default rule: realized gains are recognized except as otherwise provided … [**§ 1031** is one of these exceptions]
     3. **§ 1031(a)(1)**
        1. Must be exchange/swap [can’t be a sale for cash] of properties used in trade/business [not property for personal use]
           1. Ie. can’t convert business warehouse into personal residence and use this provision
        2. PROF: provides non-recognition of gain/loss when business/investment property is exchanged for other business/investment property of like-kind
     4. Policy rationale
        1. Liquidity & valuation
        2. No change in investment risk – really haven’t cashed out
        3. Encourage mobility of capital [mitigate lock-in effect so money can gravitate toward its best investments]
        4. History – this was originally allowed for horse trading
           1. This inertia led to exploitation (started small, so legislature was willing to concede it, but it has exploded and is now listed in the tax expenditure budget)
     5. **§ 1031(b)** Gains from exchanges not solely in kind
        1. Boot
           1. When swapping like-kind property, it is rare that the values will be identical—one party will throw something into the transaction “to boot”

This boot has to be something that is not like-kind (can be cash but doesn’t have to be)

* + - 1. **§ 1031** is meant to facilitate truly like-kind exchanges, so if TP is getting something extra (cash as boot), there is no liquidity or valuation problem
         1. In a sense, if you get cash, you have cashed out some of your risk and non-recognition benefits of **§ 1031** shouldn’t apply to the boot (this part should be recognized gain)
    1. **§ 1031(d)** Basis adjustment
       1. Property acquired in **§ 1031** swap gets transferred/same basis as the land given [decreased by the amount of money TP may have received and increased by the amount of gain/decreased in the amount of loss to the TP]
          1. Ie. if you get boot, you have to account for it in this readjustment to the basis of the acquired property
       2. “If the property so acquired consisted in part of the type of property permitted by this section, **§** [**1035**](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00001035----000-)[**(a)**](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00001035----000-#a)**, §** [**1036**](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00001036----000-)**(a)**, or **§** [**1037**](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00001037----000-)[**(a)**](http://www.law.cornell.edu/uscode/text/26/usc_sec_26_00001037----000-#a), to be received without the recognition of gain or loss [LIKE KIND PROP], and in part of other property [BOOT], the **basis provided in this subsection shall be allocated between the properties** (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange.”
       3. Conceptually:
          1. Basis is a proxy for what TP has already put in with after tax dollars
          2. If you do a **§ 1031** transaction and have a boot, this book cash is realized and recognized.

TP ought to get credit for this taxed cash – it ought to be added to basis 🡪 **original property basis + gain recognized**

Total basis to be allocated b/w property received (ie. swapped property and boot)

Ie. If boot is $10k cash, its basis is $10k. If you get a tractor as boot, take the FMV of the tractor to find its basis. Whatever is left is allocated as basis to the acquired property.

* 1. “Like-Kind” Eligibility
     1. Personal use property not eligible per **§ 1031(a)(1)**
     2. Other exceptions to eligibility under **§ 1031(a)(2)**
        1. Stocks, bonds are excluded b/c this would create a gaping hole (too big of a give away)
     3. ‘Like kind property’
        1. **Treas. Reg. 1.1031(a)-(b)**
           1. FIND DEFINITION HERE
     4. PLR 200203033 in CB
  2. Mechanics of “Like Kind”
     1. (1) What is the realized gain/loss?
        1. **§ 1001**
     2. (2) What is the recognized gain/loss?
        1. **§ 1031(a)**; with boot, look to **§ 1031(a), (c)**
     3. (3) What is the basis of the acquired property? To make sure this is a deferral, and not an exclusion
        1. **§ 1031(d)** – if the values are equal, the basis of the acquired property is the same as the property the TP exchanged (transferred basis)
           1. Formula: [initial basis of prop TP is giving up - $ received + recognized gain/(loss)]
  3. Examples
     1. Plain Vanilla Like-Kind Exchange
        1. TP A has prop X (A/B = $40k & value = $60k). TP B has prop Z (Value = $60k). Prop X & Z are of like-kind.
        2. 1st step: **§ 1001** to determine gain/loss
           1. For TP A, A/R = $60k

A/B = $40k

Realized gain = $20k

* + - 1. 2nd step: apply **§ 1031**
         1. None of this $20k gain is recognized b/c there is no boot [fits **§ 1031(a)(1)** exactly]
      2. 3rd step: what is the basis for prop. Z now that TP A got it in the swap?
         1. New A/B of prop. Z is $40k for TP A (transferred from prob X]
      3. If TP A sells prop. Z for $60k cash ten days after doing this swap:
         1. Straightforward **§ 1001** disposition

Realized & recognized gain is $20k (this is the culmination of the deferral of the built-in gain)

* + 1. Like-Kind Exchange with “Boot”
       1. TP A has prop. X (A/B = $40k & value = $60k). TP B has prop. Y (value = $50k + boot = $10k).
          1. (1) This is a realization event

After swap, for TP A 🡪 A/R = $60k

Cash + property

Realized gain = $20k

* + - * 1. (2) **§ 1031** does not apply; **§ 1031(b)** applies

How much of this $20k gain is recognized and taxed?

$10k of boot is recognized gain

This makes sense b/c the policy rationales for non-recognition don’t fit for boot (esp. cash)

* + - * 1. (3) New A/B of property Y

$40k basis for the like-kind property ($10k basis for the boot)

(40k – 10k + 10k) per **§ 1031(d)**

$50k total basis (b/c taxed now on $10k [boot] of the $20k gain)

The rest of the $10k in unrealized gains will be taxed later

* + 1. When Boot is **Greater** than the Realized Gain
       1. TP A has prop. A with a built-in gain of $20k [A/B = $40k & value = $60k]. TP B has prop. W [value = $35k & boot (cash) = $25k].
          1. (1) For TP A, A/R = $60k

A/B of prop. A = $40k

Realized gain = $20k

* + - * 1. (2) The boot is $25k, but the recognized gain is only $20k [recognized gain is capped at the amount of realized gain]

**§ 1031(b)**

* + - * 1. (3) New basis of prop. W

$35k

[40k basis of prop. A – 25k cash received + 20k recognized gain]

Per **§ 1031(d)**

$60k of basis to allocate out [b/c taxed on $20k of gain + $40k original basis]

$25k basis goes to the cash

$35k is the remainder

Basis of received property = remainder after subtracting FMV of boot from total basis = $35k (60k – 25k)

This ensures that there is no double taxation

This transaction recognized all of the $20k built in gain

Any subsequent sale of prop. W ought not to lead to any tax, and it doesn’t (b/c the A/R [FMV of prop] will equal the A/B)

Adjust basis downward to show that TP cashed out in excess of the realized gain

* + - * 1. Note: TP should be able to capture in basis any after tax dollars paid [basis keeps track of capital investment, ie. how much is going to be recovery of capital]

If there is no boot, there is no recognized gain in a swap of like-kind property

* + 1. Giving UP of Boot
       1. If you [TP A in the above examples] add cash to the transaction, there would be an upward adjustment to basis b/c you used after tax dollars
    2. Like-Kind Exchange with Loss
       1. TP A has prop. A (A/B = $40k & value = $30k 🡪 loss property). TP B has prop. P (value = $25k & boot = $5k)
          1. (1) For TP A, A/R = $30k

A/B = $40k

Realized loss = $10k

* + - * 1. (2) Recognized loss = $0 per **§ 1031(c)**
        2. (3) New basis of prop. P = $35k

(40k – 5k + 0k) per **§ 1031(d)**

* 1. Sale or Like-Kind Exchange?
     1. ***Carlton v. US***
        1. TP had a ranch and wanted another ranch and was looking for a **§ 1031** exchange. TP found someone (X) who wanted his ranch but who didn’t have like-kind property to swap. X found another ranch, bought it, then swapped. Instead of a true **§ 1031**, X messed it up by actually writing a check for cash – this mucks up the transactions
           1. Notes:

These transactions can get really complicated

FORM matters for **§ 1031** (cash can muck it up)

IRS obviates the tax benefit of deferral when form isn’t right

This is an example of a 3-corner exchange

* 1. Other Non-Recognition Provisions
     1. **§ 1033:** Involuntary Conversions
        1. If there is an involuntary conversion and it is into property “similar or related in service or use” … it is no recognized gain as long as TP uses the money to buy the same kind of property
           1. Different standard than “like kind”
        2. Ie. It is a realized gain but not recognized gain if the gov’t takes your warehouse via eminent domain and pays you, etc. (even though this would be a realization event) if you use the money to buy another warehouse.
           1. Transferred basis to the new warehouse. Deferral of this gain until you sell the new warehouse.
        3. Realization event + reinvestment into similar property
           1. Provision doesn’t say anything about the source of the destruction

PROF: good argument that this would apply to a tort settlement re: destruction of the warehouse

* + - 1. Problem:
         1. J has a business warehouse (FMV = $100k, A/B = $80k). Fire destroys warehouse; J gets $100k of insurance proceeds. If J builds a new warehouse with insurance proceeds, tax consequences:

(1) Getting insurance proceeds is a disposition event; **§ 1001** analysis

A/R = $100k

(2) If all of the money is used to buy a new warehouse, no recognized gain per **§ 1033**

(3) A/B in new warehouse is $80k

* + - * 1. If J got $100k in insurance proceeds but it actually cost $110k to build the new warehouse, TP’s basis in the new warehouse should be adjusted upward by the $10k paid in after-tax dollars.
    1. **§§ 109, 119**: Leasehold Improvements
       1. GET MORE FROM SLIDE
    2. COD Income & its exceptions
       1. GET MORE FROM SLIDE

1. Deemed Realization
   1. Short Sale
      1. Short Sale = speculators think that a stock price is going down/it is overvalued (opposite of buy low/sell high, long term position)
      2. Example:
         1. C borrows 100 shares of GOOG (from his broker) when it is worth $500/sh, and immediately sells the shares for $50k. But he still owes his broker 100 shares of GOOG (not the $ amount)
            1. Risk position? C wants GOOG stock to go down

If the price of the shares goes up and C has to pay back 100 shares to his broker in a few months, he will lose money on this deal

* + - * 1. C would short GOOG stock if he thinks that it is overvalued
  1. Short Against the Box & Deemed Realization
     1. “Box” = safety deposit box where you hold the stock that you already own
        1. Summary:
           1. TP gets $ upfront w/o immediate tax liability
           2. Neutralized risk exposure
           3. “Constructively sells” his stock to his broker
        2. Legal formalism
           1. TP still “owns” the shares, no sale/no realization

But he eliminates his risk

* + - 1. Meant to be a deferral
    1. Why would the TP/investor want to “short” his own stock?
       1. TP may want to diversity
       2. If TP is an early founder/EE of a start-up …
          1. C owns 100 shares of GOOG (cost basis = $1k; FMV = $50k)

There’s a disincentive for C to sell these shares outright (in order to diversify) b/c he would have a huge tax liability

“Short sale” – instead, C could borrow other GOOG stock from his broker, get the $50k upfront like in a regular short sale

There is no risk exposure now, b/c if GOOG stock goes up, he loses money on the short sale but he makes money on the stock that he already owns. If the stock goes down, the short sale stock goes up and the stock he already owns goes down (exactly equivalent)

In this short sale, no tax consequences for the GOOG stock he already owns (he has not sold his stock outright)

But this is not a wash b/c C has diversified his portfolio w/o taking a tax bite. **He also now has $50k of cash** and he can do whatever he wants with it (he has cashed out and still avoided the tax)

The formal legal rights do not comport with substantive economic risk, here

He does a realization event w/o a realization event (this is why it’s called deemed realization)

It’s formally not a disposition event, but looks a lot like one

The $50k cash and TP’s loan agreement in borrowing from his broker is not a taxable event (it is a loan)

But TP still has his outstanding obligation of the borrowed shares

But in reality, broker will let the TP roll over the borrowed stock year after year

This roll-over for god knows how long is deferral

* + 1. Formal legal aspects of a transaction v. economic substance
       1. If we only pay attention to formal aspect, we are going to let people who are doing funny things slip through the cracks
       2. Form matters in tax law [**§ 1031** & ***Cottage Savings***]
          1. BUT economic substance should trump legal form when the two are radically inconsistent (potential TP abuse)

Like in the short against the box example

* + 1. Congress responds to this problem with **§ 1259**
  1. **§ 1259**
     1. Congressional response to deemed realization
     2. “If there is a constructive sale [ie. short against the box type transactions] of appreciated financial positions [ie. above GOOG stock], TP shall recognize gain as if such position were sold, assigned, etc.” [ie. TAXED]
        1. Congress is really saying that economic substance trumps legal form
           1. Plug this gaping hole caused by the legal formalism that TP still technically owns the shares

There are still gaping holes in **§ 1259**, but still addresses the problem and says that economic substance trumps legal form

* + - * 1. This applies to zero cost collars, etc., too
    1. This section applied to ***Woodsam***
       1. Woodsam TP still had an upside risk [enough risk maintained in Woodsam transaction that probably wouldn’t fit into **§ 1259**]
          1. Whereas in **§ 1259** transactions, there is a complete neutralization of risk
    2. Before **§ 1259**, when C (above) “closes out” his short sale (ie. pays his broker back on the short position)
       1. C gives broker “legal title” to shares
       2. Fulfills short sale legal obligation to repay
       3. TP realizes gain then
          1. $49k (A/R = $50k – A/B = $1k) in above example

TP would get benefit of deferral

* + - 1. **§ 1014**: keep in mind with this “close out” might come
         1. TP might keep rolling it over until TP dies and can use the stepped up basis with the estate tax (then a huge gain that won’t be taxed at all)

1. Original Issue Discount [OID]
   1. Coupon Bond
      1. Debt instrument that pays regular interest (ie. cash payment of interest)
         1. Coupon represents the right to interest
         2. Coupon rate = interest rate (get is annually, semi-annually, or however the agreement is set up)
         3. This is how private & public entities raise money
         4. TP is taxed on the interest income whenever it is paid out
   2. Zero Coupon Bond
      1. Debt instrument that pays back “only” at maturity (ie. no explicit annual interest payment)
         1. Ie. TP buys the right to receive $100 in ten years
            1. Won’t give $100 right now (time value of money); buried in the original issue discount
      2. Main tax issue:
         1. (1) Stealth Interest
            1. The interest isn’t explicitly paid out every year, so there is interest in disguise/stealth interest (the value of the bond is changing over time even though there is no cash interest)

And we want to treat the regular coupon bond holder and zero coupon bond holder equally for horizontal equity

* + - 1. (2) Mismatching
         1. Example: On one end, the cash method TP who holds a zero coupon bond doesn’t receive any cash interest and will thus argue for a deferral. BUT on the other end, the issuer of the bond (ie. Eli Lilly) would use an accrual method to deduct the interest as an ordinary business deduction.

This is a huge mismatch

The IRS is getting hurt at both ends (deferral for TP and deduction for issuer)

* + - 1. (3) Substance v. Form
         1. Formal cash flow analysis or econ substance of the transaction?

Liquidity is a formal issue

* + - * 1. But has the market already accounted for the deferral of the zero coupon bond and this would have been an implicit tax?
  1. OID
     1. Debt instrument issued at a “discount” to the “face value” or payment at maturity
        1. E.g. D buys 5-year bond that pays $100 at maturity, and has issue price of $62.
           1. Face value = $100
           2. Issue price (“discount”) = $62
           3. Imputed interest = $38
     2. **§§ 1272 - 1275**
        1. Inclusion provision
           1. Tells what the TP has to include in income

Included in GI = an amount equal to the daily portions of the OID for each day during the taxable year on which holder held such debt instruments

* + - 1. This applies to a TP who is the holder of any debt instrument having an original issue discount
         1. This is a late addition to the code (1980)
    1. Why do we have these rules?
       1. Fairness & horizontal equity
          1. E.g. If D invested $62 in a CD (savings) that paid annual interest of 10%

Annual interest payments from this CD would be taxed to D

Why should anything change if D buys a zero coupon bond instead of this CD? They are functionally equivalent investments

* + - * 1. E.g. If D buys a zero-coupon bond for $62 that pays him $100 in 5 years

The present value is the driver of the OID #

This $62 lent up-front and $100 in return in 5 years is the equivalent of earning 10% yearly interest

W/o **§ 1272**, TP would defer his interest payment on $38 gained in interest until year 5 (unlike the CD TP who would have to pay every year)

But the issuer of the zero coupon bond if likely taking deductions every year

* + - 1. To achieve this matching b/w issuer deduction and TP interest inclusion, we are forcing a cash-based TP to essentially be an accrual-based TP
         1. Now we don’t have these cash-based TPs buying these zero coupon bonds—tax exempt pension funds will likely be buying them instead [not a great revenue raiser, but we have gotten back to consistency in the code)
    1. OID Income = value of bond (at end of previous period) x interest rate
    2. Example [OID Rules applies to property sales]
       1. C owns a farm (FMV = $386k), which he sells to IBM for zero coupon bonds that have an issue price = $386k; redeemable in 10 years for $1000k
          1. OID buried in these bonds. Even though C doesn’t get any cash when he makes this deal – there will still be “interest” income every year that is taxable as OID income
       2. If IBM gave C a note paying $1000k in ten years:
          1. OID rules should be applied here (the same treatment as #1)

If TP is promised a larger amount down the road, there is buried interest

* + - 1. If C’s basis in the farm is $300k; sells it to IBM for a promissory note (promise to pay $1000k in ten years)
         1. Discount the final $1000k payout to present value ($386k = present value of the note)

TP gain of $86k at moment of transaction (**§ 1001** analysis🡪 $300k basis - $386k present value of note)

All of this will be realized and recognized (default rule b/c note and farm are not of like-kind)

This is a disposition event

TP’s basis on the note is $386k

**TP will pay taxed on the $86k upfront PLUS the additional OID income over the ten years**

1. Open Transactions & Installment Sales
   1. Taxing Future (uncertain?) Payments
      1. ***Burnet v. Logan*** [1931]
         1. Facts
            1. TP owns stock (basis = $180k)

A/R in sale transactions: for her shares, TP gets $120k cash plus future yearly payments w/ present value = $100k (based on ore production)

* + - 1. Arguments
         1. TP

This should be treated as an “open transaction”—which means that due to the uncertainty of what TP is going to get in the future (plus liquidity issue of the fact that she doesn’t get the cash now) 🡪 TP should be able to defer tax until she has recovered ALL of her basis

“Open transaction” = all recovery of capital (basis) first

Yearly payments from the mine company shouldn’t be taxed until TP receives the $60k that was left of her basis [her basis was $180k = $120k cash she got upfront]

Shows same principles as ***Inaja***

There may not be as much ore we you think – open transaction in the ***Macomber*** sense (still open to future risk; future payments are susceptible to the vagaries of the market, so ought not to be taxed on the payments until basis is recovered)

* + - * 1. IRS

This is a “closed transaction”

Present value of the future payments is the functional equivalent of cash, and represents a gain on sale.

A/R = $220k; A/B = $180k; gain = $40k

This $40k would be a realized/recognized gain

B/c TP is taxed on it, she will not have a basis in future payments. The additional, future payments would then chip away at THAT basis (of $100k)

* + - 1. Held: for TP
         1. Adopts a “basis-first” rule (***Inaja***-type rule)

Strong valuation problem

Can’t accurately value the total realized amount at the moment of disposition

So go with a more formalistic rule due to no ascertainable FMV

* + - * 1. Benefit of deferral to the TP
      1. Reasoning
         1. (1) NO cash equivalency [b/w cash and promise of future payments]

Liquidity problem

* + - * 1. (2) Uncertainty

This is the heart of an open transaction – court buys the TP’s argument that these payments are still susceptible to the vagaries of the market

* + - 1. Implications
         1. Advantages to TP’s position

Easier to do this

If there is uncertainty re: value, this is the much more administrable way to go (even though it may be overly fair to the TP)

* + - * 1. Disadvantages to TP’s position

Tax revenue loss? Very friendly to TPs

To take advantage of this case TPs could put uncertainty/contingency into their future payments to get the benefit of tax deferral

Congress as not comfortable with this, so came up with a middle ground via **§ 463**

* + 1. **§ 453**
       1. Permits partial non recognition of gain when installment method of payment is used for sale of property
          1. TP has a choice to elect for this
          2. Not a direct response to ***Burnet v. Logan*** b/c that case turned on the uncertainty of the valuation of the future payments
       2. **(a)** Applies to structured payments under the installment method
          1. ***Burnet v. Logan*** rule only in very RARE circumstances when there is a huge amount of uncertainty [harder to use this case now that **§ 453** is on the books]
       3. **(b)** Installment sale defined
       4. Exceptions: dealer dispositions ... the nature of inventory turns over
       5. **(c)** What the installment method is
       6. Example
          1. T sells property with A/B of $300k for $500k to be paid over 5 years in equal installments of $100k

**§ 453** permits partial non-recognition of gain when installment method of payment is used for sale of property

Use ratio between gross profit & total contract price

Gross profit = $200k; total contract price = $500k

**Ratio = 40% (2/5)** to be recognized and taxed

The other 60% will be a recovery of basis

Thus, every year only 40% of the payment is taxed ($40k) until basis is exhausted

Pro rata distribution as rough justice/middle ground

1. Constructive Receipt
   1. **Treas. Reg. § 1.451-2**
      1. Income is “constructively received” when:
         1. Credited to TP’s account; or
         2. Set apart for TP; or
         3. Made available so that it could be drawn upon at any time (or with notice)
      2. Not constructively received when substantial limitations on control of income remain
      3. Will put a limit on the extent to which TPs can say they are on the cash-method of accounting
   2. “Constructive”
      1. May not have actually/explicitly received income in a full sense, but if you have constructive receipt, you ought to count it as income
   3. Limits of Constructive Receipt
      1. ***Amend v. Commissioner*** (1949)
         1. Facts: Cash-TP/farmer adopts practice in 1942 of delivering wheat in Aug. and getting paid the following Jan.
            1. Burris (customer) typically paid supplier when wheat was delivered
            2. But Amend purposely pushed back his entitlement to this money until Jan. via this contract (court hands its hat on this legal formalism)

Amend does this for business reasons, NOT taxes

* + - 1. Issue: when does Amend (TP) receive income?
         1. When he sells the wheat in Dec. 1944 of when he receives the check in Jan. 1945?
      2. Argument:
         1. IRS: TP could have asked for the money in 1944 upon delivery of the grain (essentially arguing the Treas. Reg. of constructive receipt of income)
         2. TP: He has good business rationales for doing this—he was being consistent and wasn’t a tax ploy.

This was an arm’s length transaction

Important b/c the bona fides of this deal are not in question

The sale contract says that delivery will happen in Aug. and payment will not be delivered until Jan. of the following year [Court looks at this K]

* + - 1. Held: for TP
         1. TP receives income when TP receives payment (Jan. of the next year). Constructive receipt turns on legal entitlements.

Form > substance 🡪 triumph of administrability

Here, application of the doctrine of constructive receipt turns on the formal entitlements in the legal K

B/c of the K terms, TP wasn’t legally entitled to the payments until Jan. of the next year.

***Cottage Savings*** also looks to these formalistic legal entitlements [to measure material difference in a swap]

* + - * 1. Recognizes that there are limits to the doctrine of CR and we have to look at the formal K
      1. If gov’t has won this case 🡪
         1. Would have to read into all of these Ks to determine whether they are at arms length and scrutinize the business practices

Instead, TP wins for the administability (just look to the K terms)

* + - 1. How much is at stake in this case?
         1. This is a small deferral for the TP

But farmers are evening/averaging business out, so it isn’t a huge revenue loss here [so respect the K]

* + - 1. If there is doubt re: whether this K was at arm’s length—
         1. Constructive receipt probably would apply if this looked like a tax ploy

Don’t open the door to allow murky Ks to take advantage of this case

* 1. Reconcile Constructive Receipt w/ H-S Notion of Income?
     1. If your salary has been set aside for you in Dec. but you don’t pick it up until Jan., you still pay tax on it in Dec.
        1. If TP has control but doesn’t have physical control, he is still better off in econ substance (could still assign it to TP’s creditors, etc.)

1. Economic Benefit Doctrine
   1. Murky distinction b/w doctrines of constructive receipt and economic benefit
   2. ***Pulsifer v. Commissioner*** [1975]
      1. Facts: Father bought winning lottery ticket from himself and children; kids’ winnings were placed in a bank account b/c they were minors (could get it out when the were 21 or when father applied for it)
      2. Issue: timing 🡪 when do the kids have the income?
         1. Ie. What happens to the other ¾ of the winnings?
      3. Held: All of the winnings are taxable in the year they are won (when the money was placed in the bank account on the kids’ behalf)
         1. B/c of the economic benefit doctrine (not constructive receipt)
         2. It is income when funds are irrevocably set aside
            1. This is the key that makes this economic benefit and not CR, to the court
      4. Economic Benefit Doctrine
         1. Individual on a cash method is currently taxable on the econ and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor’s creditors
      5. Rationale
         1. The kids are benefitting from the money right now (interest income)
         2. Key fact: if they could only get the money when they reached 21, may be more difficult to apply this doctrine, but the mere fact that the dad could trigger the payment made this case easy (the family as a unit had control over this money very early on)
      6. PROF: not sure why this is not constructive receipt
   3. Problems
      1. (1) L agrees that T can collect check at any time
         1. Classic example of constructive receipt
      2. (2) Alternatively, L agrees to put T’s payment in a special bank account but T can’t withdraw funds until Jan. 1
         1. PROF: doesn’t fit within constructive receipt, but may fit econ benefit doctrine per the murky case law b/c it has been irrevocably set aside for the TP
            1. TP could easily borrow against this money (shows a lot of dominion and control)—so ought to be taxable to TP
2. Transfers Incident to Marriage & Divorce
   1. Cash and non-cash transfers are not treated the same
   2. Property Settlements Incident to DR
      1. Tax Issues
         1. TP/Maria transfers appreciated stock (FMV = $100k; A/B = $60k) pursuant to a DR agreement to ex-spouse, Arnold.
            1. (i) Is there a realization event?
            2. (ii) There is a movement of property—how do we treat this? Is it deductible by payor and includable by payee (or the reverse)?
         2. What if the above transfer was in exchange for legal services (not related to DR)?
            1. For lawyer, included in income as compensation under **§ 61(a)**
            2. For Maria, need more facts re: what the legal services were for:

If they were for an adoption, not deductible b/c adoption is personal consumption; but

Deductible as business expense if the services were to set up Maria’s LLC

* + - * 1. This is a realization event when Maria pays for legal services with appreciated stock (straightforward **§ 1001** analysis)

Maria would have a gain of $40k on this transaction

* + 1. Old case law
       1. ***U.S. v. Davis*** (1962)
          1. Parts of this case are still good legal arguments
          2. Facts:

TP (husband) transfers appreciated stock pursuant to DR agreement to ex-spouse

* + - * 1. Issue: does TP recognize gain? And if so, how much?
        2. Held:

Gain to husband/TP is determined by the value of the consideration transferred by TP (this is how we value the dower rights that the wife is giving up)

This is still good law

There is a taxable event here b/c looks like a disposition event (wife is giving up legal entitlements of dower in exchange for this stock)

Dower, which is right to support as a widow

The issue is what is the value of these legal entitlements that the wife is giving up?

Court says that this is an arm’s length transaction, so assume the people are giving up things of equal value

This is formalistic, but hard to put a dollar value on these legal rights

* + - * 1. **§ 1041** supersedes this case
    1. **§ 1041**
       1. Non-recognition provision
          1. Congress is not saying that this is not a realization event
       2. **(a)** “Gift like” treatment for transfers b/w spouses or former spouses incident to DR
          1. **(1)** No gain or loss recognized upon a transfer of property from an individual to a spouse OR former spouse

Looks like an intra family gift under **§ 102**

But have to be concerned about basis

In the gift context, donee gets donor’s basis (except the double standard in **§ 1015**—take FMV if there is a loss)

* + - * 1. **(2)**
      1. **(b)** Basis
         1. “Carryover basis” of transferred property

But forget about the double standard for loss property in **§ 1015** if it is a transfer between spouses

* + - * 1. If it is to a former spouse, then **§ 1041** also applies
      1. Overrules ***Davis***
      2. Contrast with **§ 1015** – are all property transfers equal?
  1. Ante-nuptial Settlements
     1. ***Farid-Es-Sultaneh v. Commissioner*** (1947)
        1. Facts
           1. Timeline

1924: Prenup transfer of appreciated stock (A/B = $12k; FMV = $800k) to TP

Huge potential tax bite

1929: Divorce

1938: TP sells stock

* + - * 1. Wife was to get FMV of stock ($800k). W acknowledged this in consideration of release of her dower rights.

For income tax purposes, W does not want to call this a gift (she wants to frame it as an exchange, therefore she would get basis at the time of transfer and not the transferred basis)

* + - 1. Issue: What is the basis of the stock sold by TP (wife)?
      2. Held: Wife takes $10 basis that was the FMV of the stock at the time of the exchange.
         1. This was not a gift

This was an exchange of property rights [husband gives up stock and wife gives up dower rights]

* + - * 1. FMV = $800k becomes basis for the stock b/c this is a transfer with consideration

Not gift property under **§ 1041**

* + - * 1. Husband is taxed [?]
      1. NOTE: case essentially turns on what is the treatment of a gift
         1. Gift: No donor deduction and donee exclusion b/c we only want one layer of tax and we don’t want to squelch intra family giving [surrogate taxation]
  1. DR-Related Payments: Alimony, child support, property settlements
     1. Alimony = periodic cash support payments
        1. Payor gets deduction under **§ 215(a)** [above the line deduction under **§ 62(a)(10)**], includable for payee under **§ 71(a)**
     2. Property settlements = one time transfer of property from savings
        1. Non-deductible for payor and excludable for payee under **§ 1041**
     3. Child support
        1. Non-deductible for payor and excludable for payee under **§ 71(c)**
     4. General Rule for DR-related payments
        1. **§ 71(a), (b)**
           1. Must be in cash
           2. Received by a spouse under a DR or separation instrument
           3. When you don’t opt-out via private ordering
           4. Not members of the same household
           5. Can’t continue after the death of the payee
           6. Formal DR of separation instrument (written)
        2. **§ 215(a)**
     5. Exceptions:
        1. **§ 71(c)** Child support
        2. **§ 71(f)** Front-loading payments (1st & 2nd year can’t be more than 3rd year)
        3. **§ 71(b)(1)(B)** essentially turns alimony into property settlements
           1. Allows the deduction to be shifted to the higher bracket TP [?]

This reduces the total tax burden paid by both parties

Incentive to share: Sharing savings is a matter for bargaining

* + 1. Splitting Income
       1. Flexibility?
          1. Example:

Alimony of $40k paid from A to B

Deductible for A under **§ 215(a)** at 25% MTR

Includable in income for B under **§ 71(a)** at 10% MTR

Makes sense b/c B is the ultimate end user

* + - * 1. Trap for the unwary: wouldn’t want to invoke this rule even if you represent the payee (B) b/c you wouldn’t realize the net tax gain b/c of the difference in MTR [can’t focus narrowly on your client]
        2. There is always a 3rd party to transactions [US Treas.]

If you optimize tax liability, the US Treas. loses

Shifting income to the lower bracket TP reduces total taxes paid by the two parties – sharing savings

* + - 1. Income from Services
         1. The progressive rate structure is the driver in income splitting

Those who have a bigger tax paying ability are required to pay more in marginal terms

This progressive rate structure is a driver for incentives to shift income (have two starts from the bottom) and will be the cause of the marriage penalty

* + - * 1. ***Lucas v. Earl*** (1930)

SUM: diverting/splitting of income to a lower bracket TP via private agreement (K law), which was frowned upon by the court

Facts: Earl (lawyer) & wife made an early property-sharing contract in 1901

Issue: whose income is it?

Started semester with what is income; then when is it income; now whose income is this

Arguments:

IRS: this is all husband’s income

TP: should be taxed on half and wife should be taxed on half

Held: for IRS; you cannot use contract law to split income

Holmes: “statute could tax salaries to those who earn them … tax could not be escaped by anticipatory arrangements and contracts however skillfully devised”

Holmes impugned a tax avoidance motive to TP

PROF: It is wrong b/c this arrangement was made before the income was earned. It also doesn’t make sense b/c progressive tax rate didn’t come about for over 15 years; it was estate planning to stay out of probate

“No distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew”

Trees = people; fruit = income

Triumph of substance over form

This becomes the “**Assignment of Income**” doctrine

Can’t assign income from services

Can’t assign income if it is an attempt to undermine progressivity

Form v. Substance is the key issue here (look to the form of the K or what is actually happening)

NOTES:

This is still in the early years of the income tax

Somewhat similar to ***Kirby Lumber (1931)***

Kirby dealt with COD income

Holmes knew that the Great Depression would mean lots of COD income; he wanted to close the door to undermining progressivity

* + - * 1. ***Poe v. Seaborn*** (1930)

SUM: Splitting of income by operation of state law approved by the court

Facts:

State of WA—community property state [all prop acquired after the beginning of the marriage are owned by H&W equally]

The couple filed a joint return and split the income b/w them for federal income tax purposes/to get two starts from the bottom of the progressive rate structure

Arguments:

TPs: argued that they could do this due to the community prop laws of their state

IRS: income was earned by the H, so he should claim all of it (***Lucas v. Earl***  arg)

Held: for TP b/c under WA state law, the income was never just the H’s

Under state law, the W had a vested right in the comm prop, which included salaries

Distinguish this from ***Lucas v. Earl***

“The inveterate nature of state property law” – WA’s comm prop regime has been around a long time [court argues that the state law predates the 16th AM, so not a dubiously contrived relationship--which is different than the K in ***Lucas v. Earl***]

Also, the state law also applies to everyone, unlike a personal K? But what about people who don’t live in states with comm prop laws?

**PROF**: the inveterate nature argument is tenuous [K enforcement law is inveterate, too]

**State law v. what private parties do on their own -- the distinction the court makes**

* + - * 1. ***IRS Chief Counsel Advisory***

Non-binding

Facts: CA is a comm prop state

But registered domestic partners were excluded from this benefit

Held: registered domestic partners do NOT get to benefit from this for federal income tax law (each partner must report all of his income)

CA responds to this by changing its own tax law to send a signal to federal tax law that it thinks that same sex couples should be treated the same as marrieds

* + - 1. Income Splitting **Problem**
         1. (1) M gives her son a painting. 6 months later the son sells the painting for $100k. Who is taxed on the sale?

The son. He is better off so he should be taxed.

* + - * 1. (2) What if the son sold the painting immediately after getting it b/c M instructed him to sell to the buyer?

M would be taxed b/c she never really relinquished control [M was attempting to shift this income to a lower-bracket TP within the family; an assignment of income issue]

PROF: “skillfully devised ruse” to shift income

* + - 1. **Alimony v. Property Settlement**
         1. 3 categories of transfer:

(1) Alimony= periodic cash support payments

[infrequent in IN, but rules still apply]

Deductible for payor under **§ 215(a)** & **§ 62(a)(1)** and includable for payee under **§ 71(a)**

This makes sense b/c the end user is paying the tax

(2) Property Settlement = one-time transfer of property **from savings** incident to DR

Non-deductible for payor and excludable for payee under **§ 1041**

The non-deductibility for payor is important for incentives

Not a realization event

Basis is important 🡪 at the moment of transfer, the payee takes a transferred basis of the payor

(3) Child Support Payments

Non-deductible for payor and excludable for payee under **§ 71(c)**

Treated like a property settlement b/c if the couple was still together, money spent to take care of the children would not be deductible

* + - * 1. **§ 71(b)** & **(c)** help us determining how to treat alimony v. child support
      1. Divorce Problem
         1. H & W are getting divorced, and as part of the settlement:

(1) H agrees to transfer stock to W with FMV = $750k, A/B = $550k

Property settlement—this is a family unit splitting (no disposition), so the transfer itself doesn’t trigger tax

W takes the stock with the basis of $550k under **§ 1041**

(2) H agrees to pay W $30k/year to be reduced to $15k/year when their son, T, turns 18

If the payment is contingent on the age of the child, part of it looks like child support

$15k would be treated as alimony and $15k would be treated as child support

* + 1. Marriage Penalty
       1. Exists when each member of married unit earns roughly the same amount
          1. When you combine the incomes, the unit is higher up on the progressive ladder and the individuals pay MORE as a unit than they would as 2 individuals. This would not be a problem if our brackets were symmetrical.

**Driver**: progressivity of rate structure & asymmetry in the brackets b/c marrieds and singles. This happens b/c generally the 2nd earner’s salary is taxed at higher MTR when couple is married, and progressive brackets of married couples are **not** double that of single TPs.

But this problem was recently eliminated for lower brackets [but problem still exists for the big money at the upper brackets]

**Another driver used to be** the standard deduction (b/c it was not purely 2x for married couple) – but Congress fixed this

Turns on the contrast in the rate band. For it to be symmetrical, the married couple structure should be double that of the individual

* + - 1. Example
         1. C & D each have similar amount of taxable income. C+D’s combined income places them in a higher tax bracket and hence their tax liability as a married unit is greater than the sum of the individual tax liabilities
         2. On the margins, this many be an incentive for people not to get married
      2. Is there a rationale for why we ought to tax people who are married more?
         1. Married people share a dwelling instead of two separate rents, etc. (economies of scale)
      3. This happens b/c we like to treat families equslly
    1. Marriage Bonus
       1. Exists when one member of the married unit earns significantly less than the other, or nothing at all [ie. if you have one dominant earner/disparity in income]
       2. **Driver**: the earning capacity of the two spouses
       3. Example:
          1. A has positive taxable income, while B has none. A’s tax liability when single is greater than A+B’s tax liability as a married couple. A earns $200k, has a top MTR when single = 33%. Top MTR drops to 28% when married.
       4. **Why**:
          1. **(1)** The progressive marginal tax structure and commitment to horizontal equity between married units
          2. [**(2)** Potential availability of a larger standard deduction]
    2. Marriage/Tax **Neutrality** Between Married and Single: Is it possible?
       1. We CAN’T adhere to all 3 principles:
          1. (1) Commitment to progressivity (vertical equity) with rising MTRs

People with more ability to pay should pay more

* + - * 1. (2) Horizontal equity between married units

But treat the unit itself as a black box and don’t look into it

* + - * 1. (3) Neutrality between marriage and remaining single

\*This is the one we give up

* + - 1. “Balloon Effect”- if you squeeze the law in one place, it gives elsewhere
      2. NOTE disincentives for secondary workers & kiddie tax [if earnings from wages are given to minor children, children are taxed at the parents’ MTR [avoids income shifting]

1. Income from Property & Gifts as Carve-Outs
   1. Assignment of Permanent Interest
      1. ***Blair v. Commissioner*** (1931)
         1. Facts: TP is a beneficiary of a life estate in trust. TP assigns the right to receive interest from the trust to his children for the entire life of the estate
            1. The trust is an income producing asset
            2. Children are getting a fixed amount every year
         2. Issue: Where is the tax liability? Donor or donee?
         3. Held: children are taxed/donor is NOT taxed because donor has transferred property, not income (ie. he extinguished control over future income stream)
            1. Not splitting up the income
            2. Similar to gift of stock or real estate
            3. The donees are getting an accession to income

Not taxed on the receipt of the property itself, but are taxed on the income

* + - 1. PROF: donor should be responsible b/c this looks like assignment of income under ***Lucas v. Earl***. Ie.- this is an income shifting ruse?
         1. HYPO: what if donor is holding on to the stock in his portfolio and gives all of these bonds to the children?

The children will be taxed on this income from the bonds b/c donor has completely extinguished control of the entire property (ie. bonds)

* + - 1. Contrast this with ***Horst*** case
  1. Carve-Outs with Retained Remainder
     1. ***Helvering v. Horst***
        1. Facts: intra-family giving again.
           1. Father has bonds and cuts out the interest coupons in order to give the interest payments to his child [father doesn’t relinquish control of the bonds- which is the entire asset]
           2. This is a temporal slicing [not giving of an entire piece of property]
        2. Issue: Whose income is it in this carve-out of an income stream?
           1. This issue is different from ***Blair*** b/c the father in ***Horst*** isn’t giving the entire bond to his son, he is carving out part of the income stream to give to his son. The father retains the bond itself and other coupon payments (retains the reversionary corpus)
        3. Held: Father (donor) is taxed b/c he retains remainder and hence control over the future income
           1. Father has only carved out a **temporal** portion (unlike ***Blair***) to give to the son
           2. BUT cf. **§ 1286**: overrules ***Horst*** in the context of bond stripping
        4. Part of Court’s Rationale: Father has psychic benefits from giving these coupons to his son
           1. NOT saying that this is a gift; says this is a disposition/realization event
        5. PROF:
           1. This opinion is “wrong”; this psychic benefit isn’t realization the way we have come to understand it

Justice Stone is confused with this—this is really a gift and there is no realization event with gift property. Realization has NO place here.

* + - * 1. The right economic solution is to tax BOTH b/c both have accessions to wealth. Son has a zero coupon bond, in a sense [OID bond treatment – if son gets the coupon a the beginning of the year w/ a promise of interest later in the year]

Big banks do this type of bond stripping all the time (distribute the interest portion away from the corpus)

A lot of money is at stake here and it is easier to administer, so **§ 1286** says that we WILL do the econ sound thing

* + - 1. **§ 1286** overrules this case in the context of bond stripping [narrow context]
  1. Carve-Outs: The Economics
     1. **§ 1286**
        1. Bond stripping
           1. EX: Zero coupon bond/Trust = $100

Separate out the right to interest over time from the remainder

Sell the coupon/income interest to some person (TP A) and sell the remainder/principal of the bond to someone else (TP B)

TP A – Income Interest (I.O.) [$20 for 5 years]

PV = $60

TB B – Remainder (P.O.) [$100 at the end of 5 years]

PV = $40

Tax Treatment [econ sound way/not to punt]

Tax Both—won’t tax A fully on the $20/year b/c this wouldn’t be accurate once we strip down the bonds; tax the growth of the asset to B

B’s asset [bond principal] has OID-like income [grows from the PV to $100]

\*See excel sheet

Just b/c B doesn’t see the cash flow yearly like A doesn’t mean that his asset isn’t growing and that he shouldn’t be taxed

There is a lot at stake in being economically accurate here

* + - 1. EX: Apt. Building $100
         1. Facts:

Father gives to A – rental income (I.O.) $20 for 5 years

PV = $60

Father gives to B – Remainder (P.O.) right to building after 5 years

PV = $40

Assume that building is still worth $100 in 5 years

Functionally equivalent to a zero-coupon bond/OID income

* + - * 1. Analysis

B has an asset that is growing in value

A has a temporal right [right to income for 5 years]

But it has a basis that is equal to the PV

Econ sound argument: A ought not to be taxed on the entire $20 per year; B should be taxed on [$20 (-) amount taxed to A]

BUT we **can’t** really do this [see slide under Econ carve outs II]

Instead, we deny A the depreciation deductions so he is taxed on the full $20 per year (which is surrogate taxation)

**§ 102(b)(2)** & **§ 273**

**§ 273**: Holders of life or terminable interest

Do not get the depreciation deduction on this type of gift property of a terminable interest (this is shrinkage)

By denying this deduction we have taxed the analog (interest holder) on the entire amount of the economic gain [instead of the P.O. who gets the remainder interest] 🡪 for administrability; but we are making sure that someone pays some tax here

* + 1. Distorted treatment of **income from capital** from **income from labor**?
       1. On the margin, people will stop working when they have the ability to invest more in capital [rate difference is the big driver]
          1. This is why people argue not to tax job creators; b/c then these people will have a disincentive to work [distortion of decision making]
  1. **SUM** of Income from Property/Carve-Outs
     1. ***Blair***: donee with term interest taxed when remainder goes to donor
     2. ***Horst***: donor taxed when she retains a remainder
     3. \*Horst & Blair are the 2nd best alternatives
     4. **§ 1285**: We do the right thing and tax both
  2. **Problem**: Carve-Outs
     1. Facts: S owns a bond. She gives as a gift the right to the coupons to Mike, and the right to the principal of the bond to Mandy. Who ought to be taxed under the econ sound method?
        1. Both Mandy and Mike ought to be taxed in an econ sound method
           1. BUT in our 2nd best/workable alternative, it is likely that Mandy will be taxed b/c she has control

This is a form of surrogate taxation and there would not be any revenue loss for the government (even though we probably wont get the right answer that both should be taxed)

* + - 1. This is different from the apartment issue [**§ 273** applies to the depreciation deduction in apt building context; absent **§ 273** who knows what would happen in the apt context]
      2. ***Gavit***-like facts, here

**Ch. 4: Personal Deductions, Exemptions, and Credits**

1. Theoretical Issues/”Ideal Base”
   1. Generally
      1. Why do we tax income?
         1. Economic power as a proxy for ability to pay
      2. But we do NOT have a pure, H-S economic income tax. We sometimes deviate b/c of subsidy, historical accident, administrability, policy
         1. Examples:
            1. Carve-out gifts

We don’t do what is econ accurate for administrability

* + - * 1. Like-kind exchanges

But different b/c we defer (but benefit of time value of money)

* + - * 1. **Realization requirement**: fundamental deviation from H-S

Unrealized gains are not taxed [a subsidy for savings]

Mark-to-market would be true H-S

* + - * 1. Imputed income

Administrability issues

* + - * 1. Gifts

Policy reasons – encourage intra family giving

* + - * 1. ER-provided fringe benefits

**§ 132**: historical explanation

Some are hard to value

* + - * 1. Interest on state/local bonds

Helps raise more money (subsidy effect buried)

* + - 1. Get H-S definition from slide
    1. What’s a consumption tax?
       1. Income = consumption + savings
          1. Consumption = income (-) savings

In some ways, we already do this

IRA: money into retirement savings account; gains are not taxable until you withdraw and are maybe even deductible

401(k): huge tax expenditure for the gov’t; clearly income to EE but ER contributions are not taxed; moves us closer to a consumption tax

We have a **hybrid income-consumption tax** by carving out all kinds of things

* + - 1. Benefits of taxing only consumption:
         1. Simplicity (depending on how we structure it)
         2. Argument that an income tax taxes savings twice and this disincentive should be removed b/c it creates a distortion that incentivizes consumption

A consumption tax would encourage savings and discourage consumption

* + - 1. Drawbacks of taxing only consumption
         1. If not structured right, straight consumption tax could be regressive b/c the poorest people spend most/all of their income in consumption (so they pay more taxes as a % of their total income)
      2. Examples
         1. Sales tax is an example of a consumption tax
         2. Value Added Tax (paid elsewhere in the world)

US liberals think its regressive and conservatives think it’s a money machine

PROF: this would raise a lot of money quickly; doesn’t look too bad when you think about the deficit

How it works:

Ex: making of bread – each stage in making it the miller, baker, etc, adds value. The added value they add will be their tax.

End user ends up paying it, but it doesn’t hurt as much as filling out a **§ 1040** (not as highly visible/salient)

Fear this will lead to “insidious” raising of revenue

Conservatives: “VAT is French for big government”

* + 1. Proxies for ability to pay
       1. Why don’t we tax based on the benefits you get from the government?—how to determine if everyone benefits?
       2. Could still have progressivity with a graduated consumption tax as long as we structure it right
          1. If we don’t structure it right, there would be the drawbacks of a straight consumption tax
    2. Why a commitment to progressivity?
       1. Commitment to “ability to pay” based on economic status
          1. Diminishing marginal utility—

Applied to notion of progressivity/justification for a progressive rate structure: Warren Buffett’s last dollar brings him less utility than the last dollar of his secretary brings to her

PROF: there is even a plateau level for savings

No empirical evidence that savings is the only driver of capital investment/econ growth

* + - 1. Revenue: it raises a lot more money
      2. Address concentrations of wealth
         1. Egalitarian; economic stagnation
         2. Get at the problem of growing inequality

1. Intro to Personal Deductions, Exemptions & Credits
   1. Different kinds of deductions:
      1. (1) Required to tax NET income
         1. e.g. “Income defining” deductions for wages paid to EEs, COGS to avoid a “gross receipts tax”
         2. If it helps you create income/get to a net income, keep this in mind [related to creation of income]
         3. Most of these generally taken “above the line” on your 1040 to get to AGI
      2. (2) Unrelated to production of income (“personal deductions”)
         1. e.g. personal exemptions, home-mortgage interest deduction, etc.
         2. Mainly fall under itemized deductions
   2. Five easy steps to calculating tax liability:
      1. Step 1: Calculate gross income [**§ 61**]
      2. Step 2: Subtract “above the line” deductions – arriving at AGI [**§ 62**]
      3. Step 3: Subtract “below the line” deductions
         1. (personal exemptions + *greater* of standard ded. or itemized deds**.**) **§ 63(b)**
      4. Step 4: Apply the tax rate [**§ 1**] to this taxable income #
         1. Arriving at tentative tax liability
      5. Step 5: Subtract available tax credits
   3. Mechanics of Personal Deductions
      1. **§ 67**: subset of larger universe of itemized deductions
         1. 2% of AGI floor on MISC itemized deductions
            1. We have this floor b/c of administrative ease & this floor can keep out some of the dubious things that look like personal consumption (that way we don’t have to go after them)
      2. **Gross income** (-) Above the Line Deductions [income-production deductions] = **AGI**
         1. **AGI** (-) Below the Line Deductions [standard ded. OR item. ded] (+) personal exemption deductions] = **Taxable income**
      3. Relationship between “itemized” and “misc. itemized” deductions?
   4. **Why** have personal deductions, exemptions, and credits?
      1. (1) Incentives/subsidies
         1. Ex. Deductibility of home mortgage interest
      2. (2) Accurately define income
         1. If you have more dependents, you get more personal deductions/exemptions b/c it seems fair (you have less money overall to pay for things)
      3. (3) Fairness premised on the ability to pay
   5. General Limitations
      1. What are the general limits on the use of personal deductions (“below the line”):
         1. (1) The are itemized, so the total itemized deductions has to be greater than the standard deductions [this is a class issue]
            1. Home mortgage interest usually catapults you into the itemized deductions being greater
         2. (2) Misc. itemized deductions are limited to a floor
         3. (3) **“Phantom” MTRs**
            1. Statutory rate may not be the right rate to keep track of for planning purposes b/c of the phase-out provisions

Phaseout provision: as you make more money, maybe you don’t need all the personal exemptions [a back door tax hike/stealth way to raise taxes]

* + - * 1. Increase in EFFECTIVE MTR
        2. Example:

Calculating how phaseout provision affects your effective MTR

35% TP who gets additional income of $1k, but her taxable income increases to $1100 b/c of phaseout of a $100 deduction. Her tax liability increases due to the phaseout by $35, while her income increased by $1000 – leading to “phantom” tax increase of how much?

Phantom tax rate is 3.5%

Truly effective MTR is now 38.9%

1. Casualty Losses
   1. **Uncompensated Personal Asset (Casualty) Losses**
      1. Code & Theory
         1. If you are compensated by insurance, you are not worse off
         2. We allow a deduction for a loss for personal assets (when you are not made whole) b/c if it is a business asset that you lose through a casualty loss, you should get a deduction under category #1 above [ie. required to tax NET income]
            1. If it’s personal, tax code gives you a subsidy for the loss b/c you are not better off (H-S notion is undermined if you lose it). You are NOT made whole by insurance so we want to do something for you out of fairness.

Measuring the loss is a 2nd order question

* + - 1. **§ 165(a)-(c)(3)**
         1. Key language of **(a)**: this is a deduction for a loss during the taxable year [for which you are not compensated by insurance or otherwise]
         2. **(b)**: basis shall be the adjusted basis [loss is limited to your A/B of that property (NOT the FMV) b/c basis reflects our use of the item over time]

If you have already gotten some personal consumption out of the item, you shouldn’t be able to take a loss deduction for it

* + - * 1. Limitations in **(c)(3)**: defines how personal losses can occur –“if such losses arise from fire, storm, shipwreck, or other casualty, or from theft”

What do these events [fire, storm, etc.] have in common?

Casualty losses: suddenness, unexpected and unusual losses

Look at other limitations in **(h)**

* + - * 1. Policy concerns:

Why a tax benefit for personal assets? If it is a form of insurance from the US government

Fairness.

Horizontal equity with other TPs.

If X and Y both get paid the same; X gets mugged for all of his paycheck. Horizontal equity suggests that X’s ability to pay has been restricted and he should get a deduction. Now, X doesn’t have this income to consume or save.

Casualty losses can be categorized as category (1) in this sense, b/c you no longer have money to spend. Technically they are category (2), but see how the blend together in some ways.

Ability to pay

What about insurance?

In a sense, this is premium-free insurance that is paid for by other TPs

The insurance analog is important [perverse incentives/moral hazard – you may build your house on a fault zone if you have this public “insurance”; also see this in the medical expenses category]

Distortion occurs b/c you are encouraging risky behavior

Whether you will buy private insurance, on the margins, depends on your MTR

* + - * 1. Because this is a **deduction**, your **MTR** matters
        2. Not an itemized deduction [?]
    1. Early Cases
       1. ***Dyer v. Commissioner***
          1. Facts: cat with neurosis breaks vase

TP wants a casualty loss deduction b/c it was due to the cat’s first instance of “fits”

* + - * 1. Held: this is not what we meant by casualty loss
      1. ***Waddell***
      2. Congress responds to the above cases (ie. pets, rings, etc.) with **§ 165(h)**
    1. **§ 165(h)**
       1. Dollar threshold
          1. To get rid of pesky nickel/dime cases
          2. Congress did not eliminate **(h)(1)** when it moves to **(h)(2)**

First take $100 off the top, THEN it has to be more than 10% of AGI

**(i)** You could get a personal casualty gain if you got an insurance payout. Make sure you net the gains/losses to get NET loss.

**(ii)** Floor is 10% of AGI

PROF: this is a pretty high bar

* + 1. ***Chamales v. Commissioner*** (2000)
       1. Facts: TPs bought a house that is across the street from OJ Simpson’s house [where the murder occurred]
          1. Bought it prior to the murder

The media then becomes very interested in the neighborhood

* + - 1. TPs: try to use a casualty loss due to the loss in the FMV of their home due to the media attention
         1. They hate the “looky loos”
      2. IRS: this is not the type of casualty loss that **§ 165** is about b/c of the lack of physical loss/damage [which is required in some circuits] AND no permanent damage [which is suggested to be necessary under **§ 165**]. Also, no suddenness—this was a gradual process.
      3. Held: for IRS; denied loss deduction.
         1. Loss lacks requisite elements: **(1) suddenness; (2) permanency; (3) physical damage [9th cir.]**

Not clear that this is permanent

See that local market values have gone up

Important fact in this case was that a lot of people were still building homes in the area, which leads the court to think that this was just a temporary decline

* + 1. ***Blackman v. Commissioner*** (1987)
       1. Facts: lunatic commits arson to get back at cheating spouse
          1. The private insurance company would NOT cover this because it is reckless behavior

So it makes no sense to have public insurance for it

* + - 1. Held: denies deduction
    1. **Mechanics** of Personal Casualty Loss Deduction:
       1. Step 1: Determining loss amount
          1. Limited to adjusted basis per **§ 165(b)** b/c this reflects the remaining personal consumption to be had in this asset, which is what you’re losing

If basis and FMV are different

* + - 1. Step 2: Amount not covered by insurance
         1. Net personal casualty losses per **§ 165(h)**
      2. Step 3: $100 disallowance per casualty event per **§ 165(h)**
         1. E.g. If you have three different boats that are destroyed (with no insurance)—if there is only one storm, there is only one $100 deduction. Then take the AGGREGATE of loss.
      3. Step 4: Net personal casualty losses allowable as itemized deductions and only if greater than 10% of AGI
         1. **Subtract 10% of AGI from the loss and THAT is what you can deduct**
    1. Problem re: calculating loss deduction
       1. C’s house is destroyed by fire, leading to loss of $20k of property; C’s AGI is $100k
          1. (1) C had no insurance. How much loss is deductible?

Still take $100 off, gives us $19,900

10% of AGI = $10k (subtract this to get **$9,900 deductible**)

* + - * 1. (2) C had insurance that covered $8k of loss. How much of loss is deductible?

Net casualty loss = $12k

First deduct $100 [$11,900]

Then subtract $10k as 10% of AGI from the loss to get **$1,900** deductible

* + - 1. Car with basis of $10k and value of $15k is destroyed by earthquake. My insurance company pays me $7k.
         1. Personal casualty loss limited to A/B = $10k

Loss reduced by $7k insurance recovery

Net personal casualty loss = $3k

Take $100 disallowance off per **§165(h)** – loss now limited to $2900

Compare to 10% of AGI per **§165(h)** [this will be the big one—to make sure that these really are extraordinary casualty losses]

* + 1. Piggy-back off the private insurance market to better structure **§ 165**?
       1. Don’t allow a deduction [public insurance] if you can’t find a private insurance company to insure your asset aka if you don’t have an insurable asset (ie. if you choose to build your home on a cliff, etc.)
          1. Let the market determine
       2. **§ 165** ought to act as a backstop to the private insurance market; maybe we ought not to distort decision making and if you can’t get private insurance for a home, IRS shouldn’t be there as a 2nd risk manager
          1. But this assumes an efficient insurance market
       3. NOTE: don’t call it “free”—b/c other TPs ARE paying for it. Also think about the $100 and 10% AGI limitations.

1. Catastrophic Medical Expenses
   1. **§ 213**
      1. Allows deduction for medical expenses w/ strict limitation of 7.5% AGI
      2. **(a)** “deduction … expenses paid … not compensated for by insurance … for medical care … to the extent that such expenses exceed 7.5% of AGI”
      3. **(c)** special rule for decedents
      4. **(d)** definitions
         1. When thinking about allowing a deduction for medical expenses, Congress wanted some preventative stuff in there
            1. Also remedial, rehabilitation, insurance coverage, transportation (trying to consider many of these kinds of things—but think about this casualty loss context)

We are thinking about root canals, etc. but not toothpaste (not talking about the ordinary vicissitudes of life, etc.)

* + 1. NOTE: Prescription drugs count
  1. **§ 223** Health Savings Account [application has become more widespread]
     1. This provision tells us that TPs can take an above the line deduction
     2. HSA plans usually come with high deductibles [unlike ER-provided plans]
        1. This matters b/c TP has to pay more out of pocket up to a certain point. HSA thus encourages employed TPs [covered by ER plan] to be more rationale re: spending on medical care.
           1. HSA plans are loaded with tax preferences/benefits:

It is a deduction, so comes with pre-tax dollars; and

It also sits in an account – you can invest it in stuff [you have control over it and is earning interest—this interest is NOT taxed];

If you take the money out and spend it on legitimate medical expense, it is NOT taxable

If you take the money out for pure personal consumption, then it is taxable

* + - * 1. Encourages the type of spending we like (see this with 529 accounts, too, to encourage people to save for college)

We want to control spiraling health care costs. We want people to think rationally about the payment of their health insurance costs.

The more HSAs we have, we are moving toward what looks like a consumption tax [we are moving more away from income as our base]

* 1. Defining “Medical Care”
     1. ***Taylor v. Commissioner***
        1. TP had a grass allergy so paid people to mow his grass
           1. Wanted to take a deductible medical expense for this cost under **§213(a)**
        2. Held: denies this deduction b/c it is a personal expense under **§ 262**
           1. **§ 262**

We have this rule to make sure that people aren’t taking advantage and don’t deduct pure personal consumption

Puts a nice backstop against **§ 213(a)**

* + - 1. Note: if TP spent money on prescription drugs, this would probably be deductible
         1. BUT how do we know that he wouldn’t pay to have his lawn mowed anyway? But-for causation gets kind of messy

The court doesn’t buy that his allergy is the only reason TP paid for his lawn to be mowed (TP hasn’t proved that he wouldn’t have paid otherwise)

* + 1. ***Henderson v. Commissioner***
       1. Facts: TP spend $26k on a van for their son who has spina bifida. Have to spend more money to improve the van later. Use this van for transportation (they also have alternative vehicles, so use it only for the purposes of driving around their wheelchair-bound child)
       2. TPs are trying to deduct the depreciation on the van
          1. TPs don’t try to take the whole value of the van upfront (try to take it over time) b/c we want to match net income on an annual basis

In the business context, an asset that is going to help us produce asset over a period of time needs to be “capitalized” over time—get it back over time via depreciation deductions over time for matching [it would not have been fully deductible when you first buy it]

BUT this is NOT a business context. In the medical expense context, you would think that there would be a similar spreading out over time, BUT per **§ 213 Treas. Regs.**, this is special—our usual tax principles are violated

But TPs argue that they should have a $5k deduction every year

* + - 1. IRS: this is not an “expense paid”
         1. BUT the modifications **are** deductible
         2. The depreciation TPs are trying to take over time is a personal expense

PROF: but this doesn’t make sense. If TPs has leased this van every year for the same purpose, it would have been deductible (“expenses paid”)

But it is important that the van is only used for medically-expensable transportation – no personal consumption (have to show that they have other cars that allow for personal consumption)

* + - 1. Held: textualist denial of deductions
         1. PROF: what is this about? What is the IRS thinking ahead about?

The implications of not holding this – slippery slope

* + - 1. PROF: bad tax advice to TP – they should have tried to deduct the whole amount of the van in the same year as expenses paid [?]
      2. Connected to ***Taylor*** [?]
    1. ***Ochs v. Commissioner***
       1. Facts: TP’s wife has breast cancer. TP had his children sent to boarding school while she recovered. Not raising her voice was necessary for the wife to get better. Cost of the school was $1500.
       2. IRS: boarding school is not a medical expense; this is a personal expense
       3. TP: argues a but-for argument; but-for wife’s sickness he wouldn’t have to send his children (argues that the children had to not be in the home for the wife to get better)
       4. Held: there is too much personal [“family”] consumption here for it to be deductible [not directly related to medical condition]
          1. Slippery slope
          2. NOT a textual reasoning; there is just too much of a benefit to the kids and the TP husband who are NOT recuperating
          3. Court/IRS say that the but-for cause of the boarding school expense is the decision to have kids (this is a personal decision)

TP says that the cause of the expense is the sickness

* + - 1. PROF: is this really personal consumption?
         1. Forced personal consumption? The law is going in two opposite directions

***Benaglia***

Forced personal consumption is excluded

Did he really value at FMV the board and lodging that he had to take?

Concession to TP under **§ 119**

* + - * 1. There is a valuation problem

How much did the TPs value this school as forced consumption and how much did they really want their kids to go there? Did TPs really want to send their kids to boarding school?

The court punted the opposite way of ***Benaglia*** re: this valuation problem

Denies the deduction and makes all of this taxable

BUT TPs argue forced personal consumption – that they don’t value this item at FMV b/c there was an event that forced them to do this

* + - 1. Dissent
         1. If they had sent the wife to rehab instead, it would have been deductible b/c this would have been an isolated medical expense
  1. Policy justifications
     1. Proper definition of income
        1. Medical expenses are not personal consumption. If it is purely a broken arm, drugs, etc., NOT personal consumption
        2. Spectrum of personal consumption to legitimate medical expense
     2. Relieving public spending
        1. If we allow this deduction, we make sure that society as a whole is not paying for these dependencies later on
     3. Useful subsidy
        1. B/c medical costs are tax preferred due to these benefits
           1. But this may encourage more irrational spending
        2. Maybe we ought to allow deductible for preventative care?
     4. Necessary cost of producing income?
        1. Ie. truck driver with a bad back. Can’t work without medical care for his back. So should the threshold apply here? Category (1)?
  2. Incentives & current cost v. Preventive care
     1. (1) Dr. tells her obese patient to attend weight loss clinic. Are clinic costs deductible?
        1. 1st question: what is the illness? Is obesity a disease? Yes, per some revenue rulings
           1. So it should be deductible under **§ 213** [assuming you meet the statutory limits]
           2. But if the clinic was a resort, etc., could argue that only part of it would be deductible (look at the level of personal consumption)
        2. Incentives in contrast with hypo below
     2. (2) Dr. tells her overweight patient to join a gym. Is gym membership deductible?
        1. NO--due to but-for causation; alternative methods; how do we know that this is a direct treatment for obesity—partial personal consumption
           1. This is spending reactively (inefficient for IRS to spend more after the fact due to the treatment of these memberships?)
           2. Obesity is categorized as a medical disease; being overweight is NOT
        2. **§ 213** does mention prevention, though
           1. Can’t we hinge on this?

This looks like the toothpaste argument; not catastrophic, this is everyday kind of spending

Slippery slope – if we allow toothpaste deduction, what is NOT ok?

* + - * 1. We have to draw the line re: preventive stuff b/c exclusion of ER-provided health insurance is the largest form of spending

Case law, revenue rulings, treas regs. draw this line

* + - * 1. Smoking cessation classes have now been added to the deduction list
  1. Problems
     1. Yr. 1- K received $96k in salary and $4k worth of medical benefits under ER-provided plan
        1. Under **§ 105**, $4k is not included in GI [deductible]
     2. Yr. 1- C receives $100k in salary and spends $4k on **§ 213** medical expenses
        1. C doesn’t get to deduct $4k b/c doesn’t meet threshold and is not ER-provided
     3. \*We have an employment-based medical welfare state

1. Charitable Contributions
   1. Overview of Rules
      1. **§ 170**
         1. Statutory language
            1. (a)(1): You can deduct charitable contributions made during taxable year

Refers to Treas. Regs for line drawing

* + - * 1. (c): Outlines 5 categories-

(1) Public sector

(2) Corporations:

(A) Created by the US [foundations/trusts created by public sector]

(B)

(C) No part inures to the benefit of a private SH or individual

We don’t want scam fund foundations that only benefit one person; we are focusing on foundations with wider benefits

Thus, foundation can’t benefit just one family

(D) Not qualified for exemption under **§ 105(c)(3)**

(3) Veterans

(4)

(5)

* + - 1. **§ 170** doesn’t give a clear understanding of what exactly is deductible – look to **Treas. Reg. 1.170A-1(g)** 🡪
         1. “Actually paid during the taxable year”

ie. If you are a lawyer and volunteer your services for 2 hours a day, nothing is deductible.

“Actually paid” means that we don’t allow a deduction for services

BUT you could read this regulation to argue that your travel costs (miles as a proxy for time), etc., would be deductible

* + - 1. **§ 170(c)**: donations to which organizations?
         1. **§ 501(c)**: types of charitable organizations

Substantially broader than those listed in **§ 170(c)**

But **§ 170** generally tracks **§ 501(c)**

**§ 501(c)(3)** v. **§ 501(c)(4)**

* + - 1. Limits on deduction amount
         1. **§ 170(b)**: percentage limitations

**(b)(1)(A)**: 8 sub categories

**(iv)**: publicly supported orgs

“Shall be allowed to the extent that the aggregate of such contributions does not exceed 50% of donor’s contribution base (often AGI)”

Makes a distinction b/w public and private giving

**(b)(1)(B)**: contributions under (A) is deductible such that the aggregate is the lesser of …

* 1. Policy Rationale
     1. **§ 170(a)** policy justifications
        1. (4) Encourage charitable giving
           1. Subsidy effect; this tax treatment is structured as a deduction, which enhances subsidy effect b/c the higher MTR you have, the greater the value to you – upside down subsidy (but we want it this way b/c the higher MTR people have the money and are the people who give)
        2. (1) Substitute for government activity
           1. One of the foundations for deductions for charitable giving is that it is a substitute for public support

A clear preference for public-based orgs

* + - * 1. Ought to promise the general welfare (inure to a larger group)
      1. (2) Decentralized, pluralistic support
         1. One fundamental difference of doing this through the tax code (rather than via an endowment of the arts)—we now base the decision making for giving in the private sector

This is good b/c there is a decentralized pluralism that comes from this (broader notion of what counts as a cultural institution, etc.)

* + - 1. (3) Not personal consumption?
         1. People give for the psychic benefits (they don’t just give for the tax benefits)

This is a kind of personal consumption (but it only takes us so far)

* + 1. Does it have to be a deduction? How else could this charitable contribution tax benefit be designed?
       1. Canada uses credits instead – unhinged the benefit from the MTR structure
          1. Used a two-tier system to transition
          2. The Buffetts, etc. are going to give anyway, so maybe shouldn’t subsidize them
    2. Recipients of charity, tax symmetry and one tax layer?
       1. If we allow a deduction for donor and exempt the receipt of the income from the donee – we have diverged from our 1st principle of there being one layer of tax
          1. Social policy: who actually benefits from the Make a Wish Foundation? The beneficiaires are rather fragmented, hard to track down to tax them on the ultimate receipt of this wealth
    3. Is there a kind of giving that is deductible but that doesn’t fit into the general welfare premise?
       1. Ie. if Prof gives to Chicago Philharmonic
          1. This is not inuring to the general welfare of the public
       2. There might be orgs that provide a more narrow type of class-based type of benefit
    4. PROF: if A makes a donation to a charity in B’s name, A would likely take the deduction. B would NOT be able to deduct, too
  1. Gift of property/appreciated property
     1. **§ 170(a)(1)**: donor can deduct the full FMV of donated appreciated property (e.g. stock)
        1. U.S. Treas. could lose a lot of money
        2. **Treas. Reg. 170A-1(c)** & **170(a)(1)** set out the default rule (but see limitations under **§ 170(e)**)
     2. Example: if A has a basis of $1k in GOOG stock and donates it when it has a FMV of $10k. A can deduct $10k.
        1. This unrealized gain has gone completely untaxed
           1. In most realized transactions, we would have been able to tax this at some point, but now it is gone (this could be a major gap/tax shelter)

PROF: this ought to strike you as odd given our fundamental views of tax

* + 1. **§ 170(e)** Limitation
       1. Carve out for tangible personal property
       2. Distinctions that this sets up:
          1. With **NON-long term capital gain**: ie. if you are a real estate develop, a piece of land is inventory. Selling this would be ordinary income, NOT capital gain.
          2. Gets more complicated if you have tangible personal property

Additional complication for tangible personal property (we care about whether the donee’s use of it is related to its charitable mission)

Hedges closer to a deduction of basis amount

* + - * 1. With **long term capital gain**: sticks with the default rule of a deduction of FMV amount

This is a preference for LONG TERM CG to incentivize true long term investment (NOT day trading/speculators)

We don’t want to give day traders benefit of FMV

LTCG = held longer than a year

* + - 1. Class case this statute had in min: $1k basis in stock with FMV of $10k
         1. Keep in mind that if we are going to reduce something from FMV, we will probably reduce to basis
      2. \*Limitations in **§§ 170(b)** & **(e)** are important b/c we want to encourage giving but we don’t want it to be so huge that it washes revenue away
    1. **§ 170(b)** Limitations Problem
       1. John has AGI = $200k (no NOLs), donates:
          1. $80k to alma mater (public univ)
          2. $40k to private charity
       2. How much can he deduct?
          1. **§ 170(b)(1)(A), (B)**

**§ 170(b)(A)**: CAN deduct the $80k to public univ.

“Lesser of” ceiling rule for gift to private charity

Difference b/w 50% of TP’s contribution base [$100k] and the amount allowable under sub para (a), which is $80k

**Excess** = $20k (compare this excess to 30% of the contribution base, which is $60k—take the lesser)

So only $20k of the $40k donation will be deductible

\*Point is that the ceiling is 50% (can never go over)

* + 1. **§ 170(e)** Limitations Problem
       1. TP/retailer of Halloween Costumes, etc. buys painting in April 2002 for $5k. TP donates painting to museum in Nov. 2003, when value = $10k. TP AGI for 2003 = $100k. How much can TP deduct as charitable contribution for painting?
          1. Keep in mind what the donee’s use of the property will be
          2. Ask if the painting is part of TP’s inventory? If yes, then deduction will be A/B ($5k), not FMV
          3. If it’s not inventory (it is a personal investment), look to see if TP has had it longer than a year

**§ 170(e)**: looks like long term capital gain except that it is tangible personal property (requires us to middle through other language) –

Have to figure out what this museum is doing (if the gifted painting is related to the museum’s mission, TP can deduct FMV)

Think about policy purposes of this limitation: we want to encourage this type of giving if it will inure to the public welfare

It may be more dubious if TP gives this painting to a church (who would likely just sell it for money)

* + - * 1. \*Answer Qs like this can go different ways depending on your answers to these questions
    1. Other Limitation: Private Benefits or the “***Quid Pro Quo***” Test
       1. Think about **§ 102** & **274(b)** v. **§ 170**
          1. ***Duberstein*** standard of “detached and disinterested generosity” is NOT the standard for charitable contributions
          2. More lenient in the intra-family giving context
          3. More lenient standard for charitable contributions b/c we want to encourage lots of this kind of stuff (this is a substitute for government activity)

We are explicitly subsidizing this activity, but we also want to balance this against the possibility that the donor may be getting something from all of this

* + - 1. Spectrum b/w whether donor is getting personal consumption from this charitable giving or if it is purely altruistic giving
         1. Standard becomes: is there a substantial benefit?

***Singer v. US*** (1971)

* + - 1. Gifts with Private Benefits:
         1. ***Ottawa Silica Co. v. US*** (1983)

Facts: mining company transfers some of its acreage to local school corp. If donated, the school would also create access roads that the mining company could use

Company took a deduction at the value of the property it contributed

Now the company looks more like a real estate developer (b/c realizes that its property is valuable)- but had access problems to main roads

Couldn’t get easement rights to one main road (this makes the valuable property not as valuable as it could be); transfer to the school would give them access to this road

TP: making this donation; claiming that it is charitable b/c TP is just getting incidental benefits—the real benefit is to the school/community

IRS: this was a substantial benefit to TP; memo to demonstrate the extent of the benefit

What makes it a substantial benefit?

Balance/weighing: who benefits more? IRS says the TP benefits more

Issue: is this an incidental benefit to TP or a substantial benefit to the TP?

The availability of the deduction depends on this

Court: denies deduction b/c the TP received benefits “greater than those that inure to the general public” from such transfer

PROF: due to the denial of this deduction, have to re-characterize this transaction – ie. if it was not a charitable donation, this transaction already occurred; what is the tax treatment now?

Basis of donated property is added to basis of existing property (part TP hasn’t sold yet)

This makes logical tax sense—we don’t know the realized amount (valuation problem). This is a quasi-realization event.

***Cottage Savings***- what does disposition mean?

This is a nice compromise

We still give some solace to the TP—basis is not lost; it is just pushed later. Later gain will be less b/c we have added basis.

***Inaja***-like

Think of this as a capital improvement – it is as if TP made a capital improvement to its existing property

Still good for IRS b/c denies TP the FMV deduction that is the default rule

* + - * 1. Problem

(1) TP attends church services but doesn’t have any cash for the collection. After service, TP says that he needs cash, says that he will write a check for $100 to the church and get $80 back from the collection basket.

TP should only be able to deduct $20

(2) Would it be different if TP bid $1000 at a charity event for golf round valued at $800, won, and paid the $1000

TP should only be able to deduct $200

People try to deduct the whole $1000 – but ask what TP is getting in return (quid pro quo)

If the benefit to TP is so substantial in the weighing, can deny the deduction completely (but if it can be disentangled, figure out the value you got in return)

Ie. if you pay $1000 for golf round that is worth $3000, you probably shouldn’t be able to deduct anything as a donation (BUT if probably wouldn’t happen this way due to subjective value argument and/or reporting problems)

\*analogize to prizes

NOTE: generally can’t go with subjective value – have to go with market value [but see the cruise ship tix example]

* + - 1. **Quid Pro Quo Test**
         1. ***Hernandez v. Commissioner***

Facts: Church of Scientology members were deducting amounts given to the Church for “training and auditing”

Doctrine of exchange is important – part of everyday experience of the org

Tax issue: are payments to the “church” for “auditing and training” services charitable contributions deductions?

TPs: this is like any other church charitable contribution

What about administrability/inconsistency? People make contributions to their churches and get things in return (ie. pew rentals)?

PROF: it is easier to measure here b/c of the fee schedule, but this inconsistent argument DID haunt the IRS—so there was a settlement where the IRS DOES allow deductions b/c says that it is being inconsistent in a sense

But the IRS is contradicting SCOTUS here, allowing a deduction when it doesn’t have to – has opened the door to litigation

Congress has responded with 3rd party reporting/substantiation requirements [**§ 170(f)(8)**]

IRS: this is a quid pro quo exchange b/c there is a schedule for payments; direct reciprocal nature of this exchange

Held: denies deduction

* 1. ***NCAA v. IRS*** – Part I
     1. SUM: price for tickets themselves are NEVER deductible (personal consumption); the issue is the price paid to be part of the Booster Club itself
     2. Rev. Ruling 84-132
        1. Payment to university’s athletic scholarship program provided TP with opportunity to purchase preferred seating
           1. Booster payment is NOT deductible under **§ 170**

b/c these “donations” get you access to the best seats, etc. [this is why people join the Booster Club]

* + - 1. Huge backlash to this—have to hold public hearings on this issue
    1. Announcement 84-101
       1. IRS temporarily suspended Rev. Ruling 84-132 to hold public hearings on implications of above ruling
    2. Rev. Ruling 86-63
       1. Clarifying but affirming quid pro quo rule for donations to college athletics
    3. Contesting parties then go to Congress (below)
  1. ***NCAA v. IRS*** – Part II
     1. Tax Reform Act of 1986 [**§ 1608**]
        1. Carved out an exception to IRS Rev. Ruling for “described institutions”:
           1. (A) “mandated by a State constitution in 1876
           2. (B) est. by State legislature in March 1881, and is located in a State capital … pursuant to a statewide election in Sept. 1981,
           3. (C) campus of such institution formally opened on Sept. 25, 1883, and
           4. (D) such institution is operated under the authority of a 9 member board of regents”
           5. 🡪 They had ONE univ. in mind (rifle shot) 🡪 Univ. of Texas, but LSU also argue for and got inclusion
     2. Responded to the narrow carving/horizontal equity argument of just targeting TX and LSU with **§ 170(l)**:
        1. 80% of amount paid for right to buy preferred seats is deductible
     3. PROF: Think about the valuation concern of being part of the Booster Club
        1. Access to the tickets = TPs don’t get full amount of the deduction [Congress throws a number out there b/c of the valuation concern]
  2. Defining the Policy Behind “Charitable” Giving
     1. ***Bob Jones Univ. v. US*** (1983)
        1. Facts: this is a fundamental Christian Univ. that bans interracial dating via a disciplinary rule
        2. Issue: is this univ. really a tax-exempt org under **§ 501(c)(3)** and can donations by donors be deducted under **§ 170(c)**?
           1. If univ. is denied **§ 501(c)(3)** tax-exempt status, it would lose the subsidy effect of the donations
        3. TP (Univ.): argues that it deserves/fits **§ 501(c)(3)** tax-exempt status and thus **§ 170(c)** b/c it is a religious org (uses a textualist arg of the language of **§ 501(c)(3)-** which was chosen by democratically elected lawmakers)
           1. Textual argument: hammer on “OR” in the statute

Important b/c saying that they don’t have to fit charitable b/c they have the other things (fits educational)

* + - 1. IRS: starts this with a challenge to the Univ. in rev. ruling
         1. In response to TP’s textual argument, IRS argues not to focus on the word “OR” – look at the broader congressional intent of **§ 501(c)(3)** and by relation **§ 170(c)** – to read in this CL principle of charitable, which implies that charities can’t be doing things that fundamentally contradict public policy

TP’s policies ARE contradicting public policy

* + - 1. Held: for IRS
         1. Reads in CL notion of “charitable” – statutory interpretation
      2. Dissent (Rehnquist)
         1. Congress should have done this – institutional competency argument (court should not read in CL notions when the plain language is clear)

The maj acknowledges this and makes an argument about Congress and how Congress has already weighed in on this

“Ratification by acquiescence”

Means that Congress didn’t speak when it had a chance to (had known about this for a long time and has not overturned the IRS’s position)

PROF: but could argue that they haven’t explicitly endorsed IRS position, either

This leaves the “ratification by acquiescence” argument on shaky grounds

* + - 1. SUM:
         1. The meaning of “charitable”
         2. Plain language v. plain purpose
         3. Statutory interpretation issues
  1. Problem
     1. A buys 2 tickets to a special charity concert for $200 each. Tix for this performance usually go for $50 each, but A is willing to pay $300. Tax implications?
        1. We can disentangle the part that is personal consumption from the part that is true altruism b/c we know that the FMV is $50 each
           1. A can deduct $150/each

The fact that she would have paid $300 each has no implication here b/c subjective value is too hard to measure

But Cf. in other places, courts have been willing to at least entertain subjective value

See ***Turner*** case (cruise tix)

* + 1. What if A doesn’t actually go to the concert?
       1. No personal consumption
          1. If she surrenders the tix/gives them back to the charity, it should ALL be deductible b/c this would be a PURELY charitable contribution
          2. What if she didn’t give the tix back but didn’t go?
    2. NOTE: This is the quid pro quo rule in action [give and take]

1. Limiting the Interest Deduction
   1. Generally
      1. Interest = opportunity cost of lending money/borrowing someone else’s (ie. renting the money)
      2. Used to be that ALL interest was deductible
         1. Makes sense that all business interest would be deductible
         2. But interest on personal loans was a huge give away
            1. Since changed this, but left huge gaping hole for mortgage interest deduction if it is a qualified residence [**§ 163(h)(2)(D)**]

Think about horizontal equity argument (renter, person who buys home with debt, without debt?]

* 1. Statutory Rules
     1. **Home Mortgage Interest Deduction**
     2. **§ 163**: Interest
        1. (a) Interest portion paid on loans is deductible
           1. NO distinction b/w business and personal
        2. (h) [A creation of the 1986 Act]
           1. Excludes corporations from (h)
           2. (h)(1) makes a distinction b/w business and personal

Can’t take a deduction under this chapter for personal spending

This rule opens up the question about a personal home/residence

Under (h)(1), you wouldn’t get a deduction for this home interest paid, [but see below]

* + - * 1. (h)(2)

(h)(2)(A): Using an exception to bolster exceptions for other things related to business

ie. if you are a lawyer, it ought to be deductible if you have a consulting business on the side to help you earn more income

(h)(2)(B): Investment

**Home Mortgage Interest Deduction 🡪** (h)(2)(D): “Qualified residence interest”

Sends you to (h)(3)

* + - * 1. (h)(3)

(h)(3)(A): Definitional section—any interest that is paid … on (i) acquisition indebtedness … or (ii) home equity indebtedness

(h)(3)(B): **Acquisition Indebtedness**

(i) Acquisition indebtedness = any indebtedness which is:

(I) Incurred in the acquiring, constructing or generally improving the residence of the TP; and

(II) Is secured by that residence

(ii) Interest deduction limited to $1 million of debt ($500k if married person filing separately)

Rationale for this carve-out: owning your own home is the American dream; and helps 3rd party beneficiaries (ie. realtors, construction, banking industry)

(h)(3)(C): **Home Equity Indebtedness**

You have a home and use that home as an ATM (borrow against your equity and take an interest deduction for this personal consumption)

$100k limitation ($50k for married filing separately)

* + 1. Policy
       1. By getting a loan, all you have done is accelerate your consumption. Why should the opportunity cost to do this be deductible? It doesn’t make sense given our modern notion of income that consumption is a major component.
       2. PROF: this is an accident of history.
          1. There was a notion that interest ought to be deductible to get to net income—there was comingling early on of personal/business (so this made sense during that time, but it certainly isn’t the case today)

IRS tried to close this gaping hole, but didn’t close it completely

* + - 1. **Home mortgage interest deduction:** 
         1. On the margins, itwill distort decision making and will incentivize building/owning homes over renting

Maybe this isn’t such a good thing

The IRC was a contributing factor to the housing crisis

* + - * 1. Maybe we don’t want to subsidize this stuff (upside down housing market—helps the people who need it less)
        2. Revenue loss (is it worth the benefit of subsidizing homes?)
        3. Leaving renters out (see below)
      1. Possible reforms of the **home mortgage interest deduction**:
         1. Put reasonable limitations: why 2 homes? Why $1 mm?

Limit to one home and a lower cap

Put some would argue regional differentiations in average housing price

* + - * 1. Use phase-out provision to mitigate the regressive nature of the upside down subsidy effect

OR could structure this as a credit, which would unhinge it from the MTR

* + - * 1. NOTE: But **transitional issues** related to reform

This may not be the best time for reform—this will lower home prices further, which is probably not something we want to do right now

Would grandfather some people in, but Q of who

* + 1. Problem
       1. Year 1, TP buys a house for $50k. By year 15, house has FMV = $300k and TP has paid off previous loan. In year 20, TP takes out loan for $140k secured by the house.
          1. How much of the $140k loan will qualify for the **§ 163(h)(2)** tax benefit?

Limitations on home equity component—TP can deduct the interest on only $100k of the $140k (per **§ 163(h)(3)(C)**)

PROF: this is personal consumption, so should we even allow this at all?

* + - * 1. If TP had instead sold his house and bought another house for the same price (and got a $140k loan),

Move to acquisition indebtedness in **§ 163**

Interest on ALL of the $140k would be deductible b/c this is well within the $1 mm limit

* + - * 1. NOTE: this shows that there is an incentive for people to purchase a **new home** instead of borrowing against their existing home
  1. Loans to Buy Personal Assets
     1. Horizontal equity issues
        1. *See also* **§ 163(a)**; **§ 163(h)**
        2. This puts the homeowner with debt on par with the homeowner without debt (it is the renters who lose out)
           1. (1) Renter

Housing costs (personal consumption) paid with after-tax dollars (ie. no deduction)

* + - * 1. (2) Homeowner w/o debt

Part of housing (imputed income) is enjoyed tax-free

Non-deductible depreciation is indirectly taxed

* + - * 1. (3) Homeowner w/ debt

Part of housing is enjoyed tax-free

Deductibility of mortgage interest puts (3) on par with (2)

Only non-deductible depreciation is taxed indirectly

* 1. Student Loans
     1. Rules
        1. **IRC § 221**: Interest on education loans
           1. Just individuals
           2. An above-the-line deduction

Upside down subsidy b/c is hinged to MTR—those in a higher bracket will enjoy more of this

But could you also argue that this should be deductible as necessary to reach net income (ie. cost of creating income/investment in human capital)? [but Congress doesn’t see it this way—sees it as more of a subsidy that encourages this type of spending]

Doesn’t interfere with the standard deduction, but there are other limitations—like the phase-out as income goes up

* + - * 1. **Deduction for the amount of interest paid during the year on a qualified education loan**
        2. **(d)(1)** “Qualified education loan”

Student loan for tuition

Loan can be taken out by the student’s parent/spouse

Broadly conceived as to which TP can take this deduction

* + 1. Policy rationale
       1. Encourage educational spending
       2. Cut students a break
  1. EITC (Earned Income Tax Credit)
     1. **IRC § 32**
        1. In the case of an “eligible individual” … allowed a credit in the amount equal to the credit % of so much of the TP’s earned income … as does not exceed the earned income amount
        2. **Refundable credit** to low income TPs who have some earnings
           1. Hence a form of gov’t transfer payment
           2. Refundable: this is a negative income tax that you get for working (incentive effect)
     2. Tied to a person’s role as an EE (nudges people to work)
        1. Is meant to encourage more work, but at a certain point in the curve working more may mean less total income b/c get less of an EITC, lose childcare credits [there are disincentives on the margins]
        2. PROF: this is not a great way to fight poverty
           1. If you play with the numbers, a TP win income of ~35k could have an effective MTR of 50%
     3. Geared toward working **families** [ie. with children; don’t have to be married]
        1. Not much of a benefit for individuals
     4. Policy:
        1. Workfare-based income redistribution
        2. Reduce the burden of Social Security on the working poor
        3. US version of the living wage though the use of a negative income tax
        4. Gets working poor out of paying taxes
           1. Query whether this is a good thing
        5. Refundable credit
           1. Milton Friedman—a way to get a whole bunch of people off the tax roles [good idea?]
        6. This is “stealth” welfare spending (via the tax system)

1. Personal Deductions
   1. State & Local Taxes
      1. SALT payments are deductible on federal income taxes
      2. **IRC § 164**
         1. Federal income tax deduction for taxes already paid to SALT
      3. Policy
         1. Subsidy argument: we want federal support for state and local governments
            1. Also see this with the interest on state & local borrowing/bonds
         2. Proper definition of income argument—paying these taxes is not voluntary or personal consumption
            1. Think: but is the same kind of involuntariness as **§ 119** and ***Benaglia***?
            2. You do get **something** for your SALT payments, so there is some consumption, but **valuation** is the question

Is there a one-for-one match for the money you are paying and the benefits you are receiving?

IRC could have punted and gone all or nothing, but helps the S&L gov’ts AND the TP here

Libertarians would argue that you don’t ever get anything from gov’t, so no accession to wealth via benefits (so should get a deduction)

* 1. Dependency Exemptions
     1. ***King v. Commissioner*** (2003)
        1. F: via agreement, mother formally waived her rights to claim exemption, so father claimed daughter. Then mother marries someone else and daughter lived with mother’s family.
           1. Critical Q to the dependency test: who is providing more than 50% of the care
           2. The point of a dependency exemption is that you have less ability pay if you have more kids

If this is the rationale, then we ought to care in substance who is providing the support (substance v. form)

* + - 1. Issue: who gets to claim the dependency deduction?
      2. Held: father gets deduction b/c he has a **contract**
         1. Formalism wins out

This is a statutory interpretation issue

* + - 1. PROF: this is a cautionary tale for family law; don’t take these agreements lightly
         1. Key language in K—deduction to father for “all future years” despite the fact that the mother is the one providing the support
         2. Father also gets the other benefits that come with this (ie. EITC)
    1. Child Tax Credit
       1. **IRC § 24**: provides for each “qualifying child” an amount stated by statute
       2. Phase out produces “phantom” tax increase
          1. Effective rate probably isn’t your statutory rate
       3. No embedded inflation adjustment
          1. Have one would make sense b/c credit isn’t worth as much if you don’t adjust for the decline in purchasing power as things cost more
          2. Not adjusting for inflation dampens the revenue loss to the treasury from this credit
          3. PROF: this credit should be increased b/c it hasn’t been adjusted for inflation in years

**Ch. 5: Mixed Motive Spending**

1. Overview
   1. What to do when there is more than one rationale for the spending?
      1. GOAL: trying to figure out if this spending is trying to help us come to net income. If it is, then should be part of TP’s tax base.
   2. Policy
      1. **Questions**
         1. **Primary question**: where do we draw the line re: **purely personal consumption** (not deducible/part of tax base) **v. production of income** (ought to be deductible and not part of tax base b/c not part of consumption or savings)
         2. **Secondary question**: Timing.
            1. If spending is closer to the production of income side of the spectrum, ask if it is going to help the TP produce income **this** year.

If not, then this spending shouldn’t be a current expense, it should be a capital expenditure

* + 1. Unwarranted **business deductions** may lead to:
       1. Subsidized personal consumption
          1. Ex: for a 35% TP, a fully-deductible $100 meal = $65 non-deductible meal (ie. US Treas. is paying for $35 of your meal)

Problems with this:

Revenue loss for Treas.

Not what the statute intended

Fairness

Horizontal equity: why should someone who has a job that allows for expense-account living use this deduction when someone who has similar income but not the same situation can’t?

Think about the tax policy stool: fairness, revenue, administrability

Distort decision making

Spend more on things that look like business spending, etc.

**Now**, TP would only be able to take a deduction for 50% of the meal

* + - 1. Whenever Congress tries to amend this rule for meals (ie. wiping out deductions for meals), the restaurant lobby revolts b/c it knows that there is a macro econ distortion that leads to a lot more spending
  1. Business Expenses
     1. **Statutory Rules**
        1. **IRC § 162**
           1. “Ordinary & necessary business expenses paid or incurred … in carrying on any trade or business”
           2. Helps us get to net income
           3. Above the line deduction
        2. **IRC § 212**
           1. Expansion of **§ 162** to individuals for profit-seeking activities
           2. This is different than **§ 162** b/c **§ 212** has in mind the situation where someone takes a side job (outside of his trade or business)

We want to tax the **net** income of this side activity

Ie. law firm associate with side consulting business

* + - * 1. This is the “belt” of the “belt and suspenders” [deductible end of the spectrum]
        2. Below the line **and** misc. itemized deduction

Subject to the floor

* + - 1. **IRC § 262**
         1. “No deduction allowed for personal, living or family expenses”
         2. This is the “suspenders” to **IRC § 212**

This reinforces the fact that if it’s personal, you **can’t** deduct it (other side of the spectrum from **§ 162** and **§ 212**)

* + 1. **Mechanics**
       1. Differences in how EEs/TPs can use **§ 162** and **§ 212** deds?
          1. **§ 212** (below the line **and** misc itemized ded.) is much more restricted than **§ 162** (above the line deduction)

**§ 212** is subject to the floor in **§ 67**

* + - * 1. Why this limitation for **§ 212**?

An unreimbursed EE expense is **§ 212**-like

Maybe there is a good reason for not reimbursing—dubious expense

Wall Street Journal subscription would also fit in **§ 212**

Argument that there is probably still some element of personal consumption (more dubious b/c of this)

* + - 1. How **§ 162** and **§ 212** interact with **§ 62** and **§ 67**:
         1. Example

If you are a self employed attorney, the spending you do for your own biz will usually fall under **§ 162** (above the line- which is good b/c don’t have to worry about the standard deduction or **§ 67**)

More complicated if you are a law firm associate (EE) and you want to buy a database that your ER will not reimburse you for.

This database will be an unreimbursed EE expense that will be a **misc. item. ded.** under **§ 67** and the **2% AGI floor** and **standard deduction** obstacles apply.

If EE had been reimbursed for going on a deposition, the cost (travel, lodging, etc.) would be reimbursed. Technically, this reimbursement would be part of GI under **§ 61**, then TP could deduct the actual payments that were made.

But b/c this is a **wash**, Treas. Regs. say don’t worry about including it at all (the reporting requirements will take care of it)

* + 1. Problem 1
       1. Lauren is a solo practitioner with the following annual spending. Which are deductible as current business expense?
          1. (1) All of the salaries are deductible under **§ 162**
          2. (2) New computer & furniture

If they are used only for business purposes, looks like a business expense but **not** a current expense. Have to capitalize it b/c these are assets that will help create income over many years—beyond this taxable year.

* + - * 1. (3) Office rent is deductible under **§ 162**
        2. (4) Office supplies are deductible under **§ 162**
        3. (5) Lunches would probably not be deductible b/c looks closer to personal consumption

But if Lauren is taking clients out for some of these lunches, then it would probably be deductible—business connection (see **§ 274(n)**)

* + 1. Problem 2
       1. When T was in law school he bought a house in Btown and lived there. When he later got a job in LA he rented his house to current law students. T comes back to Btown 3x a year to check on the house—incurring travel, meals, and lodging expenses (but doesn’t stay at the house b/c the house has a tenant). Invariably, T checks on house during big IU weekends (ie. Little 5).
          1. (a) May T deduct expenses?

Looks like **some** personal consumption/recreational activity, but does this mean that **none** of these expenses are deductible under **§ 262**?

**This is deductible under § 212**

**§ 162** doesn’t apply, though, b/c TP’s “trade or business” is being a lawyer. If he doesn’t have a ton of rental properties, it doesn’t fit.

The whole point of **§ 212** is to serve as a back-stop for these other types of income

**Treas. Reg. 212-1(h)**

... **However**, ordinary or necessary business expenses re: rental property are deductible even though the property was previously used by the TP as a residence

* + - * 1. (b) Above the line or below the line deduction?

**§ 62**

Defines what counts as above the line deductions

(a)(4) Deductions attributable to rents and royalties

Cross references to **§ 212**

**So these expenses are above the line deductions under § 62**

So TP is in pretty good luck here as long as these expenses are **reasonable**

Watch for too much personal consumption not directly tied to the business side of the spending, which is to check up on the income-producing property

Ie. if he took a 1st class flight, he could deduct the cost of a coach flight and pay the rest out of pocket

1. Hobby Losses
   1. ***Nickerson v. Commissioner*** (1983)
      1. **Deals with** the threshold Q from **§ 183—**is this activity engaged in for profit?
      2. F: TP is in advertising; he and his wife have a trade/business **other** than farming. TP and his wife decide that they want to become dairy farmers, so bought a farm. Farm was not making a profit (TP didn’t expect to make a profit for the first ten years)
      3. Issue: true farmer or “hobby” farmer?
         1. TPs were taking **§ 162** deductions for recuperating this farm. Are these people truly farmers or is this personal consumption b/c this is a hobby?
            1. TPs used these losses to shelter their other income
         2. IRS is concerned that this is recreational spending
      4. Analysis:
         1. **IRC § 183**
            1. **(a)** If activity is **not** engaged in **for profit**, no deduction is allowed except as provided in the rest of the **§**

Court looks to objective factors re: what is the **primary** motive of the TP in order to figure out if there is a bona fide profit motive

**Factors** come from **Treas. Regs. 1.183-2(b)(1)-(9)**

Factors try to get at whether this looks more like recreational personal consumption or business profit

If it’s like a hobby (not engaged in for profit), no deduction

* + 1. Held: this is for profit
       1. If there are enough Treas. Reg. factors shown that TP wants to make a **profit**, then **§ 183 doesn’t apply**
          1. TP “need only prove their sincerity rather than their realism” re: making a profit

It is **not** about whether objective bystanders would expect a profit from this venture

* + - 1. Court thought that TPs **did** believe that they would make a profit
         1. Factors: have some rental income (even though spending outweighs it); consulted expert advice; rarely used it for recreation (e.g. didn’t have a pool, etc.)
  1. **IRC § 183**
     1. Profit v. Pleasure (hobby)
        1. If it is for **profit**, this is ***Nickerson***
           1. **§ 183** is not applicable and deductions are allowed under **§ 162**

Note: if you can show that you have made a net profit in the past but you have hit a rough patch, this can help prove that you are trying to make a profit and thus **§ 183** doesn’t apply

* + - 1. If it is for **pleasure** 🡪 unrelated deductions v. activity deductions
         1. **(b)(1)** Can still take deductions for unrelated deductions (things that are outside of the pleasure/profit analysis)

Goes around **§ 183**

Example: mortgage interest deduction if this were the TP’s 2nd home; SALT on this farm are NOT denied under **§ 183**

* + - * 1. **(b)(2)** Activity deductions. Key language “only if” and “only to the extent”

Can take these deductions as long as it’s not a shelter (deductions allowed only to the extent of the gross income from this activity after **(b)(1)**)

This makes sense re: **§ 183**’s goal of preventing sheltering via pleasure activities

This is an example of “basketing”

* + - 1. **(d)** Presumption that if you have profit in 3 out of the last 5 years, you have an intent to make a profit
    1. “Business” as pleasure – **Policy** rationales for **§ 183**
       1. **Targeted anti-abuse provision** 
          1. “One of the remarkable aspects of the problem of farms that create tax losses is pointed up by the fact that persons with large non-farm incomes have a remarkable propensity to lose money in the farm business”
          2. **Stops TPs from trying to use their personal losses elsewhere**
    2. **§ 183(b)** & **§ 162(a)**
       1. A deduction-limiting provision **and** a deduction-creating provision
          1. Deduction-creating b/c allows **some** mixed motive deductions (only to the extent of the income)

This is a pro-TP provision if you think about it this way

* 1. Problem – **§ 183**
     1. Facts:
        1. TP raises dogs for past 7 years w/o profit. In year 8:
           1. Income from sale of dogs = $1500
           2. Expenses from spotty records:

$1k on travel & lodging related to dog breeding

$200 on dog food

$700 on vet

$100 on grooming

**TOTAL** expenses = $2k

* + 1. (A) Analysis
       1. “W/o profit for the past 7 years” fact is important
          1. Deduction based on intention to make a profit
          2. **§ 183(d)** presumption is that if you have profit in 3 out of the last 5 years, you have an intent to make a profit

So these facts undermine this presumption

* + - 1. Spotty records
         1. If you are serious about your business, you would be serious about keeping records

Maybe suggests that this is not for profit

* + - 1. PROF: so looks like a lot of personal consumption here
         1. Would also want to know about the **9 factors**:

Does TP have any other source of income?

Ie. income that TP would want to be sheltered

If there is another source of income, looks more like a hobby

9 objective factors try to unearth the sincerity to make a profit (**subjective intent to make a profit is not enough**)

* + 1. (B) If TP hasn’t convinced anyone that the 9 factors are in her favor (thus **not for profit**), move past the threshold Q to **§ 183(b)**
       1. If it is for pleasure, TP can deduct only $1500 of her expenses [b/c up to the GI of the activity per **§ 183(b)(2)**]
          1. **HYPO**: if not for profit, but income was $2500, all $2k of her expenses would be deductible and she would include the $500 profit in her net income

In this way, **§ 183** is helping us define net income

* + - * 1. **HYPO**: what about $500 on home mortgage interest deduction?

Deductible under **§ 183(b)(1)**

* + - 1. Ought to be subject to the 2% floor in § 67 b/c of the dubious nature of this spending?

1. Travel & Entertainment Expenses
   1. **IRC § 274**: Disallowance of certain entertainment, etc., expenses
      1. Generally
         1. First helps us with what is disallowed
         2. Have to show that this spending is **directly related** to the active conduct of the TP’s trade or business
            1. If Congress had stopped here, then taking a client out to dinner for the hell of it (for good will) would **not** be deductible

Good will is too amorphous to be directly related to

* + - * 1. **But** Congress goes on to also use “**associated with**”; and
        2. **“Preceding or following a substantial and bona fide business discussion”**

Exception seems to swallow the rule; has given kind of a free rein to business expenses (but do try to limit meals)

* + 1. **(a)(1)(A)**: activity
       1. An activity that is entertainment won’t get a deduction, **unless**—
          1. It is **directly related to** OR **directly preceding or following** a substantial or bona fide business discussion

If it fits here, some will be deductible—this is a huge hole

* + 1. **(n)**: Congress stepped in w.r.t. **meals**
       1. Only **50%** of meals and entertainment expenses allowed above in this **§** are deductible
  1. Business Lunches
     1. Theory
        1. Ex: TP/lawyer takes a prospective client to lunch
           1. How should tax treat TP’s portion of the lunch?

There is still **some** personal consumption here—the portion that is the TP’s lunch (absent wooing the client, would have eaten elsewhere)

Could say that the **client’s** portion of the lunch is business

But see theoretical accuracy v. practical administration

* + 1. ***Moss v. Commissioner*** (1990 Posner)
       1. F: TP is a partner at a small litigation law firm. Every single day, TP and other firm lawyer meet for lunch to talk business at a Café (clients came only occasionally).
       2. Issue: are these daily lunches deductible for the TP?
          1. TP argues: these lunches are ordinary business-related expenses under **§ 162**

Noon: the only time they could meet b/c court was in recess

* + - * 1. IRS’s concern: frequency (every single day); concern that “enough already”—are they **all** deductible?
      1. Held: no deductions allowed for lunches b/c **not “necessary”** business expense under **§ 162**
         1. Posner also argues that:

Frequency is upsetting; and

There is not a lot of forced personal consumption here

* + - * 1. Rationale

To hold otherwise would be a windfall to TPs

No need for “social lubrication” with these co-workers

* + - * 1. Contrast: Posner says that most business lunches are, in fact, deductible

If Moss only tried to deduct the times when the client came to lunch he would have a stronger case for deductibility (more need for social lubrication with clients)

* + - 1. Legacy: the Firm loses this case, so then starts having the lunch catered at the office every day
         1. Thus, lunch was “furnished, provided by the ER”

**§ 119**, which cross references **§ 162**

Can deduct ½ if it & is not forced personal consumption

* 1. “Business” T&E – Case Law
     1. ***Benaglia*** & “all or nothing” taxation
        1. Argument for forced personal consumption for the TP/lawyer in the above example
        2. IRS punts in ***Benaglia***, but tries to come up with a middle ground for T&E
     2. ***Rudolph v. US*** (1962)
        1. F: insurance agents (and family) go to NYC for insurance conference
        2. Issue: is this income for the TP/agent; is it deductible?
           1. Whose primary purpose is determinative? Look at both the EE **and** ER

ER’s intent ought to be the primary, but court says that EE had fun

* + - 1. Held: this is too much personal consumption to be a legitimate business expense
         1. PROF: but this would probably be deductible now b/c Congress has stepped in with **IRC § 274** (ER may see this as fostering EE morale even though EE is enjoying it)
  1. **Travel Expenses**
     1. Theory
        1. **General Rule**: **commuting expenses are personal and not deductible**
           1. Presumes that the location of work/office is fixed and TP gets to make the personal choice where he lives in relation to this fixed work location

***Flowers*** is the classic case for this

* + - 1. Ex: TP/lawyer lives in B-town but works for firm in Indy.
         1. If TP drives to court/client from work, the expenses are deductible
         2. But the drive from home to work is **not** deductible

TP has to get to work, but he made the **personal choice** to live in B-town and work in Indy

Too much personal consumption wrapped up in this

* + 1. **§ 162**
       1. (a)(2) Specifically allows the deduction of “traveling expenses” while away from home in the pursuit of trade or business.
          1. “Traveling expenses” refers to both transportation costs and to ordinary living expenses (meals & lodging) that are incurred by the TP in connection with a business trip

But **§ 274(n)** says that only ½ the cost of business travel means is deductible

* + 1. Commuting Expenses
       1. ***Commissioner v. Flowers*** (1945)
          1. F: Flowers took a job as a lawyer for a RR co. He lives in Jackson, MS but the RR’s office is in Mobile, AL [185 miles apart one-way]
          2. Issue: TP tries to deduct his commuting expenses
          3. Held: no deduction b/c hits on the **“necessity”**

**3-part test** to get at what we understand to be **“while away from home”** under **§ 162(a)(2)**

**(1) Reasonable and necessary; and**

**(2) Incurred while away from home; AND**

**(3) “In pursuit of business”/”the exigencies of business”**

Court hammers the “in pursuit of business” element b/c it was a personal choice to maintain his home in Jackson

It too close to the personal consumption end of the spectrum/not part of the exigencies of business

* + - * 1. PROF: why allow deductions for **“while away from home”**?

Easy case for deductibility (if lawyer is sent to TX for a depo, travel expenses ought to be deductible b/c you are forced)

Also helps define net income properly

Gets at the idea that you have to do **duplicate spending**

You already pay rent at home, have groceries in the fridge, etc.

* + - 1. Defining “home” in **“away from home”**
         1. ***Hantzis v. Commissioner*** (1981)

F: Harvard law student (lives in Boston) gets summer job in NYC. Gets apt. in NYC and has related travel and living expenses that she tries to deduct under a **§ 162** “while away from home” argument

TP: argues that it is not practicable to make this commute every day; deductions part of definition of net income

IRS: 2-part argument

(1) Primary claim: the word “home”

TP argues that Boston is her home

IRS argues that NYC is TP’s home

(2) In “pursuit” of trade or business

B/c she is a full-time student, she is not really in a trade or business

Held: **no deductions** for TP b/c NYC was “home”

Rationale: TP doesn’t have a business reason to maintain her home in Boston

“While away from home” tries to get at the idea of duplicative spending

PROF: court is confusing—keeps going back and forth w.r.t. what is “home”

Court knows that it is going to disallow the deductions b/c of the level of personal consumption

* + - 1. Reconciling ***Flowers*** & ***Hantzis***?
         1. Is a legal education not a biz expense? This is sort of what the ***Hantzis*** court is getting at

It matters that the law student was a **full-time** student

She would **still not get** the deductions even if she had waited tables part-time during **full-time** school and then took this NYC full-time gig

The notion that she is a full-time student is what is important to the court (not in a trade or business)

* + - * 1. If Hantzis had split her summer and spent 2nd ½ in LA?

It would still be a big impediment that she is still a full-time student and has a place in Boston

If it were for the same firm, might cut in favor of allowing the deductions

If she keeps her NYC apt and commutes from NYC to LA:

There is a **stronger case for deductions** b/c she is travelling/incurring duplicative expenses again

Established a home in NYC and incurring LA expenses

But could also argue that she made a personal choice to stay in NYC (and this isn’t about the exigencies of business—***Flowers***)

Could also argue that she still shouldn’t get the deduction b/c she is **still** a full-time student

PROF: but could argue that TP is in a trade or business for this time period for this firm

* + - * 1. A lot turns on the facts—look at the 3 elements of ***Flowers***

See if there are enough facts to show that the conceptual point of **§ 162(a)(2)/duplicate spending** pushes you closer to the deduction

* + - * 1. Could make the broader argument that school is an investment in human capital—pre-operating costs, and thus you **are** in a trade or business

1. Child Care & Commuting Expenses
   1. Child care expenses
      1. **§ 21**
         1. **Credit** for expenses related to care of a dependent (includes care of elderly parents, etc.)
            1. **Not tied to MTR** (removed upside down subsidy effect by unhinging from progressive rate structure)
         2. **(a)** Allowance of credit
            1. Key language (that leads you to look elsewhere for definitions):

Qualifying individuals- defined in **(b)(1)**

Typically dependents

Credit

Applicable **%** of the employment-related expenses for which this credit is tied to

This is related to **employment**—not just a child care credit (to address the ***Smith***-type context)

* + - 1. **(c)** Cross reference re: dollar amount creditable
         1. Amount of the credit is directly ties to **§ 129** (EE exclusion for dependent care assistance provided by ER)
      2. Phases out
      3. \*Think about the balloon problems/pressure points here
         1. If you apply pressure in one place, it gives elsewhere
    1. **§ 129**
       1. EE exclusion for dependent care assistance provided by ER
    2. ***Smith v. Commissioner*** (1940)
       1. Facts: both H & W worked and wanted to deduct for babysitting expenses
          1. TP: but-for working, we would not incur these childcare expenses
       2. Court: childcare expenses are personal; not deductible for TP
          1. Though certain disbursements may in some tenuous degree relate to profitable occupation, they are nevertheless personal in their nature

Slippery slope argument for “but-for”

PROF: but courts draw the line on a slippery slope all the time?

* + - * 1. **Base-line driver of but-for causation is the personal choice to have kids**
      1. We have now addressed this in the IRC (see above)
    1. Policy alternatives
       1. Goal of **§ 21** was to mitigate some of the secondary worker disincentives that come with non-taxability of imputed income and the cost of household services
          1. PROF: but **§ 21** doesn’t do enough
       2. Joint returns drive this disincentive b/c the amount that that the 2nd earner earns is piled on top of the 1st earner
          1. Could replace joint returns with individual filing
       3. Could tax the value of imputed income from household services
          1. Roundabout way to get at this problem—but this would work b/c we give things value through the IRC
       4. Tax “penalty” for having children
          1. This may alleviate the disincentive for 2ndary workers b/c of childcare, but we are talking about **dependent care**—elderly care, too, not just childcare
       5. Could target 2ndary-earner tax benefit
       6. Could get rid of the progressive rate structure
          1. This is the driver of the tax disincentive in the first place

Notion that we have to have vertical equity is pushing a lot of this

* 1. Commuting expenses
     1. See above
     2. Different from travel expenses?

1. Clothing & Educational Expenses
   1. Clothing expenses
      1. ***Pevsner v. Commissioner*** (1980)
         1. Another example of mixed motive spending
         2. Facts: TP worked for YSL clothing boutique. TP wants to deduct the cost of her work clothing b/c she has to look fashionable at work to represent the store.
            1. **TP’s argument**: she is just wearing these clothes for work, so should be able to take these deductions under **§ 162**—this is her trade/business (unreimbursed EE expense; but remember dubious nature of these kind of expenses). She doesn’t wear these clothes for personal reasons.

PROF: could also argue forced personal consumption like ***Benaglia***

But retail workers may choose stores where they work b/c they want the discount (so some kind of empirical personal consumption)

* + - * 1. **IRS argument**: adaptable for usage as ordinary clothing, so this is ordinary spending/a lot of personal consumption
      1. Procedure: Tax court held for TP b/c on a subjective level, these clothes don’t match TP’s socio-economic lifestyle
      2. Held: for IRS; no deduction b/c clothes were **objectively suitable for ordinary use**
         1. **3-elements Test** [more objective]**:**

Clothing expense is deductible if:

(1) Required as a condition of employment;

(2) Not adaptable to general use; and

(3) It is not so worn

* + - * 1. Subjective test is an admin nightmare b/c if there are 2 YSL managers, have to decipher everyone’s socio-econ status and whether these clothes fit
        2. Horizontal equity problem that 2 YSL managers could be treated differently
        3. LEGACY: you **can** use **§ 162** for business clothing, but the courts have just narrowed it to where the court is certain that it is about business

Trying to find the **nexus** between the spending and the production of income

Narrow ex: tennis sneakers for tennis pro are not deductible b/c they are objectively suitable for ordinary use

* + - 1. PROF: what kind of business clothing **is** deductible?
         1. Police officer uniforms, military uniforms

When you have clothing that you can’t wear day to day

More clear that wearing these clothes are a condition of employment

* + - 1. NOTE: this case goes the other way from ***Benaglia***
         1. Maybe b/c Pevsner can take her clothes with her if she leaves her job but Benaglia can’t take his hotel room?
         2. Maybe this unfair to Pevsner herself, but how do we deal with this potential gaping hole for clothing subsidy over the entire tax system?
      2. NOTE: law firm could try to exploit this ***Pevsner*** rule by emblazoning code of arms on suits to make them a uniform
         1. Forcing partners and associates to wear different colors may fit ***Pevsner***
  1. Education expenses
     1. Theory
        1. In the middle between mixed motive spending and capital expenditures
           1. Treas. Regs. on this are all about defining the line b/w personal and business
        2. On the business/current expense (non-capital expenditure) side of the spectrum?
     2. ***Carroll v. Commissioner***
        1. F: Chicago cop/TP is taking a few college courses hoping to become a law student. TP tries to deduct his college tuition expenses.
           1. TP’s argument: wants to deduct these expenses b/c he wanted to improve his skills as a police officer, so **§ 162** necessary & business expense
        2. **§ 162** itself doesn’t say much about educational outlays, but Treas. Regs. do
           1. **Treas. Reg. 1.162-5**

(a) Expenditures made for education which are not expenditure of the type … are deducible as ordinary and necessary business expenses

Aka educational expenses are deductible **if** (1) the education maintains or improves skills; or (2) meets the express requirements of the ER (but flags other categories that don’t count)

**Deductible outlays:**

**(a)(1)** “maintains or improves” required skills, **or**

**(a)(2)** “meets express requirements”

**Non-deductible outlays:**

**(b)(1)** gives logical justification for why you **can’t deduct** sometimes even if you are in (a)(1) or (a)(2)—aka there is too much personal consumption/capital expenditure to pull it part and give a deduction

**(b)(2)** if spending gets you to **“minimal educational requirements”** (aka gets you in the door), this is not deductible

**(b)(3)** qualification for new trade or business (aka if you are changing careers, that is not deductible b/c too much of a personal choice to change careers)

“**Either a or b, but neither c nor d”**

* + - 1. Held: expenses were **not** deductible b/c spending is personal b/c college is general education and not sufficiently tied to current job
         1. PROF: ie. turning tug boat into a yacht
      2. Analysis
         1. TP’s argument is **(a)(1)** but this is tenuous b/c **no direct nexus** b/w the classes and TP’s job as a police officer
         2. **(a)(2)** isn’t relevant b/c not expressly required for TP’s job
         3. **(b)(3) kills the claim** b/c TP is taking these classes to get into a new trade or business (ie. law school)
    1. NOTE: if your ER pays for your (as an EE) college, more likely to fit under **§ 162** based on the logic of why ER would do it
       1. ER is the TP and wouldn’t see it as opening up different “vistas” to new trade or business—gets more dubious and fact-specific when the EE pays for it
       2. Remember that **§162** & related Treas. Regs.deal with deductions—says nothing about the inclusion for the EE in this scenario.
          1. Look at **§ 61** to argue inclusion in GI, **or** look to **§ 119** to argue forced personal consumption (even though it doesn’t fit perfectly) **or § 132** to argue fringe benefit

If it looks like GI, it should be included for the EE

* + 1. **Tug Boat analogy**
       1. If you are a tug boat operator and you keep your tug boat in good shape, this ought to be a deductible business expense b/c you are sharpening the skills
          1. Educational expenses to sharpen your skills are akin to these tug boat expenses
       2. But if you take courses that open you up to a whole vista of opportunities, it is like converting your tug boat into a yacht, and it should **not** be deductible
    2. Problem
       1. **What of the following TPs would be entitled to a current deduction?**
          1. (A) Lawyer incurs expense of tax planning course as part of CLE requirements

Deductible b/c directly related to lawyer’s business

This is like repairing the tug boat b/c we want people to keep their human capital skills sharp and intact

* + - * 1. (B) TP/JD grad takes courses towards tax LLM

Want to know what kind of lawyer he is now

(i) What if someone who just finished JD and realized they love tax and goes straight from JD to LLM

PROF: probably **won’t** be deductible

**§ 162**: not in trade or business; just continuing student education (pre-operating cost)

Not necessarily maintaining skills

Not required

(ii) If someone is practicing law (litigation) and now wants to get a LLM in tax

It **is** his trade or business (so fits face of statute under **§ 162**)

How to ferret out TP’s motive—if is already in practice area that is related to tax and there is a **nexus** b/w his current practice and the kind of LLM courses he is taking—this looks closer to improving skills and less like personal consumption—**thus deductible**

(iii) If TP is in a general litigation practice (not a lot of tax work) but sees that tax work is depression resistant. Wants to improve changes in legal practice more generally, so gets a tax LLM.

This leans more toward …?

Would want to know if ER is paying (would make it look more like a **§ 162** deduction)

(iv) Utility lawyer who decides to go back part time to get tax LLM so he could leave the regulatory field

Argument that this is deductible: TP is currently in employment, and (a)(1) says “other trade,” so as long as you are in the same realm, it is deductible

IRS counter argument: this looks like new vistas of opportunity (building a yacht)

**Hard to determine what “new vistas” are**, but the IRS has won cases that are saying things similar to “a tax lawyer is not the same thing as a regulatory lawyer”

* + - * 1. (C) Teachers

Teachers have won if you look at the Treas. Regs.

Teaching is teaching is teaching (ie. no new vista if you get more degree/masters)

But will turn on the facts

* + - * 1. (D) Sales manager enrolls in full-time MBA while continuing employment (***Allemeier v. Comm.***)

(a)(1) is a good argument b/c this is about improving skills. This degree would help TP at his current job

This is what the court **held**

Unlike a JD, which is truly unique—all an MBA does is improve your skills (everyone can use management skills)

* + - 1. **New Trade or Business** problem
         1. TP is IRS lawyer in NYC. Moves to CA and claims a deduction for CA bar review course. Tax implications?

Court says **no deduction** b/c this is personal consumption (lawyer doesn’t have to take this bar exam—it was his decision to move to CA)

It was also his personal decision to take the bar review class even if he were **required** to take the bar exam itself (too much personal consumption)

To be a CA lawyer is like a new trade or business (not the same thing as being a NY lawyer)

Another reason to **deny** the deduction

Treas. Regs get us to the Q of how much of this is personal consumption

* + - * 1. What about the TP lawyer’s bar dues?

Argue that if it is an **annual, recurring fee**, it is required for the job under Treas. Reg. **(a)(1)**

Could also argue, that if it is a **non-recurring/one-time fee**:

Could be capitalized b/c it is a one-time fee that gives privileges for ten years

Looks like an asset that will help you make future income, so ought to be **capitalized**

This is what we see for one-time hospital fee for doctors

* + 1. **Educational Tax Subsidies**
       1. **§ 25A** – HOPE/Lifetime Learning Credits
       2. **§§ 529, 530** – Future Savings Benefits
          1. *See more on* **§ 529** *below*
       3. **§ 222** – Deduction for Qualified Higher Ed. Expenditures
    2. **Pre-paid consumption**
       1. Important w.r.t. time value of money issues
       2. If TP/consumer knew he was going to pay $10k to university in 4 years, he would start saving
          1. (1) Year 0- TP saves/invests $6,830 (PV of $10k assuming 10% interest for 4 years)
          2. (2) For tax purposes, the difference b/w $6830 and $10k is interest, so should accrue taxable interest income in year 4
    3. **Pre-paid tuition plans**
       1. **In response to pre-paid consumption tax issues above,** states created trusts so TP could use short-cut method
          1. Allows TP to cut out the intermediary (bank) and **forgo taxable interest income** (give the $6,830 directly to the university)

This looks like OID, under which TP should impute the annually accrued interest (but the technical OID rules don’t fit here b/c this isn’t a debt instrument—but the concept is the same)

So this short cut was leading to evasion/avoidance problems

But the social policy goal of this was to encourage people to save for college (makes the pie bigger)—this is where Congress fell on this

* + - 1. **§ 529**
         1. Provides an **exemption** for distributions from a qualified program for higher education expenses

Have to use after-tax dollars

No deductions for initial contributions, but grows tax-free (ie. from $6,830 to $10k) provided that you actually use the money for education

* + - * 1. No limit to what you can contribute?
        2. NOTE: this undermines our H-S theory for good reason
        3. This is not as generous as health savings plans, though
      1. Distributional impact?
         1. Are the people who can afford to save for college actually the ones in need of a tax subsidy?

**Ch. 6: Capital Expenditures**

1. Overview
   1. This is a sub-set of whether the spending is business (deductible) or personal (non-deductible)
      1. **Once we decide it is a business expense, the second order question is when it is deductible**
   2. A capital expenditure is an **investment** (no change in set wealth at the moment)
      1. **The outlay is added to basis and amortized or depreciated over time**
   3. Keep H-S in mind
      1. Haig: income = “the money-value of the net accretion of economic power between two points in time”
         1. When you buy a factory for your business, it is **not** income, but it could help create income down the road
2. Current Expense v. Capital Expenditure
   1. Statutes
      1. **§ 162**: authority for current expense deduction
      2. **§ 263**: authority for capital expenditure
         1. No immediate deduction under **§ 162** allowed for money paid out for buildings
            1. Doesn’t in IRC tell us what do with this kind of spending, but can point to the overall concept of why we are doing this 🡪 **we force TPs to capitalize and depreciate certain spending over time instead of taking a deduction b/c we want to clearly reflect income (matching principle)**

Look at **§ 167 (depreciation)** to know what to do

* + - 1. **§ 263** v. **§ 446(b)** & the issue of timing
         1. **§ 446(b)** “Clearly reflect income”

Accurately match the spending with the connected income (direct nexus)

This is what capitalization lets us do

* + - 1. **§ 263(c):** Exceptions
         1. This section doesn’t apply to R&D, farmers, etc.
      2. **“One Year Rule”**
         1. **Treas. Reg. 1.461-1(a)(1)**

General rule: if benefits of the assets will go beyond one year, ought to be capitalized (but there will be exceptions)

* + - 1. NOTE: in the business context. TPs will generally prefer to accelerate deductible expenses b/c of the time value of money (don’t want to be forced to depreciate over time)
         1. **But** may prefer capitalization over time sometimes in mixed personal/business assets b/c of the personal asset benefits (casualty losses, etc.)
    1. **§ 167**: Deductibility of depreciation
       1. Use this if asset is capitalized
          1. But **no** depreciation for land, b/c **§ 1001** allows for recovery of basis at sale
  1. Problem
     1. Megan’s T-shirt business. Tax treatment of spending?
        1. (i) Salaries to sales force?
           1. **§ 162** treatment (current expense)
        2. (ii) Purchase of t-shirt screen press
           1. Capital expenditure & added to basis per **§ 263**

Depreciation deductible under **§ 167**

* + - 1. (iii) Purchase of land
         1. Capital expenditure added to basis per **§ 263**

**No** depreciation over time b/c for tax purposes, land does **not** depreciate

TP will recover at sale per **§ 1001** OR if she builds a warehouse on the land, that spending will be capitalized and deductible

* + - 1. Destruction: if screen press ($60 cost and 5 year useful life) is destroyed after 3 years, would be currently deductible at moment of destruction under **§ 165(a)** b/c it is a casualty loss of a business asset
  1. Cases
     1. ***Encyclopedia Britannica v. Commissioner***
        1. F: EB bought a manuscript (long-lived asset that would create income for TP for many years) from another company and tried to deduct the cost as a current business expense.
           1. TP: argued that it needed to outsource for good business reasons but tried to treat the situation as if the manuscript had been produced in-house

EB would have been able to currently deduct this outlay as a business expense if the manuscript had been created in-house

* + - * 1. IRS: argued that EB bought an income-producing asset, so the costs will have to properly match gross income (amortize/capitalize it)
      1. Issue: can EB do this? Does this spending need to be capitalized?
      2. Held: for IRS; no current deduction, full cost of buying manuscript must be capitalized
      3. PROF: if EB is constantly turning over this # of books, we shouldn’t care whether EB capitalizes b/c the tax will be the same (**“steady state”**)
         1. BUT here, there was a **single asset** purchased, so compares to trucks used to build power plant in ***Idaho Power***

The depreciation of the trucks is tied to the building of the power plant (EB case is closer to this than to the “steady state” case)

* + - 1. NOTE: there is an **inconsistency** after this case
         1. Production in-house v. outsourcing

Created in-house could be deducted immediately

So Congress steps in with **§ 263A**

* 1. **Recurring v. Non-Recurring**
     1. If expense has indicia of being non-recurring and abnormal, leans toward capitalizing b/c means that this spending will kick off future benefits
     2. If it is a recurring-type expense, wouldn’t really matter if it is capitalized now b/c will continue to have these expenses in the future (will end up in the same place whether take immediate deductions or capitalize)
  2. **§ 263A**
     1. SUM: cost of self-creating assets must **also** be capitalized
        1. **§ 263A(a)** only applies to **real** or **tangible property**
           1. Examples of **in**tangible property: good will, IP, money spent to hire lawyers, bankers, etc., for guidance
     2. **(a)** Non-deductibility of certain direct and indirect costs
        1. **(1)(B)** And in the case of any other property shall be capitalized
        2. **(2) Allocable costs** (are non-deductible/must be capitalized)
           1. **(A)** direct costs
           2. **(B)** and indirect costs (including taxes), part or all of which are allocable to the property
           3. NOTE: this part stems from ***Encyclopedia*** (the court in that case though that this wouldn’t be administrable)
     3. **(b)(1)** real or tangible property produced
     4. **Rationale**
        1. Push back against distortions of treating the costs related to the same kind of asset differently
  3. Intangible Property
     1. ***INDOPCO v. Commissioner***
        1. F: TP = INDOPCO; TP was being acquired by Unilever and wanted some advice. So hired bankers and lawyers (cost $2.5 mm)
           1. TP: argue that there is no way to do an accounting here, so ought to be able to deduct it as a current expense
        2. Issue: How to treat this spending of $2.5 mm? Is it a current expense or capital expenditure? It is obviously business
        3. Rationale
           1. This is **not** a separate business asset

***Lincoln Savings* says that it has to be a separate business asset for it to be required to be capitalized**

* + - * 1. But also ask if this advice will bring benefits exceeding one year?
      1. Held: forced to capitalize this $2.5 mm in fees related to the merger (**amortize** over time)
         1. **Don’t care whether there is a separate asset**
         2. Really care about matching future income and future costs (to get at net income)

There **will** be future benefits from this (will kick off more income)

If there are future benefits from this merger (past one year), it ought to be amortized

* + - 1. Connection to ***Brittanica***
         1. This merger is an abnormal, non-recurring expense—so should be capitalized/amortized
      2. NOTE: if Unilever had spend the money on this advice, would have been immediately deductible as a business expense
      3. Legacy: this case was empowering for the IRS
         1. Broad reading: all spending that leads to future income needs to be capitalized

So TPs lobbied and pushed back on the IRS

**Especially advertising agents**

Rev. Rule 92-80

Training costs

Severance pay

Rev. Rule 94-77

* + - * 1. 2004: Treasury had to step in with **“anti-INDOPCO”** regs

Creating Intangibles

Treas. Reg. **§ 1.263(a)-4**

Facilitating Acquisitions/Changes in Capital Structure

Treas. Reg. **§ 1.263(a)-5**

* 1. **Repairs & Maintenance**
     1. Case law
        1. ***Midland Empire Packing Co v. Comm.*** (1950)
           1. F: TP puts new lining in basement to make it oil-proof
           2. Issue: are these ordinary business expenses that are currently deductible?

TP: in order to continue using its meat packing facility, needs to make sure that it is oil proof. So this is just a repair and should be deductible as such

IRS: this is a one-time expense and there will be future benefits, so under the logic of ***Encyclopdia*** and ***INDOPCO***, this ought to be a capital expenditure

* + - * 1. Held: for TP; this is a **repair**—deductible as ordinary and necessary business expense

Rationale: doesn’t add to the value or prolong its expected life

Even though this was a necessary expense, TP continued to do what it had been doing before even though this was abnormal and non-recurring (didn’t expand the scope of the plant)

Court references **§ 165** (punts), but could have used analog to **§ 165** saying that this spending is akin to a casualty loss (and the cost of the repair is the valuation)

* + - * 1. Court turns to **Treas. Reg. 1.162-4** 🡪

“The cost of incidental repairs which **neither** materially add to the value of the property **nor** appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as an expense, provided the cost of acquisition or production or the gain or loss **basis** of the taxpayer's plant, equipment, or other property, as the case may be, **is not increased by the amount of such expenditures.** Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, shall either be capitalized and depreciated in accordance with **Sec.** **167** or charged against the depreciation reserve if such an account is kept.”

* + - * 1. PROF: how would you apply **§ 165** (casualty losses) to this case?

Think about whether the spending is sudden, expected, etc.

If it is more like termites, it is **not** going to be a casualty loss (it more like normal wear and tear and will get a depreciation deduction for it)

But if something sudden happened to TP’s plant, could be analogized to a casualty loss

Don’t have to worry about **§ 165(h)** b/c this is clearly a business context

Also have to determine the **value** of the loss (big issue for casualty losses)

IRC says that A/B acts as a max, but doesn’t say exactly what …

**Treas. Reg. says that REPAIRS are good proxies for determining the value of casualty losses**

This helps us argue that this is somewhat akin to a casualty loss that we can put a value on (the value is the cost of the new liner—amount of spending needed to get us back to the ex ante status quo)

* + - 1. ***Mt. Morris Drive-In*** (1956)
         1. F: TP installs drain system after initial construction caused damage to neighbor’s property

TP: argues that he had to put this in in order to continue his business, so ought to be deductible

* + - * 1. Held: TP should have foreseen that this would be a problem, so this spending has to be capitalized (it should have been part of the initial construction)

If held otherwise, incentives would be bad

* + 1. Problem
       1. City building inspector requires Matt to build a fire passageway in his theater. This requires Matt to tear out seats, decreasing profitability, and expend $20k for the new fire passageway. Tax treatment of $20k in costs?
          1. Foreseeability argument: if Matt should have known beforehand that the fire code required this but didn’t adhere to it, this should be clearly capitalized

But if the fire code was silent, or if Matt was in compliance but then the code changed:

Could argue that it still enhanced the future value of this property, so should be capitalized; OR

Could argue that Matt is just trying to continue operating his business, so this should be currently deductible

* + - * 1. If this decreased the value of the property (decreased the profitability), could argue that this is a **casualty loss**

To back this up, we have a valuation (we can use the $20k repairs as a proxy—valuation is the typical problem with casualty losses)

If this was due to the whims of the regulators (new reg), looks like the suddenness of a casualty loss

* + - * 1. If you make the case that this is a one-time, non-recurring expense, this looks more like a capital expenditure
        2. NOTE: lots of line-drawing; fact dependent

1. Depreciation/Amortization
   1. DEPRECIATION
   2. General Principles
      1. **Amortization** goes with intangibles
      2. **Depreciation** goes with tangibles
         1. **§ 167(a)**: what depreciation is
            1. Depreciation is “wear and tear” of income-producing assets is deductible
         2. Why do we allow a deduction for this?
            1. Ideally: defining net income
            2. Actually: economic incentives

Now is used almost exclusively as a econ tool (has almost nothing to do with the proper definition of income)

* + 1. Tax accounting v. financial accounting
       1. We are talking about tax accounting (the ways we determine tax liability via accounting maneuvers)
          1. All TPs have separate books for financial accounting

Tax books and fin books are in tension b/c want your taxable income to be lower, but want to max income for SH value (drivers are different)

* + - * 1. Some flexibility in accounting
  1. **General conditions that determine deductible depreciation:**
     1. (1) Business asset;
     2. (2) Determinable useful life
        1. What counts as this?
           1. Problem of artwork (this is actually appreciating); nice instruments, etc.
  2. History of Depreciation
     1. From measuring income to subsidizing investment
     2. Origins: Corporate tax of 1909
     3. Critical moments of change
        1. 1954: 1st use of accelerated method
        2. 1962: guidelines on Asset Dep. Range (ADR)
        3. 1981: Accelerated Cost Recovery System (ACRS)
        4. 1986: Modified ACRS (MACRS)
     4. Depreciation leading to urban sprawl (1950s)
        1. It is about fixed costs
           1. It is very expensive up-front to build a mall (the money comes later when you get rental income)

If you have accelerated depreciation, these high fixed costs plummet

It is NOT the character of the income, it is just that it is cheaper to build box stores and malls now on a post-tax basis

* 1. Depreciation of Tangible Property
     1. IRC says that **salvage value is irrelevant**
        1. Which is another way to accelerate depreciation
     2. **§§ 167, 168**
        1. (1) **§ 167(c)**- basis for computing depreciation
           1. **§ 168(b)(4)**- “salvage value”
        2. (2) **§ 168**- useful life or “recovery period”
        3. (3)(a) **§ 168(b)**- “method” (rate) of depreciation
           1. (b) **§ 168(d)**- “applicable convention”
  2. ACRS
     1. Recovery Periods
        1. **§ 168(c), (e)**
           1. **§ 168(e)(1)**: recovery periods < useful life
           2. **§ 168(e)(3):** particular classifications
        2. Recovery periods don’t even match the useful life, now
           1. We don’t every really care
     2. Depreciation Methods
        1. **§ 168(b)**: applicable depreciation methods
           1. **Real property** 🡪 straight line
           2. **Farm business property** 🡪 150% method
           3. **Other property** 🡪 200% method
        2. Note: **§ 168** elections provide flexibility
  3. Recapture
     1. Gets to the character of the income
        1. What happens if you sell an asset and get gain that looks like capital gain? This should strike you as a double benefit if you already got the depreciation deductions
     2. The theory
        1. **Preventing a double tax benefit**
           1. Tries to address the idea of a rigid tax year (think about the tax benefit rule)
           2. By turning capital gain into ordinary income, we try to make this rigidity more flexible
     3. **§ 1016(a)(2)** and **§ 1245**
        1. **§ 1245**
           1. Recaptures some depreciation deductions as ordinary income

Goes back to the character of the income, which is crucial

* + - * 1. Roughly speaking, applies to depreciable property other than real estate
      1. Recharacterize income that would otherwise be capital gain into ordinary income
         1. When you have taken too many depreciation deductions (which you almost have to under the code b/c of all of the acceleration)

***Haverley***

Didn’t include books in income (which was ok), but he then tried to take a charitable contribution deduction (this was not allowed)

Same concept in recapture

* 1. Problem
     1. Grandma’s Cookies buys oven (**§ 1245** property) for $10k. For years 1-2, GC takes total dep. deds of $3k. Oven’s A/B = $7k.
        1. Start of year 3, if GC sells oven for $9k, without recapture rules (**§ 1245**), there would be $2k in capital gains. Why should this be allowed since she already got dep deductions against her ordinary income in the first two years?
           1. So **§ 1245** steps in and says that this $2k is ordinary income, **not** capital gain
     2. Rare case: this oven is really important so the resale value is higher than the original value (bought it for $10k, now worth $11k and she sells for $11k).
        1. Without **§ 1245**, capital gain of $4k (but this doesn’t seem right)
        2. There is clearly a $4k gain (not all of it is capital gain)
           1. **With § 1245**, $3k is ordinary income and $1k is capital gain
  2. AMORTIZATION
     1. Goodwill & Other Intangible Assets
        1. Self-created intangibles (e.g. patent)
           1. **§ 167(a)** – do **not** get accelerated depreciation (ACRS)
        2. Purchased intangible assets (e.g. goodwill)
           1. Calculate goodwill: the amount a buyer is willing to pay over the book value of the business
           2. ***New Morning Ledger Co.*** (SCOTUS)

Allowed a newspaper/TP to amortize intangible asset of newspaper subscriber list

This led to inconsistencies between self-created v. purchased assets

**§ 197** steps in

* + 1. **§ 197**
       1. 15-year period for amortization if your asset fits under **§ 167**
          1. Congress draws a line in response to ***Newark Morning Ledger*** and gives the arbitrary # of 15 years (to stop clogging up the courts with fact-specific litigation)
    2. Problem
       1. GC is thinking of expanding by either (1) acquiring a popular competitor (Mom’s Brownies); or (2) expanding internally by making brownies and issuing a marketing campaign to announce its new products
          1. Tax implications of two options w.r.t. goodwill v. marking?

**W/ acquisition**, would have to amortize the amount of goodwill over 15 years (**§ 197**)

**W/ internal option**, **§ 162** and ***INDOPCO*** regs say that marketing expense is currently deductible

TP will prefer this internal option for tax purposes

1. Tax Avoidance/Tax Shelters
   1. **Tax Shelter** = strategy to reduce one’s tax burden without the commensurate economic risk
      1. The IRS wants the economics to go with the tax
   2. Building Blocks of Tax Shelters
      1. **Deferral**
         1. Pushing income into the future by incurring costs that are currently deductible
            1. Might be a shelter in certain kinds of ways (but also has legitimate uses)
      2. **Conversion**
         1. Converting ordinary income into tax-favored income, such as capital gain
            1. Preferential rate for capital gains
      3. **Tax Arbitrage**
         1. Incurring expenses that are deductible in order to generate income that is tax-favored, thereby creating a tax loss in excess of any economic loss (e.g. borrowing to buy tax-exempt bonds, unable today b/c of **§ 265**)
      4. \*May be a combo of these
   3. Anatomy of a Real Estate Shelter
      1. Debt included in basis
         1. ***Crane v. Commissioner***
            1. F:

1932: TP inherits property w/ FMV = $250k (subject to NR debt)

1932-38: TP takes depreciation deductions of $30k

1938: TP sells property for $2.5k (still subject to the debt)

* + - * 1. TP’s argument: “property” = “equity,” not debt

At sale: A/B = 0; A/R = $2.5k

Realized gain = $2.5k

Was looking for double tax benefit

* + - * 1. IRS argument: realized gain = $32.5k

Include debt in A/B **and** A/R

IRS allows early depreciation deductions of $30k

But “recaptures” same amount at sale

* + - * 1. IRS won the battle but lost the war

TP benefits from this case b/c allows a lot of deferral b/c TP can use depreciation deductions upfront (time value of money)

This was a building block

* + - 1. Did ***Crane*** fuel future “tax shelters”?
         1. Advantages of using non-recourse debt in questionable tax transactions:

Limited TP’s econ risk

Allowed for inflated depreciable basis (ie. allow for huge depreciation deductions; clicker sale example)

This flowed from the logic of ***Crane*** (funny money underlying)

* + - 1. ***Crane’s*** progeny & legitimate debt
         1. Judicial/CL response to restrain the logic of ***Crane*** & ***Tufts*** so it doesn’t go too far

***Estate of Franklin*** (1976)

F: TP bought a hotel via a sale/leaseback transaction w/ NR debt that is much greater than the FMV of the hotel

No 3rd party, so no arm’s length valuation of the debt

Held: this transaction lacked econ substance and the debt was unlikely to be repaid—so the debt was not included in basis

* + - * 1. ***Pleasant Summit Land Corp.*** (1988)

F: NR debt was existing debt provided by a 3rd party lender (but debt was still more than the FMV)

Held: allows the debt to be included in basis, **but only to the extent of the FMV**

* + 1. **Basics of Real Estate Tax Shelters**
       1. TP/investor buys an office building for $1000k. Put in a little bit of his own money and borrows the other 90% from bank (10% interest rate, so $90k in interest). TP then rents the building to tenants, who will pay $90k in rent. Looks like a wash in econ. terms, so why would TP do this?
          1. Answer: depreciation deductions

Annual depreciation deductions = $50k; possible LTCG

These deductions will go against TP’s labor income (one of the drivers)

* + - * 1. When TPs want to sell the building, IRS will get these depreciation deductions back

If TP sells building in year 5 for $1mm:

**§ 1001**: A/B is now $750k; A/R = $ 1mm

**Realized gain = $250k**

This is arguably **LTGC**

This is the **conversion** part (have deferral via depreciation deductions **and** this conversion buried into this real estate shelter)

* + - * 1. The depreciation deductions drive this shelter b/c give the benefit of deferral
  1. Congressional response to tax shelters
     1. See page 59 of outline
     2. **§§ 465** & **§ 469**
  2. Policy Concerns
     1. Borrowing for tax shelter investments
        1. Misuse of tax incentives
           1. Maybe it isn’t a group of doctors, dentists, etc., (who are trying to shelter income) who should be in the real estate business
        2. Distortion of economic resources
           1. Money moving to different sources that we might not want it to gravitate to
        3. Disconnect b/w risk and reward
           1. Unfairness: notion of ability to pay—similarly situated TPs are being treated differently (leads to untaxed personal consumption for these preferred TPs)
        4. Greater untaxed personal consumption
           1. Undermines overall TP morale

How do we create a culture of compliance

* 1. Ethical Issues & Pressures
     1. Learned Hand- there is nothing sinister about not paying more taxes than the **law demands**
        1. Don’t forget the legal obligations/police the line
     2. Opinion Letters
        1. Created by lawyers
        2. Why do they vary?
           1. Textual v. Purposeful reading of statutes
           2. Risk tolerance

How much risk the lawyer is understanding; how much risk the client can tolerate

* + - * 1. B/c they vary, tax shelter promoters will “shop” their opinions around to law firm until the promoter finds a lawyer to give the opinion
      1. Why have one?
         1. The search for “more-likely-than-not” legal opinions
      2. Practical pressures
         1. Difficulties

“It really comes down to the malpractice standard; you opine the likelihood …”

51%/49%

* + - * 1. Tax bar faces pressure re: what type of opinion letters to put together

Ie. to garner more work from corps like Merrill Lynch, etc.

* + 1. The law
       1. ABA’s Formal Opinion 85-352
          1. When a tax professional takes a position, has to have a “good faith belief” in that reporting position

“Good faith” means a “realistic possibility” of successful litigation

PROF: can’t quantify this

* + - 1. **§ 6662** “Accuracy-related” penalty
         1. “Substantial understatement” & “substantial authority”
         2. See the OJ case re: casualty losses

Affidavit by the preparer, so TP not hit with this penalty

* + - 1. Treasury’s Circular 230
         1. “Realistic possibility” or “non-frivolous” & “disclosure”
      2. **§ 6694(a)** Penalty
         1. On tax preparers themselves if there was not a “realistic possibility” of their position, they knew it, and didn’t disclose it
         2. Would apply to the tax plan promoters, too
      3. Riffle: look to your own moral compass
         1. Only gives letters when he is well beyond 55% certain

1. Capital Gains
   1. Statutory rules re: capital gains/losses
      1. **§ 1222**
         1. “Sale or exchange” of “capital asset”
         2. “Net capital gain”
         3. **What is a “capital asset”**
      2. **§ 1221**
         1. Property but does not include …
            1. Inventory and related inventory-stuff does **not** count as a capital asset b/c when you sell inventory, it generate ordinary income
            2. Several categorical exceptions
            3. Denying capital gains for the ordinary operations of a trade or business
      3. **§ 1(h)**
         1. Complex set of rules for calculating max rate
         2. Generally, **net** capital gains (excess of LT capital gains over ST capital **losses**) are taxed at a preferential rate; net ST cap gains are taxed as ordinary income
   2. Basketing/netting & Net capital gains/losses
      1. Holding period
         1. Long term (more than one year) v. short term (less than one year)
            1. Losses v. gains
         2. **Net LTCG > net STCL = net capital gain**
   3. Policy rationales for capital gains preference
      1. Econ incentive to encourage long term investment
      2. Mitigate “lock-in” effect
      3. Inflation
         1. This was a serious concern at one time
            1. If I bought stock in a high inflation environment and the basis didn’t change, then there is something wrong with the actual calculation of gain (& would otherwise be overtaxed upon sale—would just be an inflationary gain, not a real gain)
            2. 1986 Act—we took care of this for labor income by **indexing the brackets** every year (threshold amounts change for inflation every year)

But we **don’t index basis**, so the capital investors lose in a high inflation environment

We use capital gains treatment to indirectly fix this

We don’t index basis b/c it is more tricky (timing)

* + 1. Bunching argument (realization)
       1. If you think about it, gains over time all come together at the end. This is really not accurate—could argue that you have gains over different years. Because catching me on all this bunching at the end, ought to get a break for this via a lower rate.
          1. **But** the counter argument is that capital gains holders get this deferral benefit this whole time (time value of money)
    2. Offsets double taxation of corporate income
       1. SHs are taxed after corporation is already taxed
       2. Cap gains treatment is small mitigation of this problem
       3. Having one layer of tax would eliminate this argument for the treatment of capital gains

1. Capital Losses
   1. **§ 1211**
      1. Corp’s capital losses are limited to gains per **§ 1211(a)**
      2. Individuals also limited to gains, but excess can be **deducted from** ordinary income up to $3k per **§ 1211(b)**
   2. Policy rationale
      1. Prevent cherry picking of losses
      2. Protect tax revenues
   3. Carry backs and carry forwards
      1. **§ 1212(a)**
         1. Corps’ unused capital losses can be carried back up to 3 years and forward up to 5 years as ST capital losses
      2. **§ 1212(b)**
         1. Individual unused capital losses retain their character (ST or LT), and are carried forward forever
   4. Problem
      1. Assume TP has $100k taxable salary income, and 2 other assets:
         1. Asset 1- basis of $80k and sale price of $100k (held for 4 months)
         2. Asset 2- basis of $90k and sale price of $60k (held for 13 months)
            1. Net cap loss = $10k under **§ 1222(10)**
            2. With $100k ordinary income, $3k of this loss can be deducted from this ordinary income

Leaves taxable income of $97k under **§ 1211(b)** and capital loss carryover of $7k under **§ 1212(b)**