# I. INTRO

* 1. **Historical Background of IRC**
     1. First the US started using excise taxes on liquor, carriages, slaves, and real property
     2. Jefferson repealed taxes; tariffs became the federal revenue source
     3. Income tax re-administered as flat tax in 1894
        1. Constitutional challenge-based on mandate that direct taxes on states must be apportioned to states based on population
           1. No one knows exactly what a “direct tax” is
           2. It is agreed that a head tax—flat amount on everyone—is a direct tax
           3. Problem is that if you apportion income tax on the basis of population, people in different states would pay different rates; people in poorer states would pay a higher tax rate
  2. **Gross income §61**
     1. GI includes all income from whatever sources derived. Income from compensation, dividends, gains from dealings in property, and discharge of debt are common types. However, particular code sections exclude certain types of income from GI
  3. **Four ways Congress preferences types of income w/tax**
     1. Exclude something from gross income (§119)
     2. Allow a deduction (§170)
     3. Allow a tax credit (§24)
     4. Impose tax at a lower rate on certain classes of income: this is the current approach w/capital gains
  4. **Deductions**
     1. **Subtractions from income in computing taxable income. There are two type of deductions**
        1. Deductions from GI in computing AGI: Certain expenditures are deducted (subtracted) from GI in computing AGI
        2. Deductions from AGI in computing taxable income: The TP subtracts his or her personal exemptions and then take the larger of either the standard deduction or the itemized deduction. The standard deduction is a statutorily set amount, and the itemized deduction is the sum of all allowable itemized deductions.
  5. **Taxable Income**
     1. §63(a): for individuals who don’t itemize their deductions, it is adjusted income minus deductions
     2. §63(b): for individuals who do itemize, it is gross income minus deductions allowed.
     3. §62(a): adjusted gross income is gross income minus deductions
     4. The rule that applies to the total amount of income of the top rate in your bracket along with all of the lower rates.
  6. **Taxpayers: Categories**
     1. Married individuals filing jointly
     2. Heads of Household
     3. Single Individuals
     4. Married individuals filing separately
  7. **Leisure Time and Income Taxation**
     1. The extra money you make above normal hours will be taxed at the highest rate in your bracket—this is the most relevant number when thinking about responses to incentives of work v. leisure time.
  8. **Marriage and Income Taxation:** COME BACK TO THIS DURING INCOME ATTRIBUTION
     1. **Policy:** Should the government be encouraging people to marry or not? If so, should they do it through the tax system, in a ways that encourages some people to marry and not others, or encourages the secondary earner not to work?
        1. Bush Tax Cuts did provide some relief to the marriage penalty but only at the expense of increasing the marriage bonus/the penalty on the high wage earner staying single.
        2. It is impossible for the federal tax code to be neutral on marriage encouragement with the progressive rates structure and commitment to treating all married couples the same regardless of each spouse’s contribution
  9. **Paying Taxes**
     1. **Procedure**
        1. TP files a return with IRS service center
        2. Potential audit
        3. Potential appeal to IRS appeals office
        4. If TP fails, can litigate in
           1. US Tax Court: appealable to US Court of Appeals

If you sue here, don’t have to pay first and then sue for a refund—you can refuse to pay until it rules

No right to a jury trial here

Article I judge

Will follow the law of the Circuit where TP lives

* + - * 1. US Federal District Court: Appealable to US Court of Appeals

Article III court

Normal civil procedure

* + - * 1. US Court of Federal Claims: Appealable to Federal Circuit

Article I court

* + - 1. If TP fails at that level, can appeal to SCOTUS but only on certiorari
  1. **Time Value of Money**
     1. It is generally understood to be better to pay taxes in the future than in the present.
     2. You can set aside a small amount of money in one year and thirty years later have a lot more; so it is better to pay taxes on a certain amount many years in the future than on the same amount today.
     3. The farther in the future you defer it, the less it is worth today (so you want to defer for as long as possible).
     4. **Formula:** Present Value = Future Value divided by [one plus the interest rate] to the power of the compounding period.
        1. **Example:** in present dollars, a $25K bill in thirty years costs only $4350 or so. $25K/(1 + 0.06) to the power of 30 = $4350.
        2. **Example 2:** $20K in five years with a 10% interest rate is 20K/[1+10%]to the power of 5. Present value = $12,418.

# INCOME

* 1. **Definitions**
     1. **Income**
        1. ***Haig-Simons definition of income*:** what you spend plus what you save in a given time period – accretion of wealth
           1. Would also include imputed income (parent raising child instead of paying for childcare).
           2. We don’t use this definition for tax purposes
           3. Y = C + ΔW 🡪 accounts for consumption and any change in wealth
           4. “Accession of wealth”

Consumption (occurring during the measurement periods)

Increase (if any) of the value of property rights during the measurement period

* + - * 1. Defines a comprehensive tax base, but difficulties arise in measuring all consumption and in valuing assets each year.
      1. **Economic:** Consumption plus savings (see consumption tax section)
         1. Under this approach, income is the value of any economic benefit received by the TP regardless of the form of the benefit

Tangible items: the receipt of cash or other property generates income under this approach, even if it comes from an unusual source, such as a windfall

Barter: The exchange of services for services constitutes income to both service providers. Rev. Rul. 79-24

Intangible benefits: the receipt of an intangible benefit would be included in GI under this approach. For example, if one TP satisfies another TP’s legal obligation, the latter has income in the amount of the satisfaction. *Old Colony*. But noneconomic benefits (such as a sunny day in Oregon) are not income under this principle.

* + - 1. **Items that are NOT Income**
         1. Imputed income: the value of services one performs for oneself or one’s family and the value of any property used that one owns is imputed income, which is not considered income for FIT
         2. Capital recovery: a TP income from the sale or exchange of property is his or her profit on the transaction, not the total amount received. A TP is entitled to receive his or her capital investment in the property tax-free, although the timing of this recovery is a matter for legislative determination.
         3. Loans: Neither the creation nor the repayment of loans is a taxable event. However, forgiveness or discharge of a loan may generate income to the debtor.
      2. There is no crisp definition of income for tax purposes
      3. SCOTUS initial definition (later abandoned): gain derived from labor, capital, or both. *Eisner v. Macomber*, p. 46 🡪 proved too narrow
      4. **Commissioner v. Glenshaw Glass** (70) *also a Windfall case*
         1. FACTS: two cases involving receipt of punitive damages; both TPs excluded the punitive damages they received since they weren’t derived from income or capital, and that was the going definition of income at the time.
         2. HOLDING: punitive damages are undeniably accessions to wealth over which the TPs have complete dominion, so they are income, and the definition of “gain derived from labor or capital’ is abandoned
         3. Since this case, there is a presumption that *any increase in wealth is income*
    1. **Amount of gain or loss *= amount realized minus adjusted basis* §1001(a)**
    2. **Amount realized =** $$received plus FMV of property **§1001(b)**
       1. **§1001**: realization event occurs when a TP exchanges property, receiving some materially different item.
       2. **§1001(a):** Realized gain or loss is equal to the difference btw the amount realized on a sale or other disposition of property and the adjusted basis of the property transferred
    3. **Adjusted basis=** basis as adjusted by §1016 **§1011(a)**
       1. **§1016(a)(2)**: adjustment is what you took or could have taken for depreciation.
       2. **§1016** prevents TP from using basis twice to get extra deductions. Depreciation deductions are just an advanced recovery of basis.
    4. **Basis of property**= cost of property **§1012**
       1. **Carryover/substitute basis:** adjusted basis in the hands of the transferee is the same as adjusted basis in the hands of the transferor. **§1015(a)**
       2. **Special rule:** For determining LOSS, the basis is the FMV at the time of the gift if it was less than the transferor’s adjusted basis; FMV is only used when the result will be a loss
       3. If neither of the above calculation methods “work” then there is no gain or loss for tax purposes
  1. **Excludable/Non-Income Compensation (Employer In-Kind Compensation)**
* **§61(a)(1)** Compensation income is the consideration transferred for the performance of services, whether in the form of salary, fees, commissions, or fringe benefits, and whether in the form of cash, property, or other services
  + - 1. **Character:** ordinary income, potentially taxable at the highest tax rate
    1. **Old Colony** (50) Wood Company paid for employer’s taxes directly to IRS, but was considered part of his taxable income. Taxes directly paid to the Government was immaterial because the money paid was part of the compensation of the services the employer rendered. Holding: discharge of this debt of the employee to IRS was gross income to the employee.
       1. FACTS: ER paid federal income tax on behalf of EE
       2. HELD: This is compensation to the EE and included in GI – pyramid problem
* **§7701(o) –** codifies the economic substance doctrine, i.e., a tax “common law” concept.

Transaction must satisfy:

1. Objective test – meaningful change in economic position apart from income tax
2. Subjective Test – substantial nontax purpose for entering into transaction (e.g. business)
3. And accuracy-related penalty – 20% IRC Sec 6662(b)(6)
   * 1. **Benaglia v. Commissioner** (52)
        1. FACTS: TP was a manager of hotels in Hawaii; required as part of job that he and his wife live and take meals at one of them. IRS said TP had an undervalue of §7,845 for each year he’d worked there, for the FMV a guest would pay to stay and eat there for a year.
        2. HOLDING: Living and eating there was not income at all b/c (1) parties didn’t intend for room and board to be compensation (2) room and board were provided *for convenience of ER*
           1. It was a condition of employment and necessary to ER.
           2. Room and board, unlike stock, personal and non-transferable
           3. Room and board hard to value here b/c certainly not worth to EE/TP what it would be worth to a guest.
        3. DISSENT: room and board was not value-less and K letter has room & board as one of the terms
     2. **Turner v. Commissioner**: taxpayer wins steamship tickets to Argentina. Tickets are nonrefundable and nontransferable. But, tickets actually exchanged for other tickets. **Holding**: they settled in the middle and the court stated that a “substantial amount should be included in their income on account of winning tickets.
     3. **Haverly v. US**: school principal, Haverly, receives unsolicited sample books for review and possible adoption by the school and purchase by students. Not items for his personal consumption. **Rule**: when a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the taxpayer’s GI. Taxpayer was trying to “whipsaw” the system. He was trying to obtain the exclusion and get the deduction for the charitable deduction. Necessity for symmetry or to avoid the “whipsaw” event or to have parallelism to do the transaction.

HELD: In order to claim charitable deduction, he must claim gross income. Ledger must balance out.

* **IRC §119:** if meals and lodging are provided *for the convenience of the ER* and the EE is told they have to live and take their meals *on the ER’s premises* as a condition of employment, then meals and lodging will not be included as EE’s income.
  + - 1. Codifies the Benaglia holding, butNo intent requirement as there was in Benaglia.
      2. Employee status required: DNA to self-employed HOWEVER an employee may be treated as such even if they own all the shares (*J. Grant Farms*, p. 58)
      3. GI does not include qualified campus lodging (§ 119(d))
      4. Employee status is required. Not available to the self-employed person. To obtain exclusion of gross income you must be an employee. You can make a LLC and a limited partnership, and not a corporation.
* Example Pg. 54: If lodging is not on the employer’s premises then GI inclusion will occur.
* Example: UH President 119(d) he does not receive GI inclusion because it in located or in proximity of school.
  + 1. **§107:** Exclusion for rental value and housing allowance (i.e. cash). Rental value of parsonages - exclusion for:

1. Rental Value
2. Housing (i.e. cash allowance)
3. **Commissioner v. Kowalski:** meal cash allowance – not furnished “in kind.” Therefore, not fitting within Sect. 119. Example of leased table at McDonald’s which officers could use providing vouchers. Problem may be created because employees may use them when they are off duty.
4. **Sibla v. Commissioner:** firemen required to contribute into non-exclusionary food operation at fire station. Ninth Circuit holds payments are both
5. Deductible under 162(a) (as ordinary and necessary business expenses; not personal expense)
6. Excludible from GI under 119. Meals provided in kind by employer; even though cash payment mandated. (Pg. 1024)

**NonCash Benefits**

* + 1. **IRC §125: Cafeteria Plans**, p. 62 – EE may choose among a variety of noncash benefits but may not opt to take cash
       1. Use it or lose at end of year
       2. Non-discrimination rule applies
    2. **§132(a)(1) No additional cost services:** can’t cost the ER anything, including lost revenue, to provide to EE - any service provider by ER to EE for use by EE if such service is offered to customers and hasn’t been purchased and would exist regardless of whether employee used it – *no substantial additional cost*
       1. Under §132(j) must not be concentrated among highly compensated EEs without also being given to a group of EEs that does not discriminate on the basis of highly-paid
       2. §132(b) says it must be something that the ER offers for sale to customers in the ordinary course of business of the ER in which the EE provides services
       3. Generally applies to spouse and dependent children of EE under §132(h)(2)(A) and retired or disabled EEs or the surviving spouse of an EE under §132(h)(1)
       4. 2 or more ERs are allowed to make a reciprocal agreement for the provision of tax-free no-additional-cost services to their EEs, if the agreement is in writing and neither will incur substantial additional cost in providing the services. §132(i). (ie. Airline attendants)
    3. **§132(c) Qualified EE Discount**: EEs can get a reasonable discount on property or services offered for sale to customers by ER who employs the EE getting the discount
       1. **Goods:** Ceiling is the profit percentage: (aggregate sales price minus the aggregate cost) /aggregate sales price. §132(c)(1)(A)
       2. **Services:** discount cannot exceed 20% of the price at which the service is offered for customers. §132(c)(1)(B).
       3. If the discount is greater than the ceiling, the amount the EE saves over the amount they would save with the qualified discount is included in their taxable income.
       4. Generally applies to spouse and dependent children of EE under §132(h)(2)(A) and retired or disabled EEs or the surviving spouse of an EE under §132(h)(1).
       5. **No exclusion** for discounts on property held for investment or real property. §132(c)(4).
       6. Generally, reciprocal agreements do not apply to this section
    4. **§132(d) Working Condition Fringe:** if it is something that the EE could deduct as a business deduction if she bought it herself (i.e. ordinary and necessary business expense - §162 or §167), the ER can provide it to her without it being includable in her income.
       1. Somewhat more valuable this way as an exclusion than if EE deducts it herself
          1. Certain EE business expenses deductible only if TP itemizes §63; with working condition fringe that never comes in to the picture
          2. EE business expenses generally deductible only to the extent they exceed 2% of TP**’s** AGI. §67.
    5. **§132(e) De Minimis Fringe:** coffee and doughnuts, personal use of copy machine. Costs government $7B a year but alternative is crazy. Amount is so small, it’s a waste of time to track it
       1. Occasional dinners paid for by ER and brought to the office, or even an occasional cash allowance for dinner, to extend working hours probably count under this section.
       2. Membership in a private country club or gym does not count. Reg. §1.132-6(e)(2)
          1. However if an ER builds an athletic facility on its premises, EEs do not have to include the value of use of those facilities in their income where the use of the facility is primarily for the use of EEs and their spouses and dependent family members. §132(j)(4).
       3. Having a cafeteria where the meals are cheaper than normal (just above cost for ER) counts for exclusion. §132(e)(2).
    6. **Frequent Flyer Miles**
       1. Can be traded for (1) other airline tickets, (2) flight upgrades, or (3) other (non-airline) merchandise
       2. Not de Minimis – can clearly determine what the value is – transportation fringe
       3. Should be income to recipient, but it’s not – Congress throwing in the towel instead of trying to apply rules to the manner of use of the miles
       4. EXCEPT if transferred for property, then it’s income
       5. Personal use of miles accumulated during business trips: reimbursed or deducted?
    7. **§132(f) Qualified Transportation Fringe** Exclusion if ER provides or reimburses for a transit pass, transportation in a commuter highway vehicle (§132(f)(5)(B)), or parking w/in a monetary limit see § for limit.
       1. No nondiscrimination requirement—can be offered only to HCEs and still be excludable from their taxable income
       2. If you are given a choice b/w cash and parking, you get an exclusion if you choose parking, but not if you choose cash. Somehow meant to be an environmental initiative but utilization of ER parking went way up after this was allowed.
    8. **Valuation Issues**
       1. **Turner v. Commissioner** (67)
          1. FACTS: TP won steamship tix to Argentina. Tix FMV is not the same as value to family and tix were non-transferrable and non-refundable. FMV was $2200 but settled for $1400
          2. HELD: Court looked to value at time of transfer and redemption rather than at time TP won the tickets.
          3. They settled in the middle and the court stated that a “substantial amount should be included in their income on account of winning tickets.
  1. **Imputed Income** (71)
     1. The accession to wealth that can be attributed, or imputed, to a person when he avoids paying for services by providing the services to himself, or when he avoids paying rent for durable goods by owning the durable goods.
     2. Owner-Occupied Housing: rental value of owner-occupied house is imputed economic income to owner who lives in her home—you don’t have to pay rent b/c you live in your own house. Right to live in or allow someone else to do so is part of the value, as is appreciation. So there is no good policy reason why we don’t allow deduction on cost of rent, but of course we also shouldn’t start taxing imputed value of owner-occupied housing.
     3. Services: w/in Household - Shouldn’t start taxing them, but the failure to tax them does cause distortions
        1. Barter Transactions – Rev. Ruling 79-24 (76) – exchanged items are includable in GI as valued at FMV (§6045 – brokers)
  2. **Windfalls** – within the scope of §61
     1. **Reference:** *Glenshaw Glass* (78): Damages recovered for lost profits plus punitive damages for violations of anti-trust laws – undeniable accessions to wealth, clearly realized and over which the TP has complete dominion” are includible in GI
     2. **Cesarini v. US** (81): $5000 found in piano is a windfall and includable in GI.
        1. Reg. **§1.61-14(a)** requires TP’s finding treasure to include it in GI when reduced to undisputed possession. This Reg Section is consistent with **§61’s** statutory scheme to include all income in GI**.**
        2. Court rejected TP argument that **§74** (prizes) or **§102** (gifts) would exclude this amount from GI

# Compensation For Losses

* 1. **Compensation for Losses**

1. Requires determination of

(1) Tax basis,

(2) Amount realized, and

(3) Gain (or loss) realized.

1. Section 61(a)(3) Gains derived from dealings in property – you bought an object for $10 and you sold it for $50. Your gain would be $40. Tax basis(cost)
2. **Edward H. Clark –** taxpayers filed a joint federal income tax return under tax counsel’s advice. IRS examined the return and assessed a deficiency against the taxpayers. Tax counsel took a larger deduction from income than was allowed by law. **Holding**: Clark had exactly the same amount of money at the end as he had at the beginning. Therefore, he never had any income, he was just put in the place where he would have been had the lawyer not made a mistake. Statute of limitations had run and he could not request a refund so they could have filed separately. You received a credit (basis) because you already included the rest in gross income.
3. **Raytheon Production Corp. v. Commissioner –** Raytheon ran a radio rectifier tube that developed but RCA (another company) monopolized the market. Raytheon sued RCA and was awarded $410,00 of which it did not claim $350,00 as damages. Commissioner determined that there was a deficiency because $350k constituted income. **Holding**: Court held that damages recovered for violations of anti-trust acts are treated as income when they represent compensation for loss of profits. Raytheon could not establish the cost of its basis of goodwill. **-**Goodwill: intangible asset that is valuable. Inclusion in GI.[Facebook’s hype that people will sign in and register everyday all the time]
4. **Commissioner v. Glenshaw Glass Co.** – why was the damage awarded, and what does it constitute. Damages recovered for lost profits plus punitive damages for violations of anti-trust laws. He did not do anything to recover the money but the other 2/3 was imposed on the bad actor, instead, it went to Glenshaw Glass Company. Glenshaw has complete dominion over the undeniable accession to wealth. Punitive damages will be included in gross income by effectively incorporating that you have an accession of wealth.
   1. **Recovery of Capital** (110)
      1. **Allocation of Basis**: if only a portion of indivisible property is sold, pro rata allocation of basis. Reg. §1.61-6(a) A method of equally and proportionately allocating money, profits or liabilities by percentage
      2. Timing of when TP recovers basis determines when TP pays tax.
      3. **Example:** Π buys 10 acres of land, all the same, for $1000. Sells a few years later for $1500. Gain is $500, that is the taxable income. $1000 was just capital converted to different forms (cash🡪land, then land🡪cash).
      4. **Inaja Land v. Commissioner** (107) FUNDAMENTAL FOR BASIS RECOVERY
         1. FACTS: TP bought land for $61K bordering on water to be used as a fishing club. The city polluted the water and TP sues and gets $50K, $1000 of which went to atty’s fees. IRS said $49K was taxable income b/c use of land was for profit, it didn’t exceed the cost of the land, and the money was for lost profits. TP said it was not for lost profits b/c the reward didn’t exceed cost of land and only constituted recovery of capital (or that it was impossible to separate recovery of capital and loss of profits).
         2. IRS ARGS: The money was compensation for loss of present and future income and consideration for release of many meritorious causes of action, which represented ordinary income. Also, the Π failed to allocate the sum b/w taxable and nontaxable income, so it did not sustain its burden of showing IRS error.
         3. Π ARGS: The consideration was paid for the easement granted to the city and the consequent damage to Π’s property rights; that it was an easement means it is not practical to attempt to apportion a basis to the damaged property.
         4. HOLDING: The reward was not paid for loss of profits, it was for the conveyance of a right of way and easements and for damages to Π’s land and its property rights. The IRS is wrong. Capital recoveries in excess of cost are taxable income, but here it is impractical to apportion basis to the parts of the property damaged. Therefore, because the payment was recovery of capital/basis, and it was less than Π’s cost basis for the whole property, there is no capital income, and a basis of $12K left on the property ($61K minus $49K). ADJUSTED BASIS RULE bc impractical to attempt to allocate
         5. STRENG: note *Burnet* reference – open transaction treatment – basis recovery occurs first. Reg. §1.1001-1(a).
   2. **Damage Recoveries**
5. **Personal Injury Reimbursement**
   * 1. **§104(a)(1):** any damages received on account of personal physical injury/sickness are excludable, from workers compensation or settlement of a suit, whether a lump sum or periodic, *except punitive damages or lost profits*.
        1. (a)(2) - “Lump sum or periodic” (144) language means that Π/TP can choose an annuity; if Π/TP chooses an annuity, not only are the damages untaxed, the interest is as well
           1. Good deal for Π—creates an incentive to structure settlements to provide deferred periodic payments
           2. Bad for Δ who will be taxed on interest earned on money put aside for the periodic payments to Π, and will have to invest a larger sum in order to stretch the payments out.
        2. Generally Δ funds such payments through an insurance product
           1. Neither Π nor Δ thus pays taxes
           2. Π gets more money in the long run b/c not taxed on interest (i.e. if Π took a lump sum and invested it, the interest would be taxable income, but payments coming out of life insurance at whatever rate Π wants are not taxable to Π).
        3. NO exclusion for lost profits/lost compensation reimbursements.
        4. Exclusion does not include libel or discrimination awards.
        5. Can exclude psychological/psychiatric medical expenses if they can be proven.
        6. TP excluding the income can be someone other than the person who suffered the injury or sickness (e.g. spouse, dependent).
        7. The only case in which punitive damages are excludable are when a state ONLY allows recovery of punitive damages.
     2. **Rationale:** Exclusion serves as a proxy for a system of depreciating human capital.Other arguments for and against taxation of certain awards.
        + 1. **Medical Expenses:** Places the injured person in the same financial position they would be in without the injury; fairness dictates she should not pay more than others in taxes
          2. **Lost Wages:** replaces funds that would have been taxed otherwise; fairness dictates that she should be taxed on income she would have been taxed on but for the accident.
          3. **Punitive Damages:** These are complete windfall to the recipient so should be taxed (the only argument against taxation is that not taxing these gains might encourage more people who are actually wronged to sue to recover)
     3. **Employment Discrimination Damages**
6. Damages for sex discrimination (Title 7) are excluded. Cf., payment for “back pay.”
7. Damages for racial discrimination (Title 7) are excluded.
8. Damages under ADA (disabilities act) are excluded.
9. ADEA (age discrimination) damages not included.
   * 1. **Emotional Distress Damages**
10. No exclusion under *physical personal injuries.*
11. See Trafficking Victims Protection Act of 2000 specifying mandatory restitution (Including for psychiatric case)
12. IRS Notice 2012-12 – specifies mandatory restitution and no requirement of physical injury for GI exclusion.
13. **Murphy v. IRS:** Murphy blew whistle and company blacklisted her, she paid taxes but wanted a refund. Taxpayer’s recovery could be taxed under Article I, Section 8 of the Constitution even if the recovery were not “income” under the 16th Amendment.
14. Amount not received for *personal physical injuries* & not exempt under 104(a)(2)
15. Award is gross income for section 61 purposes (whether 16th amendment of Const Art 1 (8))
16. Tax on award is an excise tax and therefore not a “direct tax” subject to apportionment clause in US constitution.
17. Murphy sequel to Obamacare. Penalty (shared responsibility payment) to be paid for failure to purchase health insurance. Held: within the taxing power of US since it was a penalty.

* If a tax cannot be shifted to someone else, as a capitation cannot, then it is a direct tax; but if the burden can be passed along through a higher price, as a sales tax upon a consumable good can be, then the tax is indirect. 
  + 1. **Health Insurance**

1. **§162:** Employers can deduct the cost of medical insurance provided for employees.
2. **§162(l):** Self-employed can deduct costs of medical care, including health insurance. Proceeds are excluded - **§105(b).**
3. Self-insured i.e., no commercial insurance; deduction (limited) available for medical expenses.
4. **§106(a)**: EE’s gross income doesn’t include ER-provided coverage of accident or health insurance. Section also covers retired former EEs, and spouses and dependents of EEs, but not unmarried couples who aren’t dependents. ER-provided domestic partner/same sex couple coverage creates extra federal taxable income to EE.
   * + 1. ER provided doesn’t mean ER has to pay the whole bill, but ER-provided portion will be excluded from EEs income
       2. Policy originated from wage controls during WWII, when ERs had to compete for EEs using fringe benefits; by 1954 it was common not to consider health benefits income, so Congress went along with it.
5. **§104(a)(3):** Recoveries under a medical insurance policy are excluded from GI – even when recoveries exceed cost of care
6. TP’s disability insurance
7. benefits also excluded from GI
8. **§104(a)(1):** Workers comp payments excluded from GI
9. **§105(b):** Proceeds provided from ER provided insurance coverage is excluded from GI. Benefits out of an ER-provided health or accident plan also not includable in EE/beneficiary’s taxable income. Seems like a huge incentive to consume medical services, b/c of the tax subsidy at both ends.
10. **§213(d)(1)(D):** medical expense deduction provision. Proceeds are excluded - **§104(a)(3).**
11. Some think repealing these rules would increase the number of insured people (with other reforms, presumably)
    * 1. **Flexible Spending Arrangements**
12. **IRC §125 –** deduction of some GI into a spending account & subsequent payment of expenses from this account. Objective: to cover the medical expense portion not covered by the traditional ER based insurance coverage. 12-month use it or lose it rule.
    * 1. **Health Savings Account**
13. **§223 –** savings plan available when individual has only high deductible health plan coverage.
14. Limited deductions for contributions to an HSA.
15. Investments earnings of HAS are not GI to owner.
16. **§223(e) & (f):** Distributions are NOT included in GI.
17. **Ochs v. Commissioner:** FACTS: A cancer patient is told that having her children around might cause a recurrence of her cancer. Her husband, the TP, sends the kids to boarding school and deducts it as a medical expense. HOLDING: This was a general family expense, personal in nature, and not deductible as a medical expense under §262. If they had sent the WIFE somewhere for rest and relaxation away from the family, that might have been deductible as a medical expense. But people send their children to boarding school all the time for no medical reason.

* DISSENT: These expenses fall w/in the category if mitigation and treatment of disease; the deduction could be limited to the expense of the care of the children when they would otherwise be around their mother (e.g. not the expenses during school hours, but the room and board?).
  + 1. **Medical Care**

1. **§213(d)(1)(A):** includes cost of diagnosis, cure, mitigation, treatment, or prevention of disease
2. **§213(d)(1)(B):** transportation primarily for and essential to medical care.
3. **§213(d)(2):** not lavish and $50 per night limit
4. **§213(d)(1)(D):** medical insurance premiums – deductible – (d)(10) covers long term
5. Psychiatric treatment costs are deductible Treasury **Reg §1.213-1(e)(1)(ii).**
6. **§213(d)(9):** Cosmetic surgery to repair a congenital defect IS deductible.
7. Dental work
   * 1. **Capital Improvements**
8. For medical purposes are deductible to the extent they cost more than they add value.
9. Federal system cannot give a deduction for something that’s federally illegal
10. **Reg. §1.213-1(e)(1)(iii):** improvements to home (capital improvements) are deductible if necessary to medical care but only to the extent they do not add value to the home
11. NOT:
    * + 1. NOT health maintenance like aerobics lessons for someone who isn’t sick (except annual diagnostic checkup costs are deductible)
        2. NOT food and lodging while away for outpatient medical care (but travel costs and doctors fees are)
12. Major issue in these cases is a line between things people would only spend money on if they were sick.
    * 1. **Disability Insurance**
13. **§106:** GI exclusion when premium is paid. Benefits received by EE are excluded from their GI.
14. **§105(a):** amounts received by the EE for *personal injuries or sickness* are included to extent attributable to ER contributions.
15. **§104(a)(3):** amounts received through individually purchased accident or health insurance for *personal injuries or sickness* are excluded from GI (except to extent attributable to ER contributions)
    * + 1. Self-employed can also deduct the costs of medical care, including health insurance.
      1. **Life insurance**
         1. **Term Insurance:** bet between insured and life insurance company—just death benefit protection during a specified period of time. Payment only for actuarial risk. Small investment return during coverage period. No value at expiration of the term.
         2. **Whole Life Insurance:** Often level payments and early year payments exceed actuarial risk cost. Involves a savings element that produces investment return, which reduces insurance cost (but this income return is not included in GI).
         3. **Gross income exclusion is available for both:**

* Pre-death interest build-up, and
* Mortality gain (or loss), if realized at death. But, “transfer of consideration” limitations may apply to limit exclusion at death – Code 101(a)(2); see exceptions for:

1. Transfers with a transferred basis, or
2. Transfers to partners, partnership or a corporation (but not to other shareholders).
   * + 1. **Pre- Death**
3. No tax deduction for certain premiums paid – §264(a)(1). Or, for interest, 264(a)(3); any exception to this treatment – see **§264(a)(1).** Or for interest, **§264(a)(3).** Exceptions see **§264(d)(1).**
4. No current inclusion of policy earnings.
5. Policy loans to owner of policy are not treated as distributions – **§72(e)(5)(A) &(C).**
6. Life Insurance Policy – if terminated before death – gain derived (if any) is subject to GI inclusion (but, no GI inclusion for the benefit of insurance coverage during policy’s existence)
   * + 1. **Post- Death Payout**
7. Gross income exclusion is not applicable to interest accrued on policy proceeds invested after death. **§101(c) & (d).**
8. Various settlements options are available

* All cash proceeds after death
* Deferred settlement arrangements e.g. annuity or installment payments

1. **Viatical settlement**: “on the way” to heaven. A Viatical settlement provider means any person regularly engaged in the trade or business of purchasing, or taking assignments of, life insurance contracts on the lives of insured. **§101(g).**  Exclusion extends to amounts paid to or for the care of chronically or terminally ill insured’s.

* **§101(g)(1) Safe Harbor – treated as Paid by reason of death**
  + - * 1. Any amount received for a terminally ill individual
        2. Any amount received for a chronically ill individual
      1. **Group Term Life Insurance**

1. **§79 (a):** exclusion from GI for value of group term life insurance coverage up to value of $50,000 coverage per EE.
2. **§79(d):** note non-discrimination requirements. No discrimination in favor of key EEs.
   * + 1. **§101(a):** Proceeds of life insurance K’s payable by reason of death of the insured are excluded from gross income. All death benefits are excludable.
          1. **Transfer for consideration** limitation: **§102(a)(2)** no exclusion where the transfer is for value (transfers with carryover basis or transfers to partners, partnership or corporation (DNA other shareholders)
       2. **Insurable Insurance Requirement:** you can’t buy life insurance on someone with whom you don’t have some kind of relationship; this is an attempt to restrict dead peasant insurance by ERs.
       3. **K paid out before death:**
          1. Not deductible by payor for premium payments made
          2. Exclusion from income, under **§101**, when proceeds received. Post death interest is NOT excluded. Gain derived is subject to GI inclusion
          3. Loans are NOT treated as distributions **§72(e)(5)(A)**
     1. **Prior Losses – Annual Accounting**
        1. **Burnet v. Sanford & Brooks Co.:** cash basis taxpayer. Expenses exceeded income by 176x in various years; large “income” later. Issue: offset earlier year losses against current year gross income in determining current year income. No, each year stands on own. Dredging company reported net losses but a few years later it did not report them, and tried to deduct losses for 3 years. 16th amendment is not narrow and does not require taxing only profits. Affirmation of the concept that the sanctity of the annual accounting period “each year stands by itself” you cannot refile tax returns or allocate previous returns. HOLDING: TP had to include not only the interest but also the $176,271 in income in the year they received the settlement from the govt bc he had included the 176k in losses on prior tax returns. Every year stands on its own

**Clark LOSS RECOVERY OUTCOME RATIONALE**

($19,941) $19,941 recovery Recovery of capital

1932 1934 excludable

**Sanford & Brooks** ($176,271) $176,271 recovery Annual, not

1913-1915 1920 includable transactional,

Accounting

**Why the difference?**

* + - * 1. Difference in initial expenditures:

Clark, did not and could not have deducted the loss when it happened, so maybe court is trying to line up economics with tax. It was not deducted when it was lost, so it was off the tax radar, and when he received it a couple years later it was off the radar

Sanford & Brook: did take the deduction on the losses for three years. So if it had gotten the money back tax free, it would not have netted out to zero. However, their income was zero in those years, so them taking the deduction didn’t change the taxes they were paying; this means that the situations really weren’t equalized after all.

* + - * 1. What COULD the court have done to solve the unfairness?

Give individuals w/negative income a payment from the government in amount you would have paid in taxes if you have made the amount that you lost.

BAD: could incentive creation of paper losses to get gov’t money

GOOD: might incentive people to take beneficial risks.

* + 1. **Taxable Year**
       1. **IRC §441 - §443**
       2. **General:** we calculate income on the basis of each year, annually—what happens to TP in each year,
* Pretty arbitrary as a convention
* Generally the calendar year for individuals, may vary for businesses
  + - 1. **Problems:** can inaccurately measure a TP’s ability to pay particularly for transactions that span more than a year. Some code sections have evolved to address problems
      2. **§441(b) –** annual accounting period (calendar year or fiscal year)
      3. **§441(g) –** mandatory calendar year if “no books kept.”
    1. **Loss Carryovers** 
       1. **Net Operating Loss (NOL)** deduction enables averaging of *business* income (& losses) over multiple years i.e. two years back and 20 years forward.
       2. **The net operating loss deduction §172:** a TP’s excess of deductions over expenses constitutes a NOL that the TP may carryover. Not filing amended returns.
       3. **§172(a):** you get a deduction for the sum of your NOL plus your NOL carryback
       4. **§172(c)**: ***NOL*** is tax deductions minus gross income
       5. **§172(b)(1)(A):** ***NOL carryback*** is allowed for two years prior and ***NOL carryover*** is allowed for twenty years in the future.
       6. **§172(b)(2):** you do your carrybacks first, then carry forward
       7. **§172(b)(3):** you can waive carry BACKS if you want to (not carry forwards)
          1. Basically, you can take unused loss and move it back and forward in time to eat up income.
          2. Under the §172 regime, the TP in Sanford & Brooks could have carried forward the $176K loss for 20 years, wiping out the entire $176K settlement they received a few years later
       8. **§172(d)(4):** for individuals those are only business losses, i.e. NOT investment losses, personal deductions, in excess of income, etc.
       9. **§172(d)(2) –** capital losses are limited.
       10. **§1212 –** separate treatment applies for the carry forward of capital losses (not carry back).
    2. **Accounting Methods**
       1. **§446(a) –** taxpayer shall compute taxable income under method of accounting on which TP “regularly computes his income in keeping books”
       2. **§446(b) –** exception where TP’s method “does not clearly reflect income”
       3. **Methods of Accounting**
* Cash Method
* Accrual Method
  + 1. **Tax Benefit Rule** 
       1. **Taxpayer** claims a tax deduction in 1st year and then receives a recovery for the deducted item in a later year. E.g., deduction for bad debt, taxes paid or losses and then a recovery of the deducted item. Inclusion in gross income in the later year. It effectively produces transactional accounting (rather than annual accounting) for this particular item.
       2. **§111(a):** Exclusionary rule: gross income won’t include income from recovering an amount TP deducted in a previous year as long as the deduction did TP no benefit in year it was deducted. Function – preclude current tax when restoration occurs in the subsequent year, if the item when available as a deduction in the earlier year did not actually reduce the taxpayer’s income tax liability.
       3. **Inclusionary Rule:** is not available to exclude a recovery if the prior year deduction did produce a tax benefit. Return or recovery of the money or other property that was subject of a prior year’s income tax deduction must be included in income in the year of its recovery to the extent that the deduction did reduce taxes in the prior years.
       4. **§111(c):** An increase in a net operating loss (NOL) carryover that is still around is treated as reducing tax for the purpose of §111(a).
       5. **Dobson v. Commissioner:** Deduction in an earlier year and recovery in a subsequent year.. Sold stock at a loss and claimed a loss deduction on the earlier return. Transaction treated as closed and completed – but loss did not reduce income. Subsequent recovery after fraud suit. Held for taxpayer since no earlier tax benefit. Court held that the Tax Court's decisions improperly relied on reasoning not embodied in any statutory or regulatory precept, and thus were not in accordance with the law. Exclusionary side of tax benefit rule—deduction is incorrect in retrospect, but does not need to fix it because the error is harmless and didn’t save you any taxes -Don’t enforce inclusionary side of tax benefit rule if it will do more harm than good  
          -If settlement exceeded losses, then that portion of settlement would be taxable as a capital gain. **§7482.**
       6. **Example: Perry & Sullivan Cases**

1. Property was transferred to charity
2. Charitable deduction was claimed for federal income tax purposes
3. Property was returned to the donor
4. Inclusion in the donor’s GI?

* YES – (Sullivan) to the extent of the lesser of (a) earlier deduction or (b) the fair market value of the property.
  + - 1. **“Inconsistent Events” Rule**
         1. **Hillsboro:** Repayment to bank shareholders of taxes on shareholders previously paid by the bank corp. NO recognition required of the banks when refunds were made to shareholders.
         2. **Bliss Dairy:** Distribution of previously expense assets (cattle feed) in a corporate liquidation. Recovery was required to the corporation on the distribution. Now covered by **§336.**
         3. *Dissent*:allow to file amended tax returns if S/L hasn’t run
         4. ***Rule*:**Deduction available in earlier year; but, notax benefit realized in the earlier year; then later, when reversal of the earlier transaction, no GI since no tax benefit realized earlier.
      2. **§111** is chiseling away at the idea of an annual accounting period – this is transactional accounting for this item
         1. TP’s perspective: can be helpful, but if rule of inclusion comes into play as in Case I there is no relief from change in tax rates.
      3. **Income Averaging:** NOT done now; idea is that TP could average for a certain number of years to protect against swings in income. Made more sense when top marginal rates were very high.
      4. **Recoveries**

1. **Recovery of lost profits** – ordinary income when received; *Sanford & Brooks*, p. 132
2. **Punitive Damages** – includable in GI; *Glenshaw Glass*, p. 78
3. **Recovery for Destroyed Property** – GI inclusion as property sale; gain as proceeds in excess of tax basis; possible gain postponement through reinvestment up to amt of proceeds; §1033

# GIFTS AND KINDRED ITEMS

1. **Gifts**
   * 1. **§102(a):** gross income does NOT include the value of property acquired by gift, bequest, devise, or inheritance; i.e. gifts are excluded from income for tax purposes. (But no deduction to donor for wealth transfer)
        1. This applies only to the value of the gift at the time of its receipt (the principle of the gift or bequest), not income, which the gift subsequently generates. **§102(b)(2).**
        2. E.g. with a gift/bequest of a trust, if both the corpus and income were exempt from tax under **§102(a),** the exclusion would be greater when divided interests were created than when the entire property was given to one person.
        3. **§102(c)(1)** – disallows gifts btw ER and EE
        4. **Irwin v. Gait:** Taxpayer received a testamentary trust for 15 years with the remainder to his daughter. Taxpayer argued that it was unconstitutional because he had already been charged with property taxes and not income. Income derived from the trust is NOT excluded from GI under **§102.** Further, the amount received is “income” for US Constitution purposes.
     2. **Trust Income Taxation**

**1. §6641**

* + 1. **Income Interests**
       1. **Commisioner v. Early:** Early had shares on a natural gas company given to them as a gift by Van Sert deceased couple. They acquired a life estate, which they claimed was to be treated in the capacity of federal income tax. Amortization: relates to an intangible and you can only take the deduction in equal portions. Commissioner argued that they made a deal and exchanged for a life estate interest instead of stocks. Since they made a deal they sold the interest in the El Paso stock in exchange for the 32% interest and obtain a basis. Court held that the original exchange from decedent was a gift; the subsequent settlement for the life estate was a gift. NO IRC **§273** amortization.
    2. **Basis - §1015:** a recipient of property by gift or inheritance must determine the basis he or she has in the property.
       1. **Property Received by gift:** The recipient of property by gift takes the donor’s basis in the gift, plus a portion of any gift tax paid on the transfer. However, if at the time of the gift the FMV was less than the basis, for purposes of determining loss on subsequent sale or disposition, the done takes the FMV of the gift on the date of the gift
       2. **Property Received by inheritance - §1014**: The recipient of property through inheritance takes as his or her basis in the property the FMV of the property on the date of the decedent’s death.
       3. **Taft v. Bowers** (104)
          1. FACTS: A bought 100 shares of stock for $1K, which he held until 1923 when the FMV had become $2K. Then he gave them to B who sold them during 1923 for $5K. B says that she only owes tax on the appreciation during her ownership of the stock ($3K) but the IRS says she owes tax on $4K, the total appreciation since A bought it.
          2. HOLDING: Congress does have the power to require a succeeding owner to assume the place of the donor in terms of taxation—so the basis of the inter vivos gift is the same in the hands of the donee as it was in the donor. B owes taxes on the entire $4K increase in value. The stock represented only a single investment of capital that was made by the donor. Basis transfers with the gift.
          3. STRENG: Const. argument – is it within the taxing power of Congress to require a TP to pay taxes on income derived by someone else? YES – it is still income within the 16th Amendment.
    3. **Gift of Appreciated Property**
       1. Gifts for **§102** purposes can be of cash, stock, royalty interest, real property, or other types of property (including a stream of income).
       2. **Rules** 
          1. **Carryover/substitute basis:** adjusted basis in the hands of the transferee is the same as adjusted basis in the hands of the transferor. **§1015(a) – “**transferred basis”
          2. **Special rule:** For determining LOSS, the basis is the FMV at the time of the gift if it was less than the transferor’s adjusted basis; FMV is only used when the result will be a loss
          3. If neither of the above calculation methods “work” then there is no gain or loss for tax purposes.
          4. If property is **transferred at death** by bequest, inheritance, etc, the basis in the hands of the transferee is “stepped up” to the FMV at the time of death**. §1014(a).**

Accrued gain evaporates – disappears from tax base - loophole

STRENG: alternative approaches – make death a realization event, use gift tax mechanisms, or allow estates to opt out of estate tax, but go into carryover basis regime

* + - * 1. **§1022 –** in effect for (only) the year 2010 when an estate had an option to elect out of state tax – in which event a modified carryover taxis basis applied. Subject to various exceptions, e.g. basis step-up of 1.3M permitted.
        2. **§1014(f)** –specifies basis of property acquired from decedent cannot exceed value as finally determined for FIT purposes. Example: you represent the estate of your client and client had an ownership of a privately held company. You represent the estate as the probate lawyer and you take a position in filing the tax return that the property was worth 90 but then comes the administration of the estate of real property and beneficiaries ask what the basis is and you say it is 90. You tell them to take the 110 because they have the basis for it, and your professional responsibility and claim it as a 1014.
        3. **§6035(a)(1)**- specifies that executor must furnish to beneficiary information re this value.
        4. **§1014(c) & §691**–A cash basis taxpayer would not actually have “accounts receivable” –since on a cash method and not an “accrual basis” taxpayer. If there is no basis it emanates from services provided it is not included in GI. You do not want to adversely affect to those who are taxpayers because of the preferred accounting method.
    1. **Taxation Options When Gain Property Transferred**
       1. Appreciated property transferred by gift:

1. Tax the accrued gain when the property **transferred** by gift to donee; a recognition event
2. **Transfer basis** to the donee and subsequent recognition of all accrued gain to the donee
3. **Tax basis step-up** to FMV when the gift transfer occurs – no gain recognition; accrued gain disappears from the tax base.
   * 1. **Estate Tax and Gift Tax**
4. Estate tax – an excise tax on wealth transferred at death.
5. Gift Tax – tax rate schedule integrated with estate tax. Protects against any non-taxed depletion of the estate tax base.
6. Generation skipping transfer tax: additional tax when E&G tax skipped for one generation.
   * 1. **Prizes & Awards – §102 Exclusion** 
        1. **Pauline v. Washburn:** Mrs. Washburn’s telephone number was randomly selected and the radio program Pot O’Gold called and awarded her $900 for simply answering the phone. **Holding**: Court held that the radio show giveaway prize constituted a nontaxable gift since there was no expectation or effort on her part to perform any services or to make any commercial endorsement, no wager made by the recipient and it was denominated an “outright cash gift.”
        2. **§74(a) -** inclusion of awards and prizes in GI. See **§74(b)** exception from income inclusion – when income deflection to charity occurs of the amount to be received.
        3. **Paul v. Hornung:** Petitioner is a well-known professional football player for the Green Bay Packers. He received a Corvette as an award for his performance in the championship game. **Holding**: Tax Court found that constructive receipt means “unfettered control” and Petitioner failed to show that he met this standard. He could not have obtained the car the day of the award. The editor of Sports Magazine did not have the keys or title to transfer to him that day and the dealership, which was several states away, was closed. All items which constitute gross income are to be included for the taxable year in which actually or constructively received.
     2. **Scholarships and Fellowships**
        1. **§74**: Prizes and awards are included in GI unless the recipient did nothing to be selected, the recipient is not required to render substantial future services as a condition of receiving the prize, and immediately transfers the prize to charity.
        2. Scholarships covering tuition and required fees, books, supplies, and equipment at non-profit schools are excluded from gross income**. §117**.
           1. However, scholarships to go toward room and board are includable in gross income.
           2. Exclusion does not apply to scholarships conditioned on the performance of teaching, research, or other services. **§117(c).**
     3. **Commercial Gifts (For Income Tax)**
        1. **Definition**: A gift is a transfer made with detached and disinterested generosity.
        2. **Income from Property**: the exclusion does not apply to the income derived from property received by gift
        3. **Commissioner v. Duberstein** (190)
           1. FACTS: TP got a Cadillac from a business contact as a thank-you for a good lead; TP did not want it and tried to refuse, but the business contact gave it to him anyway (even though he already had a car). Then he didn’t include the value of the Cadillac as income, but it was written off as a business expense. The Commissioner asserted deficiency for the car’s value against him.
           2. HOLDING: Car was income; it was compensation for Duberstein’s past services and incentive for future services.
        4. **Stanton v. United States** (Part of Duberstein)
           1. FACTS: When TP retired from working for a church to go into business for himself, the church he worked for gave him $20K to be paid in monthly installments “in appreciation for the services rendered” by him. The members of the board described it as a gift/gratuity based on his great personality and excellent work, but there was also evidence of ill-feeling b/w Stanton and some of the board members. He had on enforceable claim to a pension or retirement benefits.
           2. HOLDING: The SCOTUS remands to the district court again. On remand, the trial court again holds that the payment was a gift, based on the standard of *“detached and disinterested” and based on generosity*.
        5. Deciding this is to be based on experience with the mainsprings of human conduct to the totality of the facts of each case 🡪 have to try every case, clogging the system
        6. Eventually SCOTUS says that whether a payment is a gift is an issue for the trial court, determining *donor’s intent*, and will be upheld unless clearly erroneous.
     4. **Business Gift Tax Analysis Options**
        1. Analyze the facts in each situation
        2. Rebuttable presumption that not a gift, but that income is derived from a business situation.
        3. Non-rebuttable presumption that compensation has been received. See **§102(c)**.
        4. **US v. Kaiser:** [Union](https://en.wikipedia.org/wiki/Trade_union) and non-union strikers were provided limited financial assistance by a [union](https://en.wikipedia.org/wiki/Trade_union). When the non-union [taxpayer](https://en.wikipedia.org/wiki/Taxpayer) filed his tax form, he did not include the amount of the assistance in his [gross income](https://en.wikipedia.org/wiki/Gross_income). **Holding**: [Court](https://en.wikipedia.org/wiki/Court) upheld the [appellate court](https://en.wikipedia.org/wiki/Appellate_court)'s decision but declined to decide whether the assistance was a gift because the government did not object to the [jury](https://en.wikipedia.org/wiki/Jury) charge regarding the gift exclusion. The [Court](https://en.wikipedia.org/wiki/Court) held that the proof was adequate to support the conclusion of the [jury](https://en.wikipedia.org/wiki/Jury). The [Court](https://en.wikipedia.org/wiki/Court) held that, in an allocation of power to decide the question, once it has been found that the decision could reasonably be reached on the evidence and the [district court](https://en.wikipedia.org/wiki/District_court)'s instructions were not overthrown, the [Court](https://en.wikipedia.org/wiki/Court)'s reviewing authority was exhausted. Jury verdict that union strike assistance in form of room rent and food vouchers constituted gift. No defect in the charge to the jury concerning deciding this “gift” question. Jury’s prerogative to make this decision. Issue reallocation of power to decide this question. Effect of jury finding: benefit here is equivalent to a government relief program. It is clearly erroneous then Court will invalidate a jury’s decision.
     5. **Revenue Ruling 61-136**
        1. IRS agrees that in cases “substantially like those in the Kaiser case” strike benefits will be treated as gifts – excluded from gross income.
     6. **EE Gifts**
        1. **§102(c)** shall NOT exclude from GI any amount transferred by or for an employer to, or for the benefit of an employee.
        2. **§7491** burden of proof shifted to IRS if certain conditions are satisfied i.e., TP includes “credible evidence.” But, taxpayer must first present various facts to shift burden of proof. Not relevant to large corporations and partnerships.
        3. **Estate of Sydney Carter v. Commissioner:** Dorothy T. Carter, the widow of Sydney J. Carter, was the taxpayer and appellant in the case. Mrs. Carter had been paid by Mr. Carter's employer what he would have earned until the end of the [fiscal year](https://en.wikipedia.org/wiki/Fiscal_year). Mrs. Carter did not include that amount as [income](https://en.wikipedia.org/wiki/Income) on a [joint return](https://en.wikipedia.org/wiki/Income_splitting) she filed. **Holding**: The court noted that, in proceedings in [United States district courts](https://en.wikipedia.org/wiki/United_States_district_court), payments to a survivor that had not been specifically characterized as [compensation](https://en.wikipedia.org/wiki/Remuneration) were consistently held to be gifts, except when the corporation was dominated by the decedent's family or there was a plan for making such payments. The court held that the test that applied was that of principal motive.
     7. **Social Insurance and Welfare Payments** 
        1. **Welfare and Unemployment**: welfare is excluded (C/L), but unemployment is included §**85** – welfare paid out in interest of public welfare, not within the definition of income under **§61.**
        2. **§85** – unemployment insurance benefits are includible in gross income.
        3. **§86** – social security benefits – 85% are included – subject to some further exclusions at lower income levels.
        4. They are going to get the benefits 2 or 3 years, but social benefits for 10 or 20 it depends on how long the retiree lives.
     8. **Revenue Ruling 2003-12**
        1. **§139 –** not in code book.
        2. Disaster relief programs: general welfare exclusion. IRS exercised some generosity in the context of catastrophic events of natural disasters or in terrorist concepts.

# CAPITAL APPRECIATION

1. **Realization Doctrine**
   * 1. **§1001 -**  concerning realization being required for FIT for an income event to occur from a property disposition transaction.
     2. **Policies behind not taxing until “realization”**
2. Liquidity issues
3. Gain could evaporate (although this *could* be solved be a deduction for loss if it does evaporate)
4. Valuation problems
5. Also, in terms of economic-only income gives some TPs control of when they are going to pay tax that other TPs don’t have.
   * + 1. **Eisner v. Macomber** (225) FACTS: TP had shares of Co., and Co. issued 50% stock dividend (for every two shares, TP got one free).NOTE: There can also be cash dividends, but this was a stock dividend.

* IRS ARGUMENTS that she should be taxed on the dividend: TP**’s** wealth increased by virtue of the dividends. Even if she’s not richer, the fact of the distribution is a realization of wealth that accumulated in corporate form. They don’t need realization even at all—an increase of wealth at corporate level taxable to TP as shareholder
* HOLDING: the dividend is not taxable income. Stock dividend doesn’t make holders any wealthier, just changes the form of their wealth. The 16th Amendment requires a realization event and there wasn’t one here. There is also a liquidity problem, and the chance that the benefit could evaporate. However a cash dividend would be taxable: there would be no liquidity, valuation problems and no chance it could evaporate.
* STRENG: The language *derived from* indicates an event must occur – cannot constitutionally tax stock dividends here. Stockholder took nothing.
  + - 1. **Unrealized Appreciation Includible in GI**

1. **§30** - re corporate stock distributions. Note further effects:
2. **§307 -** Basis allocation and
3. **§1223 (5)** - Tacking of holding period.
   * + 1. **Time Value of Money**
4. Possible relevance of timing considerations:
5. Acceleration or
6. Postponement of: either (a) income or (b) deductions
7. Important relevant factors
8. Changes in tax rates (whether changes in statutory tax rates or individual circumstances);
9. Time value of money i.e., the interest return benefit on deferred income tax payments.
   * + 1. **Pay Tax Today or Tomorrow**
10. Compound Interest: interest on the interest. Monthly is better because it makes interests quicker.
11. Tax planning objective is deferral: (1) delay income & (2) accelerate deductions.
12. Mutual funds: an investment program funded by shareholders that trades in diversified holdings and is professionally managed.
13. Pay tax today?
14. Defer tax payment for 5 years?
15. Pay small or large interest percentage per annum of compounded interest.
    * + 1. **Asset Valuation and Financial Analysis**
16. FMV of an asset is the sum of the present values of all future yields on a particular interest.
17. These “yields” can include interest, dividends, sales proceeds & liquidation proceeds.
18. **Helvering v. Bruun** (261): FACTS: TP, owner of land, leased it to renter in 1915; in 1929 renter demolishes building there, builds a new one. In 1933 renter defaults, lease is abandoned.

* LEGAL DISPUTE: IRS says TP has income as a result of 1929 improvement, as the abandonment of the lease was a realization event.
* HOLDING: abandonment was a realization event and TP should be taxed on income from improvement to land in 1933.
* **Legislative response to Bruun**
  + - * 1. **§109:** rule of exclusion: lessor’s gross income doesn’t include value of improvements to property by a renter when that lease ends. Does NOT include improvements to the LL’s property but it does include rent.
        2. **§1019:** companion provision—basis won’t change on account of income excludable under §109. Tax basis for the improvements received is zero – since no GI inclusion.
        3. These rules cut in favor of the TP, allowing more control over when they will pay the tax. Subsequent rental income from the property is not reduced by depreciation (since no depreciable tax basis is available). Result: a portion of the deferred income is actually realized prior to the disposition of the property.
      1. **Cottage Savings Association v. Commissioner** (265) - FACTS: TP is an S&L that holds mortgages. It holds many mortgages less valuable than they used to be b/c of high interest rates. TP sells its mortgages and buys others from other banks to get a loss for tax purposes, but at the same time trying to avoid reporting losses to retain certification by bank regulatory board. TP is selling 90% participations of their mortgages and buying 90% participations of other mortgages, because unlike selling whole mortgages this is an invisible transaction.
* HOLDING: The test of whether an exchange is a realization event under **§1001(a)** is whether the mortgages TP received were materially different from those it gave up. Here they were, b/c the mortgages and houses under the mortgages were different and subject to different legal entitlements and obligors. The US Supreme Court noted that **26 U.S.C. §1001** says that you cannot claim a loss on property until that loss is *realized* by "the sale or other disposition of property.” The Court found that for the IRS's exception to apply, the trade had to be 'virtually identical'. In this case, the bad loans weren't identical enough.
* STRENG: This case creates a hair trigger test for realization of losses – touch it and the event occurs – materially different very small to trigger event.
  + - 1. **Constructive Sales & Identification Issues**

1. First issue: how to determine which property was sold – when multiple lots of fungible property (e.g. listed shares).
2. Ordering rules: default rule is LIFO for stock; Reg. **§1.102(c).** Except for using specific ID (e.g. use higher basis for later purchased stock).
3. Mutual funds: average basis. **Reg §1.102(e)** & dividend reinvestment plans (DRPs)
4. Possible specific ID if different accounts – §1012(c)
   * + 1. **Deemed Realization – Constructive Sales**

1) Objectives: How to:

* + - 1. Raise cash
      2. Protect against downside risk, &
      3. Delay income tax realization

**2) E.g. “sale against the box”** – sell borrowed shares (possible?) – assuming the loan of the borrowed shares can be subsequently closed (e.g. with currently held similar shares & when the appreciation has disappeared with a **§1014** tax basis step-up at death).

**3) §1259** –Estee Lauder example (estate does not want the stocks diluted). Gain is to be recognized for federal income tax purposes on a constructive sale of an “appreciated financial position.” Cf., treatment of the purchase of a “put” – still have upside potential, but protected against downside risk with the ownership of the “put”.

**4)** Alternative structures possibly triggering applicability of Code 1259.

* + - 1. **Non-Recognition Treatment**

1. **§1001(c):** the entire amount of a gain or loss on the sale or exchange of property under §1001 will be recognized uness a specific rule prohibits or limits recognition. ***A recognized gain or loss is a realized gain or loss that TP is going to take into account for tax purposes***.
   * + 1. **Like-Kind Exchanges §1031**
          1. **§1031(a)(1):** if there is a like-kind exchange for property held for the productive use in trade or business or investment, no gain or loss recognized.

Two farmers who trade their farms, e.g.

Improved real property and unimproved real property are considered like kind if they are both held for productive use in a trade or business or for investment**. Treasury Reg.** **§1.1031(a)-1(b).**

* + - * 1. **Exceptions §1031(a)(2):** makes exceptions to §1031(a)(1). For example:

**§1031(a)(2)(A):** Doesn’t apply to stock in trade or other property held primarily for sale.

**§1031(a)(2)(C):** Doesn’t apply to securities or evidences of indebtedness or interests.

* + - * 1. **Use:** TP must have held ii intended to hold the property transferred for use in a trade or business, or for investment
        2. **Boot**

**§1031(b):** if an exchange is partially an exchange for like kind property and partially something else (boot) you recognize the gain to the extent of the FMV of the boot (or realized gain if realized gain is less).

**§1031(c):** if there is boot received along with like-kind property, a loss will not be recognized

Net relief of indebtedness is treated as boot under §1031, and it is additional to cash boot.

* + - * 1. **Basis §1031(d)**

**No Boot:** the basis of the property GIVEN is the basis in the property received in the exchange (i.e. each party keeps their old basis).

**Boot**

**TP who gets boot:** the basis of non-cash property TP gets will bethe basis of the property TP gave in exchange minus cash TP receives, plus the amount of gain or minus the amount of loss that is realized and recognized.

That basis is allocated among like-kind property and non-cash boot received by TP; the non-cash boot’s basis is its FMV.

**TP who gives boot:** the basis of the new property TP GETS in exchange will be the basis of the property TP gave plus any cash TP paid for the exchange.

* + - * 1. **Alderson v. Commissioner:** Ps, Alloy, and Orange constituting a purchase and sale agreement whereby Ps agreed to sell their Buena Park property to Alloy for $5500 per acre, at a total price of $172,871.40. Alloy deposited $17, 205.00 in the Orange escrow toward the purchase of the property. Later, escrow petitioners located 115.32 acres of farming land called Salinas property which they desired to obtain in exchange for their Buena Park property. **Holding**: **C**ourt held that because the properties were indeed exchanged, they are subject to non-recognition of gain under §1031. Transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. That is, what was the substantive transaction? Here, it was an exchange of like-kind properties.
        2. **Boot and Basis** (231)

**Example:** C has Property A with a basis of $50 and FMV of $90; D has Property B. They exchange.

* If B has a FMV of $90, it will just be a property exchange. C will realize a gain of $40 but it won’t be recognized b/c there was no boot and it was an exchange of like-kind property. Basis in B will be $50.
* If B has a FMV of $60 and comes with a $30 boot, C’s realized gain will still be $40, his recognized gain will be $30. Basis in B will be $50.
* If B has a FMV of $35 and a cash boot of $55, C’s realized gain is still $40; recognized gain will be $40 because it is the lesser of the boot or realized gain. Basis in B will be $35.
* This is basis doing what it should: keep track of what TP has been taxed on and what TP still owes in tax.
  + - 1. **Identifying Like-Kind Property**

1. Is like-kind treatment permitted for:
   * + - 1. Different types of real estate? Cf. TIC; sale-leasebacks (how long the lease?; Jordan Marsh case); oil and gas properties?
         2. Auto/ truck trade-ins? Low tax basis when prior tax depreciation; not for a personal auto.
         3. Professional athlete contract swaps?
         4. Partnership interest swaps?
   1. See limits in **§1031(a)(2).** Liquid securities inventory are not eligible. Coins? Rare coins?
2. “Starker” exchange – delayed receipt of the exchange property – by relying on the creditworthiness of the other exchanging party. Does this qualify as a **§1031** exchange (when initially receiving a promise See **§1031(1)** 45 day (Identification) & (2) 180 day (completion) limits.
3. **Jordan Marsh Co. v. Commissioner**: Petitioner conveyed the fee of two parcels on which it operated a [department store](https://en.wikipedia.org/wiki/Department_store). In return, petitioner received a cash payment, which represented the fair market value of the properties. Petitioner also received long-term leases of the same properties, with a conditional option to renew. Petitioner claimed the transaction was a sale under [26 U.S.C.](https://en.wikipedia.org/wiki/Internal_Revenue_Code) [§ 112](http://www.law.cornell.edu/uscode/26/112.html)(a) and sought a deduction. **Holding**: **C**ourt reversed the judgment of the tax court because the transaction had to be classified as a sale since petitioner received cash equal to the full value of the properties conveyed along with the long-term leases of the properties. The court determined that petitioner did more than just make a change in the form of its ownership. By the transaction, petitioner's capital invested in the real estate had been completely liquidated for cash to an amount fully equal to the value of the fee. Because petitioner received cash for the full value of the property conveyed, the court held the transaction had to be classified as a sale. Therefore, the court reversed the judgment of the tax court. Loss is deductible.
   * + 1. **Involuntary Conversion Gains & 1033 Deferral**
4. **Involuntary Conversion §1033 Deferral:** Postponement of realized gain occurs if gain is derived from an involuntary conversion of property (i.e. theft, casualty, seizure, imminent domain). When conversion is too dissimilar property, gain will be recognized but TP gets a period of time (close of 2nd taxable year) to buy like property so it won’t be. TP can always, however, recognize LOSS on involuntary conversions (generally in the amount of basis in the property).
5. **Corporate Transaction §1032:** Corporation does not recognize gain on exchange of shares for shareholder’s assets.
   * + 1. **Principal Residence Sale**
6. **§121** provides for an exclusion of gain realized on the sale of a principal residence
7. Prior §1034 enabling gain postponement when reinvestment (of a sufficient amount) in a replacement principal residence. NO $ limit
8. Requirements: principal residence; used for two of last five years; limit to $250,00 gain, unless married; then $500,000 exclusion (on joint return)
9. Exclusion available only once every two years
10. Eliminates necessity of proving one’s basis
    * + 1. **MultiParty**
           1. **§351** – no gain or loss shall be recognized if property is transferred by one or more person(s) to a corporation solely in exchange for stock and immediately after that person(s) takes control
           2. **§358 –** basis to TP - basis in original property carries over to her stock
           3. **§362(a) –** basis to corp. in contributed property - corporations basis in contributed property is same as original contributor
           4. **§357(c)** – transfer of property subject to debt – recognition of gain to the extent that liabilities exceed basis for TP – no basis left for shares of stock of the corporation
           5. **Tax-Free Reorganizations** (240) – we treat it like nothing changed for incorporation purposes, we see nothing under tax

**§354 –** no gain or loss is recognizedif stocks or securitiesin a corporation a party to a reorganization are exchanged solely for stock in another corporation party to reorganization

Nonrecognition rule does not apply to individuals

* + - * 1. **§1035:** Gain/loss from exchange of life insurance policies or other annuities non-recognized.
        2. **§1036:** Gain/loss from exchange of stock in same corporate not recognized.
        3. **§1037:** Gain/loss from exchange of US Treasury obligations for others
        4. **§1043:** Gain/loss not recognized when any officer or EE of executive branch of federal government has to sell property to comply w/conflict of interest laws.
      1. **Patton Trust:** open transaction treatment is sought by taxpayer. Transfer of stock in exchange for promise to pay in amounts is dependent upon future cash flow of the buyer. Sale was not inherently speculative. Open transaction treatment is NOT available.
      2. **Open Transaction Treatment**

Treatment is available only in “rare and extraordinary circumstances” **Reg. §1.1001-1(a)**

Other approaches: open transaction – all payments are tax basis components until full basis recovery, value the stream of expected payments as of date of sale and compare this amt with basis, or an open transaction but allocate basis to each expected payment (ie. An installment method)

Why do TP’s want open transaction treatment?

* Postpone inclusion in GI
* All proceeds treated a capital (gains) while the transaction is “open.” No receipts are considered as being interest income.

**Burnet v. Logan: (299)** FACTS: TP owned 1K shares of mining co. stock with a basis of $180K. Co. bought TP’s shares for $120K in cash and a promise to pay her what they got from the ore (undetermined amount).

* TP ARGUMENT: TP should be allowed to recover basis before required to recognize income.
* IRS ARGUMENT: It is a closed transaction worth $220K, so TP has met her basis and got $40K in income.
* HOLDING: It is an open transaction, TP is correct; the promise for future money payments was not equivalent to cash b/c it is uncertain so the transaction is still open. TP is entitled to recover basis first.
  + - 1. **Deferred Payment Transactions**

1. Possible approaches to the timing of gain recognition when a promise/contract is received:
2. Open transaction – all payments are tax basis recovery until full basis is received.
3. Value the stream of expected payments as of date of sale. Compare this amount with basis. Closed transaction status immediately.
4. Open transaction, but allocate basis to each expected payment (i.e., an installment method).
   * + 1. **Installment Method**
5. *TP favorable position*
6. **Objective:** Coordinate income tax reporting with the TP’s actual receipt of cash
7. **§453:** where there’s an installment sale, TP can take amounts paid and allocate it between the basis and the income recognized.
8. **§453(b)** installment sale means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs
9. **Ratio:** gross profit divided by contract price creates a percentage to allocate how much of each payment is gain and how much is basis. So Payment X times (gross profit divided by contract price) is the amount of income TP recognizes each year they receive a payment. **§453(c).**
10. **Installment Sale:** where payments straddle at least two taxable years. TP can opt-out of installment method for installment sales under **§453(d).**
11. **Promissory Note Not a Payment Unless** it is payable on demand or readily tradable. **§453(f)(3).** Otherwise there are liquidity problems with calling it a payment. If you sell in Year One and just get a regular promissory note for a later year, not an installment sale.
12. **§453(e)** provides if (1) 1st disposition or property is to a “related person” and (2) 2nd disposition is by the related person to another before all installments are paid on disposition One, then the 1st disposition is treated as closed when the related person sells. Prevents strawman loophole that was being exploited, but not completely bc narrow definition of related person
13. **Limitations:** **§453(b)(2) and (k**) – installment sales provision is not available for (1) inventory sales or (2) sales of publicly traded securities**; §453A** – interest charge is applicable if aggregate obligations from $150k plus sales exceed $5 mill; **§453A(d)** – a loan is treated as payment if the obligation is pledged for a bank loan; §453(i) – no deferral for installment obligation when “recapture of depreciation” income arises.
14. **No §453 eligibility** where payment in the sale is made by the buyer with (1) demand notes or (2) publicly traded debt obligations.
15. But no limitation applies where (1) the debt is guaranteed §453(f)(3) or (2) a bank guarantee with a “standby letter of credit” is provided by the buyer to seller. Reg. §15a.453-1(b)(3)(iii)
16. **Sales with Contingent Payments**: apply §453 in this order: (1) allocate basis over max to be paid; (2) allocate tax basis over the max payment period; (3) allocate tax basis in equal annual amounts over a 15 year period
    * + 1. **Capital Gains**
17. To have a capital gain a disposition of a capital asset is required. You need to hold on to the capital gain for more than a year.
18. Inventory is not a capital asset.
19. Preferred tax rate (20%) on capital gains since:
20. Gain accrues over multiple years
21. Avoid a “lock-in” effect
22. Only inflation gains (?)
23. Gain resulting from capital rate changes.
    * + 1. **Effect of Inflation**
           1. Bracket creep
           2. Income mismeasurement
           3. Objective of inflation indexation of tax rates, allowances, etc? To enable same economic burden/distribution effects after adjustments for effect of inflation.
        2. **Tax Consumption**
24. Allow an immediate deduction for all business and investment expenses, including savings deposited in banks and savings account. Result: zero basis for assets, and, therefore, income when withdrawn from investment and savings.

# Return of Capital / Timing

1. How to determine the allocation between principal & income (P&I) when payments received under a “term-certain” annuity? Options include:
2. All capital return, then income.
3. All income, then capital return
4. Same proportion of each payment
5. Level amortization, reducing principal amount – back loaded ROC; home mortgage
6. Endowment contracts – front loaded ROC
7. **Importance of Choice of Income**
8. Note: taxpayer as “lender” i.e,, banker, & wants “time value of money”
9. Taxpayer prefers to defer income recognition (and accelerates deductions) unless tax rate increases are coming;
10. IRS prefers to accelerate income recognition (and delay deductions).
11. **Fairfield Plaza v. Commissioner:** Allocation of tax cost between three portions of one parcel of property**. N**ot done on a pro rata basis, since one portion (frontage) more valuable than other parcel sold. Cost of improvements was allocated to middle property, which was retained (and these costs are then frozen in basis for this property until its future disposition).
12. **Revenue Ruling 70-510:** Payment received from government for a “flowage deed” (easement) to enable government to flood portions of taxpayer’s property. Amount paid was 20% of property value. Amount constitutes a capital return – and not separate tax basis allocation to this “easement.” Previously: Inaja Land case & river pollution damages treated as capital recovery.
13. **Capital Expenditures & Recovery:** All receipts are GI (rents or dividends), until final disposition. purchase cost must be capitalized to create basis and basis is recovered over the anticipated useful life of the asset – “matching” principle. Consider receipts from
    * + - 1. **Land**
          2. **Corporate stock**
          3. All current receipts are GI until final proceeds are received. Then, offset of proceeds by tax basis to determine gain.

- Capital expenditures for a wasting asset that yields benefits beyond the current year.

1. **Depreciation Deductions**
2. **§167** provides a deduction for exhaustion, wear and tear, and obsolescence of property used for producing income. Objective: Matching revenue and costs so as to identify current net income.
3. **§168** provides for accelerated depreciation &, therefore, greater deferral of income tax. Greatest benefit from “expensing”. No depreciation for personal costs, e.g., auto and personal residence. But, gain possible. You will only be recovering your basis so you must divide the money by dividing the bases.
4. **Commercial Annuities**
5. Payments are made periodically for a life (lives) or a term.
6. Annuities can be purchased for (1) lump sum, or (2) with periodic payments (including under a “qualified” retirement plan – with zero tax basis since plan contributions are deductible).
7. An annuity contract – a deal with a non-commercial issuer of the annuity.
8. **Method of purchase:** (1) lump sum; (2) or periodic payments.
9. **Types of Annuity Contract Payout Arrangements**
   * + 1. **Fixed Payment Annuity:** an agreed sum (for a term) or at intervals (for a life, ie actuarial factor)
       2. **Variable Annuities:** based on the results from equity security investments through annuity.
       3. **Joint and Survivorship payment**: until the death of the survivor of multiple annuitants – usually longer payout period since two lives involved – husband and wife purchase these and hope they don’t die together
10. **What** tax choices exist for determining the timing of GI inclusion?
    * + 1. **Value**/ interest accrues to the contract.
        2. **As** payments made either (a) before or (b) after annuity contract payments commence
11. **Annuity Income Inclusion Options**
12. Recovery of the entire tax basis first
13. All income 1st – as identified by the insurer.
14. A specified percentage of each payment as an includible “interest equivalent” income amount.
15. Current method – a specified percentage of each payment is included, based on the expected total return from the contract.
16. Apply a constant interest rate, similar to mortgage amortization
17. **Annuity Income Current Inclusion Method**
18. **§72(b):** when money is withdrawn, some is taxable and some is return on basis—investment in the contract is the basis and that is divided by expected return (actuary comes up with expected return).

* **Steps:** (1) Determine the total income tax basis;

(2) Determine the expected return (payment amount times the anticipated # of payments);

(3) Ratio is applied to each payment when received.

**FORMULA**: total tax basis/expected payments \* Each Payment = Amount excluded from GI

1. **Example:** TP invests §500K and actuaries say expected return is $1.5M. Ratio is 1/3, so $1 of every $3 that is withdrawn is a return of basis. If the annuity is $45K/yr, only $30K of that is taxable. You don’t ACTUALLY get basis back at a steady rate—you get more earnings in the early years, but the tax code treats you as though you are getting a pro-rata amount each time, which is a tax advantage. If someone dies too soon, estate can deduct the remainder of the K
2. **Annuity Income Current Inclusion Method**
3. **§72(e)(4)(A):** borrowing before the annuity payments commence – GI inclusion.
4. **§72(b)(2):** after annuity payments commence – living too long – no exclusion after tax basis is fully recovered.

**-** Dying too soon (i.e., not full recovery of cost basis i.e., actuarial loss) **§72(b)(3)** – deduction for the unrecovered tax basis (on the final individual tax income return)

1. **Annuity Income – “Refund Feature Considered”**
2. **§72(c)(2):** concerning the impact of the refund feature on the (a) the investment in the contract and, therefore (b) annuity income inclusion/ exclusion fraction under **§72(b)**
3. **Deferred Annuities**
4. Definition: front-end payment(s) for annuity payments to start in the future. Significant internal *investment element.*
5. Tax inclusion postponed until payment; deposit in bank savings account.
6. Cash withdrawals prior to annuity starting date are income to extent of cash value of contract in excess of investment
7. Loans against policy are treated as cash withdrawals.
8. **Cash Method Accounting**
   * 1. **Cash Method:** TP generally will include an item in gross income when actually received or made available for receipt and will deduct an item when actually lost. Individuals almost always on this method.
     2. **§446(c)(1):** cash receipts & disbursements overall method of accounting.
     3. **E.g.** for services business; accrual method for taxpayers (except small taxpayers) with inventories.
     4. **Reg. 1.446-1(c)(1)(i) –** income inclusion in the year the cash is received. Exception when capitalization rule applies.
     5. **Constructive Receipt**: a TP will be considered to have received items to which he or she had a right and the ability to claim but did not do so. **Reg. 1.451-2.** A cash method TP must include in income an unpaid amount unless their rights in that amount are substantially restricted. Reg. §1451-2(a)
     6. **Restrictions:** Some TP’s may not use the cash method of accounting, as Congress has determined that it would unreasonably accelerate deductions.
9. **Economic Benefit Doctrine**
10. Method TP must include an amount in income if ER has put the amount in a trust, or otherwise secured it for the benefit of TP beyond reach of ER’s creditors.
11. Promise to pay money in the future amounts to a current payment in kind.
12. Economic benefit requires current inclusion in GI.
13. Requirements:
    * + - 1. Fund set aside, e.g., in trust;
          2. Fund is immune from claims of creditors.
      1. **Pulsifer v. Commissioner**: minors win Irish Sweepstakes but not entitled to current funds until (1) becoming of majority or (2) court approval for funds release. Holding: winnings are to be included in GI for the year of the award, and not for the subsequent year when actually retrieved. The funds were irrevocable assigned for benefit of minors and only need to apply for the funds. “Economic benefit” occurred in the earlier year.
14. **Restricted Property**
    * 1. **§83(a):** if employee’s right to funded deferred compensation becomes “transferable or not subject to a substantial risk of forfeiture” then taxation in advance of receipt.If there is a transfer of property in exchange for performance of services, the person getting the property must include the FMV of the property minus the amount they paid for the property in their gross income at the time when the property is transferable or not subject to a substantial risk of forfeiture.
      2. **E.g.** compensation that becomes vested after the EE satisfied employment duration requirement.
      3. **Rabbi Trust:** employer puts assets in a trust but trust is within control of the ER. Assets are designated as for the benefit of the EE. But, the assets remain subject to the claims of creditors of the ER. Therefore, no constructive receipt of these funds. A “secular” trust.
15. **Cash Equivalence Doctrine**
16. **Recei**pt of the ER’s promissory note is the equivalent of cash for purposes of requiring GI inclusion to the EE recipient of that note.
17. Cash method TP must include in income any unpaid amount if rights to that amount can be pledged/assigned for value.
18. **ERISA**
19. Employee Retirement Income Security Act of 1974
20. Purpose is to enable economic protection of EEs financial rights.
21. Both “labor law” and “tax law”.
22. Rules re forfeiture & funding of plan benefits for qualified plans.
23. No discrimination favoring highly compensated.
24. **Qualified Pension / Profit Sharing Plans**
25. **Personnel objectives:** Enable EE loyalty and EE incentives (including investing in the ER’s stock; cf., Enron Corp. stock).
26. **Defined benefit (DB) plan:** ER agrees to pay fixed retirement benefits based on (1) years of service and (2) final pay amount – pay in and know what you’ll get out in the end
27. **Defined Contribution (DC) plan:** amount contributed based on formula (i.e., %5 of current compensation) and the amount paid on retirement is based on investment returns
28. **Qualified Retirement Plan & Income Tax Results**
29. ER deduction for plan contributions
30. NO current GI to the EE-participant; GI inclusion upon later distribution to retiree
31. No GI for investment returns received by the intermediary holding entity (i.e., Trust)
32. Non-tax benefit – funds are protected from ER’s financial risks (although possible actuarial underfunding for DB plans)
33. **Limitations**
34. Non-discrimination rules – can’t favor highly paid EE (but social security integration is permitted).
35. Vesting – benefit becomes non-forfeitable; CF effect of termination before retirement
36. Funding – infusion of contributions into a separate trust enables security of funds
37. Limits on contributions made by ER
38. **Special Retirement Plan Structures**
39. **§401(k) –** cash or derred arrangement.
40. **IRAs –** individual retirement accounts – e.g., when ER is not providing benefits **§408.**
41. Both IRA – nondeductible contributions, but non-inclusion for accruals and distributions
42. NOTE: (1) penalty for early withdrawals & (2) required minimum distribution (70.5)
43. **Nonqualified Deferred Compensation Limits**
44. **§409 –** various limits on deferral opportunities.
45. **Original Issue Discount (OID)** 
    * 1. When a debt instrument provides for (1) no current interest or (2) inadequate (i.e. below market) interest. Then interest income is accrued whether for (1) a cash basis or (2) an accrual basis taxpayer, i.e., treat as “OID” the “unstated interest”.
      2. **§1273** The OID is the difference between the (1) issue price and the (2) redemption price. This amount is treated as interest accrued ratably over the time between purchase and sale (for an accrual basis obligor).
      3. **Policy Objective**: to avoid delay of interest income recognition while enabling a current interest expense deduction (for accrual basis).
      4. **§1271(a):** Note: ALL OID has previously been included in GI. Prior income inclusion enables an addition to the tax basis of the debt instrument. At maturity (1) the tax basis and (2) the proceeds are the same – producing no realized gain. Before OID rules: treat all this gain as capital gain when obligation matures and is paid by the borrower.
      5. **§1272(a)(1):** requires current inclusion of annual OID in GI.
      6. **See** certain exceptions in **§1272(a)(2).**
      7. **Note:** the current interest income accrual increases the tax basis to the holder of the OID instrument.
46. **Market Discount and the Tax Effect**
47. Borrower issues debt at a 5% market rate (e.g., receiving 100x par value at time of issuance).
48. Market interest rate later increases (e.g., to 8%) and the 100x obligation declines to 70x fmv.
49. Purchaser then acquires this discounted obligation for 70x and receives (1) the 5% interest (current income) and (2) 30x profit when the debt instrument matures.
50. **§1276 and §1278** specify that this gain is ordinary income but not until debt proceeds are actually received. Prior sale? Same result.
51. As the 70x keeps increasing you need to include that amount in the interests.
52. Discount that results from the marketplace
53. Borrower has to send you a 1099.
54. Rent for the use of $ is going to be ordinary income, and that rent also is in the form of the accrual which represents the interest and then the only issue is the timing.
55. **Debt Obligation Issued for Property**
56. Sale of property occurs for a specified arm’s length amount. Price is financed with debt owing to the seller. But, the debt instrument determined to have a FMV less than the face of the promissory note.
57. E.g., sale of 100x property for debt and getting note worth 90x (because of inadequate interest).
58. **§1274(d)**
59. Any difference will be OID – to be reported on a current basis (although the OID is NOT actually received). This OID will be added to the income tax basis for the debt instrument.
60. **Exceptions to OID Current Inclusion Rules**
61. Sale for deferred payment(s) of (a) a principal residence or (b) farm for less than $1M (e.g., for a principal amount without any interest) or (c) price less than $250K.
62. **§1274(c)(3) –** specifies OID rules NOT applicable. However, see **§483 –** provides for treatment of discount portion (1) as interest income (and not as capital gain), but (2) only when the payment is received. A recharacterization rule: not a timing (i.e., accrual) rule for cash basis seller.
63. **Example re §483:**

* **Sell reside**nce for $1M with entire amount due in 5 years. Seller’s tax basis is $400K.
* If the AFR is 10%: (1) at maturity seller receives $1M, consisting of (a) $620,921 for the house (220, 921 capital gain – protected under **§121) and** (b) 379,079 of interest income.
* Buyer (a) Pays $379,079 interest expense and (b) has tax basis for the house of $620,921.

1. **Treatment of Deferred Rent Payments**
2. **§467** provides for application of these OID concepts to deferred rent payments:
3. **(1) (Cash basis)** lessor to include both (a) deferred rent and (b) interest on deferred rent in current income (as if an accrual basis taxpayer).
4. **(2) (Accrual basis)** lessee can deduct a similar amount each year. Not applicable to total payments not exceeding $250,000. **§467(d)(2).**
5. **Accrual Method Accounting**
6. **§446(a) –** requires using for tax purposes the accruing method used for keeping one’s “books”.
7. **§446(b)** – specifies the accounting method must clearly reflect income.
8. **S**ee **§448** re those taxpayers required to use the accrual method.
9. **Prepaid Income Accrual Basis**
10. **American Automobile Association:** FACTS: One year membership fee for club paid in advance. IRS argued immediate accrual to GI. TP argued it should be a ratable allocation to each month with partial deferral of unearned income to nxt year. HELD: IRS wins, immediate GI inclusion. Method of treatment of dues is “purely artificial.” Ratable reporting is not permitted
11. **Subsequent Prepaid Income Cases**

* **Schlude**: prepaid dance lessons; inclusion at time of receipt of payment because not sure when events will occur.
* **Artnell:** deferral until baseball games played for prepaid tickets to sporting events because know exactly when each game is played – recognition at time of event
* **Boise Cascade**: inconsistent receipts. Consistently reporting income when services rendered (not requiring any earlier reporting if advance receipt.)
* **§456** was subsequently enacted: to enable membership organizations to spread prepaid dues over service period.
* **Revenue Ruling 2004-34** (reporting in the current or subsequent year if consistent with financial accounting (i.e., a “booking requirement).
* **Regs. §1.451-5** (sales of goods) & similar treatment as services rules for reporting advance payments for goods.

1. **Security Deposits v. Advance Payments**
2. **Indianapolis Power & Light:** advance deposits to enable establishing electric service received by customer. Interest paid by utility on the deposit amount. Eventually credited against the customer’s account. No separate escrow or segregation of funds. HELD: equivalent to loans by customers, rather than advance payments. Loan repayment was possible and not a prepaid amount received.
3. **Inventory Accounting**
4. Inventory accounting is mandated for the seller of goods who either (1) purchases the goods sold for resale, or (2) manufactures the goods for sale to customers.
5. **§263 (a)(1)(A)** specifies that – for a taxpayer having inventory – certain costs for this inventory shall be included in “inventory costs.” These costs include both (1) “direct costs” and (2) “indirect costs.” See **§263A.**
6. Exception for taxpayer with gross receipts (as reseller) of $10M or less**. §263A(b)(2)(B)**
7. **Determining Inventory Cost for a Tax Year**
8. GI from a business selling inventory is computed as follows:
   * 1. Gross receipts – inventory cost = GI
     2. Note: NOT all inventory will be sold during a particular tax year (unless business liquidation).
9. **Determining CGS (the Cost of Goods Sold)**
10. Opening inventory cost
11. Plus: additions to the inventory during the tax year (whether (a) purchased goods for resale or (b) goods produced, including parts.)
12. Less Closing inventory
13. Equals: Cost of Goods Sold (CGS)
14. Tax planning objective: minimize the closing inventory amount (thereby increasing CGS).
15. **Method for Identifying Closing Inventory Items**
16. If value is lower, then greater cost of inventory is incurred during the current year.
17. Therefore, greater expense and income reduced.
18. **Method for Identifying Closing Inventory Items**
19. **§472:** LIFO method.
20. **FIFO** – the remaining inventory consists of goods most recently added to inventory (the “conveyor belt” approach). Usually similar to the actual physical flow of goods.
21. **LIFO** – the remaining goods are those first going into inventory (those goods still held are at the “bottom of the barrel”) – goods sold thru year were those most recently acquired
22. **§472(c) & (e)(2):** Booking Requirement – if TP uses LIFO for FIT purposes this method must also be used for reporting to shareholders and creditors
    * 1. To change reporting methods, must seek permission from IRS
23. **FIFO Method** (First in, first out)

**Example from above -** Year 2: beginning inventory = $1K (left over from year 1). New purchases = $14K. Under this accounting method, the 100 left over at the end of Year 2 are considered to be out of the ones bought in Year 2; so the value of ending inventory is $1400. So ***cost of goods sold is*** $1K plus $14K minus $1400 = $13.6K.

1. **LIFO Method** (Last in, first out)

* **Example from above**
* Year 2: beginning inventory = $1K (left over from year 1). Under this accounting method, all of the mugs sold in Year 2 are considered to be sold first so the value of ending inventory is $1K (what was left over from year one). So ***cost of goods sold*** is $1K plus $14K minus $1K = $14K.

1. **Farmers & Freed -** current deduction of feed by farmer o the cash method of accounting. **§464** – limit on deductions for certain farming expense. Limit to feed, etc. consumed during the year. Applied to prepaid feed costs – when prepayment for more than 50% of expense. Applies to farming syndicates.
2. **Thor Power Tool Company v. Commissioner:**  write-down of inventory of spare parts to “net realizable value” or scrap value. But, these inventory items were not actually eliminated and were still available. Write-down conformed to GAAP but GAAP does NOT control. **§446(b)** requires “clear reflection of income.” No effort to determine the actual purchase or reproduction cost. Thor failed to provide any objective evidence whatever that the "excess" inventory had the "market value" management ascribed to it. The Regulations demand hard evidence of actual sales and further demand that records of actual dispositions be kept. The Tax Court found, however, that Thor made no sales and kept no records
3. **“Booking Requirement” for LIFO §472(c)&(e)(2)**
4. If the taxpayer uses LIFO for federal income tax purposes the LIFO method must also be used for reporting to shareholders and creditors (i.e. for GAAP purposes).
5. What is the purpose of this financial statement consistency requirement?
6. Why might a company NOT choose LIFO when inventory costs are rising?
7. Function of LIFO: to keep you honest ad put you to the test
8. **United States v. General Dynamics Corp.:** corporation used the accrual method of accounting for federal tax purposes; its fiscal year was the same as the calendar year. Corporation purchased group-medical insurance for its employees and qualified dependents from two private insurance carriers. Corporation became a self-insurer with regard to its medical care plans. Instead of continuing to purchase insurance from outside carriers, it undertook to pay medical claims out of its own funds, while continuing to employ private carriers to administer the medical care plans. **Holding**: corporation used the accrual method of accounting for federal tax purposes; its fiscal year was the same as the calendar year. Corporation purchased group-medical insurance for its employees and qualified dependents from two private insurance carriers. Deduction was claimed for medical expenses reimbursable to EEs. 1) when the expense was incurred, but 2) no current reimbursement claim to the ER had been made at the end of the tax year. Amount claimed was based on estimates of past experience. “All Events Test” was NOT satisfied. Some EEs might not file for a claim for reimbursement.
9. **The “Economic Performance” Test**
10. **§461(h)(1)** enacts the “economic performance” test.
11. The “all events” test is not treated as met any earlier than when economic performance for that item occurs.
12. A fixed obligation to pay an amount for services to be performed next year cannot be deducted currently.
13. **Structured Settlements**
14. **§461(h)(2)(C)(ii).** Tort settlements – economic performance occurs when payment is made.
15. Consider the possibility of obtaining an immediate deduction, although actual payment is delayed over several years.
16. **Inconsistent Methods & Matching**
17. Related party transactions
18. Accrual method taxpayer owes expense or interest to a “related person” who uses the cash method of accounting.
19. Under accrual method the item of expense would be deductible under the “all events” test; but, the income item would NOT be included in GI of the cash tax basis taxpayer.
20. Objective of **§267(a)(2)** – to assure consistency of timing – obligor to use cash basis for this item.
21. **Compensating EEs.**
22. **Albertson’s Inc. v. Commissioner:** Petitioner, a Delaware corporation, had its principal place of business in Boise, Idaho, at the time the petition in this case was filed. During the year in issue, petitioner operated over 400 retail food and drug stores in the Western, Southern, and Southeastern United States. Petitioner is an accrual basis taxpayer. Prior to the fiscal year in issue, petitioner established nonqualified deferred compensation arrangements (DCA's) for eight "key" executives (employee DCA's) and for one outside member of its board of directors (director DCA). **Holding**: Court declined to adopt Albertson’s interpretation of **§404.** Allowing Albertson’s to deduct them prior to their receipt by their employees would contravene the clear purpose of the taxation scheme governing deferred compensation agreements. Tax Court’s holding that Albertson’s may not currently deduct the additional amounts. **§163** gets trumped by **§404.**
23. **Stock Options & Restricted Property**
24. Stock Option
    * + - 1. Employment context and
          2. Investment market context
25. **EE’s** right to buy stock at a specified price during a defined period of time. Compensation as an additional work inducement. C.f., a listed option for stock/investment & trading.
26. **Timing:** an economic benefit is derived in exchange for rendered services.
27. **Commissioner v. Lobue:** grant of non-transferable stock options contingent on continued employment. Subsequent exercise of options producing favorable financial results. Taxpayer argues not compensation but proprietary right in corporation; tax court so held. SCOTUS said employer transferred valuable property to employees as compensation. **Holding**: Court held that the transfer of stock to the employee for less than its value was taxable compensation, notwithstanding the employer's purpose to confer a proprietary interest on the employee. The majority held, further, that the employee's gain was realized in the year that the options were exercised, and was to be measured as of the time of the exercise of the options, and not of the grant thereof. Tax Court and COA were WRONG in their rulings.
28. **Unicorn: –** start your own company and that within a short time you will get a capitalization for the company of $1M. When these companies reach a capitalization of $1B borrowed on someone else’s $ in Silicon Valley. There are now 50 of these companies called “unicorns”.
29. **Alves v. Commissioner: §83** applies to an employee’s purchase of “restricted stock,” including when amount paid for the stock equals its FMV. Here stock was subject to a substantial risk of forfeiture and an §**83(b)** election was made. **§83** applies to taxpayers asserting the purchase of restricted stock as an investment
30. **Timing & Characterization Issues**
31. **Option ONE:**
    * + 1. EE includes value of option in GI for the year of the grant of the option
        2. ER deducts that amount as compensation in the year of grant
        3. EE increases tax basis for options/shares when income at option grant.
        4. EE has capital gain when subsequently selling shares at a price above his/her tax basis.
32. **Option TWO:**
    * + - 1. EE includes nothing in GI in the year of grant of the option.
          2. ER deducts nothing as compensation in the year of grant, but later when exercised.
          3. Later EE exercises option & realizes compensation income for FMV less option price (or earlier when forfeiture conditions lapse).
          4. EE has capital gain when subsequently selling shares at price above tax basis
33. **Option THREE**
34. EE includes nothing in GI in the year of grant of the option.
35. ER deducts nothing as compensation (neither in year of grant nor when exercise).
36. EE exercises, but NO compensation income (for FMV of stock less option price).
37. EE has capital gain when subsequently selling shares at price above tax basis (and no compensation income).
38. **Current Stock Option Taxation Alternatives**
39. **Statutory Stock Options:** stock options, i.e., incentive stock options (ISOs). §**422.** Income tax treatment: only capital gain treatment upon the eventual stock disposition.
40. **Nonstatutory stock options:**  i.e., dependent upon tax accounting rules. But, see treatment under§**83** concerning current income inclusion.
41. **Incentive Stock Option (ISO)**
42. **Rules §422-** Statutory structure permitting GI inclusion limited to Capital Gain upon sale of stock.
43. Rules

Stock retention requirements

Option price at FMV when granted

Granted under an option plan

$100k limit on option stock amount

No ER deduction for compensation

Net benefit if ER loses immediate deduction but deferral of CG for EE

1. **Non-statutory Stock Options**
2. Stock is available to EE but is subject to restrictions on transferability and a risk of forfeiture.
3. Note **§83(a)** – inclusion in GI when stock option issued if having a “readily ascertainable” FMV.
4. No current GI inclusion when the option is “nontransferable” and a “substantial risk of forfeiture” – inclusion when conditions lapse.
5. GI inclusion when exercise for the difference between (1) exercise price and (2) stock value.
6. **Election to Accelerate Inclusion re NSO**
7. **§83(b)** – EE can elect current inclusion (even if a forfeiture risk) to the extent of FMV.
8. GI inclusion is based on the value of stock without restrictions.
9. No income tax (loss) deduction by an EE who made an **§83(b)** election if forfeiture of the option subsequently occurs.
10. **But, §83(b)** is NOT applicable if an option “lacks a readily ascertainable FMV” **§83(e)(3)**

# Receipts and Liabilities

1. Borrowing of funds does NOT result in GI. Borrowing proceeds are offset by a liability to repay and, consequently, no net accretion to wealth occurs. There is no income from discharge of indebtedness if the indebtedness happens when you are in bankruptcy under Title 11 or insolvent. However, for insolvency w/o BR, the income from discharge of indebtedness can only be excluded to the extent of the insolvency immediately before the debt discharge.
2. No deduction is allowed for repayments of the loan, i.e., merely a rearrangement of the items on one’s personal balance sheet.
3. **US v. Kirby Lumber Co. v. :** FACTS: TP issued bonds (debts) in 1923 for $12M, then bought back 1/12 of the bonds for $862K.

* HOLDING: the $138K difference IS taxable income. Those who buy the bonds are loaning TP money; when TP paid off the loan by buying back the bond, it was discharging indebtedness, in this case for less than the amount of the loan.

1. Code **§61(a)(12)**
   * 1. Specifies that GIinclusion of “income from discharge of indebtedness”.
     2. Alternative scenarios:
        1. If discharge the indebtedness for less than what you owe, difference is includable in GI. Parent forgives debt owing from child.
        2. Corporation forgives debt owed by shareholder.
        3. Shareholder forgives debt owed by corporation.
        4. **Enforceable debt**: To have discharge of indebtedness income, there must be an enforceable debt in the first place.
2. **Code** **§108** – Possible COD Income Relief
3. **§108** provides various relief from this rule for insolvent \*& Chapter 11 debtors (and others), but NOT all taxpayers realizing COD income.
4. Also relief for:
   * + - 1. Qualified farm indebtedness **§108(a)(1)(C)**
         2. Qualified real property debt - **§108(a)(1)(D),**
         3. Qualified principal residences debt discharged before 1-1-2015- **§108(a)(1)(E)**

**iii**. Reduction of tax attributes required - **§108(b)**

**iv.** **§108(h)** provides relief from COD income when mortgage lender forecloses on the taxpayer’s residence. But, reduce tax basis for residence.

**v.** **§108(e)(5):** reduction in debt for a purchase price is a reduction in purchase price and not COD income to the purchaser.

**vi**. **§108(f)(2):**  COD income relief on cancellation of a student loan – under limited circumstances.

**vii. Zarin v. Commisioner:** FACTS: TP accumulated $3.4M gambling debt at a casino. NJ law says it was unenforceable, illegal gambling debt. Casino and TP settle for $500K. IRS said he had $2.9M income from the discharge of indebtedness.

* HOLDING: TP did NOT have income from discharge of indebtedness.
* It was not debt under §108(d)(1) b/c TP was not liable for it (because NJ law prevented the casino from holding him liable for it) and did not hold property subject to the debt. He paid the $500K for which he was legally responsible, and since he was legally obligated to no more, there was no income from discharge of indebtedness.
* Contested liability doctrine (see above): it follows that when a debt is unenforceable, the amount of the debt and not just the existence of obligation to pay it is in dispute; even unenforceable gambling debts are usually collected in part. The parties attached a value to the debt lower than its face value that was not set until the settlement. Therefore the debt was a contested liability and there is no discharge of indebtedness under this theory.

1. **Claim of Right Doctrine**
2. **North American Oil Consolidated:** FACTS: TP and US Government are fighting over land, which is generating income. In 1916, that income held by a receiver pending dispute resolution. In 1917 TP wins, and 1916 income is paid to TP. IRS says that money was taxable to 1917 when received; TP says it is taxable to 1916 when earned, or 1922 when the last appeal was decided in its favor. (Tax was higher in 1917 b/c of war than it was in 1916 or 1922)

* HOLDING: TP has to be taxed on the income in 1917. If a TP gets earnings ***under a claim of right***, he must report them to the government even though someone else might claim he is not entitled to the money and even though he might lose it in court later (can deduct it at that time if he does). The TP here did not do that in 1916; and he received the money in 1917; so that’s when it is taxable to him.

1. **US v. Lewis:** FACTS: On 1944 return, TP reported $22K which he had received as an EE’s bonus; however as a result of subsequent litigation, it was decided that the bonus was improperly computed and he had to return $11K to his ER. Until that judgment, he had claimed and used the $22K entirely as his own under the good faith “mistake” belief that he was entitled to it.

* HOLDING: entire amount includable in 1944; though TP gets a deduction in 1946 when he had to return half of his bonus. Under the claim of right doctrine, there is no exception merely because a TP is mistaken about his claim of right.

1. **§1341 Relief**

* Permits a reduction of income tax liability in the year of repayment by amount of excess tax repaid on that income when 1st included. Must have earlier received the income under a “claim of right.” Restoration of embezzlement income received. Voluntary payments are not eligible for this treatment.
* If the amount was included in income in prior years b/c it appeared that TP had an unrestricted right to it (***claim of right***) then TP gets a deduction on current year for that amount if it turns out TP did not have a right to that amount.
* What will happen is either:

TP will compute the tax taking into account the deduction TP will get in current year

Take the amount of tax TP would not have paid in the prior year if TP had not included the amount then, and take that as a deduction in the current year

Brings you back up to $0 if you are a loser under claim of right.

**D**oes not take away any windfall that might come to TP under claim of right.

Voluntary payments are not eligible for this treatment

1. **Alcoa, Inc. v. US:** Alcoa spent funds for environmental remediation (After CERCLA mandate enacted). Alcoa claims as a deduction and then claims **§1341** claim of right treatment, i.e., income earlier received was not really Alcoa’s since required to be used for CERCLA purposes. NOT a restoration of income. **§1341 NOT applicable.**
2. **James v. US:**  a case in which the [United States Supreme Court](https://en.wikipedia.org/wiki/Supreme_Court_of_the_United_States) held that [money obtained by a taxpayer illegally](https://en.wikipedia.org/wiki/Taxation_of_illegal_income_in_the_United_States) was [taxable income](https://en.wikipedia.org/wiki/Taxable_income), even though the law might require the taxpayer to repay the ill-gotten gains to the person from whom they had been taken. **Holding**: Court also ruled, however, that Eugene James could not be held liable for the willful tax evasion because it is not possible to willfully violate laws that were not established at the time of the violation. Although Eugene James avoided criminal liability, the opinion of the Court left James in a situation where he would be required not only to repay the embezzled $738,000 to the union, but would also be required to pay federal income taxes on the receipt of those funds, just as though he had been able to keep them. Wilcox overturned.
3. **Illegal Income**
4. Who has the priority (as a creditor) for the funds (if funds still held by the embezzler):
5. The embezzled party; or
6. The IRS (for the income tax on the embezzled funds as GI)

* Employers buy insurance (casualty insurance, embezzlement insurance) to protect themselves.
* Is this appropriate to use criminal tax proceedings to pursue “organized crime” ? Yes, that is how they caught Al Capone.

1. **McKinney v. US**: embezzler claims trade or business as embezzler and being entitled to NOL, when paying back. Not engaged in a trade or business. Reported differently than business income. Further, not entitled to use **§1341** for relief since funds were not received under a “claim of right” both (1) as a matter of law and (2) based on the facts here. No claim of right because he stole the $. NO net operating loss so **§165(c)** did not apply.
2. **Transfer of Property with Debt Attached**
3. **Alternative types of debt arrangements:**
4. **Recourse –** personal liability for the debt by the borrower (to the extent of all the assets of the borrower) (& a mortgage as security).
5. **Nonrecourse** – the debt is secured only by the pledged asset (and its income stream), but no personal liability of the property owner exists.
6. **Crane v. Commissioner:** FACTS: TP inherits land and building in 1932 with a FMV of $255K; his basis is stepped up to that amount. Land and building were fully mortgaged with a debt of $255K. TP claims a total of $25K in depreciation deductions for a few years, and in 1938 sells the property for $2500 cash and the assumption of the mortgage by the buyer.
   * + 1. TP ARGUMENTS: the property she inherited is not the land and the building, but the equity in the land and building--$0 since it was fully mortgaged. She claims her only gain was the $2500, and admits she shouldn’t have taken the $25K in deductions but that it is too late to do anything about that.
       2. HOLDING: TP took the deductions and on the sale the government is entitled to recapture that benefit. Here’s how it will happen:
          1. Her original basis in the property under §1014(a) is $255K, the FMV at the time of inheritance.
          2. An adjustment to basis under §1016(a)(2) will be depreciation, so her adjusted basis is $239K ($255K-$25K)
          3. The amount realized is the cash plus the discharge of indebtedness, so $257,500 ($2500 plus $255K)

This would be easy if it was recourse debt, a no brainer

The court decides this is the case even though it was non-recourse debt.

* + - * 1. Her gain, therefore, is $27,500 ($257,500 minus $230K). This happens to be equal to the depreciation deductions she took plus the cash she got from the buyer.

1. **Parker v. Delaney:** taxpayer in default on mortgage conveys property by quit-claim deed to the lender & receives nothing. No proof of the actual value of property as being less than the mortgage. **Holding:** Court held that the taxpayer had a taxable gain, the amount realized by the taxpayer less his basis even though the disposition involved no cash receipt whatsoever.
2. **Commissioner v. Tufts:** FACTS: Similar to Crane, but the FMV was less than the debt, but not an abuse case like Franklin; instead, the value of the property dropped naturally. Cost basis in 1970 of $1,895,000; $45K cash investment and nonrecourse debt for $1.85M. TP claimed a depreciation deduction in 1971 and 1972 of $440K, making their adjusted basis $1,445,000. In 1972 they basically give property away b/c FMV has fallen below debt; buyer gives negligible cash and assumes debt when it is $1.4M.

* HOLDING: as in Crane, ***the amount realized includes amount of non-recourse debt the buyer assumes***. So amount realized is $1.85M, adjusted basis is $1.455M ($1.8M minus $440K). That means the gain is $395K. This could also be seen as the depreciation deductions TP took minus the cash they put in, $440K - $45K.
* O’Connor Concur: logical way to treat this transaction would be to bifurcate it into two transactions: a sale of property and a discharge of debt. Results in a net gain of same amount, but the character of the gain and loss are different. Sale transaction produces capital gain or loss, and the discharge of debt is ordinary income. This discharge of debt may be subject to exclusion under **§108**

1. Property ownership purchase transaction. Basis established at acquisition; FMV at disposition identifies the proceeds then received.
2. Debt/loan transaction, including termination of the loan. Original loan established obligation; repayment for less than debt creates cancellation of debt income (COD).
3. Property gain as capital gain; COD income as current ordinary income.

|  |  |
| --- | --- |
| **Property Transaction** | **Discharge of Debt Transaction** |
| Amt Realized = $1,400,000 (FMV) | Face amt of debt = $1,851,500 |
| Less adjusted basis = $1,455,740 | Debt satisfied = $1,400,000 |
| Loss on sale = -$55,740 | Discharge of debt = $451,500 |

1. **Treasury Regulations & Nonrecourse Debt**
2. **Reg. §1.1001-2**
   * + 1. **Reg. §1.1001-2(a)(1)** – the amount realized include the amount of liabilities from which the transferor is “discharged”
       2. **Reg. §1.1001-2(a)(4)(i) –** the sale of property that secures a nonrecourse liability “discharges” the transferor from the (nonrecourse) liability
       3. **Reg. §1.1001-2(2)(b)** – the FMV of the security is *not* relevant for determining the amount of liabilities being discharged.
3. **Revenue Ruling 91-31 – Debt Reduced- No transfer**
4. Lender agreed to reduce nonrecourse debt when value of the building (800x) was less than the outstanding mortgage debt (1M) & no inclusion. Reduction of under-secured non-recourse debt by holder of debt & not the seller. Debt reduction produces realization (of non-exempt) COD income (even in non-recourse context) since no disposition of collateral has occurred y owner. (& bank gets tax deduction).
5. Discharge of indebtedness so it is GI.
6. **Non-Recourse Borrowing Exceeding Basis**
7. Remember Tufts: Original nonrecourse purchase debt is included in tax basis.
8. What effect of a later (i.e., post-acquisition) debt when borrowing against the (significantly appreciated?) property and the loan amount exceeds the income tax basis for the collaterized property.
9. **Woodsam Associates v. Commissioner**: FACTS: Wood bought property for $296,400, incurring a recourse loan. Then Wood refinanced with a $400K nonrecourse mortgage. Wood then donated property to TP, her company. In 1933 Wood defaulted on the loan.TP/Wood ARGUMENTS: When she got another loan from recourse to nonrecourse, it was a realization event

* HOLDING: the change in mortgages was not a realization event—she was the owner of the property before and after the refinancing. Court is using ownership, rather than policies arguments, as the test.
* *Cf Inaja* – don’t realize gain until sure gonna realize gain.

1. **Gifts of Encumbered Property**
2. **Estate v. Levine**: gift of property in donative transaction (to trust) with transferred liabilities in excess of tax basis. Includes current expenses assumed and paid by the donee. Only excess of (1) the value over (2) the liability is subject to tax. This transfer (liability in excess of basis) constituted a “disposition” of property for 1001 income tax purposes. Capital gain. Decedent realized gain to the extent of $425,051.79 upon the transfer of the 20-24 Vesey Street property, encumbered beyond its adjusted basis and with outstanding liabilities, to a trust for the benefit of his grandchildren. Decedent has reaped a tangible economic benefit from this transaction and such economic benefit is subject to tax under the rationale of *Crane v. Commissioner.*
3. **Diedrich v. Commissioner:** In 1972, petitioners Victor and Frances Diedrich made gifts of approximately 85,000 shares of stock to their three children, using both a direct transfer and a trust arrangement. The gifts were subject to a condition that the donees pay the resulting federal and state gift taxes. There is no dispute concerning the amount of the gift tax paid by the donees. The donors' basis in the transferred stock was $51,073; the gift tax paid in 1972 by the donees was $62,992. **Holding**: A donor (such as petitioner husband and wife and petitioner executor's decedent) who makes a gift of property on condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property. *Same as Old Colony Trust.* Gift tax liability is imposed on donor under gift tax rules - **§2502(d).** GI was deemed realized to the extent of (1) the gift tax amount (2) in excess of the tax basis for the gifted property. Note no tax basis allocation here **§1011(b).**

# State and Local Bonds

1. **§103 -** provides that GI does not include interest on an obligation of a State or political subdivision.

* Lower interest rate is paid on these bonds to reflect that no GI inclusion occurs.
* Consider the 40% taxpayer: a 10% taxable return and a 6% tax-free return have the same net effect to the bond owner taxpayer.
* No tax deduction for interest on borrowing to purchase tax-exempt bonds. **§265(a)(2).**
* Exempts interest on state, municipal, and other such bonds for TP who holds them/gets the interest from them.
* It is the locality that benefits—the interest rates are lower on tax-exempt bonds, and the difference in interest is a subsidy to the locality from the federal government.
* Limits on tax-exempt bonds:
  + - * Private activity bonds **§141(e**) & **142** – *cf. School bonds*
      * Registration Requirement
      * Arbitrage bonds **- §148**
      * This starts to break down because not everyone is taxed at the same rate:
      * Localities have to increase interest rates to attract TPs at a lower rate; can’t issue different bonds for different tax brackets
      * Above doesn’t change cost to government, but does reduce subsidy🡪difference goes to TP in highest tax brackets.

1. **South Carolina v. Baker:**
2. **§163(f) –** was enacted to deny an interest expense deduction unless obligation is in registered form. This restriction is NOT precluded by application of: (1) Tenth Amendment to US Constitution., or (2) the doctrine of intern-governmental immunity (since this NOT a tax on the “source,” i.e., a tax on the bond issuing state).
3. NO US constitutional right to the states to issue (federal) tax-exempt interest paying bonds.
4. **§163(f) –** specifies that NO “provision of law shall be construed to provide a deduction for interest on any registration – required obligation unless such obligation is in registered form.”
5. **This** limitation is NOT applicable to (1) debt issued by a natural person, (2) private debt issuances, and (3) debt for less than one year.
6. **§103 –** allows lower debt financing costs to state and local governments.
7. **State & Local Bond Interest Limits**
8. See the limits on tax-exempt bond issuances:
9. Private activity bonds **§141(e**) & **§142.** C.f. school bonds to NRG Stadium bonds.
10. Registration requirement **§149.** Bearer bonds.
11. Arbitrage bonds - **§148.** If an arbitrage bond exists the benefit of the arbitrage transaction is to be paid to the US Government.
12. **Tax Arbitrage by Taxpayers Precluded**
13. See **§265(a)(2) –** no deduction is permitted of the interest expense incurred on borrowed funds used to purchase/carry obligations producing tax-exempt interest. (Cf. Haverly case).
14. **Tax Expenditures**
15. A tax expenditure is functionally a substitute for a direct US government expenditure – accomplished through exclusions, exemptions, deductions, credits, deferrals, eetc.
16. Highest benefit to highest bracket taxpayer.
17. Baseline is (cf., Haig-Simons definition) a comprehensive income tax based on the sum of (1) consumption and (2) the change in one’s net wealth. Base does include personal exemptions, standard deductions and the deduction for expenses in earning income.
18. Exceptions to this baseline are the economic equivalent to US Government spending programs.
19. **Important Variances in Defining Income Tax Base**
20. Income taxable only when “realized.”
21. Separate corporate income tax.
22. Different tax/brackets, asked on income.
23. No adjustment (assets & debt) is made for inflation effects.
24. Gifts are NOT income.
25. Government transfer payments are NOT income.
26. Accelerated depreciation is (not) relevant.

# Deductions, Credits and Computation of Tax

1. **Problems:**
2. Child has bond income of $3,000 from bonds received by gift. Parent claims the personal exemption and NOT the child. **§151(d)(2).** Child has limited standard deduction **§63(c)(5). –** Reasoning:
3. Child realizes $5000 of summer earnings. This income is NOT subject to the to the “kiddie tax” No personal exemptions, but standard deductions.
4. **§1(g) –** special rules for the “Kiddie Tax” – tax at the parent’s marginal tax rate.
5. **Itemized Deductions (565)** – those deductions permitted for personal expenditures, including:
6. EE Business Expenses
7. Personal Interest expense
8. State and local taxes
9. Charitable contributions
10. Medical expenses
11. Casualty or theft losses.
12. **Miscellaneous Itemized Deductions (566)**
13. **See §67**  - an additional limitation on deductions is imposed. These deductions are only allowable to the extent that the exceed 2% if AGI.
14. **These deductions §67** include:
15. Unreimbursed EE business expenses **(§62(a)(1)** re EE expense below the line.) Cf., reimbursed EE expense - **§62(a)(2)(A)**
16. Investment expenses **§212**
17. **Subtractions from income in computing taxable income. There are two type of deductions**
    * + 1. Deductions from GI in computing AGI: Certain expenditures are deducted (subtracted) from GI in computing AGI
        2. Deductions from AGI in computing taxable income: The TP subtracts his or her personal exemptions and then take the larger of either the standard deduction or the itemized deduction. The standard deduction is a statutorily set amount, and the itemized deduction is the sum of all allowable itemized deductions.
18. **Revenue Ruling 2012-25**
19. A **§62(c)** reimbursement arrangement enables a trade or business deduction of the EE towards determining AGI. **§62(a)(2)(A).**
20. Holding: none of the described plans qualify (except Situation 4) where reimbursement for cleaning supply expenses occurred with separate reimbursement arrangement and the actual deductible expense was substantiated. Have to report as a GI.
21. **Overall Limit on Itemized Deductions**
22. **§68**
23. When AGI exceeds the “applicable amount” then deductions reduced by lesser of (1) 3% of AGI, or (2) 80% of itemized deductions.
24. “Applicable amount” is $300,000 for a joint return.
25. **Credits**
26. **Credi**t is an offset againt the tax liability; not against the GI in reaching taxable income. Not a deduction.
27. A tax credit is a subtraction from the net tax due (as opposed to a deduction, which is a subtraction from the income to be taxed)
    * 1. Formulas:
         1. **Gross income minus deductions = taxable income**
         2. **(Taxable income times tax rate) minus tax credit = total tax due**
28. I.e., a subtraction against the tentative tax liability.
29. Credits can be (1) refundable or (2) nonrefundable
30. E.g. **§31** permits refundable credit status for tax withholding from an EE’s wages (and transmitted to IRS by ER)
31. **Earned Income Tax Credit (579) Also refundable**
32. **File an income** tax return and receive a rebate (even if no income tax liability arises).
33. **§32** provides for the allowance of the credit
34. **The** tax credit amount depends upon:
35. Number of dependents, and
36. Income limitations/phase-outs
37. Primary objective ?????
38. **Credit for the Elderly and Disabled**
    * 1. **§22** provides a tax credit for the elderly and the disabled – up to 15% of the §22 amount
      2. **Reduction** as the amount increases above $7500 for single persons and $10k for joint returns
39. **Child Tax Credit**
    * 1. $1000 for each qualifying child under §**24(c)** (under 17, dependent, name and SSN)
      2. Phases out at higher levels of income under §**24(d).** Credit is partially refundable
      3. **§24(e)** No credit unless name of child and ID are included on the return
      4. **Incentives:** better characterized as relief to those with children than an incentive to have children. But if you are on the margins of having earned income for not, then you are incentived to push to get more earned income
      5. Largest federal child relief program, more than 2.5 times what we provide through TANF.
      6. Good for the middle class:

# Interest, Taxes & Losses

1. **Interest expense is deductible, subject to various limitations**. **§163(a)** Limitation examples:
2. Limit on investment interest - **§163(d)**
3. Obligations not in registered form - **§163(f).**
4. Personal interest not deductible, except for home mortgage and home equity debt. **§163(h).**
5. Disqualified interest & foreign lender**. §163(j)**
6. Debt-equity classification issues **§385**
7. **§265(2)** re interest to carry tax-exemptions.there can be no deduction for interest where income is exempt from taxes b/c that would be double tax avoidance. A little weird b/c it treats tax exempt bonds as though the subsidy goes to the TP, where in fact it goes to the municipality.
8. **Knetsch v. US:** FACTS**:** Knetsch bought deferred annuity bonds for $4M, paying with $4k check and $4M promissory note. Debt was secured by bonds. Prepaid 1st year’s interest of $140,000 and borrowed back $99,000 and then prepaid $3,465 interest on this borrowing. This procedure repeated in the subsequent year. In fourth year this arrangement terminated and net equity of $1000 received from the contract. Trial court declared the transaction a “sham”. HOLDING: Taxpayer paid a fee of $91, 570 to produce this loan arrangement attempting to facilitate a $294,540 interest expense deduction, thereby enabling a tax reduction of $233,298 (assuming an 80% FIT rate).

**-** Post-transaction exacted tax provision limits this arrangement. But, no enactment date protection here – since here a non-existent deal. Held a sham transaction & no interest expense deduction permitted.

1. **Goldstein v. Commissioner:** taxpayer won $140,000 in Sweepstakes and (1) borrowed funds and (2) prepaid interest expense (to partially offset some of winnings). Loan proceeds were used to buy US Treasury obligations to provide interest income in later year. Current economic loss but expected tax savings: reduced current income tax and pushed certain earnings forward. Holding: NO **§163** interest expense deduction since no non-tax purpose for the borrowing.

**-** Appellate Court affirmed and denied the deduction. The Appellate Court found that an interest payment may not be deductible under **§163(a)** even though the underlying debt is a full recourse debt.

- The Appellate Court found that the only reason for the transaction was for tax avoidance purposes.

- Goldstein's assets were never at risk unless the government defaulted on their bonds, and the chance of that was so small that it effectively meant that none of Goldstein's other assets were at risk.

- Therefore, Goldstein's situation was no different than **Knetsch**, and the *Sham Transaction Doctrine* still applies.

1. **Borrow & Life Insurance**
2. **§101** excludes life insurance policy internal build-up from GI inclusion.
3. **§264(a)(3) & (d)** disallowing an interest expense deduction.
4. **But,** see **§264(d)** concerning paying four of the first seven premium payments and then no limit on the interest expense deduction.
5. Mp non-tax purpose for the borrowing.
6. **§265**
7. There can be no deduction for interest where income is exempt from taxes b/c that would be double tax avoidance. A little weird because it treats tax exempt bonds as though the subsidy goes to the TP, where in fact it goes to the municipality.
8. **Revenue Procedure 72-18**
9. Purpose to carry tax-exempts exists where borrowing incurred to buy the tax-exempts. Not where bona fide business debt is temporarily invested in tax-exempts.
10. Cg. Wis. Cheeseman
11. Not applicable to an individual who owns tax-exempts and incurs home mortgage debt. Individual owning stocks & buying tax-exempts on margin (tax exempts as collateral).
12. **Estate of Yaeger v. Commissioner:** “Investment interest” **§163(d)** limits interest expense deduction to investment income (& not deductible against other business & personal income). But, as **§163(d)** carryover s possible. Here significant trading activities, but holding stocks for investment, and NOT a trader (i.e., not engaged in the “business” of trading stocks). The management of one’s financial investments is NOT engaging in a trade or business. Here most securities were held for more than a year. HELD: Section 163(d) limits the deductibility of investment interest by a non-corporate taxpayer to the extent of the taxpayer's investment income, plus $10,000. Any amount disallowed is "treated as investment interest paid or accrued in the succeeding taxable year."
13. **§163(d) –** cannot take excess interest.
14. **§163(a):** there shall be a deduction allowed for all interest paid or accrued within the taxable year on indebtedness
15. **Personal / Home Mortgage Interest**
16. **§163(h)(1)-** There are no deductions for personal interest paid or accrued during the taxable year.
17. **Exceptions:**

* Found in **§163(h)(2)(D) -**  exception for “qualified residence interest” to enable an interest deduction.
* **§163(h)(3)** – defines “qualified residence interest” as (1) “acquisition indebtedness” limit $1M and (2) “home equity indebtedness (limit $100,000)
* Interest allocable to a trade or business: cost of producing income from the trade or business and therefore a business expense, unless it is an expense allocable to the business of being an EE.
* **§163(h)(2)(d):** TP can deduct interest when borrowing to buy or improve a home, or borrowing against TP’s home (like a mortgage). This is a subsidy to home ownership lobbied for by national association of realtors.
* **§163(h)(4)(C) -** indebtedness shall not fail to be treated as secured b any property solely because, under any applicable State or Local homestead or other debt protection law in effect of August 16, 1986 the security interest is ineffective or the enforceability of the security interest is restricted.

1. **Deduction for Taxes Paid**
2. **§164 –** permits deduction of certain state and local taxes; income taxes and property taxes but NOT sales taxes. Other taxes may be deducted if incurred for business & investment purposes.
   * 1. Includes taxes for (1) business purposes, (2) investment property, and (3) personal purposes
     2. Also includes (1) property taxes (on the owner and not on the renter), (2) state income taxes, not in TX (but not FIT **-§275**), but (3) not sales taxes
     3. State and local sales taxes can be deducted but only if the TP gives up the deduction for state and local income taxes
     4. User fees are not treated as taxes and are not deductible
3. **Discrimination When No State Income Tax**
4. Taxpayers deducting state income taxes have benefit
5. However, see **§164(b)(5)** re election to deduct state and local sales taxes in lieu of deducting state and local income taxes.
6. **Revenue Ruling 79-180**
7. Under NY “Real Property Tax Law” renters are treated as having an interest in real property and are personally liable for real property taxes. Also: states that they are entitled to a federal itemized deduction for these taxes paid
8. Held: this is not a real property tax imposed on the renter for FIT purposes. No new economic burden has been imposed on renters from tis NY Legislation.
9. **Compare: US Estate Tax**
10. US estate tax – previously in the US a credit was provided for federal estate tax for death taxes paid to states.
11. Repealed (became a deduction - **§2058**
12. **Foreign Tax Credit**
13. A tax credit (not a deduction) is available for income taxes paid to foreign governments (including subnational government)
14. **Homeowners & Future Tax Policy**
15. See effective tax rate on owner occupied housing
16. Distribution of tax benefits from the home mortgage interest deduction
17. Policy options:
18. Replace interest expense deduction
19. Limit the exemption of
20. Repeal the state and
21. **Casualty Losses & Personal Deduction (625)**
22. **§165(c)(3) –** enables a deduction for losses from fire, storm, shipwreck, or other casualty, or from theft.
23. Limitation to losses above 10% of AGI. **§165(h)(2)**
24. Each casualty is allowed a deduction only to the extent it exceeds $100. **§165(h)(1).**
25. A loss limit per incident –MUST exceed $100
26. **§165(h)(4)(E) –** any loss of an individual described in subsection (c)(3) to the extent covered by insurance shall be taken into account under this section ONLY if the individual files a timely insurance claim with respect to such loss.
27. **Grandma’s Bracelet Example**: you spent $100 for the insurance payment but you sustained a casualty gain of $9900 since you basically sold it to the insurance company.
28. **Definition of a Casualty**
    * 1. Fire, storm or shipwreck
      2. Hurricane Katrina; tropical storm Allison
      3. Sudden or unexpected occurrence
      4. Termites – fast-eating v, slow-eating termites. Theft/ mysterious disappearance.
29. **William H. Carpenter**
30. The issue of whether a husband and wife could deduct the aggregate fair market value of the wife’s engagement ring from their income tax return, as a casualty loss under §165(a) and (c)(3) of the Internal Revenue Code of 1954, after the husband inadvertently dropped the ring in their garbage disposal.
31. The petitioners were Nancy Carpenter and William Carpenter. During 1962, Nancy owned a diamond engagement ring worth $1,010. One day, in 1962, Nancy placed the ring in a water-glass of ammonia for purposes of cleaning the ring. Nancy then left the glass, with the ring inside, next to her kitchen sink.
32. Later that day, William Carpenter was washing dishes, and William inadvertently “picked up the glass and emptied its contents down the” sink drain. William was unaware that the ring was in the glass. William proceeded to run the garbage disposal, which ultimately damaged Nancy’s ring.
33. The damaged ring was recovered from the garbage disposal and was taken to a jeweler for an appraisal. Immediately before the ring was dropped into the garbage disposal it had an aggregate fair market value of $1,010. The total aggregate fair market value of the ring immediately after being placed in the garbage disposal was $30. Subsequently, William purchased a ring for $169.50 and gave the ring to Nancy.
34. The petitioners deducted $1,010 from their income tax return as a casualty loss.
35. Respondent:
36. Nancy did not suffer a casualty loss within the meaning of section §165(a) & (c)(3) of the Internal Revenue Code of 1954. The respondents took the position that by applying the principle of ejusdem generis, it cannot be said that William dropping the ring into the garbage disposal was like or similar to a “fire, storm, or shipwreck.” Therefore, the respondent claimed that this accident did not qualify as “other casualty” under §165. Furthermore, the respondent took the position that the replacement value of the ring, which William subsequently purchased for Nancy, and the salvage value of the original ring, must be offset against the gross loss suffered by Nancy.
37. Holding: The court held that the petitioners were correct in deducting the aggregate fair market value of the ring from their income tax return as a casualty loss under §165(a) and (c)(3) of the Internal Revenue Code of 195.
38. The court relied on the fact that William’s “testimony and demeanor” led the court to believe that William was not the type of person that deliberately would place the ring in the garbage disposal. Therefore, the court concluded that William placed the original ring in the garbage disposal accidentally. Accordingly, the court stated that the damage to the ring resulted from the “destructive force of the disposal coupled with the accident or mischance of placing it therein; that because this is so, the damage must be said to have arisen from fortuitous events over which petitioners had no control.”
39. Under the facts presented to the court, the court reasoned that the amount of the loss should not be reduced by the value of the second ring. The court explained that William was not an insurer of the ring, and therefore it was difficult to conclude that Nancy had any claim against William for her loss. The court further explained that William merely made another gift to Nancy, as an act of repentance or contrition, and not as a compensatory action.

# Charitable Contributions

1. **§170 Income Tax Charitable Deduction Issues:**
2. **TWO** most important statutes egarding charitable contributions.
3. Is the **recipient eligible** to receive a tax deductible charitable contribution? **§170c**
4. Does **percentage** limitation apply to deduction amount(a cap, not a floor) ? **§170(b)**
5. What is the **type** of donated property; what special deduction limitations are applicable?
6. What is the specific **type** of eligible charitable **donee**? **§170(e)&(f)**
7. Section 501(c)(3) grants tax exemption to certain nonprofit organizations "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to influence legislation."
8. Section 501(c)(4) grants tax-exempt status to certain nonprofit organizations but contributions to these organizations are not deductible. 26 U.S.C.S. § 501(c)(4) organizations, but not § 501(c)(3) organizations, are permitted to engage in substantial lobbying to advance their exempt purposes. 26 U.S.C.S. § 501(c)(4) grants exemption to civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.
9. Gain or loss is not realized when a taxpayer gives an asset to a charity, even though the making of the gift results in immediate tax benefits to the donor-taxpayer.
10. **Charitable Contribution Deduction Mechanics**

* Percentage Limits on the Charitable Contributions Deduction:
  + - * 1. 50% of the “contribution base” when charities are recipients. **§170(b)(1)(A).**
        2. 30% (or a lesser percentage) when contribution to a “private foundation.”
        3. Corporations – 10% of taxable income limit? These limits are “ceilings” and not “floors.” “Floor” is applicable to the charitable contributions deduction (cf., casualty loss).

1. **Qualified Organizations**

**Reagan v. Taxation with Representation of Washington**

1. Non-profit corporation organized to promote certain interests in the field of federal taxation, formed to take over the operation of two other nonprofit organizations, one of which had tax-exempt status under § 501(c)(3) and the other under § 501(c)(4), applied for tax-exempt status under 26 USCS 501(c)(3). The Internal Revenue Service denied the application under § 501(c)(3), because it appeared that a substantial part of the corporation's activities would consist of attempting to influence legislation, which is not permitted by 501(c)(3). TWR then brought suit in Federal District Court for the District of Columbia against the Commissioner of Internal Revenue, the Secretary of the Treasury, and the United States. Claims: Plaintiffs challenged the prohibition against substantial lobbying as violative of the First Amendment and the equal protection component of the Fifth Amendment's due process clause, and sought declaratory judgment that it qualified for the exemption granted by § 501(c)(3), claiming that § 501(c)(3)'s prohibition against substantial lobbying is unconstitutional under the First Amendment by imposing an "unconstitutional burden" on the receipt of tax-deductible contributions, and is also unconstitutional under the equal protection component of the Fifth Amendment's Due Process Clause because the Code permits taxpayers to deduct contributions to veterans' organizations that qualify for tax exemption under § 501(c)(19).**Holding**: 1. Section 501(c)(3) does not violate the First Amendment. Congress has not infringed any First Amendment rights or regulated any First Amendment activity but has simply chosen not to subsidize TWR's lobbying out of public funds. 2. Nor does § 501(c)(3) violate the equal protection component of the Fifth Amendment. The sections of the Code at issue do not employ any suspect classification. A legislature's decision not to subsidize the exercise of a fundamental right does not infringe that right and thus is not subject to strict scrutiny. It was not irrational for Congress to decide that tax-exempt organizations such as TWR should not further benefit at the expense of taxpayers at large by obtaining a further subsidy for lobbying. Nor was it irrational for Congress to decide that, even though it will not subsidize lobbying by charities generally, it will subsidize lobbying by veterans' organizations.
2. IRS determines whether an organization is entitled to **§501(c)(3)** tax-exempt status.
3. Decision by US Congress to not facilitate lobbying by a tax-exempt **§501(c)(3)** entity.
4. NO violating equal protection clause to enable tax-exempt Vet’s organizations to lobby.
5. Option: Use a **§501(c)(4)** organization
6. **Donors do NOT** get a charitable contribution deduction
7. **Donations** to the organization do not get included in income; however the donors do not get a charitable contribution deduction.
8. **Campaign Activity §501(c)(4)**
9. Restrictions on **§501(c)(4)** organization – to be for promotion of common good and general welfare. No prohibition on campaign activities but NOT permitting supporting individual candidates.
10. Note scandal re IRS applications for tax-exempt status by Tea Party affiliated organizations.
11. Note proposed Regulation Limit on “candidate-related political activity” & H.R. 3865, the “Stop Targeting of Political Beliefs by the IRS Act of 2014.”
12. **Bob Jones University v. US - “Public Policy”**
13. Can BJ University be denied tax-exempt, charitable (educational) status as “racist”?
14. The charitable tax-exempt status for an entity is determined under **§501(c)(3)** (NOT **§170(c))**
15. But, the charity must NOT be engaged in illegal activities or violate established “public policy.”
16. **Held:** BJ’s sincerely held religious beliefs do not supersede the overriding national public policy interest.
17. BLACK LETTER RULE A declaration that a given institution is not ‘‘charitable’’ should be made only where there can be no doubt that the activity in which the institution is involved is contrary to a fundamental public policy.
18. Court looked at **§170** which helped to define what Congress meant by 'charitable', and found that **§170** and **§501(c)(3)** should be read together in order to be consistent.
19. "**§170** reveals that Congress' intention was to provide tax benefits to organizations serving charitable purposes. The form of **§170** simply makes plain what common sense and history tell us; in enacting both **§170**and **§501(c)(3)** Congress sought to provide tax benefits to charitable organizations, to encourage the development of private institutions that serve a useful public purpose or supplement or take the place of public institutions of the same kind."
20. **US v, American Bar Endowment – Unrelated Business Income**
21. Issue: does group insurance income derived members of the association by this § 501(c)(3) org. constitute unrelated business taxable income?
22. ABE's insurance program, as constituting both "the sale of goods" and "the performance of services," is a "trade or business" for purposes of the unrelated business income tax. This case presents an example of precisely the sort of unfair competition between tax exempt organizations and taxable businesses that Congress intended to prevent by providing for the unrelated business income tax. The undisputed facts do not support the inference that the dividends ABE receives are charitable contributions from its members, rather than profits from its insurance program.
23. 2. The individual respondent taxpayers have not established that any portion of their premium payments to ABA constitutes a charitable contribution. To be entitled to a deduction for a charitable contribution where he has made a payment having the "dual character" of a purchase and a contribution, a taxpayer must at a minimum demonstrate that he purposely contributed money or property in excess of the value of any benefit he received in return. Here, the most logical test of the value of the insurance policies the individual respondents received is the cost of similar policies. None of these respondents have demonstrated that they could have purchased similar policies for a lower cost.
24. ABE lost. This is unfair competition. group got discounted rates for insurance and they paid group insurance rate. Whatever was left over went to charitable organizations and the ABE obtained a refund. The organization was already tax exempt. Here, the rates were lower because lawyers are typically at a lower risk group for disease, because of their economic status. The argument was that the dividends were outside the exempt income—basically that they were making a profit from their business—it is a commercial activity taking part within the organization. This is a commercial activity in completion with other organizations who do not obtain a tax exempt status.
25. **Dowell v. US – What is a Contribution?**
26. “Sponsoship gift to Oral Roberts Evangelistic Association in anticipation of access to living in retirement center owned/managed by OR sub.
27. Assertion that a “gift” not required as condition for admission to residency. These funds to be used for the capital improvements; separate monthly payments for current services.
28. **Holding:** charitable gift (donative intent) & NOT a payment for services. Judge, held that: (1) evidence sustained finding that taxpayer's purpose in making “sponsorship gift” to retirement community was charitable in nature so as to qualify such “gift” as a deductible charitable contribution; and (2) there was not, as matter of law, significant relationship between “sponsorship gift” made by taxpayer to retirement community and taxpayer's receipt of substantial residency benefits at retirement community so as to preclude deductibility of such “gift” as a charitable contribution, in absence of a “quid pro quo,” and in absence of evidence that taxpayer expected or anticipated the exchange benefit.
29. **Hernandez Case**
30. Disallowance of a charitable contribution deduction for amounts paid by members of the Church of Scientology for “auditing sessions.”
31. Based on its religious “doctrine of exchange.”
32. In litigation IRS stipulated that Scientology is a bona fide religious organization
33. **Charitable Gifts with Benefits Received**
34. **Ottawa Silica Co.:** land developer gives land parcel to school district to build a school (and adjoining lands). Claimed a chartable deduction for the transfer. Holding a “quid pro quo” was received. Remaining property received substantial benefits. Result: NO charitable tax deduction. Spread the tax basis for the donated land over the remaining property. Tax benefit is deferred.
35. **Charitable Gifts with Benefits Received**
36. How to measure value of the benefit received by the donor? The FMV of the item as received by the donor.
37. See **§6115** re a statement to be provided to the donor re value of “goods or services” provided.
38. **Substantiation Requirements** 
    * 1. **§170(f)(8) -** substantiation requirements mandate a written acknowledgement when the gift is over $250. Must be contemporaneous.
      2. Must include information that no goods or services provided as a “quid pro quo.”
      3. If goods or services are provided the donee organization must estimate the value, unless they consist solely of “intangible religious benefits.” Qualified appraisal required for $5,000+ contributions. **§170(f)(11)(C)**
39. **Contributions to College Athletic Programs**
    * 1. **§170(1)** limits the deduction to80% of the amount contributed when taxpayer also receives the right to purchase tickets to athletic events.
      2. Remembering the prelude to **§170(l) and the antics of the US Sen**ators Long and Bentsen in this context who enacted a “non-Code” deduction provision
40. **Appreciated Property –** **Hilla Rebay** 
    * 1. Hilla’s paintings. Commissioner determined that the paintings donated did NOT have fair market value in excess of the total amounts at the dates the paintings were donated. Hilla provided extrinsic evidence that the painting was sold for $15,000 but this person had never purchased art before. **Holding:** Court determined that the paintings in question donated did not have a FMV on the dates of their respective gifts in excess of the amounts determined by Commissioner. Gifts to self-created paintings with significant valuations to varius public charities. Excessive valuations and on tax audit significantly reduced to values as determined by IRS (supported by IRS valuation experts).
      2. Excessive valuations and on tax audit significantly reduced to values as determined by IRS (supported by IRS valuation experts). Note the attempt to bootstrap the value by a sale to a friend for an excessive price.
41. **Contributions of Capital Gain Property**
    * 1. **§170(e)** – provides limitations on the deduction for contributions of (1) ordinary income property and (2) certain capital gain property.
      2. Tangible personal property
      3. Private charitable foundation as the recipient
      4. Cf., intangible property, e.g.., publicly traded stock donated to a public charity (& to a private charitable foundation; see **§170(e)(5).**
      5. **Bill Gates & Melinda Gates:** exempt and NO inclusion on GI. Deduction in FMV but capital gain is NOT taxed, and the system is whipsawed.
42. **Charities & Private Inurement** 
    * 1. Reg **§1.501(c)(3) –** charitable organization’s activities are to be consistent with public policy.
      2. E.g. consider very high salaries to the employees of the charity, or some other significant beneficial economic arrangements (e.g. automobiles).
      3. Cf. **§501(c)(3)** organization appeal for contributions & fundraisers take large %.
43. **Charitable Trusts “Temporal Divisions”**
44. Charitable *lead* trust - **§170(f)(2)(B).** For deductibility, must provide a guaranteed annuity or fixed percentage.
45. Charitable *remainder* trust - **§170(f)(2)(A).** For deductibility the format must be a charitable remainder annuity trust (CRAT) or a charitable remainder unitrust (CRUT).
46. **Fractional Interests in Property**
47. Real estate and gift of a tenancy in common
48. Fractional (vertical) interest in a painting (e.g., 50% tenancy in common). **§170(o).**
49. Remainder – Personal residence or a farm. **§170(f)(3)(B)(i).**
50. Gift of a conservation easement – see **§170(h).**
51. Remainder (horizontal) interest in tangible personal property. **§170(a)(3).**

# Personal, Living & Family Expenses

1. Deductions for expenses incurred in activities generating income:
2. **§162 – “ordinary and necessary” business expenses; and**
3. **§212 –** expenses incurred in investments (i.e. business activities but activities for profit)
4. **§262 –** no deduction is permitted for personal, living or family expenses.
5. **Child-** **Care Expenses – Smith v. Commissioner**

**i. Smith v. Commissioner:** married couple deduct child care expenses since “but for” these expenses the wife (in addition to the husband) could not be employed outside the home. **Holding:** this is a personal expense (i.e. a personal expense consumption item) and is NOT deductible. This is NOT an ordinary and necessary expense in carrying on a trade or business. The “but for” causation argument is rejected.

1. **Tax Legislation & Child Care Benefits**
   * 1. **§21 –** household care credit – possible 35% tax credit for lower income taxpayers, phased out. Maximum Credit: $3000 when one child and $6000 for more than one child. Credit can also involve the care of an elderly parent living with the taxpayer.
     2. **§129(a)** – exclusion available for benefit on employer dependent care assistance program. $5000 maximum exclusion. Non-discrimination requirement is imposed. **§129(d)(2)**
2. **Clothing Expenses – Pevsner v. Commissioner**

**i.** Employee of an upscale clothing store was required to buy and wear high fashion (YSL) clothing at work to “project the image.” She did NOT wear this clothing after business. **§162** business expense or **§262** personal cost? Apply (1) a subjective (personal preference and the taxpayer’s lifestyle) or (2) an objective test (general acceptability of this clothing? **Holding:** objective test is applicable. General rule is that the cost of clothing is deductible as a business expense only if: (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing, and (3) it is not so worn.

1. **US v. Correll:** issue re-deductibility of “travelling expenses” i.e, meals and lodging expenses. . **§162(a)(2)** permits this deduction when “away from home.” **Holding:** Court noted that a business traveler who is allowed a § 162(a)(2) business deduction receives a windfall, because part of what is spent on meals represents a personal living expense that other taxpayers are not entitled to deduct at all.[5] Therefore, fairness demands that § 162(a)(2) should not extend to all situations involving business travel. Commissioner has consistently construed travel "away from home" to exclude all trips requiring neither sleep nor rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed.
2. **Commuting Expense – Commissioner v. Flowers** 
   * 1. Transportation expenses are deductible when traveling for business purposes. **§162(a)(2).** C.f. commuting is a nondeductible expense. *Flowers* lived in Jackson, MS & worked in Mobile, Alabama. He paid his travelling expenses to commute to & his hotel cost in Mobile. **Holding:** no business relationship.The expense must be incurred while away from home, and must be a reasonable expense necessary or appropriate to the development and pursuit of a trade or business. No business relationship. expenses could not be deducted on the ground that the expenses in question had been incurred by the taxpayer for his own convenience rather than for business reasons.The relevant test for deductibility was whether the travel had been motivated by “exigencies of business” or by considerations of personal preference.
3. **Hantzis v. Commissioner:** law student living (with spouse) in Boston and has summer clerkship in NYC. She deducted under **§162(a)(2)** both (1) transportation, (2) apartment cost, and (3) meals in NYC. Tax Court permits deductibility. HOLDING: Reversed. Taxpayer was “not away from home”. Choice of two residences was hers and persona. NO business connection with Boston location.
4. **Temporary v. Indefinite Employment**
   * 1. **If** holding temporary job away from home then deductibility for travel and & living costs at destination location. Not, however, if indefinite stay at the new location – treated as if a permanent job. See **§162(a)** flush language that temporary cannot exceed 1 year.
5. **Rudolph v. US - T&E** 
   * 1. Insurance company provided Dallas to NYC trip for agents (and spouses) as a bonus reward. Fact-finding is subject to the clearly erroneous rule & no deemed importance of this litigation. HOLDING: **that the value of the trip should be treated as income to the employees and observing that there should be no deduction under §162(a).**
     2. **Dissent:** business sessions conducted in NYC and on the train. Wife’s expenses are also deductible. She is part of the “community property” team.
6. **Sanitary Farms Dairy, Inc:** 
   * 1. **§170(e)** expenses for African hunting trip paid by Sanitary Dairy as corporate employer. Dairy claimed deductible amount paid as an advertising expense. IRS asserts: (1) no deduction to corporation but (2) income to individual shareholders. HELD: (1) valid current advertising expense as deductible, and (2) no individual income – but expense incurred by employees for corporation (i.e, no preponderance of evidence element)
7. **Business Lunches – Moss Case**
   * 1. Moss as a partner in a defense litigation law firm. Partners and associates met for lunch daily at Café Angelo and discussed their cases. Deduction for these lunches?
     2. Sec. 262 no deduction for personal expenses
     3. Sec. 119 exclusion for meals provided in kind on the business premises (to employees).
     4. Sec. 162 ordinary and necessary business expenses as deductible.
     5. *Moss v. Commissioner*; T.C. 1983; daily law partner lunch at expensive restaurant not deductible. After they lost, the Moss firm hired their favorite guy from Café Angelo to cook on-site; then excludable under §119 – meals furnished on the business premises while engaged in business.
8. **Cohan**

**i.** Some business expenses incurred and some **§162** deduction should be available. Remanded to determine an appropriate tax deductible amount. Lack of substantiation did NOT limit the availability of at least some expense deduction. Code **§274.**

1. **IRC §274** – **Rules Limiting T&E Deduction**
   * 1. **§274(a)(1)(A)** – deduction for entertainment expense only if “directly related” to business. NO “goodwill” entertainment; but, deduction when expenses are in conjunction with a prior or later business discussion. E.g., expenses for Houston Texans/ Rockets/ Astros Tickets.
     2. **§274(a)(1)(B) –** no deduction for the cost of a facility. E.g., a hunting or fishing lodge.
     3. **See §274(a)(2) & (3) –** limit also for dues to social an athletic clubs.
     4. **§274(n) –** limit to 50% of the cost of meals and entertainment (with various exceptions for situations where a “captured” environment.)
     5. **§274(m)(3) -**  NO travel expense deduction or exclusion for the spouse – unless the spouse is also on business.
2. **§274(d) Substantiation Requirements**
   * 1. NO deduction for T&E unless substantiation:
        + 1. Time
          2. Place
          3. Business Purpose
          4. Amount of the expense, and
          5. The relationship to the recipients of the entertainment.
     2. Contemporaneous records are required.
     3. ***Per Diem*** reimbursement may be acceptable if at the time, place and business purpose are properly substantiated.
3. **Foreign Travel Deduction Limitation** 
   * 1. **§274(c) –** possible expense limitation if combining business and pleasure and more than a one week trip.
     2. Foreign convention limitation – see **§274(h)**
     3. **What is foreign?** See **§274(h)(6)** re defining North America
     4. **§274(h)(2)** re U.S. port limitation.
     5. Luxury water transportation - **§274(m)(1)**
     6. **§274(n) –** only 50 percent of any meal and entertainment expenses allowed as a deduction. Purpose of this limitation?
     7. Allocations to deduction/disallowance required when “all-inclusive” price for hotel, meals, etc.
     8. Some statutory exceptions - **§274(n)(2)**
4. **Hobby Losses – Bessenyey Case**
   * 1. Was profit the primary goal in her horse breeding activities (and, therefore, in business and losses could offset other income)? Tax Court Held: she did not have any intent to conduct her activities for a profit. Ct. App: Tax Court determination was not clearly erroneous. Duberstein case. See **§183** re limitations on deductions for activities not engaged in with a profit motive. See determinative factors in Reg. **§1.183-2(b) L**imitation on deductions for activities not engaged in with a profit motive.. She was a wealthy lady—but she still invested—albeit not very well—on horses. She went to stand, and she sounded like she did not know what she was taking about—so she did not appear convincing at all—that she saw the enterprise as a business investment. **§183(d)** says that an activity that is profitable in 3 out of 5 consecutive years is presumed to be engaged in for profit. Later there was an enactment that stated that if the activity has to do with horses, then 2 profitable years out of 7, because for a horse investment to be profitable, it takes longer.
5. **What Benefit of Avoiding “Hobby Loss” Treatment?**
   * 1. Losses are deductible against other income (e.g. compensation and investment income).
     2. Otherwise, see the limitations in **§183(d)** re loss utilization as deductions. See **§183(b).**
     3. Require capitalization of start-up costs? But, then a tax basis for future offset in determining gain realized upon asset dispositions.
6. **Housing – Loss on Stock Sale – Weir v. Commisioner Case**
   * 1. Sale of preferred stock in a corporation which owned building where taxpayer had an apartment. Objective of stock ownership was to influence the corporation’s management of the building. **Holding:** stock was purchased with a profit motive (e.g. to get dividends). Therefore, a loss deduction (under **§165(c)(2))** was allowed when this stock was sold for a loss.
     2. He sold his stock because he wanted to move out, for the rent was too high. After the rent was reduced, he changed his mind and repurchased the stock. Lower court held that the deduction should not be allowed because it was not for profit, but instead to hold an interest in the decision making of the apartment building.
     3. **Holding**: Purchase of stock satisfies the prima facie intent to profit, so deduction should be allowed. Here, the owner of stock wanted some leverage in the decision making of the building. This motivation should not surpass his intent to profit. His motive in holding leverage did not overtake the profit element. The purpose of this case is to show divided interest—when we think of stock ordinarily we think of capital gains or capital losses.
7. **Residence Purchase & then Sale**
8. Residence held primarily for personal purpose and therefore not primarily for investment. Loss on a sale would not be deductible, but capital gain included in gross income. Possible gain exclusion through Section **§121**
9. Principal Residence—Exclusion of income on residences owned, if during 5 year period, you live in it 2 years; exclusion up to $250,000 for individual, $500,000 for joint returns.What if you are relocated and you rent your property, but then you decide to sell at a loss?
10. Use the value at the initial time of rental as the basis, and then, use the value at the time of sale as the gain.
11. **Vacation Home & Rental Losses**
    * 1. Deductions allowable only to the extent allocable to the rental period.
      2. First: allocate the entire statutory deductions (real estate tax and mortgage interest)?
      3. Section 280A(e)- allocation of maintenance expense. **§280(A)(e)**

* There is a deduction for the real estate taxes and for the mortgage interest.
* Less than 15 days rental does not have to be included in gross income—per Section **§280A(g)**

1. **Home Offices – Drucker Case**
   * 1. Case about claiming deductions for home office by musicians. These musicians worked for MET but MET did no provide a place to practice. Thus, the musicians practiced at home, and claimed part of the rent expenditures as deductions. The room was exclusive for practice and they practices 30-32 hours per week there.
     2. Commissioner disallowed deductions claiming that this was not the primary place of business and reasoned that something that is necessary and essential is not a requirement.
     3. This court found that individual practice at home was a requirement – a condition of employment and that this was a rare situation where the employee’s principal place of business was not that of his employer. The home practice was for the convenience of the employer, thus, the deduction was allowed.
     4. What if office is principal office for trade or business of the taxpayer? The place has to be exclusively used as a principal place of business. Section permitting a home office deduction if sued for meeting customers. **§280A(c)(1)**
     5. Deduction is limited to offsetting the gross income form that activity (not other income).
2. **Office in the Home §280A(a)**
   * 1. Disallows all **§162, §165, §167, §168 and §212** deductions for a home office or work area in a personal residence. Cf., **§262.**
     2. What if office is “principal office” for trade or business of the taxpayer? **§280A(c)(1)(A).** See **§280A(c)(1)**  permitting a home office deduction if used for meeting customers.
     3. Deduction is limited to offsetting the gross income from that activity (not other income). **§280A(c)(5)** & allocation (**§280A(c)(4)(C))**
3. **Limit on §280A Deduction**
   * 1. **§280A(c)(5)** provides for a limit on the office the home deductions:
        + 1. First deductions are those allocable to the statutory deductions (e.g., taxes and interest).
          2. Additional deductions are proportionately allocated to the business use.
          3. Possible carryover of unused deductions to succeeding tax year.

- NO circumvention of rules by having employer rent space in employee’s home. **§280A(c)(6).**

1. **Soliman Case**
   * 1. Court decided whether a portion of a dwelling unit exclusively used as a principal place of business for any trade or business of a taxpayer would allow a deduction to the taxpayer's income taxes under Internal Revenue Code Section **§280A(c)(1)(A).**  Soliman was an anesthesiologist who spent thirty to thirty-five hours per week with patients at three different hospitals but none of the hospitals provided him with an office. He used a spare bedroom in his house for contacting patients and surgeons, maintaining billing records, preparing for treatments, and reading medical journals.
     2. **Holding**: The Supreme Court denied Soliman's home office deduction setting forth a two consideration test for whether the home was the taxpayer's principal place of business: (1) the relative importance of the activities performed, and (2) time spent at each place.
     3. **Dissent:** He was self-employed, so the factors to determine whether or not this was a principal place of business was (1) whether a portion of the dwelling was used exclusively for business purpose, (2) whether the portion of the dwelling that is set aside for exclusive business use is used regularly and (3) whether the space is used as the principal place of business for any trade or business of the taxpayer. Because the home office is the only place where the anesthesiologist can perform administrative functions, it should be allowed to be the principal place of business. Court says home office is not principal place of business, he provided his service as an anesthesiologist at the 3 hospitals he performed. Congress's reaction to this decision was to amend Section 280A(c) in the Taxpayer Relief Act of 1997 so that a home office could meet the "principal place of business" test if it is the only fixed location where administrative or management activities are performed. This effectively nullified the Supreme Court's decision ruling in the Soliman case.
2. **Revenue Procedure. 2013-13 Home Office Safe Harbor**
   * 1. Safe Harbor permitted of $5 per square foot up to a maximum of 300 square feet. This is an alternative to the calculation of actual home office expenses. Still must be exclusive use on a regular basis of this office in the home. Deduction cannot exceed gross income derived from activities in that office in the home (& no carryover of the excess to a later year).
3. **Litigation Expenses “Origin of Claim” Doctrine**
   * 1. **US v. Gilmore: §212(2)** deductibility of husband’s expenses for attorney’s fees for his successful resistance to wife’s community property claims in the divorce proceedings? No deductions. Husband’s property consisted if interests in three corporations holding auto dealerships. The origin of the claim doctrine (a personal divorce matter involved here) applies to deny an income tax deduction for his attorney fees.
     2. BLACK LETTER RULE: The only kind of expenses deductible under section 212(1) and (2) are those that relate to a ‘‘business,’’ or profit-seeking, purpose.
4. **US v. Patrick**
   * 1. Wife sued for divorce claiming adultery, resulted in property settlement agreement. Court ordered husband to pay attorney’s fee for both parties. Couple owned interest in stock of Herald Publishing Company and 80% of property as undivided interest as well as two houses. Respondent claimed a deduction for $16,000 (rearranging the stock interest in the publishing company done by counsel) and for 80% of the $4,000 cost of leasing the real property and transferring it to a trust. Deduction was disallowed by this court because the claims by the wife arouse out of the marital relationship—not profit seeking activities.
     2. Divorce proceedings and amounts paid for rearranging stock ownership in a privately held corporation and concluding the lease of real property to assure long term rental income stream into a trust. **Held**: the cost were incurred incidental to divorce litigation and this origin controlled the tax characterization of the cost as deductible or nondeductible. Not deductible because it still arouse out of the personal relationship.
5. **Hunter v. US** 
   * 1. Claim that attorney fees incurred in securing deduction in alimony are deductible under Sec. 212 as ordinary and necessary expenses for the production of income—because the deduction in alimony increased his taxable net income.
     2. Court does not agree. Production of income would be covered, not a reduction in liabilities or increase of net taxable income by reduction of allowable deductions in computing income. No deductions under 212 for the cost of obtaining a reduction of alimony. For Section 212 the deduction for the cost of the production of income means the creation of gross income and not the reduction of liabilities.
6. **Ruth K. Wild - Divorce Proceeding**
   * 1. Wife reported alimony payments as gross income. Also, she claimed deduction for attorney fees for negotiating alimony payments to be received. Taxpayer asserts legal fees incurred to produce the alimony income & **§212** deduction. Deductions allowed—these expenses were paid or incurred for the production of income—in the form of alimony.
     2. See Reg. **§1.262-2(b)(7),** re deductible attorney fees for collection of income (alimony). Regulations not changed after Gilmore case.
     3. **Dissent:** Gilmore controls & NO deduction.
7. **Education and Training**
   * 1. **Jorgensen Case**
     2. Courses taken in Greece and Southeast Asia by English teacher to enhance her.
     3. **Held:** 1) Deduction not barred by **§274(m)(2).** 2) **§162** expenses to improve her skills as a teacher. These are fact questions. Satisfying both the ordinary and the necessary standards. And, reasonable in amount (fact question). An educational purposes for these expenses under Reg. **§1.162-5.**
8. **Tax Benefits for Education**
   * 1. Scholarships – if qualified, excluded from gross income under **§117.** To be used to pay for tuition and fees and books, etc, but NOT for room and board.
     2. NO COD income for cancellation of cerain student debt. **§108(f)**
9. **§222 deduction for Qualified Tuition**
   * 1. Limited deduction for higher education expenses: $4000 for taxpayer with AGI below $65000 ($130000 for joint return) and $2000 with AGI below $80000 (but above $65000; $60,000 for joint return).
     2. Not a phase-out, but a “notch” and “cliff” provision.
     3. **§222** extended through 2013 in ATRA-2012.
     4. **NO §222** deduction if a **§25A** credit claimed.
10. **§529 Qualified Tuition Program**
    * 1. Income realized in the account accrues exempt from **§61** gross income inclusion.
      2. Distributions are tax-free if made for qualified educational expenses.
      3. Donor controls the investment policy and can change beneficiaries for the 529 account (within the family).
      4. Gift tax and estate tax considerations.

# Business & Investment

1. **Defining “Ordinary and Necessary”**

Personal expense (no deduction, unless a statutory exception) **§262**

Ordinary & Necessary Expense (current deduction is available) – **§162**

Extraordinary (Capital) Expense (future deductions or frozen costs) – **§263 / §263A**

**Welch v. Helvering:** Welch paid debts of the former E.L. Welch Company to improve his personal relationship with creditors of old Co. **Holding:** payments by the taxpayer were NOT ordinary (but were they necessary?) business expenses **§162;** but were these “capital expenditures” (extraordinary) for the development of the “goodwill” of the business and therefore, not “personal expenses”. Here, the Commissioner found that the repayment of debt was more akin to capital outlay than a necessary and ordinary business expense. “Appropriate and useful 🡪 necessary” 🡪 Extraordinary (capital) expense.

1. **Commissioner v. Tellier – Public Policy Limitation?**

**i.** Legal expenses incurred in an unsuccessful defense of a securities law criminal violation. Deductibility of these expenses under **§162? Yes,** as ordinary and necessary, and not required to be capitalized. Consider Sullivan case, allowing business expenses to gambling operator. **Holding:** Congress has already imposed punishment on Tellier for his illegal activities. There is no reason for this Court to punish Tellier beyond what Congress has set out by disallowing the deduction at issue. Congress has made clear that our system of federal income tax is not intended to punish wrongdoing. It is only intended to tax the net income of every individual. The same principle extends to tax deductions.

1. **Raymond Mazzei** – **Counterfeiting Investor**

**i.** Claiming theft loss for the amount lost in a fraudulent scheme purporting to enable the counterfeiting of US currency. Loss claimed under **§165(c)(2) or (3).** Allowance of deduction against public policy? No, because he was a co-conspirator to commit the crime of counterfeiting. Here, loss directly related to the illegal act. **Holding:** court rejected this argument, finding that although petitioner did not participate in the counterfeiting “process” in the same capacity as the Richey taxpayer, his actions did constitute a conspiracy in violation of U.S. law.

1. **Other Public Policy Deduction Cases**
2. **Commissioner v. Sullivan:** deductibility of rent and wage expenses incurred in operating an illegal bookmaking operation permitted. Court allowed a deduction of rent and wages even where the expenses were illegal.
3. **Cf. Tank Truck Rentals:** NO deduction for fines paid for overweight trucks on highways – to allow a deduction would reduce the impact of the criminal penalty.
4. **Deduction, Public Policy, Statutory Limits** 
   * 1. **§162(f)** NO deduction for a fine or a similar penalty. Cf. Fines paid by “banksters”.
     2. **§162(c) –** NO deduction for illegal bribes and kickbacks. See FCPA, including re “grease payments” permitting deductions.
     3. **§162(g)** – denying 2/3rds (punitive) portion of anti-trust payment when criminal violation.
     4. **§280E –** NO deduction for drug trafficking expenses; but, deduction for inventory costs of a drug dealer. Pot stores in Colorado do NOT get any deductions because it is NOT allowed in the Federal Government.
5. **Mt. Morris Drive-In Theatre**
   * 1. Capital expenditure inquiry: drive-in movie construction caused water drainage on the adjoining property. Settlement of the dispute by agreement to construct a drainage system across the neighbor’s property. Taxpayer claimed depreciation deduction for this cost and then, when an IRS challenge, asserts a **§162** or **§165** deduction available. **Holding: capital expenditures. Dissent:** this cost does NOT improve the property. Merely an expense to settle a lawsuit. **Holding:**  Majority found that the character of the transaction was that of a [capital expenditure](https://en.wikipedia.org/wiki/Capital_expenditure), and thus not deductible as an [Expense](https://en.wikipedia.org/wiki/Expense).
6. **Other Capitalization Issues** 
   * 1. Remembering the prior discussion of inventory accounting: requirement of “full absorption” accounting, i.e., direct and indirect costs included in inventory cost for federal tax purposes. See **§263A.**
     2. **Tax deduction** of the capital cost over some recovery period (or upon eventual disposition).
     3. **Full absorption**: all overhead costs that go into the transaction, as well as depreciation of the building.
     4. If you purchase a building or machinery equipment for 100x. Assuming machinery equipment is being used you
7. **Commissioner v. Idaho Power Co.** 
   * 1. Tax deductions claimed for the depreciation of trucks and other equipment, which were used in constructing capital assets (e.g. power stations for the electric utility). The allocated depreciation for these items was required to be capitalized – the cost was being incorporated into the new capital asset (power stations). Construction-related expense items, such as tools, materials, and wages to construction workers are treated as part of the cost of acquisition of a capital asset. Reasonable wages paid in carrying on of a trade or business qualify as a deduction from gross income, but when wages are paid in connection with construction or acquisition of a capital asset they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired. §263(a)(1) of the Internal Revenue Code denies a deduction for any amount paid out for construction or permanent improvement of facilities. This extends to the cost of acquisition, construction, or erection of buildings.
     2. **Treas. Reg. §1.263(a)-2(a).**
8. **Improvement and Repairs**
   * 1. **Code** **§263 -** no deduction for “improvements or betterments” of property.
     2. Improvement is (1) a betterment of the property, (2) a restoration of the property, or (3) the adaptation of the property to a new or a different use.
     3. Reg. **§1.263(a)-3(d).**
9. **Treatment of Prepaid Items**
10. Casualty insurance policy premium prepaid for three years. Boylston Market Case.
11. Prepaid rent – purchase of a possessory interest in the leased property. Deferral of the deduction for rent (but lessor cannot defer income when cash is received).
12. Prepaid interest expense. See **§461(g).**
13. **Commissioner v. Boylston Market:**  Boylston bought fire insurance for their market. They prepaid for most of the insurance years in advance, and each year after paid only a small amount for each year thereafter. $6690 up front, and then $1082 extra one year and $890 the next year. When they filed their taxes, Boylston took a deduction for the pro-rated cost of fire insurance. The IRS disagreed and assessed a deficiency. Basically, Boylston deducted not only the $1082 and the $890, but they also deducted part of the $6690 that they 'used' during the year. The IRS argued that the deductions were limited to the premiums actually paid during the year. The Tax Court found for Boylston. The IRS appealed. The Appellate Court affirmed. The Appellate Court found that the prepaid insurance was a *capital expenditure*. The Court found that *capital expenditures* must be depreciated over the life of the asset (which in this case meant the number of years the insurance plan ran). The Court found that if Boylston had been allowed to deduct the full cost of the insurance up front, that wouldn't be fair because it would have allowed them to take a big deduction immediately instead of having only small deductions each year for many year. But, the Court found that Boylston was entitled to take the deduction sometime, so the fairest thing they could do was to pro-rate the deductions.

- Basically, this case said that an expenditure which results in the creation of an asset that has a useful life extending "substantially beyond" the close of the taxable year may not be fully deducted in the year the payment is made. Instead the deductions must be pro-rated over the asset's useful life

1. **Interest and Taxes During Construction**

Cost of money is one of the costs of contruction.

Real estate tax is also incurred on property during the construction phase.

See **§263A(f) –** requiring interest expense to be subject to the uniform capitalization rules. Therefore, these amounts are added to the basis of the property and recovered through appreciation over the assets useful life.

1. **Special Statutory Treatment for Expenses** 
   * 1. See p. 812 examples re special statutes:
     2. **§174 –** current deduction available for research and development expenses.
     3. **§263(c) –** deduction for intangible drilling and development costs for oil & gas wells (IDCs)
     4. **Cf.** **§248** and fifteen year amortization of corporate organization expenditures.
2. **Indopco In. v. Commissioner - Case & Regulations**
   * 1. Investment-banking fees incurred by target corporation in a merger transaction must be capitalized. Basic premise in Indopco: Is a “future benefit” to be realized from the particular expenditures? If so, capitalization is required. Through its acquisition by Unilever, INDOPCO has undeniably obtained considerable benefits that extend far beyond the tax year at issue. As a result of the takeover, INDOPCO gained access to Unilever’s vast resources. Also, by becoming a wholly owned subsidiary, INDOPCO no longer has thousands of shareholders. INDOPCO is now free of considerable shareholder-relations expenses and no longer has administrative expenses related to its 8,000,000 common shares that have since been reduced to 1,000. INDOPCO’s expenditures are capital outlays because the changes in INDOPCO’s corporate structure have led to considerable future benefits. INDOPCO regulations. Investgative expenses in developing a particular bank.
3. **Patton v. Commissioner**

**i. §162(a)(1)** allows a deduction for a “reasonable allowance” for salaries. The income of Kirk (employee, not owner) increases significantly as a result of a bonus arrangement. IRS says only 13x (not the 46x paid) is deductible compensation under **§162.** Burden on taxpayer company (partnership) to prove reasonableness, and not proved here. But, effective double taxation: (1) employer (not deductible) & (2) employee (full inclusion).

1. **Reasonable Compensation**
   * 1. **§162(a)(1) –** provides for deduction only for “reasonable” allowance for salaries and other compensation.
2. **Special Limit - §162(m)**
   * 1. **§162(m)** limits deductible compensation for top executives of a publicly held company to $1M per year.
     2. **Note** the exception to this limitation for “performance-based compensation.” Need to establish “pre-existing goals (by outside directors) and have shareholders approve plan.
     3. **Note** even lower limits for TARP banks, etc. **§161(m)(5).** Limits thanks to TARP legislations. TARP was a solution right after the deed recession. Trouble Asset Relief Program 🡪 program of the United States government to purchase assets and equity from financial institutions to strengthen its financial sector that was signed into law by U.S. President George W. Bush.
3. **Estate of Rockefeller v. Commissioner**

**i**. Deduction claimed for his expenses for Congressional review of his nomination to be VP (For President Gerald Ford). the deductions were not allowed under IRC section 162. The Court essentially compared Rockefeller’s past job as [Governor of New York](https://en.wikipedia.org/wiki/List_of_Governors_of_New_York) with his position as [Vice President](https://en.wikipedia.org/wiki/Vice_President_of_the_United_States) and found that the two positions did not constitute the same trade or business.

1. **Other Employment Expenses**

**i.** Deduction claimed for his expenses for Congressional review of his nomination to be VP (For President Gerald Ford). the deductions were not allowed under IRC section 162. The Court essentially compared Rockefeller’s past job as [Governor of New York](https://en.wikipedia.org/wiki/List_of_Governors_of_New_York) with his position as [Vice President](https://en.wikipedia.org/wiki/Vice_President_of_the_United_States) and found that the two positions did not constitute the same trade or business.

# Losses

**§165** provides the general rule that a tax deduction is available (1) for any loss sustained during the taxable year and (2) not compensated by insurance.

**§165(b)** specifies the deduction for the loss is the adjusted basis (& not the FMV of the property).

**§165(c)** provides limitations for individuals for loss in (1) trade or business, (2) transaction entered into for profit and (3) casualty losses.

**When does a loss occur?**

1. Consider the concept of a “realization” event as being necessary (e.g. **§1001).**
2. **Reg. §1.165-1(d)**  refers to the deduction as available for the taxable year “in which the loss is sustained” and that the loss is evidenced by “closed and completed transactions” and “as fixed by identifiable events occurring in such taxable year”

**US v. S.S. White Dental Mfg. Co.:** US taxpayer owned a stock of a German corporation (subsidiary) and had loaned funds to the corporation. German government (during wartime) seized the German corporation properties in 1918 (but properties restored in 1920 when essentially worthless). Holding stock and accounts receivable were worthless and loss deduction is available. When the sequestration of the asset was made, the transaction causing the loss was completed, thus, this was deductible.

**Securities Losses**

**i. Sell the asset to realize the loss.**

**ii. See §6511(d)** re seven (not three) year period of limitation with respect to bad debts and worthless securities.

**Revenue Ruling 2009-9**

* + 1. Loss to A from embezzlement in a transaction entered into for profit:

1. **Theft** loss or capital loss under Code **§165** purposes. HELD: theft loss – from depriving A of money by criminal acts. Theft for **§165** purposes.
2. **Deduction limits:** theft loss on investment account is deductible under **§165(c)(2)** and not subject to **§165(h)** limitations. And, not subject to **§67** and **§68** limits on deduction.
3. **Year of Deduction: §165(e)** specifies loss sustained for year loss is discovered; except must wait until reimbursement claim resolved. Deduction in year of theft discovery if no claim for reimbursement. Later events: Excess recovery causes gross income inclusion; inadequate recovery enables deduction.
4. Amount of deduction: theft loss is tax basis of the property lost, less any reimbursement. Generally the initial amount invested in the arrangement, + any additional investments, less amounts withdraw, if any **–** by claims as to which there is a reasonable prospect of recovery.
5. Net operating loss available: **§172(d)(4)© specifies §165©(2)** or (3) losses are treated as business deductions. Thus carryback three (not two) years (**§172(b)(1)(F))** and carryforward for 20 years (**§172(b)(1)(A))**
6. Claim of right applicability? **§1341** applicable when subsequent reversal of an item included I gross income. Theft loss does NOT qualify for **§1341** re-computation.
7. Mitigation **under §1311- 1314?** NO since no inconsistency.

* Will you be able to deduct by reason of having a theft loss which fits within the categories of **§165** ?
* What is the amount of the deduction?
* A loss from criminal fraud or embezzlement in a transaction etered into for profit is a theft loss, not a capital loss, under **§165.**

**Related Parties Transactions**

**McWilliams v. Commissioner:** taxpayer sold stock in his account and bought same stock at same time in wife’s account. Objective to establish losses for tax purposes. Spouses filed separate tax returns. Transactions through the NYSE. IRS disallowed losses on transactions deemed concluded between tw spouses. Under **§267** IRS disallowed deductions as being from “sales or exchanges” between related parties. Congress intended to rectify by the enactment of § 24 [§ 267]. § 24 [§ 267] absolutely prohibits the allowance of losses on any sales between family members (as defined in the statute). The rationale behind the section is that the family members, although distinct legal entities, have common economic interests. The section prohibits loss recognition from even legally genuine intra-family transactions because of the familial relationship. It is thought that such transactions do not really result in economically genuine realizations of loss as within the family group.

**Section 267 Concepts**

* + 1. **§267(a)(1)** specifies no deduction available for any loss from the sale or exchange of property “directly or indirectly” between parties.
    2. Objective of this provision: limit losses when an identity economic interests exists.
    3. Basis of replacement property: **§267(d)**  - gain recognized only to extent exceeding prior loss; loss computation – use buyer’s basis. **§1015.**

**§1091 – Wash Loss Rules Loss Disallowed**

Taxpayer sells stock (or securities) and buys same stock (or securities within 30 days; NO loss deduction allowed. **§1091(a)**

**Code §1091(d) –** provides that stock repurchased take the basis of the security sold; therefore; the loss deduction is postponed until a bona fide disposition is made

**Straddles & Code §1092**

What is a ”straddle”? Offsetting positions with personal property. **§1092(c)**

Results in a “substantial diminution in risk” when holding several positions.

Loss deduction only to the extent loss exceeds unrecognized gain. **§1092(a)(1)**

**Capital Losses Code §1211**

* + 1. This provision limits the deduction of capital losses: (1) For corporations, to the extent of capital gains; and (2) for individuals, to the extent of capital gains, plus $3000 per year.
    2. Purpose of this provision: no “cherry-picking” of losses to use to offset ordinary income. C.f., hobby loss limitation provision, **§183**

**O.L. Burnett**

Taxpayer sustained 18x loss on sale of securities (as attributable to the conduct of a business). IRS says not carrying on a trading business, and therefore, limited to $2000 (now $3000) loss. Note: Property is a capital asset unless either (1) inventory or (2) held for sale to customers in the ordinary course of trade or business. See code **§1221(a)(1)** . Remember Yaeger case.

**Section 1231 Assets**

* + 1. **§1221(a)(2)** excludes depreciable business property and business realty from definition of “CAPITAL ASSET”
    2. **§1231** provides that upon the sale of these
    3. **§1221(a)(2)** assets: (1) capital gains treatment for gains, and (2) ordinary loss treatment if property sold for a loss.
    4. Required netting of **§1231** gains and losses.
    5. **§1231(c)** enacted to limit cyclical realization
    6. **§1231** gains and **§1231** losses.

**Involuntary Conversions**

**i.** Assume (1) Involuntary conversion of business property and capital assets and (2) NO reinvestment of insurance proceeds.

**ii.** To postpone gain recognition Code **§1033** mandates reinvestment to extent of proceeds.

**iii.** See Code **§1231(a)(3)(A)(ii) & B** re involuntary gain as capital gain and involuntary loss as deductible against ordinary income.

**Bad Debts – Whipple v. Commissioner**

* + 1. **§166(a)** enables a deduction for worthless debts; but **§166(d)** specifies short-term capital loss treatment for nonbusiness bad debts.
    2. Taxpayer loaned funds to corporation he controlled & the debt became worthless.
    3. Claimed business bad debt deduction status.
    4. IRS, Tax Court & 5th Circuit says nonbusiness debt.
    5. Held: NOT here engaged in a trade or business to the corporations. Loans were made to preserve his investments.

**Worthless Debt Issues**

1. Partially worthless debt - **§166(a)(2) -** provides a deduction for partially worthless bad debts. When proof and charging off for financial (GAAP) purposes.
2. Bad debt reserves – GAAP accounting requires a bad debt reserve; not (ordinarily possible for FIT purposes. However, available for small banks - **§585.**
3. Loan Guarantees – guarantor’s loss as a nonbusiness bad debt (Putnam case, Sup. Ct.)

**Employee or Investor – Generes Case**

Can employee status change a loan to the ER into a business loan (to protect one’s status/business as an employee)?

HERE: large loans to the corporation; but small compensation amount (particularly after – tax); larger investment in company’s stock.

Could NOT determine that the dominant motivation for the loans was a business purpose and therefore, NO business bad debt deduction.

# Capital Cost Recovery

Code **§167(a)** allows a depreciation deduction for a reasonable allowance for the exhaustion, wear and tear (including for obsolescence) of property (1) used in trade or business or (2) held for the production of income. Depreciation amount is based on the cost basis (**§1012)** for the asset. Then basis adjustment - **§1016.**

Similar cost recovery treatment upon the depletion of hard minerals & oil and gas.

**What is Depreciable?**

* + 1. No depreciation deduction for an asset that has an indefinite life.
    2. Examples: land and corporate stock and bonds.
    3. Tax depreciation is available for buildings and improvements to real estate; machinery & equipment; and other tangible wasting assets.
    4. Amortization (straight line cost recovery) is available for certain intangibles.

**Richard L. Simon**

Musician buys antique violin bow used in his profession and seeks to depreciate it for tax. Bow actually appreciating in FMV.

**Holding:** Bow is “recovery property” under **§168** for which depreciation may be claimed. It is “of character subject to the allowance for depreciation.” This property will suffer exhaustion, wear and tear or obsolescence. Bow not treated as a non-depreciable collectible.

**World Publishing Co. v. Commissioner**

* + 1. P purchases for 700x improved real estate with the building subject to a lease to tenant (who built the building on the property). Allocation of 300x to the building and 400x to the land. Life of building was shorter than the lease term.
    2. **Holding:** P could depreciate excess cost over land value (over remaining term of the lease).

**Newark Morning Ledger Co. v. US:** goodwill 🡪 favorable relationship. NML purchases assets of other newspapers and seeks to allocate purchase prices, including to a “paid subscribers” list (& exclusive of any allocation to “goodwill”). Statistical info is provided re the useful life of these lists. IRS says NO asset separate from goodwill and an indeterminate life for goodwill. Supreme Court says fact burden satisfied by taxpayer and an intangible asset exists with (1) ascertainable value and (2) limited useful life. **Dissent:** failure of proof by taxpayer. Confusion of subscription duration with goodwill on the date of the date of the assets acquisition. Continued support for the concept that goodwill is NOT depreciable. **NOTE:** Houston Chronicle – acquisition of a customer list from a defunct business (the prior Houston Press) & description of list.

**Intangibles & Cost Recovery**

* + 1. **§167** enable **straight-line** amortization of intangibles – e.g. patents, trademarks.
    2. **§197** provides special 15 year amortization rules for goodwill and purchased intangibles, including customer lists, skilled work force, **non-compete covenant**, etc.
    3. **§197** is the response to the Newark Morning Ledger Case.

**Non-compete Agreement**

**In making a non-compete** deal the actual term is often five years or shorter.

**Code §197** mandates a 15 year amortization of the payor’s cost of this non-compete agreement (even though income inclusion over the shorter period).

Taxpayers are paying money up front, and have to capitalize 2/3 of it, but the departing owner is receiving payments throughout the 5 years. Taxpayers are getting whipsawed.

**Depreciation Deductions**

Cost for “wasting assets” should be recovered over time – associating the cost of the assets with income productivity from the particular asset.

Tax choices:

1) Deduction for the entire cost in the acquisition year.

2) NO deduction until disposition of the asset

3) Determine actual value decline during the year.

4) Allocate some amount of the acquisition cost to each year of the asset’s anticipated usage (& possibly overstate the annual deemed cost?)

**Current Depreciation Deduction System**

* + - * 1. Determine the **useful life** (e.g. machinery & equipment; office and industrial buildings).
        2. Determine anticipated **salvage value** (but, not relevant under current system, MACRS)
        3. Determine the **method** of allocation to each year (e.g. does a greater decline in value occur during earlier years? Straight line, declining balance (e.g. DDB): some other system (e.g. income forecast)?

**§168 – Statutory Depreciation Rules**

1. Recovery period – depends on the class of property. See **§168(c)&(e).**
2. Recovery method - **§168(b).** Choices include DDB, 150% DB and straight line. With salvage value at zero. **§168(b)(4).**
3. “Placed in service” conventions - **§168(d)** re half-year convention, except for real property.
4. Limited expensing – without regard to rules above - **§179.** For 2014 – 500,0000 (**§179(b))** but 25,000 in 2015.

* DDB reflects the fact that you are entitled to the first few years because it is when it will depreciate the most.
* Applicable convention: half-year convention is a convention which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.

**Additional Depreciation Issues**

**1)** First Year – Full year’s depreciation?

**2)** “Component” Depreciation – divide parts of a building (e.g., elevators & escalators) into its various components to allocate useful lives.

**3)** Available depreciation necessitates a reduction in income tax basis (under **§1016) –** so as to avoid using tax basis twice.

**Possible recapture of depreciation:** if claiming too much depreciation (when contrasted with economic depreciation): See **§1245.**

**Real property –** limited recapture under **§1250.**

**Depletion for Oil & Gas Minerals**

**i. Cost** depletion for (1) oil & gas, and (2) hard minerals properties is allowed under **§611**

**ii.** Tax basis is allocated over the estimated recoverable units for the property

**iii. Alternative** method: **§613** – percentage depletion enables a deduction for a percentage of the **gross income** derived from the production (except for major, integrated oil companies). But, no limitation on the deduction amount even after cost basis equivalent is recovered.

**Defining an “Economic Interest”**

**i.**  To qualify for a depletion deduction the taxpayer must have an “economic interest” in the property being depleted.

**ii.** What is the purpose of this concept? Looking for a return from the production of the oil or mineral.

**iii.** An economic interest can include a royalty interest, a working interest, a carved-out interest etc.

**Percentage Limitation Questions**

What limits on the % depletion deduction?

Percentage limit for 50% of the taxable income from the property.

What is the “cutoff” point for determining “gross income” from production? See **Cannelton Sewer Pipe Co.**

Cf. the oil and gas production – the cutoff point is at the wellhead for determining gross income.

**Intangible Drilling Costs & G&G Costs**

1. **§263(c)** authorizes regulations to enable current expensing for “intangible drilling and development costs”. What are IDCs? Cf. capitalization.
2. **Consider the** tax benefit of the combination of (1) the IDC deduction (no cost basis is established, and (2) the percentage depletion deduction (NO cost basis is necessary).
3. **Cf.,** oil and gas exploration costs.

**Hard Mineral Costs**

1. **§616 – development** expenditures can be currently deducted – when incurred after proving existence of the deposit.
2. **§617** – **exploration** expenditures are currently deductible, at the election of the taxpayer. These are costs incurred to identify the existence and location of the mineral deposit.
3. **Recapture** of the deducted amount when reaching the production stage.

**Timber Tax Treatment**

1. Possible election to treat timber income as capital gain. **§631(a).**
2. Possiblealternative for **§1231** for treatment for timber royalties.

# XVII) Taxation and the Family

Fundamental issue presented in this chapter is: Who is the proper taxpayer to report certain income for federal income tax purposes?

* Fundamental tax concept in this context: to preclude an (inappropriate) “assignment of income” to another taxpayer.

**Moderating the Progressive Tax Rate**

* This can be achieved by “income splitting.”
* Gross income for FIT purposes can shift:

(1) Within a family unit (i.e., individuals), or

(2) among controlled entities and owners.

NOTE: e.g., **§1(g)** providing for unearned income of minor children to be taxed at parents’ marginal tax rate. The “kiddie tax.”

**Tax “Common Law” – Lucas v. Earl**

* Before availability of joint tax return filing – could he contract with his wife for her to receive ½ of his income and, therefore, each spouse would separately report ½ of his total gross income from salary/fees? **Holding:** income is taxable to that person earning the wages (and NOT to the legal owner for local property law purposes). NO “anticipatory assignment” of income was permitted there. the U.S. Supreme Court reversed the decision of the Ninth Circuit Court of Appeals and ruled in favor of the tax collector. The Supreme Court indicated there was "no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. "Holmes concludes his opinion with the classic metaphor: The fruits cannot be attributed to a different tree from that on, which they grew.

**Community Property & Income Splitting**

* **Poe v. Seaborn:** spouses in community property state made separate income tax returns with each reporting one-half of their total income. IRS says all income is his for tax reporting. Conclusion: income allocation here is governed by state (community) property law & wife has a vested right in ½ of the community property. IRS asserts husband’s power of management. Here: husband’s earnings were community property income from the inception. The Supreme Court held that in community property states the earned income would be treated as if it were earned equally by both spouses, regardless of who actually earned it. *Seaborn* dealt with Washington's community property law, which gave a vested interest in the property to the nonearning spouse. Thus, each spouse was taxed on half. That taxation was predicated on the idea that each spouse had a vested interest in half the property. The court held that in community property states, the community, not the individuals, earned the income.
* **After Poe v. Seaborn**
* An advantage was provided to community property jurisdictions – since splitting of the income eabled two “runs up the bracket ladder” for federal income tax purposes.
* Seaborn was a statutory case, NOT a constitutional case.
* Eventual Result (1948) : Joint income tax return for spouses – enabling equal splitting of income and two runs up the income tax bracket ladder.

**Enactment of the Joint Return Provision**

* Code **§1(a) –** enables the filing of a joint income tax return by married individuals.
* Objective: twice the income tax on one-half of the total spousal income on the return.
* This enables taxpayers in both common law and community law jurisdictions to be treated similarly. And, this enables common law states to not enact community property regimes.

**Determining Marital Status**

* Windsor case, US Supreme Court (2013)
* Invalidation of DOMA (violation of the equal protection clause in US Constitution).
* Same-sex marriages are recognized for Federal tax (estate tax) purposes.
* See Revenue Ruling. 2013-17(below) (and Notice 2013 – 61 are over-collected FICA taxes, etc., & refund procedures).

**Revenue Ruling 2013-17**

* Same sex marriages are recognized for federal tax purposes. DOMA is dead (Windsor).
* Marital status is based on where the marriage was established. This status is to be recognized for federal tax purposes in other jurisdictions.
* The “Full faith and credit” clause of US Constitution impacts this determination.
* Marital status is NOT available for registered domestic partnerships

**Marriage Penalty (& Bonus)**

* 1948 enactment of joint return opportunity.
* Twice the tax on one-half of the joint income.
* But, then a “marriage penalty” for couples where each spouse had a similar amount of income—when compared to non-married filing.

**Married Filing Separate Returns**

* Situations where situation is useful for married persons to file separately:
* Separated but not divorced.
* To avoid joint & several liability on the federal income tax return. One spouse has undisclosed income – but does the “innocent spouse.” See Code **§6015.**
* To enable one spouse to use deductions above the floor for medical expenses ( 7½% or 10%) or casualty losses (10%)

**Mapes v. US: Plaintiffs seek a refund of $1,220.10** for tax year 1976, which is the additional amount they paid to IRS as a consequence of being married and thereby precluded from filing separately under the tax schedule applicable to single taxpayers.**Holding:** The difficulty is that even if this unusual arrangement creates an additional burden for these plaintiffs, there is certainly not the massive discrimination here that is envisioned in cases such as *Reed v. Reed, supra,* and *Frontiero v. Richardson, supra.* Plaintiffs admit they cannot describe the disfavored class as those who have made agreements like theirs. In fact, the plaintiffs' extra burden appears self-inflicted.

**Two-Earner Deduction**

* Deduction was previously enacted (**§221)** to provide limited relief in the marriage penalty context.
* This provision was repealed in Tax Reform Act of 1986.
* Relief is presently accomplished indirectly through flatter income tax rates.

**Self-Help & Boynter Case**

* Were the parties married for federal income tax purposes on the relevant date (i.e., year end Code **§7703(a) –** re-designated from **§143(a)(1)?** Divorced (in Haiti) at year-end (twice), and then remarried early in next calendar year. Tax Court: concluded home state would NOT recognize foreign divorce and treated as married (and no certification to MD. High Ct.)4th Circuit: “Sham transaction” doctrine applies Remanded to Tax Court for fact determination.

**US v. Harris:**

* Tax evasion criminal convictions for two sisters receiving “gifts” from an older man. Gift tax returns filed by the man, but only for small amounts. How prove criminal intent by the recipients on their failure to report “gifts” as income for FIT purposes? What is her belief re the purpose of this payment? Court says donor’s letters should have been permitted into evidence.

**Income of Minor Children Code §1(g)**

* Child has personal exemption but NO standard deduction. Child must pay tax on unearned income above this minimum amount.
* Property can be shifted to children, including under TUTMA, without parents losing control.
* Code **§1(g) –** minor child’s unearned income to be taxed at parent’s marginal income tax rate.
* **Current rules:**

**1)** Applies to unearned income of under 18 child (previously 14) and, in some situations, up to age 24 (where child’s earned income does NOT exceed ½ of support).

**2)** Applies to all unearned income of the child, whatever the source (NOT only from parent).

**3)** Can opt to include income on the parents’ income tax return. **Code §1(g)(7)**

**Interest- Free Loans**

* **Discussion:** borrowing is not a realization event (**§1001)** – since no accession to wealth occurs when the borrowing proceeds are offset by the debt liability incurred.
* **Further,** repayment of a debt is not a realization event and does NOT cause an accession to wealth (or a reduction of wealth) when the promissory note (marked “paid”) is received from the creditor in exchange for the cash delivered for payment of the note.

**Interest-Free Gift Loans**

* Example: loan from parent to child on a ten year NO interest basis. Inquiry: can the parent have NO income and child receive the income?

1) Original funds transfer consists of (a) a loan to the borrower and (b) a note to the lender. If a term loan – measure the present value of all payments due vs. the principal amount of the loan. The excess (in the family context) will constitute a gift.

2) Income tax- deemed interest payment & receipt. The excess value will be OID to be economically realized as the debt matures. Result: OID income to the donor and accruing interest expense to donee (deductible interest?)

3) Timing – (a) for gift tax purposes – a gift at commencement of transaction; **§7872(d)(2);** (b) for income tax- **§7872(a)(2)** provides for measurement at the end of the current tax year.

**Interest Free Gift Loans Exceptions to OID Status**

1) Small gift loan exception - **§7872(c)(2)** provides a $10,000 de Minimis exception for gift loans between individuals. Not for loans to acquire income producing assets.

2) Loans NOT exceeding $100,000 -**§7872(d);** amount treated as transferred by the borrower to the lender at year end shall NOT exceed the borrower’s net investment income for the taxable year.

**Personal Exemptions**

* Taxation within the family: a personal exemption deduction ($4000 in 2015) is available to taxpayer, spouse and “dependents.”
* To be a dependent the taxpayer (e.g., the parent) must provide more than ½ support for that other person.
* That other person cannot claim an exemption even if having income (less than ½ of his support). -**§151(d)**

**Standard Deduction**

* Standard deduction: $6300 is available to the unmarried individual who does NOT claim itemized deductions; double for a couple.
* Additional amounts allowed for (1) individuals over age 65, and (2) blind individuals.
* Objective of the standard deduction: eliminate income tax for a significant number of individuals.
* But, limitation on standard deduction amount ($500) for dependents. **§63(c)(5)**

**Transfers Incident to Divorce**

1) Should transfers of property (including cash) from one divorced spouse to another cause realized ordinary income to the transferee?

2) Should such a transfer enable a tax deduction to the transferor (particularly if sourced from the transferor’s current income stream)?

3) Should a transfer of appreciated property from one spouse to another be treated as (a) a sale of property, and (b) the transfer of proceeds to the other spouse (with a **§1012** tax basis?

**Separation and Divorce §71 v. §72**

* **Bernatschke v. US:** “support payments” made? Husband provided a lump sum (equivalent to 1/3 his assets) to buy annuity contracts for departing wife. This 1/3 equaled to a “dower” amount. Annuity contract was purchased to limit her spending capability. **Holding:** He provided her a lump sum amount and the annuity payments were not treated as periodic payments of alimony (not paid because of a marital “support” obligation). **§72** applies. Cornelius Crane did not pay the consideration for the annuity contracts because of any marital obligation to support plaintiff and, accordingly, the annuity payments are not taxable under Section 71. Plaintiffs are entitled to a refund of income tax for the years involved based on the application of the rules of Section 72 to the annuity payments received in each year.

**Alimony & Child Support**

* Certain payments(alimony) after divorce:
* Income to the recipient **§71(a),** and,
* Deduction to the payor spouse **§215,** an “above the line” deduction(**§62(a)(10))**
* A federal definition of “alimony” applies to determine whether the payment constitutes **§61** gross income to the recipient. See **§71(b).**
* No deduction to the payor parent for child support payments made to the other ex-spouse.

**Alimony Requirements §71(b)**

1) Cash payments (NOT property transfers)

2) Termination of this obligation occurs at the death of the payee spouse. **§71(b)(1)(D)**

3) No excessive front-loading. **§71(f)**

**4) NO disguised child support §71(c).** Note the “deadbeat dad” treatment **§71(c)(3)**

**5) Parties are NOT living in the same household. §71(b)(1)(c)**

Under **§71(b)(1)(B)** parties can opt out of alimony tax status (and agree on NO deduction.

**Indirect Alimony Payments**

* H pays (in cash)

1) W’s mortgage payments on her residence (paid directly to the lender bank); and,

2) Premiums on a life insurance policy on his life (paid to the insurer) & she owns the policy.

Result: taxable alimony to her is she owns (1) the house and/or (2) the life insurance policy, even though she does NOT receive the funds. **§215.**

Remember: Old Colony Trust Co. Case.

**Child Support Obligations**

* **Child** support is (1) NOT deductible by the payor and (2) NOT gross income to payee.
* **See §71(c)(2)** re a payment having a contingency relating to the child (e.g., reaching age 18) being treated as child support.

**Davis v. US**

* Property transfer to ex-spouse of appreciated property in divorce context (in exchange for a “release”) is a gain recognition event to the property transferor, i.e. a “sale or exchange” Supreme Court held that the $7,000 appreciation should count as gross [income](https://en.wikipedia.org/wiki/Income), as "the 'amount realized' from the exchange is the fair market value of the released marital rights, which in this case would be equal to the value of the stock transferred."
* Congress passed **§1041**, which basically reversed Davis and said that during a divorce, the recipient and the transferor of the property will not have any income. Congress felt that divorce was difficult enough without dragging tax issues into the division of property.
* This statute provides that, generally, "no gain or loss shall be recognized on a transfer of property from an individual to...(2) a former spouse, but only if the transfer is incident to divorce."
* While this statute overrules the specific holding of *Davis*, it does not change the general rule—that "a taxpayer recognizes a gain on the transfer of appreciated property in satisfaction of a legal obligation."

**Farid es Sultaneh v. Commissioner**

* He transferred appreciated shares to her in contemplation of marriage. An ante-nuptial agreement was concluded for gift (after stock transfer where she released any dower rights. What tax basis whens he sell for $19
* **Holding:** Sufficient consideration, underlying the taxpayer's receipt of the corporate stock pursuant to an antenuptial contract in exchange for relinquishing her inchoate interest in her affianced husband's property, because this inchoate interest greatly exceeded the value of the stock transferred to her. Hence she did not acquire the stock by “gift”, and need not take her husband's cost basis in determining her taxable gain on subsequent sale of the stock. Court found that by signing the pre-nup and giving up her right to alimony, Farid was making a contract, so her acquisition of the stock wasn't a *gift* at all, it was part of a contract. Court found that the *basis* for property acquired via contract is the value on of the property at the time the contract was signed (in this case $315).

**Code §1041**

* **Provides for**

**(1)** NO recognition to the transferor on a property transfer in divorce; and

**(2)** A transferred tax basis for the property when held by the recipient

* Further, no deduction is available for the property transfer to the other (ex)spouse.
* Limit – see Revenue Ruling 87-112 re no tax-free transfer of accrued interest income.

**Property Transfers Example**

* **H and W** together own investment property:

**1)** W receives Property One- 60x tax basis and 100x Fair Market Value (appreciated).

**2)** H received Property Two – 140x tax basis and 100x Fair Market Value (depreciated)

**Equal** property division on a pre-tax baiss (but not on an after-tax basis).

# XVIII) Investment Income

1. **Fundamental Issue:** How to allocate “unearned income” (i.le., investment income) to the correct taxpayer?
2. Investment income belongs to the owner of the property – but how can that ownership be used to deflect income to a lower bracket taxpayer (within the family unit)?
3. This includes the unitization of trusts, but the arrangements in this chapter are both for trust and non-trust ownership income allocations
4. **Structure of this Chapter**

(1) Various cases examining (a) constitutional power and (b) power as authorized under specific statutes to include income as owned by the original property owner.

(2) Various statutory responses in the trust context, including:

(a) Subpart E of Subchapter J

(b) Taxation of “true” trusts;

(3) Alimony Trusts - **§682**

1. **Corliss v. Bowers**

* Taxpayer (T) transfer into trust with (1) income to wife for life and (2) remainder to children. T retains power over trust to (1) amend or (2) revoke. Income was actually distributed to wife (pre-joint income tax return era). **Holding:**  T has the power and the income is his for income tax purposes (within US Constitution). Supreme Court found that even though Petitioner transferred the income to his wife he still maintained control of all aspects of the trust. He could at any time revoke the trust and take control of the income. **Rule:** When the grantor of a trust has the power to take full ownership of any part of the corpus of the trust, then the income should be considered as grantor’s.

1. **Alimony Trust - Douglas v. Willcuts**

* T transfers securities to (irrevocable) trust for wife for specific sum and excess to be paid to T. Reversion to T at death of wife. Transfer in a divorce settlement in lieu of alimony or dower. **Holding:** (when alimony was NOT income to wife) that T’s obligation was discharged by trust income transferred to wife and (1) income attributed to T and (2) constitutional power to so attribute income. Cf. Old Colony Trust Col.

1. **Subsequent Statutory Response - §682**

* **§682** provides structure for an alimony trust – Income in trust to satisfy his obligation paid to former spouse.
* **Income** is attributable to former spouse for income tax purposes.
* **This** results after the enactment of **§71 and §215.**

1. **Questions – Problem 2**

* A) Transfer of securities in trust for minor daughter but (1) first pay transferor’s gift tax liability, (2) then accumulate income during minority and (3) distribute income at majority. **Reasoning:** income is attributable to trust or daughter, NOT GR. Daughter will receive this when she is 18 or 21.
* B) Rental property owned, placed in trust, expenses paid by trust, excess income to child.
* C) Trust created for minor children and trustee has power to use income to pay tuition for children. See Code **§677(b). Reasoning:** income in that trust is not attributable to obligation to support.

1. **Burnet v. Wells**

* **GR** created irrevocable trust and transferred securities and income to be used to pay premiums on an insurance policy on life of trust GR. Excess income to daughter for her life and then as directed under a power of appointment.
* **Holding:** income to the GR. Legislative power exists to authorize gross income inclusion.
* **Dissent:** no continuing power of GR over assets in this trust. Income to be taxed on trust.

1. **Sequel to Burnet v. Wells**
2. **1)** Enactment of **§677(a)(3)** providing income of trust funding insurance attributable to trust GR.

**2)** See Part (c) - trust with directions to accumulate income (assuming better return than insurance policy & actuarial gain).

**3)** Part (d) – assets transferred by parent to child and income from assets then used to acquire insurance on the life of the parent.

1. **Blair v. Commissioner**

* Blair (plaintiff) inherited the income interest from a life trust. He assigned a portion of his future income from the life trust to his children. The Commissioner (defendant) determined that future interest payments were still taxable to Blair. The Board of Tax Appeals ruled in Blair’s favor. Owner of a LE under a testamentary trust, but not the remainder interest.
* **Blair Trust Structure**

1) Grandfather – Last will, with assets into trust at his death.

2) Life interest – to intermediate generation, i.e., taxpayer-father

3) Remainder interest – to grandchildren

* **Rule**: where a taxpayer validly assigns his beneficial interest in trust property, the taxpayer is relieved of tax liability and the assignee assumes it.
* **Holding**: This Court finds that when Blair transferred a portion of the income to his children, he transferred his equitable ownership of that portion as well, since Blair gave no indication that he intended to transfer anything less. Through the assignment, Blair’s children became the new equitable owners of the interest income. As such, Blair’s children are liable for taxation on the income, not Blair. Assignment was valid and the income was attributable to the children/donees & not to the donor/assignor father.

1. **Stripped Bonds §1286**
   * 1. Separation of the bond and the right to the interest payment
     2. Each instrument is treated as a separate OID bond (ie. Discounted at applicable discount rate)
     3. Supersedes Horst
     4. Allocation of basis in each part and parcel
2. **Helvering v. Clifford**

* **Trust** GR as trustee; trust for five years (or earlier death); income distributed to wife in the discretion of the trustee; retained power of the GR to vote shares etc.
* **Holding:** under **§61** (predecessor) GR continued as owner of the trust corpus. Totality of all facts suggest GR held the equivalent of full ownership. Fact finder not in error when determining GR was owner of trust assets.
* **Dissent:** no explicit statute covering this.

1. **Helvering v. Horst “Fruit & Tree”**

* Delivery (by gift) of bond interest coupons to child shortly before an interest income due date.
* **Holding:** “The power to dispose of income is equivalent to the ownership of the income” This anticipatory assignment of (this) income is not permitted for income tax purposes. C.f., registered bonds v. coupon bonds. Supreme Court found that Respondent enjoyed the economic benefits of the income as though he was transferring earnings. He should not be able to avoid including these amounts as income by converting it to a gift for his son. Similarly, a donor who retains control of trust property is taxable on the income. This is a gift just of the income, not the income-generating property as in **Blair**. The power to dispose of income is equivalent to the ownership of the income. Horst purchased the bonds and remained entitled to receive the interest on the bonds even after gifting the interest coupons. By gifting only the interest coupons to his son, the interest payments were still taxable to him. Therefore, the judgment of the Court of Appeals is reversed.

1. **Helvering v. Eubank**

* Rights of an insurance agent to renewal commissions arising in the future were transferred to a trust. IRS asserts these commissions paid were includible by the transferor when paid. Relying on Horst the Supreme Court hold that the commissions are taxable to the assignor. TP was assigning future income streams, so he is taxable on it in the present year. Horst controls. The income has already been earned even if not received, unlike in Earl where it had not.
* **Disssent:** property rights were transferred – represented by the contract right and NO assignment of income occurred.

1. **Trusts**

* A property law concept where (1) legal and (2) equitable ownership are separated (between the equitable owner(s)/beneficiaries and the trustee). Distributions (income and/or corpus) are payable to one or more beneficiaries. Tax question (considering the “assignment of principle” is: Who is deemed in receipt of trust income for FIT purposes – (1) Trust GR; (2) trust itself, (3) one or more beneficiaries ? NOT trustee, an agent

1. **Irrevocable Trusts and Income Taxation**

* Assume (1) an irrevocable or true trust with (2) no retention of controls by the trust GR (including, e.g., at the time of death).
* Then: subject to federal tax rules for dividing income (for income tax purposes) between (1) the trust and (2) the beneficiaries.
* See Subchapter J **§641 - §668 (A-D)**
* I.e., “statutory” rules re assignment of income.
* Cf., trust income allocation rules for local/trust law purposes (e.g., P&I rules).
* (1) GR (2) Trust itself, (3) beneficiary

1. **Complex Trusts**

* A trust may be subject to income tax (at a steeply progressive rate) on its taxable income.
* A deduction is permitted to the trust for current income distributions to the beneficiaries.
* The beneficiaries are subject to income tax on the distributed amoung, as limited to the “distributable net income” or “DNI.” **§643(a)**

1. **Cf. GR Trust Rules Income to GR**

* **Cf.** trusts where the GR has retained significant powers i.e., “grantor trusts.” Relevant during lifetime but not after death of the GR.
* **GR** is treated as the owner of income (and deductions) for income tax purposes. I.e., an “assignment of income” has not been completed.
* Taxation of the income of the trust is to the GR/Owner. **§671 - §677 (E).**

1. **Grantor Trust Rules**

* Under what circumstances is income of a trust allocable to the trust GR (and NOT the trust or trust beneficiaries)? I.e., the trust is treated as the equivalent of an “agency.” See **§671**

**1)** Trust is revocable. **§676** requires income attribution of a revocable trust to the GR.

2) Reversions – income attribution to the GR where GR’s reversionary interest is greater than 5 percent of the value of the trust. Exceptions when a reversion after the death of minor descendant.

3) Powers of Control – GR as owner where holding a “power of disposition.” **§674.** Certain exceptions for retained power, **§674(b), (c)** (d) & also, depended upon who is the trustee.

E.g. **§674(c)** permits a “spray or sprinkle” power granted to an independent trustee.

4) Certain unusual “administrative powers” can cause GR trust treatment. **§675**

**5) §677** income for the benefit of GR. **§677(a) –** distribution to GR or spouse – presently or delayed; OR, **§677(a)(3)** – the payment of insurance premiums on the life of the GR.

**§677(b)** Satisfaction of a support obligation.

**§678 Power to Demand a Trust Distribution**

* **§678** provides that a person other than the GR can be treated as owner if holding the authority to demand income or corpus from a trust.
* Must have the power to vest the income or corpus in oneself.
* Power cannot be subject to a limitation e.g., cannot be a “support” trust.

# XXI) Future Income Streams

1. **What is the Income Tax Treatment for a lump sum payment received in exchange for a future income stream?**
2. **Choices:**

**(1)** Ordinary income, or

**(2)** Capital. Including both (a) return of capital investment (i.e., tax basis) and (b) capital gain.

1. **Prior Analysis:**

Definition of a Capital Asset

* **§1221(a)** defines the term “capital asset” as property held by the taxpayer (whether or not connected with his trade or business), but does not include eight specified items: e.g., inventory; depreciable property (§1221(a)(2)); copyrights, etc. (note the impact in the charitable contributions deductions context); accounts or notes receivable; supplies used in the ordinary course of business; and, certain other items.

1. **Depreciable Business & Real Property**

* Not a capital asset - **§1221(a)(2).** But, if property is used in the trade or business, see **§1231(a)(3)(A)(i)**) which can produce **“§1231** gain.”
* Net §1231 gains are treated as long term capital gains.  **§1231(a)(1)(A).** Loss as ordinary. But, if applicable gain is attributable to prior depreciation, this deduction can be “recaptured”  as ordinary income**.  §1245.**

1. **Ordinary Income Substitute – Hort v. Commissioner**

* Payment by a tenant for the cancellation of a real estate lease. Taxpayer received payment for cancellation of a lease. Property received from the father’s estate with a lease. Tenant payment of $140x for lease cancellation. Owner claimed loss on the lease termination. IRS says all is includible as ordinary income. Court says yes.
* **Holding:** Supreme Court found that the cancellation of the lease was a relinquishment of the right to future rental payments. It may have diminished the total amount of income Petitioner would have received, but he is not required to pay income tax on those amounts. The amount received in exchange for cancellation of a lease is taxable as ordinary income.
* **§167(c)(2)** – specifies NO allocation of tax basis to a lease is permitted when property is acquired. Thus, only the physical property is depreciable.

1. **McAllister v. Commissioner**

* Individual (widow) transfers her life interest in a testamentary trust for the receipt of cash payment. She reports a capital loss of $8,790 (amount received less her tax basis – established under “uniform basis” rules.) Amount received by her is actually an accelerated payment of her anticipated income stream? Was this like the Blair case or the Hort case?
* **Holding:** sale of entire property interest (capital) and not an income stream (treated as income). CG treatment works here. Blair controls. ***Transfer of income producing property generally results in CG treatment unless transferor retains reversion interest in the property***. Same as assignment of income.

1. **What Tax Basis for the Life Tenant?**

* **§1001(e)** – Where life tenant sells his life interest the tax basis for the life interest is zero – unless the remainderman sells at the same time, in which situation the income tax basis is proportionately allocated.  Capital gains treatment to the selling life tenant.
* Under “uniform basis” rules the original basis is allocated between (1) the life interest and (2) the remainder interest.  Basis is gradually shifted from life tenant, based on life expectancy tables.

1. **Oil Payments**

* P.G. Lake
* Corporation has a 7/8ths working interest in two oil and gas leases. Corp. assigns a $600,000 oil payment (plus a 3% interest payment) to its president to pay a debt owed to him.  Corp. reported this transfer as a sale of property producing a $600,000 LTCG.
* **Held**:  Proceeds were ordinary income (but, subject to depletion deduction). Treated as essentially a substitute for the future receipt of ordinary income. Right result?      See next slide

1. Code **§636**

* **§636(a)** – carved-out production payment – treated as a mortgage loan on the property (i.e., a payment periodically by the oil producer is made to the production payment holder on behalf of the seller).  This is not an economic interest to the recipient under a production payment, but to the  “seller” (who gets the depletion deduction).  Taxed periodically when the payments are actually made.
* Note similarity to Old Colony Trust Co.