

INCOME TAX

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Calculation of Tax:

1. Gross Income (§ 61) – starting point

- a. § 61 – “all income from whatever source derived.” – Catch all. Reaches full constitutional limit of taxing power.
 - a. *Glenshaw*. Include ALL gains, unless specifically exempted. § 61 supercedes *Macomber*.
- b. Inclusion Rules (§§ 71-90) – Tell us the boundaries; Give timing rules
- c. Exclusion Rules (§§ 101-140)
 - a. E.g., § 101 – death benefits; § 119 – meals, lodging; § 132 – fringe benefits

2. AGI (§ 62): Subtract Above the Line Deductions from Gross Income to get AGI ← everyone gets to take these deductions

- a. Generally, costs of making income - T/B deductions, property, moving, higher education
- b. §62 lists all “above the line” deductions.
- c. Note: § 62 is not the authority for deduction; it’s the authority for the place of deduction (**above/below**)
 - a. § 62(a)(1) All Trade/Business Expenses (*except* if TP is employee and not a performing artist)
 - i. §162: T/B expenses: clothing, salary, travel, meals, rebates or price adjustments
 - ii. § 165(a)/(c)(1): T/B property losses
 - iii. §§ 167/168: Depreciation and ACRS deductions (for property held for T/B)
 - b. §62(a)(2)(A): Reimbursements to ‘EE for T/B expenses (take above the line to assure no net tax cost to ‘EE).
 - i. Note: §62(c): ‘EE must provide substantiation to reimbursing party.
 - ii. If work fringe (e.g., meal w/ summer assoc.), exclude under § 132(d), don’t bother w/ include/deduct.
 - c. § 62(a)(3) - Losses from Sale or Exchange of Property → §165, everything not capital under §1221(a)
 - d. § 62(a)(4) – Deductions for Rents/Royalties (outside T/B), including §212 expenses and § 167 depreciation.
 - e. § 62(a)(10) – Alimony (§ 215)
 - f. § 62(a)(15) – Moving Expenses (§ 217)
 - g. § 62(a)(17) – Interest on Education Loans (§ 221)
 - h. § 62(a)(18) – Higher Education Expenses (§ 222)
 - i. § 62(a)(19) – Health Savings Accounts (§ 223)
 - j. § 62(a)(20) – Atty fees, court costs for discrimination lawsuits (capped at judgment income)

3. Taxable Income (§ 63): Subtract Personal Exemptions; then subtract *either* Standard Deduction *or* Itemized Deductions

- a. **Personal Exemptions** (§§ 151-152): Get 1 for TP & each dependent (unless claimed by another TP) – phase out!
- b. **Standard Deduction** (§ 63(c)): currently \$3000 for individual/\$6000 joint. § 63(c)(2).
- c. **“Itemized Deductions”** (§ 63(a)) (defined in §63(d) as all deductions except §62 deductions) – located in §§ 161-223
 - a. Miscellaneous Itemized Deductions (MID) → **subject to 2% floor** → § 63(a), §67(a): MID = all itemized deductions that are *not* listed in §67(b). Aggregate must exceed 2% of AGI before take first dollar deduction.
 - i. **§212 – Expenses for production of income not from T/B**
 1. § 212 deductions = § 162(a) deductions, except for T/B requirement. *Gilmore*.
 2. § 212(1) – ord. & nec. expenses for production of income – inc. depreciation.
 3. § 212(2) – for management, conservation, or maintenance of property – e.g., fees for management of rental property, when not in T/B of renting property.
 4. Investment Expenses are here– e.g., *broker’s fees, safety deposit box, investment newsletter*; not in §163(d) *interest* (deductible only to extent of income); all §212 deductions.
 - ii. **§ 162 – T/B Expenses Incurred by Employee** – e.g., law firm associate’s bar dues – (also § 165(a)/(c)(1) property losses incurred in T/B) – ‘EE must take deduction under § 63(a), not under § 62.
 - b. Non-Miscellaneous Itemized Deductions → (**No floor**) → § 63(a) (§67(b) Lists as *exceptions* to miscellaneous)
 - i. Interest on Indebtedness – §163 (investment (** capped), QRI, T/B interest; not purely personal)
 - ii. Taxes – §164
 - iii. Property Losses in transactions for-profit but not T/B – § 165(a), § 165(c)(2)
 - iv. Casualty Losses – § 165(a), §165(c)(3)
 - v. Gambling Losses – § 165(a), §165(d)
 - vi. Charitable Gifts – §170
 - vii. Medical Expenses – §213
 - viii. Restoring Deduction under Claim of Right §1341
 - ix. Annuity Basis Recovery §72(b)(3)
 - x. Others
 - c. § 68 Phase-out: Reduce ALL itemized deductions if AGI greater than \$100K. See § 68. (E.g., p. 340).

4. “Passive Activity Losses” subject to § 469.

5. Net Operating Losses (for income-producing activities) can be carried back 2 years, then forward 20 years. § 172.

6. Tax: Taxable Income x Rate (§ 1). [Note: §1(h): rules for capitals gains].

7. Apply credits: §§ 21-38

8. Pay AMT if greater: AMT (§§ 55-58)

- a. AMT = AMTI x § 55 rates
- b. AMTI = TI (§63) + Adjustments/Preference Items (§§ 56-58) – Statutory Exemption (\$58K married/\$45K single)

Introduction

Tax Effects:

1. **Substitution effect:** chose something else because tax has made something expensive; no longer worth it to get the last marginal amount; willing to pay less for each output point, b/c getting less for money; shifts graph to the left, b/c want input point the same.
2. **Income effect:** work harder to replicate pre-tax position, even though thing is now taxed; graph moves right, b/c want the output point to be the same.

Policy Considerations:

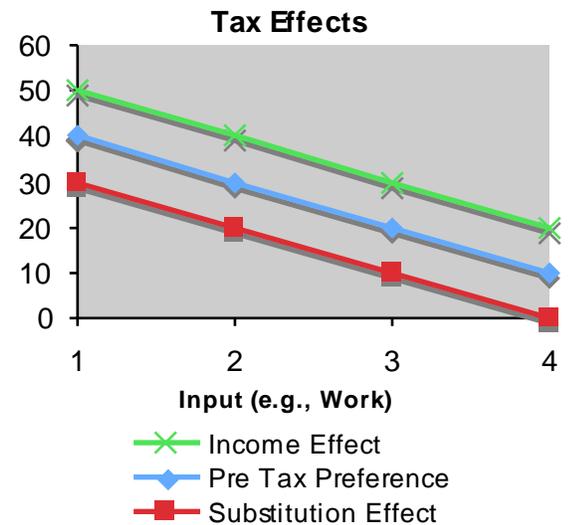
1. Equity
2. Administration
3. Incentives/Efficiency

Timing Problems:

1. Time value of money – prefer \$ now than later
2. Liquidity – need liquidity to pay tax
3. Rate brackets/No income to deduct against
4. Informational: tax something, but future changes; valuation problems

Types of Tax Base:

1. Head tax (great administratively, bad equity)
2. Benefits tax (works for some benefits, but not for public goods, doesn't redistribute)
3. Ability to Pay:
 - a. Raw ability (wage rate) – “true” ability/potential (hard to value (bad admin) and makes people work)
4. Ability to Pay proxies:
 - a. Wealth: takes snapshot; good proxy; unfair - multiple taxation; bad incentive- hits the saver
 - b. Consumption: administrable ($C = Y - \Delta S$), encourage saving; unfair? rich heir can hoard; bad proxy
 - c. Income: Formal definition (Haig-Simmons): $Y = C + \Delta S$. Intermediate proxy. Discourage savings.
5. Actual system: Nominal income tax system
 - a. Actually a hybrid of Consumption and Income Tax – allow deductions for savings (e.g., IRA, 401(k)). Any deduction for savings is a shift to consumption tax.
 - b. Note: Transition problems – switching from income to consumption taxation (or other way) would be unfair to anyone whose consumption patterns change that year.



I. Income

Defining “income” is a political, not dictionary, question. Depends on equity, administrability, incentives.

Exclusions = economic inflows that we don't count.

A. Noncash Benefits – some excluded from gross income

1. Introduction – Trying to Approximate Cash, FMV
 - a. Basic Idea:
 - i. Exclusion would create social waste:
 1. If government doesn't tax in-kind benefits → horizontal equity problem (for 'EEs paid in-kind); **social waste**, overconsumption, distortion toward jobs in service industry.
 2. For all in-kind benefits, some social waste is unavoidable → 'ER can't match benefit exactly to 'EE's SV.
 - ii. But inclusion creates valuation problem (and sometimes liquidity problem)
 1. SV is ideal → solves deadweight loss, accurately prices; but information problems
 2. FMV can be too onerous → overshoots by too much.
 3. FMV can also create *underconsumption* social waste (e.g., standby flights)
 - iii. Given valuation problem, sometimes exclusion is best solution after all.
 - b. Basic Rule
 - i. Only two choices: (1) Inclusion at FMV or (2) exclusion (Turner approach not administrable).
 - ii. Goal: Make include/exclude rules approximate SV!
 - iii. **Background rule: Include FMV of in-kind benefits**
 - iv. But can exclude when:
 1. Too Onerous – (e.g., meals for dishwasher at Mario Batali restaurant, 119 exceptions)
 2. Administrability – value too small to be worth it (e.g., de minimis fringe)
 3. Waste – No Additional Cost (e.g., standby flights), confident $SV > cost$

4. No net benefit to 'EE (e.g., Jones – army barracks, § 1.119 regs)
 5. Raw Politics – (e.g., qualified transportation)
- c. §61(a): Gross income means **all income** from **whatever source derived**.
 - i. Compensation for services including wages, salaries, fees, commissions, fringe benefits, royalties, tips, legal and medical fees, and jury fees
 - ii. *Glenshaw*: “Undeniable accessions to wealth, clearly realized, over which the taxpayers have complete dominion.” § 61 is catch-all; up to constitutional limit, rejects *Macomber* def'n.
 - iii. “Discharge by a 3rd person of an obligation to him is equivalent to receipt by the person taxed.” *Old Colony Trust* (employer paid employee's taxes). §275 denies deduction.
 - d. §1.61-1(a): Gross income includes non-cash items
 - i. “Gross income ... includes income realized in any form, **whether in money, property, or services**. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash.”
 - e. §1.61-2(d)(1): Amount of inclusion is FMV.
2. Exclusion for Meals and Lodging (§ 119)
- a. Summary
 - i. Only applies to 'EEs – not to self-employed or independent contractors
 1. But possible to be the sole 'EE of a corporation.
 - ii. Current statute and regulations are blend of majority and dissent in Benaglia;
 1. Approximate factors on benefit/detriment scale; exclude if net detriment to 'EE
 2. “On premises” → generally less SV for EE
 3. “Required as condition of employment” → tends to decrease SV for 'EE.
 4. Fancy hotels and restaurants are outliers (e.g., Benaglia, Mario Batali) – where food is really good, FMV is really high – TP is getting a big benefit – tax system just accepts.
 - b. Meals - §119(a)(1)
 - i. Can exclude meals for 'EE, spouse, dependents only if: (Reg. 1.119-1(a))
 1. For convenience of 'ER (see below for test)
 2. Furnished on business premises
 - ii. Note: If 'EE pays flat rate for meals, then exclusion is the flat rate. § 119(b)(3).
 - iii. Meals = food. 9th Cir.: meals ≠ groceries. 3rd Cir.: meals = groceries.
 - c. Lodging - § 119(a)(b) –
 - i. Can exclude lodging for 'EE, spouse, dependents only if: (Reg. 1.119-1(b))
 1. For convenience of 'ER (same definition as for meals)
 2. Furnished on business premises (employer has to own the lodging)
 3. Required as a “condition of employment.” (119(a)(2)). Necessity test, like Benaglia majority. Can't be merely required in K, facts must show it.
 - d. **“Furnished”** (§119(a)(1))
 - i. *Kowalski*: state trooper meals at highway restaurants → NO, b/c not furnished by 'ER
 - ii. *Sibla*: fireman obligatory station house organized mess → excluded
 - e. **“Business premises of employer”** (§119(a)(1))
 - i. For state police, every road and highway. *Barrett*. But: maybe not “furnished.”
 - ii. Manager's house across street from hotel. *Lindeman*. But not 2 blocks away. *Anderson*.
 - iii. Official residences of governors and President.
 - f. **Convenience of employer**
 - i. § 119(b)(1) – Employment K shall not be determinative re Convenience of 'ER
 - ii. § 119(b)(2) – do NOT take into account whether charge for meals, or 'EE can decline
 - iii. § 119(b)(4) – If more than half of employees get meals furnished on premises for convenience of employer, then all employee meals furnished on premises are excludable. Note: This helps us make sure it's a detriment (usually on campus meals aren't good).
 - iv. **Reg. 1.119-1(a): Convenience of 'ER = “furnished for a substantial, non-compensatory business reason of 'ER”**
 1. So long as substantial, noncompensatory business reason, does not matter if there is also a compensatory reason.
 2. Determined based on totality of circumstances. Mere declaration insufficient.
 3. Examples of substantial, noncompensatory reasons:
 - a. During 'EE work hours and possible emergencies; restricted meal time; peak workload during mealtime; no other eating facilities.
 - b. Immediately after 'EE work hours, and substantial non-comp reason, and duties prevented from taking during work hours.

- c. Substantial non-comp reason for “substantially all of the ‘EEs” – remaining few ‘EEs get to take it too
- d. Any restaurant or food service ‘EE for each meal period worked.
- 4. Compensatory reasons: to promote morale or goodwill of ‘EE, or attract prospective ‘EEs (no exclusion, unless also a business reason)
 - a. E.g., Meals are optional and for a charge
- v. **Benaglia dissent test: Net detriment to ‘EE**
 - 1. *Jones*: military employee’s quarters → exclude
 - 2. *Tennant*: security guard in bank to watch vault → exclude
 - 3. *Bengalia*: manager at Hawaii resorts; TP and wife get meals and lodging.
 - 4. Majority excludes. Uses necessity test → TP required to be on premises.
 - 5. Dissent: Benaglia should *include*. Received net benefit, even if necessary.
 - 6. **Dissent’s Test: Convenience of ‘ER = net detriment to ‘EE.** When more detriment than benefit, ‘EE’s salary would go *up* to compensate. For Benaglia, his salary presumably went *down* b/c fancy lodgings and meals.
 - 7. Problem w/ Dissent’s Test → **valuation problems**:
 - a. FMV (could be too high, *Bengalia*) – too onerous
 - b. What Cost to Hotel?:
 - i. Marginal cost (zero if hotel has vacancies – too low)
 - ii. Average cost (cost/room – might be too onerous)
 - c. Saved cost to employee
 - i. What ‘EE would have otherwise paid → evidence problem, incentivizes lying re monastic living
 - d. Subjective Value
 - i. Ideal rule - overcomes social waste,
 - ii. But evidence problem: hard to see inside someone’s head
 - 8. Because valuation is hard, maybe exclusion was best after all.

3. Other Fringe Benefits – excluded from gross income (§ 132)

- a. **No Additional Cost Service** (definition: §132(b); authority for deduction § 132(a)(1)):
 - i. Rule:
 - 1. Offered for sale to customers in **ordinary course of the line of business** of the employer in which ‘EE is performing services (132(b)(1)).
 - 2. ‘ER incurs **no substantial additional cost** (including forgone revenue), w/o regard to any amount paid by ‘EE – e.g., standby flights (132(b)(2)).
 - 3. Applies to retired, widows, spouses, children, and (for air flights) parents (132(h)).
 - 4. No discrimination in favor of highly compensated ‘EEs allowed (132(j)(1)).
 - ii. This is **good policy**, because prevents social waste of underconsumption.
 - 1. Options
 - a. Tax FMV → tax will be too much → don’t fly → social waste
 - b. Tax S.V. → tax will be less than SV → fly → no social waste
 - c. Exclusion → tax = 0 → fly → no social waste
 - 2. Ideally, want ‘EE to take the service anytime ‘EE’s SV > cost to ‘ER
 - a. 132(b) always guarantees that ‘EE’s SV > cost to ‘ER, b/c by definition, cost to ‘ER is zero (or substantially zero), and ‘EE choosing to take service.
 - b. Once costs to ‘ER start going up, no longer sure ‘EE’s SV exceeds → include.
 - c. Plus, once cost is substantial, more likely SV is very large, should tax.
- b. **Qualified Transportation Fringe** (definition: §132(f); authority for deduction § 132(a)(5)):
 - i. Rule:
 - 1. Commuter highway vehicle (A) (at least 6 passengers) – exclude up to \$100/mo.
 - 2. Transit pass (B) – exclude up to \$100/mo.
 - 3. Qualified parking (C) (on or near business premises) – exclude up to \$175/mo.
 - 4. No constructive receipt, even if ‘EE would have otherwise received compensation.
 - ii. This is based on raw politics:
 - 1. Benefit is fairly liquid – would be just as easy for ‘ER to pay you cash.
 - 2. ‘EE receiving net benefit.
 - 3. Including FMV would not be too onerous.
 - 4. Cost to ‘ER is not zero. No worry about underconsumption social waste.
 - 5. Distorts preferences – encourages driving to transit, and both to walking/cycling.

6. Exclusion is based on political entitlement only.
 - c. Qualified Employee Discount (definition: 132(c); authority for deduction § 132(a)(2)):
 - i. Discounts on property (other than real or investment) or services offered for sale to customer in ordinary course of line of business of 'ER in which 'EE is performing services.
 - ii. Can't transfer property below (average) cost to business and can't give services below 20% off.
 - iii. Applies to 'EE, **spouse, retired employees, widow, dependant children** (132(h)).
 - iv. No discrimination in favor of highly compensated 'EEs allowed (132(j)(1)).
 - d. Working Condition Fringe (132(d); authority for deduction § 132(a)(3)):
 - i. 'EE can exclude in-kind if would have been deductible if paid directly by 'EE as cost of work under §162 "ordinary and necessary" or § 167 (depreciation).
 - e. De Minimis Fringe (132(e); authority for deduction § 132(a)(4)):
 - i. Value is so small as to make accounting for it unreasonable or administratively impractical.
 - ii. Coffee, tickets, etc. – administratively not worth it.
 - iii. Cash is not a de minimis fringe, but occasional supper money is OK. Reg. §1.132-6.
 - f. Qualified moving expense reimbursement (132(g); authority for deduction § 132(a)(6)):
 - i. If would have been deductible under § 217 (moving expenses) if paid directly by 'EE.
 - g. Qualified retirement planning services (132(m); authority for deduction § 132(a)(7)):
 - i. Retirement planning advice to 'EE, spouse by 'ER maintaining qualified plan under 219(g)(5).
 - ii. No discrimination: well paid 'EEs get only if other 'EEs normally informed about plan do.
 - h. Qualified military base realignment and closure fringe (132(n); authority for deduction § 132(a)(8)):
 - i. Special rules 132(j): on-site gyms, car salesmen, department stores, airline alliances.
 - i. On site gyms (132(j)(4)): exclude if on premises, operated by 'ER, substantially all use by 'EEs.
 - j. Cafeteria plans (§ 125)
 - i. Supercedes doctrine of constructive receipt. §125(a)
 - ii. "Use it or lose it" rule. §125(d)(2)(A) – if elect for benefit, unused portion cannot be carried forward to next year, or paid out as compensation at end of year → benefits M.D.s in December.
4. Frequent Flyer miles
 - a. IRS Announcement 2002-18: No tax liability for personal use of business frequent flyer miles.
 5. Health Insurance
 - a. Most important noncash benefit.
 - b. 'ER can deduct cost (§ 162(a)).
 - c. 'EE can exclude (for self, spouse, dependents) (§ 106(a)).
 6. Prizes (§ 74)
 - a. Rule: Include at FMV
 - b. No *Benaglia* problem – never net detriment; though FMV may overshoot, always a net benefit
 - c. Exceptions: scholarships (117), employee achievement awards, up to amt deductible to 'ER (74(c))
 - d. *Turner* – won steamship tickets in radio contest.
 - i. Court awards SV (makes it up), b/c finds SV < FMV.
 - ii. TP would not have otherwise bought; "merely gave them an opportunity to enjoy a luxury otherwise beyond their means. Their value to the petitioners was not equal to their retail cost."
 - iii. But court's figure was arbitrary. Provides little guidance to future TPs. SV administrative bad.

B. Imputed Income

1. Definition: Imputed income transactions are cases in which the taxpayer owns property or performs services and also consumes the value of such property or services.
2. Self-production and consumption eliminates the market transaction.
3. Imputed income is not taxed. Reasons:
 - a. Valuation problem – w/o market transaction, how to value? Pro rata value of house? Rental of similar house? For services, sometimes no clear value (no market analogue).
 - b. Evidentiary problem – hard to know when services are being performed.
4. Creates problems:
 - a. Equity – A (homeowner w/ imputed rent) and B (renter w/ bank account) have same income and same investment return; but A better off, b/c nontaxation of imputed income. Unfair.
 - b. Efficiency – Creates distortions – more people buy homes than invest in bank; mom stays home even though market values her outside-home services more (e.g., \$20K salary vs. \$25K child care services).
5. Possible solutions:
 - a. Tax imputed income (impractical, and policitally impossible)
 - b. Allow deduction for disadvantaged equity counterpart – e.g., child care credit of § 21 comes close to this
6. Real Property (e.g., home ownership)

- a. Imputed income is the rental value of home.
- b. Equity: Compare to person who rents and puts money in bank. (Worse off!)
- c. Note: Homeowner benefits twice: (1) non-taxation of imputed income; (2) deduction for interest.
7. Consumer Durables (anything you can use longer than a year, e.g., TV, refrigerator)
 - a. Imputed income is the amount you could rent it for.
 - b. Equity: Compare to person who rents the item and puts money in bank.
8. Services (e.g., child care)
 - a. Imputed income is what you would otherwise pay.
 - b. Equity: Compare to person who has to pay for service.
 - c. § 21 gives credit for 35% (or less) of child care expenses, capped at \$3K (1 kid)/\$6K (2 kids).
9. Psychic Income
 - a. Earnings from labor taxed, but psychic benefit from leisure not taxed. Can also create distortions, similar to imputed income.

C. Barter

1. General rule: If you perform services and someone compensates other than cash, have to include value in income.
2. Services
 - a. Revenue Ruling 79-24: Bartered services are taxable
 - i. Lawyer services swapped for housepainter services. Holding: Each party is taxed on value of services received.
 - ii. Reg. §1.61-2(d)(1): Income = value of services received, even if FMV of property or services traded is the same.
 - b. Services (e.g., lawn-mowing):
 - Case 1: Pay somebody else
 - Case 2: Swap services, plus equivalent cash exchange
 - Case 3: Swap (stop uselessly exchanging cash) [Above line: taxed]
 - Case 4: Do service myself (imputed) [Below line: not taxed]
 - c. Goal: IRS wants to tax Case 1 – primary economy. Most worried about barterers that undermine Case 1.
 - d. Credits earned in barter club to be exchanged for professional services are taxed. Rev. Rul. 80-52.
 - e. Swapping babysitting services technically should be included, under Rev. Rul. 79-24. But in practice, IRS doesn't worry about it, b/c won't bleed into Case 1. Natural limit to the amount you can baby-sit for your neighbors. IRS most worried about catching those services that are people's livelihood, e.g., the lawyer. Otherwise could transform whole economy (Case 1 scenarios) into untaxed barterers.
 - f. Baby sitting co-op technically should be taxed, b/c easy valuation (can buy out), and analogous to barter. But don't worry because natural limit.
 - g. Socialist commune w/ 100 residents; services should be taxed; but too intrusive, evidence problem.
 - h. Reporting Requirements ≠ Substantive Tax Liability
 - i. §6045 requires info reporting of any "barter exchange."
 - ii. Reg. § 1.6045-1(a)(4) – barter exchange does not include "the informal exchange of similar services on a noncommercial basis."
 - iii. But reporting requirement does not impose or absolve liability. Easier to cheat; but still cheating.
3. Property
 - a. Rev. Rul. 79-24:
 - i. Artwork in exchange for six months rent.
 - ii. Holding: Each must include FMV of value received.
 - b. IRS generally doesn't tax property swaps – has a natural limit. Not exchange of livelihoods – not worried about undermining Case 1. People aren't going to be doing this all the time and evading taxes. Limit on number of residences and vacation homes that can be swapped.
 - c. Time share swap would not be taxed.
 - d. Property (e.g., Time Share):
 - i. Case 1: Rent out condo for the week
 - ii. Case 2: Swap time-shares, plus cash exchange [Above line: taxed]
 - iii. Case 3: Swap time-shares, no cash exchange [Below line: not taxed]
 - iv. Case 4: Stay in my own timeshare (imputed)
4. If transfer property for services (at arms-length):

- a. Conceptualize as if transferred property and received cash.
- b. First, determine FMV of services received. Pretend received that much in cash.
- c. Then, determine gain = FMV of services - basis in property transferred.
- d. Result: Only taxed on appreciation in the property transferred (unless services objectively more valuable than property – then include excess of value of services over FMV of property).
- e. Note: If you transferred bond coupons in exchange for services (at arm's length), the transferor would not be taxed on the coupon in the manner of Horst. (No fruit/tree analysis.) Instead, would be taxed as above.
- f. Note: When you try to divert salary income to the grocer you are taxed on the salary received (not on the groceries).

D. Windfalls and Gifts

1. Windfalls/Punitive Damages – include

- a. *Glenshaw Glass*:
 - i. Narrow holding: punitive damages/windfalls are income under §61.
 - ii. “Undeniable accessions to wealth, clearly realized, and over which TPs have complete dominion” → include.
 - iii. Broad holding: § 61 includes everything in income up to full constitutional limit.
 - iv. Good policy: otherwise, slippery slope of TPs finding more magic words Congress didn’t say.
 - v. Rejects Macomber definition (income = gained from labor or capital). § 61 superceded.
 - vi. Institutional competence question: how much is “right” amount of antitrust enforcement? Court doesn’t know whether Congress wanted amount of enforcement of treble damages less taxes, or plus taxes. If Congress wants more enforcement, increase damages. *Burden D*, not gov’t.

2. Gifts – exclude if really gifts

- a. Basic Rule:
 - i. §102(a): exclusion for true gifts
 - ii. Policy Reasons:
 1. Income shifting – prevents shifting to lower bracket (only an issue for families).
 2. Invasiveness – prevent intrusion into intimate family affairs (e.g., untaxed “core” of support payments can bleed into gifts).
 3. Family unit structure – avoids “double” tax on family unit.
 - iii. Negatives:
 1. Does not properly reflect recipient’s ability to pay.
 2. Incentives -- creates huge hole in tax system! Incentives to claim everything is a gift!
- b. Distinguishing True Gifts:
 - i. Non-Employee Gifts:
 1. *Duberstein*:
 - a. Holding: not a gift – Cadillac for business referrals.
 - b. Test: Gift under § 102 requires “**detached & disinterested generosity.**”
 2. Reasoning:
 - a. Common law concept of gift would exclude too much (here, no consideration, but 7 year business relationship, hope of future referrals – need to catch).
 - b. Rejects gov’t’s per se rule of no gifts in commercial context, b/c hard to swallow in face of § 102 language.
 - c. TP-friendly result: Preserves category of commercial gifts, though narrow.
 3. Critique:
 - a. Hard to apply intent-based rule (D&D).
 - b. Allows situation where Donor takes deduction, Donee not include (as here).
 - c. Kane: No shifting or intrusiveness concerns in business context – policy reasons for gift exception disappear - corporate gifts should never be allowed.
 4. Commercial gifts are indirectly curtailed by **disallowing deduction over \$25. §274(b).**
 - a. Transferor must make look more like T/B expense to get full deduct.
 - b. Theoretically possible for separate fact-finders to allow full deduct for transferor (162), and no include for transferee (102, D&D).
 - c. Tip vs. gift line depend on expectation of tip, true affection.
 - d. D&D is stronger b/c strangers w/o hope of return service.
 - ii. Employer-Employee Gifts: are presumptively taxed as salary §102(c).
 1. But exclude “employee achievement awards” §74(c) and de minimis fringes §132(e).

2. Employee Achievement Awards defined § 274(j) – tangible personal property, meaningful presentation, not disguised compensation, average cost less than \$400.

Commercial Gifts:

Parties Involved	Transferor	Transferee
Employer/Employee: compensation	'ER: Deduct §162 (no 50% cap, § 274(n)(2)(A))	'EE: Include §61, § 102(c) (Note: § 102(a) does not apply in 'ER-'EE situation)
Employer/Employee: gift (not really possible)	'ER: Deduct §162 (presumptively salary), OR proxy taxation <i>Danville</i>	'EE: Include generally. § 61, §102(c) (presumptively salary). But exclude if §74(c) achievement awards or §132(e) de minimis fringe (exclusion window very small)
Commercial: business exchange (e.g., car for future referrals)	Deduct §162 OR proxy taxation <i>Danville</i> , entertainment subject to §274 50% cap	Include §61 (windfall)
Commercial: gift (for goodwill)	Deduction capped at \$25 §274(b) (linked to § 102(a) D&D gift) → proxy taxation	Exclude if "D&D." §102(a), <i>Duberstein</i> . (VERY SMALL window)

TPs will try to straddle these boxes (company: full deduct/client: exclude)

- iii. Middle Cases – continuum of personal gift v. business compensation
 1. *Harris*: payments to mistresses were gifts → excludable.
 2. Rule: Cash for specific session of sex ≠ gift (prostitution) → include. But if relationship beyond sex, then gift → exclude.
 3. Policy: In sexual relationship, policy reasons for gift exclusion more present – there might be **shifting** (familyish, affection) and we might not want to **intrude** (sex + relationship would be gift, even if no legal entitlement).
 4. Kane: In fact, better rule would be to exclude all payments for sex (avoid intrusiveness don't lose anything b/c no reporting anyway).
- iv. Family Context
 1. Gifts w/in family can fail D&D test. E.g., For example, elderly parent says to child: I will give you \$100,000 if you come back and live with me and take the place of my live-in nurse. But must distinguish warm glow feelings from actual expectation of something in return. Practically, don't generally inquire into donor motive in family.
 2. Transfers b/w spouses tax-free; not subject to D&D test. § 1041.

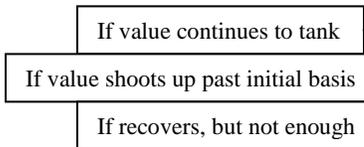
Gift Continuum:				
"CORE" EXCLUSION	----->			less likely to exclude
I-----I-----I-----I-----I				
Dependent child (food)	Adult child (rent)	Mistress	Duberstein*	Pure Business
Legal support obligation	Intrusiveness concern (but no legal obligation)	Intrusiveness/affection	D&D	(Include)

- c. Scholarships § 117.
 - i. "Qualified" Scholarships excludable:
 1. Must be degree candidate § 117(a).
 2. Only for tuition, fees and books § 117(b)(2). Room and board portion is income.
 3. Exclusion denied to the extent that services are performed § 117(c). Hammers grad students.
 - ii. Rev. Rul.: As long as scholarship goes to student regardless of services, get the exclusion.
 1. Athletic scholarships – nominally, not contingent on playing. Wiggle room.
 - iii. Shaky Policy:
 1. Value education – but can help education in many ways; this may not be best way.
 2. Students are poor – then why not help student who is working to finance school?
 3. Similarity to gift – this is probably reason why, but normal gift policies not present.
- d. Welfare/Unemployment
 - i. Welfare: excludable, as outside the scope of § 61 (§ 102 inapplicable)
 - ii. Unemployment payments: includable, under § 85.
 - iii. TANF payments: excludable as outside § 61 if based on need, and directly from welfare agency.
- e. Social Security Benefits

- i. Excluded if AGI < \$32K; As income rises, inclusion rises. § 86.
- f. Alimony vs. Gift
 - i. Alimony – deduct/include rule. Obligation terminates upon re-marriage of ex-spouse.
 - ii. Rev. Rul. 82-155:
 - 1. If know of re-marriage but continue to pay → gift, exclude under § 102/no deduct.
 - 2. If don't know of re-marriage → include; but no deduct.
- g. Basis Transfer on Gifts
 - i. Basis:
 - 1. Reference point of tax liability; TPs like big basis – offsets tax liability
 - 2. Rule: Gain does not include recovery of basis. Here's why:
 - a. § 61(a)(3) → income only includes “gains” from property
 - b. § 1001(a) → “Gain” = Amount Realized – Adjusted Basis
 - c. § 1001(b) → Amount Realized = Cash + FMV of Property Received
 - d. § 1001(c) → Recognize Amount Realized unless ...
 - e. § 1011(a) → Adjusted Basis = § 1012 Initial Basis +/- § 1016 Adjustments
 - f. § 1012 → Initial Basis = cost of asset
 - g. § 1016 → Adjustments prior to disposition (e.g., depreciation, etc).

Type of Gift	Increased Value at Time of Transfer	Decreased Value At Time of Transfer
Inter Vivos transfer	§ 1015 – substituted basis	§ 1015 – floating basis (substituted basis or FMV at time of transfer)
Transfer at Death	§ 1014 – FMV basis (“step up”) -- very generous to TPs (appreciation escapes tax)	§ 1014 – FMV basis (“step down”) -- bad for TPs – don't want to transfer depreciated property at death

- h. Inter Vivos Transfers:
 - i. Transfer is not realization.
 - ii. Gifts take **substituted basis**. §1015. Donee's basis = Donor's basis.
 - 1. *Taft*: Substituted basis constitutional; OK to tax recipient on pre-transfer appreciation.
 - 2. Reason: Not a direct tax on property; appreciation is income from policy. Formalistic.
 - 3. Policy: Otherwise, would lose ability to tax appreciated property altogether.
 - iii. UNLESS, FMV at time of transfer is less than basis → **Floating basis**. § 1015. At disposition:
 - 1. For purpose of calculating LOSS, Basis = FMV at time of transfer.
 - 2. For purpose of calculating GAIN, Basis = Substituted Basis.
 - 3. If amount realized falls b/w higher substituted basis and lower FMV basis → neither gain nor loss. Reg. 1.1015-1(a)(2).
 - iv. Unless between spouses, §1015(e), in which case determined by §1041 (always **substituted basis**, even if transferred at a loss).
 - v. Policy:
 - 1. Equity: Need substituted basis rule, or else could always avoid gains by gift.
 - 2. Never makes sense to gift property with a built-in loss if donee will sell at loss. The donor should sell it himself, take high basis.



- i. Transfers at Death:
 - i. Devisee takes a **stepped-up** basis to **FMV at time of death**. § 1014.
 - ii. Appreciation accumulated during life is never taxed. § 1014.
 - iii. If property has appreciated, incentive to wait until death to transfer.
 - iv. If property has depreciated, better to sell before death so the basis is not stepped-down.
- j. Calculation (for property disposed of after transfer from A to B):
 - i. Initial Basis = Cost to A (§ 1012)
 - ii. Calculate Adjustments in hands of A (e.g., for depreciation deductions) (§1016)
 - iii. Adjusted Basis for A = Initial Basis +/- Adjustments (§1011)
 - iv. Calculate Adjusted Basis for B
 - 1. If gift: Adjusted Basis for B = Adjusted Basis for A OR Floating Basis (§ 1015)
 - 2. If death: Adjusted Basis for B = FMV at time of death (§ 1014)
 - 3. Plus/minus any further adjustments in the hands of B
 - v. Amount Realized = Cash + FMV of property received (§1001(a))
 - vi. Gain = Amount Realized – Adjusted Basis for B (§1001(a))
 - vii. Recognize, unless there is a non-recognition provision (§ 1001(c))
- k. Divided Interests (§ 102(b)):

- i. Gift exclusion does not extend to income earned from gifted property. §102(b)(1). Can't give a gift of all future income in perpetuity!
- ii. One-person rule: Exclude gift, but not subsequent income. §102(b)(1).
- iii. Multi-party rule: Treat 2 persons same as 1 person. §102(b)(2). "All income" rule.
 - 1. Otherwise, could avoid § 102(b)(1) simply by splitting gift between 2 people.
- iv. *Irwin v. Gavit*: A receives trust interest for 15 years; B receives remainder.
 - 1. Result: A: inclusion; B: exclusion ("all income" rule). Rejects "all gift" rule.
- v. Note: Economically "correct" answer would be that donor can only give the current value of the property (not the future income stream), and each party receives some portion of present value, which should be taxed. But this is administratively complex. Actual rule is multi-party rule.

E. Recovery of Capital – Problems of Basis

1. Introduction

- a. Basic Rule: Income does not include recovery of one's capital.
- b. Problem: Hard to determine basis when don't dispose of whole property at once.
- c. Easy case: If sell the whole thing at once, exclude basis.
- d. Next easiest case: Homogeneous parcels. Exclude proportional fraction of basis.
 - i. E.g., Buy 4 identical parcels for \$100. Sell only 1 parcel. Basis is $\frac{1}{4}(100) = \$25$.
- e. Hard case: When property is not homogeneous.
- f. RULE: Regs 1.61-6 → Allocate
 - i. Even though you bought it as a whole; imagine hypothetically you had bought it in pieces; recover the "allocated basis" – allocable portion of the cost basis.
 - ii. Must allocate EVEN if it's only a guess.
- g. In real world, may be very hard to allocate—hard to know what fraction of the whole that piece represents.

2. Sale of Easements – Problem of Apportionment

- a. Reg. §1.61-6(a): equitably apportion sale of property, and sale of easement is like a sale of property.
- b. Rule: MUST allocate, even if inexact. BUT: Can argue for basis-first rule if plausible that there is NO gain at all, i.e., the basis allocable to the damage is MORE than the full payment.
- c. *Inaja*:
 - i. Initial basis: \$61K. Settlement payment of \$49K for (1) past damages; (2) future easement.
 - ii. Gov't argument: \$49K is ALL INCOME – compensation for lost profits. Problem: Property value has gone down. Not merely lost profits (i.e., from foregone fishing operation).
 - iii. TP argument: NO INCOME – basis-first rule. No income until first exhaust basis.
 - iv. In-between argument: Allocation rule: TP has essentially disposed of portion of property. Must allocate to determine basis, to determine taxable income. Reg 1.61-6.
 - v. Holding: TP wins b/c of uncertainty; plausible that city has taken ALL the value of the land.

3. Life Insurance

- a. Very tax-favorable for two reasons:
 - i. Recovery from LI is **excluded** from gross income. § 101(a)(1). (Premiums not deductible.)
 - ii. **No tax on inside build-up** (i.e., the implicit interest income). (Based on realization principle.)
- b. Why? We want to encourage LI. Plus, funeral expenses, etc. hard to account for. Plus, politics?
- c. For "pure" (basic term) life insurance, tax revenue in aggregate is roughly accurate. Pay in = pay out.
- d. But for any insurance beyond basic term insurance, there is a savings element that is untaxed.
 - i. In early years, premium payments overshoot "pure" premiums; In later years, premium payments undershoot "pure" premiums (draw on savings from early payments.)
 - ii. Savings Elements: Amount paid out, in aggregate, exceeds amount paid in, in aggregate.
 - iii. No tax on this inside build-up. Treated like stock, unlike bank account. Not treated as owning the underlying asset; just the separate piece of property. No tax until realized.
- e. Distortion: Sucker who puts money in bank account is taxed on interest; Person who buys LI isn't!
- f. Tax laws put limits on LI; can't just call something LI to get the benefit:
 - i. For given amount of savings, must have proportionate amount of LI to get the benefit.
 - ii. Must cede some control to the LI company; if you can call Met Life and tell them which stock to buy/sell, then you are treated as holding the underlying assets and are taxed on them.
- g. More fees for LI.
 - i. Actuaries have to calculate mortality risk, etc. – more costly.
 - ii. Also: company is probably charging you for the tax benefit.
- h. Backing out: you don't get back your "investment in the contract" (premiums) but you get back what you paid above that (savings + income). [true?]

	Lottery	Term Life Insurance (if you die w/in term, get payout; if not, get nothing)
Gain	Buy ticket for \$10K; Win \$100K	Buy policy for \$10K; Die, payout is \$100K
Tax treatment	Tax: Include \$90K (the \$10K was like a basis), § 61	Tax: Exclude (§ 101)
Loss	Buy ticket for \$10K; Win \$0	Buy policy for \$10K; Don't die, no payout
Tax treatment	Tax: Capped deduction (§ 165(d), up to \$10K	Tax: No deduction

- d. Why?
- i. Consumption: there is consumption aspect in gambling even when lose, so you can't deduct it.
 - ii. Enforcement:
 1. *Parchutz*: had gambling loss tickets, but no proof they were his, no deduction.
 2. If allowed unlimited deduction, everyone would "stoop" for losing tickets – tax break!
 3. LI has perfect net 0 taxation, b/c gains can't be hidden. But in gambling, all losses would be reported but not all gains. So we limit deductions. Proxy Taxation.
- e. If disputed → see *Zarin*.

6. Recovery of Loss (*Clark*)– Valuation Problems

- a. *Clark*: Attorney's payment to compensate for bad tax advice was not taxable income to TP.
- b. *IRS Rule*: Exclusion only if TP ultimately paid more than the minimum tax actually due, given all relevant facts. Does not apply if advisor just underestimated, or advised to structure facts badly.
 - i. E.g., If tax due should be \$20, but TP has to pay \$30 b/c mistake, then deduct \$10 if reimbursed.
 - ii. But if tax due is \$30, and TP pays \$30, then no deduct, even if tax advisor mistakenly thought \$20, and subsequently reimburses for "mistake." Mistake didn't actually affect tax liability.
- c. Distinguishes *Old Colony Trust*: paying taxes for someone in return for services rendered is income.
 - i. Tax overpayment operates as quasi-**basis**. Recovery of basis → excludable.
- d. *Clark* remains good law – but its foundation: "not from labor or capital" is overturned by *Glenshaw*.
- e. Equity concerns:
 - i. Clark rule achieves equity b/w Clark & person who received good advice.
 - ii. But no equity b/w Clark & person who received bad advice w/o reimbursement.
- f. Administrative **valuation** problem w/o actual reimbursement:
 - i. Cannot determine appropriate amount of deduction, absent a real recovery.
 - ii. Proof problem – incentive to overclaim and inflate losses.
 - iii. No benchmark – compare against great tax advisor, or just a decent one?
 - iv. Analogous to reverse-*Glenshaw* problem. If find money on street, include (windfall). But if lose money, no deduction, b/c of proof problem. In perfect world, would get deduction. But: If find the lost money later (in subsequent year), can exclude (cite *Clark*).

F. Transactions Involving Loans

1. Loans:
 - a. **Basic Rule: Loan proceeds are not income.** (No specific code provision says this.)
 - i. When you repay, no deduction (on principal, at least).
 - b. Reason: Offsetting liability to repay. Based on assumption you will pay it back.
 - c. Payment of interest may be deductible (depending on what you use the loan for).
 - d. Recourse Loan: Creditor is able to go after other assets of the debtor to repay.
 - e. Non-Recourse Loan: Creditor can't reach debtor's assets beyond the security interest.
 - f. **Tax system gives you an advantage if you take a NR loan on an appreciated asset:**
 - i. Appreciation of asset doesn't count as realization, b/c assume no liquidity – no tax.
 - ii. But if take out NR loan on the asset (e.g., stock):
 1. Get liquidity, and
 2. "Lock in" gain, because can surrender asset if value drops.
 - iii. Equivalent to selling the asset – get liquidity, certainty of gain – but w/o tax.
 - iv. Plus, can still capture up-side gain in asset (eliminate possibility of loss, but not of gain).
2. Discharge of Indebtedness
 - a. If end up not paying back the loan:

- i. Ex ante exclusion rule no longer justified (based on assumption you would pay back).
 - ii. Must account for the difference ex post → say you have “income” from DOI.
 - b. Rule:

<ul style="list-style-type: none"> i. § 61(a)(12): Gross income includes DOI. Case law further defines this rule. ii. § 108(a): Exclusion – no DOI if in insolvency or bankruptcy. iii. § 108(e)(5): Adjustment of purchase money debt ≠ DOI. (Just changing the price.)

 - c. *Kirby Lumber*:
 - i. Took loan of \$1M; then discharged debt for only \$900K (bought back bonds at cheaper price)
 - ii. Result: Include difference (\$100K) as income from DOI (§61(a)(12)).
 - iii. Old Kirby: “Freeing of Assets”
 - 1. DOI only if transactionally better off, looking at BOTH sides of balance sheet (assets and liabilities). No DOI if assets also go down.
 - 2. *Kerbaugh-Empire*: lost value of loan in failed business: no income b/c TP lost overall on the whole transaction. No “freeing of the assets.”
 - iv. New Kirby: reject need for “freeing of assets” ← prevailing rule
 - 1. Only look at liabilities side of the balance sheet. If that goes down, then DOI. Rejects transactional view: What you did with the loan is irrelevant.
 - 2. *Vukosovich*: Assets are irrelevant → New Kirby
 - v. Can also argue per *Estate of Franklin* that there was no loan in the first place
 - d. Note: Someone else satisfying your loan = Income, but not DOI:
 - i. If someone else pays of your loan, you have income under § 61(a)(1) as “indirect payment” or “economic benefit.” Not DOI, b/c debt was paid off in full. Analogy: Other person gives you cash, and then you pay off the loan. No DOI. Just income.
 - e. Child support obligations
 - i. Does non-custodial parent realize income from DOI when fails to make legally required child-support payment?
 - ii. Argument for NO: Not like a loan. There was no exclusion in the first place.
 - iii. Argument for YES: You are better off than the person who *did* make they payment. Should be socked w/ a DOI inclusion to capture that.
 - iv. No right answer.
3. Contested Liability Doctrine (*Zarin*):
- a. *Zarin*: Borrows \$3.4M gambling chips on credit; Settles debt w/ casino for \$500K. DOI?
 - i. Holding: No DOI. Reasoning:
 - b. No-indebtedness argument:
 - i. § 108(d)(1) defines debt for purposes of § 108 and § 61(a)(12).
 - 1. § 108(d)(1): Indebtedness of Taxpayer – For purposes of this section, the term “indebtedness of the taxpayer” means any indebtedness: (A) for which the TP is liable [i.e., Recourse], or (B) subject to which the TP holds property [i.e., Non-Recourse].
 - ii. Loan was illegal under gambling laws, so TP was never liable for it, so no indebtedness.
 - iii. This makes the TP even worse off, b/c if no indebtedness, then should have included entire \$3.4M in income at outset!
 - c. Contested Liability Doctrine:
 - i. Rule: If debtor and creditor disagree over amount of debt, then debt not “liquidated” until agree on settlement amount. In that case, no DOI.
 - ii. Sobel: Questionable VALUE of original loan. Plausible argument stock wasn’t worth what bank said it was worth when made the deal. Even though used note that said “\$21K,” argument that really only borrowed whatever the stocks were worth. Holding: No DOI (contested liability doctrine).
 - iii. Hall: Questionable ENFORCEABILITY of original loan. TP settled gambling debt for lesser value in-kind payment of cattle. Holding: No DOI (contested liability doctrine). Transfer determines value. BUT: Enforceability question only tells us what TP has to pay back to creditor. Doesn’t change what he received on front-end. Unenforceable debts should still be taxed as DOI, under New Kirby.
 - d. If VALUE contested, CLD should apply
 - i. E.g., Lemon car, bought on purchase money debt. (Purchase money debt = debt offered by seller to buyer.) Seller knocks down note when engine falls out. No DOI.
 - ii. § 108(e)(5): Adjustment of purchase money debt ≠ DOI. (Just changing the price.)
 - e. If ENFORCEABILITY contested, CLD applies, but should not apply, under New Kirby
 - i. E.g., Dissolute celebrity borrows \$3.4M, blows it all, can’t repay, has lots of other debt; creditor unsure whether he’ll recover, settles for \$500K.

- ii. Under New Kirby, clearly DOI.
 - iii. But under Hall and Zarin, no DOI.
 - f. **Key question: What value did the transfer from the casino to Zarin have?** No answer.
 - g. Zarin must show chips had LOWER VALUE, not that debt is UNENFORCEABLE.
 - i. Argument loan was worth \$3.4M:
 - 1. The chips had econ value of \$3.4M. If he had won, payout based on \$3.4M.
 - ii. Argument loan was worth zero:
 - 1. Z is a compulsive gambler. Odds guarantee that in the end, he will lose.
4. Conditional Gifts (Diedrich)
- a. Example
 - i. Donor gives gift of appreciated property → gives rise to gift tax (falls on donor) → Donor conditions the gift on the donee's paying the gift tax.
 - ii. E.g., Stock, w/ FMV: \$300K; Basis: \$50K. Gift Tax = 20% x 300K = 60K.
 - iii. Parent gives kid the stock; Kid pays off the \$60K owed by parent in gift tax.
 - b. Actual rule (like a bargained-sale; donee is paying donor for the gift):

<ul style="list-style-type: none"> i. <u>Donor</u>: Gain = Discharged Gift Tax – Basis [BUT: no loss allowed]. Reg 1.1001-1(e); ii. <u>Donee</u>: Basis = Greater of: Amount Paid OR Substituted Basis. Reg 1.1015-4 <ul style="list-style-type: none"> 1. But: Use Floating Basis if Substituted Basis > FMV at transfer. Reg. 1.1015-4, ex. 4.

 - iii. Example: FMV: \$300K; Basis: \$50K. Gift Tax = 60K
 - 1. Donor: Gain = 60K – 50K = 10K gain.
 - 2. Donee: Basis = Amount Paid is greater = \$60K basis.
 - c. Reject “net gift” rule:
 - i. The conditional donee payment is not a gift (no D&D); it is “buying” the larger gift.
 - ii. Would result in no tax liability: Donor: no gain. Donee: exclude (§ 102).
 - d. Best rule:
 - i. Divide property into “sold” portion and “gift” portion; then ALLOCATE.
 - 1. “Nor is there any doubt that had the donors sold a portion of the stock immediately before the gift transfer in order to raise funds to pay the expected gift tax, a taxable gain would have been realized.” – *Deidrich*, p. 161.
 - ii. Tax “sold” portion as a sale. Gain = Amt. Realized – Allocable Basis.
 - iii. No tax on “gift” portion.
 - iv. Basis going forward = (FMV of “sold” portion) + (substituted allocable basis of “gift” portion).
 - v. Note: Compared to this rule, the actual rule is very TP friendly—allows Donor to recover ENTIRE basis, even though really should only be entitled to ALLOCABLE basis.
 - vi. Example
 - 1. Donor: Gain = 60K – 10K (allocable basis, i.e., 1/5 x 50K) = 50K gain.
 - 2. Donee: Basis = (FMV of sold portion = 60K) + (substituted basis on gift portion = 40K) = 100K.
 - e. Note: Still better for parents to make conditional gifts than to sell portion to third party to satisfy the gift tax; Get to recover full basis instead of just allocable portion. Though gain on property is preserved through substituted basis.
5. Transfer of Property Subject to Debt
- a. Economic vs. Tax Depreciation
 - i. Economic Depreciation → capital assets generally go down in value over time (except land).
 - ii. Tax Depreciation → Tax break on account of economic depreciation; but usually more accelerated.
 - 1. Tax depreciation gives TP a **timing advantage** → incentive to invest.
 - 2. At disposition, Economic and Tax position are equalized through basis rules.
 - 3. Original basis is reduced by amount of tax depreciation claimed. § 1016. To the extent that tax depreciation overshoot economic depreciation, this will be reflected in larger gain at disposition.
 - b. Debt and Cost Basis
 - i. If TP acquires asset w/ debt financing, this amount is included in basis. § 1012.
 - c. Debt and Sales
 - i. If Buyer assumes Seller's debt in a sale, this is treated as amount realized by Seller.
 - ii. Intuition: Equivalent to case where Buyer provides cash, and Seller satisfies the liability.
 - d. Crane: Rule: NR debt of property is **included in basis and amount realized – symmetrical inclusion**.
 - i. TP received property subject to NR mortgage. NR debt = FMV at time of transfer.
 - ii. TP's theory:

1. Under § 1014, “property” = “equity.” B/c property inherited was encumbered by lien that equaled the FMV of property, never really had anything. No equity.
 2. Note: b/c basis = 0 here, depreciation deductions were therefore improper.
 3. Only gain was the \$2K cash from the sale.
- iii. Gov’t theory:
1. Initial Basis = Appraised value of land at time of transfer (notwithstanding lien).
 2. Deductions were allowable, and have now reduced basis.
 3. Amount Realized includes cash plus the discharge of the NR mortgage.
- iv. Court: Include NR debt in basis and in amount realized.
1. Plain language: “property” = property, not equity.
 2. Depreciation: Property has value, should depreciate. Can’t if basis = 0.
 3. Admin: Equity is always changing. Easier to have a fixed basis.
 4. Consistency: Need symmetry. Upset at TP’s inconsistent positions.
- v. **KEY POINT OF CRANE: SYMMETRY** – Must treat NR debt the same at beginning/end.
1. Need consistency: Initial Basis (§ 1014), Depreciation, and Amount Realized (§ 1001).
 2. Consistency is necessary to align tax and economics at end of day.
 3. But, two ways to be symmetric: Consistent inclusion, or consistent exclusion.
- vi. Possible problems with Crane rule:
1. Timing: TP gets tax benefit upfront w/ high basis and deductions. (probably OK)
 2. Tax Shelters: deductions will offset other unrelated income with no economic loss.
 - a. False inflation of basis at time of acquisition – problem softened by Estate of Franklin and Pleasant Summit.
 - b. Basis at time of disposition – remedied by Tufts.
- vii. **Footnote 37:**
1. “Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot.”
 2. Implication: If NR Debt > FMV → Amt. Realized is capped at FMV.
 3. Why? TP only really feels benefit worth FMV of property, b/c most bank could seize is property – could never get out of you whatever amount the note says.
- viii. FN 37 gives rise to two problems:
1. Basis at time of Disposition → solved by Tufts
 - a. If amount realized is capped at FMV, then TP gets tax benefit when FMV tanks. Will only realize FMV, even though has been taking deductions based on high basis (NR debt). Creates tax losses w/o concomitant economic loss.
 2. Basis at time of Acquisition → limited by Estate of Franklin, Pleasant Summit
 - a. Buyer can increase deductions by inflating amount of sale agreement. Value can be arbitrarily inflated, b/c loan will never get repaid. Buyer will just walk away. Seller won’t have to include until principal paid back (never).
- e. Inflated Basis Issue (When FMV < NR Debt at time of Acquisition):
- i. Estate of Franklin:
 1. Sale/lease-back arrangement. Seller retains possession. Only difference in the world: right to take depreciation has transferred to Buyer. This is permissible.
 2. BUT: Stated purchase price is highly inflated. Nowhere near FMV. Based on FN 37, no economic constraint on that number (Buyer can just walk away w/o ever realizing that much). Bumps up deduction rate for Buyer. No effect on Seller, b/c only receives “promise to pay”—no actual income until principal starts being paid back.
 3. Court rejected transaction entirely. Not even a sale, b/c so fraudulent. Sale price was enormous, and no risk at all. NR debt lacked econ substance b/c unlikely to repay.
 4. Rule: If TP has ZERO equity (i.e., amount of NR loan exceeds FMV of property), TP is not treated as the “owner” for the purpose of taking depreciation deductions.
 5. Basis Rule: Basis is only your out-of-pocket expenses—don’t include “debt” (rejection of Crane). → Apply this rule in abusive cases; 0% likelihood repayment; Buyer and Seller can just write anything on a piece of paper.
 6. Worry: Future TPs will not be so egregious: will add a little equity, inflate less.
 - ii. Pleasant Summit:
 1. Pre-existing NR loan on property: \$1M. FMV of property: \$400K. Third party buys for: \$1,000 cash (still encumbered by loan).

2. Why would 3rd party buy? Thinks can settle debt w/ bank for less than what he can sell property for. FMV is not actually known. Hard to tell w/ sinking assets.
 3. Rule: Basis = FMV of property + out-of-pocket expenses. → Apply this rule in non-abusive case; where there is pre-existing debt, so buyer will have to settle w/creditor for something similar to FMV; won't pay nothing, but no chance will actually pay face value of NR debt.
- iii. Which Rule To Apply to Determine Basis for NR-debt-financed Purchases:
- | |
|---|
| <ol style="list-style-type: none"> 1. Unifying Principle: Basis depends on what you will actually pay! 2. Basis = out of pocket, plus amount of debt we think you will actually pay back. 3. <u>Crane rule</u>: Basis = Out of Pocket + NR Debt → apply if likely to repay; FMV > NR Debt (e.g., property value high) 4. <u>Franklin rule</u>: Basis = Out of Pocket only → apply in abuse case; 0% likelihood of repayment (e.g., seller is lender) 5. <u>Pleasant Summit rule</u>: Basis = Out of Pocket + FMV → apply if no abuse; pre-existing debt w/ 3rd party must be settled |
|---|
- f. Discharge of Loan issue (When FMV < NR Debt at Time of Disposition):
- i. Tufts:
 1. TP purchases w/ NR debt. Takes deductions using high basis. Then FMV tanks, transfers to 3rd party. Uses FMV (not NR value) for amt realized (relying on FN 37).
 2. **Holding: Amount realized in sale includes the FACE VALUE of the NR debt, regardless of whether the FMV of the property has dropped. Rejects FN 37.**
 3. Reasoning: Overarching principle of Crane is symmetrical inclusion. Must look at both sides of transaction. Don't just ask "How much better off are you when relieved of that debt at disposition?" Also must take account of high basis at outset.
 4. Good policy: Makes tax = economics. (TP gets timing advantage only.)
 5. But note: Gain is capital gain, not DOI (ordinary income), so still a little shelter.
 - ii. O'Connor concurrence (Bifurcation):
 1. Should bifurcate the loan transactions and property transactions.
 - a. Property: buy property for cash; then later, sell for less. → Capital Loss.
 - b. Loan: Borrow NR loan from bank for full value of property; then later, settle for less than full value of the loan. → DOI income. Per *Kirby Lumber*.
 2. Pros:
 - a. Accords w/ §1001 language: amount realized = cash + FMV. (Tufts majority requires a fiction about how much "better off" you are when sell.)
 - b. Deductions and gain would match in character:
 - i. Tufts holding: Deductions were against ordinary income; but recapturing gains as capital gains.
 - ii. O'Connor: Gains are captured separately through DOI, which is ordinary income. Takes away Tax Shelter potential. Property would be capital loss (but only if FMV went below basis, not below NRD).
 - iii. Note: Capital losses can be offset against ordinary income up to 3K. So no capital loss under O'Connor unless significantly below basis.
 - c. Continuity of Basis:
 - i. Tufts holding creates discontinuity in basis, in conjunction w/ Pleasant Summit. Runs counter to logic of § 1001.
 1. Seller (governed by Tufts): amount realized includes full face value of NR debt.
 2. Buyer (governed by P.S.): basis for purchaser is only FMV.
 - ii. O'Connor's approach restores continuity. FMV = Seller's amount realized AND Buyer's basis.
 3. Cons:
 - a. IRS has been using these rules for years. Not so clearly wrong that should change. Not just writing on a blank slate with only *Crane*.
 - b. Assumption of debt is not quite the same as DOI.
- g. Main point regarding transfers of property subject to debt:
- i. **If sufficiently high likelihood of loan repayment, should include in basis.**
 - ii. Ex ante information problem: Don't know how likely repayment is.
 - iii. Correlates to riskiness of the loan → but this does NOT translate into a Recourse/NR line.
 1. E.g., NR loan secured by \$3M home in the Hamptons is a really secure, low-risk loan!

- iv. Two reasons banks would prefer NR loans:
 - 1. Sometimes less risky (if have really good security interest, as above).
 - 2. Monitoring is easier (easier to assess land parcel than person's overall worth)
- v. Tax system has trended toward rule of inclusion. I.e., assumed TPs will repay.
- vi. Has created patches when assumptions fails – happens most often in NR context.
 - 1. Tufts – include loan in amount realized, § 1001 logic be damned (not better off).
 - 2. Estate of Franklin, Pleasant Summit – ways of dealing w/ inflated basis issue.

G. Miscellaneous Items—Personal/Business Injuries, Illegal Income, Exempt Bonds, Gain from the Sale of a Home

1. Taxation of Damages (by suit or by settlement)

Categories	Business	Individuals
Medical Costs, out of pocket	N/A	Exclude , § 104(a)(2) to the extent the payment is for 'personal physical injuries' or 'physical sickness' (e.g., not for libel suit). Sound policy: it makes you whole, not income. Only problem: Person who gets recovery better off than person who doesn't (like Clark problem).
Lost profits	Include § 61 (in year received) (compensates for income, makes sense)	Exclude , § 104(a)(2) if for "personal physical injury or physical sickness" (doesn't distinguish b/w medical costs and lost profits). (Note: This "should" be income, but often hard to distinguish b/w medical costs and lost profits—can bleed into each other. Only true for individuals. So extend exclusion for lost profits for individuals.)
Punitive	Include , § 61, <i>Glenshaw</i> (in year received)	Include , § 61, <i>Glenshaw</i> (explicitly kicked out of § 104(a)(2) exclusion → back to inclusion.)
Damage to Property (e.g., involuntary sale of property)	Include but get Basis Recovery (as if sold) § 61(a)(3), § 1001 (basis) – i.e., only excess over basis is taxed. Note: Basis allocation might implicate <i>Inaja</i> issues. BUT Involuntary Conversion rule: Can defer gain if reinvest in "similar or related" service or use w/in 2 years, § 1033.	Include but get Basis Recovery (same rules as businesses, b/c § 104(a)(2) doesn't reach property damage—only for "personal" physical injury). Doctrinal framework: §§ 61(a)(3), 1001, 1033. (And no § 104(a)(2).)

Individuals and businesses treated differently here

2. Structured Settlements

- a. Damages excludable under § 104(a)(2): "whether as lump sums or as periodic payments."
- b. If take as lump sum, any interest you subsequently receive on award is taxed (income from property).
- c. If take as periodic payments, can bundle with implicit interest payment, but not taxed.
- d. TP's ideal: Get all the principal and interest, w/o paying tax on any of it.
 - i. Baseline: Award (principal) (excluded) + Interest (included).
 - ii. Structured Settlement: If award is paid later, will contain "interest," but can exclude.
- e. If payor is individual:
 - i. Damages payments are NOT deductible. Structured settlement only changes *who* is taxed on the interest (payor/tortfeasor instead of payee/victim).
 - ii. Only beneficial if payor has lower tax rate.
- f. If payor is business:
 - i. Damages payments ARE deductible (cost of doing business). D has to include interest income as earned, but gets to deduct it when pay out as award. But D wants early deductions.
 - ii. Solution: Structured Settlement – **qualified settlement funds** § 468(b) (timing provision) –
 - 1. Payor pays \$ into trust and gets upfront deductions; Trust pays out over time to Payee.

- iii. Advantages:
 - 1. Up front deduction of whole amount to Payor.
 - 2. Interest not included in income of Payee. (And can defer inclusion of punitives.)
- iv. Generous rule: Can be very large in a class action.

3. Illegal Income

a. Rule:

- i. Theft: Amount stolen included as income. (Illegality irrelevant.)
- ii. Embezzlement: Amount embezzled included as income. *James*.
- iii. If pay back: Get deduction. Rev. Rul. 65-254. (Or if pay back in same year, then it's a wash.)
- iv. If give mere promissory note: Not enough to erase inclusion. *Buff*.

b. Policy Issues:

- i. Unlikely to repay – not like a loan → include.
- ii. Government “dirty hands,” sharing in ill-gotten gains → points to exclude.

c. *Gilbert*:

- i. Took \$2M from company to meet margin call.
- ii. Holding: Exclude. Departs from usual embezzlement rule.
 - 1. Unlike *James*, he took money w/o consent but he intended to re-pay.
 - 2. Unlike *Buff*, he gave more than a note; gave assignment of valuable property.

d. Spectrum:

I-----I-----I-----I	I-----I-----I-----I	I-----I-----I-----I	I-----I-----I-----I
Theft Inclusion	Embezzlement (<i>James</i>) Inclusion	Embezzle-light (<i>Gilbert</i>) Exclusion	Loan Exclusion

- i. *James*: If no consensual recognition → Include as income.
 - 1. Pros: BL rule; easy to apply; If end up paying back, get deduction.
 - 2. Con: Gov't sharing in ill-gotten gains; plus, paying tax makes repayment less likely.
- ii. *Gilbert*: Fact-intensive inquiry re likelihood of repayment, whether good guy → Exclude.
 - 1. Pros: Avoids gov't sharing in ill-gotten gains; maybe gets repayment issue right.
 - 2. Con: Hard to apply, hard to know the rule; might miss income.
- e. Loans: exclude, but include if you happen to get out of paying (DOI).

4. Tax Exempt Bonds (§ 103)

- a. § 103 – Exclusion: income from qualified state and local bonds is excluded from income.
- b. Market shift: Tax-exempt bonds get lower interest rate due to tax benefit; results in **implicit tax** on non-tax-exempt bonds. Therefore, state can issue the tax-exempt bond for cheaper than otherwise could.
- c. Result: **§ 103 shifts revenue from federal government to the states.**
 - i. Effect is indirect, through resultant lower interest rates that state has to pay out.
 - ii. Query: Is it better for fed to transfer revenue indirectly (as under § 103), or better to use direct transfers, where could exert more power, e.g., build this thing and we'll give you this \$\$.
- d. Tax Arbitrage: Not allowed to take out loan, pay deductible interest, and then buy tax-exempt bond and get interest payments tax-free to reduce taxes. § 265(a)(2). In that case, interest on loan not deductible.

5. Sale of Home (§ 121)

- a. Rule: If sell home, can exclude up to \$250K (or if married, can exclude \$500K). § 121.
 - i. No deduction if home goes down in value.
 - ii. Because of inflation, \$250K is no longer as generous as it used to be. Maybe § 121 is too restrictive—everyone should get § 121 benefit on at least *one* house.
- b. 2 of 5 rule:
 - i. Must be principal residence for periods aggregating 2 out of last 5 years. (Can be more than 1.)
 - ii. Reason: Trying to prevent flipping, or getting exclusion for selling vacation home.
 - iii. Exception to rule: If you move b/c of your job in under 2 years, can still get benefit.
 - iv. Kane's bungalow in VA: He lived in it for 5 years, before having to move for employment. But now can't sell, so wants to rent for 4 years. Can he get the employment exception, even though the move was 4 years ago? Doesn't know....
- c. Old Rule (pre-1997) (§ 1034 – repealed) – Non-recognition if re-invest in new home w/in 2 years; not taxed on gain; but carry-over low basis of previous home. (Then if hold to death, get step-up basis.)

- i. This helped people who would otherwise have enormous gain.
- ii. But only get benefit if buy another home. No good if just want to sell.

II. Deductions

Deductions = Economic outflows that we reduce income by.

A. The Costs of Producing Income

1. Intro
 - a. Key Tenet:
 - i. We tax NET INCOME, not gross receipts. Must take out the cost of producing income.
 - b. Step 1: Above the line deductions
 - i. Move from GI to AGI. Everyone gets to take. Not subject to floor.
 - ii. E.g., Costs of earning income; moving expenses.
 - c. Step 2: Below the line deductions
 - i. Move from AGI to TI. Only available to itemizers.
 - ii. MID are subject to 2% AGI floor (§ 67). Deductions must add up to 2% AGI before allowed to take first dollar of MID deduction.
2. Case Types:
 - a. Self-employed in T/B:
 - i. E.g., sole proprietor of store making a salary expense.
 - ii. §62(a)(1) allows above-the-line deduction for T/B → go to §162 (T/B).
 - b. Employee in T/B:
 - i. E.g., law firm associate pays her own bar dues.
 - ii. Barred by § 62 (not for ‘EEs) → Can take below-the-line in §63(a) → go to §162 (T/B) → but check §67 2% floor since we are below the line.
 - c. Individual not in T/B, earning income:
 - i. E.g., individual renting out house, paying commission to real estate person.
 - ii. Barred by § 62 (must be T/B) → Can take below-the line in §63 → go to §212 (cost of earning income, not T/B) → but check §67 2% floor.
 - iii. Note: Deductions under § 212 = Deductions under § 162(a) (except T/B requirement). *Gilmore*.
 - d. Individual personal expense:
 - i. E.g., buy yourself ice cream.
 - ii. No deduction per §262 (personal expenditure).
 - iii. But some statutory carve-outs – clearly personal, but tax break (e.g., mortgage on a home).

Spectrum of cost-of-producing income deductions:

I-----I-----I	I-----I-----I	I-----I-----I
§§ 162, 212	Mixed Cases	§ 262
Costs of earning income	(e.g., buy suit for work)	Personal
Deductible		NOT deductible
(e.g., bar dues, salaries)		(e.g., ice cream)

3. “**Ordinary and Necessary**” – §162(a):
 - a. Requirements
 - i. Ordinary;
 - ii. Necessary;
 - iii. Carrying on T/B.
 - b. Extraordinary Behavior – Normalcy As Proxy for Ordinary & Necessary
 - i. **Ordinary = Normal. (DuPont).**
 1. *DuPont* rule: Ordinary = normalcy of underlying transaction in particular business.
 2. Ordinary ≠ Frequent. Can happen only once in TP’s life. *Kornhauser*.
 3. Normal is proxy for whether true cost of earning income or merely personal.
 4. Good proxy: If everyone else in a business is doing something, then more likely it’s a cost of earning income than a weird idiosyncratic thing.
 5. Bad proxy: Punishes innovation. Weird cases where not normal, but not personal.
 6. **Strategy for satisfying the test: Use abstraction.**
 - a. Characterize Goedel as securing business against risk.

- b. Characterize Trebillock as achieving normal employee motivational goals.
- 7. **Strategy to deny deduction: Characterize as idiosyncratic.**
- ii. Ordinary
 - 1. *Dancer*: truck driver hit a child; litigation expenses → deductible. Though expenses not cost of transport itself, and incident did not further T/B, still car accidents are normal part of driving and driving is a **normal** part of his business.
 - 2. *Pepper*: lawyer voluntarily paid back victims of client's scam to save reputation → deductible ("imperative" to save law practice).
 - 3. E.g., extermination of swarming locusts → deductible (though "extraordinary").
- iii. Not Ordinary
 - 1. *Gilliam*: crazy artist on the plane; legal fees not deductible. Air travel was normal, but freak-out partially caused by personal reasons. Kane: artistic soul more prone to mental instability, so part of T/B, side effects to meds are normal.
 - 2. *Dupont*: TP sold stock to executives for corporation. Just because it happened once in TP's life, doesn't mean it can't be ordinary, but it must be "normal, usual, customary" within the business.
 - 3. *Friedman*: lawyer voluntarily paid client's creditors out of ethical obligation → not deductible. Not part of lawyer's TorB. (Distinguish from *Pepper*: less reputational concern?) Kane: but maybe doing the right thing improves your reputation).
 - 4. *Goedel*: stock dealer paid premiums for LI on President (theory: death would disrupt stock market) → not deductible. Not ordinary, no other business man has ever done it (not rational business move). (Kane: innovative way to secure against risk?).
 - 5. *Trebilcock*: hires ordained minister to give motivational talks to employees → not deductible. "Personal in nature" (trying to convert for church). Counter-arg: morale-boosting, like company picnic; improves 'EE productivity.
- iv. Point: "Normalcy" tells us whether it is a true cost of earning income. If it's not normal in the business, then it's more likely that it's idiosyncratic behavior of TP.
 - 1. But this kills innovation (maybe Goedel was first to think of insurance).
 - 2. *Gilliam* is a cost of earning income, but we get thrown off because it doesn't look normal in the business.
- v. **Necessary ≠ "Necessary"**
 - 1. So long as paid to unrelated 3rd party, IRS will not second-guess business judgment re whether expenditure was truly "necessary" to business.
 - 2. BUT: Can be used as **legal hook for proxy taxation**. E.g., *Danville* (superbowl trip not "ordinary and necessary" expense – worried 'EEs & clients would not include).
- c. Reasonable Compensation (Excessive Stuff)
 - i. Disguised Dividends:
 - 1. §162(a)(1): "reasonable allowance for salaries or other compensation" is deductible.
 - a. Polices mischaracterizations, i.e., nondeductible payments disguised as salary.
 - b. Does NOT police excessiveness. I.e., "reasonable" not a constraint.
 - 2. Dividends: not deductible to the corporation (unlike salary).
 - a. If don't catch dividends, corporate income tax doesn't exist. No other corporate outflow is taxable.
 - 3. Employee/Shareholders – receive both salary and dividends
 - a. Absent any other constraints, corporation will characterize as salary, not dividend.
 - ii. Excessiveness:
 - 1. §162(m) DOES police excessiveness (passed in 1990s).
 - 2. Rule: No deduction for payments greater than \$1M to CEO or next 4 highest paid people. Does not apply to performance-based compensation, e.g., stock options.
 - 3. Why only for corporations?
 - a. Worry shareholders can't adequately police on their own. By contrast, professional athletes are subject to the market.
 - b. Irony: Ostensibly to protect s/holders, but remedy is to deny deduction to corporation – meaning less money to s/holders. Not the execs.
 - 4. Why incentive compensation preferred?
 - a. Aligns interests of managers and s/holders. Both want stock to go up.

5. Kane: § 162(m) encourages shift to incentive compensation, which encourages risk-taking, which led to econ bailout. Irony: New § 162(m)(5) reduces cap to \$500K – will further push into incentive comp packages, will worsen dangerous cycle.
- d. Illegal or Unethical Activities (Bad Stuff)
- i. Pre-1969 Common Law: murky judicial standard.
 1. Some courts disallowed deductions for moral, but not legal, violations:
 2. **Morally suspect** though not illegal (*United Draperies*: legal kickbacks disallowed);
 3. Frustration of **public policy** though not illegal (*Teiler*: legal expenses for breaking the law don't frustrate PP, but fines for trucks do (*Tank Truck Rentals*)).
 - ii. Post-1969: **§162 provides exclusive list of disallowances for TorB**. Eliminates residual "legal but not moral" category for disallowance. And focuses only on a subset of illegal transactions.
 1. § 162(c): **Bribes and kickbacks** to government employees; and to other people if bribe subjects to criminal penalty or loss of license (and generally enforced).
 2. § 162(f): **Fine or penalty** paid to government for violation of law.
 3. § 162(g): Punitive portion (2/3) of any **antitrust violation** damages.
 4. § 280(E): all expenses incurred in drug trafficking.
 - iii. *Stephens* – TP paid back embezzlement funds pursuant to court order to suspend sentence.
 1. § 162 does *not* apply, b/c embezzlement is not a T/B.
 2. Deduction under: **§ 165(c)(2) for loss incurred in transaction entered into for profit** though not connected w/ T/B.
 3. Rev. Rul. 65-254: Deduction for payback of embezzled funds.
 4. Gov't arguments:
 - a. "Sting": Rev. Rul. only applies to voluntary payback. Here, ordered by court, in lieu of jail. Allowing deduction would take away the "sting."
 - b. Public policy: Would violate p.p. to give deduction. Rev. Rule 77-126: common law categories in §165 still exist, §162 doesn't map directly on.
 5. Holding: TP wins.
 - a. "Double sting": TP already included income earlier. Denying deduction would be "double sting." BS. Don't know how much "sting" judge intended. Probably only cared about restitution to Raytheon, not the "sting" to D.
 - b. Public policy: § 162 provides "evidence" of whether violative under § 165. If violates § 162, *must* violate § 165. If doesn't violate § 162, then "evidence" it doesn't violate § 165.
 - iv. Rule:
 1. In theory, preserves possibility for residual public policy exception to § 165 (Rev. Rule 77-126). Exceptions under § 162 are a *non-exclusive* list w/r/t § 165.
 2. But in practice, b/c **§ 162 exceptions are "highly relevant" to § 165**, probably only the same enumerated exceptions will suffice. This makes things easier.
 - v. *Lincoln* – denied theft loss (§ 165(c)(3)) for TP who was swindled as he tried to buy stolen money. Note: *Stephens* court would have allowed the deduction, b/c no exception under § 162.
 - vi. See also *Blackmun* (casualty loss under § 165 denied, b/c PP gross negligence, arson).

B. Mixed Cases (Business/Personal Outlays) – The Question of Administrability

Fundamentally *intractable* problem: Because these are **truly mixed cases**, the 100% deduction or 100% non-deduction result will always lead to some inaccuracy. Must pay attention to **fairness** and **incentives for TP overreaching**, and other issues (e.g., proxy taxation, public policy, work incentives).

1. Hobby Losses (§ 183)

- a. Goal: Separate business from personal using proxy of "profit."
- b. **§ 183 "hobby" losses = losses from activity "not engaged in for profit."**
- c. Rule:

- iii. Deductions for ord. & nec. expenses capped at amount of income from that activity. §183(b)(2).
- iv. After reducing income by deductions that would be deductible anyway, e.g., taxes. § 183(b)(1).
- v. All § 183 deductions subject to 2% floor of § 67.
- vi. Note: TPs want to *avoid* § 183 (cap), by claiming activity *is* for profit (i.e., 162 or 212 - no cap).

- d. To determine whether activity is "engaged in for profit":
 - i. § 183(c): Not for profit: Any activity other than those that generate § 162 or § 212 deductions.
 - ii. § 183(d): Presumption activity is for profit if profit is received in 3 of past 5 years.
 - iii. **Primary Purpose test** (*Nickerson*): TP's primary purpose must be to make a profit.

1. Only need “bona fide expectation of profit”—doesn’t have to be reasonable.
 2. Take long-view: don’t do “freeze-frame” analysis – start-up losses ≠ not for profit.
 3. Note: *Nickerson* long-view is very generous to TPs – can tell a good story to get out from under 183, take losses for 20 years before forced to acknowledge not “for profit.”
- iv. **Objective Factors:** §1.183-2(b) (1)-(9) – none is dispositive, list is not exhaustive. (p. 405)
1. (1) Manner in which taxpayer carries on the activity – businesslike books, similar to others, change in methods, new technology.
 2. (2) Expertise of the taxpayer or his advisors – preparation for activity, unless trying to be innovative.
 3. (3) Time and effort expended – much personal time, so long as no personal or recreational aspects, unless other competent people doing it.
 4. (4) Expectation that assets used may appreciate – even if no profit from current activity
 5. (5) Success of taxpayer in carrying on other similar or dissimilar activities – even if presently unprofitable.
 6. (6) Taxpayer’s history of income or losses w/ respect to the activity – beyond start-up losses, if not unforeseen.
 7. (7) Amount of occasional profits – small profits w/ large losses would be bad; but substantial, even though occasional, would be good.
 8. (8) Financial status of taxpayer – other substantial income would be bad.
 9. (9) Elements of personal pleasure or recreation – recreational elements are a red flag. But “exclusive” intention of profit not required.
- e. Cases:
- i. *Nickerson*: start-up losses from renovating dilapidated farm for eventual career change → for profit → fully deductible under §162 (T/B) → no cap; can be used to offset advertising salary.
 - ii. *Farish*: horse-breeding brings only spotty profits – but so does oil prospecting → for profit.
 - iii. *Dailey*: antique collectors never sold item for 30 years, claimed deduction for cost of trip to Europe – hoped to make a profit through appreciation → not for profit. “Floating expectation” not enough.
 - iv. *Todd Palin*: Wins \$17K for snowmobile races; Claimed deductions of \$26.5K for car, truck, supplies, fuel, entry fees, gear, etc. → probably for profit (makes enough money) → no cap.
- f. Critique:
- i. TPs are “indefatigably optimistic” about chance of profit in these cases. Can almost always spin a story to construe hobby as long-run profit-making enterprise.
 1. E.g., collecting – argue will ultimately sell for profit;
 2. E.g., activity – argue at some point will be good enough to win prize.
 - ii. Conversely, for-profit activity could have large personal aspect (but still no cap).
 - iii. Separating business from personal is truly subjective – can’t determine
 - iv. Proxy: whether there’s a profit – for that, look to objective factors.
 - v. Note: Gambler can’t claim profit-generating trade to take losses. Gambling cap of § 165 functions as overlay on § 162. In general, fitting into a more generous deduction category doesn’t help, if a more limiting category still applies.

2. **Vacation Homes** – limit deductions when *personal* use is greater than business

- a. Business/Personal:
 - i. Personal: Use for vacation.
 - ii. Business: Rent the rest of the year.
- b. § 280A → Purely Objective Test → main purpose is to curtail deductibility
 - i. **§ 280A is a disallowance provision. The deductions actually arise under § 162 T/B (or 163, 164, 167, 168, etc.).**
 - ii. §280A(a): baseline of **non-deductibility** for expenses relating to dwelling unit used by TP as a residence → trumps §162
 - iii. §280A(b): can still deduct expenses allowable irrespective of profit-motive, e.g., interest, taxes.
 - iv. §280A(c): exceptions to (a) that allow for deductions:
 1. (c)(1): **home offices**;
 2. (c)(3): **rented vacation homes**
 - v. Threshold requirements:

<ol style="list-style-type: none"> 1. § 280A(f): “<u>Dwelling unit</u>” = everything but a hotel. 2. § 280A(d): “<u>Use as residence</u>” = use in excess of <u>greater of 14 days or 10% of the number of rental days</u> (if more than 140 rental days). So if you rent more, you can live there more w/o § 280A kicking in. Always get 14-day safe-harbor, no matter what. TP
--

wants to *avoid* being labeled a “residence,” b/c less generous. Note: Even if not a residence, § 280A applies if there is *any* use for a “personal purpose.” § 280A(e).

vi. Limitations on Deductions:

1. § 280A(e)(1): only get to deduct **ratable portion of expenses** (i.e., % of expenses equal to $\frac{\# \text{ days rented}}{\text{total \# days used}}$).
2. 280A(c)(5): **Deduction capped at rental income**, reduced by allocable amount of expenses that relate to the rental business, but not to the home itself (e.g., advertising), reduced by allocable amount of § 280A(b) expenses that are deductible regardless of profit motive, e.g., taxes (determined by # of days rented/365 days in year).

vii. Carry Forward: Excess that was cut off by § 280A(c)(5) cap can be carried forward 1 year.

c. **4 types of cases:**

i. No Personal Use

1. §280A does not apply. Full deductions under §162. Pure investment property.
2. But: §469 (passive activity loss rule) may limit deductions (tax shelter concern).

ii. Mostly Business: not “used as a residence,” but some personal use (less than 14 days)

1. B/c some personal use, § 280A applies. But b/c less than 14 days, not “residence.”
2. Deduct §280A(b) stuff (what you get irrespective of profit motive).
3. Deduct **ratable portion of other expenses** (i.e., % of expenses equal to $\frac{\# \text{ days rented}}{\text{total \# days used}}$). §280A(e)(1)
4. E.g., take % of depreciation on the property equal to % of rental time. § 162.
5. Can’t take QRI mortgage interest deduction under § 163 b/c not a “residence” – but can deduct ratable portion of mortgage interest as T/B expense. § 162.

iii. Mostly Residence: “used as a residence,” (more than 14 days or 10%) plus de minimis rental use (fewer than 15 days). §280A(g).

1. Deduct §280A(b) stuff as usual (property taxes).
2. No rental deductions allowed. § 280A(g).
3. BUT get to exclude rental income. §280A(g)
4. Reason: Not really for business, so don’t get deductions. But so as not to be punitive, and b/c admin difficult, just exclude the rental income.
5. Note: Windfall if can rent for high rents for short time (e.g., grad wknd).

iv. Closer Mix: “used as a residence” (greater of more than 14 days or 10% of rental days) w/ rental use (more than de minimus 15 days)

1. Deduct §280A(b) stuff (but have to allocate it to above the line and below the line).
2. Deduct ratable portion of rental expenses (e.g., depreciation). § 280A(e)(1). BUT: Deduction capped at rental income, reduced by allocable amount of § 280A(b) expenses, e.g., taxes. § 280A(c)(5). (Allocable amount of §280A(b) expenses determined by # of days rented/365 days in year (not total days property used)).
3. Carry forward amount of deduction you can’t take to next year.

v. Example (Mixed Case):

1. Problem 3(b) at page 414. Anne uses her vacation home 15 days a year and rents it out 85 days. Rental income = 8K, real estate taxes = 2K, and depreciation/maintenance = 10K.

vi. Analysis

1. Home is “used as a residence” because 15 days of use exceeds greater of 14 or 8.5 (10%*85).
2. De minimis rule does not apply. (Rental more than 15 days.)
3. Anne may deduct all 2K of the real estate taxes. 280A(b)
4. Anne may deduct a ratable portion of depreciation, or $85\% * 10K = 8500$. However, the deduction is limited to rental income (8K) reduced by allocable expenses taken under 280A(b). For these purposes expenses are allocated on the basis of rental days as a portion of the entire year (i.e., 365), rather than as a portion of total days of use (i.e., 100). In other words, allocable taxes = $(85/365) * 2K = \$466$. The allowable depreciation deduction is thus capped in an amount = $8K - \$466 = \$7,534$.

3. Home Offices:

a. **§ 280A is a disallowance provision. The deductions actually arise under § 162 T/B (or 163, 164, 167, 168, etc.).**

b. Statutory Rule: §280A(c)(1):

i. Qualifying for deduction:

1. Portion of dwelling unit “**exclusively used**”
2. “on a **regular basis**”

3. as the “**principal place of business**” for a T/B (can only be *one* PPB) – see below (or if used for “meeting or dealing” in normal course of T/B, or if the area is a “separate structure.”)
4. If employee → only if for “**convenience of employer.**”

- ii. To calculate deduction:
 1. Consider all deductions (under any section, e.g., §§ 162, 167, etc.) that are “w/ respect to a dwelling unit which is used by TP as a residence.” Then must determine how much survive § 280A(c):
 2. Calculate “business percentage” of home, by dividing square footage of business use by total area of home, or by number of rooms over total number of rooms. Reduce by portion of year in which it was used for business purposes.
 3. Calculate gross income from T/B (taking out expenses that do not relate to the use of the home itself, e.g., phone lines, office supplies).
 4. Deduct “business percentage” of § 280A(b) expenses (deductible regardless of profit-motive).
 5. Deduct “business percentage” of the other expenses (i.e., relating to house in virtue of its business use), capped at amount of gross income MINUS allocable § 280A(b) expenses.

iii. Carry forward: Excess over § 280A(c)(5) cap can be carried forward 1 year.

iv. Examples of expenses:

1. Expenses deductible regardless of profit motive (deduct allocable %):
 - a. Real estate taxes
 - b. Qualified mortgage insurance premiums
 - c. Deductible mortgage interest
 - d. Casualty losses
2. Expenses deductible only if home used for business (deduct allocable %, capped):
 - a. Depreciation
 - b. Insurance
 - c. Rent
 - d. Repairs
 - e. Security system
 - f. Utilities and services

c. Principal place of business (can only have one):

- i. Soliman test: two-part test: (1.) relative importance and (2.) time spent
 1. **Relative importance** of the place
 - a. Place where the most important functions are performed.
 - b. For goods or services, “great weight” given to “**point of delivery.**”
 2. **Amount of time**:
 - a. Compare amount of time spent at home w/ time spent at other places where business activities occur.
- ii. Problem w/ Soliman test: no guidance if factors point in different directions.
 1. Solution: Combine into one test by discounting amount of time by relative importance.
 2. I.e., use real or hypothetical wage rate to represent importance of each location; multiply by # of hours spent; whichever is more is the PPB.
 3. E.g., Attorney: 10 hrs prep @ \$200/hr = \$2000. 1 hr in court @ \$500/hr = \$500. Therefore, PPB is office, even though court is “point of delivery.”
- iii. Solimon: anesthesiologist; administers drugs at hospital, but does significant background and record-keeping work at home office. → PPB is hospital, b/c that is point of delivery.
 1. Exception now if home office is used for “administrative or management” of the T/B and there is nowhere else that is done. §280A(c)(1)(C).
- iv. Popov: professional violinist; practices 4-5 hrs./day in living room of 1-br apt. → PPB is home.
 1. Court finds “relative importance” prong indeterminate, b/c music isn’t service or good. Therefore, TP wins based on “time spent.”
 2. Note: Realistically, there’s no way the TP satisfied exclusivity in this case.
 3. Incentives: If too harsh on Popov, incentivize moving activity outside home – arguably inefficient (despite obvious mixed use).
- v. Drucker: Met Opera musicians practiced at home → PPB home, b/c “focal point.” (Focal point test overruled by Solimon, but not result of case.)

d. Trade or Business

- i. *Moller*: rich retirees spend 40 hrs/wk managing investment portfolio from dedicated office in winter and summer home. → No deduction, b/c not T/B.
 - 1. Traders = T/B (lots of buying/selling short-term changes).
 - 2. Investors ≠ T/B; mere pastime (hold for a long time, not much buying/selling).
 - 3. But both are income-generating activities; not a business/personal issue. Not what § 280A is usually policing. Don't usually ask how smart business decisions have been.
 - 4. Worry: Can of worms. Everyone is an investor. Don't want everyone to claim.
 - 5. But: encourages inefficient "trading" just to get deduction?
4. Income Unconnected to Trade or Business - § 67 acts as a hammer on potential TP overreaching
 - a. *Whitten*: Wheel of Fortune contestant – won \$19K in cash & prizes (clearly income under § 74); wants to deduct \$2K of personal expenses from trip (e.g., transport and lodging).
 - i. Could claim under § 212 – costs of earning income. BUT: subject to 2% floor, b/c MID.
 - ii. Could claim under § 162 (T/B) – must make argument in T/B of "cruciverbalism." Try to show that gameshow fits into his larger trade. Otherwise, won't get the generous § 162 provision.
 - iii. TP tries to claim under § 165(a) – incidental expenses are gambling "losses," which can offset gambling "gains." § 165(c)(d). No 2% floor for gambling (b/c already limited by basketing).
 - iv. Cites *Kozma* for proposition that expenses incident to gambling = wagering losses.
 - v. *Kozma*: TP was in T/B of gambling. Claimed incidental expenses under § 162, exceeding gambling gains. Court disallowed; held § 165(c)(d) basketing rule applied to the expenses – no net loss allowed when in T/B of gambling.
 - vi. Court rejects TP's argument: *Kozma* did not define "wagering losses" as including expenses incident to gambling. Merely held that policy behind § 165(d) basketing rule acts as a gloss on § 162; can never claim a net loss due to gambling.
 - vii. Holding: Incidental expenses for gambling NOT deductible, unless in T/B of gambling, and even then, no net loss is ever allowed.
 - b. Function of § 67
 - i. **§ 67 acts as a hammer that comes down on possible TP overreaching.** When TP is claiming income that is not part of a T/B, seems susceptible to abuse, e.g., claim some plausible income, than take a lot of personal deductions on it.
 - ii. § 162 is spared the hammer b/c not as worrisome; once someone has a T/B, less ripe for abuse.
 - iii. § 67 floor doesn't apply to gambling b/c already limited by basketing rule.
5. Office Decorations – Must plausibly generate income
 - a. *Henderson*: state employee claims § 162 deduction for plant and framed picture for office.
 - i. No deduction; personal. § 262. No plausible argument that these items could influence income. Her income is fixed as salary from the state.
 - b. Law firm can deduct fancy art because has business purpose: signal to clients you are successful; necessary cost of earning income in legal business. Even though employees get personal satisfaction too.
 - c. If State gave her the painting to make her happy, they would get deduction, but she would have to take inclusion.
6. Listed Property
 - a. §280F(b): Special "listed" property—anything generally used for entertainment (e.g., cars, cell phones).
 - b. If listed property is used less than 50% for business, then no ACRS deduction (only straightline using normal useful life, pro rata for business use).
 - c. For an employee: No deduction unless "for convenience of employer" and "required as a condition of employment." §280F(d)(3). Law professor's computer doesn't count – not objectively literally required by employer. *Dole*.

7. Travel and Entertainment Expenses

Biggest danger of TP overreaching here!

Type	Payer/Firm – Deduction	Payee/Client-Employee – Inclusion
Self-Employed (e.g., Law firm partner buys herself a meal) ** Most worried about TP overreaching here!! **	<u>Business</u> : Deduction, § 162/subject to § 274. <u>Personal</u> : No deduction, §262. **Moss in this box (daily partner lunch)	N/A (no payee—just buy yourself a meal).
Employer to Employee	"Business": Deduction (T/B), §162/274 (274(n) 50%)	<u>Business</u> : Exclusion under §132(a)(3)/(d) working condition

(e.g., ‘EE buys meal for ‘EE)	Personal: (1) Deduction – (tantamount to in-kind salary) – ‘ER doesn’t care whether expense is business or personal. §162/274 (no 50% cap if compensation). OR (2) No deduction because proxy taxation. E.g., <i>Danville</i> employees.	fringe (collapses § 61 inclusion & § 162 deduction to give exclusion) or § 132(a)(4)/(e) de minimis fringe. Personal: Inclusion as in-kind salary under §61. No §162 deduction, therefore no §132(d). ** <i>Rudolph</i> in this box.
Business to Client (e.g., firm buys meal for client); (e.g., commercial gift, like <i>Duberstein</i>)	Business: Deduction , §162/274. <i>Churchill Downs/Duberstein</i> (full deduction, but 50% cap if food or entertainment § 274(n)); (consider using SV, a la <i>Turner</i>); OR No deduction (proxy taxation). E.g., <i>Danville</i> customers. Personal: (1) Capped \$25 deduction , if commercial gift (i.e., if D&D per <i>Duberstein</i>). §162 deduction, §274(b) cap.	Business: Inclusion/Deduction (§61 inclusion, then § 162 deduction, subject to § 274 (50% cap if food or entertainment)) → need include/deduct b/c no analogue to § 132(d) exclusion outside of employment context. Personal: Exclusion if D&D per <i>Duberstein</i> . § 102.

- a. *Rudolph* – before § 274
- i. Issue: Can ‘EE deduct NYC trip paid for by ‘ER under § 162? (Pre-§ 132(d)).
 - ii. Per curiam test: Allow deduction if “dominant motive and purpose” of trip is business.
 1. Whose motive? ‘EE or ‘ER? ‘EE should matter more (‘ER gets deduction either way).
 2. Problem: Different results across ‘EEs depending on who likes the trip more...
 3. Problem: No answer even for individual ‘EE—probably genuinely mixed feelings.
 4. Subjective test → but determine through objective factors (e.g., how much time spent on business vs. recreation) → even so, hard to apply.
 - iii. Douglass Dissent: Trip is “all expenses paid”; should not be income under § 61.
 1. This is wrong. In ‘ER-‘EE relationship, must always look to how much business was actually performed. Otherwise, too easy to disguise salary.
- b. § 274 – **Disallowance Provision for Travel, Entertainment, Meals – superimposed on § 162.**
- i. To deduct, must satisfy *both* § 162 (ord. & nec.) and § 274.
 - ii. **Threshold: Entertainment** → objective test → “activity is of a type generally considered to constitute entertainment,” e.g., dinners, hotel, sporting events, trips. Reg. § 1.274-2(b)(1)(ii).
 1. **Exception: Not entertainment if comprises core of the TP’s T/B.** E.g., fashion show for clothing designer, theater ticket for theater critic. Reg. § 1.274-2(b)(1)(ii). But gala before horse races doesn’t count—outside core T/B entertainment. (*Churchill Downs*).
 2. Meals, hotel rooms, cars instrumental to business don’t count. Reg. § 1.274-2(b)(1)(ii).
 - iii. Must be “**ordinary and necessary**” under §162.
 1. Only traveling expenses which are reasonable and necessary to the conduct of employer’s business and which are directly attributable to it. Reg. § 1.162-2(a).
 - iv. §274(a)(1)(A): Disjunctive test for deduction. To deduct, entertainment must be:
 1. “**Directly related to**” T/B (Not just goodwill. Reg. § 1.274-2(c)); OR
 2. **Associated w/ T/B**, and event **directly precedes or follows** a “substantial and **bona fide business discussion.**” [no business need be discussed at the actual event.]
 - v. §274(n) – **Arbitrary Disallowance: 50% flat disallowance for meals and entertainment.** → Hammer (avoid overreaching); Proxy taxation (worry won’t be included) (*Churchill Downs*).
 1. § 274(n) hammer applies *even if* jump through all other hoops of § 274. I.e., if TP wants to deduct a meal, must first satisfy § 274(a), but even so, will still be limited under the 50% rule of § 274(n). (E.g., includes law firm lunch for summer associate.)
 - a. RT: Doesn’t this mean that *Churchill Downs* court was right, that TP loses under cap b/c mostly meals, regardless of “entertainment” question? Maybe one way to resolve: no cap if not entertainment at all; but cap if entertainment, even though “directly related to” or “associated w/” business.
 2. Technically applies to all food and beverages (§ 274(n)(1)(A)) → but can argue that still must satisfy threshold “entertainment” def’n of § 274(a) before § 274(n) applies.
 - a. This is why parties in *Churchill Downs* didn’t brief the issue.
 3. Exceptions: Doesn’t apply if de minimis fringe under 132(e); or if expense is treated as compensation for ‘EE. § 274(n)(2)(A), (B).
 4. Creates distortion: If buy billboard, get 100% deduction; If throw gala, only 50%.

5. **If ‘EE pays and then reimbursed**, gets full above-the-line deduction (§62(a)(2)(A)) [take above-the-line to assure no net tax cost to ‘EE], or outright exclusion if working condition fringe (§ 132(d), e.g., meal for summer associate). **Reg. §1.162-17** → employee may exclude income from reimbursement and omit the deduction.
 - a. ‘ER takes only 50% deduction, above the line, for reimbursement payment.
 6. **If employee pays w/o reimburse**, then it’s below the line, “miscellaneous itemized” and hit by 2% floor (because you get to §162 through §63 and not §62, and its not on §67(b)’s exceptions) and might not be more than standard deduction. **Incentive for employee not to pay** – will either have employer buy, or be reimbursed.
 - a. Policy: cash is harder to police, we want the business involved somewhere.
 - b. But it’s a tax penalty for just doing business. Expenses might have personal element, determined by employee.
- vi. §274(m)(3): no expenses for spouse’s travel unless
 1. she is an employee of TP,
 2. had a business purpose,
 3. expenses are otherwise deductible.
 - vii. Sports tickets: could argue that part of season tickets that doesn’t go to client is needed for others (which are associated or directly following) and it’s cheaper to buy them all at once. Also §132 de minimis fringe.
- c. Moss – partner lunch everyday at local restaurant → not deductible.
- i. § 162 just can’t reach that far (everyday is just too much); falls under § 262 personal.
 - ii. Not §119 – TP is not ‘EE, and not on premises of employer.
 - iii. Not §162(A)(2) – TP is not traveling away from home.
 - iv. Rule: Can’t get free lunch everyday under § 162, even if satisfy statute. Maybe once/month.
 - v. Other options:
 1. Tax only SV of meal (get deduction for amount that FMV exceeds SV) → but too hard and incentives to downplay.
 2. Get full deduction if SV < FMV. *Sutter*. But IRS doesn’t apply *Sutter*. Requires you to buy expensive meals to get deduction. Same information problems.
 3. Deduction only if client present. But 7th Cir. allowed deduction for partner lunch.
 4. Require literal meaning of “necessary” under § 162. But it’s never really “necessary.” E.g., conflicts with § 274 “associated” test (clearly not “necessary”).
- d. Examples:
- i. Lawyer takes client to lunch to discuss case. → Deductible. (satisfies 274 direct test)
 - ii. Client takes lawyer to lunch to discuss case. → Deductible. (satisfies 274 direct test)
 - iii. Partner takes associate out to discuss associate’s future in firm → Deductible.
 - iv. Partner takes associate out to discuss pending case → Deductible.
 - v. 2 partners go to lunch once a week to talk about an ongoing case. → ?? Not clear. *Moss*.
- e. Danville – Proxy Taxation: Superbowl trip. 4 types of attendees: (1) ‘EEs; (2) ‘EEs’ spouses; (3) EEs’ children; (4) Clients. Issue: Deductible under § 162/274? (Court denies all four under § 162.)
- i. Children – NO; clearly not deductible under § 162. No business reason for their presence.
 - ii. Spouses – NO; did some “businessy” things, but mostly social. Now, barred by § 274(m)(3).
 - iii. ‘EEs – court denies deduction b/c not “directly attributable” to business. Reg. § 1.162-2(a).
 - iv. Customers – court denies deduction b/c not common in business (*Gilliam*).
 - v. BUT: Should never deny deduction for the clients and ‘EEs! For clients, it’s never personal (D&D window is tiny), and we don’t second-guess business judgment. For ‘EEs, it’s either business and excludable, or it’s salary and excludable.
 - vi. Only explanation: **proxy taxation**. “Right” solution is for clients/’EEs to include. But enforcement problems – doubtful that payee will include, and auditor will never know about it. So hit the payor with it.
- f. Churchill Downs – Gala before horse race satisfies § 162. But 50% “entertainment” cap under § 274(n).
- i. Rule: Entertainment expenses subject to 50% cap UNLESS such entertainment is your business.
 - ii. TP must define its business broadly to reach galas → selling “glamour,” not just horse races.
 - iii. Gov’t defines business narrowly → income is from ticket sales and wagers only.
 - iv. **Proxy Taxation**: Obviously gala is for business reasons (not a gift). Should be deductible. But for recipients, feels like personal consumption. 50% cap claws back some of the deduction when there’s a large personal consumption component.
 - v. Note: Get 100% deduction if buy a billboard to promote event; but only 50% deduction if throw gala dinner. Reason: concern there is some consumption by employer going on in latter case.

8. Child-Care Expenses

- a. *Smith* – Child-care expenses are not deductible, even though “but for” work, wouldn’t have expenses.
 - i. Causal Over-Determination (like *Gilliam*): but for work, no expense. But also, but for kids, no expense. On business/personal line, right result – having children is core personal decision.
 - ii. But: Incentive problem – creates disincentive for secondary worker to work outside home.
- b. § 21 - Credit for Childcare Expenses
 - i. Partially addresses incentive problem.
 - ii. Formula:
 1. $(35\%-20\%) \times \text{Expenses}$ (Capped at \$3K for 1 kid/\$6K for 2 kids)
 2. Range is 35%, reduced by 1% for every \$2K that AGI > \$15K, down to 20%.
 - iii. Doesn’t solve incentive problem: cap is low, and benefits peeled back as you get better off.
 - iv. Phase-out: Want poor people to work, but don’t care if rich people act efficiently?
 - v. Cap: If cost of earning income, why allow first-class hotel, but not first-class childcare?
 - vi. Expenses cannot exceed income of lower earning spouse; then it’s not earning income, it’s just letting them not do child-care.

9. Commuting/Travel

- a. Rule § 162(a)(2):

<ol style="list-style-type: none">i. Must be ordinary and necessary “traveling expenses” (including meals (50%) and lodging, if not lavish and expensive)ii. while away from home;iii. in the pursuit of a T/B (not personal).
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- b. Paradigmatic Examples
 - i. Commuting: E.g., cost of commuting from suburb to downtown → not deductible. Reflect personal choice to live in suburbs.
 - ii. Short trip for work: E.g., cab from office to client meeting → deductible under § 162(a) general ordinary & necessary expense.
 - iii. Day trip for work: E.g., trainfare and meals for daytrip to D.C. for meeting → deductible under § 162(a) general or § 162(a)(2) travel.
 - iv. Long trip for work: E.g., overnight business trip → travel, lodging, meals deductible under § 162(a)(2). [don’t have to show business connection for each expense.]
- c. *Flowers* – Issue: “home” = home, or “home” = work? Holding: If no work at home, travel not for T/B.
 - i. Facts: TP longtime resident of Jackson, Miss. accepts job in Mobile, AL. TP tries to deduct train fare to/from Mobile, and living expenses while in Mobile.
 - ii. Policy concern: If “home” = Jackson, then TP gets to deduct traveling expenses that are really just personal commuting expenses. Choice to live in Jackson is like choice to live in suburbs.
 - iii. Court: Avoids “home” question by finding fails “in pursuit of a T/B” prong. B/c there was 0 business reason to be in Jackson, travel b/w the two locations must be personal.
 - iv. Ask hypo: Does TP’s income increase by even \$1 by virtue of his residence location? If not, then transit b/w the two must not be in pursuit of T/B.
 - v. Harder case: If there is business going on in both places.
- d. *Hantzis* – 2L summer associate from Boston cannot deduct expenses for being in NY (rent, travel).
 - i. Court creates functional test that interprets 2nd and 3rd prong together.
 - ii. **Rule: In the case of 2 homes, if reason for keeping original home is personal, then home = work (PPB); if reason for duplicate residences is business, then home = home.**
 - iii. Upshot: Must have business reason for *both* homes (but the 2 works need not be related).
 - iv. Goal: “§ 162(a)(2) seeks to mitigate the burden of the TP who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur addition and duplicative living expenses.”
 - v. Note: Argument that school is a business reason, i.e., investment in future earning activity, fails. School itself is not deductible as cost of earning income, thus nor is it a business exigency.
 - vi. Court treats TP as single TP—but actually filed jointly w/ husband, who worked in Boston—as a joint entity, looks like there is a business reason for both homes. Court doesn’t consider.
- e. Temporary Employment Doctrine
 - i. Can only take § 162(a)(2) deductions if “temporarily” away from home.
 - ii. Employment is temporary if < 1 yr. § 162(a)(3).
 1. § 162(a)(2) allows deduction for expense of maintaining 2nd home so long as employment is “temporary” and not “indefinite” or “permanent.” But continued maintenance of 1st home must still have business justification. *Hantzis*.

- 2. *Frederick*: “temporary” employment suggests that travel is due to business necessity, not personal choice, unlike when employment is permanent. Rev. Rule 99-7.
 - iii. TP must expect to be away for less than 1 year. If intended to be temporary, but then exceeds, get deduction up until time it is clear will exceed 1 year.
 - iv. Kane: Once you know the assignment is longer than a year, can argue that the new place is now the home. So could buy a new 1-year window back the other direction.
 - v. Rev. Rul. 75-432: “home” is the “principal business” post, so you can deduct only those expenses while at the minor post.
- f. Per Diems
- i. Per diems are excludable if would have been entitled to deduction under § 162(a)(2).
 - ii. Need not prove actual expenses = per diem. No income, even if don’t spend whole per diem.

10. Clothes

a. Uniform Test: Clothing is deductible if

- i. Of a type **specifically required** as a condition of employment;
- ii. **Not suitable for ordinary wear** (determined **objectively**); and
- iii. It is not so worn (i.e., as street wear).

- b. *Pevsner* – (Unfairness): no deduction for sales worker w/ “simple” tastes buying fancy YSL clothes.
- i. Adopts objective test for “not adaptable to general use as ordinary street wear.” Good for admin and incentives. But can be UNFAIR, as for *Pevsner*.
 - ii. Possible subjective tests:
 1. Give 100% deduction, if expense > what would have otherwise spent. (Overly generous – TP had to buy *some* clothes.)
 2. Give deduction for part of expense that exceeds what would otherwise have spent. (“Right” rule, as in *Moss*.)
 3. BUT: HUGE admin problem: hard to know what TP “would have” spent; incentive for TP to say she would wear rags; different results across TPs for same wardrobe.

11. Legal Expenses

- a. *Gilmore*: legal expenses in divorce are not deductible b/c did not arise from income-producing activity.
- i. §212(2) allows deductions for “**conservation of property held for production of income.**”
 - ii. TP claims legal expenses are to conserve his stock, which produces his income.
 1. Note: Not in T/B of stockholding/trading. Otherwise, could claim under § 162.

iii. **Origin of the Claim test:** If income-producing property is the origin of the litigation, then deduct. If income-producing property is merely affected by litigation, then no deduct.

1. Text: Litigation costs in defending claim are deductible if the “claim arises in connection w/ TP’s profit-seeking activities.” It is not enough that litigation might have *consequences* for TP’s income-producing property (where origin of claim is personal).
 2. To distinguish b/w origin and consequences: remember *Accardo* case. If guilty of crime, can deduct legal expenses under § 162, for T/B of illegal activities. But if not guilty, can’t use § 162, b/c would have to admit guilt (that he’s in T/B of bad stuff). Under § 212, “origin” requires admitting the bad acts (b/c profit-generating activities themselves led to the legal problems); wants to use “consequences” instead—legal expenses are necessary to protect income-producing assets from judgment.
 3. Consequences Test is clearly wrong. Could deduct legal fees every time have to satisfy the judgment out of income-producing assets (e.g., sell stock).
 4. Causal over-determination: Origin-of-claim test is indeterminate when claim has both business and personal causes. E.g., *Gilliam* (plane/stress for business, but freakout partially due to personal problems); *Gilmore* (claim depends both on marriage and his work at car dealership). Test breaks down when origin is truly mixed. But text works unproblematically in many cases, e.g., the infidelity claim.
- iv. Court denies deduction; says both claims stem entirely from marital relationship.
 - v. Kane: Claim re: infidelity leading to greater division of assets is clearly only personal. But claim re: whether assets are community property depends on whether appreciation of asset is due to mere market conditions or to husband’s hard work (making it a “fruit” of the marriage) → this is a truly mixed claim. But for marriage, no claim. But also, but for services, no claim.
 - vi. Note: Origin-of-the-claim test should equally apply to § 162(a) T/B expenses.
 - vii. **Basis:** whether personal or business, defending title costs are added to basis. *Gilmore*.
 1. Must be capitalized (included in capital expense and depreciated) if spent in getting long-term asset. Reg. 1.263(1).

12. Educational Expenses

- a. Regulation – Workable Objective Test

- i. Reg. §1.162-5 deduction if: (after in business)
 - 1. (a)(1) – Maintains or improves *skills required* for employment; OR
 - 2. (a)(2) – Expressly required by employer or law as a *condition* of keeping the job;
- ii. but lose it if: (starting)
 - 1. (b)(2) – Meeting *minimal* education requirements in the T/B (can be required by law or ‘ER) (law school out, but business school might count)
 - 2. (b)(3) – Qualification for a *new* T/B.
- b. *Carroll*: police commissioner taking ‘ER-recommended liberal arts classes at college not deductible.
 - i. Claim under (a)(1) – improving detective skills. But category is narrow: e.g., industrial psychology course for industrial psychologist (see Regs).
 - ii. Education is mixed expense – personal fulfillment; but also related to augmenting income.
 - iii. Issue of how generous or stingy to be, given this mixed nature. Must draw line somewhere.
 - iv. Law students lose: J.D. is minimum requirement, AND a new T/B.
 - v. Business students: need to weave b/w requirements; show meets (a)(2) – express requirement of ‘ER (e.g., for promotion); but not (b)(2) a *minimum* requirement, nor (b)(3) a new T/B.

13. Summary of Mixed Business/Personal Expenses

- a. Fundamentally Intractable Problem
 - i. These cases are genuinely mixed—both business and personal.
 - ii. Theoretically “correct” answer is to give deduction just for the business element of the expense (Posner’s *Moss* suggestion). But this is not administratively possible. Can’t compare to counterfactual world w/o the business component. So must look for second-best solution.
- b. Flawed Approaches
 - i. Strict Plain Meaning (e.g., *Henderson* – plants)
 - 1. I.e., not “necessary” for production of income. *Henderson*’s plant was not strictly necessary to T/B, but neither are advertisements that fail.
 - 2. This only works in cases that aren’t truly mixed (i.e., *Henderson*’s plants really were purely personal). As a rule, “necessary” doesn’t mean necessary (defer to business judgment).
 - ii. Subjective Primary Purpose:
 - 1. Can incentivize TPs to lie and downplay personal component.
 - 2. *Nickerson* – can lose money forever and claim profit-expectation.
 - 3. *Rudolph* – TP herself may not know her “primary purpose” on boondoggle trip.
 - iii. Casual Tests
 - 1. Only works in easy case. Breaks down when have multiple causes.
 - 2. *Flowers*: commuting from Jackson to Mobile (only easy if find ZERO business reason for being in Jackson, i.e., eliminate multiple causes).
 - 3. *Smith*: child-care expenses (but for child ... also but for work).
 - 4. *Gilmore*: legal expenses (but for marriage ... also but for services).
- c. Workable Approaches:
 - i. Objective tests (based on objective factors, not dependent on things in TP’s head):
 - 1. Reg. §1.183 factors for whether hobby losses are actually for-profit activity
 - 2. Reg. §1.162-5 educational expenses test
 - 3. §280A home office and vacation home deductions
 - ii. Proxies:
 - 1. *Gilliam* normalcy test – if other people are doing it, then more likely business.
 - 2. *Pevsner* “suitable for ordinary wear” test.
- d. Stakes:
 - i. Unfairness: Lose 100% deduction, despite true non-personal component
 - 1. E.g., fancy clothes (*Pevsner*), investor home office (*Moller*), business lunches (*Moss*).
 - ii. Perverse Incentives: TP overreaching, trying to squeeze in
 - 1. *Popov* – gets 100% deduction, even though implausible no personal use of living room.
 - iii. To police overreaching, have arbitrary disallowance rules:
 - 1. §274(n) – 50% limit for food and entertainment
 - 2. §67 – 2% floor
- e. Non Business/Personal Issues:
 - i. Incentives for secondary worker (regardless of personal aspect of children) (*Smith*)
 - ii. Proxy taxation – enforcement issue, not business/personal (*Danville*, *Churchill Downs*)
 - iii. Public policy – *Stephens* – (question about “sting,” not business/personal thing)

C. Deductible Personal Expenses – Ability to Pay and Incentives

- **Ability to pay** → refining concept of income to accord with **fairness**. This is a fundamentally *tractable* problem, b/c no genuine attempt to truly account for consumption value – just give TP a small window of carve-outs from § 262 (e.g., casualty losses, extraordinary medical expenses, taxes, personal exemptions).
- **Incentives** → like a direct subsidy for expenses we encourage → only a question of **policy** (e.g., where to draw line for charitable deductions, or how much to encourage home ownership.) Note: Deductions are worth more to the wealthy than the poor (“upside-down” subsidy).

1. Casualty Losses – (Ability to Pay)

a. §165(c)(3): “fire, storm, shipwreck, or other casualty, or from theft”

b. Judicial Doctrines Limiting Abuse:

- Suddenness: (foreseeability) goes to **moral hazard**. If takes time, want TP to take precaution.
 - Dyer*: cat tipping over vase was foreseeable. Not sudden (proxy for foreseeable).
 - Termite damage (Rev. Rul. 63-232) and dry rot (*Hoppe*) not sudden → no deduct.
 - Wedding ring cases: different results (slip off finger, flush down toilet → no deduct, no sudden destructive force; garbage disposal, car door slam, diamond simply missing from setting → deduct). Don’t really look like a suddenness issue.
- Permanent: goes to **chance of recovery** – don’t give loss if might recoup (analogy to realization). Make sure not really still getting consumption value.
- Physical: goes to **proof problem** – hard to prove diminished SV.
 - Chamales*: no deduction for living next to OJ, even though 30% drop in market value, b/c no physical damage and not permanent – not likely that you didn’t fully consume.
 - Factors in 9th Cir. *Chamales*: (1) Suddenness; (2) Physical damage – more likely you didn’t fully consume; (3) Permanent damage – can’t just take advantage of housing market dip.
 - Note: If property is “personal” (under § 262), don’t get depreciation deductions, and can’t claim loss if sell house for less (though must realize gain if appreciates and sell). Further cuts against awarding casualty loss to *Chamales* for this decline in value of home.
- Gross Negligence: (foreseeability) denies deduction where **moral hazard problem** aggravated.
 - Blackman*: domestic strife arson case; no deduction if you cause casualty loss by gross negligence; foreseeable b/c he started fire. Ordinary negligence is OK.
 - Violates PP to reward arson – not specific exception to statute in § 165 or § 162 – just background PP (like what IRS wanted to apply in *Stephens* embezzlement case).
 - Kane: Tax system not designed to deter arson—that’s what criminal laws are for. If he had burned down neighbor’s house, would have no tax consequences, only criminal sanctions.

c. Mechanical Rules for Casualty Losses – Limit Abuse by Statute

- Floor: §165(h) Limited to extent that losses exceed 10% of AGI, after reduction by a \$100 floor (like an insurance deductible) for each individual loss.
- Loss limited to amount of basis (§ 165(b))– only deduct the lower of FMV or basis. No recovery of unrealized gain in property (makes sense – didn’t get taxed on gain, and we can’t tell FMV).
- Loss limited to uninsured amount (§ 165(a)) – not anything you recovered already. § 165(a).
- Deduction for losses covered by insurance only allowed if timely claim was filed. § 165(h)(4)(e).
- Include a casualty gain if insurance pays you more than you lost. § 165(h).

d. Mechanical Process:

- Start with basis (or FMV if lower); Subtract any gain (e.g., insurance payment); Subtract \$100, then subtract 10% of AGI → deduct what’s left.

ii. Example: Car with basis of 10,100, FMV of 15,000, destroyed by tornado. No insurance recovery. AGI = 60,000. Casualty loss is reduced from 10,100 to 10,000 in virtue of the 100 “deductible.” Deduction is only available for amount that exceeds 10% of 60,000, or 6,000. Thus casualty loss deduction = 4,000.

e. Policy:

- Ability to pay concerns, we give free insurance when:
 - Loss was too unforeseeable to be insurable (not *Blackman* and *Dyer*)
 - Lost consumption value – no tax if you don’t get to consume (like if *Chamales* was physical damage).
- Social Waste: Leads to suboptimal insurance, b/c no internalization of risk – insurance available in market at actuarial fair price is more efficient.
- Moral Hazard: Free insurance, incentive to take excessive risk, not insure. (Mitigate by foreseeability.)
- Personal: Casualty losses have personal element – tax system shouldn’t take account of personal risk-taking choices (e.g., decision to live on flood plane). Other TPs subsidize risky behavior.

2. Personal property losses
 - a. Not deductible (e.g., sell home for a loss) → no deduction
 - b. Individuals can only claim property loss for:
 - i. § 165(c)(1) property used in a T/B
 - ii. § 165(c)(2) property that is income-producing.
 - iii. § 165(c)(3) casualty losses.

3. Medical Expenses – (Ability to Pay/Get to Baseline/Distinguish from Personal)
 - a. §213(a): Expenses for “medical care” deductible, to the extent:
 - i. Not compensated by insurance;
 - ii. Exceeds 7.5% AGI.
 - b. §213(d): “Medical care” = Expenses paid . . . → unquestionably includes insurance premiums. For other expenses, must look to caselaw to determine if allowable. Includes devices.
 - i. (A): “for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body” OR
 - ii. (B): “for transportation primarily for and essential to medical care”
 - iii. (C): nurse in home
 - c. Floor – Limit Abuse -- Statute: Deductible to the extent exceeds 7.5% of AGI – like insurance w/ a co-payment of 100% [minus] marginal rate, and only after paying a 7.5% AGI deductible on an annual basis.
 - d. Limit Abuse – Judicial – tax base would be gone:
 - i. Taylor: costs of lawn mowing per doctor’s order due to allergies → not deductible.
 1. Mixed medical/personal – if significant personal benefit, want to tax.
 2. Causal overdetermination: But for allergies, no cost . . . but for lawn (suburbs), no cost.
 3. Rule is *not* just that if doctor ordered it, get deduction. Still may have personal element.
 - ii. Henderson: depreciation of special van for son w/ spinal bifida → not deductible.
 1. But modifications to van were deductible. Depreciation wasn’t an “expense paid” under § 213(a). → this reasoning is terrible. If take purchase price all in Year 1, then deductible?
 2. Real issue: **Vehicles are a core personal expenditure**. Worried about TP overreaching.
 3. § 213(d)(B) – transportation primarily for and essential to medical care – sometimes, used van to go to hospital; other times, probably used it to take him to camp.
 - iii. Ochs: mom w/ cancer had to send kids to boarding school → not deductible.
 1. Large personal component: Decision to have kids.
 2. But stronger case than *Taylor*: maybe no better off than baseline here (didn’t want to send kids to boarding school), while *Taylor* was saved 2 hours mowing lawn.
 3. Note: Severity of illness irrelevant to deductibility. Cancer vs. allergies is irrelevant.
 - e. Summary of Medical Expenses Deduction:
 - i. Rationale: Expense is only returning you to **baseline** of well-being – doesn’t count as consumption.
 - ii. Line-drawing problems: sometimes expenditure also looks like core personal expense under § 262. E.g., home care, vehicles/travel, children. If exceeds baseline, want to deny deduction.
 - iii. Generally, only the classic trappings of medical profession are deductible: doctors, hospitals, prescription drugs. Keeps it cabined. Oral contraceptives are both medical & personal – deductible. Delivering baby at hospital deductible – but not sick. Just looks “medical.”
 - iv. Rules are over- and under-inclusive.
 1. Underinclusive: Arguably *Ochs* should have gotten deduction – didn’t rise above baseline.
 2. Overinclusive: Only people above 7.5% floor are either very poor, OR have huge expenses that verge on personal, e.g., private nurse at home. Deductible b/c w/in “trappings” cabin.
 - v. Incentive for employers to provide medical insurance – employees don’t want deductible, want first-dollar coverage, want high premiums so they get above floor.

4. Charitable Contributions (incentives)

a. **Rule: Donation is deductible for the donor if:**

i. **§170(c)(2)(A)-(D):**

1. Goes to U.S.-based organization;
2. Entity is a “good guy,” i.e., “exclusively for religious, charitable, scientific, literary or educational purposes, or amateur sports competition, or prevention of cruelty to children or animals.”
3. No part of organization’s net earnings inure to benefit of private s/holder or individual;
4. Organization can’t polictially lobby under 501(c)(3).

ii. Plus must meet:

1. Must have no private benefit from gift
2. Must be a common law charity → PP

b. Other Rules:

- i. Contributions of long-term capital gain property: deduction is equal to full FMV of property (not FMV [minus] basis). Better result than selling and donating cash. So they want you to donate this higher amount. §170(e). 1 year. Allocate basis if don’t give whole thing. § 170(e)(2).
 1. Here limited to 30% of AGI.
 2. For short-term capital gain or OI, deduction is limited to TP’s basis in property.
- ii. Cap on Deductions: §170 deduction limited to 50% of AGI, with rest carried over for 5 years.
- iii. Charity Itself: 501(c)(3) tells us when the organization itself doesn’t have to pay tax on its income (usually they overlap, but political organizations are under 501, but not §170).
 1. Unrelated Income: if organization does stuff unrelated to tax-exempt stuff, it is taxed on it. *NYU Case*. But returns on endowments/investment income is not something unrelated.

c. Private Benefit:

i. Summary:

1. In all hard cases, TPs are getting something in return for donation. Must determine whether the thing they’re getting is: (1) in line w/ the org’s purpose, i.e., a usual public-regarding expenditure, or (2) inconstant w/ org’s purpose (i.e., the thank-you CD, or the radio broadcasts)?
2. In business context, if “substantial benefit” → lose deduction entirely (*Ottawa Silica*).
3. In non-business, if “private benefit” → deduct excess over value to contributor.
 - a. E.g., Radio CDs: give \$50, get \$15 CD, only deduct \$35. We don’t want to subsidize the purchase of the CD. **You only deduct amount greater than FMV of thing received.**
4. More concern that not a charitable motive in business context. Plus, expenses deductible for businesses anyway, so less worried.
5. No deduction if you get something for free – didn’t pay income, and then try to take deduction. *Haverly* (teacher school books). Donation to charity treated as simultaneous income/deduction.

ii. Ottawa Silica: TP donated land to school; school must build access road, that will benefit TP.

1. Rule: If have “**substantial private benefit**” → Lose entire deduction.
2. “Incidental benefit” is OK → TP merely benefits by being member of general public.
3. Court denies deduction b/c benefit is personal (not just like member of public).
4. Better way to distinguish b/w substantial and incidental:
 - a. If you get something that *depletes* the org’s funds, such that they can now do *less* good stuff → “substantial,” lose deduction. E.g., CD for donation to radio station. Don’t want gov’t subsidy of CD, only of the good works.
 - b. If your benefit inures w/o impeding the org’s desired means of benefiting the public → merely incidental. Get deduction.
5. Under this standard, road was merely “incidental.” School did exactly what it wanted to.
6. Note: TP wants deduction under § 170 (rather than under § 165 cost of earning income):
 - a. More generous: Deduct full FMV (otherwise, just basis § 165).
 - b. Timing: Deduct now (otherwise, no benefit until actually dispose of – realization).

iii. Singer: TP donated sewing machines to school to create future customers → no deduction.

1. Benefit is substantial, not incidental. If giver has received or expects to receive substantial award, then quid pro quo removes transfer from deductibility. No weighing – ANY substantial benefit.

2. Precedent for *Ottawa Silica* case. Course thinks same.
 - iv. *DuVal*: TP donates to library; gets zoning variance in return → deductible.
 1. Test: If “not in substance a gift” → Lose deduction.
 2. Here, received zoning concession, but not literally condition precedent, and no real cost to town if zoning was arbitrary, so deduction is upheld.
 3. Kane: Zoning changes probably do cost something; this is private benefit, not like public road; should be no deduction.
 - d. Common Law “Charity” – Judicial Incentives: *Bob Jones*: no deduction because interracial dating policy violates PP and they are not “charitable.” Case about tax-exempt status of organization under §501(c)(3). We don’t want to subsidize govt partnership here.
 - i. Problem: § 501(c)(3) – “charitable *or* educational”—need not be both.
 - ii. Court moves to § 170, b/c works hand-in-hand w/ § 501(c)(3), and wants word “charitable.”
 - iii. But “charitable contribution” is defined disjunctively in § 170, too. No good.
 - iv. Argument: common law do-gooder gloss overlays § 170.
 - v. Problem: Can’t reach public consensus on “do-gooder” status, aside from definitional categories. Con Law doesn’t help, b/c *Brown* was public schools – this is private, facially neutral. Can’t claim 501(c)(3) status makes it “public,” b/c then religious orgs would be out.
 - vi. Some people are always going to find some private charity activity problematic.
 - vii. Legislative process won’t fund all the places we want. Plus, private donors are better at monitoring—private stake.
5. Personal Interest Expense
- a. Pre-1989, personal interest was fully deductible, Post-1989 fully disallowed.
 - b. Policy (Compare Credit Card Hog to...):
 - i. As compared to someone that has no money and defers consumption (i.e., fiscal conservative), it seems like taking a loan is a personal choice and no deduction. E.g., taking a vacation now is more expensive than taking it later when you have money. Don’t usually get deduction for this choice.
 - ii. As compared to someone with savings (i.e., trust fund baby), who blows it to consume (forgoing after-tax savings interest), it seems like you should be able to take loan and deduct interest payments to equalize these two cases.
 - iii. Law student response to N.Y. Times: Purpose of debt-funding is to spread consumption over life. E.g., student has time now, but no \$. Later, will have \$, but no time. Spread it out.
 - iv. Rules tell us it matters what you spend your money on; puts a lot of strain on tracing rules; have to know which pocket the money came out of; this is an issue whenever some money is debt-financed and other is savings or from accumulated wealth.
 - c. §163(a) – baseline rule of general deductibility of interest paid.
 - i. §163(a), (d) business and investment interest is deductible.
 - ii. §163(h)(1) – general rule of no deduction for personal interest – flips baseline
 - iii. §163(h)(2) Carve-outs:
 1. (B) Investment interest (under §163(d))
 - a. Borrowing to buy income-producing assets (i.e., investment assets), e.g., take out loan to buy stocks.
 - b. Below the line, but not MID (or above line if for rent or royalty, §212, §62(4))
 - c. Must realize investment income in that year; **only deductible up to income**, but if you don’t you can carry it forward until you sell (so just timing loss).
 - d. Not if you **claim capital gains rate on gains** (don’t want low rate for gain and big rate of deduction); then it’s ordinary income. (like cash dividends paid).
 - e. Policy: it’s earning money, not personal.
 2. (D) Qualified Residence Interest (under §163(h)(3)) – Statute Incentives
 - a. A.k.a., home mortgage deduction.
 - b. Below the line under §63, not MID under §67.
 - c. Deduct up to \$1M of acquisition debt for construction, purchase, improvement on principal residence (under §121) AND one other residence (w/in meaning of §280A(d)(1) – more than 14 days or 10% of rental days (check 141 rental days))
 - d. Deduct up to \$100K on home equity debt (i.e., any debt secured w/ home – loan can be used for anything).
 - e. Policy: homeownership subsidy. But houses tie up assets; less investment in other things. Plus, home equity loan can go to personal consumption.
 3. (F) Student loan interest (under §221)
 - a. Above the line under §62(a)(17).

- b. \$2500 max; Phase out above \$50K AGI; lose deduction if income over \$65K (individual, inflation-adjusted). § 221(b)(2)(B).
 - c. Policy: human capital, increased earning potential.
 - d. Tracing and Allocation: rules are formalistic and look at what account money comes from – use of money. Reg. 1.163-8T.
 - i. If use loan to start the business → deductible.
 - ii. If use loan to buy food or car → not deductible. Use cash in bank for personal expenses.
 - iii. Rules for commingled accounts: Treas. Reg. § 1.163-8.
6. State and Local Taxes Deductible - §164 – (Ability to pay)
 - a. When pay state and local taxes → deduction. But federal taxes → not deductible.
 - b. Itemized deduction, but not MID, so no 2% floor of §67. Possible 3% phase-out. (§ 68).
 - c. Taxes and QRI are the big-ticket itemized deductions. The two major ways TPs switch from being standard deducters to itemizers.
 - d. Can also claim deduction under §162 if T/B or §212 if for-profit activity.
 - e. User fees (sewer, tuition) not deductible.
 - f. Foreign income taxes also deductible but generally taken as credits under §901.
 - g. Policy: Ability to pay, not an incentive thing. Maybe you don't personally get benefit (kids go to private school); but still most taxes do give consumption benefit. So it's shifting – state and local taxes are cheaper at expense of federal government.
7. Personal and Dependency Exemptions (§ 151) – (Ability to Pay/Get to Baseline)
 - a. Personal exemption (w/ standard deduction) functions like zero rate bracket – some baseline should not be taxed. Amount is ~ \$3,500 (inflation-adjusted).
 - b. Qualify just by being alive. Everyone gets applied to SOMEONE's return. Only question is WHO?
 - c. BL Rule: Custodial parent claims dependent deductions. May transfer that right to the other parent through waiver (§ 152(e)(2)).
 - d. *King*: custodial parent executed waiver, but then wanted to disavow—claimed only applied to married couples. Holding: Waiver is effective b/w unmarried parents too.
 - e. Main point: IRS only wants each deduction taken ONCE. And makes sense to give presumption to custodial parent, and allow waiver through bargain. Marriage should be irrelevant. But code has not been explicit enough.
8. Earned Income Tax Credit (EITC) - §32
 - a. Wage subsidy for working poor → fully refundable → actually get money back!
 - b. Up to 2 kids increases number of credits.
 - c. Eligibility ignores gifts, support payments, and SS payments. Much fraud.
 - d. Phaseout as income increases → creates implicit tax on earning more → disincentive to increase earnings. Problematic b/c goal of provision is to encourage people to work.
 - e. Only way to mitigate phaseout disincentive is to make the phaseout line less steep – but then have to recoup more from higher incomes. No good solution.
9. Summary of Personal Deductions
 - a. Rationale can be broken into two types:
 - i. Ability to Pay
 - ii. Incentives (for things we like)
 - b. Ability to Pay
 - i. This is a fundamentally *tractable* problem (unlike business/personal question).
 - 1. The spectrum for the business/personal question has two clear endpoints (§ 162/212 vs. § 262). But no conceptual analogue of the business endpoint in this context.
 - 2. Conceptual analogue would be like saying that paid \$10 for ice cream, but if subjective consumption value turned out to only be \$8, we give you a \$2 deduction. We don't do this. If we did, would have genuine intractability. Problem here is administrable b/c no general attempt to determine real consumption value.
 - 3. Just allow a partial window of exceptions: Casualty Losses, Extraordinary medical expenses, taxes, personal/dependency exemption
 - 4. These exceptions induce behavior of TPs trying to cram things into those doctrinal boxes.
 - ii. Mechanisms for curbing TP abuse:
 - 1. Statutory: Floors (§ 165(h) (losses), 213(a) (medical))

2. Judicial: Core personal expenses (Taylor, Henderson, Ochs – home, child care, and transportation), Foreseeability (Dyer, Chamales – cat & OJ – if you have ability to not suffer this loss, then no deduction).
- c. Incentives
 - i. Has nothing to do with ability to pay. Not a problem of tractability – administrable. Just a matter of policy disputes. Difficult to reach consensus on the best policy.
 - ii. Charitable contributions – lesson of Bob Jones – how broad should deduction be, and how to draw line b/w organizations that give rise to deduction or not – if have to reach consensus, then why not just do it through legislature.
 - iii. Qualified Residence Interest – encourage home ownership—but lead to debt-fueled home ownership, plus sinking capital into houses.

III. Timing

A. Annual Accounting – taxable periods create informational and acceleration/deceleration problems.

1. Intro: Taxable Periods
 - a. An indefinitely long taxable period would be most fair (i.e., treat the artist w/ fluctuating income the same as the office employee w/ stable income).
 - b. But need finite taxable periods for administrability. Fixed taxable periods create informational and time-value of money problems.
 - i. Informational – From an ability to pay perspective when we slice taxpayer activity into arbitrary periods we may end up with results that are wrong under a longer time horizon (*Sanford & Brooks/sec. 172; Claim of Right Doctrine/North American Consolidated/Lewis, Tax Benefit Rule*)
 - ii. Acceleration/Deceleration – Because of time value of money considerations taxpayers now have incentives to assign income to later periods and deductions to earlier periods
 - c. Full refundability would solve information problem, and create better incentives
 - i. Full refundability: symmetry for losses and gains; get refund for losses, pay tax for gains.
 - ii. Resolves information problem when losses and income are in different years. Refunds and tax net out, as if in same taxable period.
 - iii. Creates better incentives: Tax system should reflect that person w/ \$0 income is better off than person w/ -\$100 income. Further, doesn't encourage losses (still losing more than tax benefit).
 - iv. Example of good incentives:
 1. Investment has a 50% chance of a \$1.5M gain and a 50% chance of a \$1M loss. This investment has expected value ex ante of \$250K (i.e., $50\% * 1.5M + 50\% * (-\$1M)$). It has positive expected value so it would be efficient for the taxpayer to undertake the project.
 2. Now consider a system with a 40% tax rate and no refundability (much like our actual system). The expected value of the investment is now negative \$50K (i.e., $50\% * \$900K + 50\% * (-\$1M)$). The taxpayer does not undertake the project.
 3. Now add full refundability of losses. The expected value of the investment rises to \$150K (i.e., $50\% * \$900K + 50\% * (-\$600K)$). Proper incentives are restored. Another way to look at it is that with a 40% rate a pre-tax expected return of \$250K should yield an after-tax expected return of \$150K. That's the result we'd get with full refundability but a result that we do not get under our current system.
2. Use of Hindsight – carrying things forward or back
 - a. *Sanford & Brooks*: court award of \$\$ to compensate for losses in prior year taxable in year awarded.
 - i. TP argument: Applying annual accounting is tantamount to a gross receipts tax (b/c don't get to take out offsetting expenses) → violates Constitution b/ no apportionment.
 - ii. 16th Amendment allows Congress adopt annual accounting, even though it doesn't account for losses in past years. Congress didn't deny deductions—TP just didn't have any income to offset against at the time. Issues: time value, higher rates in different years, no refundability.
 - iii. Note: § 172 (Net Operating Loss deduction) passed in response to such injustice to TPs.
 - iv. You have to have income in year to take loss in that year. **Non-refundable system.**
 - v. Refundable system is best solution:
 1. Wouldn't encourage loss: it would only dampen the disincentive to lose money, just like we dampen the incentive to make money. And it would make government share loss of risk, just like it shares risk of gain.
 2. Planning tax shelters and political concerns against it.
 - vi. Four possible solutions, w/o adopting refundability:
 1. Lifetime accounting: NO - not administrable; wouldn't work for corporations at all.

2. Transaction accounting: NO - hard to define particular Ks (no “natural” meaning); hard to allocate general expenses across Ks; long Ks approach lifetime problem.
 3. Capitalization: YES - spread expense over period in which income is coming in (useful life); allows for some degree of matching. Doesn’t help S&B b/c not capital.
 4. Net Operating Losses deduction: YES. Would have saved TP.
- b. **Net Operating Losses** (§172): Allows TP to take deduction for net operating losses over span of yrs.
- i. **2/20 window**: Can carry loss back 2 years, forward 20 years. TP doesn’t get to choose which years to apply it to—take deduction in earliest possible year when you have income (starting w/ Y-2, then Y-1, Y1, Y2, . . .).
 - ii. This is an **overt exception to annual accounting rules**.
 - iii. Not a transactional model—can offset income from any transaction.
 - iv. This works for §162 & § 212 expenses that exceed income to offset.
 - v. §165(a)-(c): TP can take deduction for T/B losses, for-profit activity losses, casualty losses.
 1. Limited to amount of basis.
 2. Can’t use it for personal assets.
3. Claim of Right (include) – if cloud, include income in early year, but end up getting to deduct if wrong.
- a. *North American Oil*: Y1: receiver held disputed \$; Y2: gave it to TP; Y3: dispute resolved for TP. TP must include in Y2, b/c actually received, under claim of right, w/o restriction as to disposition.
 - b. *Lewis*: Y1: TP received illegal bonus; Y2: had to give back half the bonus. TP must deduct in Y2, not carried back to recomputed Y1.
 - c. Fact pattern (both *NAO* and *Lewis*):
 - i. Y1: Receipt of money w/o restriction on use, but cloud on title (need not know about cloud).
 - ii. Y2: Resolution of cloud.
 - d. Rule (both *NAO* and *Lewis*):

<ol style="list-style-type: none"> i. Y1: If receive cash in Y1 under claim of right, then claim in Y1, notwithstanding cloud. ii. Y2: When cloud is resolved, get deduction IF you pay the money back. Otherwise, do nothing.
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 - e. Problems with rule:
 - i. Deferral – TP loses benefit of deferral (but maybe accurate, b/c had \$\$ all along to invest).
 - ii. Changing tax rates – TP wants to take deduction in high-rate year. (resolved by § 1341).
 - iii. Alternative rule: wait-and-see → bigger finality problem. Also, big deferral benefit.
 - f. **§1341**: Claim of Right Credit
 - i. If claim-of-right deduction > \$3K, then TP chooses:
 1. Deduct in Y2, OR
 2. Take credit for amount deduction would have been worth in Y1.
 - ii. TP will claim this credit when Y1 has *higher* tax rate. TP is immunized from low rate swing, but can get benefit from high rate swing (TP win-win).
 - g. Policy: Tension b/w “perfect” equity for TP and finality (maintain taxable periods) w/ imperfect info.
4. Tax Benefit Doctrine (deduction) – opposite problem of claim-of-right.
- a. Paradigm case – *Alice Phelan Sullivan Corp.*
 - i. TP makes charitable contribution; takes the deduction. But org has to use it for X purpose. If they can’t use it for X purpose, return a few years later.
 - ii. TP should have to include in Y2, b/c took deduction in Y1. (watch for DOI.)
 - b. Paradigm Structure:
 - i. Y1 = Deduction + Contingency
 - ii. Y2 = Expense Returned
 - c. Rule:

<ol style="list-style-type: none"> i. Deduct in Y1; then include in Y2. ii. § 111: BUT if (or to the extent that) the TP got 0 value from the deduction in Y1 (e.g., if already had net losses) (and any loss carryovers from deduction have expired), then may exclude in Y2. iii. Note: No equivalent to § 1341 here – if rates go up, TP suffers b/c include higher than deduct.

 - d. Examples (re fluctuation in rates):
 - i. Y1 → 15% rate; \$100 deduction → \$15 value
 - ii. Y2 → 40% rate; \$100 inclusion → \$40 tax cost (here, the tax benefit rule is operating harshly—lost more cost than gain in value) – no equivalent of 1341.
 - iii. Y1 → 40% rate; \$100 deduction → \$40 value
 - iv. Y2 → 15% rate; \$100 inclusion → \$15 tax cost (here, the tax benefit rule gives TP a large benefit) – and no provision claws it back. Systematically gives TP tax breaks if rates drop.
 - e. Policy: Same tension b/w “perfect” equity and finality in face of imperfect info in Y1, as above.

B. Investment in Property – Gains and Losses

1. Intro: Realization and Recognition

- a. Realization principle means accessions to wealth are not always taxed currently.
- b. Realization began as a constitutional doctrine (*Macomber*) but was quickly repudiated (*Bruun*) in favor of statutory and common law principles.
- c. **Policies underlying the principle: liquidity, valuation, and uncertainty of gain/loss.**
- d. § 1001 equates realization with a “sale or disposition.” → much struggle to determine meaning of “disposition” → should decide based on underlying principles.
- e. Potentially difficult issues arise when taxpayer seeks to take losses without fully closing out its position (*Cottage Savings* and “legal entitlements” test, *Jordan Marsh* – TPs still have econ stake) or avoid gains while essentially closing out its position (*Woodsam* and midstream nonrecourse debt)
- f. Statutory nonrecognition provisions prevent otherwise realized gains from being taxed currently (§ 1031 like-kind exchanges; § 1033 involuntary conversions; § 1041 property transfers b/w spouses)

2. Constitutional Realization Principle

- a. *Eisner v. Macomber*: stock dividends → not taxed (no realization).
 1. Corp issues stock dividend. Stock dividends decrease value per share, but increase liquidity of stock (e.g., hard to buy in \$250 chunks). Par value = amount initially paid in for stock. Corp. must re-classify some of their \$\$ to par total to account for the extra shares. Gov’t is trying to tax the value added to the par at the time of the dividend.
 2. No question that *cash* dividends are income. Only issue is whether *stock* dividends are too.
 3. Statute is clear: “stock dividend shall be considered income, to the amount of its cash value.”
 4. TP argues statute is unconstitutional for two reasons:
 - a. No increase in wealth – just cut piece of paper in half → this is completely wrong (could apply same argument to cash dividend – no better off, just changed form of wealth from company’s coffers to \$ in pocket)
 - b. Wrong type of wealth increase – tax on stock is like tax on underlying property, rather than the income from property (cite *Farmer’s Loan*) → TP wins on this.
 5. Court’s test: Income → derived = severed from capital and received by TP for his *separate use*. (This sets line b/w income and property.)
 - a. Stock dividend fails test → not severed for purposes of TP → no additional rights to get at corporation’s assets (corps don’t allow you to just turn in stock and claim \$\$).
 - b. By contrast, cash dividend is severed for TP – has right to \$\$.
 6. Lousy constitutional law (we don’t need severance any more).
 7. But good tax policy. Reasons for requiring realization (and why stock dividend fails):

<ol style="list-style-type: none">a. Valuation: hard to valueb. Liquidity: don’t have cashc. Certainty: might go down or up tomorrow

 8. *Pollack v. Farmer’s Loan*: pre-16th Amendment: taxing rent on property is like taxing underlying property, and you can’t do that w/o apportionment → 16th Amendment overruled to the extent that you can tax income from property; but still can’t tax property itself.
 9. *Holmes Dissent*: “Income from whatever source derived” is as capacious as can be – whole point of amendment is to avoid silly metaphysical distinctions b/w income and property. Realization shouldn’t be in the constitution – this is today.
 10. *Macomber* has never been overruled – *Bruun* just limits it to its facts so essentially gone.
- b. §305: Current law on stock dividends: **Stock Dividends** are not taxable – must be realized; but §305(b) taxable if you had option to take cash.
 1. After stock dividend, basis of old shares allocated b/w old and new shares. §1.307-1(a).
 2. New shares for capital gains purposes deemed held as long as old ones. §1223(5).
 3. Foreign Corporation: foreign corporations don’t get taxed on interest. If you control foreign corporation and it’s earning interest income that isn’t realized, we still tax you on it, even though you haven’t sold that company. Taxing appreciation on growth of foreign shell. So no constitutional realization doctrine.

3. Non-constitutional realization principle

- a. *Bruun*: Tenant improvements → realization
- b. LL taxed on building built by tenant on land, even though building can’t be severed from the land. Limits *Macomber* to its facts. Constitutionally right; Wrong result.
- c. Options for when the TP is made better off:
 - i. At time of lease, LL is no better off: just trade income stream for right to use land.

- ii. At time of construction of building: LL is no better off, b/c building has only 50-year life, will be gone by the time LL has right to re-enter.
 - iii. At abandonment: LL gets to re-enter early and gets new building he didn't have before – looks better off now. But is he really? T abandoning b/c lost value. Despite building, no gain in aggregate. No underlying wealth increase.
 - iv. Wrong result b/c probably no increase in value.
 - d. **§109 Exclusion for Improvements** (reverses *Bruun*), but:
 - i. But can't make the tenant improve instead of rent to get out of income on rent.
 - e. §1019 cannot include improvement in basis – so if we are wrong, and improvements do increase property value, you pay tax on sale (but deferral).
4. **Current status of realization principle:**
- a. Closest provision: §1001: Realization = “**sale or disposition.**”
 - b. *Bruun* tells us realization principle still exists: “While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset.”
 - i. I.e., realization principle exists.
 - ii. Sale of an asset is always realization (most obvious case for value, liquidity, certainty).
 - iii. But don't always need to have a sale for cash.
5. **(Midstream) Nonrecourse Borrowing In Excess of Basis (No Realization)**
- a. *Woodsam*: Want to Liquify, But Don't Want Gain
 - i. Years after acquiring property, Wood took out \$400K NR loan on property in which she had \$296K basis. Later, transferred property to corporation Woodsam (takes substituted basis). Later, corporation “sold” for \$0, subject to mortgage, then \$381K outstanding.
 - ii. Issue: What was basis? (Depends on whether NR loan was realization.)
 - iii. TP: refinancing was realization event; had taxable gain of [NR loan] – [basis]; should have been taxed; basis in property then increased to amount of NR loan (\$400K). Transfer now is a LOSS b/c high basis (\$400K - \$381K).
 - iv. Government: probably would rather have TP's acceleration of gain in earlier year, too.
 - v. Court: NR refinancing was not realization – straight statutory interpretation: TP didn't “dispose” (§1001(a)) of property, as in “get rid of” or “relinquish.” Was still the same owner before and after mortgage. Wants TP to have paid in early year (now closed). Plus, *Crane* says NR = R.
 - vi. But really, principles of realization were satisfied by NR loan:
 - 1. **Liquidity**: you get cash from loan.
 - 2. **Valuation**: get floor of valuation (property must be worth *at least* NR loan).
 - 3. **Certainty of gain**: gain is locked in; never pay \$\$ back if property tanks.
 - vii. By contrast, recourse loan does not satisfy realization principles;
 - 1. Liquidity: yes (get cash)
 - 2. Valuation: no (tells us nothing about value of property)
 - 3. Certainty of gain: no (if property tanks, can go after other assets)
 - viii. Thus, in *Crane*, saying NR = R was legit, b/c NR/R difference not significant to the question of likelihood of repayment, which is the only issue for whether to include amount of loan.
 - ix. Here, saying NR = R is not legit, b/c NR and R have different realization consequences.
6. **Loss** – seeking loss without fully closing out – Swapping Properties (realization)
- a. Easiest way to get a tax loss on depreciated property: Sell it! But if TPs think value might go back up or still want to use, they want realization now, w/o selling.
 - b. Cottage Savings: thrift allowed to realize losses when exchanged devalued mortgages for other mortgages, b/c different “legal entitlements,” thus “materially different.” So §1001(a) loss.
 - i. **Test: Realization requires distinct “legal entitlements.”**
 - ii. Analysis:
 - 1. Bad realization policy: swapping legal entitlements gives no info about valuation. E.g., swap unique artworks – distinct legal entitlements, but learned nothing about valuation. Valuation depends on liquid market in the property (not legal entitlements). Plus, legal entitlements distinction can be arbitrary (e.g., bale of cotton, or palette X of cotton).
 - 2. Worry TPs can manufacture losses opportunistically – will only swap when tax loss. Bad for tax policy.
 - 3. But at least it's an easy test! Alternative rule required looking to attitudes of parties, regulators, and secondary mortgage market regarding whether change had econ substance → not administrable at all!

4. Plus, swapping requires large TCs (must pay brokers). So banks can't just trigger the tax loss willy-nilly. Court's solution may be elegant after all, b/c very administrable, and at least there's a limit to abuse.
- iii. Case:
1. Bank takes in \$ through demand deposits (fixed debts, variable interest rates); pays out \$ in exchange for mortgages (assets, fixed interest rates); then interest rates go up, making mortgage notes worth *less* (b/c could make the same loan for *more* now). Income stream stays fixed, while expenses go up (b/c must make higher interest payments on the deposits).
 2. Therefore, value of bank's main asset (mortgages) has gone *down*, making s/holder equity go *down*, meaning debt to capitalization ratio goes *up*, approaches 100% (debt/debt+equity [original deposits/assets]), that is, leverage has gone up, and equity cushion is almost zero (if equity cushion low, creditors will run to bank to demand their deposits back, b/c in danger).
 3. FDIC (TPs) must pay creditors if bank can't. So federal regs require shutting down bank once equity cushion drops below certain level. Ostensibly to protect depositors; but depositors will get paid—the reg is really to protect TPs.
 4. Bank wants to recognize loss for tax benefit; but if sell, would have to record accounting loss, and risk closure by fed. Still hoping interest rates will go back down; just trying to stay afloat until then.
 5. Memo R-49 (1980): if you exchange mortgage for “substantially identical” mortgage, then you can amortize accounting loss over the life of the mortgage (helps thrifts—don't have to recognize whole loss in year of exchange). But get whole tax loss upfront. Fed explicitly acknowledged purpose was to generate tax losses w/o affecting econ position of bank.
 6. Bank exchanged mortgages – all for single-family homes in Cincinnati. Face value \$7M, but FMV \$4.5M. Claimed tax loss of \$2.5M.
 7. Court: § 1001 requires “disposition” for realization → “disposition” requires “material difference” b/w the properties (longstanding treasury reg) → “material difference” requires “legal entitlements that are different in kind or extent” (reincorporation cases). Therefore: **Realization requires “distinct legal entitlements.”**
 8. Here, mortgages are for different houses, therefore distinct legal entitlements, therefore material difference, therefore realization, therefore tax loss.
- iv. *Higgins*: but if you sell securities to yourself, not arm's length, then it doesn't count.

7. Non-Recognition Provisions

a. Like-Kind §1031

- i. Even if have realization (e.g., *Cottage Savings*), still no tax if no recognition. Recognition is statutory overlay reflecting tax policies of deferring gain or loss. (But if don't have legal entitlements under *Cottage Savings*, then don't even get to recognition question.)

ii. Rule (§ 1031):

1. (a)(1) **No recognition of gain or loss** when exchange properties that are “**like kind**,” so long as both are used in **T/B or for investment**. (No gain—just assume old basis (tax deferral)).
2. (a)(2): But **doesn't apply to stocks, bonds, notes** (and other); these are recognized, even if swapped for like-kind. (why it didn't apply to *Cottage Savings*.)
3. (b): **If there is boot, then recognize the gain, up to the amount of boot received.** (I.e., recognize everything you get, minus old basis, but capped at cash/FMV of boot).
4. (c): If there is a loss, **no loss recognized, notwithstanding boot.** (i.e., adding a little boot doesn't mean you get to take a loss).
5. (d) **New Basis = Old Basis + Gain Recognized – Money Received.** (Remember: you are trying to preserve the untaxed gain so it can be taxed later.)

iii. Meaning of “Like-Kind”:

1. No clear test for “like-kind.” Look to regs and Rev. Rulings.
2. “Like kind” references the **kind, class, nature, or character** of the property, and not its **grade or quality**. Reg. §1.1031(a)-1(b).
3. Rev. Ruling 82-166: **gold and silver** have different properties are not like kind (“intrinsically different metals and primary used in different ways”).

4. Gold (bullion) vs. gold coins are not like-kind b/c “represent totally different types of underlying investment,” i.e., investment in gold itself on world market vs. coins themselves. Rev. Rul. 79-143.
 5. All real estate is like-kind, whether improved or not; and leasehold greater than 30 years = real estate. Vehicles used for same purpose are like kind. Copyrights for novels are like kind, but copyright for novel vs. copyright for song are not. Examples of like kind: Reg. §1.1031(a)-1(c).
 6. Swapping primary residence house for house held for investment is *not* like-kind.
- iv. Basis Calculation:
1. No Boot: Keep old basis (property swapped) for the new property.
 2. If boot received: §1031(d): **new basis** of property = old basis of property swapped PLUS gain *recognized* MINUS any money received (boot).
 - a. So §1001 *amount realized* is FMV of property you get + boot received. *Gain* is amount realized MINUS basis (of old property, whether borrowed or cash).
 1. But under §1031, gain is only *recognized* up to amount of boot.
 - b. **Net debt relief:** counts as boot, debt relief MINUS debt you take on.
 - c. Old basis will typically remain. But old basis will be *reduced* if value of boot received is greater than the gain of the property (so now you are *net positive* and we need to tax that). Or if you realized loss in exchange
 - i. So if there is a loss, you don’t get to take it upfront, it just gets added to the basis of the property you take. No loss recognized. 1031(c). So bring in 3rd party to buy the property that was lost.
 - d. Person who gives boot gets to increase basis by *amount of boot given*. Reg. § 1.1031(d)-1(a).
- v. Example:
1. Property 1: Adjusted Basis = 10; FMV = 100
 2. Property 2: Adjusted Basis = __; FMV = 80
 3. Swap #1 for #2. Plus throw in cash = \$20. (B/c swapping 100 for 80.)
 4. Amount Realized = 100 (b/c getting 100 value = 80 + 20).
 5. Gain Realized = 100 (amount realized) – 10 (basis) = 90.
 6. Gain Recognized: § 1031(b): Recognize gain of 90 up to the boot (i.e., 20). Therefore, 20 recognized.
 7. New Basis = 10 (old basis) + 20 (gain recognized) – 20 (boot) = 10.
 8. Basis going forward is \$10.
- vi. Policy:
1. Combats lock-in. Want trades to take place for efficiency, so person who values property more has it. Don’t want to impede by forcing tax cost. Problem: this argument applies equally to any appreciated property, not just like-kind. Artifact of realization-based system: anytime you have untaxed appreciation, lock-in problem.
 2. Fairness: Given commitments of realization based system, this just doesn’t look like the right time to tax you. Your position hasn’t changed much. And you might not have liquidity. And valuation problems (that’s why we only tax up to boot – tells us the parties’ *difference* in valuation).
- b. Jordan Marsh: Taking Losses w/o Closing Out (same goal as *Cottage*) - Recognize
- i. Sale & leaseback is realization (like *Cottage Savings*) and it’s recognized (not in §1031).
 - ii. Leasehold has no capital value in itself (unless rent prepaid) so it’s not “like-kind.”
 - iii. This a §1001 disposition: not a §1031 “like-kind” exchange – they actually sold the property for \$2.3M. Lease has no capital value b/c of offsetting obligation to pay rent.
 1. Note: If had prepaid rent, then leasehold would have capital value.
 - iv. This transaction looks like a loan: TP gets cash upfront (sale price); then pay back slowly over time (“rent”); if default, lose property. If called it a loan, then no realization. *Woodsam*. But b/c it was a “sale,” TP wins.
 - v. And TP doesn’t lose value of depreciation deductions, b/c deducts rental payments instead.
 - vi. But Reg. §1.1031(a)-1(c) says that 30-year plus leasehold *is like-kind* to real estate.
 1. Maybe only if no rent liability, and it therefore has capital value.
- c. Involuntary Conversions - §1033
1. If property is involuntarily converted (e.g., by “destruction, theft, seizure, requisition, or condemnation”), there is **no gain recognized:**

- e. If property is **replaced with “similar”** property (§1033(a)(1)), then mandatory nonrecognition, or
 - f. If money is paid, if money is used to by similar property within 2 years (§1033(a)(2)), then nonrecognition is optional (except to the extent the money exceeds the cost of the replacement property).
2. No change in position, so no tax on replacing property.
 3. Losses can be recognized (outside of § 1033) – we aren’t afraid you will trigger the loss and not take the gain because it’s involuntary by definition.

C. Constructive Receipt and Related Issues

1. Constructive Receipt - where nothing is actually received (include if unrestricted right to receive)
 - a. Unrestricted right to get *cash* = received (**fiction**). – subject to will and control of TP.
 - b. Note: Goes against cash basis accounting (i.e., no income until cash in hand).
 - c. Paradigm case:
 - i. Dec. 31 at 4PM, employer gives you a bonus that you can pick up in accounting office. You don’t pick it up until Jan. 2. Rule: Include in Y1, b/c had right to claim it, even though didn’t.
 - d. Amend (grain dealer): no constructive receipt because no actual right to get cash under the grain K, even though services were delivered in that year. You can contract around constructive receipt.
 - i. Can achieve deferral by contract, i.e., by giving up legal right to get funds that year.
 - ii. Mere promise to pay in future ≠ CR ≠ cash (no include; don’t even worry about installment).
 - iii. Have to be consistent though – override if accounting doesn’t “clearly reflect income” §446(b).
 - iv. Court finds TP wasn’t being opportunistic by shifting income to low-rate years – but not clear relevant to the rule. Only problem is information (TPs don’t know when low rates will be).
 - e. Obviously passes §83.
2. Economic Benefit – where something is received, but it’s not cash (include if safe from creditors)
 - a. Actual receipt of valuable property that is not cash. E.g.: in-kind benefits, right to get cash in the future (constructive receipt overlaps – CR is one kind of economic benefit).
 - b. Note: Goes against cash basis accounting (i.e., no income until cash in hand).
 - c. Pulsifer: TP must include *now* sweepstakes winnings to which he had an absolute, nonforfeitable right.
 - i. Winnings were **“irrevocably set aside for him in trust and is beyond the reach of creditors.”** All TP had to do to receive was apply for them as his children’s legal guardian.
 - ii. B/c TP could immediately apply for funds, looks like CR too.
 - iii. If hadn’t been able to immediately apply—just set aside, safe from creditors, but can’t receive until future, not CR, just EB (but it has to be secure (*Rev. Rul 60-31* and it has to be able to be valued (*Minor*)).
 - iv. If property for services, §83 also must be met to include.
 - d. See also OID.
 - e. For deductions, you have to actually pay. But if you write a check, or a credit card, that counts.
3. Deferred Compensation –
 - a. Paradigm:
 - i. Y1: Services; Y2: Receive compensation. (Why? TPs want tax deferral.)
 - b. Goals:
 - i. Gov’t wants to match the income item w/ the deferral item (include when ‘ER deducts).
 - ii. TP wants security w/o taking cash currently. (But deferral usually entails risk.)
 - c. **Rev. Ruling 60-31** (incorporates common law doctrines):
 - i. **Mere promise to pay in the future** → no inclusion. (accords w/ *Amend* (no CR)).
 - ii. But if **funds are set aside from creditors** → inclusion (rule of EB, *Pulsifer*).
 - d. *Minor*:
 - i. TP is doctor, gives services to corporation; corporation takes payments from ‘EEs, puts money in a trust; TP paid from trust over time. (Corp., not TP, is beneficiary.)
 - ii. Issue: Include for TP in year services performed, or year \$\$ from trust paid out?
 - iii. No constructive receipt b/c TP may not demand payment; only right to the \$ is through the K.
 - iv. No economic benefit b/c property was not secured, i.e., segregated from creditors. Property had to pass through corporation. (B/c not secured, then § 83 is irrelevant.)
 - e. § 83: Transfers of Property
 - i. Applies only if (1) not cash; (2) property if secure from creditors (otherwise, not property).
 - ii. If you receive property for services, then includable when earlier of 2:

1. **Transferable** (company stock might not be); or
 2. **Not subject to substantial risk of forfeiture** (from anything: credit or leaving company early, or otherwise).
- iii. And property is something that is **easy to value**: Economic benefit rule tells us to include, but §83 tells us when.
- iv. §83(h): Match inclusion and deduction: employer gets deduction when employee includes.
- v. § 83 serves two functions in code:
1. Backstop to TP's tax planning. Even if get past CR and EB, still have to include in Y1 if § 83 says so.
 2. Deals w/ situation where employer gives restrictive compensation as "golden handcuffs," i.e., if you leave the company, you'll lose it.
- f. Qualified Plans
- i. Nonqualified plans have to squeeze through §83 and common law like *Minor*. But not capped.
 - ii. *Rabbi Trust*: set it up so no current right to cash and creditors can slightly get at it (so it's not under §83), but only if something triggers it, like insolvency of the employer paying the money in. So nonqualified, but protected.
 1. Tension between tax benefit of deferral and risk that it won't be paid by company (like basketball player payment example).
 - iii. § 409A (applies to nonqualified plans): Amounts payable in future are taxable when bargained-for if the plan allows employees to accelerate benefits or provides that upon deterioration of the employer's financial health, assets are shielded from outside creditors.
 - iv. *Olmsted*: assignability doesn't matter – its just one K replacing another one, doesn't mean that it's constructive receipt. Getting a new K is not property (like *Amend*). (Cf. *Eubank*)
 - v. Qualified plans are blessed by statute, but are capped. §401(k).
 - vi. Employer gets deduction when contribution goes in, but employee only includes when gets paid later.
 - vii. Non-discrimination provisions.
- g. Al-Hakim: TP wins deferral, b/c genuine risk could lose \$\$ (if eliminate risk, lose tax benefit).
- i. TP negotiated Ks for professional athletes; took commission as interest-free loan to be repaid over 10 yrs.; then takes fees over 10-yr. period (loan repay and fees offset each other).
 - ii. Achieves deferral: Only pay tax on yearly fees that are coming in (not on upfront "loan").
 - iii. TP wins: Agent is taking risk – loan and fees are not contingent on each other. If player went bankrupt, TP would lose fees, but still be responsible for loan repayments. Genuine risk that even though sitting on all money in Y1, won't get to keep it all.
 - iv. Only way to eliminate risk is to make payments secured – but then would be taxable.

D. Transfers Incident to Marriage and Divorce

Not only about timing issues.

The more something looks like an arms-length transaction, the more it should be a taxable transfer.

1. Property Settlements (in marriage, exclude; if pre-nuptial, include)
 - a. Davis (divorce) – "overruled" by § 1041 (or, more accurately, § 1041 says don't recognize, notwithstanding that it counts as realization under Davis)
 - i. Transfer of appreciated stock to wife pursuant to property settlement agreement executed prior to divorce is a realization event because she traded back a release of other claims.
 - ii. Value? Rights are inchoate until judicial determination tells us what they are. Can't value inchoate rights. Makes assumption that amount realized is value of stock transferred, that is, that it's arms-length tx, and value of property = value of consideration given in exchange.
 - iii. Transferor: Gain = Amount realized (FMV of stock *transferred*) – Basis. (Just like sale.)
 - iv. Transferee: §1010 cost basis in stock acquired is **FMV at transfer**. (Implicit.)
 - v. Outside marriage – **Davis is still good law for valuation principle: for hard-to-value items, use the value of the consideration given in exchange.** E.g., stock for art work → transferee will take stock at FMV basis. Transferor taxed on gain of stock, b/c art work is hard to value.
 - b. §1041: Nonrecognition of Property Transfers During Marriage: ("overrules" *Davis* result)
 - i. **No gain or loss recognized** on transfers of property *between spouses OR incident to divorce* (within one year). → Treat it like a gift. Account for gain through substituted basis.
 - ii. Transferor: no tax, never realized gain.

- iii. Transferee: treated as gift, takes **substituted basis** of original donor (**even if transferor had a loss**) (substitutes for §1015).
 - iv. Not available to unmarried couples! Would not apply to *Farid*, unless waited to transfer until after already married.
 - v. Applies at divorce, even though divorce looks like an arms-length transfer, not a gift. This is b/c don't want federal tax to depend on state property law regimes (community vs. civil).
- c. *Rev. Rule 87-112* (OID)
- i. § 1041(a) does not apply to untaxed interest build-up prior to transfer; if H transfers bond to W, then interest accrued from date of original issuance until date of transfer is includable in H's income; after transfer, interest is taxable to W.
- d. *Farid* (**pre-nuptial**) – transfers before marriage are like a sale
- i. Transfer *before* marriage, w/ pre-nuptial agreement to waive rights.
 - ii. Majority: transfer is not a gift; valuation for both parties is FMV of the property (like *Davis*).

<ul style="list-style-type: none"> 1. Transferor gain = FMV – adjusted basis (not a gift; must recognize). 2. Transferee = FMV cost basis. § 1010. She will only pay tax when she sells.
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 - iii. Dissent (option 1): this is a gift; not taxable; recipient takes substituted basis.
 - iv. Dissent (option 2): not a gift, but valuation must account for value of rights W surrendered, which were huge (H is rich). Upshot: H gets huge gain; W gets huge basis in property; W will get huge loss when sells the property. This is crazy. Why is should be a gift.
 - v. Valuation question:
 - 1. If it's really **arms length**, then the value of the stock works (*Farid, Davis*).
 - a. Note: Could contract around to have transfer take place *during/after* marriage – then get §1041 result.
 - 2. If it's really **out of love**, then it should be a gift (*Farid* dissent)
 - a. In pre-nuptial context, couple still loves each other, less likely to be arms length, more likely gratuitous. Waived rights might be much larger than property transferred. (Though no rights unless he says “I do!”).
 - b. Pre-nup is really like saying marry me as if I'm poor, and I'll give you a gift. Thus, should be gift.
2. Alimony (cash to ex-spouse – include, b/c more likely to be arms-length than property or child support)
- a. Rule:
 - i. § 71: Inclusion for recipient spouse (above the line § 62)
 - ii. § 215: Deduction for transferring spouse. ← benefits the transferor.
 - b. Conditions:
 - i. Must be in cash. §71(b)(1). (If it's property, then in § 1041 box).
 - ii. Cannot be used for child support. §71(c)(1).
 - iii. Parties can opt out.
 - iv. Under written divorce agreement, §71(b)(1)(A)
 - v. Can't continue after death. §71(b)(1)(D).
 - vi. Can't end at a certain age of children, §71(c)(1).
 - vii. Must live in separate households, §71(b)(1)(C).
 - viii. Can't be front-loaded in first three years. §71(f). → pushes it to property settlement § 1041.
 - c. Policy: Why distinguish b/w cash and property?
 - i. Property → not taxable, looks more like a division of pre-existing jointly held property, not yet arms length.
 - ii. Cash → taxable, more likely to be arms length, and accrued after the end of the marriage.
 - iii. Cash/property line is imperfect, only a proxy.
3. Child Support (exclusion b/c less likely to be arms-length)
- a. If Paid:
 - i. No deduction; No inclusion. (Exclusion rule is implicit in § 71.)
 - ii. Just a support payment to your child that you love.
 - b. **If not Paid: Rule: No deduction for would-be recipient if payment not made.**
 - i. *Diez:*
 - 1. Ex-wife wants “Bad Debts” deduction (§ 166) b/c didn't get the \$ she was owed.
 - 2. § 166 is the inverse of DOI (bank gets deduction if borrower doesn't repay in full).
 - 3. TP loses, b/c she didn't technically lend anything – has no “basis” in the debt.
 - ii. *Kane:*

1. Could give TP basis in the “debt” through payments actually made to support child; or in virtue of the value of rights she surrenders in exchange for support payments; or could view as gift. All three would support a deduction here. The doctrine just fails.
 2. To achieve equity b/w TP who receives child support and the TP who deserves child support but doesn’t get it, should give deduction (like *Clark* analysis) – no valuation problem here (unlike bad tax advice situation), b/c payment amount stipulated.
- c. § 166 – Bed Debts
- i. Like the inverse of DOI. Here, bank gets deduction if borrower doesn’t repay in full. Standard principle of tax law: if never get the income that is supposed to offset basis, get to deduct your basis. Allow realization when reasonable degree of certainty that won’t be repaid.
4. Summary
- a. As transactions get more arm’s length, then we tax like a realization event (alimony, property before marriage).
 - b. If not arm’s length, then we say it’s a gift (property transfer during/after marriage, child support).

E. Cash Receipts v. Accrual Methods

1. Intro: Methods of Accounting
 - a. Cash basis taxpayers report income when cash is received and deductions when cash is paid.
 - i. General exceptions: constructive receipt, economic benefit (*Pulsifer*), OID
 - ii. Application: deferred compensation. Cash basis taxpayers may in general defer income by contract (*Amend*) but must navigate CR and EB doctrines and § 83.
 - b. Accrual basis taxpayers report income and expense when *fact* and *amount* of income/liability are settled with reasonable certainty (All Events Test). This reflects a more accurate picture of economic position – would rather be A w/ right to \$1M in Y2, than B, w/ \$50 in Y1. Rights matter.
 - i. “Late Cash” – Include in income unless reasonable expectation of insolvency (*Georgia School Book*); not usually a problem for accrual basis b/c don’t care about time of cash, except for in a narrow case like *Georgia School Book*.
 - ii. “Early Cash” – Accurate reflection would require accrual over time (AAA and §§ 455/456). Worry about mismatching – cured to some extent by § 456 and *Artnell*.
 - c. Installment method trumps both cash method and accrual method → helps TPs.
 - d. Relation between tax accounting and financial accounting – accuracy versus administration.
 - i. Cash basis – relatively simple, but less accurate.
 - ii. Accrual – more difficult, but more accurately reflects finances.
 - iii. Similarly, tax accounting rules are more simple than financial accounting – but the price for that simplicity is accuracy. Exemplified by AAA.
2. Accrual Accounting: usually more accurate than cash, except early and late cash problems.
 - a. **All Events Test**

<ol style="list-style-type: none"> i. <u>Income</u>: Reg. 1.451-1(a): Includable when all events have occurred such that: <ol style="list-style-type: none"> 1. <u>Right</u> to receive money fixed <ol style="list-style-type: none"> a. Reasonable Expectancy money will be paid. <i>Georgia School</i>. b. If right is in dispute, or debtor insolvent, need not include. <i>Id</i>. 2. <u>Amount</u> can be determined with reasonable accuracy. ii. <u>Deductions</u>: 1.461-1(a)(2): Deductible when all events have occurred such that <ol style="list-style-type: none"> 1. <u>Fact</u> of liability fixed; 2. <u>Amount</u> of liability fixed w/ reasonable accuracy; 3. Economic performance has occurred.
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3. Late Cash: right is established, but payment dubious.
 - a. *Georgia School Book Depository* – (TP fails)
 - i. TP is book agent, earns 8% commission from publisher for sales K b/w state and publisher. TP must include commissions if reasonable expectancy of payment, based on solvency of obligor. TP’s args;
 - ii. Not yet earned: Receipt of money from state to give to publisher is actual part of right accruing – part of what agent had to do. But that was “least of his duties.”
 - iii. “**Reasonable expectancy**” of being paid. Uncertainty must be interpreted narrowly b/c otherwise would undermine accrual method (obligor will deduct, obligee will wait to include).

1. Narrow exception: “To allow exception there must be a definite showing that an unresolved and allegedly intervening legal right makes receipt contingent or that the insolvency of his debtor makes it improbable.”
 2. Court says state of GA is good for its debts, so TP must include. Actually irrelevant—TP’s rights run against publisher—should look at solvency of publisher. TP has *right* to be paid by publisher, even if state hasn’t paid yet. TP still has a right. See who you can go against.
- b. Hallmark Cards – (TP succeeds)
- i. If no change in title to property, no right to income yet (dispositive under A.E.T.).
 - ii. Court will not be as strict if both counter-parties must be consistent – serves as natural check on TP manipulation. Here, legal title is clearly determined by property law, so confident both counter-parties will take consistent positions. Hallmark doesn’t have to accrue income, but stores can’t deduct. By contrast, “reasonable expectation” is vague, could abuse.
4. Early Cash: cash upfront, but expenses spread.
- a. AET looks satisfied if you get cash early: (1) right; (2) certainty of amount. But argument that since accrual method is all about accuracy in reflecting income, should spread income across expenses.
 - b. AAA v. U.S.:
 - i. A.E.T. requires including all annual membership dues as all income in taxable year paid, even though services are spread out over two years. Members *could still demand* it all in early year.
 - ii. If members were *legally bound* to spread out services, then Sup. Ct. might have allowed.
 - iii. AAA wanted to include 50% in Y1/ 50% in Y2, to match income to expenses in aggregate.
 - iv. Other options: ratably by time (period joined); expense matching (by predictable expense).
 - c. § 456: **prepaid membership dues can be spread out ratably over 3 years.** Overrides AAA.
 - d. § 455: magazine subscriptions can be spread out.
 - e. If not covered by statute, AAA still binding law, but income-matching still possible:
 - i. *Michigan*: tried expense matching, but no evidence of when expenses accrued. Include.
 - ii. *Schlude* (dance case): pre-pay, dance lessons spread out over time, can’t demand. Include.
 - iii. *Arnell* (baseball season tax): Allow pre-pay income deferral for games to be played in following year. Couldn’t possibly demand services back early. Time & extent of future services sufficiently specific. → Opens door to income matching.
 - f. Income-matching problem cannot be solved by accelerated deductions, b/c of § 461(h).
 - i. **Economic performance** requirement: Cannot take deduction until actually perform services.
5. Deposit v. Advance Payment: can get around inclusion rule by structuring it as a security deposit. Must be protected against risk of being paid late or not at all. Case from the book here?
6. Policy
- a. Tax accounting favors administrative ease over financial accuracy.
 - b. But breaks down in *Georgia* and AAA when there is dubious economic reality.

F. Recognition of Losses, OID, Open Transactions and Installment Sales

1. Original Issue Discount [not on exam]
 - a. Implicit interest inside zero-coupon bonds (no interest until Y10) must be reflected for both bondholder and bond issuer. Determine by difference b/w amount paid in Y1, and payout in Y10.
 - b. Reason: Match deductions to income; bank (accrual method) is taking deductions over time; bond holder (cash method) was waiting to claim income until Y10. OID resolves. §1.272-75.
 - c. If you give property in exchange for bond, then calculating OID more difficult: must assume prevailing interest rate, and use Y10 payment amount to figure out value of consideration paid: to find basis.
2. Open Transactions/Installment Sales:
 - a. Open Transaction: when total value of consideration to be received for sale is dependent on a contingency, and so uncertain we cannot put a present value on it. Unsure if will even recover basis.
 - i. **Rule: Basis first recovery.** Burnet v. Logan. (VERY small window.)
 - ii. *Burnet v. Logan*: TP received \$120K cash, plus future payment contingent on the amount of ore the company could mine. Basis first based on uncertainty (like *Inaja*).
 - b. Closed Transaction: Put present value on future stream of income and **include all in Y1**.
 - c. Installment Sale (statutory default): §§ 453, 453A, 453B
 - i. **Realize income in amount proportional to ratio of total gain / total payments.** § 453(c).
 - ii. E.g., if TP sells property w/ \$100K basis for \$300K total payments over 5 years, then total gain/payments = 2/3. For each payment, 2/3 will be recognized, 1/3 go to basis recovery.
 - iii. TP can opt out of installment method. § 453(d). But then will almost surely be closed tx.

- iv. Installment method applies to ('trumps') both cash and accrual method of accounting.
Benefits TP in both cases:
 - 1. For cash basis, if you have a negotiable note from purchaser, treated as equivalent to cash → installment method benefits TP, b/c otherwise would probably be closed tx.
 - a. But mere promise to receive payment in future is not cash (*Amend*).
 - 2. For accrual basis, you would accrue income in Y1, would most often be closed tx → TP benefits from installment method.
 - v. § 453(e): Can't "sell" to daughter as installment sale, then have her sell to 3rd party for full payment upfront. When daughter receives the \$, mom treated as receiving it too.
3. Summary of Exceptions:
- a. Cash: CR, EB, OID, Installment Sales
 - b. Accrual: Early Cash, Late Cash, Installment Sales.

G. Timing of Deductions – Capitalization & Portioning of Assets

- 1. Intro to Capitalization:
 - a. Terminology:
 - i. "Expense" = current deduction (i.e., take whole amount as offset against income in year it occurs)
 - ii. "Capitalization" = create basis in a long-lived asset; then recover that basis either through (1) depreciation deductions, or (2) realization event at disposition.
 - iii. Long term capital asset is any asset held for longer than a year, unless inventory § 1221.
 - b. Policy:
 - i. More accurately reflects how well off TP is that year – TP has merely converted her wealth from one form to another – not worse off until asset starts to lose value (if deducted full cost, would result in understatement of income, b/c still has valuable asset at end of year);
 - ii. Matches expense of long-lived asset w/ income it produces over time. Accrual method alone is not enough to achieve spreading, b/c accrue full expense in Y1.
 - iii. Allocation problems in *Encyclopedia* (what project), *Seeds* (seeds or farm), *Norwest* (general plan), *Water Tower* (getting back to baseline). (like subjective valuation, or business/personal, don't know what that person really thinks it is).
- c. Code Geography for Capitalization:
 - i. § 162: generally allows deduction for T/B expenses.
 - ii. § 263(a): denies immediate deduction of "capital expenditures" even if T/B.
 - iii. § 263A: provides that direct or indirect costs of creating assets must be capitalized.
 - iv. § 167: allows depreciation deductions for property that is income-producing or T/B.
 - v. § 168: allows ACRS deductions.
 - vi. Depreciation:
 - 1. TP can take a depreciation deduction for exhaustion and wear and tear for assets held for the **production of income** or used in **T/B** (excludes personal assets). § 167.
 - 2. Deduction is taken against ordinary income. § 167.
 - 3. Asset must be "wasting asset." Land, antiques excluded.
 - 4. Must determine "useful life" of property in order to depreciate.
 - 5. § 168 – ACRS speeds up depreciation of basis (tax faster than economics).
 - 6. § 174 – Exception for R&D (need not be capitalized).
 - vii. When dispose of asset, any gain is treated as capital gain. Except:
 - viii. Recapture Rule:
 - 1. For personal property, gain on disposition is treated as ordinary income to the extent of prior depreciation deductions. § 1245. Any gain beyond that is capital gain.
 - 2. For real property, recapture amount is excess of accelerated depreciation over straightline. § 1250. (All property acquired after 1986, uses straightline anyway.)
- 2. Encyclopedia Britannica: (capitalize costs of creating a capital asset)
 - a. Cash advance paid to 3rd party for encyclopedia manuscript (which goes against future royalties) → TP must capitalize, b/c cost of creating valuable long-lived asset, i.e., the encyclopedia. Follows rule of *Idaho Power*, b/c no admin complexity here.
 - c. *Faura/Snyder* (exception): freelance authors can deduct expenses (notwithstanding hope will create future income stream). EB court reconciles by saying this case is an exception based on administrative complexity: too hard to match expenses to future assets when have multiple projects simultaneously.

- d. *Idaho Power* (rule): capitalize amount spent on trucks over *useful life of capital asset created* – the power lines (longer useful life than trucks). But absorb cost of truck into power line basis. **Cost of creating capital asset must itself be capitalized**. If you buy something with a longer life to make something with shorter, you keep it at longer life – it will produce more stuff.
- e. Note: Creates disincentive to outsource. If outsource, clear allocation → must capitalize. But if bring in-house, will be hard to allocate among the multiple projects going on → will get to deduct.
- 5. § 263A: Requires capitalization even of in-house expenses (at cost of admin complexity).
 - a. Need not capitalize marketing, advertising, and costs of general and administrative expenses that do not relate to sale or production. Reg. § 1.263A-1(e)(4).
- 3. Rev Rul. 85-82: (buying hybrid capital/expense, i.e., farm w/ plants):
 - a. Farmer buys farm. Sale price includes value of the crops already growing on it. Farmer may not immediately deduct the cost for the crops (though he could deduct if he planted himself, under regs). Can only recover by adding amount into basis and then selling.
 - b. Reg. 1.162-12: cost of seeds and young plantings may be deducted immediately → helps farmers.
 - c. Benefit of the regulation does not transfer to Buyer (even though Seller didn't take it). Not a problem of double deduction (if seller took deduction, would have offsetting income item from higher sale price). Plus, allowing transfer would help Seller, b/c could get higher sale price.
 - d. Problem here is allocation. Don't know how much seeds/young plants were worth. Buyer has incentive to say 90% of price was for crops, deduct right away, no basis.
 - e. Rule introduces distortion: comparatively more expensive to plant then sell, than to plant and harvest.
 - f. Whenever buy assets, allocation to basis among the assets is messy. Each asset has different useful life. Incentive for purchaser to push purchase price onto relatively short lived property, take deductions early. Disincentive to push onto long lived property. Rev. Rul. 85-82 avoids problem by denying deduction. But in corporate acquisitions, won't be able to avoid—must allocate.
- 4. Capitalization of Intangibles – “Amortization”
 - g. Acquired intangibles:
 - i. § 197: Provides 15-year amortization for all acquired intangibles (inc. goodwill).
 - ii. Amount paid above FMV of assets.
 - iii. Solves problem of TPs litigating which label applied to various intangibles. E.g., Newark–TP arguing subscriber base not “goodwill” (b/c no depreciation for goodwill).
 - iv. [??] If not on the list, then you have to prove it has a useful life. If you can't prove that, no deduction. [is this right??]
 - h. Self-created intangibles:
 - i. *Lincoln Savings* (1970): bank paid premium to secondary reserve for insurance; if premiums exceed pay-outs, \$ in reserve can go to future insurance premiums. Holding: must capitalize in virtue of fact that reserve was “**separate and distinct**” asset.
 - ii. *Briarcliff Candy* (1973): **no separate and distinct asset** created for just promoting candy in pharmacies; *even though* it will create a future benefit. Can deduct expenses immediately.
 - iii. For years, TPs took *Lincoln* and *Briarcliff* to mean “separate and distinct asset” was a necessary *and* sufficient condition for capitalization.
 - iv. *INDOPCO* (1992): when acquire another company in a merger, the cost of lawyers and bankers in negotiating the merger must be capitalized, b/c creating a **future benefit**, even though not separate and distinct asset. Separate and distinct is sufficient, but not necessary for capitalization. Key sentence: Realization of benefit beyond the current year is “undeniably important” in determining capitalization (i.e., emphasis on future benefit). Problem: Led to uncertainty about tax position.
 - v. Reg. § 1.263(a)-4 (overrides *INDOPCO*) – rule for self-created intangibles:
 - 1. List of certain intangible assets you must capitalize expenses related to.
 - 2. If not on list, IRS will not argue that capitalization is required merely b/c of expectation of future benefit. (Overrides *INDOPCO*). (generous to industry)
 - vi. But if you have a “separate and distinct” asset, then you still must capitalize per *Lincoln Savings*: if it's measurable and capable of being sold. Reg. § 1.263(a)-4(b)3.
 - vii. [??] What if it's created by TP and is intangible, but not on list [which list??]? Then go back to common law (§167, just for tangibles) – justify life on intangible, then get depreciation. But if it's indefinite, then no depreciation. Like *Welch*.
- 5. Goodwill (self-created)
 - i. *Welch v. Helvering*: TP voluntarily pays off debts that were discharged from old company in bankruptcy to have goodwill with new company (still dealing w/ same sellers).

2. Water treatment structure → Capitalize. Physical structure w/ value beyond year.
 3. Soil → Deduct (§ 162). Only returns TP to baseline – no better off.
 4. *Plainfield-Union* before/after test: compare asset *after* expense to asset *before* condition that gave rise to expenditure: If no better off, then not capital.
 5. Could argue water treatment facility would pass *Plainfield-Union* test too—only returns groundwater to its clean state—no value if water isn't bad. Maybe distinction is device vs. soil. Or maybe TP looks better off in virtue of treatment fixtures, b/c can prevent situations in the future.
 6. Maybe some of soil goes above baseline? Too hard administratively—just deduct.
 7. Soil here is different from *Idaho Power* because not part of production of capital asset. (But isn't it indirect cost of creating the goods that TP manufactures?? – but that may not be a capital asset.)
- iii. Rev. Rul. 2004-18: (similar facts to above)
1. TP must “inventory” cost to remediate soil, b/c it's an indirect cost of producing inventory (TP owns a manufacturing plant).
 2. This doesn't overrule R.R. 94-38—just fills out meaning, under new § 263A.
 3. Inventory accounting: method of accounting that TPs are required to use whenever acquiring and selling goods. Analogous to capital recovery – inventory being sold over time. Remediation of soil was just one of indirect costs of acquiring inventory.
 4. This rule would not apply if TP did not have inventory, e.g., if TP were a ski resort. Then could claim deduction under authority of Rev. Rul. 94-38.
- m. Reversing Decline AND Adding Value (capitalize everything)
- i. *Norwest*: learn about asbestos in building. Remove asbestos in conjunction w/ remodel. Cost of removing the asbestos is capitalized, b/c it's part of the **general plan of rehabilitation**.
 - ii. *Plainfield-Union* (if it's to make you whole, then it's just deduction) and *Midland* (basement repairs, proxy for loss) tell us to deduct. Revelation about asbestos caused econ loss.
 - iii. Govt: But the building was just bad from the start – there was no loss that caused repair. It was bad, you just didn't know it before, and now you are making it better. Plus, no “baseline” to compare against—“baseline” would be no-knowledge world. Can't go back.
 - iv. Kane: Knowledge is an “event,” b/c pricing takes risk into account. E.g., buy life insurance against risk—not a bad purchase just b/c you don't die.
 - v. Court agrees w/ TP that asset did not materially increase in value. But still requires capitalization, b/c remodel and asbestos removal were integrated into **single general plan of rehabilitation**. But for remodel, no asbestos removal.
 - vi. Ideal rule: Bifurcate the two transactions. But administratively difficult.
 - vii. Court's rule encourages people to separate asbestos removal and remodel (so efficiency losses). But other way would make people stick them together and claim more \$\$ was for asbestos (tax distortion). Must figure out which distortion is worse.
- n. Summary of Repair and Maintenance Expenses
- i. Treas. Reg. 1.162-4:
 1. “Incidental Repairs” that do not add value → Deduction
 2. Repair “arrests deterioration” or “prolongs life” → Capitalize
 3. Does not answer all questions
 4. What is rationale where “incidental repair” adds no value compared to some baseline but involves a long-lived attribute?
 - ii. Scenario 1: Repair reverses an unexpected decline in economic value
 1. Theoretically “correct” answer would be to give taxpayer a loss under § 165 but cannot do this because the loss has not been realized under sec. 1001.
 2. The “correct” answer is approximated through a **repair deduction under § 162**, which stands as a good proxy for the amount of the loss. (i.e., the very amount we'd be worried about not knowing w/o realization.)
 3. Indeed, with accelerated depreciation, the deduction under section 162 may be optimal because it best maintains chosen divergence between tax and economic depreciation. (When give loss, smashes econ and tax together; have to start divergence over – though don't restart the period – just steeper line.)
 4. *Midland Empire, Rev. Rul. 94-38* (soil & water remediation deduction), *Plainfield Union*

- iii. Scenario 2: Repair is a routine cost of maintenance consistent with expected decline in economic value
 1. No economic loss in this case (i.e., no discrete jump ahead on econ curve).
 2. The theoretically “correct” answer is capitalization where item has useful life beyond the current year.
 3. **Rule is deduction**, understandable for reasons of administrative convenience
 4. Treas. Reg. 1.162-4 (first rule).
 5. *Example*: Contrast expensive truck that never requires replacement of belts with cheap truck that requires replacement of belts every three years.
 - a. *Expensive truck* – cost of extra-good belts will be built into capital expense.
 - b. *Cheap truck* – will get deduction for the belts – even though “correct” answer would be to capitalize it over the three years.
- iv. Scenario 3: Repair reverses an unexpected decline in economic value but also adds economic value
 1. Theoretically “correct” answer would be to bifurcate into a reversal of loss component (deductible as in Scenario 1) and a valued added component (capitalized)
 - a. Before/after component (e.g., asbestos removal) – should get deduction.
 - b. Value-added component (e.g., attendant remodel) – capitalize.
 2. **Rule is capitalize everything**, understandable for reasons of administrative convenience but note distortions
 3. *Norwest v. Commissioner, Rev. Rul. 94-38* (treatment facilities), Treas. Reg. 1.162-4 (second rule)

IV. Who is the Taxpayer?

1. Intro to Income Splitting/Shifting:
 - a. This is a WHO question.
 - b. Arises for two reasons:
 - i. **Progressive rate schedule** (*Sanford*): you want to shift extra money from higher rate bracket to lower, and want a “**fresh start**” at bottom of bracket.
 1. Part of this is that phase-outs and credits are part of progressivity.
 2. Also shifting from taxable entity (corporation) to tax exempt organizations.
 3. Flat tax would solve this.
 - ii. **Non-refundability** of tax system.
 1. Shifting can counteract net losses. Shift to TP who has a net loss, b/c she is indifferent to adding another income item, b/c of non-refundability.
 2. Full refundability would solve this.
2. The Marriage Penalty and Bonus
 - a. Optimal split b/w two TPs is always 50-50. Can never do better than 50-50.
 - b. Two main marriage issues:
 - i. **Singles Issue**: traditional family (one earner) v. single person: if we allow shifting, then man who marries is better off than man who is single. **Shifting leads to marriage bonus and singles penalty**. Argues for: *no shifting*.
 - ii. **Modern Family Issue**: traditional v. modern (two earners) – modern family gets “shifting” benefit naturally, b/c their incomes are divided b/w them. To get parity – allow shifting within traditional family. Must view family as a “unit.” **No shifting disfavors the traditional family**. Argues for: *allow shifting*.
 - c. Four distinct periods:
 - i. Period 1: *Earl* and *Seaborn* to 1948: Separate filings for everyone. Can’t use Ks to get beneficial split. In common law, its 100% (*Earl*); in community property, it’s 50/50 (*Seaborn*). Puts pressure on states to move toward community property. Plus, federal income tax shouldn’t depend so much on states.
 - ii. Period 2: 1948 to 1969: Congress creates joint return – still just one rate table. For married couples, tax liability = double the amount of tax on half of income. Rule gives effect of **50-50 splitting**, two starts. **Full Marriage Bonus**. But maximum **Singles penalty**.
 - iii. Period 3: 1969 to 2003: Congress – new rate tables for different filers. Married couples use joint form w/ lower preferential rate, but based on all the income. Rule has effect of **80/20 splitting**. **Smaller Marriage Bonus**: for traditional family (1 earner). But for the *modern couple* (2 earners) where they would have 50-50 split *by themselves*, then it screws them: they now have to combine at 80-20 (at the preferential rate). **Marriage Penalty**: for modern couples. Cannot opt out—required to file jointly. Only way out is not to get married.

- iv. Period 4: 2003 – present: Effective 50-50 split (i.e., no marriage penalty) in 15% bracket. Higher brackets remain at 80/20. Encouraging marriage and “traditional” values for low-income people. (But not higher income people b/c tax system can’t afford it?)
- d. No good solution:
 - i. Three “entities” in play:
 1. Singles
 2. Traditional Family
 3. Modern Family
 - ii. 50/50 shifting (*Seaborn*):
 1. Maximum marriage bonus – good for traditional families.
 2. But maximum singles penalty – bad for “modern” couples and singles.
 3. Plus, puts much huge pressure on fault line of whatever is recognized by society as “marriage.”
 - iii. 0/100 (no shifting) (*Earl*):
 1. No marriage penalty or bonus (marriage is irrelevant to tax law)
 2. Good for “modern” couples.
 3. Disfavors traditional family, vis-à-vis “modern” family. BUT: traditional family probably has imputed income that is not being taxed – so maybe shouldn’t be worried about this apparent “disfavoring.”
 4. May not properly reflect the fact that family functions as single economic unit.
 5. Would result in political push-back from “conservatives.”
 - iv. Compromise: Anything b/w 50/50 and 0/100:
 1. Currently, 80/20 for higher rate brackets.
 - v. But note: this is only a fairness/equity issue. Not an efficiency issue—don’t think people are actually shaping their behavior based on tax.

3. Income Shifting Generally (Beyond Marriage)

- a. Direct question: Is this an anticipatory assignment of income in order to get around the progressive rate structure?
- b. **Proxy Test: Is assignment negotiated? → tracks possibility for manipulation by TP.**

	Shifting Allowed?	Type of Law	Negotiation?
<i>Earl</i>	No	Private	Yes
<i>Seaborn</i>	Yes	Public	No
<i>Armantrout</i>	No	Private	Yes
<i>First Security Bank</i>	Yes	Public	No
<i>Teschner</i>	Yes	Private	No (K of adhesion)

- c. *Earl* (private law, negotiated):
 - i. Husband contracted with wife in 1901 to send 50% earnings directly to her. (1921 system: separate filings, one rate table). **Result: No shifting**; H must claim all money. Good law, but narrow holding now: **no anticipatory assignment of services income**.
 - ii. Intent to dodge tax? contract was made before income tax, so that wasn’t why they had the K.
 - iii. If H controlled defacto?: yes, ignore K then. But that doesn’t drive the court. Party who performs services get taxed. Ultimate use/control is irrelevant.
 - iv. “The fruits are attributed to a different tree from that on which they grew” → but this doesn’t help always; with partnership you do allocate salary differently from earning them.
 - v. Holmes: issue is not to be decided by “**attenuated subtleties**” → fruit and tree matters.
 1. **Reg. §1.61-2(c)**: if you perform services *directly for* charitable organization, then no income arises. Son runs charity, mom is a singer. So that’s a way to give income.
- d. *Seaborn* (public law, non-negotiated):
 - i. W reported 50% of H’s salary, b/c state community property laws automatically vest 50% of income w/ W. **Result: Shifting allowed**. Distinguish from Earl:
 1. Ontological claim – “Instantaneous vesting” theory: In *Seaborn*, rights vested in W instantaneously, while in *Earl*, K was only effective b/c vested for a moment in H. Therefore, property was first “of” Mr. Earl, then subsequently transferred by operation of K.
 2. Method of assignment – state-created right vs. private K.
- e. *Armantrout* (college fund, private):

- i. Employer sets up trust for employees' children's college expenses. If leave company, don't get anything.
 - ii. **Result: No shifting**, private arrangement. Like *Earl*. Effectively just diverting labor income to children. Should be taxed to employee, not child.
 - iii. But, if employee in a large company—has limited negotiating power. So maybe quasi-private, not really manipulative. Like *Teschner*.
 - f. *First Sec. Bank*:
 - i. Holding company w/ 2 subsidiaries: bank and insurance company. Bank issues insurance policies, then under reinsurance, policies go to insurance company. All income from insurance goes to insurance company.
 - ii. If were operating at arms-length, bank would clearly have earned commission from valuable service. Therefore, IRS wants to “deem” some income as commission to bank (§ 482 – must act like arms-length). Bank wants insurance co. to get to report all the income.
 - iii. **Result: Shifting allowed**. Public law bar: would be illegal for bank to earn the money.
 - g. *Teschner*: TP assigns right to win contest to his daughter because she's under 17. Contest rules governed by private law, but court says yes, shifting!
 - i. **Result: Shifting** (even though private law). – narrows *Earl*.
 - ii. Rationale: It's a **non-negotiated arrangement**, just like public law – “independent third-party.” No possibility for TP manipulation.
 - h. *Clerical Cases*: vows of poverty – court says no shifting because it's negotiated.
 - i. But this is wrong from a PP standpoint – there is **no manipulation** (even though **negotiation**). You are an agent for the church. Nun must include income under § 61.
 - ii. This evidences that the negotiation proxy doesn't always get the policy right.
 - iii. Plus hit by another bad law—only get to deduct 50% for donating to charity (§ 170), even though entire wage goes to the order!

4. Transfers of Property vs. Income-Producing Property

a. Rules:

Blurry line!!

Past services can morph into property

- i. No assignment of (future) *services income*. *Earl*. (salary) (human capital not assignable.)
 - ii. Yes assignment *income-producing property*. *Blair*. (equitable interest) (alienable.)
 - iii. No assignment of *income from property*. *Horst*. (coupons)
 - iv. No assignment of *income from past services*. *Eubank*. (commissions)
 - v. Yes assignment of *past services if bundled w/ other rights*. *Heim*. (royalties + negotiation)
 - b. Line b/w human capital and property can be blurry. E.g., *Eubank*, *Heim*.
 - c. Line b/w property and income-from-property can be blurry. E.g. *Blair*, *Horst*.
 - d. Goal: For transfer to be effective, must package as something the court will be willing to view as a chunk of property.
 - e. Chart shows in **bold** whether court thought the assigned interest was property (tree) or income from property (fruit):

	Assignment Allowed?	Tree (OK)	Fruit (not OK)
Earl (salary)	N	Human Capital (future)	Services Income
Blair (trust beneficiary)	Y	Corpus	Trust Income
Horst (coupon bond)	N	Bond/Principal	Coupons
Eubank (commissions)	N	Human Capital (past)	Commissions
Heim (patent royalties)	Y	Royalties + Negotiation	Royalties

f. Income-Producing Property: (assignment OK)

- i. *Blair*:
 1. TP has life estate in trust (payments for rest of life). Assigns \$9K each to three kids (also for full duration of life estate).
 2. Result: Shifting OK. Children received more than income—got “**equitable interest**” – children got **right to enforce the trust**, e.g., could sue trustee if he absconded. This was a **horizontal slice** of the full property that Dad had to give.
- ii. *Leininger*: no assignment of partnership-distributed share
- iii. *Earl*: no assignment of services income
- iv. Services v. Property:

1. Property: §102: exclusion for gift recipient of property; §102(b) exclusion does not extend to **income from property** transfers by gift. Stock cash dividend is *included*. The income must **run with the property**, b/c **property is alienable**.
 2. Services: Human capital, giving services income. Can't give that human capital corpus. The underlying corpus here is **not freely alienable**. No shifting effect.
- g. **Income from Property**:
- i. Horst:
 1. Dad gives bond coupons to son.
 2. Result: No shifting. Bond coupons not assignable. (Note: Would be assignable outside of family context.)
 3. Three arguments:
 - a. Is there property? Dad still holds bond. Coupon is merely income from the bond. This is only a **vertical slice** of the income flow. Dissent: coupon is negotiable bearer instrument, just like bond – clearly transferable. If bond is property, coupon must be. Note: court does not examine whether coupon confers extra rights such that it looks like an “equitable interest” under Blair.
 - b. “Realization”: more about cash-basis accounting. Can't avoid including income simply by diverting it, e.g., to grocery store. *Old Colony Trust*. Likewise, Dad gets the benefit of the \$, b/c gets value from giving gift to son. Problem: would apply equally to Blair.
 - c. Fruit and Tree: tree is property, fruit is income. Fruit and tree blur. Coupons look like property when you snip. Plus, underlying asset of trust estate in Blair may have been a bond—income payments funded by coupons!
 4. Theoretically best result:
 - a. Both Dad and Son are taxed on **present value of their respective interests**.
 - b. But this would be too administratively complex. Instead, rule is all-or-nothing—everything taxed to Dad.
 - c. The error will get larger and larger, the more the bulk of the value is carved out to son, e.g., if income payments had extended for 50 years, instead of 3.
 - ii. Rules:
 1. No assignment of *services income*. *Earl*. (salary)
 2. Yes assignment *income-producing property*. *Blair*. (equitable interest)
 3. No assignment of *income from property*. *Horst*. (coupons)
5. Services v. Property
- a. Human Capital: *Eubank*: life insurance agent assigns renewal commissions. These are **earnings** (human capital), but in the **past** (so looks more like property—certain rights in the world).
 - i. Result: No shifting. Too much like Earl. No property-ish thing like a patent.
 - ii. Considerations:
 1. If allow shift: Looks like giving credence to instantaneous vesting theory—Earl must vest for a moment, while Eubank the rights are fixed, need not vest.
 2. If don't allow shift: Ignoring fact that right to income looks property—mere K saying you get income if X occurs (i.e., renewals). Not human capital.
 - b. Income-Producing Property: *Heim*: assigns inventions and patents to corporation (owned by family); corporation pays out royalties to TP; TP assigns royalties to family members.
 - i. Result: Shifting OK. Kids received more than royalties (which looks like mere income from property). **Received royalties-PLUS**. Can also re-negotiate, or demand stuff in case of underperformance. It's a package of rights. Like Blair. More property-like.
 - ii. Plus patent is more property-ish. We're used to it producing income.
6. Summary:
- a. Services, coupons, commissions → not effective (fruit).
 - i. Services: if they are going to be in the future, then clear, human capital is not alienable. *Earl*.
 - ii. Past services: commissions. Have to worry about alienability; it can be packaged into something like property. *Eubank*.
 - b. Equitable interest, royalties-plus → assignable (tree).
 - i. Property: hard to draw line. Alienable. *Blair* and *Horst* blend. *Heim*: if it *looks* like property, then you can do it, also assigned whole thing.
 - c. Practical point: if you want to shift, then make it look like property. Look at legal rights in “income.”
 - i. *Architect* transferring plans to child, somewhere in between. Plans look more like independent property than commissions. But plans don't usually result in independent income stream, like royalties. If just assign rental payments, no good. *Earl*.

V. Tax Shelters

1. Intro:

1. Every shelter is about finding mismatch b/w income item and deduction item.
2. But legitimate transactions do that as well (e.g., ACRS deductions). Must try to distinguish!
3. For all non-gratuitous transfers:
 - i. Inflow = X; Outflow = Y. Tax only net income, i.e., X – Y.
 - ii. Intuitive Tax Treatment = R x (X – Y) = RX – RY, where R = tax rate.
 - iii. **Effective Rate:** True “rate” applied, capturing all complexity of timing, character, who, etc.
 1. Exclusion → same as applying a zero rate to inflow.
 2. Denying a deduction → same as applying a zero rate to econ outflow.
 3. Timing → deferral is the same as applying a lower rate.
 4. Character → ordinary income is a higher rate than capital gains.
 5. Who → effective lower rate if able to shift.
4. **Key for all tax shelters: Effective rate of outflow > Effective rate of inflow.**
 - i. E.g., Inflow: \$100; Outflow: \$100.
 - ii. If rate on inflow/outflow is the same:
 1. $R(\$100) - R(\$100) = 0$.
 - iii. But if increase outflow rate relative to inflow rate, get a tax benefit that can be used to shelter another income item on your return:
 1. $(.10)(\$100) - (.20)(\$100) = -\$10 \leftarrow$ tax benefit (can use to “shelter”)
5. All tax shelters include one or more of three factors (if combine, even more supercharged):
 - i. **Deferral:** deduct now (higher effective rate), income later (lower effective rate).
 - ii. **Conversion:** deduct against OI (higher rate), include in CG (lower rate)
 - iii. **Tax Arbitrage:** deduct (higher effective rate), then exempt or exclude the income (zero rate).
6. Must distinguish shelters from legitimate transactions: No clear list of acceptable vs. non-acceptable tx.
7. Ways to attack suspected tax shelters:
 - i. Judicial decisions – *Knetsch* (sham in fact), *Goldstein* (no non-tax motive), *Franklin* (no equity), *Winn-Dixie* (sham in substance)
 - ii. Statutory rules – PALs, investment interest, at-risk rules
 - iii. AMT – nuclear option
8. TP will always cite *Gregory* – allowed to minimize tax liability.

2. Knetsch – (Sham Transactions)

1. Egregious case – anchoring point of tax shelters. Shelter based on **deferral**.
2. Basic idea:

	Borrow	Invest
Econ	\$100, at 10% = \$10 cost	\$100, at 10% = \$10 income
Tax	\$10 @ 80% = (\$8) loss	\$10 @ 0% = \$0

No reason to do this, absent tax

Get tax benefit

- i. Only differences:
 1. Rate was actually *higher* for loan than investment, so losing money pre-tax.
 2. Inclusion was just deferred (tax free interest buildup)—so lower rate, but not 0.
3. TP buys annuity policy, and simultaneously takes out NR loan on the cash value of the policy to fund the policy. (All at one time—circular cash flow.) Then takes further loan to meet the interest payment due on the initial loan. Leaves only \$1K net cash value in policy. Then cash value goes up. Does it again.

	Cash Value (2.5% rate)	Loan (3.5% rate)	Out of Pocket
Step 1: Borrow/buy policy	\$4M	\$4M	\$0
Step 2: Interest paid/due	+ 100K (interest paid)	→ \$140 interest due	\$0
Step 3: Borrow to pay interest due		+ 99K	+ \$41K
Step 4: Interest due on new loan		→ \$3K interest due	
Step 5: Pay interest due			+ \$3K

4. Totals:
 - i. Income: \$100K ** (no receipt until later)
 - ii. Interest Expenses: \$143K ** (even though some of this not paid in cash)
 - iii. Out of Pocket: \$44K
5. Tax Treatment: $R1(100) - R2(143) = Z$.
 - i. Idea: Rate differential b/w R1 and R2 is big enough to create a big enough tax benefit Z to make up for economic loss. Remember: R1 is low b/c get tax-free build-up in Cash Value until payout (deferral). R2 is big b/c upfront deduction for interest on indebtedness (§ 163(a)).
6. Holding: No indebtedness → therefore no deduction. (TP loses.)

- i. § 163(a) requires indebtedness. But, here there is certainty of repayment (debt is secured by the policy, which has a higher cash value). Indebtedness is not the core problem.
 - ii. §264(a)(2) bars deductions for interest on debt used to purchase single premium annuity contract. Single premium: frontloaded premium payments (take big deductions early). Court rejects argument that Congress must have blessed such transactions before 1954 revision.
7. Rationale: **This was a sham transaction**, i.e., mere paper shuffling. No actual change in parties' rights and responsibilities in the world. Knetsch just created money, w/o any risk at all. Note: Could also have been decided based on no non-tax motive (*Goldstein*)—but better to use sham theory if you can.

8. Sham-in-fact: Offensive features leading to “sham” label:

- i. Same-party Lender
- ii. Non-Recourse Loan
- iii. 100% financed.

9. Way to achieve same purpose, w/o offending factors:
- i. Use 3rd party lender (e.g., borrow \$4M from the bank to buy the \$4M policy);
 - ii. Use recourse debt (still no riskier than NR, b/c keep cash value higher than loan);
 - iii. Avoid 100% financing (take out \$3.9M loan, not \$4M).
10. Here, TP would win, b/c not a “sham”—transaction has actual substance. OK to be highly leveraged.
11. Recipe for shelter (easy to do!):
- i. Identify preference item w/r/t income (e.g., annuities).
 - ii. Finance it with debt, resulting in deductions.

3. Goldstein – (No Non-Tax Motive)

1. TP wins \$140K in sweepstakes. Then borrows \$465K @ 4% interest from bank, and prepays the interest. Then purchases treasury bonds for \$465K that will be redeemable for \$500K in 3 years, w/ interest of 1.5%. Effective interest rate of bonds: 3.95% (combination of stated 1.5% interest and implicit interest in OID).
2. Econ: Borrowing at 4% to invest at 3.95%! Bad investment, absent tax.
3. Tax: Shelter uses **deferral** and **conversion**:
 - i. Prepay interest → deduct now.
 - ii. 1.5% interest payments, periodic over 3 years → get deferral benefit
 - iii. Increase in value from \$465K to \$500K → treated as capital gain (at that time).
4. This is the “smart” version of Knetsch. No longer a sham.
 - i. 3rd party lender
 - ii. Recourse – but has bonds as security
 - iii. Risk – bank has right to call loan at any time (but very likely b/c prepaid interest)
5. In background: Gregory v. Helvering: TPs allowed to minimize tax liability.
6. Holding: TP still loses.
7. **Rationale: If can't plausibly state a single non-tax reason for transaction, then lose. (Sham in substance)**
 - i. Role of motive: If there is some non-tax motive, then there must be risk. So can't just enlarge these transactions to an arbitrary scale to zero out tax liability. B/c also increasing risk.
8. Rule: TP must convince the court that even w/o tax benefit, there is some shred of a reason to do the transaction. OK if took taxes into account, or even if tax benefit gave the biggest oomph. *Gregory*. TP only loses if there is NO non-tax motive at all.

4. Estate of Franklin – (Equity Theory)

1. Sale/lease-back. TPs buy Motel for \$1.2M. Motel lends the full amount. TPs “prepay” \$75K interest. Each month, TPs owe interest on loan, Motel owes rent; Interest = rent (no money changes hands). B/c TP is owner, gets depreciation deductions. Also interest deductions. Tax shelter uses **deferral** (deduct interest/depreciation now, include DOI income much later).
2. Option Theory: (lower court applied)
 - i. TPs didn't buy the Motel; just bought an option to buy at later time. Don't get a deduction for only buying an option. Why does it look like an option? NR (only lose \$75K if walk away); No deed transfer; Balance of payments (no \$ changing hands).
 - ii. 9th Cir. rejects option theory, b/c can imagine a situation that meets this framework but where deduction is legitimate. E.g., FMV = \$80; Note = \$60; Cash = \$20. Also looks like an option: buy the option for \$20, exercise price is \$60. **Key difference: Likelihood of exercising the option.** In this example, it's an “in the money” option—it makes sense to pay off the note for \$60 to get the asset valued at \$80. **Likelihood of exercising option depends on equity.**
3. Equity Theory:
 - i. So long as you have any equity, even only 1%, treated as owner and get the depreciation deductions.
 1. E.g., TP: 1%; Bank: 99% → TP treated as full owner, gets depreciation deductions.

- ii. But if no equity (i.e., NR loan > FMV), then not “true owner,” b/c unlikely to ever actually pay.
 - iii. Here, TPs had inflated the loan notes far above FMV, so not true owner.
 - iv. **Rule: If TPs want to be treated as “owner” for purpose of taking depreciation and interest deductions, NR loan must be less than FMV at purchase. [or at least not grossly exceed.]**
 - v. Constraining principle: **Equity creates risk, which prevents arbitrary scale.** Equity means you’ve put actual money in. And you might lose it. Therefore, can’t run to arbitrary scale. By contrast, if no equity, no risk, can run to arbitrary scale. That’s what we want to prevent.
 - 4. See also § 465 At-Risk Rule – serves similar function.
5. AMT – nuclear legislative response to tax shelter problem.
- 1. Intro:
 - i. AMT has broader base but lower rates.
 - ii. Maybe the AMT is actually purer, eliminates many preference items.
 - iii. Odd: tax system endorses preference items, even if people use to reduce tax liability by millions. Tax system only cares when individual TPs happen to reduce their liability to 0 with them (similar to charity cap concern).
 - iv. Statutory exemption is not indexed to inflation – so more people fall into AMT’s jaws every year.
 - 2. Mechanics:
 - i. Normal tax: Taxable Income under §63 x §1 rates = normal liability.
 - ii. AMT: AMTI (broader base) x §55 (lower) rates = AMT liability.
 - iii. AMT is not optional! TPs must pay whichever is greater.
 - 3. Calculating AMTI:
 - i. Taxable Income §63
 - ii. PLUS Adjustments/Preference items (§§ 56-58), e.g., state taxes.
 - iii. MINUS Statutory Exemption (\$58K married/\$45K single)
 - 4. Preference Items that TPs lose under AMT:
 - i. State and local income tax
 - ii. Personal exemptions for dependents
 - iii. Business or investment expenses that must be itemized (e.g., § 212).
 - iv. Credits, e.g., child and education credits.
 - v. Heads of households – treated as singles under AMT.
 - 5. *Klaasen*:
 - i. Under regular tax, claiming 10 exemptions for kids. No exemptions under AMT. Ability to pay issues.
 - 6. *Prozman*:
 - i. Nonreimbursed employee expense, can’t claim § 162 miscellaneous deductions for T/B expenses (through §63) + 2% §67 floor. Under AMT, cannot get anything. It’s a cost of earning income, shouldn’t be kicked out of AMT.
 - 7. Bad side of AMT:
 - i. Horrendous. If preference items were good policy, then why do we care if a TP happens to zero out their tax w/ them sometimes? Just childish: Everyone should pay at least some tax. AMT was supposed to hit rich people. But catches middle class people (e.g., w/ 10 kids). And too mechanical to make argument that AMT wasn’t “meant” to apply to me.
 - 8. Redemptive view:
 - i. It raises revenue w/o revolt. Too much political backlash if Congress raises taxes. AMT secretly raises taxes but people don’t know. Plus, w/ Turbo Tax, no added administrative hassle.
 - 9. But this is depressing:
 - i. It’s better to raise taxes in a clear, thoughtful, distribution-conscious way. Difference b/w raising taxes or just relying on the AMT.
6. Congressional Responses to Tax Shelters
- 1. **§469: Passive activity loss disallowance**:

<ul style="list-style-type: none"> i. Baskets: <ul style="list-style-type: none"> 1. T/B w/ no material participation [if many, put them all in the same bucket] 2. T/B w/ material participation, Investments ii. <u>Rule: Cannot use losses from Basket #1 to offset gains from Basket #2.</u> iii. <u>But: Can carry forward any disallowed loss to offset gain in same basket the next year.</u>
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 - iv. “Passive activity”:

1. T/B (or § 212 activity)
2. in “which the TP does not materially participate.” § 469(c).
- v. Rental activity is passive if TP does not devote 750 hrs. and ½ her personal services to it. § 469(7)(B).
- vi. “Material participation”:
 1. Regular, continuous, and substantial. § 469(h).
- vii. “Passive activity loss”:
 1. Amount by which aggregate losses from all passive activities exceed aggregate income from all passive activities. § 469(d).
- viii. This rule is an abstract way of tackling many abuse problems. But note: if you invest in a restaurant, but don’t materially participate, might be hit with the rule.
- ix. Example: Invested 250K cash, no material participation. Loss of 50K. Deduct zero → only deduct if you have passive gain, even if active gain, or investment income gain.
- x. Note: Both At-Risk and PAL only apply to “losses” – do not impose limit on deductions up to amount of income in the same basket.

2. §163(d): Investment Interest

- i. Basketing rule for investment interest expense.
- ii. **Rule: If borrow money for income-producing activity, can deduct investment interest, but capped at amount of net investment income for the year.**
- iii. E.g., borrow to purchase stock. Can deduct interest expense if you have cash dividend income (but: if gain would have been tax-preferred, have to bring it into OI to get the deduction).
- iv. This rule hits the paradigm tax shelter of **deferral**, e.g., borrow money for income-producing activity, use money to buy stocks, get deduction now, income later.
- v. Note: Can add gain even on *nonborrowed* funds to cap that you can deduct against.

3. §465: At-Risk Provisions

- i. **Rule: Can only take loss to the extent you have an amount at risk, i.e., cash put in + Recourse debt.**
 1. Qualification: NR lending for real estate w/ 3rd party lender is allowed (b/c common to buy real estate on NR from bank – outside of rule).
- ii. Clever rule that attacks false inflation of basis through NR debt, i.e., when you put purchase price on property that you never have any intention of paying, as in *Estate of Franklin*.
- iii. Compare to *Estate of Franklin* rule:
 1. *Franklin*: If NR Debt > FMV of Asset → no equity → no tax loss
 2. § 465: Can take tax loss up to amount at risk → cash and/or recourse debt.
- iv. Statute is easier to apply than Franklin, b/c less info necessary. Just need to know actual **amount of risk** (cash + recourse debt). For Franklin, must determine FMV of property (or what the TP thought it was).
- v. Note: Both At-Risk and PAL only apply to “losses” – do not impose limit on deductions up to amount of income in the same basket.
- vi. Example:
 1. Borrow \$200K NR to buy restaurant (not real estate), net loss of \$40K → no deduction.
 2. If the next year, you had \$25K net income, and took out recourse loan of \$10K, deduct \$25K from previous year carried over → §465 doesn’t kick in because you don’t have a loss yet for that year (it’s just loss carried over from before, soaked up in you gain). But you have \$15K loss left over, which can only be taken UP TO amount of risk, which is now \$10K through recourse loan. \$5K to be carried forward for next year.
 3. Next year, could take the \$5K against any other no-risk activity that generated gains, or against any activity at all to the extent of risk.
 4. This isn’t like material participation where we don’t let the loss at all. This is a disallowance rule → trumps rules that say you could deduct it.

7. Modern Corporate Shelters

1. Tomb Raider:

- i. Sale/License-back (similar to *Estate of Franklin*). Paramount holds copyright to “Tomb Raider” movie; P sells copyright to German Film Fund for FMV of copyright (\$94M); GFF licenses copyright back to P, including distribution rights and option to buy. License price: \$82M.
- ii. Benefit to P: Net profit of \$12M.
- iii. Benefit to GFF: Get immediate deduction for \$94M (special rule for films). German law recognizes GFF as “owner,” though U.S. law might not (sham, no non-tax motive).

- iv. Plus, P “double dips” – claims ownership in U.S. – amortizes. Exploits gap b/w the two tax systems. Double dip = international tax arbitrage.
- v. TPs win. Note that the \$12M payment to P comes from German TPs.

2. Winn-Dixie (2002):

- i. Tax shelter built on § 101 death benefits exclusion rule, plus interest deductions. Arbitrage: big upfront deduction, excluded income.
- ii. ‘ER takes out life insurance on rank and file ‘EEs (more than just top management). Don’t tell ‘EEs. When ‘EE dies, company collects as beneficiary. But no morbid motive—not trying to kill the cashiers—so doesn’t violate insurable interest requirement principle. Not yet tax shelter. Need deductions too.
- iii. ‘ER borrows to fund the policies. § 264 says must pay for 4 out of 7 years in cash. So TP borrows the full amount for first 3 years (producing deductible interest expenses); then pays cash for the last 4.
- iv. TP loses, for similar reasons as Knetsch. § 264 says you lose if you don’t meet 4 of 7. But doesn’t say you win if you do meet 4 of 7. Can lose for non-statutory reasons. Common law backstops: notwithstanding that you met the statutory text, you still lose.
- v. Sham Transactions:
 - 1. **Sham in fact** (*Knetsch*) – mere paper shuffling – no real change in obligations – completely circular.
 - 2. **Sham in substance** (*Winn-Dixie*): TP using statutory provisions to subvert purpose.
 - a. Economic substance – objective – could have been profitable on pre-tax basis.
 - b. Business purpose – subjective – state some reason why would have done this, absent taxes.
- vi. This transaction is clearly sham in substance:
 - 1. Pre-tax: \$755M loss.
 - 2. Tax savings: \$3B.

3. COLI:

- i. §101 exclude death benefits → used in an unexpected way by legislature. Want disparity, deductions at high rate inclusions at low rate. LI is one inclusion that will be delayed/exclude. Need to find a way to get into that provision. LI on key executives already. But state law doesn’t want us to buy insurance to kill someone → so can’t buy “unreasonable” insurance on one person. Active-passive method: everything above assets in company that were passive, could be insured to management (active). So we need to look beyond key employees → **janitor’s insurance**. So we have exempt income, We need deductions, take policy loans → *Knetsch* put no \$ in to the policy, so couldn’t take loan. Company needs to put \$ in. §464: **interest disallowance provision**—interest on policy loans is disallowed (*Knetsch*), but only occurs if you fail to pay 4 of the first 7 premiums. Borrow in 1-3. Court disallowed in *Winn Dixie*, doesn’t matter you are within §467, still a “sham.” *Knetsch*= “sham in fact” mere paper shuffling. *Winn Dixie*= “sham in substance” --> 1)Econ substance (objective excuse, *Winn Dixie*: **no possibility of pre-tax profits**); and/or 2)Business purpose (subjective motive—*Goldstein*).

8. The Tax Lawyer

- 1. **Tax Opinion:** TP can lose on the merits, but not pay penalty if has opinion; but if you also don’t have an opinion, you pay tax+interest+penalties.
- 2. Penalties:
 - i. §6662: **Significant Understatement penalty** → if understatement was >10% of amount due, then penalty is 20% x Overstatement. But if you have an opinion, then you are out of §6662 penalty. Menu: Need “substantial authority” for position you took (40% likely).
 - ii. Cynical view: Tax lawyer already knows the “right” answer b/f he writes opinion—pressure to just use the “magic words” that the client needs to get.
- 3. Possible opinions:
 - i. Substantial Authority (40%)
 - ii. More Likely Than Not opinion (51%)
 - iii. “Should” opinion (60%-70%)
 - iv. “Will” opinion (close to 100%)
- 4. Tax Planning Schemes:
 - i. Promoter of a transaction asks for an opinion. Life insurance company, investment bank. Use opinion to sell the transaction—but facts might have changed.
- 5. Limitations:

- i. §6664(d): substantial understatement penalty → TP cannot rely on the opinion of a disqualified advisor (the firm the promoter of the transaction used)
 - ii. KPMG: first indictment of tax advisors for criminal conspiracy to commit tax fraud.
 - iii. Circular 230: must make reasonable effort to unearth all the facts. Cannot assume any legal conclusions. Must deal w/ all significant income tax issues.
6. Remember: “The law” includes anti-abuse common law doctrines – even if thread the statutory rules!