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# INTRODUCTION & VOCABULARY

|  |  |  |
| --- | --- | --- |
| Calculating taxable income | |  |
| Income |  |  |
| - Exclusions | §§ 101 - 137 | Don’t even figure into gross income—the Code is saying forget about it, it’s fine |
| = Gross Income | § 61 | Includes everything else |
| - Above the line deductions | § 62 | Specified by statutes (i.e. ordinary and necessary business expenses, contributions to a traditional IRA, interest on student loans)—more restricted than exclusions, less than below the line deductions |
| = Adjusted gross income | § 62 |  |
| - Below the line (miscellaneous) deductions | Personal exemptions (§§ 151 - 52) + either standard deduction (§ 63) or itemized deductions (§§ 161 - 249)  §§ 67-68—floor and haircut | Charitable contributions, medical payments, home mortgage interest deductions—only take these if they add up to be more than **standardized deduction** |
| = Taxable income | § 1 | 🡪 Goes into brackets |
| - Credits | §§ 21 - 49 | Always valued more than a deduction of the same nominal value |
| **= Tax liability** |  |  |

* **Basis** = portion of sales recovered without tax liability
* **Adjusted basis** = purchase price adjusted to reflect expenditures on or tax benefits of asset
  + Adjusted basis > sales price 🡪 **loss**
  + Adjusted basis < sales price 🡪 **gain**
  + \*\*both of these are recorded on accrual NOT CF method

Purpose of Taxation.

* **Taxation:** The process by which the government transfers resources from the private to public sector
* Main purposes:
* Raise revenue—finance public goods; redistribute
* Correct for market failures—finance public goods;
  + **Externalities.** Price that consumers pay does not take into account the cost or benefit to other people—efficiency requires taxing or subsidizing negative and positive externalities
  + “**Pigovian Tax**”—i.e. tax credits for solar panels, hybrid cars, low carbon consumption—social cost (or benefit) of activity not covered in private cost (or benefit)
* What makes a “good” tax? 3 factors:
* **Equity** 
  + **Vertical equity**—more wealthy people should pay more (contra-Thatcher’s head tax)
    - **Progressive**—proportionate tax rate rises as income increases
    - **Proportionate**—proportionate tax rate constant
    - **Regressive**—proportionate tax rate declines as income increases
  + **Horizontal equity**—people with the same ability to pay should be taxed the same
* **Efficiency or neutrality**
  + Tax system should interfere with the system as little as possible and interfere to correct for market failure
  + **Deadweight loss**: how people see their purchasing power declines because of a tax—“the efficiency loss of the tax”
    - Elasticity—responsiveness
      * Elastic goods (BMW example)—give up the good and don’t respond—bear burden of the tax, but we collect no revenue—*only a loss without social benefit*
    - How high the tax is—deadweight loss rises with the square of the tax rate; for example:
      * small car tax—people who give up cars will value their cars little over alternatives
      * large car tax—even people who value their car more than what they’re paying will give up car
    - Interaction between market failures and the tax
      * Pollution tax (general Pigovian taxes or subsidies) vs. taxing volunteer work—if the activity should be subsidized we’re losing double
  + **inefficient to change behavior with taxes**
* **Simplicity**
  + **Compliance complexity.** The cost of following the Code—less as tax services become cheaper
  + **Rule complexity.** Unclear rules or administrative regulations. Not necessarily reflected in length—vague principles vs. clearly outlined tax liabilities
  + **Transactional complexity.** When taxpayers organize behavior to minimize taxes.
  + **Often a tradeoff between these three**

Interpretive Process.

* **District Court or Court of Claims**—taxpayer must pay deficiency and then they can file suit to get a refund
* **Tax Court**—don’t have to pay deficiency—within 90 days you have to file with the tax courts
  + Tax court judges have greater expertise
  + Appellate process—tax court and DC: goes to Court of Appeals; Court of Claims: federal circuit

Tax Bases.

* **Fundamental Tax Reform**—generally refers to consumption tax
* **Fair tax**—retail sales tax
* **Endowment tax**—with perfect information, we could tax earning ability—is this equitable?
* **\*\*what is the best indicator of ability to pay**?
* **Taxable income**. Term of art—hybrid of economic income tax and consumption tax—hybrid allows for “gaming”
* **Economic income**. Hague-Simons income—personal consumption plus changes in net worth

Tax Terminology.

**Gross income**—all income from whatever source derived. § 61. \*\*includes gains derived from property

**Basis—**usually what you paid, adjusted—essentially the portion or value of asset which has already been taxed

**Above the line deductions—**§ 62—certain business deductions, alimony, etc

**Itemized deductions**—worth less than ATL deductions—2% floor, 3% haircut § 68—only used by 1/3 of taxpayers—must choose between this and standard deductions (rationale: simplification)

**Exclusions—**economic equivalent of above the line deductions

**Credits—**more valuable than deductions—reduces tax liability NOT income—~40% of taxpayers have no tax liability 🡪 nonrefundable credits have no value to them

**(AGI) Adjusted Gross Income—**gross income less above the line deductions. § 63.

**Personal Exemptions—**§ 151 and 152. Don’t forget to adjust for inflation!

**Head of Household—**dependents without being married filing jointly

**Itemized Deductions—**include charitable deductions, state and local taxes, medical deductions, etc.

**Average tax rate—**total tax liability/AGI—distinguish from **marginal tax rates**

**Implicit marginal tax rates**: if you get food stamps and TANIF, then as benefits are rescinded you pay more and it’s considered a greater than 100% tax rate

**Tax Gap**—16-20% collection problem —including the fact that 15% of the US economy is off the books

**Capitalize**:

* “**Capitalize into pric**e”—incidence of the tax or benefit
* **Capital** **value** = “present value”
* (Legal term) **Recovery of Capital**—synonymous with basis—recovery of after-tax asset
* (Legal term) **Capitalize an expense**—effect of depreciation over time
* (Legal term) **Capital assets or gains**—subset of capital expenditures—when you sell stock you are taxed on the capital gains and you get to recover your capital asset basis
* **Code § 1.** Tax imposed
* **Code § 61.** Gross income defined—“all income from whatever source derived”
* **Code § 62.** Adjusted gross income defined.
* **Code § 63.** Taxable income defined.
* **Code § 67.** 2-percent floor on miscellaneous itemized deductions.

# WHAT IS INCOME?

* Income means net income—we are taxing the taxpayer’s profits
* **Haig-Simons Income—personal consumption and changes in net worth**
  + Vs. Posner’s definition of income—focuses on command over resources—mirrors an endowment tax—the tax on unearned resources would be equivalent to taxing leisure time

## Form of Receipt.

* **Code § 83.** Property transferred in connection with performance of services.
* **Code § 119.** Meals or lodging furnished for the convenience of the employer.
* **Code § 132.** Certain fringe benefits.
* **Code § 274(m)(3).** Disallowance of certain entertainment, etc., expenses**—**Travel expenses of spouse, dependent, or others.
* **Code § 275.** Certain taxes.
* **Regulation § 1.61-1(a).** Gross income—General definition
* **Regulation § 1.61-2(d)(1).** Compensation for services, including fees, commissions, and similar items—Compensation paid other than in cash.
* **Regulation § 1.83-2(a).** Election to include in gross income in year of transfer—In general.
* **Regulation § 1.83-3(a).** Meaning and use of certain terms—Transfer.
* **Regulation § 1.119-1(a).** Meals and lodging furnished for the convenience of the employer—Meals.
* **Regulation § 1.132-5(t).** Working condition fringes—Application of section 274(m)(3)
* **Regulation § 1.132-6(d)(2).** De minimus fringes—Special rules—Occasional meal money or local transportation fare
* **Regulation § 1.132-8(a).** Fringe benefit nondiscrimination rules—Application of nondiscrimination rules.
* **Regulation § 1.132-8(c).** Fringe benefit nondiscrimination rules—Availability on substantially the same terms.

Old Colony Trust Co. v Commissioner—SCOTUS—1929—Taft

American Woolen Company paid Mr. Wood’s federal income taxes for 1918 and 1919—**payment of income taxes is taxable income**—the “form of receipt” is irrelevant—a gain derived by the employee from his labor is equivalent to receipt by the person taxed 🡪 is itself taxable

|  |  |  |  |
| --- | --- | --- | --- |
| 1918 | Pre-tax income | Taxes Paid | After-tax Income |
| Old Colony ex ante | $1 million | $700,000 | $1 million |
| Old Colony result | $1.7 million | $1.19 million | $1 million |
| Grossing up | $3.3 million | $2.3 million | $1 million |

* 🡪 average tax rate = 70% and marginal tax rate > 70%
* IRS Claim: want Wood to pay tax on the taxes paid by American Woolen
  + This was necessarily compensatory
  + a ruling contra-*Old Colony* would trigger a flight to the positions that could pay taxes as well as salary—*plus*—would result in less tax collections by the IRS
  + underscores the principle: **form of receipt doesn’t matter**
* **GROSSING UP—**Taxpayers are required to report using “grossing up”—their salary is equal to their after-tax income plus the taxes paid by employer
  + **(value/1-t) – value = taxes**

## Fringe Benefits.

Often not treated as income because Congress has decided treat them “specially”—because they’re not taxed, the cost to employer of fringe benefits is $1 per $1 realized benefit (as opposed to wages which cost $1 per tax-rate reduced realized benefit)—can violate horizontal equity—very complex

* ***Benaglia***. Hawaii hotel—salary $10,000—room & board $8,000—which is income? $10,000 or $18,000
  + $8,000 was excludable—not for his benefit, **for the benefit of hotel**
  + Hague Simons income? $18,000
  + Without administribility considerations: Best way to resolve? Would he rather take the $8,000 or the room—if he would rather have the $8,000 or if he’s indifferent then clearly excludable; if he would chose the room the his value over $8,000 should be taxed
  + BUT court ignores that he would place any value on the room and says the whole room is just for the hotel’s benefit
* ***United States v Gotcher* (1968).**
  + Mr. and Mrs. Gotcher took a trip to check out a Volkswagen plant—total expenses $1372.30, taxes $356.79—did not declare as income—he was hired by the gifting Volkswagen dealership
  + **Holding**: his expenses were not taxable, hers were (total expenses $686.15)
  + **Standard: Itinerary—**what if he had more control? When would this be taxable?
    - Makes analogy to § 119 (Meals or lodging furnished for the convenience of the employer)
    - How far can we push itinerary control and still make trip excludable?
      * *Business-oriented*. Control wouldn’t degrade integrity of the business information—goes to Hague Simons—tax personal leisure activities
      * *Looks like Benaglia.* Was trip personal consumption? Where do we draw that line? **Current system—trip is all-or-nothing personal or business consumption**
    - **§ 61—**what is income? Is analogy to § 119 legitimate? What about the expressio unius principle of exceptions listed in § 119?
  + **NOW: What is the resolution of *Gotcher*’s issue?**
    - § 274(m)(3)—speaks to deduction *only*
      * employer’s test: if she’s an employee 🡪 can deduct
      * employee’s test: if he has a bona fide business purpose 🡪 can deduct (\*weaker)
    - **Surrogate taxation.** Taxing employer for employee—he gets the value, they pay the tax
      * breaks down when employer is tax exempt

Problem Set 2. Compensation for Services

**In each case, the question is which items should be included in gross income and what amount should be included?**

* + 1. **Angela, a summer associate at a law firm, receives the following.**
       1. **Her NYC income taxes are paid by the firm. Assume her (federal and NYC) taxable income is $30,000 and the NYC tax rate is 2%.**

Federal taxable income: x(.98) = 30,000 🡪 x = 30,612 with deductable state tax payment

**§ 1.61-(1)(a)—**income is more than just salary

* + - 1. **On days when she works past 8:00pm, the firm does the following:**

1. **Reimburses her for the cost of a restaurant meal of up to $20 at a neighborhood restaurant.**

**§ 1.119-1(a)**—not on premises 🡪 not excludable

**§ 1.132-6(d)(2)**—de minimus—would be difficult to defend, especially if it happened frequently

1. **Provides dinner, which is catered by a fancy French restaurant and served in the firm dining room. The dinner costs the firm $50 per person but is only worth $20 to Angela.**

**§ 132**—she’s working and on premises—convenience to employer? (*Benaglia, Boyd Gaming*)

Drawbacks: zero valuation on fringe benefit is inefficient; deadweight loss of $30

* + 1. **Gives her $20 of supper money, of which she uses $10 to buy a sandwich and eat at her desk.**

**§ 119** doesn’t apply, not on premises 🡪 **§ 132** de minimus is our only option (eliminated if frequent)

BUT more like compensation because she has discretion in her spending—can use the $10 however she wants

* 1. **If she had the option (highly unlikely) to take either the catered dinner (option ii) or the supper money (option iii), how would the tax treatment affect her decision? What else would you need to know?**

She would likely take the French dinner if she values it at $20 and the $20 would be subject to tax—§ 119-1(c) business premises

* + - 1. **The firm also provides her with free parking in the building where the firm's offices are located. The garage charges $1,200 per month to members of the public who park in the garage.**

**§ 132(f)(2)(b)**—only $175 is excludable as parking fee--$230 inflation adjusted—must include $970

* + 1. **A commercial airline permits its employees and families to fly free on any scheduled flight on a standby (i.e., space available) basis. The airline also permits employees and their families to buy reserved-seat tickets at a 15% discount. This is basically an airline subsidy—can pay employees less for the same after-tax income**
       1. **Bob, a flight attendant, and his wife Belinda fly free to Los Angeles.**

Excludeable as no additional cost service—**§ 132(h)(2)**—spouse or child treated like employees

* + - 1. **Bob buys discount tickets to Hawaii for himself and Belinda.**

**§ 132(c)(1)(B)**—Discount on service less than 20% 🡪 excludeable

if it were a good **§ 132(c)**, discount can go to profit margin aka “gross profit percentage”

* + - 1. **The airline's policy permits top executives to fly first-class on a standby basis, while rank-and-file employees** **(e.g., flight attendants) may only claim standby coach seats. Connie, the firm's CEO, flies free on first-class to** **London.**

**§ 132(j)(1)** Non-discrimination requirement: owes taxes on the whole price of the ticket**—§ 1.132-8(a)(2)—**Consequences of discrimination—include entire price as income—discourages discriminatory policy and not compliance with special circumstances and restrictions on discriminatory policy

* + 1. **Dierdra is a first-year law student whose airfare is paid by a law firm to enable her to fly to California for an interview.**

Not an employee—**Revenue Rule 63-77**: does not count as wages if she’s not an employee

*Gotcher*—depending on itinerary, excludeable if trip is for firm benefit

* + 1. **When Fred becomes the general counsel of Luxury Living, Inc., a developer of luxury apartment buildings, he purchases an apartment from the corporation for $1 million. The price was calculated to reflect the forgone income stream that would have been produced by a renter, but is substantially under market for similar apartments available for purchase in the neighborhood (which cost, say, $1.5 million). His ownership is restricted in that he must resell the apartment to Luxury Living for $1 million if he leaves his position as general counsel during the next ten years. Fred consults you to determine if there are any tax consequences to the purchase of the apartment. Following are some questions that you should think about in deciding how to advise him.**
       1. **What, if anything, should (or must) Fred include in income when he purchases the apartment?**

**§ 83(b)**: The difference between the fair market value and $1M

**§ 83(c)(3):** there exists a substantial risk of forfeiture 🡪 could elect to exclude entirely under **§ 83(a)**

* + - 1. **What tax results are there, if any, if Fred leaves the corporation in five years?**

If he initially reported under **§ 83(a)** (excluded entirely)—no gains or losses (purchased for $1M, sold for $1M)

If he initially elected under **§ 83(b)** (reported the difference)—loss equal to the original income reported

* + - 1. **What tax results are there, if any, if Fred remains for more than ten years and the apartment is worth $3 million at that time?**

No taxes—Realization requirement

(assumes property was originally worth $1.5, purchase price $1M)

If he initially reported under **§ 83(a)** (exclude entirely) (If he sells—he would pay tax on the $2M gain)

If he initially elected under **§ 83(b)** (reported the difference) (if he sells—tax on difference of $2M gain-)

* + - 1. **What tax results are there, if any, if Fred sells the apartment for $3.5 million in 12 years?**

(assumes property was originally worth $1.5, purchase price $1M)

Taxable gain on property: $2.5M

If he initially reported under **§ 83(a)** (exclude entirely)—if he’d paid taxes on $2M in (c) he would only owe taxes on $.5M remaining for change since valuation

If he initially elected under **§ 83(b)** (reported the difference)—he’s already paid taxes on $.5M when he initially reported so he would owe taxes on $2M for change since valuation

* + - 1. **What if the sale price after 12 years is $900,000? Could Fred claim a loss?**

Yes—depends on primary residence code

* + - 1. **What tax results are there, if any, if the corporation instead simply rents the apartment to Fred for $150,000** **per year? What if the market rent is $200,000 per year?**

|  |  |  |
| --- | --- | --- |
|  | **83(a)** | **83(b)** |
| T= 0 | $0 (exclude entirely) | $.5M |
| b | $0 | $0 (no loss) |
| c | $2M | $0 (realization requirement) |
| d | $500K | $2M |
| Total | $2.5M | $2.5M |

* How does Fred decide between 83(a) and 83(b)?
  + Depends on the probability that he’ll leave in 10 years
    - Going to leave: don’t make § 83(b) election
    - NOT going to leave: make § 83(b) election

## Imputed Income

* **Code § 74.** Prizes and awards.
* **Code § 102.** Gifts and inheritances.
* **Code § 162(a)(1).** Trade or business expenses.
* **Code § 262.** Personal, living, and family expenses.
* **Code § 274(b).** Disallowance of certain entertainment, etc., expenses—Gifts.
* **Regulation § 1.74-1(a)(1).** Prizes and awards—Inclusion in gross income.
* **Regulation § 1.74-1(a)(2). PROPOSED.** Prizes and awards—Exclusion from gross income.
* **Regulation § 1.102-1(a).** Gifts and inheritances—General rule.
* **Regulation § 1.102-1(b).** Gifts and inheritances—Income from gifts and inheritances.
* **Regulation § 1.102-1(c).** Gifts and inheritances—Gifts and inheritances of income.
* **Regulation § 1.102-1(f). PROPOSED.** Gifts and inheritances—Exclusions.

**Imputed income:** benefits derived from labor on one’s own behalf or the benefits from ownership of property—not treated as income for tax purposes—inefficient, but taxing imputed income would be inadministrable

**\*\*under Hague Simons—**imputed income IS income 🡪 should be taxed—but it’s generally excluded—creates unintended incentives

Problem Set 3. Imputed Income, Gifts, Bequests and Prizes

1. **Gwen is a doctor who does not charge Harry for medical services she performs for him. In exchange, Harry, who owns a ski cabin, lets Gwen stay there for one week. The cabin rents for $1,500 per week. Who has income and in what amounts?**

**Regulations Section § 1.61-2(d)—Compensation paid other than in cash**

Fair market value of services received 🡪 Gwen’s income= $1,500

Harry’s income = value of doctor’s services (presumably the same)—why doesn’t this function like a dollar for bread transaction? (I would not count the bread as income)—because the bread is taxed and so the value of the doctor’s services are also taxed—“rental income would have been taxed 🡪 value of the services should also be taxed”—would be imputed income if Harry stayed in his own cabin, not here

*\*\*but Harry doesn’t come out with any income—he loses the value of the doctor’s services in exchange for services 🡪 Gwen’s income should be taxed and Harry’s should not?*

1. **Ian works overtime and earns an extra $25 each day. He uses the money to pay Jeff to walk his dog each evening. Kate, who has the same job as Ian, never works overtime and walks her own dog each evening. Who has (or should have) gross income?**

Incentive Structure: Ian is penalized for working—he should walk his own dog if society values dog walking as much as working (unless he likes working more than dog walking in at least the amount of his tax rate on $25)

* + Ian: $25 – taxes - $25 to Jeff = $-taxes
  + Kate: $0

1. **Larry goes to a local pub to see the Red Sox game. Each person is given a number as they walk in and the pub owners say that if the Red Sox win, they will draw one number and give the winner an all-expenses-paid trip to Boston to see the Red Sox play in Fenway Park. The Red Sox win and Larry’s number is drawn. Does he have gross income and, if so, in what amount?**

Yes—**§ 1.74-1(a)—**taxes on the fair market value of the trip—Door prize = income at fair market value

1. **Mari and Neal are married. Mari is a doctor whose before-tax income is $100,000. Currently Neal stays home. He is a full-time parent for their three children. Neal has an education degree and was recently offered a position as a teacher that pays $30,000. He estimates that it would cost $20,000 to hire someone to perform the services he performs at home. Mari and Neal file jointly and their marginal tax rate is 40%. Ignore all other deductions and credits.**
2. **Will Neal take the job?**

* $100 x .6 = $60,000
* $130 x .6 = $78,000 – 20,000 = $58,000
  + 🡪 No, they would be $2,000 worse off

1. **If the salary associated with Neal’s job offer was tax-exempt, what would Neal do?**

Take the job and be $10,000 better off 🡪 this tax is inefficient

1. **What issues are raised in your answers to a) and b)? How could these issues be resolved?**

Could fix inefficiency with: a tax credit for childcare; a deduction for childcare; or file separately and get a lower marginal tax rate—or tax Neal’s current imputed income to eliminate inefficiency

## Gifts and Bequests.

Commissioner v Duberstein—1960—SCOTUS—Brennan

* *Duberstein*—was a Cadillac car given in return for suggesting customers a taxable income? YES
* *Stanton*—was a $20,000 “gratuity” given to a retired church comptroller a taxable income? NO
* Government wants a test to define “gift: transfers of property made for personal as distinguished from business reasons”
* **RULE:** 
  + “detached and disinterested generosity” would imply a gift—not set as a hard standard
  + \*\*pre-existed *Duberstein*; SCOTUS just advocates the status quo system—**look to motivation for exchange to decide if it’s a gift or if it’s income**
* **Decision:** 
  + “it was at the bottom a recompense for Duberstein’s past services” 🡪 taxable income
  + fact-finder’s opinion on *Stanton* was too sparse, can’t tell if it why it was not a gift—remanded
* Why does the distinction between gifts and income matter?
  + Recipients: exclude (gift**, § 102**) or taxed (compensation, **§ 61**)
  + Payor: deduct (business expense, **§ 274(b)**) or not (personal expense)
* Could have promulgated a standard with regulations—could have been complicated or difficult to administer
* Ways around the “Business gift to an employee”—if it’s a family business there is a PROPOSED regulation:
  + **§ 1.102-(1)(f)**—family relationship would warrant a gift even if they work together

|  |  |  |
| --- | --- | --- |
|  | **Recipient** | **Payor** |
| Compensation | Include § 61 | Deduct § 162 |
| Pure Gift | Exclude § 102 | No deduction § 262 |
| Business Gift to employee | Include § 102(c) | Deduct § 162 |
| Business Gift to associate | Exclude § 102 | No deduction if > $25, § 274(b) |

\*\*Burman deducted Cadillac as compensation; Duberstein called it a gift 🡪 IRS got no tax

\*\*surrogate taxing—all very symmetrical, if recipient is taxed, payor is not

Bequests.

Bequests are generally exempt from income under **§ 102**

“The Supreme Court stated that the test was not whether the testator gave the legacies for services but whether the legatees had to perform the services in order to earn the bequests.”

* **§ 102** If gifts are gratuitous—donee doesn’t report them as income
* **§ 262** if gifts are gratuitous—donor can’t deduct them as a personal expense

|  |  |  |
| --- | --- | --- |
| How could we tax gifts and bequests differently? | | |
|  | DONOR | HEIR |
| A (current tax) | No deduction | Exclude |
| B | Deduction | Include |
| C | No deduction | Include |

A—current tax penalizes donor and NOT heir

B—would incentivize transferring wealth to avoid taxes

* Externalities—there is double utility in a gift—LB values her nephew’s well-being $100 and he values the gift at $100
* Takeaways—failure to tax both (to not implement C) means we move away from strictly taxing Hague Simons income (so we take in less than we could) BUT gifts have double utility, do we necessarily want to double tax them?
* Of the two ways to tax just one, A prevents gaming the system
* **OPRAH’S PONTIACS**
  + Gift taxes—Pontiac and Oprah both had promotional incentives 🡪 not “detached and disinterested”
  + **§ 1.74-1(a)**—door prizes—buying a ticket to Oprah is sufficient to constitute self-enrollment
  + What are the family’s options?
    - Sell car, pay taxes
    - Not accept car
      * probably $30,000 x marginal tax rate < $30,000 🡪 should accept car
      * new cars are notorious for losing value—if resale value dropped 60% and tax rate = 40% family shouldn’t accept the car—UNLESS they could claim the resale price as their income, probably depends on whether or not they drive the car and when they resell it

## Basis Recovery

* **Code § 61.**
  + **Regulation § 1.61-2(a)(2).** ???
  + **Regulation § 1.61-2(d)(2)(i).** Compensation for services, including fees, commissions, and similar items—Property transferred to employee or independent contractor.
  + **Regulation § 1.61-6(a).** Gains derived from dealings in property—In general.
* **Code § 1001.** Determination of amount of and recognition of gain or loss.
  + **Regulation § 1.1001-1(a).** Computation of gain or loss—General rule.
  + **Regulation § 1.1001-1(e).** Computation of gain or loss—Transfers in part a sale and in part a gift.
* **Code § 1011(a).** Adjusted basis for determining gain or loss—General rule.
* **Code § 1012.** Basis of property—cost.
* **Code § 1014.** Basis of property acquired from a decedent.
  + **Regulation § 1.1014-1.** Basis of property acquired from a decedent.
* **Code § 1015.** Basis of property acquired by gifts and transfers in trust.
  + **Regulation § 1.1015-1(a).** Basis of property acquired by gift after December 31, 1920—General rule.
  + **Regulation § 1.1015-4(a).** Transfers in part a gift and in part a sale—General rule.
* **Code § 1016.** Adjustments to basis.
* **§ 1001: Gain** is the excess of the **amount realized** from the sale over the taxpayer’s **basis** for the property.
  + **§ 1001(a)—**Gain = AR (amount realized) – AB (adjusted basis)—(if AB>AR we have a loss)
  + **§ 1001(b)—**AMOUNT REALIZED: any money received PLUS the fair market value of the good
  + **How do we decide if the basis is appropriate? What if we suspect that a cheap sale is a gift in disguise?**
    - Look to motivation—would the ‘gift’ pass the “detached and disinterested” test? Or is the sale for cheap because it’s an illiquid asset?
* **§ 1012: Basis** of property is usually its **cost** to the taxpayer, except as otherwise provided.
* **The realization requirement**—not taxed until taxpayer realizes a benefit—ease of administration
* **Three ways of accounting for costs**—taxpayer cannot choose when to deduct
  + FIRST Immediately deduct expenses
  + LAST Capitalize expenses—cost only realized upon sale—“recovery of basis at the back end”
  + GRADUALLY Depreciate expenses—deduct cost over time
* **Basis of Property Acquired by Gift.**
  + When taxpayer disposes of gift his basis FOR DETERMINING LOSS is either the original purchase price OR the fair market value at the time of gift, which ever is less (🡪 whatever makes tax payment higher)
  + Basis for determining a gain? Reg. **§ 1.1015-1(a)—**“same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift”
  + **EXCEPT for gifts from a decedent**—fair market value of the property at the death date

HOrt v Commissioner—SCOTUS—1941—Murphy

Hort inherits a building—was supposed to have a contract to lease office space 1932-1947 for $25,000/year —the contract defaulted—he got $140,000 which was **$21,494.75 less than his projected income** from the term of the lease

Hort deduced $22K as a loss—Commissioner claimed he owed tax on $140,000 income for rent

* **§ 1014**—basis equal to the FMV when he received it
* **Decision**: he had a premium lease—they would have paid him rent (goes into income) 🡪 this replacement payment just represents rent that they would have paid and should all be income
  + 🡪 he has NO basis in the premium lease—income of $140,000
  + fruit and tree case—if you sell the fruit you can’t recover basis—if you sell a part of the tree (right of the property in perpetuity) you can recover basis
  + Trying to claim a loss on the building depreciation without selling the whole building—trying to mark-to-market and accelerate his losses
  + **Capitalization**. We allow Hort to depreciate the building to recover his basis over time—supposed to account for the building’s declining value—this is why we can tax the fruit (rent)—in terms of Hague-Simons income, the change in net worth is deductible (depreciation) plus the consumption (here, the rent)

Basis Recovery—Gifts and Bequests.

* We allow people to shift appreciation to lower tax brackets when it’s a gift of property—inconsistent treatment between cash and property gifts
* **§ 1014—**With a bequest we eliminate appreciation before the time of bequest with the STEPPED UP BASIS RULE

Problem Set #4: Recovery of Basis

**Time Value of Money. For the following questions, refer to Appendix A on p. 826 of the casebook:**

**What is the value in 10 years of a $1 reduction in tax liability today if the interest rate (or rate of return) is 10 percent, compounded annually?**

$2.594 Present value = Future value/ (1 + r)^n Future value = Present value\*(1 + r)^n

**What is the value in today’s dollars of a $1 reduction in tax liability in ten years if the interest rate (or rate of return) is 10 percent, compounded annually?**

$0.386

**ALL TAXPAYERS WANT TO DEFER TAXES AND TAKE DEDUCTIONS SOONER**

**Gifts and Bequests. For the following problems, keep in mind that the concept of “basis” is used to determine gain or loss on the sale of property:**

**Gain = Amount realized – Adjusted basis**

**Loss = Adjusted basis – Amount realized**

* 1. **Danika gives her brother, Blake, 100 shares of stock worth $100 (total value). Danika bought the stock years ago for $45. Blake holds the stock for two years and sells it for $150. What is Blake’s basis, and what is his gain or loss?**

Original purchase price = $45

Value at time of gift = $100 🡪 no income per **§ 102(a)**—“income does not include the value of property acquired by gift”

Realized market value = $150

Gain = $150 – 45 (basis) = $105

\*\*how could we tax Danika for $55 appreciation before the time of gift? New law—make gift a realization event—D taxed at gift, B would have a higher basis

**Reg § 1.1015-1(a)**—“same as it would be in the hands of the donor”

* 1. **Same facts except the stock is worth only $30 when Danika makes the gift, and Blake later sells the stock for only $15. What is Blake’s basis, and what is his gain or loss? What if Blake sells the stock for $50? For $35?**

*Stock is depreciating 🡪 the loss disappears from the time of purchase to the time of gift. Danika could sell and re-buy at time of gift to be able to deduct that loss, otherwise would lose the deduction*

*CARRYOVER BASIS DEFERS TAX FOR APRECIATING PROPERTY—shifts donor’s income to donee*

Original purchase price = $45

Value at time of gift = $30

Realized market value = $15

Loss = $15 – 30 (basis) = $15

**§ 1.1015-1(a)**—(if the original purchase price is greater than the fair market value of the property at the time of the gift) “the basis for determining LOSS is the fair market value at the time of the gift”

Realized market value = $50

Gain = $50 - 45 (basis) = $5

**Reg § 1.1015-1(a)(2)**—(if the gift will realize a gain) “the basis is the original purchase price”

Realized market value = $35

Gain = $35 – 30 (basis) = $5

Nick: No loss, no gain **§ 1.1015-1(a)(2)**

**§ 1.1015-1(a)**—(if the original purchase price is greater than the fair market value of the property at the time of the gift) “the basis for determining LOSS is the fair market value at the time of the gift”

1. **In class example:**

$-100 year 1 purchase asset

$15 year 2 income of $15 (§ 61(a))

$175 year 3 sell asset—basis: $100 **§ 1012** (gain = $75)

**Hague-Simons income in year 2?** Would look at stock appreciation and mark to market (unrealized appreciation, a tax on the accrual)

**What if we recovered the basis in year 2?** Basis = $100 - $15 dividend 🡪 year 3: $175 – 85 (basis adjusted for dividend) = $90 taxable gain

Turns on the difference between:

**1 2 3 OR 1 2 3**

0 15 75 0 0 90

**\*\*taxpayer prefers the second scenario because he would recover his basis earlier**

1. **Bequests § 1014—basis is market value at the time of transfer—“stepped up basis”**

Same facts as Danika, except that the GIFT is a BEQUEST.

Original purchase price = $45

Value at time of gift = $100

Realized market value = $150

Gain = $150 – 100 (basis) = $50

*\*\*$55 was subject to estate tax—the gain disappears entirely from taxable revenue*

Deprives the government of $40 billion taxable revenue—creates the **LOCK IN EFFECT**—horizontal equity issues

What would our other options be?

* Use carry-over basis OR
* treat bequeath as a realization event—efficient BUT politically unpalatable
  1. **Same facts as 3.b, except that the gift is a bequest.**

Original purchase price = $45

Value at time of gift = $30 (if this is the same as value on date of death)

Realized market value = $15

Loss = $15 – 30 (basis) = $15

*Nothing happens when D bequeaths to B—when B sells she would deduct a loss for only $15—***§ 1014** *says that the basis is fair market value when asset is bequeathed—incentivizes Danika to elect to sell all assets that have lost value because she can trigger the loss deductions*

*BUT basis is NOT inflation-adjusted—even if an asset loses value but stays pegged to the same nominal value, a taxpayer can’t realize deductions for real losses that aren’t represented by the old basis (not inflation adjusted)*

Realized market value = $50 (if this is the same as value on date of death)

Gain = $50 – 30 (basis) = $20

Realized market value = $35 (if this is the same as value on date of death)

Gain = $35 – 30 (basis) = $5

1. **Senator Jones has proposed the following addition to Code § 1001:**

"(f) Notwithstanding any other provision of this part, all property owned by a decedent shall be treated as having been sold, on the date of death, for an amount of money equal to the fair market value of such property on that date. Gain or loss realized pursuant to this rule shall be taken into account on the final income tax return filed on behalf of the decedent by her estate. This rule shall be effective for deaths occurring on or after January 1, 2010."

* Basically: Realization Event.
* estate would pay the tax instead of the gains disappearing into the ether
* Pros:
  + Equitable
  + Less of a lock-in effect
  + Efficient—death is hard to avoid 🡪 can’t strategically avoid dying for tax benefits—people may change the kind of car they purchase because of tax benefits, unlikely to change their date of death
* Cons:
  + Liquidity
  + Administration

**Senator Smith rejects Jones' proposal and offers the following amendment to the Code:**

**"Section 1014 is hereby repealed. Section 1015 shall be amended to apply to property acquired from a decedent. This amendment shall be effective for deaths occurring on or after January 1, 2010."**

**Should either of these proposals be enacted into law? Why or why not?**

* Basically: **§ 1015**
  + If there is a loss until asset is bequeathed and it continues to lose—§ 1014 and 1015 have the same benefit
* **Treat bequests exactly like gifts**
* Cons:
  + Lock in effect.
  + Taxed on the gain that accrued before the asset was bequeathed 🡪 taxpayer has greater liability under **§ 1015** than he would under **§ 1014**

**Which would we choose? Fairness—efficiency—simplicity**

* **Public purse**—realization allows earlier collection 🡪 better for government
* **Fairness**:
  + Realization prevents gaming and allocates taxes to earner and not his heirs
* **Efficiency**:
  + **Valuation**—stepped up basis would be better—realization 🡪 immediate valuation
  + **Liquidity**—realization requires estate to pay taxes 🡪 Oprah-Pontiac problem
    - run into even bigger problems when the asset is something that the recipients have a high idiosyncratic value on the asset

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Purchase** | **Bequeath** | **Sale** |
|  | **$45** | **$100** | **$150** |
| § 1015 |  |  | $150 - $45 = **$105** |
| § 1014 |  |  | $150 -$100 = **$50** |
| Realization Event |  | $55 | $50 |
| Hague-Simons | Tax as income accrued…$150 total | | |

1. **In 2000, Marge purchases 400 acres of vacant land in fee simple. She pays $200,000. What are the tax consequences of each of the following:**
   1. **In 2002, Marge contemplates selling the land and has it appraised. Although the value of the land has increased to $250,000, Marge decides not to sell it.**

No realization 🡪 no tax liability

**§ 1.61-6(a):** “Gain REALIZED on the sale or exchange of property is included in gross income”

* 1. **In 2010, Marge enters into an agreement with Norm permitting him to hunt on the land for ten years in exchange for an annual payment of $10,000.**

Marge will get $10,000 ordinary income—no deduction off basis, will be recovered in sale

* 1. **Alternatively, in 2010, Marge sells the hunting rights to the 400 acres to Norm in perpetuity for $100,000 (the land is worth $500,000 at that time).**

$100,000 is 1/5 of $500,000 🡪 she should pay taxes on 1/5 of the gains

$500,000 – 300,000 = $200,000/5 = $40,000 taxable income (capital gains?)

**§ 1.61-6(a)—**selling a right in perpetuity is like selling a piece of the asset itsel**f**

* **What if we don’t know the relative values at the time of purchase?**
  + *Foster, Anaja Land*—if you don’t know the value of the FMV you can just take no income and take the sale off the basis

**From property: this is called an easement. When someone bought the land from Marge they would be informed that Norm has perpetual rights to hunt on the land.**

## The Realization Requirement

* **Regulation § 1.61-14.** Miscellaneous items of gross income.
* Benefits
  + prevents liquidity problems
  + easily administered (no mark-to-market)
  + savings subsidy (to the extent that we want to incentivize savings)
* Problems:
  + (in conjunction with **stepped up basis**) assets kept within a family won’t be taxed
  + **Horizontal equity**—asset values change, only pay during realization events
  + **Begins to look like a consumption tax**—only taxed at liquidation 🡪 can spend the money you would be taxed at a different rate/different times
  + **Lock-in effect**—avoid realization & you won’t ever be taxed 🡪 lower ATR
* In class example:
  + If you invest $100 in a really risky stock and have a 50-50 chance of year 2 value of $200 or $0
    - Win—gain $100 and defer taxes—elect to not realize gain by not selling stock
    - Lose—deduct the $100 loss—**value = $100 x MTR (50%) =$50 🡪 $100 loss and $50 tax benefit 🡪 lose only $50**
    - Incentive:
      * Trigger losses and not gains—could exacerbate business cycles
      * Invest in more risky assets

|  |  |  |
| --- | --- | --- |
|  | Pre-Tax | Post-Tax with Realization Election |
| Win | $100 (gain) | $100 (defer) |
| Lose | $-100 (loss) | $-50 (realize immediately) |
| Expected Value | $0 | $25 |

**Invest $50 in IBM 🡪** (scenario 1) 50% chance you’ll have $100 in IBM at t2 🡪 lock-in $100 later, defer capital gains

(scenario 2) 50% chance you’ll have $0—realize tax benefit of loss immediately

* **Compliance Complexity**—forms and frequency of filing—LOTS in mark-to-market
* **Rule Complexity**—lots of time spent reading codes and regulations (ironic since realization req. isn’t in Code)
  + **Transactional Complexity**—when you ex ante reorganize behavior for tax reasons—lock-in effect
* **Alternatives:**
  + Blended system—mark-to-market for assets that are easy to value
    - but would exacerbate the problem of incentivizing investment in a certain type of asset
    - when would we mark the assets to market? Would influence valuation
  + What if we just assumed? i.e. stocks gain at about 20% 🡪 we’ll just tax at 20%
    - We might be on net taxing Hague-Simons but there would be individual tax inequities
    - *Holt*—this is what we do with depreciation, but sometimes catastrophes like the Great Depression come along and we have to adjust our valuation

Cesarini v US—DC Ohio—1970

Cesarini bought a piano and then found money inside—owes taxes on windfall profit—year found, not bought

**§ 61:** “gross income means all income from whatever source derived”

**§ 1.61-14**: treasure trove includable as income

* **Rev. Rul. 1953-1** “the finder of treasure-trove is in receipt of taxable income”

Haverly v US—1975

Unsolicited textbooks sent to a principle, given to a library, and recorded as charitable deductions are taxable

**Commissioner v Glenshaw Glass**—“**Section 61(a)** encompasses all ‘accessions to wealth, clearly realized, and over which the taxpayers have complete dominion.’”

Cottage Savings Association v Commissioner—SCOTUS—1991—Marshall

Is the exchange of residential mortgage loans a realization event for tax-deductible losses (even if not required to be reported on the balance sheet)? YES

Cottage Savings swapped $6.9M in assets for $4.5M and claimed a $2,447,091 deduction for the loss—“the issue before us is whether the transaction constitutes a ‘disposition of property’”

Policy behind delaying tax benefits: ease of administration

**Standard for realization requirement:** if the exchanged property is similar the taxpayer realizes income ONLY if he did not receive “a thing materially different from what he theretofore had”

**Holding:** an exchange of property gives rise to a realization event so long as the exchanged properties are “materially different”—that is, so long as they embody legally distinct entitlements

* Why didn’t they just sell the mortgages?
  + If they had gotten cash it would have been a realization event—their **regulator FHLBB (Federal Home Loan Bank Board) said that they didn’t have to report the loss on a swap but they *would* have to report a loss on a sale**
  + 🡪 Wanted tax benefit of loss w/o book loss that would require regulators close down S&L
    - Would realize the $2.4 M loss and for tax purposes they would have an asset worth $4.5M but for regulatory purposes they would still have an asset worth $6.9M
    - Keep them on the books looking like they’re ok but still getting the tax benefit—but the tax benefit makes perfect sense, but sounds like shady regulatory practice
* **\*\*very common to have a difference between book and tax accounting**
  + Accountants use actual depreciation—tax accountants use estimated, backed out depreciation
  + Discrepancy creates incentive for tax shelters
    - 🡪 want books to show valuable assets and taxes to show no assets
* Did Cottage Savings realize a loss? Look to section **§ 1001**
  + Requires a sale or disposition of property to realize a loss
  + **Reg § 1.1001-1**—in order for there to be a realization event (if this is a disposition) there needs to be an exchange of materially different properties
  + Compare to *Phellis*, *Marr*, and *Weiss*
    - *Phellis* and *Marr*—Companies reincorporating from New Jersey to Delaware
      * Legally distinct entitlement—materially different to own all the same assets in a different state
    - *Weiss*—stayed within the original state
      * NOT a legally distinct entitlement—same assets under the same laws
* Are we moving closer or farther away from taxing Hague-Simons income?
  + Tiny change in legal entitlements creates a realization event 🡪 closer to mark-to-market and Hague-Simons income

Problem Set 5.

1. **In early October of 2010, first-year Met Jason Bay is putting the finishing touches on a historic season for an otherwise struggling Metropolitans organization. Bay has recently hit his 73rd home run, tying the single-season record. Quinn, a diehard Mets fan, pays a scalper $2,000 for a ticket to the Mets’ final game of the season. The face value of the ticket is $50.**

**The baseball that Bay hits to break the record will reportedly be worth $500,000. Quinn has intentionally selected a ticket in the left field bleachers, an area where Bay hits a majority of his home runs. On October 4th, 2010, Jason Bay crushes a Roy Oswalt fastball over the left field wall of Citi Field, and into Quinn’s outstretched palm.**

**Describe the potential tax consequences to Quinn for the following scenarios.**

1. **Quinn sells the ball for $500,000 in 2010.**

**§ 61** Taxable treasure trove income of $500,000 in 2010

1. **Quinn sells the ball in 2012 for $600,000.**

**§ 1.61-14**—undisputed possession in 2010 🡪 trove income of $500,000 taxable in 2010

Taxable gain of $100,000 in 2012

1. **Bay is stripped of the record for confirmed use of performance-enhancing drugs. Quinn, disgusted, sells the ball in 2012 for $1,000.**

Taxable treasure trove income of $500,000 in 2010

Tax-deductable loss of $499,000 in 2012—argue for FMV

1. **Quinn immediately returns the ball to Jason Bay after the game.**

Undisputed possession? Probably not? 🡪 no taxable income

## Transactions Involving Borrowed Funds

* **Code § 61(a)(12).** “If [a] debt is subsequently cancelled for less than its face value, [the taxpayer] is considered to have income.”
* **Code § 65.** Ordinary loss defined.
* **Code § 108(a).** Income from discharge of indebtedness—Exclusion from gross income.
* **Code § 108(b).** Income from discharge of indebtedness—Reduction of tax attributes.
* **Code § 108(d)(1).** Income from discharge of indebtedness—Meaning of terms; special rules relating to certain provisions—Indebtedness of taxpayer.
* **Code § 108(d)(2).** Income from discharge of indebtedness—Meaning of terms; special rules relating to certain provisions—Title 11 case.
* **Code § 108(d)(3).** Income from discharge of indebtedness—Meaning of terms; special rules relating to certain provisions—Insolvent.
* **Code § 108(e).** Income from discharge of indebtedness—General rules for discharge of indebtedness (including discharges not in Title 11 cases or insolvency)
* **Code § 108(f).** Income from discharge of indebtedness—Student loans.
* **Code § 165(c).** Losses—Limitation on losses of individuals.
* **Code § 165(d).** Losses—Wagering losses.
* **Code § 6321.** Lien for taxes.
* **Regulation § 1.61-12(a).** Income from discharge of indebtedness—In general.

No gain on loan—no loss on lending—gains (for lender) on interest payments—gains (for borrower) on cancelled debt

* + **Tax benefit**—don’t initially include debt as income b/c they intended to pay it back—once they don’t intend to pay it back 🡪 taxable

Collins v Commissioner—1993

Off-track Betting parlor—drafted up tickets worth $80,280—at the end of the day was behind $32,105—at the end of the day had tickets worth $48,000 (same day restitution)

**All unlawful gains are taxable** 🡪 taxable income = $80,280 (“Collins took illegally acquired assets and spent them unwisely”)—can only deduct gambling losses against his winnings—taxed for the benefit he derived from stealing

* Why isn’t this excludable as borrowing?
  + No mutuality of intent to repay the loan
  + ***James v United States*—unlawful gains taxable**—test: mutual intent and consensual recognition
* What is the authority for deducting $42,000?
  + **§ 165(c)**—Limitation on losses of individuals
  + Can he deduct the $38,000 loss?
    - Could he call it a transaction entered into for profit? A transaction is 1-sided, but generally a good argument
    - Unlikely to make money, irrational to expect to profit 🡪 IRS could argue that gambling is not an enterprise where one could expect to make profit
      * i.e. stealing to use for personal gains? If Avi stole cash from Ben and used the money to buy a car he could NOT deduct the car but he COULD deduct the restitution
  + **§ 165(c)(3)**—can deduct gambling losses
* **§ 165(d)**—just within gambling transactions you can net your gambling position against your game

|  |  |  |
| --- | --- | --- |
|  | Scenario 1 | Scenario 2 |
| Amount Stolen | $80 | $80 |
| **Round 1** |  |  |
| Winnings/Losses | ($38) | $10 |
| **Round 2** |  |  |
| Winning/Losses |  | ($48) |
| Net Gambling Position | ($38) | ($38) |
| Deduction | $0 | $0 |
| **Total Gross Income** | **$80** | **$80** |

* Does this seem harsh that he’s being taxed on all $80,000?
  + No—someone else who was able to gamble with $80,000 would be taxed on that income
  + Doesn’t measure his ability to pay—but punitive value
* What is the policy of making people include stolen funds in income? (J. Blackmun’s dissent in *Rutkin*)
  + **§ 6321**—IRS gets a lien—gets priority over victim’s restitution

*James* Test—stealing or borrowing?

What is the *James* test exactly? “consensual recognition, express or implied, of the obligation to repay”

“Without restriction on the disposition”—why is this here? Illiquid—can only use for specified purpose—*James* refers to taxable income, not nontaxable—if car dealership sells you a car for $30,000 then says you only have to repay $7,000 don’t have to pay $23,000 forgiven debt—we’ll come back to this later

Gilbert v Commissioner

Gilbert acquired a bunch of Celotex (his employer) stock on margin—had the corporation pay for the stock—Board didn’t approve the borrowing from the company

* Similar to *Collins* but because he has authority he can argue that he was going to pay Celotex back

Problem Set #6: Transactions Involving Borrowed Funds

1. **Rob borrows $1,000 from the bank and spends it. Is the money he borrows income? When Rob repays the loan, can he deduct the $1,000 he repays? (Ignore, for now, the question of whether the interest Rob pays on the loan is deductible.)**

**§ 61**—can’t be income b/c he intends to repay—no income 🡪 no deduction—increase in assets offset by increase in liability

*Collins* is the best authority for this (no Code section) if the borrower pays business interest they get to deduct it, lender realizes income from **interest § 61**

1. **Suppose David Zarin, the compulsive gambler, finds himself back in a casino and sitting next to someone who is very drunk and has a large pile of gambling chips. What are the tax consequences if:**
2. **Zarin simply takes chips worth $200,000 from this fellow gambler without anyone suspecting anything and loses them all gambling?**

Taxable income = $200,000 under *James* (“all unlawful gains are taxable”)

1. **Zarin takes the $200,000 of chips but says to the drunk gambler, “Don’t worry. If I win, I’ll pay you back.” He then loses all of them.**

Probably still taxable—not a “mutual understanding between the borrower and the lender of the obligation to repay and a bona fide intent on the borrower’s part to repay the acquired funds”

Can he reasonably expect that he will win? No intention to repay if he lost 🡪 taxable like (a)

1. **Same as (b) except that Zarin wins $280,000. He returns the $200,000 of chips to the drunk gambler and pockets $80,000. Would it make any difference if he hit the jackpot at 11:55pm on New Year’s Eve and replaced the chips at 1:00am on New Year’s Day?**

Loan: actual repayment indicates mutual understanding of obligation 🡪 taxable income = $80,000

OR (more consistent) still unlawful gains, not loan 🡪 taxable income = $280,000 w/ deduction for $200,00 repayment

**§ 165(c)—**restitution only counts in the same year—if the stealing and the repayment come on New Years Eve and New Years Day he’ll lose out—forced to take deduction in the future (TVM)—may not be able to use entire deduction against gambling losses—could be in a different tax bracket

## Discharge of Indebtedness

“Immediate inclusion in income of the loan proceeds was not required on the grounds that the loan will be repaid. If it is not, the failure to repay is a taxable event.”

* **§ 108(b**)—losses that you’re carrying forward must be reduced by excluded cancellation of indebtedness
  + i.e. if you discharge $300K of indebtedness you don’t have to pay taxes on that $300K BUT you have to adjust the basis of an asset by $300K so that when you sell that asset that $300K income will be taxed
* Insolvency exception
  + Idea: you can defer paying taxes while in bankruptcy, but cannot if you come out of bankruptcy later—we don’t want to exacerbate precarious financial position

Zarin v Commissioner—1989

Zarin had $3,435,000 in gambling debt—paid $500,000—difference is taxable—Can he deduct gambling losses against this income? No—different years

Tries to argue that he received nothing of “tangible value”—Resorts risk that he would win and cash his chips

\*\*he isn’t paying for happiness or pleasure—it’s **opportunity**

\*\*why were they giving out unenforceable lines of credit?

* In 1978-79 he lost $2.5M and paid it off to Resorts—indicates that he intended to repay the $3.5M
* Was the reduction in obligation a debt reduction?
  + If it was a reduction—he owes taxes on $3M cancellation of indebtedness income
  + If it was not a reduction—no taxes
* Two models:
  + Taking a world-wide trip, get bank to loan you $1M, spend everything but $300K—which you repay and the bank would write down as a bad loan
    - $700K you can’t deduct the money you blow going around the world
  + Failed widget business, borrow $1M and settle with the bank for $300K (which you have from other sources)—insolvency—would either have a $1M loss with $300K restitution OR have $700K loss
* **Arguments:**
  + *Zarin* looks more like the around the world model—consumption in gambling or traveling
  + Could argue a purchase-price reduction—marker not currency—can’t spend however he wants
* If we’re really thinking about Hague-Simons income is Mr. Zarin $3M better off? Setting aside the law, is the $3M an indicator of his ability to pay?
  + Student: He’s already in a bad situation and making him pay taxes exacerbates
    - LB: but other people could take out a loan for a trip in bad situations, is this different?
  + Student: He did something bad (compulsive gambling)—it doesn’t make sense to reward him for his bad act.
    - If we allow him to not pay taxes on this we implicitly raise taxes for everyone else. Is that fair?
    - Assumes that we aren’t going to decrease spending and everyone else will have to carry greater burden than if we taxed Zarin
  + Student: he gave up the opportunity of spending this $3M in another way
  + Student (Elliot’s idea): less utility than if he were engaged in actual business practice—unfair to tax the failed legitimate businessman and not the compulsive gambler
    - LB: but if it’s a business, you get to take a deduction for the loss which is taxed for cancelled indebtedness so it’s not comparatively punitive (widget example from last class)
    - Student: because the chips were only used for gambling—one product or securitized obligation—it looks like a dedicated business loan which would be *only* for the proposed business plan
      * Economically, how are these ‘loans’ different?
        + Could you sell the chips to someone else? Could you transfer the loan to another businessman? Does our treatment change predicated on liquidity?
        + Is gambling an enterprise of purchasing entertainment or a business investment?
  + Student: looks like purchase price reduction—couldn’t spend marker anywhere but the casino
    - LB: Resorts International probably wouldn’t just give him a loan—he could probably only get the money for gambling and not for a loan—looks very much like purchase price reduction when seller finances a purchase
    - How are gambling markers and purchase price adjustments the same (Sandy’s argument)?
      * Student: Chips come from the casino—the bank isn’t loaning a businessman money to buy widgets for the bank
      * Student: **return on chips produces chips; return on widgets produces cash**
  + Student: casino doesn’t produce wealth like a business loan
    - Student: but our entertainment industry provides legitimate income and industry
    - LB: should we penalize gambling because we think it’s a ‘bad’ way to spend money
  + Student: markers aren’t like loans—they will make money every time they settle so long as the settlement value exceeds the services provided
    - LB: why does it matter that this is seller financing? Maybe casino knew he wouldn’t be able to pay it back—then they know his debts will exceed their comp-ed services—no third party screen determining whether or not purchase predicate was worth the loan amount
    - Student: casino derives value from compulsive gamblers even if he cannot settle his entire bill
  + LB: Code generally doesn’t try to value utility—if we were going to look at utitlity we could say that he suffered from a gambling addiction but legally the better arguments
* Legal Arguments
  + **Disputed debts**—if parties don’t agree on debts we cannot value it properly—Zarin didn’t dispute the markers’ face value, but their enforceability
    - Markers not enforceable in NJ 🡪 should $3M be treated as taxable income?
      * Yes—if it’s not taxable it would be a windfall—affects whether or not he has to repay the marker but NOT the tax consequences
    - What about deducting gambling losses?
      * Student: **current structure discourages people from gambling their whole tax liability to increase their deduction—to allow the deduction of all gambling losses would incentive gambling**
  + **Jacobs’ dissent—page 193**
    - Gain from wagering transaction
    - Chip income is gambling gains🡪 Zarin can offset losses against tax liability
    - Does this make sense?
      * Student: no, because the chip marker is inconsistent with a win—you repay a marker and retain chips
    - What would happen to § 165(d) if we followed Jacobs opinion?
      * Zarin got $3.5M in chips would become gambling gain, then everything you lose can be claimed against chip income
    - Trying to make an end-run around § 165(d)—get Zarin out of his liability
  + **Purchase money debt reduction**
    - Unclear what the property is—is the opportunity to gamble considered property?
* **LB: *Zarin* is really a valuation case:**
  + **He borrowed from a seller (not a bank)**
  + **He didn’t pay back the whole debt 🡪 raises purchase money debt reduction**
* Think back to *Collins*—is the holding in *Collins* fair relative to *Zarin*?
  + Zarin took money with mutuality of agreement and (plausibly) Resorts only expected to get back $500,000—Collins stole the money

|  |  |  |
| --- | --- | --- |
|  | Zarin | Collins |
| “Borrows” | 3.5M | 80K |
| Loses | 3M | 38K |
| Repays | 500K | 42K |
| Tax Result | Zero (logic is he borrowed 500K and repaid it) | 38K |

* “seller financing should always make you look twice at a transaction”

Problem Set #6: Transactions Involving Borrowed Funds

1. **Corporation X issued 1,000 bonds with a face amount of $500 each. Corporation X received $500 for each bond issued (total $500,000). The bonds are now trading for $200 in the market because many investors think that the corporation will not pay off the bonds. Corporation X buys back all its bonds in the market and pays $200 cash for each bond (total $200,000). The fair market value of the corporation's assets exceeds its total liabilities both before and after the bond buyback. Does Corporation X have any income for tax purposes as a result of the transaction?**

$300,000 reduction of debt liability **§ 108(a)** 🡪 taxable OR § 108(e)(5) Purchase-money debt reduction for solvent debtor treated as price reduction 🡪 taxable as income for discharge of indebtedness

Intuitively: shouldn’t be taxable because bond-holders purchased a risky instrument—traded in the market 🡪 transferred and fairly valued

Value of bond is decreasing because of market expectations OR changes in interest rates (if t-bill goes above bond rate they will be worth less)

COD: Cancellation of Debt—similar to *United States v Kirby Lumber*

1. **How would your answer to (3) change if Corporation X's buyback of its bonds were pursuant to a bankruptcy plan approved by a Federal court in a Chapter 11 bankruptcy proceeding? Are there any collateral tax consequences to Corporation X in that case?**

**§ 108(b)** difference between FMV of assets – discounted discharged debt ($200,000) = taxable income

BUT still traded and transferred 🡪 not taxable? **§ 108(e)(10)**—“debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument”—does this hang on when instruments are repurchased?

**§108(a)(1)(a)**—exclusion for companies in bankruptcy

1. **Sue sold an apartment building to Taylor in exchange for Taylor’s $1.5 million promissory note, which bears interest at a market rate. Taylor later discovers that the property is contaminated with asbestos, and, as a result, he must incur $500,000 of asbestos removal costs. The contract of sale had warranted the building to be free of asbestos. Sue agrees to reduce the amount of Taylor's debt by $500,000 to avoid a lawsuit.**
   1. **Does Taylor have income for tax purposes as a result of the cancellation of part of his debt? (See Section 108(e).)**

§ 108(e)(5) Requires: Sue has to be the seller AND the lender

* + not bankruptcy,
  + purchaser not insolvent, and
  + price reduction must come from Sue
  1. **What is Taylor’s basis in the apartment building after the cancellation of debt?**

Intuitively—would remain $1.5M—began with debt of $1.5M, spent $500K to clean asbestos, discharged $500K debt for a new debt liability of $1M

Can he keep his basis at $1.5M?

Cost basis (imagine he discovered asbestos and Sue adjusted sale price pre-sale) would still be $1M under **§ 1012**

\*\*depends if he deducted the $500K

## Tax Expenditure Exemptions

* **Code § 103.** Interest on state and local bonds.
* **Code § 104(a).** Compensation for injuries or sickness—In general.
* **Code § 105.** Amounts received under accident and health plans.
* **Code § 106.** Contributions by employer to accident and health plans.
* **Code § 127.** Educational assistance programs.
* **Code § 7702B.** Treatment of qualified long-term care insurance.

“Tax expenditures include any reductions in income tax liabilities that result from special tax provisions or regulations that provide tax benefits to particular tax payers.”

* How can you tell if a provision is ‘special’?
  + Normal tax or referent tax—how would the tax structure have looked without the special tax?
  + LB: generally there are 6 objectives of any tax provision—i.e. possible income tax objectives:
    - Measure net income (i.e. the costs of producing income)
    - Distributional
    - Simplicity (i.e. no administrable alternative to realization requirement)
    - Efficiency
    - Expressive (i.e. crim law penalties—we just want to express condemnation for actions)
    - No objective (i.e. lobbying or obsolete objectives)
  + Tax expenditure budget is about the last 4 objectives (does not include assessment of net income or distributional objectives, though there are additional standard adjustments for the blind and earned income credits)
* Surrey pushed to have tax expenditure budget in the public dialogue—Bittker really pushed back: unclear baseline would single out certain provisions for scrutiny and ignore others
  + Surrey’s argument:
    - Procedural: enumerate provisions
      * We could eliminate the budget for Department of Defense by created a weapons supply tax credit
      * Same effect, same weapons, budget would shrink by $5B
      * In one case they get a check from the Defense Department, in another they get it from the IRS
      * Thought that people should be aware of spending
    - Substantively:
      * Upside-down subsidy
      * Generally he was writing exemptions and deductions and not many credits—Surrey was offended that deductions (valued at marginal rate x deduction) would necessarily be valued higher for wealthier citizens
* Is the tax expenditure budget a good idea?
  + Wall Street Journal—“concept presumes that every dollar belongs to the government”
    - Student: budget requires manipulation for equitable distribution
    - Student: misses the point that the normal level isn’t 100%
  + Thoughts about Surrey’s proposal?
    - Student: methodology problems—Interaction between one line and other can be compared in a tax expenditure budget but it’s hard to differentiate between a single provision and a direct expenditure—differences between taxes and direct expenditures
    - Student: Bittker’s point is academic—the tax expenditure budget doesn’t cover controversial line items
    - Student: completely ignores the incentive structures that would change with our new expenditures system
      * LB: tax expenditure budget looks at different kinds of behavioral changes and what the alternative tax structure would be
        + i.e. if you repealed 401(k)—it would take **alternate tax treatment** into account that people would shift money into IRAs—it would NOT take into account that people might just save less and that would have macroeconomic effects
        + **Revenue estimates** (a different system than tax expenditures) looks also at **individual behavioral response**—would more people save? Give to charity? Immediate effects on revenue.
        + Could then use a **Dynamic Scoring system** to look at these two and the **macroeconomic** effects—DS could be subject to manipulation and distortion from politicians who decide what programs will be profitable in the long run

|  |  |  |  |
| --- | --- | --- | --- |
|  | Tax Expenditures | Revenue Estimates | Dynamic Scoring |
| Alternate Tax Treatment | √ | √ | √ |
| Individual Behavioral Response |  | √ | √ |
| Macroeconomic Effects |  |  | √ |

* What about the Joint Committee of Taxation’s provision?
  + Proposing to have 2 big categories of tax subsidies and structural effects
    - Subsidies: should be deviations from a general rule in the Code
      * **Tax Transfers**—refundable tax credits made without regard to your tax liability
      * **Social Spending**—effects on social labor, intended or has the effect of changing income
      * **Business Synthetic Spending**
      * \*\*sometimes you will just have to make a judgment call—subject to manipulation, political distortion
    - Structural Provisions: should be used when there is no general rule
      * Different treatment between different kinds of taxation (i.e. debt and equity)
        + i.e. unclear if we should tax non-residents for their income 🡪 no general rule AND taxation would affect behavior 🡪 use structural goals as a boilerplate rule
  + Does this seem like an improvement?
    - Student: seems like it’s important to have a clear standard—if the administration can change the baseline then they can make any project look profitable
    - Student: Not an improvement—just a new way of articulating and obscuring the normal tax base—“there are some things that just don’t fit”
    - Student: they care more about categorization than quantification—without quantification we can’t assess how tax expenditure budget compares to any tax system besides the current, baseline income tax structure
  + What does the normal baseline include?
    - All provisions measuring income
    - Rate brackets
    - Different filing statuses
    - Realization requirement (often argued that it’s impractical to not have this rule)
  + LB wrap up points:
    - We consciously deviate from Hague Simons income for different reasons—whether or not we have a tax expenditures budget it’s important that we know what we’re doing and why
    - Tax system doesn’t work individually—you need to know about an interactive and dynamic policy areas
    - Bittker’s problem—objected to provisions that he thought were measuring ability to pay or well-being and others disagreed with him—i.e. medical expense deductions—should these be tax expenditures? Not indicative of ability to pay
* What are the basic pros and cons of direct expenditures and tax programs?
  + Administrative costs of direct outlay (vs rule complexity from the Code)
    - If there was already an existing program (i.e. food stamps) that could go pick up this costs
    - EIC **administrative costs** are 2% (vs. food stamps which have 20% administrative costs)
      * Not auditing as often as we would in a direct outlay system—**fraud** in tax
      * **Non compliance** rate for EIC was very high in the 1990s—there were 30% over claims (usually someone who would still get the EIC, they were just claiming the wrong amount)
      * Pushes administrative costs onto taxpayer—higher compliance costs for taxpayer—BUT if you’re already filing taxes the incremental cost isn’t high, applying to a new office for a new program would be very costly
    - **Regressivity**
    - **Public Choice**—if you try to withdraw a tax expenditure it may be easier than a direct outlay (lobbying entrenchment)
      * Direct expenditures go through the approval process every year and tax provisions just remain in the Code once they’re there
    - **Public perception**—tax cut looks like small government, direct expenditure looks like big government
    - **Stigma**—everyone files taxes, direct outlays may single out certain citizens
    - **Spending limits**—taxes let the taxpayers decide who is going to take advantage of the incentives; direct outlays put those spending decisions in the hands of the government
    - **Take up—**should be faster if everyone just puts an extra line oh his tax return; depends on application process and compliance
      * **lower income households are more likely to comply with tax credits—goes to stigma**
      * trade off between take up and fraud/non compliance—about 30% of EIC and food stamps recipients are off—EIC about 25% are over claiming with a 2% administrative costs; food stamps about 5% is over claiming with 25% administrative costs
        + More money is paid through EIC to the wrong taxpayers; more money is paid through food stamps to government workers
        + Do we have a preference between these programs’ traditional overspending?
    - Tax programs are **annual—**only going to get the benefit at tax time and benefits will be predicated on annual income; direct outlays—can look at a smaller time increment

Problem Set #7: Tax Expenditure Exclusions

1. **Congress wants to provide taxpayers with $10 for each minor child they support in order to help parents pay for vitamins for their children.**
2. **How could Congress structure this benefit as a direct outlay?**

Social spending program: unrestricted cash, vouchers (direct or through producers), direct provision (distribute vitamins)

1. **How could it structure the benefit as a tax expenditure if the average marginal income tax rate for all taxpayers supporting minor children is 15 percent?**
2. tax program: refundable tax credit, $66 deduction (15% mtr x $66 = $10; assumes that reducing income by $66 wouldn’t change their marginal tax rate)
3. Above the line 🡪 wouldn’t have to itemize to get this deduction
4. Refundable credits—perhaps people don’t have $10—could make it “advance-able” (e.g. EITC)
5. **What are the pros and cons of (a) and (b), and the options within them?**
6. **Section 103 excludes interest received on state and local bonds from gross income?**
   1. **Is § 103 a tax expenditure?**

Suppose corporate borrowers with the same risk profile as New York City issue bonds that pay a 10% interest rate. New York City issues bonds with an interest rate of 7.5%. Who is getting the benefit of the exclusion?

## Health Insurance Exclusions

* + **Health Insurance Exclusions** for employer-provided health insurance is the most costly individual tax incentive
    - **§ 106**—insurance plans that employers provide are excludable—no cap on spending amounts
    - **§ 105**—decides which payments can be excluded and which ones must be included in income—§ 213 determines which types of health care are deductible
      * **§ 105(a)** include health insurance payments
      * **§ 105 (b)** exclude this specific list of health insurance payments (will single out specific procedures or payments and leave something like cosmetic surgery as income) excludable medical expenses listed under § 213
    - **§ 104 equivalent of § 105 for pay on your own plans**—allows you to exclude compensation for injuries or sickness—can you ever get health insurance tax benefits if your employer doesn’t pay for your health insurance?
      * **§ 162(l)—**self-employed can get an itemized deduction if premiums are greater than 2%
      * What if you’re employed but buy your own health insurance?
        + Could claim **§ 213—only to the extent that medical expenses are more than 7.5%**
    - Medicare/Medicaid—don’t pay taxes

|  |  |
| --- | --- |
| Pay on Own | ESI |
| 104(a) 🡪 | 105(a) includable |
|  | 105(b) excludable |
| 162(l) | 106 |

* **Why are tax benefits for employer provided health care bad?**
  + Lock-in to jobs—would stay in a job for employer-sponsored health insurance
  + Only covers people in employer sponsored plans (ESI)
* **Why are tax benefits for employer provided health care good?**
  + Employees may underestimate their ability to get sick
    - Not everyone values health care properly—for this to work, you have to be able to do a wage trade-off between wages and health coverage
  + Adverse selection of having insurance companies cover high-risk individuals
    - Drives up cost for all insured
    - Risk pooling—the more people you get randomly the less likely they will each be systematically sick
  + Good for society—if people are covered by their employer they are less likely to rely upon the government
  + Non discrimination rules—intended effect: highly compensated employees and least highly compensated get the same health care 🡪 highly compensated employees insist on good health care plans and blue collar employees benefit implicitly
  + Moral hazard—because exclusion is uncapped it incentivizes expensive plans with low deductibles—why should this go only to employer provided insurance?
* **If we had no § 106 what would the effects?**
  + More employer provided health insurance
  + More lock-in—employees won’t move to ensure health insurance
  + Provided plans would be more generous
    - 🡪 with § 106 we have more health insurance
  + **How could we improve this?**
    - Group people in different ways—through a union or professional association
    - Cap the exclusions—only applies to insurance that costs less than any set amount
    - Restructure provider compensation
* Are tax-exempt bonds (§ 103) a tax expenditure?
  + Which individuals would benefit?
    - Corporate bonds pay 10%—NYC bonds pay 7.5%
      * 🡪 if everyone had a 25% MTR—NYC would get all the benefit (two options would be worth the same to consumer)
      * 🡪 for customers who have greater than 25% MTR if they buy NYC bonds the customer would capture some of the benefit
      * 🡪 for customers who have less than 25% MTR they would marginally lose by purchasing NYC bonds and *should* buy Corporate bonds
      * \*\*tax-exempt entities should NOT buy state or local bonds because they won’t take advantage of the tax exemption for NYC
    - IF Corporate bonds pay 10%--NYC bonds pay 8%
      * NYC sell bonds for 10% (same effect for taxpayers as corporate bonds) and have the government directly pay NYC 2%
* Tax credit bonds--**§ 54(a) and 54(a)(a)**—used to only be for certain energy conservation and educational efforts—stimulus expanded by implementing “Build America Bonds”—these reduce the borrowers’ interest rates by 80-100 basis points
  + 🡪 currently Corporate bonds pay 10%, NYC pays 8%, Build America Bonds pay 7%
  + Build America bonds can be issued by states predicated on their unemployment rate as a means to raise capital for the state
    - Corporate bond pays 10% to bond holder—NYC pays 7.5% and the bondholder gets 1/3 refundable tax credit = 2.5% 🡪 gets the same 10% benefit from corporate and NYC bond

## Health Care

* Issues with the current system:
  + No universal health care
  + More health insurance
  + High health care costs
  + Shift non-group to employer coverage
  + Low health insurance if we encourage pooling—only available to some
    - Why only to employers?
* Reform options:
  + Regulate insurers—require them to offer plans to everyone, price predicated on certain criteria
  + Compete across state lines (would incentivize choosing where to incorporate & flocking to certain states
  + Consumer directed health care—expose consumers to costs to internalize/understand relevant costs
  + Instead of being an exclusion—could have a credit up to a certain cap 🡪 everyone would have access to a certain tax benefit and if a taxpayer wanted more it would be available
  + Accountable care
    - Doctors compensated for the number of patients for which they’re responsible—not predicated on tests, etc.
  + How should we implement these?
    - Exclusion wouldn’t solve the problem of people not knowing their health care costs
    - Deduction would regressively offer more value to people with higher income
    - Credit—would work best if it were flat and refundable for cost of insurance (not health care)
      * 🡪 health care providers would still be providing to a varied pool—people would be permitted to choose whatever health care plan they wanted and if they wanted more than their credit they would just pay extra
* Senate plan:
  + Creates exchanges (pools) with certain minimum policies
    - Available to both employers and individuals
  + Keeps employer tax incentives
  + Creates credits
  + Regulates what insurance companies can use to price (pre-existing conditions only 3x, age, smoker, family size)
  + Penalized for non-compliance—imposed through the tax system (?)
  + Effects:
    - Progressive
    - Refundable credits subsidizing co-pays
      * Tries to correct for co-pay’s effects on take up—would cut back on care available to low income taxpayers

## Fiscal Policy Analysis

* What is your theory of distributive justice?
  + Welfarist—maximize some function of well being—subjective or objective?
* What is the most just basis for redistribution?
  + Equal opportunity predicates on opportunity
  + Welfarists predicates on well being
* What is the best real world proxy (for your most just basis for redistribution)?
* How can we modify the proxy to better approximate the ideal?
* What is the ideal level and form of redistribution based on modified proxy?
  + Costs of raising revenue from different sources
  + Benefits of redistribution in different ways
  + Balance under theory of justice
* How can we enhance efficiency holding this distribution constant?
  + Correct for externalities—administration costs may outweigh benefits
    - Magnitude of externalities
    - Elasticity
  + Limit transactional complexity
    - Tax like things alike
    - Draw lines where activities are poor substitutes (i.e. debt/equity; annuity/bank account)
  + Finance public goods

## Annuities and Life Insurance

* **Code § 72(a).** Annuities; certain proceeds of endowment and life insurance contracts—General rule for annuities.
* **Code § 72(b).** Annuities; certain proceeds of endowment and life insurance contracts—Exclusion rules.
* **Code § 72(c).** Annuities; certain proceeds of endowment and life insurance contracts—Definitions.
* **Code § 72(e)(1).** Annuities; certain proceeds of endowment and life insurance contracts—Amounts not received as annuities—Application of subsection.
* **Code § 72(e)(2).** Annuities; certain proceeds of endowment and life insurance contracts—Amounts not received as annuities—General rule.
* **Code § 72(e)(3).** Annuities; certain proceeds of endowment and life insurance contracts—Amounts not received as annuities—Allocation of amounts to income and investment.
* **Code § 72(q).** Annuities; certain proceeds of endowment and life insurance contracts—10-percent penalty for premature distributions from annuity contracts.
* **Code § 101.** Certain death benefits.

**Three ways to recover basis on an annuity: (i.e. if purchase price were $267.30 for 3 $100 coupon payments)**

1. All up front: No income until year 3 ($32.70)
2. Fixed Ratio: $267.30/300 = 89.1% 🡪 each year income = $10.90 (x 3 = $32.70)
3. Bank account: equivalent interest paid each year

* **Annuities**
  + Can be used to shelter earnings from taxes
  + Traditionally: a contract to pay a lump sum up front and receive a set payment each year for a specific amount of time
  + Subsidizing savings relative to a bank account
  + Annuities allow us to protect against:
    - Mortality risk (that we outlive our savings)
    - Does this allow us to tax the ideal? Does it measure ability to pay?
    - Inefficient? Creates incentives to invest for tax reasons and NOT because we value their insurance values
* **Life Insurance**
  + Exempts all earnings on savings from tax
  + Most has savings AND term insurance (protects beneficiaries against premature death)
    - Pure term—insure against death in the following year
    - Whole life—pay much more now and no matter when you die you get the same payout—basically pay a series of pure term payments upfront
  + Liquidity of cash makes it more valuable
  + POLICY CONSIDERATIONS
    - Estate preparation--

Problem Set #8: Annuities & Life Insurance

**For the following problems, you should focus on Sections 61, 72(a)-(c) and 101. There is no need to calculate the exact tax consequences of each scenario. Instead, the goal is simply to deepen your understanding of the advantages and disadvantages of each investment option from a tax perspective.**

1. **Oliver is retired and contemplating two investments. One is the purchase of an annuity for $7,000. It will pay him (or, in the event of his death, his heirs) $1,000 per year for 10 years. Alternatively, he could deposit $7,000 in a bank account paying 7% interest. On a pre-tax basis, this would permit him to withdraw $1,000 a year for 10 years after which point his balance in the account will be zero.**
   1. **In a world without taxes, what would you advise?**

In a world without taxes, these are the same--$7,000 expenditure and 10 years of $1,000 dispersals—bank account would be more liquid but they would be otherwise identical

* 1. In light of the tax consequences, what would you advise?

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Bank Account** | | |  |  |  |  |
|  | Year | Beginning Balance | Ending Balance | Taxable Interest Gains | After Withdrawal | PV Taxable Gains |
|  | 1 | $7,000.00 | $7,495.11 | $495.11 | $6,495.11 | $495.11 |
|  | 2 | $6,495.11 | $6,954.51 | $459.40 | $5,954.51 | $429.05 |
|  | 3 | $5,954.51 | $6,375.67 | $421.16 | $5,375.67 | $367.36 |
|  | 4 | $5,375.67 | $5,755.89 | $380.22 | $4,755.89 | $309.74 |
|  | 5 | $4,755.89 | $5,092.28 | $336.38 | $4,092.28 | $255.93 |
|  | 6 | $4,092.28 | $4,381.72 | $289.45 | $3,381.72 | $205.67 |
|  | 7 | $3,381.72 | $3,620.91 | $239.19 | $2,620.91 | $158.73 |
|  | 8 | $2,620.91 | $2,806.29 | $185.38 | $1,806.29 | $114.89 |
|  | 9 | $1,806.29 | $1,934.05 | $127.76 | $934.05 | $73.95 |
|  | 10 | $934.05 | $1,000.11 | $66.07 | $0.11 | $35.72 |
|  |  |  |  |  |  |  |
|  |  |  | Total Gains | $3,000.11 |  |  |
|  |  |  | Interest Rate | 7.073% |  |  |
|  |  |  | Discount Rate | 7.073% |  |  |
|  |  |  | PV Total Gains | $2,446.15 |  |  |
|  |  |  |  |  |  |  |
| **Annuity** | |  |  |  |  |  |
|  | Year | Taxable Interest Gains | PV Taxable Gains |  |  |  |
|  | 1 | $300.00 | $300.00 |  |  |  |
|  | 2 | $300.00 | $280.18 |  |  |  |
|  | 3 | $300.00 | $261.67 |  |  |  |
|  | 4 | $300.00 | $244.39 |  |  |  |
|  | 5 | $300.00 | $228.25 |  |  |  |
|  | 6 | $300.00 | $213.17 |  |  |  |
|  | 7 | $300.00 | $199.09 |  |  |  |
|  | 8 | $300.00 | $185.94 |  |  |  |
|  | 9 | $300.00 | $173.65 |  |  |  |
|  | 10 | $300.00 | $162.18 |  |  |  |
|  |  |  |  |  |  |  |
|  |  |  | Total Gains | $3,000.00 |  |  |
|  |  |  | Interest Rate | 7.073% |  |  |
|  |  |  | Discount Rate | 7.073% |  |  |
|  |  |  | PV Total Gains | $1,948.51 |  |  |

* **Exclusion ratio** = initial investment/total nominal payments = 7,000/10,000
* 🡪 (.7\*nominal payment) is excluded as recovery of basis under § 72
* annuity takes advantage of deferral value of TVM
* treating the annuity like a bank account would be like taxing the imputed interest on an annuity
  1. **Which investment is taxed more in line with the Haig-Simons definition of income?**

The imputed interest tax—would be the same as taxing interest less withdrawal with consumption benefit added in (taxable income = interest -$1000 + $1000 = interest)

1. **Paula is also late in life and contemplating two investment alternatives. She does not need any income herself and is only concerned with maximizing the amount of money that she can pass on to her heirs. The first is the purchase of a life annuity for $7,000. It will pay her $1,000 per year for the remainder of her life, which the annuity provider estimates to be 10 years. She will deposit these payments in a bank account paying 7% interest and bequeath the balance to her heirs. The second is the purchase of universal life insurance for a one-time payment of $7,000. Upon her death, the life insurance policy will pay her heirs $13,864, which is the present value of $7,000 in 10 years assuming an interest rate of 7%.**
   1. **In general terms, what are the tax consequences of each investment?**

* **Annuity**: she’s taxed with exclusion ratio (70%) 🡪 include $300 income/yr for the first 10 years
  + If she dies after 5 years
    - 5 years basis recovery = 5\*$700 = $3,500 🡪 can deduct unrecovered basis (= $3,500) on her last tax return **§ 72(b)(3)-(4)**
  + If she dies sometime after 10 years
    - She’ll have recovered all of her basis 🡪 all of her $1,000 annual payments after first 10 are taxable income **§ 72(b)(2)**
* **Life Insurance**
  + **§ 101(a)** if you get the payment by reason of death she can exclude it entirely (doesn’t matter if Paula or her heirs are direct beneficiary)
  + § 102—this would be a bequest and not taxable
  + **Life insurance: entire gain on life insurance is tax exempt—including savings element (not specifically defined anywhere in Code)**
  + Annuity—tax is deferred, taxed only on gain of savings element and mortality gain/loss if the life expectancy estimate is off
    - What is a **mortality gain**?
      * Only comes into play if the insured dies off schedule
      * LIFE INSURANCE: If you die BEFORE you’re supposed to you get a mortality gain (which isn’t taxable because it’s L.I.)
      * ANNUITY: If you die AFTER you’re supposed to you get a mortality gain because you’re getting more payments than they thought you should (more than you technically paid for)
    - What if you might cash-out the policy? 🡪 MODIFIED ENDOWMENT CONTRACT
      * Tax treatment would become similar—would lose the tax-benefits of life insurance **§ 72(e)**
      * **§ 72(q)**—if you cash-out prior to 59½ you pay a 10% penalty (unless you have a terminal disease or disability—special exceptions)
  1. **If Paula expects to live 10 years, what would you advise?**

PV would be the same 🡪 should get life insurance because it has better tax consequences

* 1. **If she expects to live 5 years?**

Life insurance—she would only receive 5 annuity payments which would be less than the cost of the life insurance 🡪 even on a pre-tax basis she should choose the life insurance

**Mortality loss § 72(b)(3)—**can deduct unrecovered basis

* 1. **If she expects to live 20 years?**

More complicated—**Mortality gain § 72(b)(2)**

# DEDUCTIONS

* Before when we discussed “What is Income?”
  + Valuation issues (distinguishing business from personal consumption of defining what is and is not income)
    - Realization requirement—driven largely by valuation issues—look to transaction to value income instead of doing a subjective assessment every year—administration costs lower
    - Consumption tax—would decrease the efficacy of realization requirement
  + Managing Complexity in the Code
    - Life insurance section is HUGE
    - Complex assets of tax code NOT in code (benefit of the employer and realization requirement)
    - When is complexity useful and when is it wasteful?
  + Tax expenditures
    - Code used to distribute and encourage socially beneficial behavior
    - What are the potential objectives of a tax expenditure?
      * Measuring income, measuring ability to pay 🡪 not a tax expenditure
    - What is the best way to implement a tax expenditure?
      * Credit vs. deduction vs. exclusion

## Business Expenses

* **Code § 67.** 2-percent floor on miscellaneous itemized deductions.
* **Code § 68.** Overall limitation on itemized deductions.—*3% haircut—itemized deductions reduced to 3% of income over $100,000*
* **Code § 162(a)**. Trade or business expenses; In general.
* **Code § 162(b)**. Trade or business expenses; Charitable contributions and gifts accepted.
* **Code § 162(c)**. Trade or business expenses; Illegal bribes, kickbacks, and other payments.
* **Code § 162(e)**. Trade or business expenses; Denial of deduction for certain lobbying and political expenditures.
* **Code § 162(f)**. Trade or business expenses; Fines and penalties.
* **Code § 162(g)**. Trade or business expenses; Treble damage payments under the antitrust laws.
* **Code § 162(g)**. Trade or business expenses; Certain excessive employee remuneration.
* **Code § 212.**  Expenses for production of income.
* **Code § 280E.** Expenditures in connection with the illegal sale of drugs
* **Regulation § 1.162-1(a)**. Business expenses—In general.
* **Regulation § 1.162-6**. Professional expenses.
* **Regulation § 1.162-20**. Expenditures attributable to lobbing, political campaigns, attempts to influence legislation, etc., and certain advertising.
* **Regulation § 1.162-21(b).** Fines and Penalties—Definition.
* **§ 162**—permits deductions only in connection with a **trade or business**
  + Three general questions:
    - To what extent does the phrase “ordinary and necessary” imply that there is a class of nondeductible business expense?
    - What distinguishes a “trade or business” expense from a personal expense?
    - What separates a deductible expense from a capital outlay?
* **§ 212**—permits deductions for “**ordinary and necessary**” expenses stemming from income-producing activities that do not qualify as a trade or business
  + Two important distinctions:
    - § 212 applies **ONLY** to individuals
    - only a deduction from AGI (not from gross income) 🡪 only used AFTER deductions exceed the standard deduction
* **§ 165—**permit deductions for **losses incurred in a trade or business** or in a profit-seeking activity
* **§ 162(a)**
  + **“Ordinary and necessary”**
    - ***Welsh v Helverling***—Welsh was in the grain business, went out of business and wanted to get back in so he paid off, to the extent that he could, the old Welsh Company’s debts
      * **Legal issue**: Can Welsh deduct the debt payments for the former company?
      * **Holding**: No
        + was necessary—defined as “appropriate and helpful”
        + was *not* ordinary—considered an extraordinary cost—Cardozo’s standard: normal people don’t pay off old businesses’ debts

Is this a good standard?

* + - * + **Welsh is usually considered a case about when costs can be deducted and when they must be treated as a capital expense**
      * Were Welsh’s expenses personal?
        + Student: Yes—E.L. Welsh Company—perhaps this was about maintaining his good name and his family’s reputation

If this were personal, how would you handle expense? No deduction.

***Welsh* draws lines about personal vs. business expenses**

**Chirlstein: “a case full of soggy philosophy”**

* + - How should we treat a business that pays someone to learn about the Internet and online markets to develop a company in the online marketplace?
      * Cardozo’s faulty rule—any time you were doing something unique to your market you would not be able to deduct it
    - ***Giliam v Commissioner****—*Gilliam agreed to lecture in Tennessee, had just switched medication—began acting irrationally—were litigation expenses to plead not guilty for reason of insanity deductible?—Gilliam was acquitted in criminal court for reasons of insanity
      * Are legal expenses generally deductible?—Yes
        + Test: “source of the claim”

Business-related: deductible

Personal: not deductible

* + - * Question: did this arise out of events furthering the business?
        + **Holding**: the expenses of traveling would be ordinary and necessary but the event was so extraordinary that it cannot be deductible—the altercation was not an expense undertaken to further business
  + ***Dancer v. Commissioner***—Mr. Dancer was riding from his horse-training facility to his home office on his farm for lunch—hit a child—court held that he COULD deduct litigation expenses as a business expense—driving for work implies necessary harms
    - Student: Distinguishable from *Gilliam* because medicine is clearly a personal expense 🡪 consequences and effects of medicine do not create deductible litigation
    - driving has to be a *part of our business* to be eligible for a deduction should litigation arise from consequences of your driving 🡪 only effects people driving *for* work, not *to* work
      * Student: can we use whether or not the business was paying gas mileage to define whether or not the travel was business or personal?
  + **“Ordinary and Necessary” cases takeaway**—student: this was not a business expense, but he was off the hook for the real liability, the tort or criminal injuries (vs. Dancer who could deduct the cost of his litigation but also had to pay damages to the child he injured)
    - Student: whether or not litigation costs were deductible will not organize behavior ex ante—we should be concerned with the incentive structures we create
    - LB: hard to determine whether the cause of something giving rise to litigation is personal or business—
      * **i**.e. negligent driving always business OR cell phone makes driving personal?
      * requires more facts, and often makes these hard to parse
      * “ordinary and necessary” cases often come down to whether or not these expenses can be deducted or capitalized
  + ***Commissioner v Tellier***—
    - Tellier’s argument: this was ordinary and necessary as a part of his business
    - IRS: there is an implied exception to **§ 162** when the business expenses are contrary to public policy (and this one would be contrary to public policy because it’s illegal)
    - Can you deduct litigation fees? Yes
      * “Federal income tax is a cost on net income, not a sanction on wrongful activity”
    - What do people think?
      * Student: if you consider this expense “necessary” doesn’t it mean that you knew your activity would spark litigation (and was therefore illegal and should be taxed)?
      * Student: decision was right—if you were held innocent and you developed the line drawn by the law for when securities transactions are legal—shouldn’t differentiate between innocence and guilt for tax purposes
    - **What about relative to *Gilliam*?**
      * Walter F. Tellier: The King of the Penny Stock Swindles
      * LB: value of the deduction turns on MTR and costs of legal fees
      * It’s odd but we differentiate between business and personal crimes--

Kickbacks

Securities fraud (vs. murder—unless hitman can deduct the cost of his gun)

* + ***Tank Truck Rentals v Commissioner***—industry practice was to violate trucking regulations and pay penalties—IRS disallowed deductions for penalties, SCOTUS affirmed IRS assessment
    - Who is losing out by allowing a deduction?
      * The IRS
      * BUT Pennsylvania was able to realize gains from the trucking industry by having the penalty function as a de facto tax
    - Compare with *Tellier*—it’s not universal to commit securities fraud, but it’s also not universal to have to pay legal fees
      * Paying legal fees is not illegal—if you disallow this deduction you vary whether or not you have a protracted legal battle
      * BUT—fines are not
    - Should we disallow the litigation fees for tank truck whether or not they have to pay the fees?
      * Was directly related to business expense 🡪 under *Tellier* the origin of the claim is strictly business related because if you’re arguing that you shouldn’t be subject to the fines/regulations then the claim necessarily arises from business expenses

## Executive Compensation—“ordinary and necessary”

* **§ 162(m)—Certain excessive employee remuneration**
  + disallows compensation over $1M to CEO and next four highly compensated employees in publically traded companies
  + in addition to reasonableness exception—outlines what performance-based compensation is
  + **What does this section do?**
    - Implicit tax rate
    - Incentive for companies to give performance-based compensation rather than pure compensation
    - **Problem**: In practice this is a way for CEOs and Boards to get around performance-based criteria—can set criteria wherever they want and be OK
    - Performance-based compensation is supposed to align the interests of management with the shareholders’
    - Effectively nothing—anyone can get around it
* **Hypothetical—Privately held company—CEO Willa gets a $2M salary**
  + Was the $1M over performance-based? (doesn’t matter--§ 162(m) doesn’t apply b/c private)
  + What is the internal rate of return on the stock?
  + Is she a majority shareholder? (More likely to have salary be disguised dividend)
  + Is she related to any other shareholders?
  + Is the success of the company tied to the CEO’s work? Or did they stumble upon oil and the company suddenly (and accidently) significantly increased their rate of return?
  + Has the company paid dividends?
    - Could be more likely that they’re just hiding them? Or is that indicative that shareholders just want to reinvest their earnings?
* **Take-aways**
  + **Disguised dividends**—we’re trying to preserve double taxation
  + If we don’t like the corporate tax this isn’t an issue—disguised dividends are self-help mechanisms used to circumvent the tax code
  + Major problem: agency costs—CEOs and Board take advantage of power to squeeze out funds
    - One of a variety of types of market failures (i.e. externalities, information asymmetries)

Exacto Spring Corporation v Commissioner—1999—Posner

* Language in code: “reasonable allowance for salaries and other compensation”
* Exacto incentives for high salary—disguise income as salary; disguise (taxable) dividends as salary
* **Decision:**
  + Reject 7-factor test; instead implement **“INDEPENDENT INVESTOR TEST”**—returns inquiry to basics
  + Links manager’s generation of returns to salary—greater returns, greater allowable salary
* Class Notes
  + Corporate taxes for dividends from c-corps—
    - Exacto Spring wants this to be a dividend
    - C Corporations are subject to the corporate income tax
      * if this were a partnership the income would pass through the entity to the partners
    - Dividend tax is a double-tax—Bush tax cuts tried to get a credit for corporate tax paid distributed to dividend receivers so that
  + What if Exact Springs were a publically traded company?
    - Less likely to be a dividend in disguise as salary
  + **Independent Investor Test—**
    - Would an investor accept the rate of return adjusted for risk?
    - usually expect 13% return; getting 20% 🡪 salary ok
    - Should the IRS get to be this far into corporate governance?
    - Can the CEO be held accountable for returns?
  + What is the best way to decide if salary is reasonable?
    - Comparables—assumes market competitiveness
      * But disguised dividends could be consistent across companies
  + When is this a problem?
    - When CEO is a majority shareholder

Commissioner v Tellier—1966—SCOTUS—Stewart

Tellier charged with securities fraud—spent $22,964.20 on defense—tried deduction as business expense—ordinary and necessary?

“No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense.”

**Decision**: “There can be no serious question that the payments deducted by the respondent were expenses of his securities business under the decisions of this Court, and the Commissioner does not contend otherwise.”

Problem Set #9: Business Expenses

1. **Vic runs a moonshine business in a dry county. His costs include corn, barrels and bottles. Are these expenses deductible? Are the following expenses deductible?**

Yes—would he want to alert the authorities to his operation? Probably not.

Issues to think through:

* capital expenditures,
* make sure moonshine is not a controlled substance under **§ 280E** (which it’s not because this is a local restriction),
* ordinary and necessary (really more about being non-personal and not a capital expense),
* whether or not this was a trade to generate income (vs. for personal consumption)
* **§ 212** is generally more about investment income; this would be more likely deductible under **§ 162**
* Particular provisions barring deduction for being contrary to public policy
  + **§ 162(c)(2)**—would these be illegal payments? Corn and bottles would probably be ok
  + **§ 1.162-1(a)**—unless we enumerate this as something we’re disallowing, if it’s a business expense he should be able to deduct it.
  1. **He pays a revenue agent a bribe to ignore the illegal business.**

**§ 162(c)(1)**—“No deduction shall be allowed…for any payment made…to an official or employee of any government…if the payment constitutes an illegal bribe or kickback.”

* 1. **He pays someone to make the revenue agent “disappear.”**

**§ 162(c)(2)**—“No deduction shall be allowed…for any payment made…to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State…**which subjects the payor to a criminal penalty** or the loss of license or privilege to engage in trade or business”

* 1. **He is caught and has to pay a fine of $10,000.**

**§ 162(f)**—“No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government of the violation of any law.”

* 1. **He pays an attorney to defend him when he is charged with running a moonshine operation. Does it matter if he is convicted?**

*Commissioner v Tellier*—attorney’s expenses deductible

Does it matter if he’s convicted? No—as long as it’s a business crime it’s deductible

* 1. **He advocates for changing the law by lobbying his local legislators and state representatives, and by paying for advertisements in the county newspaper.**

**§ 162(e)(1)**—“No deduction shall be allowed under subsection (a) for any amount paid…(A) influencing legislation.”  
EXCEPTION: **§ 162(e)(2)**—“In the case of any legislation of any local council or similar governing body...paragraph (1)(A) shall not apply.”

**🡪 can deduct expenses to lobby local legislatures**

Prospectively thinking about entering the moonshine business: **§ 162(e)(2)(b)**—if he’s not in the moonshine business he cannot deduct for lobbying for his moonshine business

Does he have any recourse in terms of the state legislatures? **§ 62**—in-house lobbying expenses as long as it’s less than $2,000 he can deduct them as a de minimus expense

What about advertisements in the county newspaper? Not deductible—doesn’t fit within the Code allowances **§ 162(e)(1)(c)**—not deductible for elections, legislatures, or referendum; **§ 1.162-20** not deductible unless it’s a good will advertisement

* 1. **Would any of your answers change if he sold illegal drugs instead of moonshine?**

**§ 280E**—“NO deduction or credit shall be allowed for any amount paid or incurred…if such trade or business…consists of trafficking in controlled substances”

CAN deduct the COGS, but not the ancillary expenses

## Personal Expenses

* **Code § 21.** Expenses for household and dependent care services necessary for gainful employment.
* **Code § 129.** Dependent care assistance programs
* **Code § 274(a).** Disallowance of certain entertainment, etc., expenses—Entertainment, amusement, or recreation.
* **Code § 274(b).** Disallowance of certain entertainment, etc., expenses—Gifts.
* **Code § 274(c).** Disallowance of certain entertainment, etc., expenses—Certain foreign travel.
* **Code § 274(d).** Disallowance of certain entertainment, etc., expenses—Substantiation required.
* **Code § 274(e).** Disallowance of certain entertainment, etc., expenses—Specific exceptions to application of subsection (a).
* **Code § 274(k).** Disallowance of certain entertainment, etc., expenses—Business meals
* **Code § 274(l).** Disallowance of certain entertainment, etc., expenses—Additional limitations on entertainment tickets.
* **Code § 274(m).** Disallowance of certain entertainment, etc., expenses—Additional limitations on travel expenses.
* **Code § 274(n).** Disallowance of certain entertainment, etc., expenses—Only 50 percent of meal and entertainment expenses allowed as deduction.
* **Regulation § 1.162-2(e).** Traveling expenses—“commuters’ fares are not considered as business expenses and are not deductible”

Often blurred—ideally we would be able to divide—sometimes the business and personal value exceed the cost—should we be taxed on everything for our personal value? 🡪 if we pay $200 for A/C and we value it at $400 we should pay taxes on value because we’re better off

* What is the rationale for the 2% floor?
  + Raise tax rates on higher income people
  + Simplicity—most people don’t go above 2% floor 🡪 standard deduction
* Can we defend the 2% floor?
  + Shores up the standard deduction—can make it higher and still fair
  + Applies only to unreimbursed employee business expenses—
    - Encourages employers to reimburse their employees—**expresses skepticism about expenses that aren’t reimbursed**—if we are going to believe that this is really for business purposes we want really great documentation and to make you work for it.
* What about the TOOL RULE?
  + If her laptop, etc. were her tools and she needed the car service to transport the tools she could deduct the cost IF the tools travel separately
  + **These cases go back to valuation**

Pevsner v Commissioner—1980

Girlfriend works at a YSL store—has to wear YSL to work—can she deduct the clothes?  
**Test**: “adaptability for personal or general use depends upon what is generally accepted for ordinary street wear”—OBJECTIVE standard—doesn’t matter whether or not these clothes would fit with HER lifestyle

* What if YSL had provided her a uniform and deducted it out of her paycheck?
  + De minimus—given the price of clothing probably wouldn’t work
  + § 132(c)—could use a discount , but couldn’t be 100%
* Was this the right decision on policy grounds?
  + She wasn’t barred from wearing the clothes outside of work 🡪 seems fair
  + Subjective test would be the best solution, but objective test is more easily administered
  + What about efficiency? How is this like *Benaglia*?
    - It may be good for the business that she wears the clothes
    - most efficient rule would be to tax her unique value—far too complex for administration
* What about *Benaglia*? Why is this different?
  + He was required to stay at the hotel—she has more election here
  + She gets to keep the clothes—Benaglia would have to move out when he quits
  + **Financial transaction—employer in Benaglia was paying, Pevsner paid for the clothes and was seeking her own deduction**

Hantzis v Commissioner—1981

2nd year law student Ms. Hantzis lived in NYC to work (apart from husband)—NYC living expenses not deductible

“A taxpayer’s home for purposes of **§ 162(a)(2)** is the taxpayer’s regular or principal place of business”

* **§ 162(a)(2)**—you can deduct traveling expenses while away from home in pursuit of trade or business
* *Flowers* test—turns on whether or not the pursuit is of business
* Is this a personal expense? She doesn’t meet which purpose of the statute?
  + She’s not away from home if she has an apartment and is based in NYC—Boston is not her home for tax purposes
  + **Test for your tax home**:
    - **Majority**:
      * no bus. connections in Boston (all business NYC); Boston trips were personal
    - **Concurrence**:
      * when taxpayer only has a business relationship in one location it is her home—look to entire clause “away from home in pursuit of a trade or business”
    - *\*\*no functional distinction between these two, but majority definition is more circuitous than concurrence*
    - **IRS:** 
      * Business expenses cannot be incurred if you don’t have business connections before the expenses are incurred
* Could we consider her apartment an investment to reduce commuting costs from Boston—not necessary to take the subway just because it’s cheaper than a cab

Moss v Commissioner—1983

Firm held lunch meetings everyday at a restaurant—lunches were “personal and therefore non-deductible”—“daily meals are an inherently personal expense”

Flowers

* Home and business in two totally different metropolitan areas
* **Compare to *Hantzis:*** 
  + Hantzis who was temporarily away from Boston—what the court seems to hold is that you have to be in the **same** line of business—Hantzis would need to be in the legal business, that business took her to NYC and then took her back—cannot be in one business (school) and then go to NYC for legal business (a different trade or business) 🡪 not all part of a continuous trade or business—she TRIED to get a job in Boston, more sympathetic than Flowers

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  |  | Earn | Expenses | AGI | Tax Imputed Income | Allow Deduction |
| Jacksons | 2 earners + kids | $100 | $20 | $100 | $100 | $80 |
| Browns | 1 earner + kids | $80 | $0 | $80 | $100 | $80 |
| Jones | 1 earner (no kids) | $80 | $0 | $80 | $80 | $80 |

* **How do we think they should be taxed?** 
  + Equally—the Jacksons shouldn’t be taxed more because they have the same net income
  + Either tax the Browns’ imputed income (inherently a personal expense 🡪 taxable) OR allow a deduction for Jacksons (childcare costs are business or deductible expense)
    - Taxing imputed income: creates distortions in equitability and efficiency (people act differently)
  + **Current system** assumes there are two income earners
    - **Implication**: incentivizes someone to stay home to care for children
* **Allowing deduction would eliminate the incentive for one parent to stay home and look after the children**
  + Will cost the government a LOT of tax income
  + Could encourage higher childcare costs—the Jones would be paying for the Jacksons’ childcare
  + BUT would encourage childcare providers to work AND for 2 people to work in the workforce
* **Framing: childcare as personal consumption or childcare as business expense**
  + What if we value kids and their positive externalities? Child rearing as a social good?
  + Current law: childcare BY THE PARENT is a social good
* **Things to think about:**
  + Imputed income—what does a taxpayer get from children? How should we measure that?
  + How do we view kids—i.e. get credit for first 2 kids, no more

Problem Set #10: What is a Personal Expense?

**Ursula is an associate in the tax department of a large law firm. She pays for the following items. Which can she deduct? How does her tax treatment differ, if at all, if her law firm pays the expense directly? What if she pays for the expense and is reimbursed by her firm? Hypothetical salary: $200,000**

1. **A beautiful Eames chair from Design Within Reach for her office.**

* **§ 1.162-6**—furniture with a **short** useful life—deduct; last a **longer**—depreciate
* Firm pays for the chair—**§ 132(d)—**exclusion (🡪 not subject to the 2% floor)
* She pays, firm reimburses
  + **§ 67**—**2% floor** on miscellaneous itemized deduction—only get to deduct amount above 2% of income 🡪 if chair costs $1,000 and she earns $200,000—can deduct $0 (2% of $200,000 is $4,000)
  + **§ 68—3% haircut—itemized deductions are reduced by 3% of your income over $100,000 OR 80% of your otherwise available deductions**
    - if chair cost $5,000 she could deduct $1,000 under **§ 67**—then we haircut 3% of her income excess over $100,000
    - 🡪 $200,000-$100,000 \* .03 = $3,000 🡪 $1,000 deduction under **§ 67** would get a 3% haircut to -$2,000 (effectively 0)

1. **The cost of suits, blouses, dress shoes, etc., that she is required to wear in the office. She hates all of these clothes and never wears them when she is not at the office.**

* Must be required for employment, can’t be adaptable for general use, can’t be worn for personal use
* **§ 132(b)(3)** qualified employee discount
* **Rev Ruling 72-110:** (1) reimbursement for the acquisition and maintenance of uniforms is includible in an employee's gross income; (2) the cost thereof to the extent of such reimbursement is deductible in computing his gross income; and (3) expenses in excess of the reimbursement are deductible in computing taxable income if deductions are itemized.

1. **Payments to a nanny ($20,000 a year) to care for her 3-year-old child while she works.**

***Smith v Commissioner****—*cannot deduct childcare costs—“inherently personal concern” incentivizes people to stay home and not work

* **What other tax benefits for childcare expenses could she qualify for?**
  + Nonrefundable Credit: **§ 21**--$3,000 cap on expenses that qualify for the credit—35% tax credit, around $45,000 of income triggers reduced 20% credit
* **What if the employer provides for or reimburses childcare?**
  + **§ 129**—can exclude up to $5,000 of income derived from this kind of employer-provided income
  + Can’t claim both **§ 21** and **§ 129**
    - **§ 21(c)**—can exclude up to $5,000 (dollar for dollar reduce $3,000 cap against which she can take her credit)

1. **The cost of a private car service that picks her up at home each morning, takes her to work, and returns her each evening. She works during the entire ride, using her cell phone and laptop.**

* Not deductible--**§ 162(a)(2)**—traveling expenses to and from work aren’t deductible
* **Reg § 1.162-2(e)**—commuting expenses aren’t deductible
* Why? Personal expense—your choice to live far from where you work *Flowers* (away from home)
  + Still applies even if you’re working on a nuclear test site
    - **§ 1.61-21(k)**—transportation provided for unsafe working conditions can be deducted
  + What if the EMPLOYER pays for the transportation—income?
    - **§ 132(f)(2)(a)** can exclude up to $100 each month for transportation or transit pass

## Deductible vs. Capital Expenses

* **Code § 263.** Capital expenditures.
* **Code § 263A(a).** Capitalization and inclusion in inventory costs of certain expenses—Nondeductibility of certain direct and indirect costs.
* **Code § 263A(b).** Capitalization and inclusion in inventory costs of certain expenses—Property to which section applies.
* **Code § 263A(c).** Capitalization and inclusion in inventory costs of certain expenses—General exceptions.
* **Code § 263A(g).** Capitalization and inclusion in inventory costs of certain expenses—Production.
* **Code § 263A(h).** Capitalization and inclusion in inventory costs of certain expenses—Exemption for free lance authors, photographers, and artists.
* **Regulation § 1.162-4.** Repairs.
* **Regulation § 1.162-7(a).** Compensation for personal services.
* **Regulation § 1.263(a)-1.** Capital expenditures in general.
* **Regulation § 1.263(a)-2.** Examples of capital expenditures.
* **Regulation § 1.263(a)-4.** Amounts paid to acquire or create intangibles.
* **Regulation § 1.263A.**
* **Code § 263**—capital expenditures are not deductible—must be either depreciated or reduce the capital gain by the investment basis upon sale
* **Reg § 1.263(a)-2(a)**—costs incurred in the acquisition of an asset must be capitalized
* **Reg § 1.263-1(b)**—you have you capitalize improvements to property that adapt it to a new or different use OR that increase the useful life of the asset
* **§162**—certain business expenses must be capitalized
* **What if I am purchasing stock?**
  + Can’t deduct—have to recover basis on sale
  + Can’t deduct broker fees
  + For example:
    - If you purchase stock for $100 with a $5 fee—adjusted basis = $105
    - Sell stock for $110 with $5 fee—amount realized = $105
      * **§ 1.263(a)-2(e)**—you can deduct the sale fee directly from the sale price

Woodward v Commissioner—1970—SCOTUS—Marshall

Does litigation cost to determine appraisal value represent capital expenditure or expenses?

Capital expenditure defined by **Reg § 1.263(a)-2(a)** as “**property having a useful life substantially beyond the taxable year”**

**Decision**: because the appraisal process was a state-constructed substitute for negotiations the costs of getting the stock appraised is a long-term investment sufficient to be considered a capital expenditure

## Intangible Assets

* If the Code allows expensing when an asset should otherwise be capitalized the taxpayer benefits are HUGE

|  |  |  |  |
| --- | --- | --- | --- |
|  |  | Capitalize | Expense |
| Year 1 | Pre-Tax Earnings | 200 | 200 |
| Initial After-Tax Investment | **100** | 100 |
| Other After-Tax Investment |  | 100 |
| Year 10 | Yield | 100 + X | 200 + 2X |
| Tax | 50%\*X | **100** + 50%\*2X |
| MTR = 50% Assumes non-depreciating asset that produces income in year | | | |

* Can defer tax liability for $100 for 10 years—looks like an interest-free loan for 10 years
* **How is expensing LIKE a consumption tax?**
  + Each investment would be tax exempt 🡪 the only taxed when consuming
* **Yield exemption—in class example**
  + If you’re going to buy trees—yield exemption means that you pay taxes up front on the purchase and then keep all of your proceeds
  + Vs. expensing/consumption tax—buy your trees with your money and then pay taxes on your yield

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
|  |  | Year 1 | | | Year 2 | | | |
|  | Pre-Tax Income | Tax | Trees Bought | Basis | Apples | Amount Realized | Tax | After-Tax Income |
| Income Tax | 200 | 100 | 1 | 100 | 5 | 110 | 5 | 105 |
| Expensing | 200 | 0 | 2 | 0 | 10 | 220 | 110 | 110 |
| Yield Exemption | 200 | 100 | 1 | N/A | 5 | 110 | N/A | 110 |
| MTR = 50%; Cost of Tree = $100; Value of 5 Apples = $100 | | | | | | | | |

* **Yield exemption looks like IRA valuation**
  + - **IRA** upon withdrawal = Deposit\*(1+r)y\*(1-MTR)
    - **Roth IRA** upon withdrawal = Deposit\*(1-MTR)\*(1+r)y
    - Assumptions:
      * MTR is constant
      * Deductions can be used immediately (i.e., other income to offset)
      * Interest rate is constant
  + **Take aways:**
    - Double tax
    - Allowing immediate deduction = exempting investment from tax (given enough time)
    - Expensing—exhibits a move from income tax to more of a wage/consumption tax
    - Subtle: there is a lot of debate—what happens if assumptions are relaxed?
      * Government collects part income, technically sharing in the risk 🡪 rational investors will be able to invest in riskier assets with the same return

INDOPCO v Commissioner—1992—SCOTUS—Blackmun

*Lincoln Savings*: “expenditure that ‘serves to create or enhance a separate and distinct’ asset should be capitalized under **§ 263**”—benefits beyond tax year in question 🡪 couldn’t be deducted

Revenue rulings have SINCE narrowly interpreted “future benefit” 🡪 advertising, new employee training can be deducted

1. INDOPCO—acquired by Unilever—deducted investment banking and legal fees for friendly takeover
   1. Not “ordinary and necessary” **§ 263** 🡪 has to be capitalized
   2. Why not controlled by *Woodward*?
      1. What is National Starch’s (INDOPCO) argument?
         1. *Lincoln Savings*—capital expenditures must create or enhance an asset
         2. No separate or distinct asset🡪 nothing to capitalize
   3. **Reg § 1.263(a)-4)(e)(i)**—pursuit of transaction 🡪 must be capitalized under **§ 1.263(a)-4(b)(i)**
      1. Overturning INDOPCO? IRS promulgates more specific regulation interpreting the Code differently—as long as they’re basically similar you can say that you’re not overruling

Rev. Ruling 2001-4 Deductible Repairs and Capital Improvements

Problem Set #11: Deductible v. Capital Expenses

1. **Zeeshan purchases a piece of equipment to be used in his trade or business. The price is $20,000. At all relevant times, his marginal tax rate is 25%. Assume that the equipment has a useful life of five years, after which point its fair market value will be zero.**
   1. **If he were entitled to deduct the full cost of the asset today (year 1), how much would he currently save in taxes as a result of this deduction?**

PV Tax liability (T0) = ($20,000)\*25% = (5,000)

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Nominal Value of Cost Recovery | | | Present Value of Cost Recovery | | |
| **Year** | **Recover Today** | **Recover in 5 Years** | **Pro Rata Recovery** | **Recover Today** | **Recover in 5 Years** | **Pro Rata Recovery** |
| 1 | 5000 |  | 1000 | 5000 |  | 1000 |
| 2 |  |  | 1000 |  |  | 952 |
| 3 |  |  | 1000 |  |  | 907 |
| 4 |  |  | 1000 |  |  | 864 |
| 5 |  | 5000 | 1000 |  | 4115 | 823 |
| **Total** | **5000** | **5000** | **5000** | **5000** | **4115** | **4565** |
| Cost of machine = $20,000  Assumes a 5% discount rate | | | | | | |

* We want to reflect net income as it’s earned—match the cost to the income produced:

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  |  |  | Taxable Income | | |
| **Year** | **Income Produced** | **Decline in Value of Machine** | **Expensing** | **Cap. & Dep.** | **Cap. & Recovering Cost at Disposition** |
| 1 | 8,000 | (4,000) | (12,000) | 4,000 | 8,000 |
| 2 | 8,000 | (4,000) | 8,000 | 4,000 | 8,000 |
| 3 | 8,000 | (4,000) | 8,000 | 4,000 | 8,000 |
| 4 | 8,000 | (4,000) | 8,000 | 4,000 | 8,000 |
| 5 | 8,000 | (4,000) | 8,000 | 4,000 | (12,000) |
| **Total** | **40,000** | **(20,000)** | **20,000** | **20,000** | **20,000** |
| Cost of machine = $20,000 | | | | | |

* 1. **If he were required to wait until the end of year 5 to deduct any portion of the cost, how much would he save in taxes at that time? What is the present value of those savings? (You should refer to Appendix A in the casebook and assume a 5% discount rate.)**

PV Tax liability (T5) = (20,000)\*25% = (5,000) / (1.05)5 = (3,917.63)

* 1. **Suppose Zeeshan recovered his cost in the asset by deducting a ratable portion each year he used it in his business (years 1-5). In aggregate, how much would he save in taxes? What is the present value of those savings?**

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Depreciation | Tax Deduction | Tax Liability |
| 1 | $4,000.00 | $1,000.00 | $(952.38) |
| 2 | $4,000.00 | $1,000.00 | $(907.03) |
| 3 | $4,000.00 | $1,000.00 | $(863.84) |
| 4 | $4,000.00 | $1,000.00 | $(822.70) |
| 5 | $4,000.00 | $1,000.00 | $(783.53) |
|  |  |  | **$(4,329.48)** |

* 1. **Which of the three methods of cost recovery described above would he prefer?**

The first, the third, and then the second

1. **An automobile manufacturing company incurs the following expenses. Which are deductible and which must be capitalized?**
   1. **The company has 10,000 employees and its annual payroll is $150 million.**

**Reg § 1.162-7(a)** Compensation for personal services is deductible—BUT if employee is producing future income they can require that you capitalize all salaries (i.e. construction workers’ salaries)—almost always doing something to produce income past the current year BUT employee is also building the firm’s brand

* 1. **In 2009, the company purchases 75 computers at a cost of $225,000.**

**Reg § 1.263(a)-2(a)—**property having life substantially beyond the current year

* 1. **In 2009, the company decides to build a racetrack in a remote area, which it will use to test prototypes of new car designs.**
     1. **The company pays $1.5 million for a suitable parcel of land and incurs $20,000 of legal fees in connection with the acquisition of the land.**

***Lincoln Savings*—**legal fees not deductible—the “Woodward Origin Test”--**§ 1.263(a)-2(c**)—“The cost of defending or perfecting title as property”

Land not deductible under **§ 263A—**building and land have to be treated separately

(people who purchase and people who build have the same capitalization requirements)

* + 1. **The company spends $400,000 on construction supplies (e.g., asphalt, wood, nails).**

Not deductible—used for long-term improvements **§ 263A(a)(2)(A)** allocable direct costs

* + 1. **It also pays $100,000 in wages to construction workers and an annual salary of $250,000 to corporate counsel who, among other duties, negotiated the purchase of the construction materials and handled all employee benefit questions related to the construction.**

**§ 263A—***Idaho Power*—the $250,000 and the $100,000 would both have to be capitalized—direct and indirect costs—if CC was doing other stuff, just allocate the part of their time spent on the racetrack to capitalization

TANGIBLE ASSETS treated very differently than intangible assets

* + 1. **On January 1, 2009, the company purchases an asphalt paver for $60,000 and uses it in 2009 solely to construct the racetrack.**

***Idaho Power*—**Only capitalize the part that went to constructing the racetrack—capitalize WITH the racetrack so that the depreciation of the part of the paver that went into the racetrack will be properly depreciated (probably have different useful lives)

* + 1. **After purchasing the land, the company discovers that endangered turtles live on the land. Under state law, it may only build the racetrack if it first relocates the turtles. The company pays $10,000 for the services of a biologist, who identifies a $300,000 tract of land that is a suitable habitat for the turtles. The company purchases this tract of land. Can the company deduct the services of the biologist and/or the cost of the new habitat? What is the company’s basis in the racetrack site? In the turtle habitat?**

If the turtles were there when the land was purchased he cannot deduct the cost of removing them BUT if he deposited turtles on the land while working there (somehow) and later had to remove him he could deduct it

🡪 $310,000 would be capitalized into racetrack or turtle land—could go either way

*Plainview Union Water*—value is the planned value for uses before the scenario arose

*Dairy Farm*—you look to the value of the land assuming the taxpayer knew about turtles

* **Case A:** Pay $1M for buildable land, ascertaining that there were no turtles beforehand
* **Case B:** Pay $800K for land that I know will require turtle relocation of $200K
* **Case C:** I pay $1M for land not knowing whether or not there are turtles either because of ignorance or risk.
  + Clearly in cases A & B you will capitalize $1M—what do we want to happen in C? No deduction for cost of investigating turtles
  + Allowing deduction in case C can create a lot of gaming—people will always say they didn’t know the turtles were there because then they can deduct the cost🡪 more administrable—encourages risk taking
    1. **Two years later, the company pays $25,000 to repave the track, which has been damaged by harsh winter weather and daily wear and tear.**

**§ 1.162-4** cost of incidental repairs can be deducted immediately

**§ 263(a)(1)—**improvement or betterments must be capitalized

🡪 Is this a repair or an improvement? Expected life, when were repairs expected, improvement, increase in value, expected value and life when you purchased/originated the racetrack, can you deduct the cost of repaving? If it’s expected, you can deduct it—storm, you can deduct it. The real question turns on whether or not you’ve improved the racetrack

Casualty losses—you can deduct the loss from a natural disaster and then capitalize the repairs to get back where you began—do we recalculate the useful life? Or could we just re-use the old useful life

* 1. **In 2009, the company spends $100,000 to acquire new custom software that it will use to manage inventory. The software is expected to have a useful life of five years. It also pays an independent contractor $5,000 to train its employees in how to use the software.**

1. Software
   1. What happens in general if it’s a cost of creating an intangible asset? **§ 1.263(a)-4(b)(i)(iii)**—in general you have to capitalize the cost of creating an intangible asset
   2. Relief from this requirement--**§ 1.263(a)**------somewhere there is an exception for software
   3. **§ 1.263(a)-4(c)(i)(xiv)**—you have to capitalize the cost of computer software
2. Training
   1. Can be expensed—unless you purchase training as a part of the software costs
3. **In 1994, Donald bought the Gotham Palace Hotel in New York City for $20 million. He paid $5 million in cash and financed the rest of the purchase with a $15 million nonrecourse mortgage on the hotel. From 1994 to 2009, Donald deducted $4 million in depreciation but did not make any principal payments on the mortgage.**
   1. **In 2004, Donald started a major new advertising campaign for the hotel. The new ads featured pictures of Donald and the catchy slogan “This is my hotel.” Partly because of the advertising campaign, the hotel’s market value plummeted, and by 2009 it was only worth $10 million. Donald enjoyed the attention that the ads brought him, however, and he hoped that over the long run the ads would create name recognition for the hotel. He continued to run the ads at a cost of $200,000 per year from 2004 through 2008. Can Donald deduct his $200,000 of advertising costs in 2008?**

**Rev. Rul. 92-80, 1992-2 C.B. 7—**advertising deductible UNLESS this could be considered “significantly beyond future benefits traditionally associated with ordinary product advertising or with institutional or goodwill advertising.”

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Advertising Costs | TI if Deduct | TI if Capitalize |
| 1 | $100K | -$100K | -$50K |
| 2 | $100K | -$100K | -$100K |
| 3 | $100K | -$100K | -$100K |

When would this mean that we were shifting a lot of income? If we don’t advertise every year

* 1. **In 2008, Donald discovers that the hotel’s insulation contains asbestos, which poses potential health risks to both workers and customers. Fearing future lawsuits, he spends $600,000 in 2008 to have the asbestos removed. Can he deduct these costs or must they be capitalized?**

Long-term improvement 🡪 capitalized BUT was it necessary to have the asbestos remedied immediately?

*Dairy Farmers*—if the asbestos was there at the time of purchase you have to capitalize any cost of removing it because the negative value of the asbestos was probably included in the selling price

## Depreciation

* **Code § 167(a).** Depreciation—General rule.
* **Code § 167(b).** Depreciation—Cross reference.
* **Code § 167(c).** Depreciation—Basis for depreciation.
* **Code § 168(a).** Accelerated cost recovery system—General rule.
* **Code § 168(b).** Accelerated cost recovery system—Applicable depreciation method.
* **Code § 168(c).** Accelerated cost recovery system—Applicable recovery period.
* **Code § 168(d).** Accelerated cost recovery system—Applicable convention.
* **Code § 168(e).** Accelerated cost recovery system—Classification of property.
* **Code § 168(g).** Accelerated cost recovery system—Alternate depreciation system for certain property.
* **Code § 179(a).** Election to expense certain depreciable business assets—Treatment as expenses.
* **Code § 179(b).** Election to expense certain depreciable business assets—Limitations.
* **Code § 179(c).** Election to expense certain depreciable business assets—Election.
* **Code § 197(a).** Amortization of goodwill and certain other intangibles—General rule.
* **Code § 197(b).** Amortization of goodwill and certain other intangibles—No other depreciation or amortization deduction allowable.
* **Code § 197(c).** Amortization of goodwill and certain other intangibles—Amortization section 197 intangible.
* **Code § 197(d).** Amortization of goodwill and certain other intangibles—Section 197 intangible.

**§ 1016**—you reduce basis by deduction amount of depreciation—we have depreciation because of our realization requirement—lets you take a partial loss deduction before you sell the asset

**§ 167** “permits as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of assets used in a trade or business or held for the production of income

**§ 168** “provides a mandatory system of depreciation”

**§ 197**—most intangibles are amortized on a straight line basis over a 15-year period

Depreciation schedule is applied to basis (**§ 1011**) + any capital expenditures to that basis (**§ 1016**)

**Straight-line method—**allocated in equal amounts over useful life

**Declining balance method**—larger portion of the cost to earlier years, lesser portion in later years—constant percentage

* **What is depreciable**?
  + Assets that decline in value
  + *Simons* case
    - violinists bought an old violin bow for $30,000 and used it—tried to depreciate it over time—can’t depreciate something that is going to retain most of its value
    - if a normal bow costs $3,000 and he’s made this bow useless for playing perhaps he should only be able to depreciate $3,000
    - could deny deductions entirely—to give

Problem Set #12: Depreciation

1. **Ben purchases an asset on January 1, 2009 for $5,000. The asset will produce $1,300 of gross income at the end of each year for five years and will then be worthless.**

**If Ben were only allowed to deduct “economic depreciation” of the asset, what would his depreciation deductions and net income be for each of the five years? How does this compare to straight line depreciation? (In order to figure out the answer, you can refer to the table below, which shows the present value of the remaining stream of payments that he will receive as of the beginning of each of the five years.)**

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
|  | Nominal Payment | Present Value of Remaining Payments | | | | |
| Payment Date | | 1/1/09 | 1/1/10 | 1/1/11 | 1/1/12 | 1/1/13 |
| 1 | $1,300 | $1,188 |  |  |  |  |
| 2 | $1,300 | $1,086 | $1,188 |  |  |  |
| 3 | $1,300 | $993 | $1,086 | $1,188 |  |  |
| 4 | $1,300 | $908 | $993 | $1,086 | $1,188 |  |
| 5 | $1,300 | $830 | $908 | $993 | $1,086 | $1,188 |
| Total | $6,500 | $5,004 | $4,175 | $3,267 | $2,274 | $1,188 |
| Economic Loss | | $830 | $908 | $993 | $1,086 | $1,188 |
|  |  |  |  |  |  |  |
| Discount Rate | 9.40% |  |  |  |  |  |
|  |  |  |  |  |  |  |
| **Economic Depreciation** | |  |  |  |  |  |
|  |  | 1 | 2 | 3 | 4 | 5 |
|  | Receipts | $1,300 | $1,300 | $1,300 | $1,300 | $1,300 |
|  | Economic Loss | $830 | $908 | $993 | $1,086 | $1,188 |
|  | Taxable Income | $470 | $392 | $307 | $214 | $112 |
|  |  |  |  |  |  |  |
| **Straight Line Depreciation** | |  |  |  |  |  |
|  |  | 1 | 2 | 3 | 4 | 5 |
|  | Receipts | $1,300 | $1,300 | $1,300 | $1,300 | $1,300 |
|  | Economic Loss | $1,000 | $1,000 | $1,000 | $1,000 | $1,000 |
|  | Taxable Income | $300 | $300 | $300 | $300 | $300 |
|  |  |  |  |  |  |  |
|  | Value | 5000 |  |  |  |  |
|  | Useful Life | 5 |  |  |  |  |

1. **Christopher purchases a machine in August, 2009 for a purchase price of $150,000 that will be useful in his business for 10 years. The salvage value of the machine (the fair market value of the asset at the end of its useful life) is $10,000.**

**Under current law, how would Christopher recover his cost? Assume that the asset has a guideline life of nine years (which means that it is depreciated over five years) and that Christopher is allowed to, and does, make an election under § 179(c). You need not calculate the exact amount of depreciation in each year.**

* Tangible property **§ 168**
* Depreciable base **§ 167(c)(1)**
* In 2009, under **§ 179(b)(7)** he can expense up to $250,0000—we need to know his aggregate income and he cannot have spent more than $800,000 in 2009—only lose the $250,000 to the extent that you go over $800,000—so if you spend $850,000 you can only deduct $200,000
  + 🡪 if Christopher has spent less than $800,000 this year he can expense the full $150,000
* In 2010, expense cap is $125,000
  + 🡪 Christopher would expense $125,000
  + Recovery period = 5 years
  + **§ 168(b)**—applicable depreciation method is 200% declining balance method—can elect to do straight line depreciation—half-year convention: you treat the investment as if it were placed in service in the middle of the year 🡪 you get half the depreciation deductions
* If this were commercial real estate
  + **§ 168(b)**—recovery period is 39 years—cannot elect to use straight line depreciation
* Conversions:
  + You’ve depreciated the entire asset—5.5 years—sell for $10,000—recapture lost basis as ordinary income—**§ 1245**—to the extent that you have a gain that represents already recovered basis it’s an ordinary gain, NOT a capital gain
* No incentive to have economic depreciation mirror effective depreciation—a lot of ways that accelerated depreciation has been
* Efficiency—gives windfalls to taxpayers who would have invested already—are people actually responding to this code, or are they just taking advantage according to their usual investment habits—ways to subsidize investment outside depreciation incentives
  + Real estate is very heavily favored by the tax system
  + Does investment generate externalities? Should we incentivize savings more than wage spending, etc.?

## Taxation of the Family

* **Tax Imposed**
  + **Code § 1(a).** Tax imposed—Married individuals filing joint returns and surviving spouses.
  + **Code § 1(b).** Tax imposed—Heads of households.
  + **Code § 1(c).** Tax imposed—Unmarried individuals (other than surviving spouses and heads of households.
  + **Code § 1(d).** Tax imposed—Married individuals filing separate returns.
  + **Code § 1(e).** Tax imposed—Estates and trusts.
  + **Code § 1(f).** Tax imposed—Phaseout of marriage penalty in 15-percent bracket; adjustments in tax tables so that inflation will not result in tax increases.
  + **Code § 1(g).** Tax imposed—Certain unearned income of children taxed as if parent’s income.
  + **Code § 1(i).** Tax imposed—Rate reductions after 2000.
* **Code § 2.** Definitions and special rules.
* **Code § 24.** Child tax credit.
* **Code § 32.** Earned income.
* **Code § 71(a).** Alimony and separate maintenance payments—General rule.
* **Code § 71(b).** Alimony and separate maintenance payments—Alimony or separate maintenance payments defined.
* **Code § 71(c).** Alimony and separate maintenance payments—Payments to support children.
* **Code § 151.** Allowance of deductions for personal exemptions.
* **Dependents:**
  + **Code § 152(a).** Dependent defined—In general.
  + **Code § 152(b).** Dependent defined—Exceptions.
  + **Code § 152(c).** Dependent defined—Qualifying child.
  + **Code § 152(d).** Dependent defined—Qualifying relative.
  + **Code § 152(e).** Dependent defined—Special rule for divorced parents, etc.
* **Code § 215(a).** Alimony, etc., payments—General rule.
* **Code § 215(b).** Alimony, etc., payments—Alimony or separate maintenance payments defined.
* Taxes serve 4 purposes
  + Measure well-being relative to each other
  + Redistribute based on that measure
  + Create incentives/penalties for socially desirable activities
  + Administribility
* Central Problems:
  + Income shifting—rate arbitrage
    - If families are shifting income to lower tax brackets
    - To fix this problem:
      * Earned income is taxed to the person who earned it—property is taxed to the person who owns that property
  + **§ 1(g) Kiddie tax**—unearned income can be shifted to kids—can make kids owner of assets 🡪 income from assets belongs to low-marginal kid—will only have to pay gift tax if it’s over a large amount (right now $1M)
    - to fix this problem you tax kids at their parents’ rate for income from assets

Druker v Commissioner—1983—Friendly

“income tax unfairly discriminates against working married couples”—violates equal protection clause of 14th amendment—denied “there can be no peace in this area, only an uneasy truce”

Tax increase due to marriage doesn’t significantly interfere with our fundamental right to marry—progressive tax code and letting husbands and wives file jointly 🡪 we’ll have either penalties or bonuses for marriage

|  |  |  |
| --- | --- | --- |
| Person | Income | Tax if Single |
| A | 10 | 1 |
| B | 10 | 1 |
| C | 0 | 0 |
| D | 20 | 3 |
| Singles’ tax rate: 10% on first 10, 20% on next 10 | | |

* If A and B married and C and D married
  + if we had them pay just their combined amount A and B would pay $2 and C and D would pay $3
  + what about implicit benefit of C not having to work? Could taxing that be fair?
* Most recent estimates—42% get marriage bonuses, 51% get marriage penalties
  + Penalties more common for low-income people because they lose eligibility for the EITC
    - EITC starts phasing out around $16,000
* Globally—most countries have the same rate structure for couples and singles
* Joint filing tends to discourage secondary earners from working (usually women)
* Why doesn’t married filing separately solve this problem?
  + Provisions often drafted to NOT apply to MFS
  + Economically, MFS is almost always a bad idea
* Gay and Lesbian Couple
  + **Federal Defense of Marriage Act**—LGBTQ couples can’t file jointly
  + Mirrors global tax systems—everyone files individually
  + Could get a tax penalty for marriage 🡪 could increase collection for the government
  + Other costs of LGBTQ couples:
    - Health care is income for partners but not for spouses
    - Social Security

Problem Set #13: Taxation of the Family

1. **The Earned Income Tax Credit currently costs about $48 billion and the Child Tax Credit about $54 billion per year. By comparison, the federal government spends about $17 billion annually on Temporary Assistance for Needy Families (welfare) and $35 billion on Food Stamps.**
   1. **What effect does the EITC have on the marginal tax rate of a head of household filer with two children when the EITC is phasing in? What about when it is phasing out?**

Lowers MTR—for everyone else it increases their relative marginal tax rate—when it’s phasing in every dollar of earned income generates 40% of EITC 🡪 implicit marginal tax rate of -40%

As it’s phasing out 21.06% 🡪 for each dollar that you earn over a cap you lose 21.06% of your earned income credit

* 1. **What effect does the Child Tax Credit have on marginal tax rates for a head of household filer with two children?**

Similar to EITC—partially refundable tax credit—everyone gets $1,000 per kid—BUT you can only refund a part of it—cap for this year $3,000 in earned income

When it’s phasing in at $3,000 you start getting the CTC and then it phases out later

* 1. **What effect do you imagine that TANF and Food Stamps have on marginal tax rates?**

Estate tax penalties—much more expensive to give to a partner than a spouse

## Tax Expenditure Deductions and Credits

* **Hope and Lifetime Learning Credits**
  + **Code § 25A(a).** Hope and Lifetime Learning Credits—Allowance of Credit.
  + **Code § 25A(b).** Hope and Lifetime Learning Credits—Hope Scholarship Credit.
  + **Code § 25A(c).** Hope and Lifetime Learning Credits—Lifetime Learning Credit.
  + **Code § 25A(d).** Hope and Lifetime Learning Credits—Limitation based on modified adjusted gross income.
  + **Code § 25A(e).** Hope and Lifetime Learning Credits—Election not to have section apply.
  + **Code § 25A(f).** Hope and Lifetime Learning Credits—Definitions.
  + **Code § 25A(i).** Hope and Lifetime Learning Credits—American Opportunity Tax Credit. In the case of any taxable year beginning in 2009 or 2010.
* **Code § 36A.** Making work pay credit.
* **Code § 164(a).** Taxes—General rule.
* **Code § 164(c)(1).** Taxes—Deduction denied in case of certain taxes.
* **Charitable Contributions**
  + **Code § 170(b)(1)(A).** Charitable, etc., contributions and gifts—Percentage limitations—Individuals—General rule.
  + **Code § 170(b)(2)(A).** Charitable, etc., contributions and gifts—Percentage limitations—Corporations—In general
  + **Code § 170(e)(1).** Charitable, etc., contributions and gifts—Certain contributions of ordinary income and capital gain property—General rule.
* **Code § 213(a).** Medical, dental, etc., expenses—Allowance of deduction.
* **Code § 213(b).** Medical, dental, etc., expenses—Limitation with respect to medicine and drugs.
* **Code § 213(d)(1).** Medical, dental, etc., expenses—Definitions.
* **Code § 222.** Qualified tuition and related expenses.
* **Code § 501(a).** Exemption from tax on corporations, certain trusts, etc.—Exemption from taxation.
* **Code § 501(b).** Exemption from tax on corporations, certain trusts, etc.—Tax on unrelated business income and certain other activities.
* **Code § 501(c).** Exemption from tax on corporations, certain trusts, etc.—List of exempt organizations.
* **Code § 1011(b).** Adjusted basis for determining gain or loss—General rule.

If you give appreciated property to charity you don’t realize the gain like you would upon sale BUT code allows you to deduct full market value

Deferring compensation—nonqualified and qualified plans

* Concept of tax expenditures is controversial
  + Easier to get through Congress than spending bills
  + Definitions of tax expenditures
    - Departures from normal income tax
    - Departures from general rules
* 5 Justifications for tax codes:
  + Ability to Pay—Defining ability to pay to tax income
  + Simplification—Administribility provisions
  + Distributional—EITC or different marginal tax rates
  + Incentives—some would argue that tax expenditures all fall in this category
  + Expressive—social approval/disapproval,
  + Think about taxation of the family:
    - Are we encouraging marriage and kids?
    - Are we just assessing the changed ability to pay after marriage
* Donating Appreciated Property
  + **§ 170(e)**—donating appreciated property
  + property must otherwise have been subject to a long-term capital gain
  + tangible personal property which is related to the exempt purpose of the charity
  + HUGE amount of fraud with the charitable deduction
* State and Local Tax Deduction
  + Value of deduction is MUCH higher in blue states and lower in red states
    - (blue states tend to collect more state and local taxes 🡪 deduction more valuable)
  + Being repealed gradually by the AMT
    - **AMT:**
      * Created in 1969
      * State and local tax deduction biggest provision denied in AMT taxable income
      * AMT cap was not indexed to inflation—but repealing the AMT costs more than repealing the income tax
* Retirement savings
  + 4 Types:
    - Qualified plans
      * Defined benefit
      * Defined contribution
    - IRAs
    - Savers Credit
  + Employer-sponsored retirement plans:
    - **Defined benefit (“DB”)**
      * Usually insured 🡪 if employer goes under you still get your pension
    - **Defined contribution**
    - Used to be that everything was a DB plan—you don’t have your own account, you just gradually get more entitlement to your pension
  + Risks of saving:
    - Inflation risk
    - Investment risk
    - Longevity risk—if you outlive your savings
    - Social security addresses ALL of these risks—inflation-adjusted life annuity
    - Defined Contribution (401(k) and IRA)—don’t address any of these risks
    - Defined Benefit (Pension plans) are fixed payments on life annuity—don’t address inflation risks
  + Today:
    - 73% of retirement savings are in Defined Contribution Plans and IRAs
      * 401(k) are taxed on a traditional basis—no tax on investment, when you withdraw you pay ordinary income taxes
      * Roth instruments—pay ordinary income tax now and none when you withdraw
        + When Congress budgets they don’t look to the effects past 10 years—the expense of Roth instruments as compared to traditional plans increase revenue within the budget window even though we’re losing revenue over time
    - 27% are Defined Benefit Plans
    - Internalities—people don’t make choices in their own long-term interest
  + Savers credit
    - Non-refundable credit that you get between 10 and 50% of your contributions to IRA
    - Targeted to low income people
  + Proposals
    - To make Savers Credit fully refundable
    - To make employers default enroll employees in IRA programs—could increase enrollment with inertia

Hernandez Case (unassigned)

IRS denied charitable contribution deductions for the Church of Scientology—members pay fixed donations in exchange for “auditing services” to tell you how to be promoted within the church

SCOTUS held for the IRS because this was a quid pro quo—BUT could we characterize all religious services as a quid pro quo?

THEN the IRS reversed itself (and SCOTUS)—why? Apparently the COS started bogging down the IRS with minor litigation and the IRS just decided it wasn’t worth it

Problem Set #14: Tax Expenditure Deductions & Credits

1. **What are the potential justifications for the charitable deduction? What do they imply about how it should be structured?**

**§ 170** incentivizes charitable giving

* Student: if you’re giving something away your tax liability should be reduced
* Would be a deduction or exclusion—doesn’t count toward the assessment of ability to pay
* Shouldn’t be limited to certain organizations
* What does this imply about beneficiaries?
  + Student: they are better able to pay 🡪 tax their receipt, not your gift
  + Not always low income
    - Operas, universities, art museums—tend to be consumed by more wealthy
    - People tend to give within their economic bracket—low income people to churches, higher income to universities, etc.
* If we allow deduction for gift/charitable contributions—we should tax the beneficiaries
  + Who would we tax for a donation to an environmental organization?
  + What about taxing the charity—if we can’t identify beneficiaries we can tax charity as a proxy
* Charitable deductions subject to 3% haircut
* Justifications:
  + Incentivizes charitable gifts
    - We value education
    - Altruistic externality—donors don’t necessarily take recipients’ appreciation into account
    - Redistributional externality—when private gifts displace government aid
    - Public goods
* How should we structure to promote this incentive?

1. **How do you think the tax system should treat contributions to charitable organizations and why?**

* Things to consider:
  + **Responsiveness**—are people going to donate regardless of the tax structure? Does out of pocket spending change with incentives?
  + **Citizen-directed transfer**—government benefits go to charities but individual donors choose where it goes—“**Democratic Pluralism**”—allows minority to decide where government money goes even when majority dominates government
    - Credit—more benefit to lower income people—student: rich people have enough of a voice, don’t need to give them an opportunity to direct government funds
  + ***\*\*\*Agency costs****—certain situations require non-profit entities—maybe we want to subsidize donors who give a lot to one charity 🡪 would implicitly create monitors for each charity*
* How should we change the tax structure for charities?
  + Student: incentives rationale
    - Expand the benefit of tax liability to everyone who contributes—try to get around standard deduction by making this an **above the line deduction**
      * BUT most people who contribute are more likely to itemize
      * Would get around 3% haircut
      * If top 1/3 of population itemize and top 2/3 have tax liability—the lion’s share of this benefit would go to the middle
  + Student: get rid of it
    - If we aren’t incentivizing donation with the code we should just get rid of it—people will give anyway
    - Student: BUT isn’t there a benefit of having some public goods provided by charities and not the government

# CAPITAL GAINS AND LOSSES

* **Code § 11.** Tax imposed.
* **Code § 1211.** Limitation on capital losses.
* **Code § 1212.** Capital loss carrybacks and carryovers. (caps the loss deductions for corporations at gains and non-corporate taxpayers at gains + $3,000)
* **Code § 1221(a).** Capital asset defined—In general.
* **Code § 1221(b)(3).** Capital asset defined—Definitions and special rules.
* **Code § 1222.** Other terms relating to capital gains and losses.
* More than 12 months 🡪 long–term capital asset & **preferential treatment** (15%, or if your ordinary income is taxed at 0-10% you get 0% tax on capital gains)
  + Less than 12 months, short-term
* Basketing effect—individuals can use capital loss to offset ordinary income up to $3,000
  + Can carryback excess losses 3 years, or carry forward 5 years
  + (Corporations can only deduct losses to the extent that they have gains)
* ONLY applies when you have a sale or exchange
  + Sometimes you have to bifurcate your gains—i.e. if your employer pays $14.1K for an asset worth $12.1K that you bought for $10--$2.1K capital gains, $2K compensation (or you could try to justify an idiosyncratic value)
* Interest income is capital income (as in income from saving and investing) but it’s NOT a capital gain
* Capital assets are not necessarily just assets you capitalize—we have to look at code to see what qualifies to generate capital gains/losses
* Individuals
  + Capital losses are fully deductible against capital gains **§ 1211(d)**
  + You can deduct a loss against up to $3,000 in ordinary income
  + If IBM stock that you’ve held for more than 1 year loses $5,000 you can deduct the loss against any capital gains and $3,000 of ordinary income and the rest you can carry forward to deduct against capital gains and $3,000 of ordinary income in the next year
  + Can carry forward indefinitely—but can only carry forward to the extent of your capital income
    - If you have: 8,000 Net capital loss; Taxable income = 4,000
    - Deduct 3,000 against TI; carry forward 4,000; lose 1,000 of deduction
  + Can deduct short-term capital losses against long-term capital gains
* Corporations
  + can only carryback for 3 years and forward 5 years
  + Why can’t corporations carry forward indefinitely?
    - We want to limit corporations cherry picking—selling losing capital assets for deductions and never realizing income on appreciating capital assets
    - **Driven by the realization requirement**—motivates concern about cherry picking

*\*\*as an individual you really like capital gain income and ordinary losses—preferential rate and deductions at ordinary income rates*

**Capital Asset--§ 1221(a)—more than one year generate long-term capital gains/losses taxed at preferential rate—up to and including one year generate short-term capital gains/losses taxed as ordinary income**

**What defines a capital gain?**

1. The transaction must involve “property” that is a “capital asset”
2. The property must be transferred in a “sale or exchange” and
3. The minimum holding period must be met.

* **Policy Discussion: Capital Gains Preference**
  + Arguments FOR Preference
    - Bunching
      * problem arises because people would otherwise cherry pick to avoid the implications of the realization requirement and stepped up basis **§ 1014**
        + Other potential responses to bunching?

Mark-to-market and accrual taxation

Income averaging—apply gains to all years that taxpayer held the asset

* + - * Inflation—capital gains increase long-term lockstep with inflation 🡪 capital gains try to tax only growth over the inflation rate
        + We inflation-adjust the brackets—much more difficult than it sounds
    - Lock-in
      * Stepped up basis
      * You have to hold a capital asset for a year to get preferable treatment—exacerbates lock in effect
      * If you raise the capital gains rate people might hold assets longer to delay realization
        + If you suggest cut the capital gains rate—someone will have a study that says it will raise more revenue—does not seem to be the case in the long run
    - Dynamic Scoring
      * Takes into account macroeconomic effect
      * Makes revenue estimates depend on feedback effects and assumptions
      * Capital gains are concentrated among high-income households
    - Encourages savings and economic growth
      * Will stimulate more savings overall
      * Incentivizes investing in risky assets

Problem Set #15: What is a Capital Asset?

1. **Ruth is an individual taxpayer in the 35% bracket. She has the choice to invest in one of the following three assets:**
   1. **A bond selling for $10,000 that will pay $1,000 each year for two years, (ORDINARY INCOME)**
   2. **$10,000 of growth stock that will pay no dividends and that Ruth expects to be worth $12,100 in two years when she will set it, (CAPITAL ASSET § 1221(a)(1)) or**
   3. **Stock selling for $10,000, which will pay dividends of $1,000 each year for the next two years and maintain its initial value. (CAPITAL ASSET § 1221(a)(1) + DIVIDENDS TAXED AT PREFERENTIAL RATE)**
2. **If Ruth were indifferent between these investment choices (pre-tax), how might tax considerations influence her behavior?**

A—Interest income is ordinary income

B—preferential rate—$12,100 subject to long-term cap gains rate in 2 years

C –preferential rate—$11,000 at cap gains rate in 2 years and $1,000 at preferential rate in 1 year (dividends taxed like capital gains **§ 1(h)(11)**)

\*\*TVM of payment of preferential rate 1 year earlier makes B more favorable than C and preferential rates make both B and C more favorable than A.

1. **If the taxpayer in (1) was a university instead of an individual in the 35% tax bracket, how might tax considerations influence its behavior?**

**§ 115** Tax exempt 🡪 would look only at CFs and risk profiles

1. **Given the answers in (1) and (2), how might the market react to the cost of the investments described above?**

The market would be fragmented in its preferences—individuals would purchase B (relatively inflate) 🡪 as universities invest they will prefer C because B’s price will inflate slightly—market sorting, price capitalization of tax benefit likely imperfect but present

## What is a Capital Asset?

* **Code § 1223.** Holding period of property.
* **Code § 1231.** “Capital gains when disposed of at a net gain and ordinary loss when disposed of at a net loss”
  + **Code § 1231(a)(1).** Property used in the trade or business and involuntary conversions—General rule—Gains exceed losses.
  + **Code § 1231(a)(2).** Property used in the trade or business and involuntary conversions—General rule—Gains do not exceed losses.
  + **Code § 1231(a)(3).** Property used in the trade or business and involuntary conversions—General rule—Section 1231 gains and losses.
  + **Code § 1231(b).** Property used in the trade or business and involuntary conversions—Definition of property used in the trade or business.
  + **Code § 1231(c)(1).** Property used in the trade or business and involuntary conversions—Recapture of net ordinary losses—In general.
  + **Code § 1231(c)(2).** Property used in the trade or business and involuntary conversions—Recapture of net ordinary losses—Non-recaptured net section 1231 losses.
* **Code § 1245(a).** Gain from dispositions of certain **depreciable** **property**—General rule.
  + **Code § 1245(b)(1).** Gain from dispositions of certain depreciable property—Exceptions and limitations—Gifts.
  + **Code § 1245(b)(2).** Gain from dispositions of certain depreciable property—Exceptions and limitations—Transfers at death.
  + **Code § 1245(b)(3).** Gain from dispositions of certain depreciable property—Exceptions and limitations—Certain tax-free transactions.
  + **Code § 1245(b)(8).** Gain from dispositions of certain depreciable property—Exceptions and limitations—Disposition of amortizable section 197 intangibles.
* **Code § 1250(a).** Gain from dispositions of certain **depreciable realty**—General rule.
  + **Code § 1250(b).** Gain from dispositions of certain depreciable realty—Additional depreciation defined.
  + **Code § 1250(c).** Gain from dispositions of certain depreciable realty—Section 1250 property.
  + **Code § 1250(d)(1).** Gain from dispositions of certain depreciable realty—Exceptions and limitations—Gifts.
  + **Code § 1250(d)(2).** Gain from dispositions of certain depreciable realty—Exceptions and limitations—Transfers at death.
  + **Code § 1250(d)(3).** Gain from dispositions of certain depreciable realty—Exceptions and limitations—Certain tax-free transactions.
  + **Code § 1250(d)(4)(A).** Gain from dispositions of certain depreciable realty—Exceptions and limitations—Like kind exchanges; involuntary conversions, etc.—Recognition limit.
* **Code § 1231.** “Capital gains when disposed of at a net gain and ordinary loss when disposed of at a net loss”
  + Applies to “quasi-capital assets”—real or depreciable property not covered under **§ 1221(a)(2)**—must be held for at least 1 year

Malat v Riddell—1966—SCOTUS

**§1221(a)(2)**—taxpayers don’t want to fall in this code because then they will get ordinary income treatment

they want real property held in connection to a trade or business 🡪 want **§ 1221** exception and to fall under **§ 1231** (? Numbers) 🡪 they will get capital gains treatment

* Do any of these rationales map onto how we actually define capital assets?
  + Asks about “primarily” 🡪 in real estate provision if you’re holding this like inventory you can’t treat this as a capital asset; if you’re holding this like a capital asset (long term, infrequent transactions)
* How could we improve **§ 1221**?
  + There could be a simple 1 year requirement
    - BUT many more assets would become capital assets—government could lose revenue
    - BUT cherry-picking would incentivize liquidation on day 366—need flexible standard

Bramblett v Commissioner—1992

Investors bought land—resold—was the income ordinary or capital gains? Mesquite East would treat land as capital, Town East would treat the land as ordinary income 🡪 capital gains flowed through Mesquite East partnership and isolated development risks in limited liability corporation

1. **Was the taxpayer engaged in a trade or business, and if so, what business?**
2. **Was the taxpayer holding the property primarily for sale in that business?**
3. **Were the sales contemplated by the taxpayer “ordinary” in the course of that business?**

Factors to consider:

1. The nature an purpose of the acquisition of the property
2. The extent and nature of the taxpayer’s efforts to sell the property
3. **The number, extent, continuity and substantiality of the sales**
4. The extent of subdividing, developing, and advertising to increase sales,
5. The use of a business office for the sale of property
6. The character and degree of supervision or control exercised by the taxpayer over any representative selling the property, and
7. The time and effort the taxpayer habitually devoted to the sales.

Investment, not directly in the business of selling land 🡪 subject to capital gains rates NOT ordinary income

Problem Set #16: What is a Capital Asset?

1. **In the current year, Sarah earned $90,000 in salary from her job as an English professor. She also realized the following gains and losses:**
   1. **$9,000 gain on the sale of business inventory (she runs her own discount Internet bookstore in her spare time).**

**§ 1221(a)(1)** everything is cap assets but certain property including inventory

**§ 1231** There is a trade or business and this is a part of the trade or business 🡪 ordinary income **§ 62**

*(not a capital gain—ordinary income)*

* 1. **$12,000 loss on the sale of a personal residence.**

**§ 1245(a)(C)**—personal residence is **§ 1245** property

**§ 1245(a)(B)(i)—**if $12,000 exceeds basis it’s ordinary income

**you can’t claim a loss in property you hold for personal reasons**

*(can’t claim loss)*

* 1. **$5,000 loss on Google stock.**

GENERALLY—a capital asset

If you’re a dealer/trader in stock you can earmark the stock as inventory—have to do that upfront—(no authority)

What’s the limit? She can only claim this against capital gains + $3,000 of ordinary income **§ 1211(b)**—even if this is her personal investment

Personal property held for profit **§ 162** (?)—if it gains you have to pay tax on it, if it loses you can’t deduct it—asymmetry

*(capital loss—up to $3,000 against ordinary income)*

* 1. **$12,000 gain on the sale of her boat (used for recreational purposes).**

Capital asset that you hold for personal reasons—taxed on the gains, can’t deduct the lost

Rationale for taxing the gains: Congress just wants to get revenue where it can

*(Capital gain)*

* 1. **$6,000 loss on the sale of business real estate.**

**§ 1221(a)(2)—**ordinary

**§ 1231—**this is a “quasi-capital asset” 🡪 as a gain it’s a capital gain, as a loss it’s an ordinary loss

*(ordinary loss)*

1. **Sarah’s holding period is over two years for each asset. What is her net capital gain for the year under § 1222(11)? What other gains or losses should she report?**

Overall net capital gain: $12,000 gain - $5,000 loss = $7,000 capital gain

Overall net ordinary income: $9,000 gain - $6,000 loss = $3,000 net ordinary income

1. **Tim buys a machine for his home renovation business for $200,000 and holds it for five years. He takes $120,000 in depreciation deductions and, at the end of five years, he sells it for $100,000. What income or loss should he report? What if he sells the machine for $220,000 instead?**

$20,000 of ordinary income—when he takes depreciation he **§ 1012** adjusts basis 🡪 adjusted basis will be $80,000 and his amount realized is $100,000 🡪 he has $20,000 in ordinary income **§ 1221(a)(1)**—he’s in the business of home renovation 🡪 he’s not selling inventory, he’s selling machinery

Recapture rules**--§ 1231** asset—falls under:

**§ 1221(a)(2)** 🡪 ordinary; BUT **§ 1231** says that you get capital gains rate on ordinary income

recapturables—if you take depreciation on an asset you get to list your income as a capital gain—started in WW II

* All of the gains on sale of assets are treated as capital unless they fall in an exception in **§ 1221**
  + inventory, property held in a trade or business that is real property or depreciable, copyrights
  + Recaptureables
    - **§ 1245**—assets other than real property
    - **§ 1250**—real property—have to recapture and treat as ordinary income any depreciation you took above straight line—real property is currently straight-line depreciated 🡪 this doesn’t apply now
      * **§ 1(h)(6)**—depreciation you’ve taken on real property—what you would recapture if this were not real property will be taxed at a 25% rate
* Example:
  + $1,000 for building
  + ($800) for depreciation deductions
  + $200 adjusted basis
  + $500 amount realized
  + $300 capital gain—if this were a machine this would be ordinary income, BUT since it’s real estate to the extent of all depreciation ($800) we will tax this at a 25% rate under **§ 1(h)(6)**
    - 🡪 if the capital gain was greater than the depreciation the amount of depreciation would be taxed at 25% and the remaining capital gain would be at regular capital gains rate (15%)
      * IF personal property **§ 1245** $800 is recaptured as ordinary, $200 is capital gain
      * IF not personal **§ 1(h)(b)**—$800 taxed at 25% and $200 is capital gain—casebook pg 565

# ADVANCED TIMING ISSUES

## Effect of Debt on Basis and Amount Realized

* **Code § 1001(b).** Determination of amount of an recognition of gain or loss—Amount realized.
  + **Regulation § 1.1001-2(a).** Discharge of liabilities—Inclusion in amount realized.
  + **Regulation § 1.1001-2(b).** Discharge of liabilities—Inclusion in amount realized.
  + **Regulation § 1.1001-2(c).** Discharge of liabilities—Inclusion in amount realized.

*Crane v Commissioner*—1947—SCOTUS—“a taxpayer who sold property encumbered by a nonrecourse mortgage must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale”

**Recourse debt**—personally liable for debt obligation

**Nonrecourse debt**—can only satisfy the loan with the asset itself—can only foreclose and take the property—lender bears some of the downside risk—a little like an option—bank owns building and I have a call option—what is bank’s incentive to lend nonrecourse –higher interest rate

Crane v Commissioner

Crane inherits a building:

* Year 1
  + Purchase price = $250
  + Nonrecourse debt = 250
  + After-tax invested = 0
* Years 2-9
  + Depreciation deductions = 25
  + After-tax investment = 0
* Year 10
  + Sale price = 3 + assumption of nonrecourse debt

If this were **recourse debt**—we would want to know the amount of debt obligation that was cancelled

$250—basis

$(25)—depreciation deduction

$225—adjusted basis

$253—amount realized (debt + $3)—there is a value for getting basis back

Footnote 37: what would happen if nonrecourse debt exceeded the value of the property? Question left open.

* **Crane takeaways:**
  + Debt incurred to purchase an asset goes into the basis
  + Debt relieved as part of the sale is part of the amount realized
  + No difference between recourse and non-recourse debt
* IRS Litigation Strategy
  + Result was largely driven by the IRS’s concession that she was entitled to depreciation deductions
  + Other options:
    - (1) Only include equity as basis (exclude recourse and nonrecourse debt)
      * We would wind up with taxpayers unable to take losses even if they have an economic loss greater than their equity
      * Administribility
        + If we don’t give taxpayer basis, who do we give it to? The lender? Would get very complicated—as repayment was made the lender’s basis would change and deduction would be complicated to figure out
        + We would always want to say that we bought depreciable assets with cash and appreciating assets with recourse debt so that—then he would be able to take depreciation off the basis of cash-purchased assets
    - (2) Exclude nonrecourse debt from basis and amount realized
      * makes the borrower bear more risk, preventing tax shelters
      * Current system: who gets the worst end of the deal?
        + The lender—borrower can take recourse debt as a shell limited liability corporation—better interest rates, same insulation from recourse
        + The owners—backloaded depreciation for people who really to want to own their property
* Post-*Crane*
  + Reserved the question if nonrecourse debt exceeded the FMV of property (Footnote 37)
  + Taxpayers would take more depreciation deductions

|  |  |  |  |
| --- | --- | --- | --- |
|  | Basis | Depreciation | Interest |
| Year 0 | 300 |  |  |
| Year 1 | 200 | -100 | 15 |
| Year 2 | 100 | -100 | 15 |
| Year 3 | 0 | -100 | 15 |
| Total |  | -300 (-210 after-tax if 70% MTR) | 45 |
| **AR at Foreclosure** | 200 |  |  |
| **Capital Gain** | 200 (60 after-tax if 30% MTR) |  |  |
| **Purchase Price = 300. Nonrecourse Debt = 300. FMV at all times = 200.** | | | |

Commissioner v Tufts—1983—SCOTUS—Blackmun

If nonrecourse loans forgiven/transferred upon sale exceed sale price the difference is reportable as income

“When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation.”

*“a taxpayer must treat a nonrecourse mortgage consistently when he accounts for basis and amount realized”*

**TUFTS—CONCURRENCE—O’Connor**

“classic situation of cancellation of indebtedness”

* 1970
  + purchase price = $1.9M
  + NRD = $1.89M
* 1971-72
  + Depreciation = $450
* 1972
  + Sale price = $0 plus took subject to NRD
  + FMV = $1.4M
  + Basis = $1.45
* SCOTUS finally resolved the reserved question from footnote 37 in *Crane*
* Arguments:
  + Taxpayer wanted to report a loss—claiming AR = FMV because even though they owed $1.89M they were only liable for $1.4M
  + Commissioner wanted this to mimic forgiveness of indebtedness and have AR = $1.89M
* Rationale:
  + Tax benefit theory. (vs. in Crane the economic benefit theory—when buyer gave Crane cash she got econ benefit, but here there is a built-in loss) If you give basis up front for NRD and taxpayer claims depreciation deductions on borrowed funds the IRS should be able to take back those deductions
  + What would happen if the taxpayers were able to claim only $1.4M?
    - Could pass the property on NRD with basis resetting to $1.89M and claiming a depreciation deduction of $450 for only a much smaller loss
      * Bank can take a bad debt deduction of $450,000 when the get the $1.4M property for their NRD $1.85M
* O’Connor’s concurrence:
  + Barnett’s amicus brief
  + If it wasn’t for *Crane* she would have treated this as cancellation of indebtedness
  + Bifurcate the situation: the loan and the buying/selling of the property
    - They would realize the loss on the property (sell for FMV and take $50,000 loss) AND then pay off the debt with the proceeds of the asset sale
    - 🡪 lender will have implicitly reduced the NRD from $1.85 less $1.4 = $45,000 cancellation of indebtedness income
    - They have depreciated their basis from $1.85 🡪 $1.45, so they would recognize a capital loss of $50,000 (difference between $1.45 basis and $1.4 FMV)
  + \*\*the worst possible situation for taxpayers
  + the real difference: forgiveness of indebtedness would be ordinary income NOT capital (which is how it actually came down)
    - With the recapture rules, are these even different?
      * §1(h)(6)—taxed at 25% (for real property) vs. ordinary income (for personal property) which is probably higher
      * 🡪 under O’Connor’s view this would be ordinary NOT quasi-capital transaction
* **§ 1.1001-2(a)(2)(c) Example 8.** If recourse debt is forgiven
* **Tufts takeaways**
  + Clarifies *Crane*
  + If you get to exclude borrowed funds from income when you receive them and then you take tax depreciation deductions 🡪 you HAVE to

Estate of Franklin

* 5 year depreciable property for $500,000—like *Crane* and *Tufts*, you can buy with NRD 🡪 could wipe out Holly’s income ($100,000 each year) by selling her property for NRD secured by property (in example, chalk)—she will take deduction every year and offset her whole salary
* Taxes aside, would Holly pay $500,000 for a piece of chalk? No—and would never purchase with recourse debt (but NRD the only thing you can ever get back is the chalk)
* Would get tax-free income and then if lender asked for interest, etc. Holly would just walk away and return the chalk
  + What would be her AR?
    - $500,000 because in exchange for the chalk lender would resume $500,000—if this is ordinary income she gets TVM and if capital gains she gets a preferable rate AND TVM
    - If **§ 1245** recapture rule applies 🡪 ordinary income
* Lender would sacrifice nothing economically 🡪 no natural market constraint
  + Can lender take deduction? Yes—she could get a $500,000 bad debt deduction
* **Installment Sale Rules**: If on paper receiving all of the purchase price you don’t have taxable gain until you’re paid—get chalk at the end of the 5 years, collect no income, get $500,000 gain AND bad debt deduction 🡪 no tax consequences
  + Forgetting installment sale rules—create a tax shelter
    - If seller were tax exempt (501(c)(3) or anyone who is going to file a loss anyway)—this tax shelter of creating basis without limit by selling an asset for nonrecourse debt would work for anyone tax exempt until *Estate of Franklin*
* **Facts:**
  + Partners purchased motel for $1.2M in exchange for 10 year NRD note
  + Prepaid interest of $75,000
  + Partners paid interest and principle of $110,000
  + Romneys leased the property back and paid rent of $110,000 🡪 no money changing hands
  + At the end of 10 years partners would have to pay principle of about $1M
* **Law:**
  + If NRD significantly exceeds FMV can the taxpayer include that debt in their basis?
  + In this case they were taking depreciation deductions—if you use NRD then you get much, much higher depreciation
* **Decision:**
  + Adopted IRS interpretation: this functions like a call option—the right but not the obligation to purchase something for a specified price
  + 🡪 if you don’t take the option then you don’t ever really own the property—with accelerated depreciation the Doctors were able to depreciate to zero way before the property is worth zero—just transfer again to re-set basis and re-trigger depreciation deductions
  + *Tufts*
    - If in *Tufts* the FMV was much less than the NRD value there would have been a problem, but was probably close enough to be ok
    - Doesn’t overrule *Tufts* or *Crane*—limits when the FMV is far-off from NRD
* **9th Circuit**
  + Does NOT adopt option theory
  + Dual rationality: If you have NRD and **no real obligation** to make balloon payment **you never have ownership** of the property
  + **Holding**: you can’t include the value of the loan in the basis 🡪 partners should have basis of $75,000 and all the depreciation and interest deductions were disallowed
  + How does he distinguish between NRD just being mis-estimated and when the debt actually substantially exceeds FMV?
    - Would be fine if you purchased motel with NRD for FMV—too little equity in the property creates a problem—if you structure the payment so that you have no equity before balloon payment 🡪 it’s “unfair for tax purposes”
    - Focuses on overvaluation—not that the sale-leaseback generated no income for the owners
    - Evidence that building was only worth $600,000 but sold for $1.2M
* (Congress enacted some new rules—we’ll see these later)
* Recap class notes 4.20.10
  + Deducting interest payments for a total of $865,000—payment on mortgage perfectly netted with the lease-back rent 🡪 no gain or loss, no equity, only realizes tax benefits
  + Depreciation deductions—aren’t the Romney’s losing tax benefits (could have already depreciated their basis OR could have a much smaller basis—wouldn’t mind losing given the benefit of not having to own the asset)
  + Completely driven by: this being NON-recourse debt AND seller financing (bank would never have lent $1.2M on property worth only $400,000)
* First step toward treating recourse and non-recourse debt differently
  + Abusive tax shelter—benefits not intended by Congress
  + Judicial response—IRS had tried to litigate for years—Judge realized that if the property was overvalued and the owners never had equity they should lose the depreciation deductions because they never really owe the principle on the non-recourse loan
  + IRS response—Not very effective with revenue rulings—valuation disputes, audit lottery
  + Congressional response—reduce accelerated depreciation **§§ 1245 & 1250**
    - At risk rules **§ 465**
      * Limited the availability of deductions when there was purchase money non-recourse debt
      * BUT deductions are only allowed to the extent that you’re at risk (to the extent of your equity 🡪 in *Estate of Franklin* no equity, no depreciation)
      * Quickly replaced by **§ 469**
    - Passive loss rules
      * Limit losses claimed—but not limited to purchase money non-recourse debt
      * All partnership income is passive income—deductions limited to the extent that you have passive income, carryforward
    - New rule:
      * Effective at closing down individual tax shelters
      * Overbroad at times
      * Complex—what is passive income, material participation, etc.

Problem Set #17: The Effect of Debt on Basis and Amount Realized

**An Explanation of Some Business Terms**

The following summary of some business terms may be helpful in understanding the *Crane*, *Tufts*, and *Estate of Franklin* line of cases.

**What is equity?** FMV – Debt. A taxpayer’s equity in a piece of property he owns is the **difference between the fair market value of the property and the amount of the debt securing the property**. At the time of purchase, the taxpayer’s equity is the amount of non-borrowed cash that the taxpayer puts into the deal. In other words, if a taxpayer owns a piece of property, we can divide the investment into two components: equity and debt.

**Example 1:** If I pay $1 million for a building, by coming up with $200,000 in cash and borrowing $800,000, my equity in the building is, initially, $200,000 (i.e., my equity is the difference between the $1 million FMV and the $800,000 debt).

**Example 2:** If the property appreciates to $1.5 million (but the principal amount of the debt remains $800,000), my equity rises to $700,000 (i.e., my equity is the difference between the $1.5 million FMV and the outstanding debt of $800,000).

**Example 3:** If the property depreciates to $700,000, I have no equity in the building (or negative equity, if the debt is recourse).

You should think about what role this concept of “equity” plays in the court’s opinion in *Estate of Franklin*.

**What is a mortgage?** A mortgage is the name for a **loan that is secured by a particular piece of property**. The mortgagor is the property owner, who gives the mortgagee (a bank, or in seller financing, the seller of the property), a security interest in the property. A security interest allows the creditor (mortgagee) to foreclose (or take ownership of the property) if the mortgagor does not pay the debt. The terms of a mortgage typically allow the creditor to foreclose quickly, without first pursuing a lengthy course of other legal remedies, and they typically give the creditor first priority claim to the asset in the event of bankruptcy, which is a valuable right if the debtor’s total debts exceed her assets. A mortgagor typically cannot sell the property without paying off the debt or arranging for the buyer to assume the debt or take the property subject to the debt.

**What is seller financing?** In seller financing, the seller of property “takes back” a note (a debt obligation) from the buyer in lieu of cash. Suppose that the price of Blackacre is $1 million. I might sell it to you for $1 million in cash. Or I might accept instead your promise to pay $1 million on a fixed schedule, plus interest at an agreed-upon rate. The latter transaction is seller financing: the **seller functions in a dual capacity as both the seller of the property and the lender of the purchase price**. *Estate of Franklin* involves seller financing, as did *Zarin*.

Why would any lender advance money (or sell property) on a nonrecourse basis? Nonrecourse debt may initially sound like a bad deal from the lender’s point of view. As discussed in the casebook, recourse debt is debt where the borrower is personally liable for repayment. Unlike recourse debt, the lender of a nonrecourse loan forfeits his or her right to obtain satisfaction of the obligation from the taxpayer’s other assets. Put another way, the nonrecourse lender bears the downside risk—the risk that the property’s value will fall below the amount owed. So why would a lender take this risk? Presumably the lender is compensated for the risk in some way: she gets a higher interest rate on the loan or (if she is the seller of property) a higher price for the property. How much this risk premium will be depends on market forces.

**What is a balloon payment?** A typical residential mortgage calls for monthly payments of both principal and interest so that the principal is amortized (paid off) over the life of the loan, typically with level (equal) monthly payments. (In the early years, the level payment consists mostly of interest; in the later years, it consists mostly of principal. You can see this in the “bank account” example we discussed in the context of annuities.) A commercial mortgage (i.e., a mortgage loan for the purchase of commercial real estate) may be structured very differently, with the structure depending on the asset being purchased, market conditions, and the negotiations between the buyer and the lender. A commercial mortgage may require interest-only payments for some years and then a “balloon payment,” which is just **a large principal payment**.

**Assumption of debt / taking subject to debt.** These ideas can be illustrated by a couple of examples:

**Example 1**: Bob buys Blackacre for $1 million, paying $200,000 in cash and taking out a (recourse) mortgage of $800,000. A year later, Blackacre has appreciated to $1.5 million. Bob agrees to sell the property to Cynthia for $700,000 in cash and Cynthia’s assumption of the $800,000 debt. When Cynthia assumes the debt, she accepts personal liability for the debt. (In general, Bob is not relieved of liability for the debt; he remains secondarily liable if Cynthia defaults.) Why would Bob accept only $700,000 in cash for property worth $1.5 million?

The answer is that relief from the $800,000 debt is worth $800,000 to Bob, (This assumes that the debt carries a market rate of interest) so that in effect the total consideration he receives is $1.5 million. Note that the cash Bob receives ($700,000) is equal to his equity in the property.

**Example 2**: The same facts, except that the original debt is nonrecourse. As long as the amount of the nonrecourse debt is less than the value of the property, the sales transaction can be structured the same way (i.e., if Bob agrees, Cynthia could pay the purchase price by paying $700,000 in cash and taking over the debt). But in that case there is a legal difference in terminology and substance: **Cynthia does not assume the debt, since the term “assumption” connotes personal liability**. Instead, she generally will take Blackacre subject to the (nonrecourse) debt, meaning that she (like Bob) has no personal liability. (Cynthia could assume the debt, turning it into recourse debt. The bank would be very happy to accept an additional set of creditor's rights. But unless Cynthia bargains to change the terms of the debt (*e.g.*, lower the interest rate), she would have no particular incentive to do so.)

Note that the *Tufts* court appears to misuse this terminology. The court says that the buyer “assumed the nonrecourse mortgage.” Presumably the buyer did not “assume” a debt in excess of fair market value. The court should have said that the buyer took the apartment building subject to the nonrecourse debt.

**Problems**

* + - 1. **Ajit buys a building for $1 million cash. He later sells it for $800,000 cash. What is his basis in the building, his amount realized, and his gain on the sale?**

**§ 1.1001-2(a)(2), *Crane*** Basis: $1M; AR: $800K; Loss: $200K (if this is a capital asset it’s a capital loss; could be a quasi-capital asset under **§ 1231**)

* + - 1. **Instead he purchases the building by putting $800,000 on his credit card and paying $200,000 in cash. When he sells the building he receives no cash but the purchaser assumes his credit card debt. How does your answer change?**

***Crane***, Basis: $1M; AR: $800K; Loss: $200K

* + - 1. **What if he instead finances the purchase with $800,000 in nonrecourse debt and $200,000 in cash, and when he sells the building he receives no cash but the purchaser takes the building subject to the $800,000 nonrecourse debt?**

Basis: $1M; AR: $800; Loss: $200K

|  |  |  |  |
| --- | --- | --- | --- |
|  | Cash Purchase | Recourse Debt | Nonrecourse Debt |
| Purchase Price | $1M Cash | $800K RD + $200K cash | $800K NRD + $200K cash |
| Sale Price | $800K | Assume $800K RD | Subj. To $800K NRD |
| Economic Gain/Loss | ($200K) | ($200K) | ($200K) |
| Basis | $1M | $1M | $1M |
| Amount Realized | $800K | $800K | $800K |
| Tax Gain/Loss | ($200K) | ($200K) | ($200K) |

\*\*include the whole debt in amount realized if it’s either recourse OR nonrecourse debt

Problem Set #18: Review Problem

Following is a review problem in case you want to test your understanding of some of the concepts that we have covered so far. We will not discuss the problem in class, but I have included the answer on the following page.

**Problem**

**Aisha is an investor and bought a small commercial building in 1990 for $1 million. She paid $850,000 of the purchase price out of her own resources and financed the remainder of the purchase by taking out a nonrecourse mortgage of $150,000 on the building. Over the years that followed, Aisha took $300,000 in depreciation deductions.**

**In 2007, when the appraised value of the building was $800,000, Aisha transferred it to her daughter, Tiffany, by gift. Tiffany, drawing on her own resources, promptly invested $100,000 in elevator and lobby improvements. Between 2007 and 2009, Tiffany took depreciation deductions of $70,000.**

**At the end of 2009, Tiffany sold the building, still subject to the mortgage, for $700,000, receiving $550,000 in cash from the purchaser. Neither Aisha nor Tiffany had ever made any principal payments on the mortgage.**

**What are the income tax consequences of these events for Aisha and Tiffany?**

**Sample Answer**

This is a basis question, involving, among other things, the *Crane* doctrine and **§ 1015**. Aisha’s original basis in the building was $1 million (the $850,000 she paid in cash plus the $150,000 of nonrecourse debt that is included in basis under *Crane*). In 2007, after Aisha had taken $300,000 in depreciation deductions, her adjusted basis (under **§§ 1012 and 1016**) was $700,000 (her original basis of $1 million minus the $300,000 of depreciation deductions).

The gift of the building is treated as a part-sale, part-gift. Aisha’s amount realized is the $150,000 mortgage subject to which Tiffany takes the property. Aisha’s basis is $700,000 and under Reg. **§ 1.1001-(e)**, she can allocate all her basis to the part-sale portion to offset any gain but she cannot claim a loss. Thus, she has no gain or loss on the transfer.

Under § 102, Tiffany had no income at the time of the gift. Because it is a part-sale, part- gift, under Reg. § 1015-4 Tiffany's basis is the greater of the amount Tiffany paid (effectively $150K) or Aisha's carryover basis ($700,000) so Tiffany takes a carryover basis of $700K. Under § 1016, Tiffany’s basis in the building increased to $800,000 when she paid $100,000 for improvements. In 2009, after Tiffany had taken $70,000 of depreciation deductions, her basis was $730,000 ($800,000 basis minus $70,000 of depreciation).

Tiffany’s amount realized on the 2009 sale of the building was $700,000 ($550,000 cash plus the $150,000 mortgage, which is included in her amount realized under *Crane*). Thus, Tiffany recognizes a loss of $30,000 on the sale under § 1001. The special “loss basis” rule in § 1015 does not apply because § 1015 creates a lower “loss basis” only if the donor’s basis exceeded the fair market value of the property at the time of the gift. In this case, at the time of the gift, Aisha’s basis was $700,000 and the property’s fair market value was $800,000. In other words, § 1015 only limits losses that are “built-in” at the time of the gift; it does not affect losses that accrue after the time of the gift.

## Interest Deductions

* **Code § 1(h)(2).** Tax imposed—Maximum capital gains rate—Net capital gain taken into account as investment income.
* **Code § 1(h)(11)(D)(i).** Tax imposed—Maximum capital gains rate—Dividends taxed as net capital gain—Special rules—Amounts taken into account as investment income.
* **Code § 163(a).** Interest—General rule.
* **Code § 163(d).** Interest—Limitation on investment interest.
* **Code § 163(h)** Interest—Disallowance of deduction for personal interest.
* **Code § 264(a)(2)** Certain amounts paid in connection with insurance contracts—General rules.
* **Code § 265(a)(2)** Expenses and interest relating to tax-exempt income—General rule—Interest.
* **Code § 469(e)(1).** Passive activity losses and credits limited—Special rules for determining income or loss from a passive activity—Certain income not treated as income from passive activity.

|  |  |  |  |
| --- | --- | --- | --- |
|  | Sue | Bert | Jean |
| Assets at start of year |  |  |  |
| Cash | 100 | 100 | 0 |
| Assets at end of year |  |  |  |
| Cash | 0 | 100 |  |
| Interest income |  | 10 |  |
| Vacation Debt |  | -100 | -100 |
| Interest Payment |  | -10 | -10 |

* If we allow for deductions on interest we create differences between Bert and Sue—tax arbitrage
* If we don’t allow deductions on interest we
* IF we want to tax income from savings, Jean is dis-saving
* Tax arbitrage: economically, do the exact same thing as Sue BUT gets a benefit from the government
  + Deductible borrowing for tax-exempt income creates negative MTR

“In any circumstance where interest expense is entirely deductible and the income from the preferred asset is entirely excluded from income, taxpayers often will find that their total tax liability is negative on a fully leveraged investment.”

§ 163(d)(1)—can deduct investment interest up to investment amount; (2) carryforward disallowed interest

* **Economic substance doctrine**
  + **§ 7701(o) in healthcare bill**
    - “A transaction is treated as having economic substance only if the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer’s economic position, and the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into such transaction.”
  + Only applies to sections to which the “economic substance doctrine is relevant”
    - Case law standard: if the shelter is what Congress intended
  + 40% penalty for understatements of transactions found to lack economic substance—if you include a note on your tax return about the transaction but still underpay it’s a 20% penalty

knetsch v United States—1960—SCOTUS—Brennan

|  |  |
| --- | --- |
|  |  |
| Loan to Knetch from insurance company | ($4M) |
| Interest Due on Loan (3.5%) | ($140K) |
| Investment by Knetsch in Annuity | $4M |
| Tax-Free Interest on Bond (2.5% interest) | $100K |
| **Pre-Tax Income** | **($40K)** |

* Functioned like a bank account—growing at 2.5% but not paying tax until he starts getting annuity payments at age 90—net result: he pays $40,000—he’s claiming he can deduct $140,000 even though on net he’s only giving them $40K—he had an 80% tax rate 🡪 value of deduction: $112,000 for paying on net $40,000 🡪 made $72,000 after-tax (converted $40,000 pre-tax economic loss into $72,000 after-tax gain)
* When annuity is paid he will owe tax on interest gains—so if he paid mark-to-market taxes he would have no tax benefit, but with realization requirement he will have the TVM of tax payments on interest
* How is this like tax arbitrage (investing in a tax-exempt asset)—he’s not paying taxes on appreciation of annuity and he won’t pay tax on the interest until he either closes out the transaction or turns 90
* Interest deductions disallowed because there was “no real indebtedness”—he only invested about a$1,000 each year (in LB’s simplified example he invested $0)
* Now: this would fall under **§ 264(a)(2)** barring interest deductions for investing in insurance/annuities contracts with certain characteristics--**§ 183(d)** would limit deductions to investment income ($40,000)
* *Estate of Franklin*—this looks similar because they’re taking deductions without having any real indebtedness/equity
  + BUT here it’s not an over-valued asset, he could have waited until he was 90 and let the bond run its course to have a nice tax shelter—in *EoF* he always intended to have the Romneys foreclose upon the property
  + Nonrecourse debt—the object of the shelter is excess deductions and deferral of income—tax arbitrage (huge deductions now with deferred income)
  + **Legal doctrines:** 
    - *EoF*—debt didn’t exist b/c they had no equity—nonrecourse debt and overvaluation
    - *Knetsch*—debt didn’t exist b/c he as no equity in the annuity bonds—he borrows it all back on a non-recourse basis
* **Rationales.**
  + We want people to invest in annuities
  + Tax capital income at a lower rate—BUT Knetsch has no real capital income, he’s just reducing labor income, MTR with benefits intended for capital income
  + Pre-tax profit test—if interest rates fell below 2.5% he could arbitrage the spread with his loan for profit
* Insurance company—why would they participate in this?
  + Interest deduction of $100K—also possible that insurance company had 40% tax rate as a c-corp

Problem Set #19: Interest

1. **Dan, Eve, and Frank each have $400,000 in the bank. Assume that they have similar jobs and earn similar incomes. Dan uses his $400,000 to buy an apartment. Eve buys an identical apartment, but she finances the entire purchase with a $400,000 mortgage from a bank. Her annual interest payment on the mortgage is $20,000. As a result, Eve still has her original $400,000 to invest. She keeps the money in the bank where it earns $20,000 in interest each year. Frank does not buy an apartment. Instead, he keeps his money in the bank, where it earns $20,000 per year in interest, and he rents a third, identical apartment for $20,000 per year. What are the tax consequences for each of them? What do you think the tax consequences should be?**

Haig-Simons income: Eve = Frank > Dan

**§ 163(h)(3)(B)**—interest is deductible on up to $1M used to acquire a home (Eve)

Eve and Frank taxed on $10,000 income

🡪 Tax liability: Frank > Eve > Dan

|  |  |  |  |
| --- | --- | --- | --- |
|  | Dan | Eve | Frank |
| Apartment | 400 | 400 |  |
| Mortgage on Apartment |  | -400 |  |
| Interest Due on Mortgage |  | -20 |  |
| Cash in Bank |  | 400 | 400 |
| Interest Received from Bank |  | 20 | 20 |
| Rent |  |  | -20 |
| Imputed Rental Income | 20 | 20 |  |
| **Taxable Income** |  |  |  |
| Imputed Income Excluded & HMID Allowed | 0 | 0 | 20 |
| Imputed Income Excluded & HMID Disallowed | 0 | 20 | 20 |
| Imputed Income Taxed & HMID Allowed | 20 | 20 | 20 |

* Tax code incentivizes home ownership—BUT home prices internalize tax benefits
  + Allows people to have more positive association with their neighborhood, school, promotes community sentiment
* How could we make this equitable?
  + Allow deductions on rent—removes incentive for home ownership BUT establishes horizontal equity—would just subsidize everyone
  + We might want to tax housing MORE than other goods—externalities: energy consumption
  + Ideally: just tax imputed rent
  + First Time Home Buyers—part of stimulus package--$8,000 refundable credit
  1. **Gina wants to purchase a car that she will use for personal purposes and a machine that she will use in her business. She does not have sufficient cash and thus must borrow. Assuming the interest rates are identical, does it make any difference if she borrows to purchase the car or the machine?**

Interest on machine deductible (allowable up to her investment income) **§ 163(d)(2)(A)**

No interest deductions on personal car **§ 163(h)(1)**

**§ 1.163-8T** Looks to **use**—what did you buy first?

* 1. **Suppose alternatively that Gina wants to purchase the car and some securities. Assuming again that the interest rates are identical, does it make any difference if she borrows to purchase the car or the securities?**

Securities if purchased for personal use allow interest deductions to the extent of her investment income (but would have the b enefit of realization requirement) **§ 163(h)(1)**

**§ 163(d)** if you don’t have investment income, can carry the deductions forward

**§ 163(h)(3)—**home mortgage interest deduction—look to the collateral for the loan (i.e. home for a mortgage) and NOT to how you use the loan

* 1. **Suppose that instead she only wants to purchase the car but does not have sufficient cash. Assuming the lender is indifferent, does it make any difference if she uses the car or her home as security?**

1. **Hillary borrows $40,000 and pays 10% interest per year. Is the interest deductible (and should it be) if she uses the proceeds in the following ways?**
   1. **She invests in NYC municipal bonds.**

**§ 103**—no tax state and local bonds

**§ 265(a)(2)**—general prohibition on interest deductions when the proceeds of the loan are used to purchase tax-exempt assets

|  |  |  |
| --- | --- | --- |
|  | Pre-Tax | After-Tax (50% MTR) |
| Interest Received | 8% | 8% (**§ 103**) |
| Interest Paid | -10% | -5% (gets a deduction for the 10%, value subject to MTR) |
| Return | -2% | 3% |

Possible solution: deny the interest deduction BUT would allow **investors with funds** to invest in state and local bonds to take advantage of the interest benefits but would disincentivize **borrowers** from investing in state and local bonds: (do we want to incentivize borrowers investing at all?)

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | Hillary (borrowing) | | Bill (has funds) | |
|  | Pre-Tax | After-Tax | Pre-Tax | After-Tax |
| **Tax-Exempt Bonds** |  |  |  |  |
| Interest Received | 8 | 8 | 8 | 8 |
| Interest Paid | -10 | -10 |  |  |
| Return | -2 | -2 | 8 | 8 |
| **Taxable Bonds** |  |  |  |  |
| Interest Received | 10 | 5 | 10 | 5 |
| Interest Paid | 10 | 5 |  |  |
| Return | 0 | 0 | 10 | 5 |

* 1. **She invests in preferred stock in Little Rock Co. that pays dividends.**

**§ 163(d)** no deduction except to the extent of the investment income—if dividends equal or exceed the amount of interest due you can deduct the interest

**§ 1(h)(11)(D)—**if you’re going to **take the § 163(d) deduction for investment income on qualified dividend income,**

* 1. **She invests in common stock in Little Rock Co. that pays no dividends but is expected to appreciate in value instead.**

**§ 163(a)** Can deduct to the extent of the capital gain

**Tracing rules**—apply depending on what you use your debt for

## Losses

**CAN ONLY DEDUCT FOR LOSSES FROM TRADE OR BUSINESS *OR* IF LOST TO FIRE, STORM, SHIPWRECK, OR OTHER CASUALTY, OR FROM THEFT.** (§ 165(c))

* **LOSSES**
  + **Code § 165(a).** Losses—General rule.
  + **Code § 165(b).** Losses—Amount of deduction.
  + **Code § 165(c).** Losses—Limitation on losses of individuals.
  + **Code § 165(d).** Losses—Wagering losses.
  + **Code § 165(e).** Losses—Theft losses.
  + **Code § 165(f).** Losses—Capital losses. (🡪 §§ 1211-12)
  + **Code § 165(g).** Losses—Worthless securities.
  + **Code § 165(h).** Losses—Treatment of casualty gains and losses.
    - **Regulation § 1.165-1(b).** Losses—Nature of loss allowable.
    - **Regulation § 1.165-1(c).** Losses—Amount deductible.
    - **Regulation § 1.165-7(b)(1).** Casualty losses—Amount deductible—General rule.
    - **Regulation § 1.165-8(c).** Theft losses—Amount deductible.
* **Code § 172(a).** Net operating loss deduction—Deduction allowed.
* **Code § 172(b).** Net operating loss deduction—Net operating loss carrybacks and carryovers.
* **Code § 183.** Activities not engaged in for profit.
* **RELATED TAXPAYERS & LOSSES**
  + **Code § 267(a).** Losses, expenses, and interest with respect to transactions between related taxpayers—In general.
  + **Code § 267(b).** Losses, expenses, and interest with respect to transactions between related taxpayers—Relationships.
  + **Code § 267(c).** Losses, expenses, and interest with respect to transactions between related taxpayers—Constructive ownership of stock.
  + **Code § 267(d).** Losses, expenses, and interest with respect to transactions between related taxpayers—Amount of gain where loss previously disallowed.
* **SELLING STOCK—LOSSES** 
  + **Code § 1091(a).** Loss from wash sales of stock or securities—Disallowance of loss deduction.
  + **Code § 1091(b).** Loss from wash sales of stock or securities—Stock acquired less than stock sold.
  + **Code § 1091(c).** Loss from wash sales of stock or securities—Stock acquired not less than stock sold.
  + **Code § 1091(d).** Loss from wash sales of stock or securities—Unadjusted basis in case of wash sale of stock.
* Arise in 2 situations:
  + Seller exchange an asset and amount realized is less than adjusted basis
  + Transaction produces deductions in excess of income in a year
* can’t deduct losses for personal activities UNLESS casualty, wagering, or theft loss
* **§ 165(a)**—Losses—General rule
* **§ 1.165-1(b)**—can’t claim losses until there is a closed or completed transaction
* **Hobby Losses**:

Plunkett v Commitssioner—1984

**§ 162; § 212**—Plunkett deducted the costs of these activities

IRS—he couldn’t claim deductions because these weren’t activities entered for profit **§ 183** (Can’t take deductions in excess of income unless it’s for the production of income or a trade or business)

Holding: truck pulling is engaged in for profit; mud racing was just a hobby (so losses from mud racing are only deductible to the extent of his income)—9 factors—**was either a bona fide business or investment activity?**

* If this is something he’s doing for FUN he can’t deduct; if it’s for profit the tax system gives him a break
* **§ 183** is a favorable provision—even though **§ 262** says you can’t take deductions for personal expenses—but **§ 183** says that you CAN take deductions to the extent that your personal activities generate income
* Is § 183 a good provision?
  + Incentivizes art and culture
* **Casualty losses**
  + Not limited to a basket (like hobbies or gambling)
  + If casualty losses exceed casualty gains they count as capital losses **§ 165(h)(2)**
  + …as insurance:
    - **Personal**: Basically getting insurance equal to the value of the deduction (loss x MTR)—also limited by 10% and $100 thresholds
    - **Business**: you would have recovered your basis earlier BUT you get the TVM of accelerated deductions
    - Do we want the government to function as insurance?
      * This is NOT a miscellaneous deduction--§ 67(b)(3) 🡪 don’t have to worry about 2% floor, but we have a greater floor
      * Are we crowding out the private insurance industry?
      * Moral hazard—we want people to be vigilant in protecting their property
      * Deduction mirrors Haig-Simons income
      * NOT purchasing insurance is a form of consumption—you consume your income in other ways

Fender v United States—1978

Loss is not a bona fide loss—cite to regulation **§ 1.165-(1)(b)** only a bona fide loss is disallowable, substance and not form will govern

If we have this catch-all, why do we need all these family rules, wash sale rules?

Holding: essentially this is a sale to a related party—Fender had a lot of influence, even though he didn’t own more than 50%

Think back to *Cottage Savings*—we saw a transaction solely to realize a tax loss; no economic benefit

*\*\*pretty aggressive substance over form case*—let’s the government cut down on abuses, makes ex ante behavioral organization difficult

Problem Set #20: Losses

* + 1. **You own a house that you purchased in 1995 for $200,000 and that you use as your residence. In 2000, you replaced the leaky roof at a cost of $75,000, and upgraded from ordinary asphalt shingles to fancy slate roof tiles in the process.**
       - 1. **Suppose that you sell the house for $300,000. Do you report a taxable gain on the sale and, if so, how much?**

**Make adjustments to basis: § 1016—**AR: $300; AB: $275; Gain: $25

**§ 121** can exclude many gains on residence

**[cases in casebook]** repair on roof not a casualty loss, not sudden 🡪 can’t deduct the cost of replacing

* + - * 1. **Suppose that you sell the house for $150,000. Do you report a taxable loss on the sale and, if so, how much?**

AR: $150; AB: $275; Loss: $125—doesn’t have to include his gains up to $250K, can’t deduct his losses **(§ 165(c))**—part of the reason his home has declined in value is the wear-and-tear (rationale doesn’t hold up when home prices across the board fluctuate i.e. 2008)

1. **Ingrid purchases a van to use in her trade or business for $100,000. She holds the van for three years and takes $60,000 in depreciation deductions. In October of the third year, the van is stolen. The fair market value of the van before it is stolen is $45,000, but it would cost her $65,000 to buy a new van.**
   1. **What can Ingrid deduct?**

**§ 165(e)** she can deduct for theft loss—her deduction will be her adjusted basis $40,000

**§ 165(b)—**this will be allowed to the extent that it exceeds 10% of her AGI

**§ 165(h)(2)(A)**—10% of AGI test applies ONLY to personal assets

**BUT Reg. § 1.165-7(b)(1)** says the amount deductible is the lesser of AB and [FMV before the casualty loss less the FMV after the casualty loss (assumed to be 0 in theft)]—in this case $40,000 and $45,000—makes sense because it limits her to deducting as much as she spent originally (combined with her depreciation deductions)

**§ 165(h)(2)** 10% floor for casualty losses AND a $100 threshold

🡪 $40,000 loss - $100 – 10% AGI = deduction (**§ 165(b) and § 165(h)**)

* 1. **Suppose the fair market value at the date of the theft was $25,000. What can Ingrid deduct?**

Her adjusted basis $40,000 **§ 165(b)**

**BUT Reg. § 1.165-7(b)** says the amount deductible is the lesser of AB and FMV before the casualty loss less the FMV after the casualty loss (assumed to be 0 in theft)—in this case $40,000 and $25,000

* 1. **Suppose she collected $55,000 of insurance. What are her tax consequences?**

No deduction for loss compensated by insurance **§ 165(a)**—would make sense to make everything in excess of her deduction income, can’t find a Code section

Capital gain **§ 165(h)(2)(b)** casualty gains over casualty losses

**§ 1.165-1(c)(4)** when you determine loss you make adjustments for compensation received (insurance) 🡪 not THAT explicit but

* 1. **What if Ingrid torched the van to collect the insurance?**

That’s the insurance company’s business—the IRS is only interested in collecting taxes—if they don’t compensate her she can still take the loss (?)

Willful 🡪 under ***Blackmun*** this wouldn’t be a loss because this was intentional or a result of gross negligence

1. **Ajay purchases stock for $500,000 in 2002. What is includable / deductible in each of the following scenarios and when?**
   1. **In 2004, Ajay sells the stock to Nina, his sister, for $330,000. Nina subsequently sells the stock to Nancy for $420,000.**

No deduction for $170,000 between brother and sister **§ 267(a)(1)**

**(c)(4)**—Nina would report a gain of $90,000 but offset that gain Ajay’s disallowed losses **§ ??**

* 1. **Alternatively, Ajay sells the stock to Noah, Nina’s husband (his brother- in-law) for $330,000. Noah sells it back to Ajay for $335,000.**

**§ 267(c)(2)** constructive ownership—Noah is the same person as Nina 🡪 Ajay effectively sells to Nina and the loss is disallowed under **§ 267(a)(1)**

What if Ajay sold to Noah’s brother Eli for $330,000? **§ 1091 wash sale**—neither party would have losses or gains and Ajay wouldn’t have a loss

If Eli sold back to Ajay for $335,000? **§ 1091(b)** we tax Eli on his gain but Ajay gets to recover his basis**--§ 267(b)**

Stacking rule—if you have a tax payer subject to multiple rules and you have to decide which come first—EITC is generally stacked last, if you put it first the EITC would eat up income and they’ll stop being eligible for nonrefundable credits

* 1. **Instead, Ajay sells the stock to Lucia, Nina’s 16-year-old daughter (his niece) for $330,000. Sixty days later, Lucia sells it back to Ajay for $340,000.**

**§ 267(c)(2)** constructive ownership would still apply—but then we have an exchange among family members and no one can claim a loss

But what if this were Eli? A brother-in-law doesn’t count for **§ 267(c)(2); (c)(5)** can only do constructive family ownership ONCE (can attribute Lucia or Noah to Nina but CANNOT attribute to Eli, Noah’s brother) AND 60 days is outside the wash sale rule 🡪 do they have to let Ajay claim a $165,000 loss—did Ajay have sufficient dominion over the transaction?

**§ 1091(d)**—the loss of $165,000 is lost forever because they engaged in this abusive sale; essentially a penalty, if you try to do this and you’re caught

Tax Shelters

Economic substance different from the form of a transaction—*Fender, Estate of Franklin*

*Fender*—question if there’s a realization event when there is a sale and re-purchase near one another

*Crane, Tufts, Estate of Franklin, Knetsch*—there can be non-economic losses AND how the law doesn’t distinguish well between blended ownership—law places emphasis on non-economic distictions

* Is there a better way to think about this?
  + Is the goal just to measure income?
    - Allow no deductions to the extent that property is debt financed; there is no risk
    - Allocate ownership interest between lender and buy and allow them to split deprecation deductions in line with their economic ownership
    - Statutory approaches—disallow losses to the extent that you don’t have money in the deal or you aren’t being taxed for income generated
      * Related party rules
      * Recapture rules
      * Wash sale rules
      * **At risk rules § 465**
        + Disallow deductions to the extent that they exceed taxpayer’s funds at risk—purchase investment, recourse debt, and nonrecourse debt secured by other assets—limited carry forward
      * Passive loss rules
        + Disallow deductions for passive losses to the extent that they exceed income from passive activities—NOT portfolio investments, NOT trade or business activities in which you materially participate

Passive loss rules apply EVEN IF you’ve truly invested in the property

***\*\*Don’t apply to c-corporations*—**disclosure rules, straddle rules

**Straddle rules:** mark-to-market taxation

When is a corporation materially participating in an activity?

* + - * BASKET RULES
        + Passive loss rules have a big basket—all investment and all income from passive activities
        + Have basically eliminated the problems from *Knetsch* and *EoF*
        + *Fender*—passive loss rules wouldn’t apply; at risk rules wouldn’t apply; neither would related party rules or wash sales rules

🡪 this shelter to a certain extent still exists

Overview

* 3 main purposes of tax system
  + Raise revenue to finance public goods
  + Redistribute
  + Correct for market failures (esp. externalities)
* Challenges faced by income tax
  + Valuation
    - Distinguish business from personal consumption
      * Convenience of employer; § 119; § 162; hobby loss rules; Benaglial Gotcher
    - Realization rule
      * Bunching, cherry-picking, lock in, capital gains, key contributor to ALL tax shelters
      * If we had mark-to-market we wouldn’t see tax shelters
        + § 264, § 265 at risk rules passive loss rules wash sale rules
  + Managing complexity in the law
    - Interest deductions
      * started with simple rule and had to amend as tax arbitrage became apparent
      * 🡪 HMID, § 264, § 265, layered on complexity to deal with initial problem
  + Income shifting
    - Product of progressive rate structure and taxable unit
    - Kiddie tax; split ownership at business level
  + Whether/When/How to implement social policy
    - System of economic regulation
    - Creates incentives/disincentives
    - Think about effects on distribution of income
    - Progressive rates—EITC, all the new HC benefits, HMID, retirement savings codes
    - Taxation of non-market activities
      * Imputed income—we incentivize staying home to care for kids; marriage penalties, marriage bonuses
* Always alternatives—are they better or worse? Re-frame: we currently spend over $1T on tax expenditures—are we spending that money on the right objectives? Are they designed well? Is this how we want to spend revenue that we could be raising?

## Manoj’s Review Session

* Study problem sets—know what was discussed in class (esp. policy)—casebook (sections about things talked about in class, variations from book are likely exam questions)—assigned Code sections we didn’t talk about in class
* RIA Checkpoint on the library website—will explain Code sections--
* Potential policy questions: health care, home mortgage interest deduction, tax expenditures generally, rationales for capital gains
  + Three criteria:
    - Equity
      * Horizontal equity—similarly situated tax payers should pay the same tax
      * Vertical equity—a taxpayer who makes more shouldn’t pay less in taxes than his lesser earning counterpart (not necessarily a progressive tax)
    - Efficiency
      * **Inefficiency**: when people change their behavior predicated on tax code UNLESS it’s a change we want
      * i.e. society values Tom working at $10/hour and Tom values leisure at $8/hour—if his tax rate is 25% and he gets $7.5/hour after tax 🡪 but for the tax system, Tom would work and societal deadweight loss is $.5/hour
      * **Elasticity**: price-sensitive people will purchase less as taxes are imposed
      * **Negative externalities**: we want to curb some behavior—factory makes $100 for each disposal in a river; $120 to clean up river; if you tax the factory > $100 they will be properly deterred to not dispose in the river
      * **Pigovian tax**: we tax something that causes a harm—you pay 5 cents per grocery bag in DC—hard to make people internalize the cost of their behaviors on society, so we tax them
    - Simplicity
      * Compliance (administribility)
        + Least costly form of simplicity—a form of efficiency
      * Rule
      * Transactional
        + The most costly—scheming to avoid taxes
  + **Wage tax** is a consumption tax equivalent—“The more deducting, expenses, excluding you do on what you spend the more you move away from an income tax and toward a wage tax (which is a consumption tax)”
    - Income = wages + return on investment
    - Expensing an income-producing asset is equivalent to exempting the income from that asset from tax.
      * 🡪 this basically clips out return on investment and we are left with only wages (to spend or save) 🡪 functions like a consumption tax because everything that you’re spending is taxed and everything that you save is deducted
      * \*\*see page 294
  + **Realization requirement**
    - No purpose in taking money out of an asset until you need to spend it 🡪 realization requirement moves us toward a consumption tax

|  |  |
| --- | --- |
| Calculating taxable income | |
| Income |  |
| - Exclusions | Don’t even figure into gross income—the Code is saying forget about it, it’s fine |
| = Gross Income | Includes everything else |
| - Above the line deductions | Specified by statutes (i.e. ordinary and necessary business expenses, contributions to a traditional IRA, interest on student loans)—more restricted than exclusions, less than below the line deductions |
| = Adjusted gross income |  |
| - Below the line deductions | Charitable contributions, medical payments, home mortgage interest deductions—only take these if they add up to be more than **standardized deduction** |
| - Miscellaneous deductions | Even more restricted, § 67 (include haircut and 2% floor)—i.e. unreimbursed employee expenses |
| **= Taxable income** | 🡪 Goes into brackets |

* **Vocabulary**
  + **MTR**—affects decisions going forward
  + **ATR** = total taxes paid / taxable income—always higher than MTR, picture of overall tax profile
  + Refundable vs. nonrefundable credits
  + Deductions vs. exclusions
  + **Tax inclusive vs. tax exclusive**
    - Sales taxes (which we didn’t talk about) are exclusive—you calculate tax that you owe and pay from another source
    - Income taxes are inclusive—taxes that you owe are included in your base (i.e. if you have $100 and a 30% rate you pay $30 and have only $70 left—base NOT in tact)
    - When we have equivalent tax rate the inclusive rates are nominally lower, exclusive rates are nominally higher
      * a 20 % inclusive tax on $100 is equivalent to a 25% exclusive tax on $80
      * Oliver was a complete boner about this.
* **Fringe benefits**
  + Rule driven with wiggle room—we will probably have to argue within facts (de minimus? For the benefit of the employer? Use Code factors and argue both sides, traditional law school question)
    - **§ 132** All fringe benefits not excluded by this section are included in income
      1. No additional cost service
         * must be offered for sale of customers in the ordinary course of business
         * employee must in employers line of business
         * employer cannot forgo income
      2. Qualified employee discount § 132(c)
      3. Working condition fringes
         * Any expense that the employee paid for which she otherwise would have been able to deduct, take into account § 274 but not limitations about itemization requirements
      4. De minimus fringe
         * § 1.132-6(d) on whether or not meals are de minimus
      5. Qualified transportation fringe
    - **Reg § 1.132-5(a)(1)(B)(i)**
      * Nondiscrimination rules—doesn’t apply to de minimus and qualified transportation fringe
    - Employee is defined on page 120
    - Spouses—§ 274(m)(3) AND § 1.132-5(t)—*Gotcher* and VW trip—bona fide business purpose
      * Surrogate taxation
  + Fred example.
    - FMV of home = $1.5M
      * Does Fred make § 83(b) election? MTR = 40%

|  |  |  |
| --- | --- | --- |
|  | § 83(b) | ~ § 83(b) |
| e/o Year 0 Cash | $2M | $2M |
| Year 1 |  |  |
| Home price | ($1M) | ($1.5M) |
| Cash income | $0 | $500K |
| Income from home | $500K | $0 |
| Taxes paid | ($200K) | ($200) |
| Basis | $1.5M | $1.5M |
| e/o Year 1 | $800K cash + $1.5M basis | $800 cash + $1.5 M basis |

* + - * + **AB = cost + amount on which you pay taxes**

Adjusted basis v. important

* Imputed Income
  + Homes—actually administrable (as opposed to imputed income on cutting your own hair)
  + Rental income
    - If you purchase a candy bar and eat it you pay for the consumption—NOT an investment
    - You expect an investment to go up in value—BUT a home is a blended purchase between investment and consumption—you NEVER expect your home to be valued at $0 after 30 years
    - Criticisms of taxing imputed income don’t necessarily apply to these large expenditures
* **Gifts.**
  + General rule: donors can’t deduct and recipients get to exclude
  + 2010—estate tax is gone, traditionally had exclusion amount and beyond that you paid taxes on the difference
  + Any one person can give any other person $12,000 each year without tax consequences—can give $12,000 to as many people as you like
  + Lifetime $1M giving cap—if you give more than $1M in your life the DONOR will pay tax on it—this $1M is eaten away by each annual gift over $12,000 per recipient
    - Year 1: $1.012M gift (no more than $12,000 to any one recipient)
    - Year 2: $13,000 gift—donor pays tax on $1,000
  + Generally speaking
    - gifts you get a carryover basis
    - bequests you get a stepped up basis
      * if you’re about to die—sell your property which have lost value to realize loss deductions, bequeath your property which has gained value
  + Danika and Blake—know these problems well, don’t mess them up
    - You neither recognize loss nor gain—basis = FMV at time of gift or giver’s basis for loss purposes—if the property loses
* **Charitable Gifts.**
  + Page 447 in casebook; really good examples on 449—rules on charity using assets for the intended purpose
  + Tax law confers a generous benefit on contributors of appreciated property.
    - NOT the same as selling the property, paying taxes and donating proceeds
    - Purchase price: $1,000; FMV: $10,000
      * if you sell and donate you pay taxes on $9,000 CG and can deduct some
      * if you donate the appreciated asset you can deduct the whole value
      * Restrictions:
        + Only—assets which would otherwise generate capital gains
* **Fruit and trees.**
  + You’ve got all these issues in *Hort* because we’re moving away from a mark-to-market system toward a system of depreciation; there is no clear and principled way to define a realization event.
* **Transactions involving borrowed funds.**
  + *Zarin*—don’t try to draw principles out of this case, it’s just supposed to be fun—overturned
  + **Stealing vs. borrowing**
    - lacking mutual consent? Include in income—establishment of mutual consent? Off-setting liability for borrowed funds
  + **Cancellation of indebtedness vs. purchase price adjustment**
    - Purchase Price Adjustment—**§ 108(e)(5)—**price reduction NOT income
      * Debt MUST be from seller 🡪 buyer
      * Buyer CAN’T be insolvent (we don’t want people to mask cancellation of indebtedness as purchase price adjustment)
      * (Functionally you’re returning an asset, getting a refund, and purchasing it back for less)
    - Cancellation of Indebtedness Income
      * Reduces tax attributes if you’re insolvent (forgive cancellation of indebtedness income to the extent of your insolvency; BUT if you have adjusted basis in an asset it will be reduced dollar-for-dollar and when you realize income on that asset you will have gain
* **Annuities and Life Insurance.**
  + Life insurance is a really sweet deal from a tax perspective, especially if you die early.
  + Mortality gain—you died early and got a good deal
  + Mortality loss—bad deal on life insurance policy
  + Annuity.
    - You get the basis in the annuity BUT you also recover basis at a pro-rated rate; after you recover your basis anything you receive is taxed in full.
  + Modified endowment contracts.
    - Scheming—if you have what looks like a life insurance contract you can get tax free earnings and cash out whenever you want—if you overfund your life insurance contract it looks like a savings vehicle and you have to pay taxes on withdrawals. BUT if you died then the IRS knows you were serious about dying and taxes like a life insurance plan (0%) and not like a savings instrument
* Policy question
  + Have an opinion
  + Will give partial credit