Basic Income Tax

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About the Author

Professor William Kratzke is a Cecil C. Humphreys Professor of Law at the University of Memphis. He received his B.A. in Political Science and the Far Eastern & Russian Institute from the University of Washington in 1971. This naturally caused him to be interested in attending law school. He received his J.D. from Valparaiso University in 1974 and was a member of the Valparaiso University Law Review's editorial board. He received his LL.M. from Georgetown University in 1977.

Professor William Kratzke teaches tax law courses at the University of Memphis. He has been a faculty member there since 1979. He has taught courses across the curriculum. In addition to tax courses, he has taught trademarks, torts, civil procedure, world trade law, economic analysis, and other courses. He visited Santa Clara University and the University of Mississippi. He received Fulbright Teaching Awards in 1997 (Moldova) and 2001-2002 (Russia).

Professor Kratzke has written in the areas of tax law, trademark law, tort law, and antitrust law.

Notices

This is the first version of the first edition of this casebook, updated May 29, 2013. Visit http://elangdell.cali.org/ for the latest version and for revision history.

The author wishes to express thanks to his research assistants, Magdalene Smith and Jay Clifton.

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Preface

This book is a basic income tax text. I intend this text to be suitable for a three-hour course for a class comprised of law students with widely different backgrounds.

Certain principles permeate all of tax law. I have found that certain axioms or principles will carry us a long way. For example, income is taxed once – or treated as if it has been taxed. Once it has been taxed, its investment gives the taxpayer basis – which I define not as cost but as money that will not be subject to tax again. Etc. The text returns to these principles throughout. I usually put these matters in text boxes.

At a minimum, I want students who have completed basic income tax to know these principles and to be able to apply them, i.e., to develop some "tax intuition." This intuition will serve well the student who wishes to take more tax classes. I tried to identify what I want students to know before enrolling in corporate tax or partnership tax – and to make certain that I covered these principles in the basic course. Such intuition will also serve well the student for whom the basic course is a "one and done" experience. Like it or not, tax law affects most legal topics, and such intuition should at least give students working in other areas of the law an idea of when it is time to ask questions concerning lurking tax issues.

In some areas, I have relied heavily on the CALI drills by Professor James Edward Maule (Villanova University). These drills both review and, in some instances, teach a little substance. Each zeroes in on a specific topic and should take a student about twenty minutes to complete if she has adequately prepared to do the drill. Of course, students can work through such drills at their own speed.

I have tried to make this text very readable – so that students can easily understand. I have aimed at law students who "know" they have no interest in income tax – but who may find that they in fact have a considerable interest in tax law. With my political science background, I was such a student. I am proof that one does not have to have an accounting background to find income tax law both important and interesting. Additionally, Magdalene Smith and Jay Clifton III were two such students; they assisted me greatly in making this text as accessible as possible to all law students. I thank them now for their work.

WPK

Memphis, Tennessee, July 2013

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Chapter 1: The Government Raises Money: Introduction to Some Basic Concepts of Taxes and Taxing Income

I. Introduction to Some Basic Concepts

The word is out: the United States Government needs money in order to operate. The vast majority of us do want the government to operate and to continue to provide benefits to us. There are many ways in which the Government may endeavor to raise money, only one of which is to tax its own citizens on their income. A few examples follow:

Tariffs: The Government might impose tariffs (i.e., taxes) on imports or exports. In order to sell their wares in the United States, foreign merchants at one time had to pay very high tariffs. Tariffs would of course protect domestic producers of the same wares who did not have to pay such tariffs. However, this hardly helps domestic *consumers* of products subject to a tariff because they must either pay an artificially inflated price for an import or a higher price for a (lower-quality?) domestic product. Export duties could also have a pernicious effect. They encourage domestic producers to endeavor to sell their goods at home, rather than in foreign markets where they might have made more profits. Export tariffs also discourage imports of perhaps more efficiently produced (and therefore more inexpensive) foreign imports. And notice: the use of tariffs as a means of raising revenue creates a cost that mostly the buyers and sellers of those products alone pay. The burden of paying for Government is not spread very evenly if tariffs are the means of raising revenue to support the Government. Nevertheless, tariffs were one very important source of revenue for our country in its early days. This is not nearly so true any longer.

Government Monopoly: The Government might choose to enter a business and perhaps make competition in that business unlawful. Lotteries were illegal in most places until some wag discovered that the state could make a lot of money by engaging in the business of running lotteries and giving itself a monopoly over the business. Nowadays, most states have lotteries that they run with no competition other than what they are willing to tolerate, e.g., low-stakes bingo games that charities operate. One argument favoring this means of financing government is that there is no compulsion to buy lottery tickets, i.e., willing buyers contribute to the Government coffers. States may also become quite adept at making customers feel good about buying lottery tickets because the state is able to do so much good with the money it raises. Again, the burden of paying for what lottery proceeds purchase falls only on the consumers of lottery tickets. Many non-purchasers derive benefits from lottery proceeds at the expense of those willing to give up some of their wealth in the forlorn hope of hitting it big. Also, governments may engage in businesses other than lotteries. For example, many states own the liquor stores that operate within its borders. Governments may charge for services that they provide with a view to making profits that are spent in pursuit of other government objectives. There is always the risk that the Government might not be very good at running a particular business. Government-operated airlines are notorious money-losers. And again, why should consumers of certain products or services be saddled with the burden of paying for a government that (should) benefit(s) all of us?

Taxing Citizens: Instead of trying to raise money from those willing to give it to the Government, Government may tax its citizens or residents – and perhaps try to tax non-citizens or non-residents. This raises the question of what it is government should tax – or more formally, what should be the "tax base." There are various possibilities.

The Head Tax: A head tax is a tax imposed on everyone who is subject to it, e.g., every citizen or resident, every voter. The tax is equal in amount for all who must pay it. A head tax has the advantage that it is only avoidable at a cost unacceptable to most (but not all) of us: leave the country, renounce one's U.S. citizenship, surrender the right to vote. Its relative inescapability assures that all who derive some benefit from the existence of a government bear its cost burden. A head tax of course has many drawbacks. Obviously, its burden falls unequally on those subject to it. Some persons might hardly notice a head tax of $1000 per year while others might find it to be a nearly insurmountable hardship. Surely we as a society have a better sense of fairness than that. With one notable exception, we hear very little of involuntary head taxes in the United States.

The notable exception was the poll tax whereby some southern states in the post-Civil War era imposed a uniform tax, payment of which was necessary in order to vote. The very purpose of imposing such a tax was to discourage recently emancipated and almost uniformly poor Black persons from asserting their constitutional right to vote. The unfairness of the relative tax burdens associated with this cost of voting led to adoption of the 24th Amendment to the Constitution, which made poll taxes unconstitutional.

Consumption Taxes: As the name implies, consumption taxes tax consumption. There are different variants of consumption taxes. Three important consumption taxes are the sales tax, the excise tax, and the value added tax (VAT).

> *Sales Tax*: A sales tax is a tax on sales and are usually a flat percentage of the amount of the purchase. Sellers usually collect sales taxes at the point of sale from the ultimate consumer. Many states and localities rely on a sales tax for a substantial portion of their revenue needs. Sales taxes are relatively easy to collect. By their very nature, sales taxes are not collected on amounts that citizens or residents save. Hence, their effect is more burdensome to those persons who must spend more (even all) of their income to purchase items subject to a sales tax. While such taxes are nominally an equal percentage of all purchases, their *effect* is *regressive* (*infra*) for those who accumulate no wealth and who spend all of their income on items subject to them.
>
> In states that have sales taxes applicable to all purchases, every citizen or resident who buys anything pays some sales tax. In this sense, citizen/beneficiaries may more equitably share the burden of paying for state or local government than is the case of the financing schemes already noted.[1] The recent financial crisis has made clear that a state's revenues are vulnerable to economic downturns during which citizens or residents must

> *The Ramsey Principle*: Taxes on items for which demand is inelastic raise the most revenue for the state. *See* F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927). For our purposes, "inelastic demand" means that the quantity that buyers buy does not change (much) as prices increase or decrease. A life-saving drug might be such an item. Unfortunately, the things for which demand is inelastic are often things that poorer people must buy. Strict adherence to the Ramsey principle would create an excessive burden for those least well-off. Moreover, the burdens of such taxes would not fall evenly across those who benefit from them.

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1 Of course, state legislatures may c… t to a sales tax, or to a reduced sales ta… tax. Online purchasers from out-of-state … not (yet) subject to sales taxes. *See* Quill …

reduce their purchases. Such downturns are the very occasions when states need more funds to finance services for which their citizens stand in greater need.

Sales taxes are particularly attractive to states that perceive an ability to pass them on to non-citizens or non-residents. There is nothing quite so politically attractive as making someone who cannot vote in state elections fill the state's coffers. Tourist-destination states that persons from out-of-state visit find sales taxes attractive

Excise Taxes: An excise tax is a sales tax that applies only to certain classes of goods, e.g., luxury items. Excise taxes on luxury items may be politically popular, but those excise taxes do not raise much revenue because they are avoidable. The demand for luxury items is usually highly elastic (*see* text box, *The Ramsey Principle*). Excise taxes on high-demand (arguably) non-necessities, e.g., cellular telephones, raise much more revenue. Tourist-destination states find excise taxes on services that out-of-state visitors are more likely to purchase than residents to be attractive, e.g., renting cars, staying in hotels, visiting tourist sites.

Some states impose excise taxes on "sin" purchases, e.g., cigarettes, alcohol. The public health costs associated with activities such as smoking or drinking may be high, so states tax heavily the purchases of products that cause it to have to provide such services. Arguably, such taxes may discourage persons from making the purchase in the first place.

Value Added Tax: This tax is imposed upon every sale, not only the sale to the ultimate consumer, i.e., it is imposed at every stage of production of a product. One who pays a VAT to a seller and who later collects a VAT from a purchaser is entitled to a refund of the tax that he/she/it paid. Thus, the tax base is only a purchase's actual additions to the value of a product. Since the final consumer does not resell the product, he/she/it pays the final tax bill. Many European countries favor a VAT, often in combination with an income tax.

A Progressive Consumption Tax: As we shall see *infra* from our discussion of the Schanz-Haig-Simons concept of income, it is quite possible to collect a tax only on consumption once per year upon filing a tax return. We could simply use the information that we already collect or can easily begin collecting. We now know what an employee-taxpayer's total wages are; every taxpayer who works for an employer receives a W-2 wage statement. If a taxpayer saves a portion of his/her earnings, the saving or investment institution could report resulting increases to a taxpayer's total savings or investment. Similarly, such institutions could report the total amount of a taxpayer's withdrawals from savings or investments. A taxpayer's total consumption for the year would be his/her/its income minus increases to savings or investment plus withdrawals from savings or investment. Importantly, the tax on such consumption could be made *progressive*, i.e., the rate of tax increases as the amount of a taxpayer's consumption increases (*infra*).

Wealth Taxes: We could tax wealth. There are at least two common forms of wealth taxes: estate taxes and property taxes. The estate tax is imposed on the estates of decedents and the amount of the tax depends on the size of the estate. Property taxes are imposed on taxpayers because they own property. Municipalities often rely on property taxes to raise the revenues they need. Notice that in the case of property taxes, the taxing authority can tax the same "wealth" again and again, e.g., every year. This is quite unlike an income tax, *infra*. The burden of wealth taxes falls upon those who hold wealth in the form subject to tax. Both persons subject to the tax and those not subject to the wealth tax may reap its benefits.

Wage Taxes: We could tax wages by a flat percentage irrespective of how much those wages are. This is sometimes called a "payroll" tax. Some states rely on a payroll tax. It is cheaper to administer than an income tax because there are few deductions or exclusions from the tax base – at least there are few that are not also deducted or excluded from the tax base of the income tax. Social security taxes and Medicare taxes are wage taxes. The tax base of the Social Security tax (6.2%[2] on both employer and employee) is limited to an indexed amount, about the first $100,000 of wage income. The ceiling on the tax base of the Social Security tax of course creates a *regressive* effect (*infra*), i.e., those with incomes higher than the ceiling pay an effective rate that is lower than the effective rate that those whose income is below the ceiling must pay. The tax base of the Medicare tax (1.45% on both employer and employee) is not subject to a limit. These programs mainly benefit senior citizens – and both are funded by a flat tax on wages of those currently working. The flat tax on all wages of low- to middle-

[2] For tax years 2011 and 2012, the employee portion of this tax is temporarily reduced to 4.2%.

income persons (combined 7.65% plus a like amount paid by employers) assures that many workers pay more in these flat taxes than they do in progressive income taxes. This point makes the burden of paying federal taxes of whatever type much less progressive than the brackets established by § 1 of the Internal Revenue Code imply.[3]

Income Tax: And of course we could tax income. We recognize that this is what the United States does. In the pages ahead, we describe just what we mean by "income," i.e., the tax base. It might not be what you expect. We also describe the adjustments (i.e., reductions that are called "deductions") we make to the tax base and the reasons for these adjustments. An income tax is difficult to avoid: a citizen or resident must have no income in order not to be subject to an income tax.[4] Thus the burden of income taxes should be spread more evenly over those who derive benefits from government activities.

II. Taxing Income

The United States taxes the income of its citizens and permanent residents. This personal income tax accounts for about 50% of the United States Government's revenues.[5] The Government's reliance on the personal income tax as a source of revenue has increased, and the proportion of its revenue from other taxes such as the corporate income tax or the estate and gift taxes has contracted. These facts alone provide some reason for law students to study the law of individual income tax.

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[3] *See* William P. Kratzke, *The Imbalance of Externalities in Employment-Based Exclusions from Gross Income*, 60 THE TAX LAWYER 1, 3-8 (2006) (noting that employment taxes reach even income that the income tax would not reach because of the standard deduction and personal exemptions applicable to the latter).

[4] The federal income tax applies to the worldwide income of citizens and permanent residents of the United States.

[5] This figure is derived from the accompanying table, *SOI Tax Stats at a Glance*. The portion of total tax revenues derived from corporate income taxes is 11.9%, from employment taxes (Social Security and Medicare) 35.3%, from excise taxes 2%, from gift taxes 0.1%, and from estate taxes 0.7%. Do these percentages surprise you?

Multiple-Choice: In any law practice, there will be times when you can
A. Practice a little tax law.
B. Malpractice a little tax law.
There is no option C.

•Consider: P was injured in an automobile accident. P sued D for damages, prevailed, and collected damages. Tax consequences? Does it make any difference if P recovers only for her emotional distress? Does it make any difference if P recovers because her employer discriminated on the basis of sex?
•Consider: S is a law student. Her university awarded her a full tuition scholarship. Any tax issues?
•Consider: H and W are divorcing. They will divide their property (including their investments), arrange for alimony, and arrange for child support. Any tax issues?
•Consider: A sells Blackacre to B for $30,000 more than A paid for it. Any tax issues? Do the tax issues change if B agrees to pay A in ten annual installments?
•Consider: A wants to save money for her pension. If she understands some tax law, can she save some money – or more directly, enlarge her pension?
•Consider: The federal government has established a program whereby homeowners who owe money on a mortgage can have the principal of their loan reduced. Any tax issues?
•Consider: E's employer permits E to purchase items that it sells for a discount. Tax consequences?
•Consider: R is an employer who mistakenly paid E, an employee, a bonus in December. After discovering the mistake, E repaid the bonus to R. Any tax issues?
•Consider: For tax purposes, how should a businessperson treat the costs of generating income? What if the businessperson purchases a machine that will generate income for at least several years into the future? What if the businessperson sells from inventory that s/he purchased?
•And so on. Do you really think that you can avoid issues such as these by ignoring them?

Beyond this, the whole of title 26 of the United States Code (the Internal Revenue Code), the title that provides the federal rules of taxation, is one of the most significant statements of policy in American law. It affects everyone with an income. It affects everyone who might die. Tax law is hardly the exclusive domain of accountants and number crunchers.[6] Tax law is also the domain of anyone who cares about such objectives as fairness, economic growth, social policy, and so on – in short, everyone. The Code defines broadly the income on which it imposes a tax. It provides exceptions to these rules for those taxpayers Congress has deemed deserving of exceptions. This legislative exemption from an otherwise universal tax implicitly states policies on many subjects.

Far more persons will be subject to the Code's rules year after year than will be tort victims or defendants, parties to a contract dispute, or

[6] Your author had a double major as a Russian Institute. His LL.M. is not in tax law. He learned income tax law the same way you are going to: by reading the Code, studying texts, and talking to people.

victims of crime – although many persons reading these lines consider those topics much more important to their legal studies and eventually their legal careers. Such persons may be right, but they might be surprised at how much the individual income tax will affect their practices for the simple reason that the individual income tax affects the lives of nearly all Americans. Federal taxation is about *money*. Those who claim that they will avoid tax issues in their practices will find that they work for and with people who *do* care about money, and they will find that avoidance of tax issues can make for some less-than-satisfied clients and colleagues.

SOI Tax Stats at a Glance

Summary of Tax Collections Before Refunds
by Type of Return, FY 2010

Gross Tax Collections
Type of Return Number of Returns(Millions of $)

Individual income tax141,166,805 1,163,688
Corporation income tax2,355,803 277,937
Employment taxes29,787,494 824,188
Excise taxes836,793 47,190
Gift tax230,007 2820
Estate tax28,700 16,931

Selected Information from Returns Filed

Corporate Returns (TY 2008)
Number filed with assets $250 million (M) or more13,942
Percent of total corporate net income reported by firms
with assets $250M or more73.5%

S Corporation Returns (TY 2008)
Number of returns4,049,944

Partnership Returns (TY 2009)
Number of returns3,168,728

Individual Returns
Top 1-percent adjusted gross income
(AGI) break (TY 2009)$343,927
Top 10-percent AGI break (TY 2009)$112,124
Bottom 10-percent AGI break (TY 2009)$6449
Median AGI (TY 2009)$32,396

Percent that claim standard deductions (TY 2009)65.7%
Percent that claim itemized deductions (TY 2009)32.5%
Percent e-filed (TY 2010) through 5/26/201181.2%
Percent using paid preparers (TY 2009)57.3%

Number of returns with AGI $1M or more (TY 2009)241,528
State with the highest number—California (TY 2009)34,889
State with the lowest number—Vermont (TY 2009)276

Number of individual refunds (TY 2009) (millions)109.4
Total Individual refund amount (TY 2009) (billions of $)$333.1
Average individual refund amount (TY 2009)$3045

Earned Income Tax Credit (TY 2009)
Number of returns with credit (millions)27.0
Amount claimed (billions of $)$59.2

III. Some Definitions

Tax Base: The tax base is what it is we tax. The tax base of the federal income tax is not all income, but rather "taxable income." "Taxable income" is "gross income" minus deductions named in § 62, minus either a standard deduction or itemized deductions, minus personal exemptions. Only the amount remaining after these subtractions is subject to federal income tax.

> *The Tax Formula*:
>
> (gross income)
> MINUS deductions named in § 62
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or itemized deductions)
> MINUS (personal exemptions)
> EQUALS (taxable income)
>
> Compute income tax liability from tables in § 1 (indexed for inflation)
> MINUS (credits against tax)
>
> **Learn this formula.**

Notice that in the accompanying box ("The Tax Formula"), there is a line. We frequently refer to this as "the line." The figure immediately beneath the line is "adjusted gross income" (AGI). In a *very* rough sense, § 62 deductions are for obligatory expenditures or for deferring income that will be subject to income tax at the time of consumption. Subtractions may be "above the line" or "below the line." Taxpayer is entitled to § 62 deductions irrespective of and in addition to itemized deductions or the standard deduction.

When a subtraction is "below the line," what happens above the line might be very relevant. The Code limits certain itemized deductions to the amount by which an expenditure exceeds a given percentage of a taxpayer's AGI. For example, a taxpayer's deduction for medical expenditures is only the amount by which such expenditures exceed 10% of a taxpayer's AGI. Congress can use such a limitation to do some customization of such deductions. A 10%-of-AGI-floor on deductibility of medical expenses provides some rough assurance that the amount of a medical expense deduction requires a common level of "pain" among high- and low-income taxpayers.

Progressive Tax Brackets, Progressive Tax Rates, or Progressive Taxation: Not all dollars have the same worth to different taxpayers. To a person whose annual taxable income is $10 million, one dollar more or less has far less value (as gain or loss) than the same dollar has to a person whose annual taxable income less is than $1000.[7] Hence, the person with $10 million of income who receives one more dollar might feel the same level of sacrifice if s/he must pay $0.90 of it in federal income tax – and so keeps only $0.10 of it – as the person with $1000 of income who receives one more dollar of income might feel if s/he must pay $0.05 of it in federal income tax and so keeps $0.95 of it. The Tax Code endeavors to require equal sacrifice by establishing progressive tax rates. Look at § 1 of the Code – preferably the latest table that the IRS has promulgated in a Revenue Procedure that adjusts tax rates for inflation. An understanding of the tax formula should lead you to conclude that the first dollars of a taxpayer's income are not taxed at all. The next dollars above that threshold – and only those dollars – are subject to a tax of 10%. The next dollars above the next threshold – and only those dollars – are subject to a tax of 15%. And so on – at rates of 25%, 28%, 33%, and 35%. Tax brackets that increase as taxable income increases are "progressive" tax brackets. The highest individual tax bracket is 35%, but no taxpayer pays 35% of his/her taxable income in federal income taxes; do you see why?

> *Progressive Rates and Income Redistribution*: An argument favoring progressive tax brackets – aside from the declining marginal utility of money – is that the effect of progressive tax brackets is to redistribute income in favor of those who have less. After all, Government has only to spend the many dollars contributed by higher-income taxpayers for the benefit of those less well-off – and there will be income redistribution. Any person who is even slightly aware of current social conditions knows that the Tax Code has not proved to be a particularly effective instrument of income redistribution. Inequality in wealth distribution is at near historically high levels. Perhaps high-income taxpayers are able to keep more of their incomes and to pay less in taxes than serious efforts at redistribution require. Perhaps Government has become, for whatever reason, reluctant to spend tax revenues on (more) programs that benefit the poor. Or perhaps both.

A *regressive tax* is one where the percentage that taxpayers pay *decreases* as their

[7] We refer to this phenomenon as the declining marginal utility of money.

income increases. A *flat tax* is one where the percentage that taxpayers pay is equal at all income levels. Some flat taxes are *regressive in effect*, e.g., a flat sales tax imposed on necessities, *infra*.

Effective tax rate: Because we have a progressive rate structure, not every dollar of taxable income is taxed at the same rate. Moreover, income derived from some sources is taxed differently than income derived from other sources. For example, an individual taxpayer's "net capital gain" (essentially long-term capital gains plus most dividends) is taxed at a lower rate than his/her ordinary income. It may be useful for policy-makers to know what certain taxpayers' "effective tax rate" is, i.e., (amount of tax)/(total income).

Marginal Tax Rate: A taxpayer's marginal tax rate is the rate at which the next (or last) dollar is taxed. Because we have a progressive rate structure, this rate will be greater than the taxpayer's effective tax rate. Among the reasons that the marginal tax rate is

The Upside Down Nature of Deductions and Exclusions: A taxpayer pays a certain marginal rate of tax on the next dollar that s/he derives in gross income. Hence, a high-income taxpayer who pays a 35% marginal tax rate gains $0.65 of additional spending power by earning one more dollar. The *higher* a taxpayer's marginal tax bracket, the *less* an additional dollar of income will net the taxpayer. The same principle works in reverse with respect to deductions. The same taxpayer might be considering contributing $1 to his/her local public radio station for which s/he would be entitled to a charitable contribution deduction. The public radio station would receive $1 of additional spending power while the taxpayer sacrifices only $0.65 of spending power. On the deduction side, the *higher* a taxpayer's marginal tax rate, the *more* an additional dollar of deduction will save the taxpayer in income tax liability. *And* the *lower* a taxpayer's marginal tax rate, the *less* an additional dollar of deduction will save the taxpayer in income tax liability. A taxpayer whose marginal rate of tax is 10% must sacrifice $0.90 of spending power in order that his/her public radio station receives $1 of additional spending power. The same principle applies to exclusions from gross income. A high-income taxpayer saves more on his/her tax bill by accepting employment benefits excluded from gross income than a low-income taxpayer, *infra*. These results might be the opposite of what policy-makers desire, i.e., they are "upside-down." The magnitude of "upside-downness" depends upon the magnitude of progressivity of tax rates. Raising tax rates on high income earners will *increase* the "upside-downness" of deductions and exclusion.

important is that it is the rate that determines the cost or value of whatever taxable-income-affecting decision a taxpayer might make, e.g., to work more, to have a spouse work outside the home, to incur a deductible expense, to accept a benefit that is excluded from his/her gross income in lieu of salary from an employer.

Tax Incidence: The incidence of a tax is the person on whom the burden of a tax falls. The phrase is used to identify occasions where the ostensible payor of a tax is able to shift the burden to another.[8] For example, a property owner may be responsible for payment of real property taxes, but their incidence may fall on the tenants of the property owner.

Exclusions from Gross Income: We (say that we) measure "gross income" by a taxpayer's "accessions to wealth." However, there are some clear accessions to wealth that Congress has declared taxpayers do not count in tallying up their taxpayer's "gross income," e.g., employer-provided health insurance (§ 106), life insurance proceeds (§ 101), interest from state or local bonds (§ 103), various employee fringe benefits (e.g., §§ 132, 129, 119). Many exclusions are employment-based.[9] Congressional exclusion of clear accessions to wealth from the tax base creates certain incentives for those able to realize such untaxed gain – *and* for those who profit from supplying the benefit (e.g., life insurance companies, (some, but not all) employers, providers of medical services[10]) in exchange for untaxed dollars.

Deductions from Taxable Income: Congress permits taxpayers who spend their money in certain prescribed ways to subtract the amount of such expenditures from their taxable income. A deduction is only available to reduce income

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8 Constitutional scholars have observed that the phrase "direct taxes" (*see* Art. I, § 9, cl. 4 of U.S. Constitution) refers to taxes whose burden cannot be transferred to another, e.g., head taxes. Implicitly, "indirect taxes" are taxes whose burden can be transferred to another, e.g., excise taxes. The point at which a transferee is not willing to pay the "indirect tax" constitutes a practical limit congressional power to increase such taxes.

9 *See* William P. Kratzke, *The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income*, 60 THE TAX LAWYER 1 (2006).

10 *See* William P. Kratzke, *Tax Subsidies, Third-Party Payments, and Cross-Subsidization: America's Distorted Health Care Markets*, 40 U. MEM. L. REV. 279, 311-12 (2009) (tax subsidized health insurance makes more money available to health care providers).

(otherwise) subject to income tax. Hence, the person who gives his/her time to work for a charity may not deduct the fmv of the time because taxpayer is not taxed on the fmv of his/her time. A taxpayer has no basis in wages that s/he never receives.[11] From a tax perspective, this is the critical difference between an exclusion from gross income and a deduction from taxable income (or from adjusted gross income).

Alternative Minimum Tax: In response to news stories about certain wealthy people who managed their financial affairs so as to pay little or nothing in federal income tax, Congress enacted the alternative minimum tax (AMT) scheme. I.R.C. §§ 55-59. The basic scheme of the AMT is to require all taxpayers to compute their "regular tax" liability and as well as their "alternative minimum tax liability." They compute their AMT liability under rules that adjust taxable income upward by eliminating or reducing the tax benefits of certain expenditures or of deriving income from certain sources. They reduce the alternative minimum taxable income by a flat standard deduction. A (nearly) flat rate of tax applies to the balance. Taxpayer must pay the greater of his/her regular tax or AMT. Congress aimed the AMT at high-income persons who did not pay as much income tax as Congress thought they should. However, the AMT income levels are not indexed for inflation, whereas the tax brackets of the regular tax are indexed for inflation. These facts have brought more upper-middle income persons into its grasp.[12]

Credits against Tax Liability: A taxpayer may be entitled to one or more credits against his/her tax liability. The Code allows such credits because taxpayer has a certain status (e.g., low-income person with (or without) children who works), because taxpayer has spent money to purchase something that Congress wants to encourage taxpayers to spend money on (e.g., childcare), or both (e.g., low-income saver's credit). The amount of the credit is some percentage of the amount spent; usually (but not always) that percentage is fixed.

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[11] There is a separate sub-section on "basis," *infra*.

[12] We will not spend any more time on the AMT. You should be aware that it exists and of its basic approach to addressing a particular (perceived) problem.

The Right Side Up Nature of Tax Credits: The effect of a tax credit equal to a certain percentage of a particular expenditure is precisely the same as a deduction for a taxpayer whose marginal tax the marginal tax bracket of a low-income taxpayer but lower than the marginal tax bracket of a high-income taxpayer. Such a credit will benefit a lower-income bracket is the same as the percentage of the expenditure allowed as a credit. Thus, if Congress wants to encourage certain expenditures *and* wants to provide a greater incentive to low-income persons than to high-income persons, it can establish the percentage of the expenditure allowed as a credit at a level higher than taxpayer more than a deduction would and a higher-income taxpayer less than a deduction would. If this is what Congress desires, the effect of a tax credit is "right side up."

Income Phaseouts: When Congress wants to reduce the income tax liability of lower-income taxpayers for having made a particular expenditure but not the income tax liability of higher income taxpayers who make the same expenditure, it may phase the benefit out as a taxpayer's income increases. For example, a Code provision might provide a deduction that is reduced by 10% for every $2000 of a taxpayer's taxable income that exceeds $150,000 of taxpayer's adjusted gross income. Congress can apply phaseouts to both credits and deductions. The precise mechanics and income levels of various phaseouts differ. Income phaseouts increase the complexity of the Code and so also increase the cost of compliance and administration. They can make it very difficult for a taxpayer to know what his/her marginal tax bracket is – as *any* change in AGI or deductions effectively changes his/her tax bracket. Income phaseouts are a tool of congressional compromise. Perhaps Congress is so willing to enact income phaseouts because there are many inexpensive computer programs that taxpayers use to perform all necessary calculations.[13]

A Word about Employment Taxes: "Employment taxes" are the social security tax and the medicare tax that we all pay on wages we receive from employers.[14] Employers pay a like amount.[15] Self-employed persons must pay the equivalent

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13 SOI Tax Statistics at a Glance notes that 57.3% of individual taxpayers pay a tax preparer. Certainly, many more purchase off-the-shelf tax preparation programs. About 78,000,000 taxpayers received assistance by calling or walking into an IRS Office or taking advantage of an IRS program.

14 26 U.S.C. § 3101(a) (for "Old-Age, Survivors, and Disability Insurance;" 6.2%); 26 U.S.C. § 3101(b) (for "Hospital Insurance;" 1.45% and 2.35% for amounts over a certain threshold).

15 26 U.S.C. § 3111(a) (for "Old-Age, Survivors, and Disability Insurance;" 6.2%); 26 U.S.C. § 3111(b) (for "Hospital Insurance;" 1.45%).

amounts as "self-employment" taxes. The Government collects approximately 35% of its tax revenues through these taxes – much more than it collects from corporate income taxes, gift taxes, estate taxes, and excise taxes combined. Eligibility to be a beneficiary of the social security program or medicare program does not turn on a person's lack of wealth or need. In essence, the federal government collects a lot of money from working people so that *all* persons – rich and poor – can benefit from these programs.

IV. Not All Income Is Taxed Alike

Any accession to wealth, no matter what its source, is (or can be) included in a taxpayer's "gross income." However, not all taxable income is taxed the same. Notably, long-term capital gains[16] (or more accurately "net capital gain") plus most dividend income of an *individual* is taxed at a lower rate than wage or salary income. Interest income derived from the bonds of state and local governments is not subject to any federal income tax. Certain other income derived from particular sources is subject to a marginal tax rate that is less than the tax rate applicable to so-called ordinary income. This encourages many taxpayers to obtain income from tax-favored sources and/or to try to change the character of income from ordinary to long-term capital gain income. The Code addresses some of these efforts.

Three Levels of Tax Law: Tax law will come at you at three levels. The emphasis on them in this course will hardly be equal. Nevertheless, you should be aware of them. They are –
(1) Statute and regulation reading, discernment of precise rules and their limits, application of these rules to specific situations;
(2) Consideration of whether Code provisions are consistent with stated policies;
(3) Consideration of the role of an income tax in our society. What does it say about us that our government raises so much of its revenue through a personal income tax? Other countries rely more heavily on other sources of revenue. A personal income tax raises a certain amount of revenue. Some countries raise less revenue and provide their citizens (rich and poor alike) fewer services. Other countries (notably Scandinavian ones) raise more revenue and provide their citizens (rich and poor alike) with more services. The United States surely falls between the extremes – although it provides middle- and high-income persons with more services and benefits than most people realize.

V. Layout of the Code

We will be studying only certain portions of the Internal Revenue Code. You should learn the basic outline of Code provisions that establish the basic

[16] That is, gain on the sale of property that a taxpayer owns for more than one year.

income tax. This will give you a good hunch of where to find the answer to particular questions. Some prominent research tools are organized according to the sections of the Code. Specifically –

§§ 1 and 11 establish rates;
§§ 21-54AA provide credits against tax liability;
§§ 55-59 establish the alternative minimum tax;
§§ 61-65 provide some key definitions concerning "gross income," "adjusted gross income," and "taxable income;"
§§ 67-68 provide rules limiting deductions;
§§ 71-90 require inclusion of specific items (or portions of them) in gross income;
§§ 101-139E state rules concerning exclusions from gross income;
§§ 141-149 establish rules governing state and local bonds whose interest is exempt from gross income;
§§ 151-153 establish rules governing personal exemptions;
§§ 161-199 establish rules governing deductions available both to individuals and corporations;
§§ 211-223 establish rules governing deductions available only to individuals;
§§ 241-249 establish rules governing deductions available only to corporations;
§§ 261-280H deny or limit deductions that *might* otherwise be available;
§§ 441-483 provide various rules of accounting, including timing of recognition of income and deductions;
§§ 1001-1021 provide rules governing the recognition of gain or loss on the disposition of property;
§§ 1031-1045 provide rules governing non-recognition of gain or loss upon the disposition of property, accompanied by a transfer and adjustment to basis;
§§ 1201-1260 provide rules for defining and calculating capital gains/losses;
§§ 1271-1288 provide rules for original issue discount.

These are (more than) the code sections that will be pertinent to this course. Obviously, there are many more code provisions that govern other transactions.

VI. Illustration of the Tax Formula:

Bill and Mary are husband and wife. They have two children, Thomas who is 14 and Stephen who is 10. Bill works as a manager for a large retailer. Last year, he earned a salary of $60,000. His employer provided the family with health insurance that cost $14,000. Mary is a schoolteacher who earned a salary of $45,000. Her employer provided her a group term life insurance policy with a death benefit of $50,000; her employer paid $250 to provide her this benefit. Their respective employers deducted employment taxes from every paycheck and paid each of them the balance. In addition to the above items, Bill and Mary own stock in a large American corporation, and that corporation paid them a dividend of $500. Bill and Mary later sold that stock for $10,000; they had paid $8000 for it several years ago. Bill and Mary have a joint bank account that paid interest of $400. Bill and Mary paid $3000 for daycare for Stephen. They also paid $3000 of interest on a student loan that Bill took out when he was in college. What is Bill and Mary's tax liability? Assume that they will file as married filing jointly.

How much are Bill's employment taxes? How much are Mary's employment taxes?

> •*Answer*: Employment taxes are 6.2%[17] for "social security" and 1.45% for "Medicare." The total is 7.65%. The tax base of employment taxes is wages.
>
> > •Bill: Bill's wages were $60,000. 7.65% of $60,000 = <u>$4590</u>.
> > •Mary: Mary's wages were $45,000. 7.65% of $45,000 = <u>$3098.25</u>.

How much is Bill and Mary's "gross income?" You should see that this is the first line of the tax formula. We need to determine what *is* and what is *not* included in "gross income." *See* §§ 61, 79, and 106.

> •*Answer*: Since Bill and Mary will file jointly, we pool their relevant income figures. Notice that the employment taxes do not reduce Bill and Mary's adjusted gross income. Thus, they must pay income taxes on at least some of the employment taxes that they have already paid.
> •"Gross income," § 61, is a topic that we take up in chapter 2. It encompasses all "accessions to wealth." However, there are some "accessions to wealth" that we do not include in a taxpayer's "gross

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[17] This has been temporarily reduced to 4.2%.

income." The Code defines these exclusions in §§101 to 139E. The Code also defines the scope of certain inclusions in §§ 71 to 90 – and implicitly excludes what is outside the scope of those inclusions.

•Bill and Mary must include the following: Bill's salary (§ 61(a)(1)) of $60,000; Mary's salary (§ 61(a)(1)) of $45,000; dividend (§ 61(a)(7)) of $500; capital gain (§ 61(a)(3)) of $2000; interest income (§ 61(a)(4)) from the bank of $400. TOTAL: <u>$107,900</u>.

•Bill and Mary do *not* include the amount that Bill's employer paid for the family's health insurance (§ 106)(a)), $14,000, or the amount that Mary's employer paid for her group term life insurance (§ 79(a)(1)), $250. Bill and Mary certainly benefitted from the <u>$14,250</u> that their employers spent on their behalf, but §§ 106 and 79 provide that they do not have to count these amounts in their "gross income."

How much is Bill and Mary's adjusted gross income (AGI)? *See* §§ 221 and 62(a)(17). *Do not adjust the § 221 phaseout by the inflation adjustment of § 221(f)*.

•Section 221 entitles Bill and Mary to deduct interest on the repayment of a student loan. While the couple paid $3000 in student loan interest, § 221(b)(1) limits the deduction to $2500.

•Section 221(b)(2) requires the computation of a phaseout – or a phasedown, in this case. Section 221(b)(2)(A) provides that the deductible amount must be reduced by an amount determined as per the rules of § 221(b)(2)(B). Section 221(a)(2)(B) establishes a ratio.

•Since Bill and Mary are married filing a joint return, § 221(a)(2)(B)(I) establishes a numerator of: $107,900 − $100,000 = $7900. Section 221(b)(2)(b)(ii) establishes a denominator of $30,000.

- •The § 221(b)(2)(B) ratio is $7900/$30,000 = 0.26333.
- •§ 221(b)(2)(B) requires that we multiply this by the amount of the deduction otherwise allowable, i.e., $2500.
- •0.2633 x $2500 = $658.33. *Reduce* the otherwise allowable deduction by that amount, i.e., $2500 − $658.33 = $1841.67.

•Section 62(a)(17) provides that this amount is *not* included in taxpayers' AGI.

•Thus: Bill and Mary's AGI = $107,900 − $1841.67 = <u>$106,058.33</u>.

How much is Bill and Mary's "taxable income"? *See* §§ 151, 63.

•*Answer*: Sections 151(a, b, and c) allow a deduction of an exemption amount for taxpayer and spouse and for dependents. Sections 151(d and

e) provide that this amount is $2000; it is subject to adjustment for inflation.

•Section 63(a and b) defines 'taxable income" as EITHER "gross income" minus allowable deductions OR AGI minus standard deduction minus deduction for personal exemptions.

•We are told of no deductions that would be "itemized," so Bill and Mary will elect to take the standard deduction. Bill and Mary may claim a total of four personal exemptions: one each for themselves and one for each of their children.

•Go to the pages for "Consumer Price Index Adjustments for 2012" that appears at the front of your Code.

•The standard deduction for taxpayers who are married and filing jointly is $11,900. The personal exemption amount is $3800. Do the math: $106,058.33 MINUS $11,900 MINUS $15,200 equals <u>$78,958.33</u> of "taxable income."

How much is Bill and Mary's income tax liability? *See* §§ 1(a and h), 1222(3 and 11).

•*Answer*: Remember, not all income is taxed alike. Long-term capital gain and many dividends are taxed at a maximum rate of 15%. § 1(h)(1)(C) and § 1(h)(11). Bill and Mary received $2000 in long-term capital gain and $500 in dividends. This portion of their taxable income will be taxed at the rate of 15%, i.e., $375.

•The tax on the balance of their taxable income will be computed using the tables at the front of your Code. $78,958.33 MINUS $2500 equals $76,458.33. Go to table 1(a). Bill and Mary's taxable income is more than $70,700 and less than $142,700. Hence their federal income tax liability on their ordinary income equals $9735 PLUS 25% of ($76,458.33 − $70,700) = $9735 + $1439.58 = $11,174.58.

•Do you see the progressiveness in the brackets?

•Total tax liability = $375 + $11,174.58 = <u>$12,989.08</u>.

Are Bill and Mary entitled to any credits? If so, what is the effect on their income tax liability? *See* §§ 21 and 24. Do not use indexed figures to determine the amount of any credit.

•*Answer*: Section 21 provides a credit of up to $3000 for the "dependent care" expenses for a "qualifying individual." Stephen is a "qualifying individual," § 21(b)(1)(A). Thomas is not a "qualifying individual," but Bill and Mary did not spend any money for Thomas's "dependent care."

The credit is 35% of the amount that Bill and Mary spent on such care that is subject to a phasedown of 1 percentage point for each $2000 of AGI that Bill and Mary have over $15,000 down to a minimum credit of 20%. § 21(a)(2). Bill and Mary may claim a tax credit for dependent care expenses of $600.

•Bill and Mary may also claim a "child tax credit" for each of their children equal to $1000. § 24(a). Both Thomas and Stephen are a "qualifying child." § 24(c)(1). While § 24 provides for a phasedown of the credit. Bill and Mary's income is less than the threshold of that phasedown. Hence, Bill and Mary may claim a "child tax credit" of $2000.

•Total tax credits = $600 + $2000 = <u>$2600</u>.

•The effect of a tax credit is to reduce taxpayers' *tax liability – not* their AGI or "taxable income." $12,614.08 minus $2600 equals <u>$10,014.08</u>.

What is Bill and Mary's effective income tax rate?

•*Answer*: Bill and Mary's federal income tax liability is $10,014.08. Their effective tax rate computed with respect to their "taxable income" is $10,014.08/78,958.33, i.e., <u>12.68%</u>.

•Notice that we could use a different income figure to determine their effective tax rate, e.g., "gross income," "gross income plus exclusions," AGI.

What is Bill and Mary's marginal tax bracket?

•*Answer*: We answer this question with another question. Bill and Mary had $78,958.33 of taxable income. After making $78,957.33, what was the tax rate that they paid on the *last dollar* that they made?

•25%. You should recognize this as the multiplier that we obtained from the tax table.

•*Question*: If Bill and Mary made a deductible contribution of $1, how much would this save them in federal income tax liability?

•25% of the amount they contributed, i.e., $0.25.

•*Question*: If the neighbors paid Bill for mowing their lawn, how much additional federal income tax liability would Bill and Mary incur?

•25% of the additional income that Bill and Mary received, i.e., $2.50.

VII. Sources of Tax Law and the Role of Courts

Think of the sources of tax law and their authoritative weight as a pyramid. As we move down the pyramid, the binding power of sources diminishes. Moreover, every source noted on the pyramid must be consistent with every source above it. Inconsistency with a higher source is a ground to challenge enforcement.

At the pinnacle of the pyramid is the *United States Constitution*. Every source of tax law below the United States must be consistent with the Constitution. Immediately below the Constitution is the *Internal Revenue Code*. Courts may construe provisions of the Code. Depending on the level of the court and the geographic area (i.e., federal circuit) subject to its rulings, those decisions are binding constructions of the Code's provisions.[18] The IRS may announce that it does or does not acquiesce in the decision of a court other than the Supreme Court.

Immediately below the Code are *regulations*

Enforcement of the Tax Laws and Court Review: The IRS, a part of the Department of the Treasury, enforces the federal tax code. It follows various procedures in examining tax returns – and we will leave that to a course on tax practice and procedure or to a tax clinic. When it is time to go to court because there is no resolution of a problem, a taxpayer has three choices:

1. Tax Court: The Tax Court is a specialized court comprised of nineteen judges. It sits in panels of three judges. There is no jury in Tax Court cases. Taxpayer does *not* have to pay the amount of tax in dispute in order to avail himself/herself of court review in Tax Court. Appeals from Tax Court are to the United States Court of Appeals for the Circuit in which the taxpayer resides.
2. Court of Claims. The Court of Claims hears cases involving claims – other than tort claims – against the United States. It sits without a jury. Taxpayer must pay the disputed tax in order to avail himself/herself of review by the Claims Court. Appeals from a decision of the Court of Claims are to the United States Court of Appeals for the Federal Circuit.
3. Federal District Court. Taxpayer may choose to pay the disputed tax and sue for a refund in the federal district court for the district in which s/he resides. Taxpayer is entitled to a jury, and this is often the driving motivation for going to federal district court. Appeals are to the United States Court of Appeals for the federal circuit of which the federal district court is a part.

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[18] *See* Marbury v Madison, 5 U.S
and interpret it). In other coun
The Code still prevails in such
persons other than parties to a pa

that the Secretary of the Treasury promulgates. These regulations are generally interpretive in nature. So long as these regulations are consistent with the Code[19] and the Constitution, they are *law*. The same subsidiary rules of court construction of the Code apply to construction of regulations.

A *revenue ruling* is a statement of what the IRS believes the law to be on a certain point and how it intends to enforce the law. Since the tax liability of a taxpayer is (generally) the business of no one but the taxpayer and the IRS,[20] this can be very valuable information. A *revenue procedure* is an IRS statement of how it intends to proceed when certain issues are presented. The IRS saves everyone the expenses of litigating such questions as whether an expenditure is "reasonable," "substantial," or "de minimis" in amount. Revenue rulings and revenue procedures are *not* law, and courts may choose to ignore them.

A *private letter ruling* is legal advice that the IRS gives to a private citizen upon request (and the fulfillment of other conditions). These rulings are binding on the IRS only with respect to the person or entity for whom the IRS has issued the letter ruling. Publication of these rulings is in a form where the party is not identifiable. While not binding on the IRS with respect to other parties, the IRS would hardly want to establish a pattern of inconsistency.

Other statements of the IRS's position can take various forms, e.g., technical advice memoranda, notices. These statements are advisory only, but remember: the source of such advice is the only entity who can act or not act on it with

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[19] In Mayo Found. for Medical Educ. and Res. v. U.S., ___ U.S. ___, ___, 131 S. Ct. 704 (2011) the Supreme Court passed upon the validity of a rule that the Treasury Department promulgated which provided that any employee normally scheduled to work 40 or more hours per week does not perform such work "incident to and for the purpose of pursuing a course of study" and so his/her employer is not exempt from paying employment taxes. In the absence of any justification, the Supreme Court would give *Chevron* deference to this Treasury Department regulation. *See id.* at ___ U.S. ___, ___, 131 S. Ct. 704, 713 (2011). Chevron, U.S.A. Inc v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984) established a two-part framework by which courts determine whether to defer to administrative rulemaking: (1) Has Congress addressed the precise question at issue? If not: (2) Is the agency rule "arbitrary or capricious in substance, or manifestly contrary to the statute." If not, then the reviewing court is to defer to the agency rule. *Id.* at 711-12.

[20] *See* Simon v. Eastern Kentucky Welfare Rights Organization, 426 U.S. 26, 40-45 (1976) (taxpayer unable to show that tax benefit given to other taxpayers caused injury to itself that any court-ordered relief would remedy).

respect to a particular taxpayer.

VIII. Some Income Tax Policy and Some Income Tax Principles

The United States has adopted an income tax code, and the discussion now zeroes in on the income tax that Congress has adopted.

Fairness and Equity: Issues of fairness as between those who must pay an income tax arise. *A reduction in one taxpayer's taxable income of course produces a reduction in that taxpayer's taxes. If the government is to raise a certain amount of money through an income tax, a reduction in one taxpayer's tax liability necessarily means that someone else's taxes must increase. This is why the reduction of some taxpayers' tax liability is a matter of concern for everyone else. The government may* ***choose*** *to discriminate in its assessment of tax liability. The policy considerations that justify reducing one taxpayer's tax liability but not another's are the essence of tax policy.*

Three Guiding Principles: This leads us to observe that there are three *norms* against which we measure income tax rules:

1. Horizontal equity: Taxpayers with the equal accessions to wealth should pay the same amount of income tax. Like taxpayers should be taxed alike. Of course, we can argue about which taxpayers are truly alike.
2. Vertical equity: Taxpayers with different accessions to wealth should not pay the same amount of income tax. Unlike taxpayers should not be taxed alike. Those with more income should pay more *and* pay a higher percentage of their income in taxes. Income tax rates should be progressive.
3. Administrative feasibility: The tax system only applies to persons who have incomes. The rules should be easy to understand and to apply – for both the taxpayer and the collection agency, the Internal Revenue Service.

The first two of these principles are corollaries, i.e., each is little more than a restatement of the other. Without taking up administrative feasibility, consider how closely we can come to defining the "income" that should be subject to an income tax so that compliance with the first two principles would require little more than establishing the progressive rates that would produce (an acceptable level of) vertical equity.[21]

IX. What Is Income?

We may think of "income" as the amount of money we receive for working at a job or for investing money that we have saved. However, if we wish to tax alike all taxpayers whose situations are alike, our notion of income must expand. Surely two workers whose wages are the same should not be regarded as like taxpayers if one of them wins $1M in the state's lottery. The difference between these two taxpayers is that one has a much greater capacity to consume (i.e., to spend) and/or to save than the other. This suggests that pursuing the policies of horizontal and vertical equity requires that we not limit the concept of "income" to the fruits of labor or investment. Rather we should treat the concept of "income" as a function of both spending and saving. Indeed:

> Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.[22]

The economist Henry Simons propounded this definition. Derivation of the same formula is also attributed to Georg von Schanz and to Robert Murray Haig. We may refer to this formula to as the Schanz-Haig-Simons formula, the Haig-Simons formula, or the SHS formula.

Consumption plus or minus increments to savings: We may accept the idea that "income" is not only money we receive as wages or salary plus return on investments (e.g., interest on a savings account) plus consumption acquired in a way not requiring the taxpayer to spend his/her/its own money. But shouldn't the definition of "income" have something to do with "work," "labor," and perhaps "return on investment?" How is it that "income" is determined not by what we *make* by but what we *save* and *spend*?

Consider this simple fact pattern. A taxpayer earns at his/her job $50,000. S/he has no other income. What are the *only* two things this taxpayer can do with that money? Answer: spend it (consumption) or save it (addition to his/her store of property rights). Consumption and additions to the store of property rights are the two elements of income in the SHS definition of income. What the SHS formula of income can incorporate quite easily are "non-traditional" forms of income such as winning a lottery or winning a sizeable addition to savings, even when one cannot spend (consume) the winnings immediately. *See Pulsifer v. Commissioner*, 64 T.C. 245 (1975) (minors whose winnings in the 1969 Irish sweepstakes were held in trust for them by an Irish court realize income in 1969, not the year in which they turn 21; economic benefit doctrine applied). Lottery winnings of course are either spent on consumption or saved. Receipt of a U.S. savings bond is an addition to a taxpayer's store of property rights.

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21 *See* Boris I. Bittker, *A "Comprehensive*
925, 934 (1967) (arguing that many of th
would be unacceptable).

22 HENRY C. SIMONS, PERSONAL INCOM

If Algebra or Economics Scare You –

The terminology of the SHS formula is not as daunting as might appear. The phrase "rights exercised in consumption" merely reflects what a taxpayer spent (or would have spent if s/he received something for which s/he did not have to pay) to purchase something. The phrase "additions to the storehouse of property rights" merely reflects a taxpayer's saving money, perhaps by depositing some of his/her income in a savings account or in a more sophisticated investment.

The SHS definition is in fact an (enormously convenient) "algebraic sum." If it is true that:

(Income) = (Consumption) + (Additions to the store of property rights)

then it is equally true that

(Income) − (Additions to the store of property right) = (Consumption).

This point is quite useful to those who (believe that they) want the government to tax consumption rather than income, perhaps because they believe that those who save rather than spend will pay less in taxes than they do under the current system. Use of the algebraic quality of this definition means that no matter what our tax base is, we would never have to bear the expense or endure the inconvenience of keeping keep track of what we individually spend on consumption. Anyone who has received a W-2 from an employer or a 1099-INT from a bank knows that we can expect an employer or a bank to provide the pertinent information about wages or savings with an acceptable degree of accuracy. We already understand that the disposition of these funds is either going to be consumption or additions to saving. From this information, the amount a taxpayer spent on consumption can easily be determined simply by manipulating the SHS formula as above. When a(n odd) question arises outside the ambit of W-2s or 1099s, e.g., whether a taxpayer should include in his/her taxable income the value of a sumptuous meal that s/he would never have purchased for himself/herself, an affirmative answer requires no more than to add that value to "Consumption" which in turn increases the algebraic sum that is "Income." Identifying a particular element of consumption, savings, or income will drive the others. Income, consumption, and savings are functions of each other.

Some Obvious or Not-so-Obvious Implications of the SHS Definition of "Income"
If we choose to tax what we spend and what we save, then in some manner we are taxing only *increments* to a taxpayer's overall well-being. Our tax code demands an annual accounting and assessment even though this can be inconvenient – and even inaccurate – for some taxpayers. What happens during the year is treated as an increment to what happened before, e.g., we added to a savings account that we already had, we consumed (only) a small portion of an asset we already own. We are not taxing *accumulated* wealth – property taxes and estate taxes do that. A concept integral to our income tax is "basis," and its function is to assure that our income tax does *not* tax accumulated wealth but only *increments* to it.

a. Taxing Income Is Taxing Consumption Plus Increments to the ***Power*** *to Consume*

Focus for now only on additions to "the store of property rights" that a taxpayer may accumulate during a relevant period and not on the consumption element of the SHS definition. By taxing increments to savings and investment, we actually tax a taxpayer's additions to his/her *unexercised power* to consume. Taxation of income is therefore the taxation of consumption and additional increments to the *power* to consume.

People save money only if they value future consumption more than current consumption *and* believe that they can spend their savings on future consumption. Imagine living in a country where inflation is so high that a single unit of the local currency now buys virtually

Three Principles to Guide Us Through Every Question of Income Tax: There are three principles (which are less than rules but close enough):
1. We tax income of a particular taxpayer once and only once.
2. There are exceptions to Principle #1, but we usually must find those exceptions explicitly defined in the Code itself.
3. If there is an exception to Principle #1, we treat the untaxed income *as if* it had been taxed and we accomplish this by making appropriate adjustments to

The Unit of Measurement of Income, Consumption, and Savings – USD: Inflation in the United States or elsewhere affects the relative value of savings held in different currencies. We measure taxable income by the currency of the United States, i.e., dollars. Similarly, we measure basis in assets by dollars. We assume that the value of a dollar does not change because of inflation. (We might alter the ranges of income subject to particular tax rates – i.e., to index – but we do not alter the number of dollars subject to income tax.) We do not adjust the amount of income subject to tax because the value of a dollar fluctuates against other of the world's currencies. Instead, we require that transactions carried out in other currencies be valued in terms of dollars at the time of the relevant income-determinant events, i.e., purchase and sale.

nothing.[23] Would you expect the savings rate in such a country to be very high? Why not? Discuss this for awhile, but ultimately your answer will be that such savings will not buy anything for consumption in the future.

The citizens of a country may manifest their lack of confidence in the future spending power of their savings by biasing their spending decisions towards current consumption or by choosing to hold their wealth in more stable but perhaps illiquid forms. After the fall of the Soviet Union, Russian citizens did not save very much money in banks but chose instead to consume (e.g., trips abroad) or to purchase items such as Sony television sets whose consumption could be spread over many years. Purchase of a Sony television set had elements of both consumption and saving. The property in which the spending power of savings was most stable after the demise of the Soviet Union was the flats that former Soviet citizens received.

b. Income, Consumption, and Value

The measure of value is what a person is willing to pay for something s/he does not have or the price at which a person is willing to sell something s/he does have. A person cannot value something more than what s/he has to give in exchange. There are no truly "priceless" things. A person should pay no more than the value s/he places on an item s/he wants or sell an item for less than the value s/he places on it.[24]

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23 The Zimbabwean dollar once fit this description.

24 A person tends to value what s/he already has more than what s/he does not have.

Taxing Only the Creation of Value? Voluntary exchanges are often essential to the creation of the income that the Internal Revenue Code subjects to income tax. Arguably, the Code should not subject to tax events that everyone understands (probably) *reduce* a taxpayer's wealth, but this is not the case. Court-ordered damages that a plaintiff deems inadequate to compensate for the loss of an unpurchased intangible (e.g., emotional tranquility) may nevertheless be subject to income tax. *See* § 104(a).

In fact, buyers try to purchase items at prices less than they value them. The excess is "buyer surplus." Sellers try to sell items at prices higher than those at which they are actually willing to sell them. The excess is "seller surplus." "Buyer surplus" plus "seller surplus" equals "cooperative surplus." The cooperative surplus that buyer and seller create may or may not be shared equally – in fact there is no way to determine with certainty how they share the surplus. Those buyers or sellers with more market power than their counterparts – perhaps they have a monopoly or a monopsony – may capture all or almost all of the cooperative surplus. Nevertheless, every voluntary transaction should increase the overall wealth of the nation, i.e., the sum of the values we all place on what we have.

We assume that taxpayers who voluntarily enter transactions know best what will increase surplus value to themselves, and that the choices each taxpayer makes concerning what to buy and what to sell are no concern of any other taxpayer. The Internal Revenue Code, insofar as it taxes income, assumes that all taxpayers make purchasing choices with income that has already been subject to tax. Indeed, § 262(a) reflects this by denying deductions to taxpayers for purchases of items for personal consumption, including expenditures for basic living expenses. The statement that an expenditure is "personal" implies a legal conclusion concerning deductibility. If the money used to purchase items for personal consumption is subject to income tax, as a matter of policy the choices of any taxpayer with respect to such purchases should be unfettered. This observation supports *not* taxing the money taxpayer spends to make purchases over which the taxpayer exercises no choice.

On the seller's side, we should not have a tax code that favors selling one type of good or service over another. Sellers should be encouraged to utilize their resources in whatever trade or business maximizes their own seller surplus, even illegal ones.[25] This is good for buyers because sellers should choose to produce those things whose sale will create buyer surplus. A seller's choice of which good or service to offer should not depend on the cost of producing or providing that good or service. A necessary implication of this is that we should tax only the *net* income of those engaged in a trade or business – not gross proceeds. Section 162 implements this policy by allowing a deduction for ordinary and necessary trade or business expenses. One engaged in a trade or business generates profits by consuming productive inputs, and the cost of those inputs should not be subject to tax. If a taxpayer's trade or business consumes productive inputs only slowly, i.e., over the course of more than a year, principles of depreciation[26] require the taxpayer to spread those costs over the longer period during which such consumption occurs. *See, e.g.*, §§ 167 and 168. Those who engage in activities that cannot create value but which really amount to a zero-sum game, e.g., gambling, should not be permitted to reduce the income on which they pay income tax to less than zero. *See* § 165(d).[27]

If the choices of buyers and sellers concerning what to buy and what to sell are matters of self-determination, then their choices should theoretically generate as much after-tax value as possible. A "neutral" tax code will tax all income alike, irrespective of how it is earned or spent. In theory, such "tax neutrality" distorts the free market the least and causes the economy to create the most value possible. We recognize (or will soon

Tax Expenditures: Congress may choose not to make citizens pay income tax on receipt of certain benefits or on purchase of certain items. For example, an employee who receives up to $10,000 from an employer for "qualified adoption expenses" may exclude that amount – as adjusted for inflation and subject to a phaseout – from his/her "gross income." § 137. A taxpayer who pays such expenses may claim a credit equal to the amount that s/he paid. § 36C. A taxpayer who benefits from either of these two provisions enjoys a reduction in the federal income tax that s/he otherwise would have paid. We can view that reduction as a government expenditure. In fact, we call it a "tax expenditure." These two tax expenditures were expected to be $0.5B in tax year 2010. CONG. RES. SERV., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS 749 (2010). The tax expenditure for employer contributions for employee health care was expected to be $105.7B. *Id.* at 6. Total tax expenditures for tax year 2010 were expected to be $1076.3B. *Id.* At 12. A government expenditure of $1.1 trillion should be a matter of some policy concern.

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25 The only exception to this principle i
substances. *See* § 280E.

26 ... or amortization or cost recovery.

27 *But see* Commissioner v. Groetzinger,
solely for his own account is engaged in a

recognize) that the tax code that the nation's policy-makers, i.e. Congress, have created is *not* neutral. Rather, we reward certain choices regarding purchase and sale by not taxing the income necessary for their purchase or by taxing less the income resulting from certain sales. Such deviations from neutrality cost the U.S. Treasury because they represent congressional choices to forego revenue and/or to increase the tax burden of other taxpayers who do not make the same purchase and sale choices. Such deviations take us into the realm of tax policy.

Deviations from neutrality can ripple through the economy. They cause over-production of some things that do not increase the nation's wealth as much as the production of other things would. We tolerate such sacrifices in overall value because we believe that there are other benefits that override such foregone value. When deviations are limited to transactions between two particular parties who can negotiate the purchase and sale of an item or benefit only from each other, e.g., employer and employee, one party may be able to capture more of the cooperative surplus for itself than it otherwise might. An employer might provide a benefit (e.g., group health insurance) to its employees, reduce employee wages by what would be the before-income-tax cost of the benefit, and pocket all of the tax savings. Such capture might be contrary to what Congress intended or anticipated.

Basis – Or Keeping Score with the Government

Section 61(a)(3) informs us that a taxpayer's "gross income" includes gains derived from dealings in property. Intuitively, we know that a gain derived from a dealing in property is the price at which a seller sells property minus the price that the seller paid for the property. In the context of an income tax, why should we subtract anything to determine what income arises from gains derived from dealing in property? "It's obvious" is not an answer. After all, in the case of a

> *The Essence of Basis*: Adjusted basis represents money that will not again be subject to income tax, usually because it is what remains after taxpayer already paid income tax on a greater sum of money. More pithily: basis is "money that has already been taxed" (and so can't be taxed again).
>
> If Congress chooses to allow a taxpayer to exclude the value of a benefit from his/her gross income, we must treat the benefit *as if taxpayer had purchased it with after-tax cash*. By doing so, we assure ourselves that the value of the benefit will not "again" be subject to tax. This means that taxpayer will include in his/her adjusted basis of any property received in such a manner the value of the benefit so excluded. If the amount excluded from gross income is not added to taxpayer's basis, it will be subject to tax upon sale of the item. *See, e.g.*, § 132(a)(2) (qualified employee discount). That is hardly an "exclusion."

property tax, the tax authorities would not care what price the owner of property paid except as evidence of its current fair market value.

Section 1001(a) instructs us how to determine the measure of gains derived from dealing in property. Subtract "adjusted basis" from the "amount realized," i.e., the amount of money and the fair market value of any property received in the transaction. Hence, a taxpayer's adjusted basis in an item is not subject to income tax. *The reason for this is that a taxpayer's adjusted basis represents savings that remain from income that has already been taxed*. The purchase of something from a taxpayer's "store of property rights," *to the extent that it is not for consumption*, represents only a change in the form in which taxpayer holds his/her wealth. It does not represent an additional increment to wealth and so does not fall within the SHS definition of "income." It should never again be subject to income tax lest we violate the first of our guiding principles by taxing the income necessary to purchase the item twice.

> *Losses and Basis*: When the Code permits the taxpayer to reduce his/her taxable income because of a loss sustained with respect to his/her property, the loss is limited to taxpayer's adjusted basis in the property – not some other measure such as the property's fair market value. Whatever loss the Code permits to reduce taxpayer's taxable income *must* also reduce his/her basis in the property. The reduction cannot take taxpayer's adjusted basis below $0. Do you see that this prevents the Code from becoming a government payment program?
>
> When taxpayer has no adjusted basis in something measurable by dollars, we treat any amount a taxpayer realized in connection with the disposition of that "something" as entirely taxable income, i.e., the result of (amount realized) minus $0. This accounts for the rule that all of the proceeds from the sale of taxpayer's blood are subject to income tax. It also makes the precise definitions of exclusions for damages received on account of personal physical injury set forth in § 104 particularly important.

Section 1012(a) tells us that a taxpayer's "basis" in something is its cost. Taxpayer will pay for the item with money that was already subject to tax upon its addition to his/her store of property rights. Section 1011(a) tells us that "adjusted basis" is basis after adjustment. Section 1016 tells us to adjust basis upwards or downwards according to whether taxpayer converts more assets from his/her store of property rights in connection with the property (§ 1016(a)(1)) or consumes a portion (§ 1016(a)(2)) of the property, i.e., improves it, or consumes some of it in connection with his/her trade or business, or in connection with his/her activity engaged in for profit (i.e., depreciation (cost recovery) or amortization). The upshot of all this is that adjusted basis represents the current score in the game between taxpayer and the Government of what wealth has already been subject to tax and so should not be subject to tax again.

Investment, Basis, Depreciation, and Adjustments to Basis. An investment in an income-producing asset represents merely a change in the form in which a taxpayer holds after-tax wealth. A change in the form in which taxpayer holds wealth is not a taxable event. We assure ourselves that the change is not taxed by assigning basis to the asset. When the investment is in an asset that will eventually but not immediately be used up in the production of other income, income-producing consumption and "de-investment" occur simultaneously. The income-producing consumption is deductible – as is all (or almost all) income-generating consumption (§ 162) – and so reduces taxable income. This expense of generating income is separately accounted for in whatever name as depreciation, amortization, or cost recovery. The accompanying de-investment requires a reduction in the adjusted basis of the income-producing asset.

SHS Accounting for Spending Savings and Borrowing Money

Another implication of the SHS conception of income is that we might have to follow the money into or out of taxpayer's store of property rights and/or his expenditures on consumption. If a taxpayer takes money from savings and spends it on instant gratification so that s/he acquires no asset in which s/he has an adjusted basis, intuitively we know that taxpayer does not have any income on which s/he must pay income tax. The SHS definition of income accounts for this by an offsetting decrease to taxpayer's store of property rights and increase in rights exercised in consumption.

Borrowing Money

So also, the taxpayer who borrows money may use the funds so borrowed either to exercise a right of consumption or to increase his/her store of property rights. In either case, SHS might provide that

Building a Stronger Economy: Not taxing loan proceeds but permitting a taxpayer to use loan proceeds to acquire basis has tremendous implications for economic growth, long ago taken for granted. However, countries where credit is scarce have low growth rates. Not taxing loan proceeds until the time of repayment decreases the cost of borrowing. Basic rule of economics: When the cost of something goes down, people buy more. When the cost of borrowing money goes down, they borrow more; they invest what they borrow (or use it to make purchases for consumption); the economy grows.

taxpayer has realized income. However, an obligation to repay accompanies any loan. *This obligation counts as a decrease in taxpayer's store of property rights*. Hence, the addition to income is precisely offset by this decrease in the value of taxpayer's store of property rights. Incidentally, the Code nowhere states that loan proceeds are not included in a taxpayer's gross income.

AND: taxpayer may use loan proceeds to purchase an item for which s/he is credited with basis, just as if s/he had paid tax on the income used to make the purchase. Doesn't this seem to violate the first principle of income taxation noted above? No. Taxpayer will repay the loan from future income that will be subject to tax. Taxpayer actually pays for his/her basis with money to be earned *and taxed* in the future. Repayment of loan *principal* is never deductible. Sometimes the cost of borrowing, i.e., interest, is deductible.

> *The Relationship Between Basis and Deductions from Taxable Income*. An important point concerning the fact that adjusted basis is income that has already been subject to tax is that deductions, i.e., reductions in taxable income allowed to the taxpayer because taxpayer spent income in some specified way, are only allowed if taxpayer has a tax basis in them. Section 170 permits a deduction of contributions made to charitable organizations. In point of fact, a charitable deduction only reduces the taxable income in which taxpayer has adjusted basis. This explains why the taxpayer may deduct the costs of transportation to get himself/herself to the place where s/he renders services to a charity, but not the value of his/her services for which the charity pays him/her nothing. Presumably taxpayer incurred the costs of transportation from after-tax income and paid no income tax on the income s/he did not receive.

In the pages ahead, we examine various topics concerning income tax. In all cases, keep in mind how they fit into the principles described in this chapter. Hopefully, the text will provide enough reminders to make this a relatively easy task.

Wrap-up Questions for Chapter 1

1. A major issue in recent presidential elections has been whether the income tax on high income earners should be increased. Can you think of any standard by which to determine the appropriate level of progressivity in the Code?

2. The more progressive the Code, the greater the "upside-downness" of

deductions. How might this be a good thing? What would be the advantage of granting tax credits instead of deductions or exclusions?

3. What are phaseouts? Why would Congress enact them? How do they affect a taxpayer's effective tax rate?

4. Taxpayer received a tax-free benefit, perhaps a gift from a company that wanted to increase its business. Why must taxpayer have a fmv basis in the item?

5. If taxpayer receives a benefit but has no choice regarding its consumption – the manager of a lighthouse must live with his family in the lighthouse – should taxpayer be taxed on the value of the benefit? Why or why not?

6.   Taxpayer owned some commercial property. Taxpayer recorded the property on its corporate books at a certain value. Over the course of several years, the value of the property fluctuated up and down. Taxpayer did not pay income tax on the increase in the property's value. Why should taxpayer not be permitted to deduct decreases in the property's value?

Chapter 2: What Is Gross Income: Section 61 and the Sixteenth Amendment

Recall the "tax formula" in chapter 1. Now we take up various elements of the formula. You should place whatever we are studying at the moment (the "trees") within that formula (the "forest"). This chapter introduces you to the concept of "gross income," the very first item in the tax formula.

You will notice that after adding up all of the items encompassed by the phrase "gross income," every succeeding arithmetical operation is a subtraction. If an item is not encompassed by the phrase "gross income," it will not be subject to federal income tax. The materials that follow consider various aspects of gross income: its definition, whether certain items that taxpayer has received constitute "gross income," the timing of "gross income," and valuation.

The Tax Formula:

➔ (gross income) ≈
<u>MINUS deductions named in § 62</u>
EQUALS (adjusted gross income (AGI))
MINUS (standard deduction or itemized deductions)
MINUS (personal exemptions)
EQUALS (taxable income)

Compute income tax liability from tables in § 1 (indexed for inflation)
MINUS (credits against tax)

No later than when we complete chapter 2, you should do the following CALI exercises by Professor James Edward Maule:

•*Basic Income Taxation: Gross Income: Realization Concepts in Gross Income*

•*Basic Income Taxation: Gross Income: Indirect Transfers for Services*

These are fairly short Lessons that you may do several times as we cover this chapter.

I. The Constitutional and Statutory Definitions of "Gross Income"

Article I of the Constitution, which grants legislative powers to the Congress, contains several provisions concerning federal taxes.

> Article I, § 2, clause 3: Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three fifths of all other Persons. The actual Enumeration shall be made within three Years after the first Meeting of the Congress of the United States, and within every subsequent Term of ten Years, in such Manner as they shall by Law direct. ...
>
> Article I, § 7, clause 1: All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.
>
> Article I, § 8, clause 1: The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States[.]
>
> Article I, § 9, clause 4: No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

The Constitution does not delegate to any other branch of the government any authority to impose taxes. In Article I, § 9, cl. 4, the Constitution refers to "direct" taxes, and restricts them to impositions upon states according to their population. The founding fathers regarded consumption taxes as "indirect taxes" and regarded them as superior to "direct taxes" in terms of fairness and for purposes of raising revenue. *See* Alexander Hamilton, FEDERALIST NO. 21.

An income tax is a "direct tax." *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, 630 (1895) (tax on income from property). Imposition of an income tax required an amendment to the Constitution. That came in 1913:

> Amendment 16: The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Read § 61(a) of the Code. Notice that it encompasses "all" income "from whatever source derived." The language of the Code tracks that of the Sixteenth Amendment, and it has been noted many times that in taxing income, Congress exercised all of the constitutional power that it has to do so. However, that point left open the question of what exactly is "income[], from whatever source derived." Taxpayers have argued many times that the "income" that Congress wants to tax is beyond the scope of "income" as the term is used in the Sixteenth Amendment. *See* Ann K. Wooster, Annot., *Application of 16th Amendment to U.S. Constitution – Taxation of Specific Types of Income*, 40 A.L.R. FED.2d 301 (2010).

We consider here two cases in which the Supreme Court undertook to provide a definition of "gross income, " the phrase that Congress used in § 61(a). In *Macomber*, notice the justices' differing views on the internal accounting of a corporation.

- What does the Court mean by "capitalization?"
- What does the Court mean by "surplus?"
- By way of review: a demurrer is a creature of code pleading and is the equivalent of a motion to dismiss for failure to state a claim. In *Macomber*, taxpayer sued for a refund. The Commissioner (Eisner) demurred. The federal district court overruled the demurrer, so taxpayer-plaintiff prevailed. The Supreme Court affirmed.

Eisner v. Macomber, 252 U.S. 189 (1919).

MR. JUSTICE PITNEY delivered the opinion of the Court.

This case presents the question whether, by virtue of the Sixteenth Amendment, Congress has the power to tax, as income of the stockholder and without apportionment, a stock dividend made lawfully and in good faith against profits accumulated by the corporation since March 1, 1913.

It arises under the Revenue Act of September 8, 1916, 39 Stat. 756 et seq., which, in our opinion (notwithstanding a contention of the government that will be noticed), plainly evinces the purpose of Congress to tax stock dividends as income.[28]

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[28] Title I. – Income Tax

The facts, in outline, are as follows:

On January 1, 1916, the Standard Oil Company of California, a corporation of that state, out of an authorized capital stock of $100,000,000, had shares of stock outstanding, par value $100 each, amounting in round figures to $50,000,000. In addition, it had surplus and undivided profits invested in plant, property, and business and required for the purposes of the corporation, amounting to about $45,000,000, of which about $20,000,000 had been earned prior to March 1, 1913, the balance thereafter. In January, 1916, in order to readjust the capitalization, the board of directors decided to issue additional shares sufficient to constitute a stock dividend of 50 percent of the outstanding stock, and to transfer from surplus account to capital stock account an amount equivalent to such issue. ...

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 percent, or 198.77 shares, par value $19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of $19,877 because of the new shares, and, an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint, she alleged the above facts and contended that, in imposing such a tax the Revenue Act of 1916 violated article 1, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment.

"Part I. – On Individuals"

"Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived, ... also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever: Provided, that the term 'dividends' as used in this title shall be held to mean any distribution made or ordered to be made by a corporation, ... out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether, in cash or in stock of the corporation, ... which stock dividend shall be considered income, to the amount of its cash value."

A general demurrer to the complaint was overruled upon the authority of *Towne v. Eisner*, 245 U. S. 418, and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

....

We are constrained to hold that the judgment of the district court must be affirmed[.] ...

....

[I]n view of the importance of the matter, and the fact that Congress in the Revenue Act of 1916 declared (39 Stat. 757) that a "stock dividend shall be considered income, to the amount of its cash value," we will deal at length with the constitutional question, incidentally testing the soundness of our previous conclusion.

The Sixteenth Amendment ... did not extend the taxing power to new subjects, but merely removed the necessity which otherwise might exist for an apportionment among the states of taxes laid on income. *Brushaber v. Union Pacific R. Co.*, 240 U. S. 1, 240 U. S. 17-19; *Stanton v. Baltic Mining Co.*, 240 U. S. 103, 240 U. S. 112 et seq.; *Peck & Co. v. Lowe*, 247 U. S. 165, 247 U. S. 172-173.

A proper regard for its genesis, as well as its very clear language, requires also that this amendment shall not be extended by loose construction, so as to repeal or modify, except as applied to income, those provisions of the Constitution that require an apportionment according to population for direct taxes upon property, real and personal. This limitation still has an appropriate and important function, and is not to be overridden by Congress or disregarded by the courts.

In order, therefore, that ... Article I of the Constitution may have proper force and effect, save only as modified by the amendment, and that the latter also may have proper effect, it becomes essential to distinguish between what is and what is not "income," as the term is there used, and to apply the distinction, as cases arise, according to truth and substance, without regard to form. Congress cannot by any definition it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.

The fundamental relation of "capital" to "income" has been much discussed by economists, the former being likened to the tree or the land, the latter to the fruit or the crop; the former depicted as a reservoir supplied from springs, the latter as the outlet stream, to be measured by its flow during a period of time. For the present purpose, we require only a clear definition of the term "income," as used in common speech, in order to determine its meaning in the amendment, and, having formed also a correct judgment as to the nature of a stock dividend, we shall find it easy to decide the matter at issue.

After examining dictionaries in common use (Bouv. L.D.; Standard Dict.; Webster's Internat. Dict.; Century Dict.), we find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (*Stratton's Independence v. Howbert*, 231 U. S. 399, 231 U. S. 415; *Doyle v. Mitchell Bros. Co.*, 247 U. S. 179, 247 U. S. 185), "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets ...

Brief as it is, it indicates the characteristic and distinguishing attribute of income essential for a correct solution of the present controversy. The government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word "gain," which was extended to include a variety of meanings; while the significance of the next three words was either overlooked or misconceived. "*Derived from capital*;" "*the gain derived from capital*," etc. Here, we have the essential matter: *not* a gain *accruing* to capital; not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value, *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being "*derived*" – that is, *received* or *drawn* by the recipient (the taxpayer) for his *separate* use, benefit and disposal – that is income derived from property. Nothing else answers the description.

The same fundamental conception is clearly set forth in the Sixteenth Amendment – "incomes, *from* whatever *source derived*" – the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.
Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into

shares to which a nominal or par value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company, he can do so only by disposing of his stock.

For bookkeeping purposes, the company acknowledges a liability in form to the stockholders equivalent to the aggregate par value of their stock, evidenced by a "capital stock account." If profits have been made and not divided, they create additional bookkeeping liabilities under the head of "profit and loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property, and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding-up of the company) does the stockholder realize a profit or gain which becomes his separate property, and thus derive income from the capital that he or his predecessor has invested.

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about $45,000,000, in addition to outstanding capital stock of $50,000,000. In this, the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division, the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or in decrease of outstanding liabilities. When only a part is available for dividends, the balance of the year's profits is carried to the credit of undivided profits, or surplus, or some other account having like significance. If thereafter the company finds itself in funds beyond current needs, it may declare dividends out of such surplus or undivided profits; otherwise it may go on for years conducting a successful business, but requiring more and more working capital because of the extension of its operations, and therefore unable to declare dividends approximating the amount of its profits. Thus, the surplus may increase until it equals or even exceeds the par value of the outstanding capital stock. This may be adjusted upon the books in the mode adopted in the case at bar – by declaring a "stock dividend." This, however, is no more than a book adjustment, in essence – not a dividend, but rather the opposite; no part of the assets of the company is separated from the common fund, nothing distributed except paper certificates that evidence an antecedent increase in the value of the stockholder's capital interest resulting from an accumulation of profits by the company, but profits so far absorbed in the business as to render it impracticable to separate them for withdrawal and distribution. In order to make the adjustment, a charge is made against surplus account with corresponding credit to capital stock account, equal to the proposed "dividend;" the new stock is issued against this and the certificates delivered to the existing stockholders in proportion to their previous holdings. This, however, is merely bookkeeping that does not affect the aggregate assets of the corporation or its outstanding liabilities; it affects only the form, not the essence, of the "liability" acknowledged by the corporation to its own shareholders, and this through a readjustment of accounts on one side of the balance sheet only, increasing "capital stock" at the expense of "surplus"; it does not alter the preexisting proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

A “stock dividend” shows that the company’s accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company’s assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

....

We are clear that not only does a stock dividend really take nothing from the property of the corporation and add nothing to that of the shareholder, but that the antecedent accumulation of profits evidenced thereby, while indicating that the shareholder is the richer because of an increase of his capital, at the same time shows he has not realized or received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in the stock dividend, and so he may, if he can find a buyer. It is equally true that, if he does sell, and in doing so realizes a profit, such profit, like any other, is income, and, so far as it may have arisen since the Sixteenth Amendment, is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock, he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company likewise is diminished. Thus, if one holding $60,000 out of a total $100,000 of the capital stock of a corporation should receive in common with other stockholders a 50 percent stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having sixfifteenths instead of six-tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock, it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock and a like diminution of the seller's comparative voting power – that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that, in the nature of things, it requires conversion of capital in order to pay the tax.

....

Conceding that the mere issue of a stock dividend makes the recipient no richer than before, the government nevertheless contends that the new certificates measure the extent to which the gains accumulated by the corporation have made him the richer. There are two insuperable difficulties with this. In the first place, it would depend upon how long he had held the stock whether the stock dividend indicated the extent to which he had been enriched by the operations of the company; unless he had held it throughout such operations, the measure would not hold true. Secondly, and more important for present purposes, enrichment through increase in value of capital investment is not income in any proper meaning of the term.

....

It is said there is no difference in principle between a simple stock dividend and a case where stockholders use money received as cash dividends to purchase additional stock contemporaneously issued by the corporation. But an actual cash dividend, with a real option to the stockholder either to keep the money for his own or to reinvest it in new shares, would be as far removed as possible from a true stock dividend, such as the one we have under consideration, where nothing of value is taken from the company's assets and transferred to the individual ownership of the several stockholders and thereby subjected to their disposal.

....

Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the Sixteenth Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the accumulated profits behind it, as income of the stockholder. The Revenue Act of 1916, insofar as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of Article I, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the Sixteenth Amendment.

Judgment affirmed.

Mr. Justice Holmes, dissenting. [omitted]

MR. JUSTICE BRANDEIS delivered the following opinion, in which MR. JUSTICE CLARKE concurred.

Financiers, with the aid of lawyers, devised long ago two different methods by which a corporation can, without increasing its indebtedness, keep for corporate purposes accumulated profits, and yet, in effect, distribute these profits among its stockholders. One method is a simple one. The capital stock is increased; the new stock is paid up with the accumulated profits, and the new shares of paid-up stock are then distributed among the stockholders pro rata as a dividend. If the stockholder prefers ready money to increasing his holding of the stock in the company, he sells the new stock received as a dividend. The other method is slightly more complicated. Arrangements are made for an increase of stock to be offered to stockholders pro rata at par, and at the same time for the payment of a cash dividend equal to the amount which the stockholder will be required to pay to the company, if he avails himself of the right to subscribe for his pro rata of the new stock. If the stockholder takes the new stock, as is expected, he may endorse the dividend check received to the corporation, and thus pay for the new stock. In order to ensure that all the new stock so offered will be taken, the price at which it is offered is fixed far below what it is believed will be its market value. If the stockholder prefers ready money to an increase of his holdings of stock, he may sell his right to take new stock pro rata, which is evidenced by an assignable instrument. In that event the purchaser of the rights repays to the corporation, as the subscription price of the new stock, an amount equal to that which it had paid as a cash dividend to the stockholder.

Both of these methods of retaining accumulated profits while in effect distributing them as a dividend had been in common use in the United States for many years prior to the adoption of the Sixteenth Amendment. They were recognized equivalents. ...

....

It thus appears that, among financiers and investors, the distribution of the stock, by whichever method effected, is called a stock dividend; that the two methods by which accumulated profits are legally retained for corporate purposes and at the same time distributed as dividends are recognized by them to be equivalents, and that the financial results to the corporation and to the stockholders of the two methods are substantially the same, unless a difference results from the application of the federal income tax law.

....

It is conceded that, if the stock dividend paid to Mrs. Macomber had been made by the more complicated method [of] issuing rights to take new stock pro rata and paying to each stockholder simultaneously a dividend in cash sufficient in amount to enable him to pay for this pro rata of new stock to be purchased – the dividend so paid to him would have been taxable as income, whether he retained the cash or whether he returned it to the corporation in payment for his pro rata of new stock. But it is contended that, because the simple method was adopted of having the new stock issued direct to the stockholders as paid-up stock, the new stock is not to be deemed income, whether she retained it or converted it into cash by sale. If such a different result can flow merely from the difference in the method pursued, it must be because Congress is without power to tax as income of the stockholder either the stock received under the latter method or the proceeds of its sale, for Congress has, by the provisions in the Revenue Act of 1916, expressly declared its purpose to make stock dividends, by whichever method paid, taxable as income.

....

... Is there anything in the phraseology of the Sixteenth Amendment or in the nature of corporate dividends which should lead to a [conclusion] ... that Congress is powerless to prevent a result so extraordinary as that here contended for by the stockholder?

First. The term "income," when applied to the investment of the stockholder in a corporation, had, before the adoption of the Sixteenth Amendment, been commonly understood to mean the returns from time to time received by the stockholder from gains or earnings of the corporation. A dividend received by a stockholder from a corporation may be either in distribution of capital assets or in distribution of profits. Whether it is the one or the other is in no way affected by the medium in which it is paid, nor by the method or means through which the particular thing distributed as a dividend was procured. If the dividend is declared payable in cash, the money with which to pay it is ordinarily taken from surplus cash in the treasury. ...

... [W]hether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management whether the distribution shall be, for instance, in bonds, scrip or stock of another corporation or in issues of its own. And if the dividend is paid in its own issues, why should there be a difference in result dependent upon whether the distribution was made from such securities then in the treasury or from others to be created and issued by the company expressly for that purpose? So far as the distribution may be made from its own issues of bonds, or preferred stock created expressly for the purpose, it clearly would make no difference, in the decision of the question whether the dividend was a distribution of profits, that the securities had to be created expressly for the purpose of distribution. If a dividend paid in securities of that nature represents a distribution of profits, Congress may, of course, tax it as income of the stockholder. Is the result different where the security distributed is common stock?

....

Second. It has been said that a dividend payable in bonds or preferred stock created for the purpose of distributing profits may be income and taxable as such, but that the case is different where the distribution is in common stock created for that purpose. Various reasons are assigned for making this distinction. One is that the proportion of the stockholder's ownership to the aggregate number of the shares of the company is not changed by the distribution. But that is equally true where the dividend is paid in its bonds or in its preferred stock. Furthermore, neither maintenance nor change in the proportionate ownership of a stockholder in a corporation has any bearing upon the question here involved. Another reason assigned is that the value of the old stock held is reduced approximately by the value of the new stock received, so that the stockholder, after receipt of the stock dividend, has no more than he had before it was paid. That is equally true whether the dividend be paid in cash or in other property – for instance, bonds, scrip, or preferred stock of the company. The payment from profits of a large cash dividend, and even a small one, customarily lowers the then market value of stock because the undivided property represented by each share has been correspondingly reduced. The argument which appears to be most strongly urged for the stockholders is that, when a stock dividend is made, no portion of the assets of the company is thereby segregated for the stockholder. But does the issue of new bonds or of preferred stock created for use as a dividend result in any segregation of assets for the stockholder? In each case, he receives a piece of paper which entitles him to certain rights in the undivided property. Clearly, segregation of assets in a physical sense is not an essential of income. The year's gains of a partner is [sic] taxable as income although there, likewise, no segregation of his share in the gains from that of his partners is had.

....

Third. The government urges that it would have been within the power of Congress to have taxed as income of the stockholder his pro rata share of undistributed profits earned even if no stock dividend representing it had been paid. Strong reasons may be assigned for such a view. [citation omitted]. The undivided share of a partner in the year's undistributed profits of his firm is taxable as income of the partner although the share in the gain is not evidenced by any action taken by the firm. Why may not the stockholder's interest in the gains of the company? The law finds no difficulty in disregarding the corporate fiction whenever that is deemed necessary to attain a just result. [citations omitted]. The stockholder's interest in the property of the corporation differs not fundamentally, but in form only, from the interest of a partner in the property of the firm. There is much authority for the proposition that, under our law, a partnership or joint stock company is just as distinct and palpable an entity in the idea of the law, as distinguished from the individuals composing it, as is a corporation. No reason appears, why Congress, in legislating under a grant of power so comprehensive as that authorizing the levy of an income tax, should be limited by the particular view of the relation of the stockholder to the corporation and its property which may, in the absence of legislation, have been taken by this Court. But we have no occasion to decide the question whether Congress might have taxed to the stockholder his undivided share of the corporation's earnings. For Congress has in this act limited the income tax to that share of the stockholder in the earnings which is, in effect, distributed by means of the stock dividend paid. In other words, to render the stockholder taxable, there must be both earnings made and a dividend paid. Neither earnings without dividend nor a dividend without earnings subjects the stockholder to taxation under the Revenue Act of 1916.

Fourth. ...

Fifth. ...

....

Sixth. If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends, they will pay these taxes not upon their income, but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is inconceivable. Our sole duty is to ascertain their intent as therein expressed. In terse, comprehensive language befitting the Constitution, they empowered Congress "to lay and collect taxes on incomes from whatever source derived." They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded not only by the plain people, but by investors and financiers and by most of the courts of the country, is shown beyond peradventure by their acts and by their utterances. It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits taxable as income whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. ...

Notes and questions:

1. In *Macomber*, consider the different views of the excerpted opinions of a

Capital and Surplus: The opinions in this case provide a primer on corporation law. A corporation's shareholders are its owners. They pay money (or transfer other property) to the corporation to purchase shares that represent ownership of the corporation's productive *capital*. Once the corporation begins to operate, it earns *profits*. The corporation might choose not to retain these profits but rather to distribute them profits to its shareholders as dividends. Alternatively, the corporation might not distribute the profits. Instead, it might hold the profits for later distribution and/or use the profits to acquire still more productive capital assets. Corporation law required that the "capital stock account" and the "surplus account" be separately accounted for.
•Sections 301 and 316 still implement this scheme. Dividends are taxable as income to a shareholder only if a corporation pays them from its "earnings and profits."

corporation. Recall that under the SHS definition of income, an *addition* to an investment is taxable income, but a mere *change in the form* in which wealth is held is not a taxable event. Consider how the two opinions implicitly[29] handle these points. Is one view better than the other? Why?

2. If ten shareholders each contribute \$100,000 upon the formation of a corporation so that the corporation's paid-in capital is \$1M and two years later the fair market value (fmv) of the corporation's assets has not changed but the corporation has accumulated undistributed profits of \$200,000, what would be the fmv of each shareholder's shares?

> •Is it even possible to avoid merging the capital and profits accounts of a corporation when considering whether a shareholder has enjoyed an increment to his/her consumption rights?
> •Should each shareholder pay income tax on a share's increased fmv if the corporation does not distribute the profits?

3. Does the concept of realization determine when taxpayer may spend an increment to his/her consumption rights on consumption as s/he sees fit? If the corporation will not pay out undistributed profits, why can't the shareholder simply borrow against his/her share of the undistributed profits? The interest taxpayer must pay is simply the (nominal?) cost of spending money that s/he "owns" but is not entitled to receive.

4. What exactly is the holding of the majority with respect to the meaning of "income" under the Sixteenth Amendment? Which of the following are critical?

> •That shareholder did not "realize" any income and that without realization, there is no "income?"
> •That shareholder did not receive any property for his/her use and benefit and that in the absence of such receipt, there is no

Substance and Form: The argument of Justice Brandeis that two methods that accomplish the same thing should bear the same tax consequences – i.e., that substance should prevail over form – applies on many occasions in tax law. However, tax law does *not* treat the two methods he describes in the first paragraph of his opinion by which a corporation can in effect distribute its accumulated profits without increasing its indebtedness as "equivalent." §§ 305(a), 305(b)(1).
•Moreover, the law of corporate tax does *not* treat equity interests (stock) and creditor interests (debt) as equivalent – and so treats distributions of stock and debt differently.

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29 There was no SHS definition of "incom

"income?"

•That a corporation's undistributed accumulations do not constitute "income" to a shareholder?

•That if the corporation does not segregate particular assets for the shareholder, there is no "income?"

•That shareholder's receipt of shares did not alter his/her underlying interest in the corporation or make him/her richer, so the receipt of such shares is not "income" within the Sixteenth Amendment?

5. This case is often said to stand for the proposition that "income" within the Sixteenth Amendment must be "realized?" True?

> *The Corporation as Separate Entity*: The most important point of any dissent is that it is a dissent. Notice that Justice Brandeis would tax shareholders in the same manner that partners in a partnership are taxed on undistributed earnings. His view did not prevail. This fact firmly established the identity of a corporation as separate from its shareholders – unlike a partnership and its partners.

6. Justice Brandeis's parade of horribles has come to pass. We tax dividends differently depending on how they are distributed. § 305. We tax partners on undistributed income but not corporate shareholders. Corporations *do* hold onto income so that shareholders do not have to pay income tax. The Republic has survived.

7. Is a stock dividend an increment to taxpayer's store of rights of consumption? We tax all income once. When (and how) is a stock dividend taxed?

8. Income is taxed only once. "Basis" is money that will not again be subject to income tax, *usually* because it has already been subject to tax. Thus, basis is the means by which we keep score with the government. Mrs. Macomber owned 2200 shares of Standard Oil. Let's say that she paid $220,000 for these shares, i.e., $100/share. After receiving the stock dividend, she owned 3300 shares.

•What should be her basis in both the original 2200 shares and the 1100 dividend shares?

•Suppose Justice Brandeis's view had prevailed. What should be her basis in the original 2200 shares and in the 1100 dividend shares?

•Justice Brandeis acknowledged that he would tax corporate shareholders in the same manner as partners in a partnership are taxed.

•How do you think partners are taxed on undistributed partnership profits?
•How should that change a partner's basis in his/her partnership interest?
•What should happen to the partner's basis in his/her partnership interest if s/he later withdraws cash or property from the partnership?

Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955)

Mr. Chief Justice WARREN delivered the opinion of the Court.

This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. … The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income under [§ 61] of the Internal Revenue Code. [footnote omitted] In a single opinion, 211 F.2d 928, the Court of Appeals [for the Third Circuit] affirmed the Tax Court's separate rulings in favor of the taxpayers. [citation omitted] Because of the frequent recurrence of the question and differing interpretations by the lower courts of this Court's decisions bearing upon the problem, we granted the Commissioner of the Internal Revenue's ensuing petition for certiorari. [citation omitted]

The facts of the cases were largely stipulated and are not in dispute. So far as pertinent they are as follows:

Commissioner v. Glenshaw Glass Co. – The Glenshaw Glass Company, a Pennsylvania corporation, manufactures glass bottles and containers. It was engaged in protracted litigation with the Hartford-Empire Company, which manufactures machinery of a character used by Glenshaw. Among the claims advanced by Glenshaw were demands for exemplary damages for fraud [footnote omitted] and treble damages for injury to its business by reason of Hartford's violation of the federal antitrust laws. [footnote omitted] In December, 1947, the parties concluded a settlement of all pending litigation, by which Hartford paid Glenshaw approximately $800,000. Through a method of allocation which was approved by the Tax Court, [citation omitted], and which is no longer in issue, it was ultimately determined that, of the total settlement, $324, 529.94 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income for the tax year involved. The Commissioner determined a deficiency claiming as taxable the entire sum less only deductible legal fees. …

Commissioner v. William Goldman Theatres, Inc. – William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew's, Inc., alleging a violation of the federal antitrust laws and seeking treble damages. … It was found that Goldman has suffered a loss of profits equal to $125,000 and was entitled to treble damages in the sum of $375,000. … Goldman reported only $125,000 of the recovery as gross income and claimed that the $250,000 balance constituted punitive damages and as such was not taxable. …

It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by § [61](a)?

The sweeping scope of the controverted statute is readily apparent: …
This Court has frequently stated that this language was used by Congress to exert in this field 'the full measure of its taxing power.' [citations omitted] Respondents contend that punitive damages, characterized as 'windfalls' flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. [citations omitted] … [Our] decisions demonstrate that we cannot but ascribe content to the catchall provision of [§ 61(a)], 'gains or profits and income derived from any source whatever.' The importance of that phrase has been too frequently recognized since its first appearance in the Revenue Act of 1913 [footnote omitted] to say now that it adds nothing to the meaning of 'gross income.'

Nor can we accept respondents' contention that a narrower reading of [§ 61(a)] is required by the Court's characterization of income in *Eisner v. Macomber*, 252 U.S. 189, 207, as "the gain derived from capital, from labor, or from both combined." [footnote omitted] … In that context – distinguishing gain from capital – the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions. [citations omitted]

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

….

Reversed.
Mr. Justice DOUGLAS dissents. ...

Notes and Questions:

1. Taxpayers acknowledged that Congress could constitutionally impose a tax on punitive damages. Interestingly, the Supreme Court has indeed observed many times that Congress exercised all of the power granted it by the Sixteenth Amendment. How much room does this really leave for a taxpayer to argue that Congress *could* tax windfalls but had not?

2. Memorize the elements of "gross income" stated in the first sentence of the last paragraph of the case. You'll have to do this eventually, so save some time and do it now.

3. SHS holds that income includes all rights exercised in consumption plus changes in a taxpayer's wealth. Does the phrase "accessions to wealth" encompass more or less than that?

4. Is the receipt of any accession to wealth, e.g., receiving exemplary damages, what most people think of as "income?" If not, what objectives does the Tax Code implicitly pursue by including all accessions to wealth in a taxpayer's taxable income?

5. The following case provides a good primer (review) of Congress's constitutional power to tax, a matter of considerable importance in today's health care debate.

Murphy v. Internal Revenue Service, 493 F.3d 170 (CADC 2007), *cert. denied*, 553 U.S. 1004 (2008).

On Rehearing
GINSBURG, Chief Judge:

....

I. Background

[After successfully complaining to the Department of Labor that her employer had blacklisted her in violation of various whistle-blower statutes, the Secretary of Labor ordered Marrita Murphy's former employer to remove any adverse references about Murphy from the files of the Office of Personnel Management and remanded the case to determine compensatory damages. On remand, a psychologist testified that Murphy suffered both "somatic" and "emotional" injuries along with other "physical manifestations of stress, i.e., anxiety attacks, shortness of breath and dizziness. Also, Murphy's medical records revealed she suffered from bruxism (teeth grinding), a condition often associated with stress that can cause permanent tooth damage. The Administrative Law Judge (ALJ) recommended $70,000 in compensatory damages: $45,000 for past and future emotional distress, and $25,000 for damage to Murphy's vocational reputation. The Department of Labor Administrative Review Board (Board) affirmed the ALJ's recommendation. Murphy included the $70,000 in her gross income, but later filed an amended return claiming that she was entitled to a refund because I.R.C. § 104(a)(2) excluded the $70,000 from her gross income. Murphy provided medical records documenting her physical injury and physical sickness. The IRS concluded that Murphy failed to prove that the compensation damages were attributable to "physical injury" or "physical sickness" and that I.R.C. § 104(a)(2) applied to her case. Hence, it rejected her claim for a refund. Murphy sued the IRS and the United States in federal district court.

Murphy argued: (1) I.R.C. § 104(a)(2) excluded the compensatory damages from her gross income because the award was for "physical personal injuries;" (2) taxing her award is unconstitutional because her damages were not "income" within the meaning of the Sixteenth Amendment. The district court rejected all of Murphy's claims, and granted summary judgment for the IRS and the Government. Murphy appealed. On appeal, the court, 460 F.3d 79 (CADC 2006), reversed the district court's decision, concluding that I.R.C. § 104(a)(2) did not exclude Murphy's award from her gross income, but that her award was not "income" within the Sixteenth Amendment. The Government petitioned for a rehearing and argued that even if Murphy's award was not "income" within the Sixteenth Amendment, there was no "constitutional impediment" to taxing Murphy's award because a tax on such an award is not a direct tax and the tax is imposed uniformly. On rehearing, the court held that Murphy could not sue the IRS but could sue the United States.]

... In the present opinion, we affirm the judgment of the district court based upon the newly argued ground that Murphy's award, even if it is not income within the meaning of the Sixteenth Amendment, is within the reach of the congressional power to tax under Article I, Section 8 of the Constitution.

II. Analysis

....

B. Section 104(a)(2) of the IRC

Section 104(a) ("Compensation for injuries or sickness") provides that "gross income [under § 61 of the IRC] does not include the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." 26 U.S.C. § 104(a)(2). Since 1996 it has further provided that, for purposes of this exclusion, "emotional distress shall not be treated as a physical injury or physical sickness." *Id.* § 104(a). The version of § 104(a)(2) in effect prior to 1996 had excluded from gross income monies received in compensation for "personal injuries or sickness," which included both physical and nonphysical injuries such as emotional distress. *Id.* § 104(a)(2) (1995); [citation omitted]. ...

....

Murphy ... contends that neither § 104 of the IRC nor the regulation issued thereunder "limits the physical disability exclusion to a physical stimulus." In fact, as Murphy points out, the applicable regulation, which provides that § 104(a)(2) "excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness," 26 C.F.R. § 1.104-1(c), does not distinguish between physical injuries stemming from physical stimuli and those arising from emotional trauma ...

For its part, the Government argues Murphy's focus upon the word "physical" in § 104(a)(2) is misplaced; more important is the phrase "on account of." In *O'Gilvie v. United States*, 519 U.S. 79 (1996), the Supreme Court read that phrase to require a "strong[ ] causal connection," thereby making § 104(a)(2) "applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries." The Court specifically rejected a "but-for" formulation in favor of a "stronger causal connection." The Government therefore concludes Murphy must demonstrate she was awarded damages "because of" her physical injuries, which the Government claims she has failed to do.

Indeed, as the Government points out, the ALJ expressly recommended, and the Board expressly awarded, compensatory damages "because of" Murphy's nonphysical injuries. ... The Government therefore argues "there was no direct causal link between the damages award at issue and [Murphy's] bruxism."

....

Although the pre-1996 version of § 104(a)(2) was at issue in *O'Gilvie*, the Court's analysis of the phrase "on account of," which phrase was unchanged by the 1996 Amendments, remains controlling here. Murphy no doubt suffered from certain physical manifestations of emotional distress, but the record clearly indicates the Board awarded her compensation only "for mental pain and anguish" and "for injury to professional reputation." ... [W]e conclude Murphy's damages were not "awarded by reason of, or because of, ... [physical] personal injuries," *O'Gilvie*, 519 U.S. at 83. Therefore, § 104(a)(2) does not permit Murphy to exclude her award from gross income.[30]

C. Section 61 of the IRC

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[30] Insofar as compensation for nonphysical personal injuries appears to be excludable from gross income under 26 C.F.R. § 1.104-1, the regulation conflicts with the plain text of § 104(a)(2); in these circumstances the statute clearly controls. *See* Brown v. Gardner, 513 U.S. 115, 122 (1994) (finding "no antidote to [a regulation's] clear inconsistency with a statute").

Murphy and the Government agree that for Murphy's award to be taxable, it must be part of her "gross income" as defined by § 61(a) ..., which states in relevant part: "gross income means all income from whatever source derived." The Supreme Court has interpreted the section broadly to extend to "all economic gains not otherwise exempted." *Comm'r v. Banks*, 543 U.S. 426, 433 (2005); *see also, e.g.*, [citation omitted]; *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 ("the Court has given a liberal construction to ["gross income"] in recognition of the intention of Congress to tax all gains except those specifically exempted"). "Gross income" in § 61(a) is at least as broad as the meaning of "incomes" in the Sixteenth Amendment. [footnote omitted]. *See Glenshaw Glass*, 348 U.S. at 429, 432 n. 11 (quoting H.R.Rep. No. 83-1337, at A18 (1954), reprinted in 1954 U.S.C.C.A.N. 4017, 4155); [citation omitted].

Murphy argues her award is not a gain or an accession to wealth and therefore not part of gross income. Noting the Supreme Court has long recognized "the principle that a restoration of capital [i]s not income; hence it [falls] outside the definition of 'income' upon which the law impose[s] a tax," *O'Gilvie*, 519 U.S. at 84; [citations omitted], Murphy contends a damage award for personal injuries – including nonphysical injuries – should be viewed as a return of a particular form of capital – "human capital," as it were. *See* GARY S. BECKER, HUMAN CAPITAL (1st ed.1964); Gary S. Becker, *The Economic Way of Looking at Life*, Nobel Lecture (Dec. 9, 1992), in NOBEL LECTURES IN ECONOMIC SCIENCES 1991-1995, at 43-45 (Torsten Persson ed., 1997). ...

... Murphy cites various administrative rulings issued shortly after passage of the Sixteenth Amendment that concluded recoveries from personal injuries were not income, such as this 1918 Opinion of the Attorney General:

> Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They are therefore "capital" as distinguished from "income" receipts.

31 Op. Att'y Gen. 304, 308; *see* T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918); Sol. Op. 132, I-1 C.B. 92, 93-94 (1922) ("[M]oney received ... on account of ... defamation of personal character ... does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder"). ...

Finally, Murphy argues her interpretation of § 61 is reflected in the common law of tort and the provisions in various environmental statutes and Title VII of the Civil Rights Act of 1964, all of which provide for "make whole" relief. *See, e.g.*, 42 U.S.C. § 1981a; 15 U.S.C. § 2622. If a recovery of damages designed to "make whole" the plaintiff is taxable, she reasons, then one who receives the award has not been made whole after tax. Section 61 should not be read to create a conflict between the tax code and the "make whole" purpose of the various statutes.

The Government disputes Murphy's interpretation on all fronts. First, noting "the definition [of gross income in the IRC] extends broadly to all economic gains," *Banks*, 543 U.S. at 433, the Government asserts Murphy "undeniably had economic gain because she was better off financially after receiving the damages award than she was prior to receiving it." Second, the Government argues that the case law Murphy cites does not support the proposition that the Congress lacks the power to tax as income recoveries for personal injuries. In its view, to the extent the Supreme Court has addressed at all the taxability of compensatory damages, *see, e.g.*, *O'Gilvie*, 519 U.S. at 86; *Glenshaw Glass*, 348 U.S. at 432 n. 8, it was merely articulating the Congress's rationale at the time for not taxing such damages, not the Court's own view whether such damages could constitutionally be taxed.

Third, the Government challenges the relevance of the administrative rulings Murphy cites from around the time the Sixteenth Amendment was ratified; Treasury decisions dating from even closer to the time of ratification treated damages received on account of personal injury as income. *See* T.D. 2135, 17 Treas. Dec. Int. Rev. 39, 42 (1915); T.D. 2690, Reg. No. 33 (Rev.), art. 4, 20 Treas. Dec. Int. Rev. 126, 130 (1918). Furthermore, administrative rulings from the time suggest that, even if recoveries for physical personal injuries were not considered part of income, recoveries for nonphysical personal injuries were. *See* Sol. Mem. 957, 1 C.B. 65 (1919) (damages for libel subject to income tax); Sol. Mem. 1384, 2 C.B. 71 (1920) (recovery of damages from alienation of wife's affections not regarded as return of capital, hence taxable). Although the Treasury changed its position in 1922, *see* Sol. Op. 132, I-1 C.B. at 93-94, it did so only after the Supreme Court's decision in *Eisner v. Macomber*, 252 U.S. 189 (1920), which the Court later viewed as having established a definition of income that "served a useful purpose [but] was not meant to provide a touchstone to all future gross income questions." *Glenshaw Glass*, 348 U.S. at 430-31. As for

Murphy's contention that reading § 61 to include her damages would be in tension with the common law and various statutes providing for "make whole" relief, the Government denies there is any tension and suggests Murphy is trying to turn a disagreement over tax policy into a constitutional issue.

> *Determining gain or loss on disposition of property*: Section 1001 establishes a formula for determining gain or loss on the sale or other disposition of property. To determine gain, subtract adjusted basis from the amount realized. § 1001(a). We abbreviate this as AR – AB. To determine loss, subtract amount realized from adjusted basis. § 1001(a). Section 1001 does not impose any tax or determine any income; it simply provides a means of measuring gain or loss. Section 1012 defines "basis" to be the cost of property. Section 1011(a) defines "adjusted basis" to "basis" as "adjusted." Section 1016 names occasions for adjusting basis.

Finally, the Government argues that even if the concept of human capital is built into § 61, Murphy's award is nonetheless taxable because Murphy has no tax basis in her human capital. Under the IRC, a taxpayer's gain upon the disposition of property is the difference between the "amount realized" from the disposition and his basis in the property, 26 U.S.C. § 1001, defined as "the cost of such property," *id.* § 1012, adjusted "for expenditures, receipts, losses, or other items, properly chargeable to [a] capital account," *id.* § 1016(a)(1). The Government asserts, "The Code does not allow individuals to claim a basis in their human capital;" accordingly, Murphy's gain is the full value of the award. *See Roemer v. Comm'r*, 716 F.2d 693, 696 n. 2 (9th Cir.1983) ("Since there is no tax basis in a person's health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth") (dictum).

Although Murphy and the Government focus primarily upon whether Murphy's award falls within the definition of income first used in *Glenshaw Glass* [footnote omitted], coming within that definition is not the only way in which § 61(a) could be held to encompass her award. Principles of statutory interpretation could show § 61(a) includes Murphy's award in her gross income regardless whether it was an "accession to wealth," as *Glenshaw Glass* requires. For example, if § 61(a) were amended specifically to include in gross income "$100,000 in addition to all other gross income," then that additional sum would be a part of gross income under § 61 even though no actual gain was associated with it. In other words, although the "Congress cannot make a thing income which is not so in fact," *Burk-Waggoner Oil Ass'n v. Hopkins*, 269 U.S. 110, 114 (1925), it can label a thing income and tax it, so long as it acts within its constitutional authority, which includes not only the Sixteenth Amendment but also Article I, Sections 8 and 9. *See Penn Mut. Indem. Co. v. Comm'r*, 277 F.2d 16, 20 (3d Cir.1960) ("Congress has the power to impose taxes generally, and if the particular imposition does not run afoul of any constitutional restrictions then the tax is lawful, call it what you will") (footnote omitted). Accordingly, rather than ask whether Murphy's award was an accession to her wealth, we go to the heart of the matter, which is whether her award is properly included within the definition of gross income in § 61(a), to wit, "all income from whatever source derived."

Looking at § 61(a) by itself, one sees no indication that it covers Murphy's award unless the award is "income" as defined by *Glenshaw Glass* and later cases. Damages received for emotional distress are not listed among the examples of income in § 61 and, as Murphy points out, an ambiguity in the meaning of a revenue-raising statute should be resolved in favor of the taxpayer. *See, e.g.*, *Hassett v. Welch*, 303 U.S. 303, 314 (1938); *Gould v. Gould*, 245 U.S. 151, 153 (1917); [citations omitted]. A statute is to be read as a whole, however [citation omitted], and reading § 61 in combination with § 104(a)(2) of the Internal Revenue Code presents a very different picture – a picture so clear that we have no occasion to apply the canon favoring the interpretation of ambiguous revenue-raising statutes in favor of the taxpayer.

... [I]n 1996 the Congress amended § 104(a) to narrow the exclusion to amounts received on account of "personal physical injuries or physical sickness" from "personal injuries or sickness," and explicitly to provide that "emotional distress shall not be treated as a physical injury or physical sickness," thus making clear that an award received on account of emotional distress is not excluded from gross income under § 104(a)(2). Small Business Job Protection Act of 1996, Pub.L. 104-188, § 1605, 110 Stat. 1755, 1838. As this amendment, which narrows the exclusion, would have no effect whatsoever if such damages were not included within the ambit of § 61, and as we must presume that "[w]hen Congress acts to amend a statute, ... it intends its amendment to have real and substantial effect," *Stone v. INS*, 514 U.S. 386, 397 (1995), the 1996 amendment of § 104(a) strongly suggests § 61 should be read to include an award for damages from nonphysical harms. [footnote omitted]. ...

....

... For the 1996 amendment of § 104(a) to "make sense," gross income in § 61(a) must, and we therefore hold it does, include an award for nonphysical damages such as Murphy received, regardless whether the award is an accession to wealth. [citation omitted].

D. The Congress's Power to Tax

The taxing power of the Congress is established by Article I, Section 8 of the Constitution: "The Congress shall have power to lay and collect taxes, duties, imposts and excises." There are two limitations on this power. First, as the same section goes on to provide, "all duties, imposts and excises shall be uniform throughout the United States." Second, as provided in Section 9 of that same Article, "No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken." *See also* U.S. Const. art. I, § 2, cl. 3 ("direct taxes shall be apportioned among the several states which may be included within this union, according to their respective numbers").[31] We now consider whether the tax laid upon Murphy's award violates either of these two constraints.

1. A Direct Tax?

Over the years, courts have considered numerous claims that one or another nonapportioned tax is a direct tax and therefore unconstitutional. Although these cases have not definitively marked the boundary between taxes that must be apportioned and taxes that need not be, *see Bromley v. McCaughn*, 280 U.S. 124, 136 (1929); *Spreckels Sugar Ref. Co. v. McClain*, 192 U.S. 397, 413 (1904) (dividing line between "taxes that are direct and those which are to be regarded simply as excises" is "often very difficult to be expressed in words"), some characteristics of each may be discerned.

Only three taxes are definitely known to be direct: (1) a capitation, U.S. Const. art. I, § 9, (2) a tax upon real property, and (3) a tax upon personal property. *See Fernandez v. Wiener*, 326 U.S. 340, 352 (1945) ("Congress may tax real estate or chattels if the tax is apportioned"); *Pollock v. Farmers' Loan & Trust Co.*, 158

[31] Though it is unclear whether an income tax is a direct tax, the Sixteenth Amendment definitively establishes that a tax upon income is not required to be apportioned. [citation omitted].

U.S. 601, 637 (1895) (*Pollock II*).[32] Such direct taxes are laid upon one's "general ownership of property," *Bromley*, 280 U.S. at 136; *see also Flint v. Stone Tracy Co.*, 220 U.S. 107, 149 (1911), as contrasted with excise taxes laid "upon a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property." *Fernandez*, 326 U.S. at 352; *see also Thomas v. United States*, 192 U.S. 363, 370 (1904) (excises cover "duties imposed on importation, consumption, manufacture and sale of certain commodities, privileges, particular business transactions, vocations, occupations and the like"). More specifically, excise taxes include, in addition to taxes upon consumable items [citation omitted], taxes upon the sale of grain on an exchange, *Nicol v. Ames*, 173 U.S. 509, 519 (1899), the sale of corporate stock, *Thomas*, 192 U.S. at 371, doing business in corporate form, *Flint*, 220 U.S. at 151, gross receipts from the "business of refining sugar," *Spreckels*, 192 U.S. at 411, the transfer of property at death, *Knowlton v. Moore*, 178 U.S. 41, 81-82 (1900), gifts, *Bromley*, 280 U.S. at 138, and income from employment, *see Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 579 (1895) (*Pollock I*) (citing *Springer v. United States*, 102 U.S. 586 (1881)).

Murphy and the amici supporting her argue the dividing line between direct and indirect taxes is based upon the ultimate incidence of the tax; if the tax cannot be shifted to someone else, as a capitation cannot, then it is a direct tax; but if the burden can be passed along through a higher price, as a sales tax upon a consumable good can be, then the tax is indirect. This, she argues, was the distinction drawn when the Constitution was ratified. *See* Albert Gallatin, *A Sketch of the Finances of the United States* (1796), *reprinted in* 3 THE WRITINGS OF ALBERT GALLATIN 74-75 (Henry Adams ed., Philadelphia, J.P. Lippincott & Co. 1879) ("The most generally received opinion ... is, that by direct taxes ... those are meant which are raised on the capital or revenue of the people; by indirect, such as are raised on their expense"); *The Federalist No. 36*, at 225 (Alexander Hamilton) (Jacob E. Cooke ed., 1961) ("internal taxes[ ] may be subdivided into those of the direct and those of the indirect kind ... by which must be understood duties and excises on articles of consumption"). *But see* Gallatin, *supra*, at 74 ("[Direct tax] is used, by different writers, and even by the same writers, in different parts of their writings, in a variety of senses, according to that view of the subject they were taking"); EDWIN R.A. SELIGMAN, THE INCOME TAX

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32 Pollock II also held that a tax upon the income of real or personal property is a direct tax. 158 U.S. at 637. Whether that portion of Pollock remains good law is unclear. *See* Graves v. New York ex rel. O'Keefe, 306 U.S. 466, 480 (1939).

540 (photo. reprint 1970) (2d ed.1914) ("there are almost as many classifications of direct and indirect taxes are there are authors"). Moreover, the amici argue, this understanding of the distinction explains the different restrictions imposed respectively upon the power of the Congress to tax directly (apportionment) and via excise (uniformity). Duties, imposts, and excise taxes, which were expected to constitute the bulk of the new federal government's revenue, *see* Erik M. Jensen, *The Apportionment of "Direct Taxes": Are Consumption Taxes Constitutional?*, 97 COLUM. L.REV. 2334, 2382 (1997), have a built-in safeguard against oppressively high rates: Higher taxes result in higher prices and therefore fewer sales and ultimately lower tax revenues. *See The Federalist No. 21*, *supra*, at 134-35 (Alexander Hamilton). Taxes that cannot be shifted, in contrast, lack this self-regulating feature, and were therefore constrained by the more stringent requirement of apportionment. *See id.* at 135 ("In a branch of taxation where no limits to the discretion of the government are to be found in the nature of things, the establishment of a fixed rule ... may be attended with fewer inconveniences than to leave that discretion altogether at large"); *see also* Jensen, *supra*, at 2382-84.

Finally, the amici contend their understanding of a direct tax was confirmed in *Pollock II*, where the Supreme Court noted that "the words 'duties, imposts, and excises' are put in antithesis to direct taxes," 158 U.S. at 622, for which it cited *The Federalist No. 36* (Hamilton). *Pollock II*, 158 U.S. at 624-25. As it is clear that Murphy cannot shift her tax burden to anyone else, per Murphy and the amici, it must be a direct tax.

The Government, unsurprisingly, backs a different approach; by its lights, only "taxes that are capable of apportionment in the first instance, specifically, capitation taxes and taxes on land," are direct taxes. The Government maintains that this is how the term was generally understood at the time. *See* Calvin H. Johnson, *Fixing the Constitutional Absurdity of the Apportionment of Direct Tax*, 21 CONST. COMM. 295, 314 (2004). Moreover, it suggests, this understanding is more in line with the underlying purpose of the tax and the apportionment clauses, which were drafted in the intense light of experience under the Articles of Confederation.

The Articles did not grant the Continental Congress the power to raise revenue directly; it could only requisition funds from the States. *See* ARTICLES OF CONFEDERATION art. VIII (1781); Bruce Ackerman, *Taxation and the Constitution*, 99 COLUM. L.REV. 1, 6-7 (1999). This led to problems when the

States, as they often did, refused to remit funds. *See* Calvin H. Johnson, *The Constitutional Meaning of "Apportionment of Direct Taxes*," 80 TAX NOTES 591, 593-94 (1998). The Constitution redressed this problem by giving the new national government plenary taxing power. *See* Ackerman, *supra*, at 7. In the Government's view, it therefore makes no sense to treat "direct taxes" as encompassing taxes for which apportionment is effectively impossible, because "the Framers could not have intended to give Congress plenary taxing power, on the one hand, and then so limit that power by requiring apportionment for a broad category of taxes, on the other." This view is, according to the Government, buttressed by evidence that the purpose of the apportionment clauses was not in fact to constrain the power to tax, but rather to placate opponents of the compromise over representation of the slave states in the House, as embodied in the Three-fifths Clause.[33] *See* Ackerman, *supra*, at 10-11. *See generally* SELIGMAN, *supra*, at 548-55. As the Government interprets the historical record, the apportionment limitation was "more symbolic than anything else: it appeased the anti-slavery sentiment of the North and offered a practical advantage to the South as long as the scope of direct taxes was limited." *See* Ackerman, *supra*, at 10. *But see* Erik M. Jensen, *Taxation and the Constitution: How to Read the Direct Tax Clauses*, 15 J.L. & POL. 687, 704 (1999) ("One of the reasons [the direct tax restriction] worked as a compromise was that it had teeth – it made direct taxes difficult to impose – and it had teeth however slaves were counted").

The Government's view of the clauses is further supported by the near contemporaneous decision of the Supreme Court in *Hylton v. United States*, 3 U.S. (3 Dall.) 171 (1796), holding that a national tax upon carriages was not a direct tax, and thus not subject to apportionment. Justices Chase and Iredell opined that a "direct tax" was one that, unlike the carriage tax, as a practical matter could be apportioned among the States, *id.* at 174 (Chase,

[33] Many Northern delegates were opposed to the three-fifths compromise on the ground that if slaves were property, then they should not count for the purpose of representation. Apportionment effectively meant that if the slaveholding states were to receive representation in the House for their slaves, then because apportioned taxes must be allocated across states based upon their representation, the slaveholding states would pay more in taxes to the national government than they would have if slaves were not counted at all in determining representation. *See* Ackerman, *supra*, at 9. Apportionment was then limited to direct taxes lest it drive the Congress back to reliance upon requisitions from the States. *See id.* at 9-10.

J.); *id.* at 181 (Iredell, J.), while Justice Paterson, noting the connection between apportionment and slavery, condemned apportionment as "radically wrong" and "not to be extended by construction," *id.* at 177-78. [footnote omitted]. As for Murphy's reliance upon *Pollock II*, the Government contends that although it has never been overruled, "every aspect of its reasoning has been eroded," *see, e.g.*, *Stanton v. Baltic Mining Co.*, 240 U.S. 103, 112-13 (1916), and notes that in *Pollock II* itself the Court acknowledged that "taxation on business, privileges, or employments has assumed the guise of an excise tax," 158 U.S. at 635. *Pollock II*, in the Government's view, is therefore too weak a reed to support Murphy's broad definition of "direct tax" and certainly does not make "a tax on the conversion of human capital into money ... problematic."

Murphy replies that the Government's historical analysis does not respond to the contemporaneous sources she and the amici identified showing that taxes imposed upon individuals are direct taxes. As for *Hylton*, Murphy argues nothing in that decision precludes her position; the Justices viewed the carriage tax there at issue as a tax upon an expense, *see* 3 U.S. (3 Dall.) at 175 (Chase, J.); *see also id.* at 180-81 (Paterson, J.), which she agrees is not a direct tax. *See Pollock II*, 158 U.S. at 626-27. To the extent *Hylton* is inconsistent with her position, however, Murphy contends her references to the *Federalist* are more authoritative evidence of the Framers' understanding of the term.

Murphy makes no attempt to reconcile her definition with the long line of cases identifying various taxes as excise taxes, although several of them seem to refute her position directly. In particular, we do not see how a known excise, such as the estate tax, *see, e.g.*, *New York Trust Co. v. Eisner*, 256 U.S. 345, 349 (1921); *Knowlton*, 178 U.S. at 81-83, or a tax upon income from employment, *see Pollock II*, 158 U.S. at 635; *Pollock I*, 157 U.S. at 579; *cf. Steward Mach. Co. v. Davis*, 301 U.S. 548, 580-81 (1937) (tax upon employers based upon wages paid to employees is an excise), can be shifted to another person, absent which they seem to be in irreconcilable conflict with her position that a tax that cannot be shifted to someone else is a direct tax. Though it could be argued that the incidence of an estate tax is inevitably shifted to the beneficiaries, we see at work none of the restraint upon excessive taxation that Murphy claims such shifting is supposed to provide; the tax is triggered by an event, death, that cannot be shifted or avoided. In any event, *Knowlton* addressed the argument that *Pollock I* and *II* made ability to shift the hallmark of a direct tax, and rejected it. 178 U.S. at 81-82. Regardless what the original understanding may have been, therefore, we are bound to follow the Supreme Court, which has strongly intimated that Murphy's position is not the law.

That said, neither need we adopt the Government's position that direct taxes are only those capable of satisfying the constraint of apportionment. In the abstract, such a constraint is no constraint at all; virtually any tax may be apportioned by establishing different rates in different states. *See Pollock II*, 158 U.S. at 632-33. If the Government's position is instead that by "capable of apportionment" it means "capable of apportionment in a manner that does not unfairly tax some individuals more than others," then it is difficult to see how a land tax, which is widely understood to be a direct tax, could be apportioned by population without similarly imposing significantly non-uniform rates. *See Hylton*, 3 U.S. (3 Dall.) at 178-79 (Paterson, J.); Johnson, *Constitutional Absurdity*, *supra*, at 328. *But see, e.g.*, *Hylton*, 3 U.S. (3 Dall.) at 183 (Iredell, J.) (contending land tax is capable of apportionment).

We find it more appropriate to analyze this case based upon the precedents and therefore to ask whether the tax laid upon Murphy's award is more akin, on the one hand, to a capitation or a tax upon one's ownership of property, or, on the other hand, more like a tax upon a use of property, a privilege, an activity, or a transaction, *see Thomas*, 192 U.S. at 370. Even if we assume one's human capital should be treated as personal property, it does not appear that this tax is upon ownership; rather, as the Government points out, Murphy is taxed only after she receives a compensatory award, which makes the tax seem to be laid upon a transaction. *See Tyler v. United States*, 281 U.S. 497, 502 (1930) ("A tax laid upon the happening of an event, as distinguished from its tangible fruits, is an indirect tax which Congress, in respect of some events ... undoubtedly may impose"); *Simmons v. United States*, 308 F.2d 160, 166 (4th Cir.1962) (tax upon receipt of money is not a direct tax); [citation omitted]. Murphy's situation seems akin to an involuntary conversion of assets; she was forced to surrender some part of her mental health and reputation in return for monetary damages. *Cf.* 26 U.S.C. § 1033 (property involuntarily converted into money is taxed to extent of gain recognized).

At oral argument Murphy resisted this formulation on the ground that the receipt of an award in lieu of lost mental health or reputation is not a transaction. This view is tenable, however, only if one decouples Murphy's injury (emotional distress and lost reputation) from her monetary award, but that is not beneficial to Murphy's cause, for then Murphy has nothing to offset the obvious accession to her wealth, which is taxable as income. Murphy also suggested at oral argument that there was no transaction because she did not profit. Whether she profited is irrelevant, however, to whether a tax upon an award of damages is a direct tax requiring apportionment; profit is relevant only to whether, if it is a direct tax, it nevertheless need not be apportioned because the object of the tax is income within the meaning of the Sixteenth Amendment. *Cf. Spreckels*, 192 U.S. at 412-13 (tax upon gross receipts associated with business of refining sugar not a direct tax); *Penn Mut.*, 277 F.2d at 20 (tax upon gross receipts deemed valid indirect tax despite taxpayer's net loss).

So we return to the question: Is a tax upon this particular kind of transaction equivalent to a tax upon a person or his property? [citation omitted]. Murphy did not receive her damages pursuant to a business activity [citations omitted], and we therefore do not view this tax as an excise under that theory. *See Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 414-15 (1913) ("The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money"). On the other hand, as noted above, the Supreme Court several times has held a tax not related to business activity is nonetheless an excise. And the tax at issue here is similar to those.

Bromley, in which a gift tax was deemed an excise, is particularly instructive: The Court noted it was "a tax laid only upon the exercise of a single one of those powers incident to ownership," 280 U.S. at 136, which distinguished it from "a tax which falls upon the owner merely because he is owner, regardless of the use or disposition made of his property," *id.* at 137. A gift is the functional equivalent of a below-market sale; it therefore stands to reason that if, as *Bromley* holds, a gift tax, or a tax upon a below-market sale, is a tax laid not upon ownership but upon the exercise of a power "incident to ownership," then a tax upon the sale of property at fair market value is similarly laid upon an incidental power and not upon ownership, and hence is an excise. Therefore, even if we were to accept Murphy's argument that the human capital concept is reflected in the Sixteenth Amendment, a tax upon the involuntary conversion of that capital would still be an excise and not subject to the requirement of apportionment. *But see Nicol*, 173 U.S. at 521 (indicating pre-*Bromley* that tax upon "every sale made in any place ... is really and practically upon property").

In any event, even if a tax upon the sale of property is a direct tax upon the property itself, we do not believe Murphy's situation involves a tax "upon the sale itself, considered separate and apart from the place and the circumstances of the sale." *Id.* at 520. Instead, as in *Nicol*, this tax is more akin to "a duty upon the facilities made use of and actually employed in the transaction." *Id.* at 519. To be sure, the facility used in *Nicol* was a commodities exchange whereas the facility used by Murphy was the legal system, but that hardly seems a significant distinction. The tax may be laid upon the proceeds received when one vindicates a statutory right, but the right is nonetheless a "creature of law," which *Knowlton* identifies as a "privilege" taxable by excise. 178 U.S. at 55 (right to take property by inheritance is granted by law and therefore taxable as upon a privilege);[34] *cf. Steward*, 301 U.S. at 580-81 ("[N]atural rights, so called, are as much subject to taxation as rights of less importance. An excise is not limited to vocations or activities that may be prohibited altogether.... It extends to vocations or activities pursued as of common right.") (footnote omitted).

2. Uniformity

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[34] For the same reason, we infer from Knowlton that a tax laid upon an amount received in settlement of a suit for a personal nonphysical injury would also be an excise. *See* 178 U.S. at 55.

The Congress may not implement an excise tax that is not "uniform throughout the United States." U.S. Const. art. I, § 8, cl. 1. A "tax is uniform when it operates with the same force and effect in every place where the subject of it is found." *United States v. Ptasynski*, 462 U.S. 74, 82 (1983) (internal quotation marks omitted); *see also Knowlton*, 178 U.S. at 84-86, 106. The tax laid upon an award of damages for a nonphysical personal injury operates with "the same force and effect" throughout the United States and therefore satisfies the requirement of uniformity.

III. Conclusion

For the foregoing reasons, we conclude (1) Murphy's compensatory award was not received on account of personal physical injuries, and therefore is not exempt from taxation pursuant to § 104(a)(2) of the IRC; (2) the award is part of her "gross income," as defined by § 61 of the IRC; and (3) the tax upon the award is an excise and not a direct tax subject to the apportionment requirement of Article I, Section 9 of the Constitution. The tax is uniform throughout the United States and therefore passes constitutional muster. The judgment of the district court is accordingly

Affirmed.

Notes and Questions:

1. Notice in the first footnote of the case, the court acknowledged an inconsistency between a regulation and the Code. Obviously, the Code prevails. *See* ch. 1, § VII *supra*.

> *Exclusions from Gross Income*: Section 104(a)(2), which the court quoted, provides for an *exclusion* from gross income. Obviously $70,000 is money that taxpayer could spend. *If* an exclusion had applied, taxpayer would not have to count it in her gross income even though she clearly received it.

2. In the first paragraph of part IIC, the court states our second guiding principle of tax law: "There are exceptions to [the principle that we tax all of the income of a particular taxpayer once], but we usually must find

those exceptions in the Code itself."

3. What is supposed to determine the measure of compensatory damages in tort law? Exactly what is the "restoration of capital" argument that the Attorney General bought into in the early days of the income tax? *See Clark v. Commissioner, infra.*
   - Why is this argument no longer persuasive?

> *Basis, Restoration of Capital, and MONEY*: The income tax is all about *money*, i.e., U.S. dollars. Basis is how we keep score with the government. We keep score in terms of dollars – not in terms of emotional well-being or happiness. These latter concepts are real enough, but not capable of valuation in terms of money. While tort law may structure an after-the-fact exchange of money for emotional well-being, tax law does not recognize the non-monetary aspects of the exchange – except as § 104 otherwise provides.

4. What is a direct tax under the Constitution? What taxes do we know are direct taxes? What is the constitutional limitation upon Congress's power to enact direct taxes?
   - The Supreme Court's most recent pronouncement on the subject came in *National Federation of Independent Business v. Sebelius*, 567 U.S. ___, 132 S. Ct. 2566 (2012):

> A tax on going without health insurance does not fall within any recognized category of direct tax. It is not a capitation. ... The whole point of the shared responsibility payment is that it is triggered by specific circumstances—earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on the ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several States.

Id. at ___, 132 S. Ct. at ____.

5. What is an indirect tax under the Constitution? What taxes do we know

are indirect taxes? What is the constitutional limitation upon Congress's power to enact indirect taxes?

6. The court provides a good review of the power of Congress to impose taxes *aside from* the income tax. The court held that a tax on tort damages for emotional distress is *not* a tax on income in the constitutional sense (i.e., Sixteenth Amendment) of the word. How should this affect the fact that all items of gross income are added together and form the bases of other important elements of the income tax, e.g., AGI, tax brackets applicable to *all* income. Does a tax upon such damages "operate[] with the same force and effect" throughout the United States?

7. Do you think that taxpayer Murphy would place more value on her pre-event emotional tranquility and happiness or on her post-event emotional tranquility, happiness, and $70,000?

- Is it possible that we tax events that actually *reduce* a taxpayer's overall wealth?

8. The court cited the case of *Penn Mut. Indem. Co. v. Comm'r*, 277 F.2d 16, 20 (CA3 1960) with this parenthetical: "Congress has the power to impose taxes generally, and if the particular imposition does not run afoul of any constitutional restrictions then the tax is lawful, call it what you will." In *National Federation of Independent Business v. Sebelius*, 567 U.S. ___, 132 S. Ct. 2566 (2012), the Supreme Court "confirmed" a "functional approach" to whether an assessment is a tax. 567 U.S. at ___, 132 S. Ct. at ____ ("shared responsibility payment" actually a "tax," even though called a "penalty").

- In *Eisner v. Macomber*, the Supreme Court said: "Congress cannot by any definition [of "income"] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised."
    - Are these positions inconsistent?
- Does this imply that Congress can enact a tax – assuming that the legislative proposal originates in the House of Representatives – and later search for its constitutional underpinning?

II. The Constitutional and Statutory Definitions of "Gross Income:" Accessions to Wealth

A. Some Recurring Themes

Consider now the many forms that an "accession to wealth" can take. Section 61(a) of the Code provides a non-exclusive list of fifteen items. Obviously, "gross income" includes compensation for services. § 61(a)(1). We should not be especially surprised that "gross income" includes the other items on the list. However, the first sentence of § 61(a) does not limit "gross income" to the items on this list. This point has required courts to consider whether various benefits constituted an "accession to wealth." The following cases, some of which pre-date *Glenshaw Glass*, present some examples.

Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929)

MR. CHIEF JUSTICE TAFT delivered the opinion of the Court.

....

William M. Wood was president of the American Woolen Company during the years 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his federal income tax return for 1918. In 1919, he received as salary and commissions from the company $548,132.87, which he included in his return for 1919.

August 3, 1916, the American Woolen Company had adopted the following resolution, which was in effect in 1919 and 1920:

> "Voted: That this company pay any and all income taxes, state and Federal, that may hereafter become due and payable upon the

> salaries of all the officers of the company, including the president, William M. Wood[,] ... to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, state or federal, which taxes are to be paid out of the treasury of this corporation."

....

... [T]he American Woolen Company paid to the collector of internal revenue Mr. Wood's federal income and surtaxes due to salary and commissions paid him by the company, as follows:

> Taxes for 1918 paid in 1919 . . . . $681,169 88
> Taxes for 1919 paid in 1920 . . . . $351,179 27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $681,169.88 and $351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

The question certified by the circuit court of appeals for answer by this Court is:

> "Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?"

....

... Coming now to the merits of this case, we think the question presented is whether a taxpayer, having induced a third person to pay his income tax or having acquiesced in such payment as made in discharge of an obligation to him, may avoid the making of a return thereof and the payment of a corresponding tax. We think he may not do so. The payment of the tax by the employers was in consideration of the services rendered by the employee, and was again derived by the employee from his labor. The form of the payment is expressly declared to make no difference. Section 213, Revenue Act of 1918, c. 18, 40 Stat. 1065 [§ 61]. It is therefore immaterial that the taxes were directly paid over to the government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed. The certificate shows that the taxes were imposed upon the employee, that the taxes were actually paid by the employer, and that the employee entered upon his duties in the years in question under the express agreement that his income taxes would be paid by his employer. ... The taxes were paid upon a valuable consideration – namely, the services rendered by the employee and as part of the compensation therefor. We think, therefore, that the payment constituted income to the employee.

....

Nor can it be argued that the payment of the tax ... was a gift. The payment for services, even though entirely voluntary, was nevertheless compensation within the statute. ...
It is next argued against the payment of this tax that, if these payments by the employer constitute income to the employee, the employee will be called upon to pay the tax imposed upon this additional income, and that the payment of the additional tax will create further income which will in turn be subject to tax, with the result that there would be a tax upon a tax. This, it is urged, is the result of the government's theory, when carried to its logical conclusion, and results in an absurdity which Congress could not have contemplated.

In the first place, no attempt has been made by the Treasury to collect further taxes upon the theory that the payment of the additional taxes creates further income, and the question of a tax upon a tax was not before the circuit court of appeals, and has not been certified to this Court. We can settle questions of that sort when an attempt to impose a tax upon a tax is undertaken, but not now. [citations omitted]. It is not, therefore, necessary to answer the argument based upon an algebraic formula to reach the amount of taxes due. The question in this case is, "Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?" The answer must be "Yes."

Separate opinion of MR. JUSTICE McREYNOLDS [omitted].

Notes and Questions:

1. Taxpayers pay their federal income taxes from after-tax income. This was not always true. Act of Oct. 3, 1913, entitled "An act to reduce tariff duties and to provide revenue for the Government and for other purposes," part IIB, granted a deduction for national taxes paid. After Congress repealed this deduction, the American Woolen Company began paying William Wood's federal income taxes.

2. The Court seems to say both that taxpayer received additional compensation (taxable) and that taxpayer benefitted from third-party satisfaction of an obligation (also taxable).

A Little Algebra: Is the argument that the Commissioner creates a never-ending upward spiral of taxes upon taxes true?
•No.
•If taxpayer is to have $X remaining after payment of taxes and the tax rate is λ, then taxable income equal to $\$X/(1 - \lambda)$ will produce $X of after-tax income. Obviously, graduated tax rates would require some incremental computations.
•We call such a computation "grossing up."

3. A taxpayer's wealth increases when someone pays one of his/her obligations. Thus, when taxpayer's employer pays taxpayer's federal income taxes, taxpayer should include the amount of taxes in his/her gross income. The principal is applicable in other contexts as well.

- A key consideration is whether a third party makes a payment to satisfy an actual "obligation" of the taxpayer, or merely to "restore" to taxpayer "capital" rightfully belonging to him/her. *See Clark infra.*

Clark v. Commissioner, 40 B.T.A. 333 (1939)

Opinion. LEECH.

This is a proceeding to redetermine a deficiency in income tax for the calendar year 1934 in the amount of $10,618.87. The question presented is whether petitioner derived income by the payment to him of an amount of $19,941.10, by his tax counsel, to compensate him for a loss suffered on account of erroneous advice given him by the latter. The facts were stipulated and ... so far as material, follow[]:

3. The petitioner during the calendar year 1932, and for a considerable period prior thereto, was married and living with his wife. He was required by the Revenue Act of 1932 to file a Federal Income Tax Return of his income for the year 1932. For such year petitioner and his wife could have filed a joint return or separate returns.

4. Prior to the time that the 1932 Federal Income Tax return or returns of petitioner and/or his wife were due to be filed, petitioner retained experienced counsel to prepare the necessary return or returns for him and/or his wife. Such tax counsel prepared a joint return for petitioner and his wife and advised petitioner to file it instead of two separate returns. In due course it was filed with the Collector of Internal Revenue for the First District of California. ...

....

6. [Tax counsel had improperly deducted more than the allowable amount of capital losses.]

7. The error referred to in paragraph six above was called to the attention of the tax counsel who prepared the joint return of petitioner and his wife for the year 1932. Recomputations were then made which disclosed that if petitioner and his wife had filed separate returns for the year 1932 their combined tax liability would have been $19,941.10 less than that which was finally assessed against and paid by petitioner.

8. Thereafter, tax counsel admitted that if he had not erred in computing the tax liability shown on the joint return filed by the petitioner, he would have advised petitioner to file separate returns for himself and his wife, and accordingly tax counsel tendered to petitioner the sum of $19,941.10, which was the difference between what petitioner and his wife would have paid on their 1932 returns if separate returns had been filed and the amount which petitioner was actually required to pay on the joint return as filed. Petitioner accepted the $19,941.10.

9. In his final determination of petitioner's 1934 tax liability, the respondent included the aforesaid $19,941.10 in income.

10. Petitioner's books of account are kept on the cash receipts and disbursements basis and his tax returns are made on such basis under the community property laws of the State of California.

The theory on which the respondent included the above sum of $19,941.10 in petitioner's gross income for 1934, is that this amount constituted taxes paid for petitioner by a third party and that, consequently, petitioner was in receipt of income to that extent. ... Petitioner, on the contrary, contends that this payment constituted compensation for damages or loss caused by the error of tax counsel, and that he therefore realized no income from its receipt in 1934.

We agree with the petitioner. ... Petitioner's taxes were not paid for him by any person – as rental, compensation for services rendered, or otherwise. He paid his own taxes.

When the joint return was filed, petitioner became obligated to and did pay the taxes computed on that basis. [citation omitted] In paying that obligation, he sustained a loss which was caused by the negligence of his tax counsel. The $19,941.10 was paid to petitioner, not qua taxes [citation omitted], but as compensation to petitioner for his loss. The measure of that loss, and the compensation therefor, was the sum of money which petitioner became legally obligated to and did pay because of that negligence. The fact that such obligation was for taxes is of no moment here.

....

... And the fact that the payment of the compensation for such loss was voluntary, as here, does not change its exempt status. [citation omitted] It was, in fact, compensation for a loss which impaired petitioner's capital.

Moreover, so long as petitioner neither could nor did take a deduction in a prior year of this loss in such a way as to offset income for the prior year, the amount received by him in the taxable year, by way of recompense, is not then includable in his gross income. Central Loan & Investment Co., 39 B.T.A. 981.

Decision will be entered for the petitioner.

Notes and Questions:

1. Does the Commissioner's position follow from the Supreme Court's holding in *Old Colony Trust*?

A return of capital is not gross income. After all, the capital that is returned has already been subject to income tax.

2. Is this holding consistent with SHS? What do you know from reading the case about what taxpayer's after-tax wealth should have been? In fact, is that not what the court was referencing when it described the payment as "compensation for a loss which impaired [taxpayer's] capital?

3. Why would it make a difference whether taxpayer previously deducted the amount restored to him?

Gotcher v. United States, 401 F.2d 118 (CA5 1968)

THORNBERRY, Circuit Judge.

In 1960, Mr. and Mrs. Gotcher took a twelve-day expense-paid trip to Germany to tour the Volkswagon facilities there. The trip cost $1372.30. His employer, Economy Motors, paid $348.73, and Volkswagon of Germany and Volkswagon of America shared the remaining $1023.53. Upon returning, Mr. Gotcher bought a twenty-five percent interest in Economy Motors, the Sherman, Texas Volkswagon dealership, that had been offered to him before he left. Today he is President of Economy Motors in Sherman and owns fifty percent of the dealership. Mr. and Mrs. Gotcher did not include any part of the $1372.30 in their 1960 income. The Commissioner determined that the taxpayers had realized income to the extent of the $1372.30 for the expense-paid trip and asserted a tax deficiency of $356.79, plus interest. Taxpayers paid the deficiency, plus $82.29 in interest, and thereafter timely filed suit for a refund. The district court, sitting without a jury, held that the cost of the trip was not income or, in the alternative, was income and deductible as an ordinary and necessary business expense. [citation omitted] We affirm the district court's determination that the cost of the trip was not income to Mr. Gotcher ($686.15); however, Mrs. Gotcher's expenses ($686.15) constituted income and were not deductible.

... The court below reasoned that the cost of the trip to the Gotchers was not income because an economic or financial benefit does not constitute income under § 61 unless it is conferred as compensation for services rendered. This conception of gross income is too restrictive since it is [well]-settled that § 61 should be broadly interpreted and that many items, including compensatory gains, constitute gross income. [footnote omitted]

Sections 101-123 specifically exclude certain items from gross income. Appellant argues that the cost of the trip should be included in income since it is not specifically excluded by §§ 101-123, reasoning that § 61 was drafted broadly to subject all economic gains to tax and any exclusions should be narrowly limited to the specific exclusions. [footnote omitted] This analysis is too restrictive since it has been generally held that exclusions from gross income are not limited to the enumerated exceptions. [footnote omitted] ...

In determining whether the expense-paid trip was income within § 61, we must look to the tests that have been developed under this section. The concept of economic gain to the taxpayer is key to § 61. H. SIMONS, PERSONAL INCOME TAXATION 51 (1938); J. SNEED, THE CONFIGURATIONS OF GROSS INCOME 8 (1967). This concept contains two distinct requirements: There must be an economic gain, and this gain must primarily benefit the taxpayer personally. In some cases, as in the case of an expense-paid trip, there is no direct economic gain, but there is indirect economic gain inasmuch as a benefit has been received without a corresponding diminution of wealth. Yet even if expense-paid items, as meals and lodging, are received by the taxpayer, the value of these items will not be gross income, even though the employee receives some incidental benefit, if the meals and lodging are primarily for the convenience of the employer. See Int. Rev. Code of 1954, § 119.

… [T]here is no evidence in the record to indicate that the trip was an award for past services since Mr. Gotcher was not an employee of VW of Germany and he did nothing to earn that part of the trip paid by Economy Motors.

The trip was made in 1959 when VW was attempting to expand its local dealerships in the United States. The 'buy American' campaign and the fact that the VW people felt they had a 'very ugly product' prompted them to offer these tours of Germany to prospective dealers. ... VW operations were at first so speculative that cars had to be consigned with a repurchase guarantee. In 1959, when VW began to push for its share of the American market, its officials determined that the best way to remove the apprehension about this foreign product was to take the dealer to Germany and have him see his investment first-hand. It was believed that once the dealer saw the manufacturing facilities and the stability of the 'new Germany' he would be convinced that VW was for him. [footnote omitted] Furthermore, VW considered the expenditure justified because the dealer was being asked to make a substantial investment of his time and money in a comparatively new product. Indeed, after taking the trip, VW required him to acquire first-class facilities. ... VW could not have asked that this upgrading be done unless it convinced the dealer that VW was here to stay. Apparently these trips have paid off since VW's sales have skyrocketed and the dealers have made their facilities top-rate operations under the VW requirements for a standard dealership.

The activities in Germany support the conclusion that the trip was oriented to business. The Government makes much of the fact that the travel brochure allocated only two of the twelve days to the touring of VW factories. This argument ignores the uncontradicted evidence that not all of the planned activities were in the brochure. There is ample support for the trial judge's finding that a substantial amount of time was spent touring VW facilities and visiting local dealerships. VW had set up these tours with local dealers so that the travelers could discuss how the facilities were operated in Germany. Mr. Gotcher took full advantage of this opportunity and even used some of his 'free time' to visit various local dealerships. Moreover, at almost all of the evening meals VW officials gave talks about the organization and passed out literature and brochures on the VW story.

Some of the days were not related to touring VW facilities, but that fact alone cannot be decisive. The dominant purpose of the trip is the critical inquiry and some pleasurable features will not negate the finding of an overall business purpose. [citation omitted] Since we are convinced that the agenda related primarily to business and that Mr. Gotcher's attendance was prompted by business considerations, the so-called sightseeing complained of by the Government is inconsequential. [citation omitted] Indeed, the district court found that even this touring of the countryside had an indirect relation to the business since the tours were not typical sightseeing excursions but were connected to the desire of VW that the dealers be persuaded that the German economy was stable enough to justify investment in a German product. We cannot say that this conclusion is clearly erroneous. Nor can we say that the enthusiastic literary style of the brochures negates a dominant business purpose. It is the business reality of the total situation, not the colorful expressions in the literature, that controls. Considering the record, the circumstances prompting the trip, and the objective achieved, we conclude that the primary purpose of the trip was to induce Mr. Gotcher to take out a VW dealership interest.

The question, therefore, is what tax consequences should follow from an expense-paid trip that primarily benefits the party paying for the trip. In several analogous situations the value of items received by employees has been excluded from gross income when these items were primarily for the benefit of the employer. Section 119 excludes from gross income of an employee the value of meals and lodging furnished to him for the convenience of the employer. Even if these items were excluded by the 1954 Code, the Treasury and the courts recognized that they should be excluded from gross income. [footnote omitted] Thus it appears that the value of any trip that is paid by the employer or by a businessman primarily for his own benefit should be excluded from gross income of the payee on similar reasoning. [citations omitted]

In the recent case of *Allen J. McDonnell*, 26 T.C.M. 115, Tax Ct. Mem. 1967-68, a sales supervisor and his wife were chosen by lot to accompany a group of contest winners on an expense-paid trip to Hawaii. In holding that the taxpayer had received no income, the Tax Court noted that he was required by his employer to go and that he was serving a legitimate business purpose though he enjoyed the trip. The decision suggests that in analyzing the tax consequences of an expense-paid trip one important factor is whether the traveler had any choice but to go. Here, although the taxpayer was not forced to go, there is no doubt that in the reality of the business world he had no real choice. The trial judge reached the same conclusion. He found that the invitation did not specifically order dealer to go, but that as a practical matter it was an order or directive that if a person was going to be a VW dealer, sound business judgment necessitated his accepting the offer of corporate hospitality. So far as Economy Motors was concerned, Mr. Gotcher knew that if he was going to be a part-owner of the dealership, he had better do all that was required to foster good business relations with VW. Besides having no choice but to go, he had no control over the schedule or the money spent. VW did all the planning. In cases involving noncompensatory economic gains, courts have emphasized that the taxpayer still had complete dominion and control over the money to use it as he wished to satisfy personal desires or needs. Indeed, the Supreme Court has defined income as accessions of wealth over which the taxpayer has complete control. *Commissioner of Internal Revenue v. Glenshaw Glass Co.*, *supra*. Clearly, the lack of control works in the taxpayer's favor here.

McDonnell also suggests that one does not realize taxable income when he is serving a legitimate business purpose of the party paying the expenses. The cases involving corporate officials who have traveled or entertained clients at the company's expense are apposite. Indeed, corporate executives have been furnished yachts, *Challenge Mfg. Co. v. Commissioner*, 1962, 37 T.C. 650, taken safaris as part of an advertising scheme, *Sanitary Farms Dairy, Inc.*, 1955 25 T.C. 463, and investigated business ventures abroad, but have been held accountable for expenses paid only when the court was persuaded that the expenditure was primarily for the officer's personal pleasure. [footnote omitted] On the other hand, when it has been shown that the expenses were paid to effectuate a legitimate corporate end and not to benefit the officer personally, the officer has not been taxed though he enjoyed and benefited from the activity. [footnote omitted] Thus, the rule is that the economic benefit will be taxable to the recipient only when the payment of expenses serves no legitimate corporate purposes. [citation omitted] The decisions also indicate that the tax consequences are to be determined by looking to the primary purpose of the expenses and that the first consideration is the intention of the payor. The Government in argument before the district court agreed that whether the expenses were income to taxpayers is mainly a question of the motives of the people giving the trip. Since this is a matter of proof, the resolution of the tax question really depends on whether Gotcher showed that his presence served a legitimate corporate purpose and that no appreciable amount of time was spent for his personal benefit and enjoyment. [citation omitted]

Examination of the record convinces us that the personal benefit to Gotcher was clearly subordinate to the concrete benefits to VW. The purpose of the trip was to push VW in America and to get dealers to invest more money and time in their dealerships. Thus, although Gotcher got some ideas that helped him become a better dealer, there is no evidence that this was the primary purpose of the trip. Put another way, this trip was not given as a pleasurable excursion through Germany or as a means of teaching taxpayer the skills of selling. The personal benefits and pleasure were incidental to the dominant purpose of improving VW's position on the American market and getting people to invest money.

The corporate-executive decisions indicate that some economic gains, though not specifically excluded from § 61, may nevertheless escape taxation. They may be excluded even though the entertainment and travel unquestionably give enjoyment to the taxpayer and produce indirect economic gains. When this indirect economic gain is subordinate to an overall business purpose, the recipient is not taxed. We are convinced that the personal benefit to Mr. Gotcher from the trip was merely incidental to VW's sales campaign.

As for Mrs. Gotcher, the trip was primarily vacation. She did not make the tours with her husband to see the local dealers or attend discussions about the VW organization. This being so, the primary benefit of the expense-paid trip for the wife went to Mr. Gotcher in that he was relieved of her expenses. He should therefore be taxed on the expenses attributable to his wife. [citation omitted] Nor are the expenses deductible since the wife's presence served no bona fide business purpose for her husband. Only when the wife's presence is necessary to the conduct of the husband's business are her expenses deductible under § 162. [citation omitted] Also, it must be shown that the wife made the trip only to assist her husband in his business. ...

Affirmed in part; reversed in part.

JOHN R. BROWN, Chief Judge (concurring):

...

Attributing income to the little wife who was neither an employee, a prospective employee, nor a dealer, for the value of the trip she neither planned nor chose still bothers me. If her uncle had paid for the trip, would it not have been a pure gift, not income? Or had her husband out of pure separate property given her the trip would the amount over and above the cost of Texas bed and board have been income? I acquiesce now, confident that for others in future cases on a full record the wife, as now does the husband, also will overcome.

Notes and Questions:

1. What tests does the court state to determine whether the trip was an "accession to wealth?"

2. If the procurement of a benefit "primarily benefits" the payor rather than the recipient, has the recipient really realized an "accession to wealth" whose value should be measured by its cost?

3. How important should the absence of control over how money is spent be in determining whether taxpayer has realized an accession to wealth on which s/he should pay taxes? What factors are important in determining whether a non-compensatory benefit is an "accession to wealth?"

4. Is *Gotcher* a case where taxpayer did not receive any "gross income" or a case where taxpayer did receive "gross income" that the Code excluded? It might make a difference.

- What happened to our second principle – that all income is taxed once unless an exception is specifically found in the Code?

> *Taxability of a Price Reduction*: What happens when taxpayer is able to purchase a computer that "normally" retails for $1000 for $800 during a "computer blowout sale?" Does our taxpayer enjoy a $200 accession to wealth? Answer: No.
>
> *A "mere reduction in price" is not taxable income*. A contrary rule would raise insurmountable problems of value determination. Recall the alternative definitions of "value" in chapter 1. Perhaps the computer simply was not "worth" any more than $800 in the first place.

5. Can you think of any reasons other than those offered by Judge Brown for not including the cost of Mrs. Gotcher's trip in Mr. Gotcher's gross income? How does (can) her trip fit within the rationale that excludes value of Mr. Gotcher's trip from his gross income?

- Does Judge Brown's analysis support his conclusion?

6. This case involved a prospective investor. The recipient may also be a prospective employee or a prospective customer.

7. Back to windfalls, plus some dumb luck ...

Cesarini v. United States, 296 F. Supp. 3 (N.D. Ohio 1969)

YOUNG, District Judge.

….

… Plaintiffs are husband and wife, and live within the jurisdiction of the United States District Court for the Northern District of Ohio. In 1957, the plaintiffs purchased a used piano at an auction sale for approximately $15.00, and the piano was used by their daughter for piano lessons. In 1964, while cleaning the piano, plaintiffs discovered the sum of $4,467.00 in old currency, and since have retained the piano instead of discarding it as previously planned. Being unable to ascertain who put the money there, plaintiffs exchanged the old currency for new at a bank, and reported a sum of $4,467.00 on their 1964 joint income tax return as ordinary income from other sources. On October 18, 1965, plaintiffs filed an amended return …, this second return eliminating the sum of $4,467.00 from the gross income computation, and requesting a refund in the amount of $836.51, the amount allegedly overpaid as a result of the former inclusion of $4,467.00 in the original return for the calendar year of 1964. … [T]he Commissioner of Internal Revenue rejected taxpayers' refund claim in its entirety, and plaintiffs filed the instant action in March of 1967.

Plaintiffs make three alternative contentions in support of their claim that the sum of $836.51 should be refunded to them. First, that the $4,467.00

found in the piano is not includable in gross income under § 61 of the Internal Revenue Code. (26 U.S.C. § 61) Secondly, even if the retention of the cash constitutes a realization of ordinary income under § 61, it was due and owing in the year the piano was purchased, 1957, and by 1964, the statute of limitations provided by 26 U.S.C. § 6501 had elapsed. And thirdly, that if the treasure trove money is gross income for the year 1964, it was entitled to capital gains treatment under § 1221 of Title 26. The Government, by its answer and its trial brief, asserts that the amount found in the piano is includable in gross income under § 61(a) of Title 26, U.S.C., that the money is taxable in the year it was actually found, 1964, and that the sum is properly taxable at ordinary income rates, not being entitled to capital gains treatment under 26 U.S.C. §§ 2201 et seq.

... [T]his Court has concluded that the taxpayers are not entitled to a refund of the amount requested, nor are they entitled to capital gains treatment on the income item at issue.

The starting point in determining whether an item is to be included in gross income is, of course, § 61(a) ..., and that section provides in part: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:" * * *'

Subsections (1) through (15) of § 61(a) then go on to list fifteen items specifically included in the computation of the taxpayers' gross income, and Part II of Subchapter B of the 1954 Code (§§ 71 et seq.) deals with other items expressly included in gross income. While neither of these listings expressly includes the type of income which is at issue in the case at bar, Part III of Subchapter B (§§ 101 et seq.) deals with items specifically excluded from gross income, and found money is not listed in those sections either. This absence of express mention in any code sections necessitates a return to the 'all income from whatever source' language of § 61(a) of the code, and the express statement there that gross income is 'not limited to' the following fifteen examples. …

The decisions of the United States Supreme Court have frequently stated that this broad all-inclusive language was used by Congress to exert the full measure of its taxing power under the Sixteenth Amendment to the United States Constitution. [citations omitted]

In addition, the Government in the instant case cites and relies upon an I.R.S. Revenue Ruling which is undeniably on point:

> 'The finder of treasure-trove is in receipt of taxable income, for Federal income tax purposes, to the extent of its value in United States Currency, for the taxable year in which it is reduced to undisputed possession.' Rev. Rul. 61, 1953-1, Cum. Bull. 17.

….

… While it is generally true that revenue rulings may be disregarded by the courts if in conflict with the code and the regulations, or with other judicial decisions, plaintiffs in the instant case have been unable to point to any inconsistency between the gross income sections of the code, the interpretation of them by the regulations and the Courts, and the revenue ruling which they herein attack as inapplicable. On the other hand, the United States has shown consistency in the letter and spirit between the ruling and the code, regulations, and court decisions.

Although not cited by either party, and noticeably absent from the Government's brief, the following Treasury Regulation appears in the 1964 Regulations, the year of the return in dispute:

> '§ 1.61-14 Miscellaneous items of gross income.
> '(a) In general. In addition to the items enumerated in section 61(a), there are many other kinds of gross income * * *. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.'

… This Court is of the opinion that Treas. Reg. § 1.61-14(a) is dispositive of the major issue in this case if the $4,467.00 found in the piano was 'reduced to undisputed possession' in the year petitioners reported it, for this Regulation was applicable to returns filed in the calendar year of 1964.

This brings the Court to the second contention of the plaintiffs: that if any tax was due, it was in 1957 when the piano was purchased, and by 1964 the Government was blocked from collecting it by reason of the statute of limitations. Without reaching the question of whether the voluntary payment in 1964 constituted a waiver on the part of the taxpayers, this Court finds that the $4,467.00 sum was properly included in gross income for the calendar year of 1964. Problems of when title vests, or when possession is complete in the field of federal taxation, in the absence of definitive federal legislation on the subject, are ordinarily determined by reference to the law of the state in which the taxpayer resides, or where the property around which the dispute centers in located. Since both the taxpayers and the property in question are found within the State of Ohio, Ohio law must govern as to when the found money was 'reduced to undisputed possession' within the meaning of Treas. Reg. 1.61- 14 and Rev. Rul. 61-53-1, Cum. Bull. 17.

In Ohio, there is no statute specifically dealing with the rights of owners and finders of treasure trove, and in the absence of such a statute the common-law rule of England applies, so that 'title belongs to the finder as against all the world except the true owner.' *Niederlehner v. Weatherly*, 78 Ohio App. 263, 29 N.E.2d 787 (1946), appeal dismissed, 146 Ohio St. 697, 67 N.E.2d 713 (1946). The *Niederlehner* case held, inter alia, that the owner of real estate upon which money is found does not have title against the finder. Therefore, in the instant case if plaintiffs had resold the piano in 1958, not knowing of the money within it, they later would not be able to succeed in an action against the purchaser who did discover it. Under Ohio law, the plaintiffs must have actually found the money to have superior title over all but the true owner, and they did not discover the old currency until 1964. Unless there is present a specific state statute to the contrary, [footnote omitted] the majority of jurisdictions are in accord with the Ohio rule. [footnote omitted] Therefore, this Court finds that the $4,467.00 in old currency was not 'reduced to undisputed possession' until its actual discovery in 1964, and thus the United States was not barred by the statute of limitations from collecting the $836.51 in tax during that year.

Finally, plaintiffs' contention that they are entitled to capital gains treatment upon the discovered money must be rejected. [Taxpayers' gain did not result from the sale or exchange of a capital asset.] …

Notes and Questions:

1. How did the court treat Rev. Rul. 1953-1? What does this tell you about the legal status of a revenue ruling?

2. What role did state law play in the resolution of this case? Why was it necessary to invoke it?

3. What tax norms would the court have violated if it had held in favor of the Cesarinis?

Other statutory items of gross income: Recall from chapter 1 that the Code specifically names items of gross income in §§ 71-90. You should at least peruse the table of contents to your Code to get an idea of what Congress has deemed worthy of specific inclusion. We will take up some of these provisions in a bit more depth. These Code sections often define the precise extent to which an item *is* (and so implicitly *is not*) gross income. Sometimes Congress is clarifying or stating a position on a point on which courts had previously ruled otherwise. For example:

Prizes and Awards: Read § 74(a). With only the exceptions noted in §§ 74(b and c), gross income includes amounts received as prizes and awards. A significant question with regard to non-cash prizes is their valuation. For reasons you can readily determine, valuation must be an objective matter. However, this does not mean that the fmv of a prize to the recipient is necessarily the price paid by the giver. For example, most persons would agree that merely driving a new automobile from the dealer's lot substantially reduces its value. The winner of an automobile should be given at least some credit for this fact. *See McCoy v. CIR*, 38 T.C. 841 (1962) (prize of automobile). Taxpayer might demonstrate the value that she or he places on the prize by trading it as quickly as possible after receiving it for something she or he values more – in economic terms, a "revealed preference." *See McCoy*, *supra* (taxpayer traded automobile for $1000 cash plus a different new automobile); *Turner v. CIR*, T.C. Memo. 1954-38 (taxpayer exchanged two first-class steamship tickets for four tourist class tickets).

B. Section 61(a)(3): Gains Derived from Dealings in Property

Section 61(a)(3) includes in a taxpayer's "gross income" "gains derived from dealings in property." This provision does not tell us how to determine what those gains might be. For that, we turn to §§ 1001(a and b). Read it. (The word "over" frequently appears in the Code as a directive to subtract whatever is described.) Section 1001(a) directs you to § 1011. Read it. Section 1011 directs you to §§ 1012 and 1016. Read § 1012(a) and 1016(a).

The effect of subtracting "adjusted basis" is to

Fluctuations in Value: The value of property may fluctuate over the time taxpayer owns it. If its value increases, taxpayer must recognize taxable gain upon its sale. If its value decreases, § 165(a) *might* permit taxpayer to reduce his or her gross income by the amount of the loss upon its sale. If its value increases and taxpayer could have sold it but does not – does taxpayer realize a *tax* loss when s/he later sells it for more than his/her basis but less than the fmv it once had?

exclude that amount from taxpayer's "gross income" and so from his/her income tax burden. That money was of course already subject to income tax at the time the taxpayer put it into his/her "store of property rights" and so should not be subject to tax again.

We begin with a case dealing with a *loss* from a dealing in property.

Hort v. CIR, 313 U.S. 28 (1941)

MR. JUSTICE MURPHY delivered the opinion of the Court.

....

Petitioner acquired the property, a lot and ten-story office building, by devise from his father in 1928. At the time he became owner, the premises were leased to a firm which had sublet the main floor to the Irving Trust Co. In 1927, five years before the head lease expired, the Irving Trust Co. and petitioner's father executed a contract in which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of $25,000, the term to commence at the expiration of the head lease.

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of $140,000. Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of $21,494.75 on the theory that the amount he received as consideration for the cancellation was $21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. ...

The Commissioner included the entire $140,000 in gross income, disallowed the asserted loss, ... and assessed a deficiency. The Board of Tax Appeals affirmed. 39 B.T.A. 922. The Circuit Court of Appeals affirmed per curiam ... [W]e granted certiorari limited to the question whether, "in computing net gain or loss for income tax purposes, a taxpayer [can] offset the value of the lease canceled against the consideration received by him for the cancellation."

....

The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section [61] [footnote omitted] ... expressly defines gross income to include "gains, profits, and income derived from ... rent, ... or gains or profits and income from any source whatever." Plainly this definition reached the rent paid prior to cancellation, just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. [citations omitted] That the amount petitioner received resulted from negotiations ending in cancellation of the lease, rather than from a suit to enforce it, cannot alter the fact that basically the payment was merely a substitute for the rent reserved in the lease. So far as the application of [§ 61(a)] is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments, rather than to engage in litigation, possibly uncertain and expensive.

The consideration received for cancellation of the lease was not a return of capital. We assume that the lease was "property," whatever that signifies abstractly. ... Simply because the lease was "property," the amount received for its cancellation was not a return of capital, quite apart from the fact that "property" and "capital" are not necessarily synonymous in the Revenue Act of 1932 or in common usage. Where, as in this case, the disputed amount was essentially a substitute for rental payments which [§ 61(a)] expressly characterizes as gross income, it must be regarded as ordinary income, and it is immaterial that, for some purposes, the contract creating the right to such payments may be treated as "property" or "capital."

....
We conclude that petitioner must report as gross income the entire amount received for cancellation of the lease, without regard to the claimed disparity between that amount and the difference between the present value of the unmatured rental payments and the fair rental value of the property for the unexpired period of the lease. The cancellation of the lease involved nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises. Undoubtedly it diminished the amount of gross income petitioner expected to realize, but, to that extent, he was relieved of the duty to pay income tax. Nothing in [§ 165] [footnote omitted] indicates that Congress intended to allow petitioner to reduce ordinary income actually received and reported by the amount of income he failed to realize. [citations omitted] We may assume that petitioner was injured insofar as the cancellation of the lease affected the value of the realty. But that would become a deductible loss only when its extent had been fixed by a closed transaction. [citations omitted]

The judgment of the Circuit Court of Appeals is affirmed.

Notes and Questions:

1. Taxpayer measured his gain/loss with the benefit of the bargain as his reference point. An accountant or financial officer would not evaluate the buyout of the lease in this case any differently than taxpayer did. If a lessor's interest has a certain value and the lessor sells it for less than that value, why can't the lessor recognize a *tax* loss?

- Evidently it was a good lease for the lessor. The present

Lump sum payments: On occasion, taxpayer may accept a lump sum payment in lieu of receiving periodic payments. The tax law characterizes the lump sum in the same manner as it would have characterized the periodic payments. For example, a life insurance salesman who sells his/her right to receive future commissions for a lump sum must treat the lump sum as commission income. We saw the Court apply this principle in *Glenshaw Glass* when it treated a lump sum payment in lieu of profits as if it were profit.

value of the contracted rents was greater than the fair rental value of the property. The difference was to be profit.
•$140,000 was $21,500 less than the anticipated profit.

2. The Tax Code taxes all income once unless specifically provided otherwise. Basis is the means by which a taxpayer keeps score with the government concerning what accessions to wealth have already been subject to tax.
•How does the Court's opinion implement these principles?
•How did taxpayer's contentions fail to implement these principles?
•What exactly was taxpayer's basis in its lessor's interest in the leasehold?

C. Barter

Now suppose that instead of accepting money in exchange for property or services, taxpayer accepts services for services, property for property, property for services, or services for property.

Rev. Rul. 79-24
GROSS INCOME; BARTER TRANSACTIONS
....

FACTS
Situation 1. In return for personal legal services performed by a lawyer for a housepainter, the housepainter painted the lawyer's personal residence. Both the lawyer and the housepainter are members of a barter club, an organization that annually furnishes its members a directory of members and the services they provide. All the members of the club are professionals or trades persons. Members contact other members directly and negotiate the value of the services to be performed.

Situation 2. An individual who owned an apartment building received a work of art created by a professional artist in return for the rent-free use of an apartment for six months by the artist.

LAW

The applicable sections of the Internal Revenue Code of 1954 and the Income Tax Regulations thereunder are 61(a) and 1.61-2, relating to compensation for services.

Section 1.61-2(d)(1) of the regulations provides that if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary.

HOLDINGS

Situation 1. The fair market value of the services received by the lawyer and the housepainter are includible in their gross incomes under section 61 of the Code.

Situation 2. The fair market value of the work of art and the six months fair rental value of the apartment are includible in the gross incomes of the apartment-owner and the artist under section 61 of the Code.

Notes and Questions:

1. Each party to a barter transaction *gave up* something and *received* something. If the fmv of what a party gives up is different from the value of what s/he received, it is the value of what taxpayer *receives* that matters. Read the Law and Holdings carefully. Section 1001(a) also requires this. This implies that two parties to a transaction may realize different amounts.

- Why would it be wrong to measure the amount realized by what taxpayer *gave up* in a barter transaction? Consider –

2. (continuing note 1): Let's say that the fmv of the painting was $6000. The fmv of the rent was $7000. We say that we tax income once – but we don't tax it more than once. In the following questions, keep track of what the taxpayer has and on how much income s/he has paid income tax.

- What should be the apartment-owner's taxable gain from exchanging rent for the painting?
- What should be the apartment-owner's basis in the painting s/he received?
- What is the apartment-owner's taxable gain if s/he sells the painting immediately upon receipt for its fmv?

3. Sections 61(a) lists several forms that gross income may take. The Code does not treat all forms of gross income the same. Different rates of tax may apply to different forms of gross income. Or, the Code might not – in certain circumstances – tax some forms of gross income at all. Thus there are reasons that we should not (always) treat gross income as a big hodge-podge of money. In the following case, the court distinguishes between a gain that taxpayer derived from dealings in property from gains that taxpayer derived from a discharge of his/her debt. Determine what was at issue in *Gehl*, what the parties argued, and why it mattered.

United States v. Gehl, 50 F.3d 12, 1995 WL 115589 (CA8), *cert. denied*, 516 U.S. 899 1995)

NOTICE: THIS IS AN UNPUBLISHED OPINION.

....

BOGUE, Senior District Judge.

Taxpayers James and Laura Gehl (taxpayers) appeal from an adverse decision in the United States Tax Court finding deficiencies in their income taxes for 1988 and 1989. For the reasons stated below, we affirm.

BACKGROUND

Prior to the events in issue, the taxpayers borrowed money from the Production Credit Association of the Midlands (PCA). Mortgages on a 218 acre family farm were given to the PCA to secure the recourse loan. As of December 30, 1988, the taxpayers were insolvent and unable to make the payments on the loan, which had an outstanding balance of $152,260. The transactions resolving the situation between the PCA and the taxpayers form the basis of the current dispute.

Pursuant to a restructuring agreement, taxpayers, by deed in lieu of foreclosure, conveyed 60 acres of the farm land to the PCA on December 30, 1988, in partial satisfaction of the debt. The taxpayers basis in the 60 acres was $14,384 and they were credited with $39,000 towards their loan, the fair market value of the land. On January 4, 1989, taxpayers conveyed, also by deed in lieu of foreclosure, an additional 141 acres of the mortgaged farm land to the PCA in partial satisfaction of the debt. Taxpayers basis in the 141 acres was $32,000 and the land had a fair market value of $77,725. Taxpayers also paid $6,123 in cash to the PCA to be applied to their loan. The PCA thereupon forgave the remaining balance of the taxpayers' loan, $29,412. Taxpayers were not debtors under the Bankruptcy Code during 1988 or 1989, but were insolvent both before and after the transfers and discharge of indebtedness.

After an audit, the Commissioner of Revenue (Commissioner) determined tax deficiencies of $6,887 for 1988 and $13,643 for 1989 on the theory that the taxpayers had realized a gain on the disposition of their farmland in the amount by which the fair market value of the land exceeded their basis in the same at the time of the transfer (gains of $24,616 on the 60 acre conveyance and $45,645 on the conveyance of the 141 acre conveyance). The taxpayers petitioned the Tax Court for redetermination of their tax liability for the years in question contending that any gain they realized upon the transfer of their property should not be treated as income because they remained insolvent after the transactions.

The Tax Court found in favor of the Commissioner. In doing so, the court "bifurcated" its analysis of the transactions, considering the transfers of land and the discharge of the remaining debt separately. The taxpayers argued that the entire set of transactions should be considered together and treated as income from the discharge of indebtedness. As such, any income derived would be excluded as the taxpayers remained insolvent throughout the process. 26 U.S.C. § 108(a)(1). As to the discharge of indebtedness, the court determined that because the taxpayers remained insolvent after their debt was discharged, no income would be attributable to that portion of the restructuring agreement.

On the other hand, the court found the taxpayers to have received a gain includable as gross income from the transfers of the farm land (determined by the excess of the respective fair market values over the respective basis). This gain was found to exist despite the continued insolvency in that the gain from the sale or disposition of land is not income from the discharge of indebtedness. The taxpayers appealed.

DISCUSSION

We review the Tax Court's interpretation of law de novo. [citation omitted] Discussion of this case properly begins with an examination of I.R.C. § 61 which defines gross income under the Code. In order to satisfy their obligation to the PCA, the taxpayers agreed to participate in an arrangement which could potentially give rise to gross income in two distinct ways.[35] I.R.C. § 61(a)(3) provides that for tax purposes, gross income includes "gains derived from dealings in property." Likewise, income is realized pursuant to I.R.C. § 61(a)(12) for "income from discharge of indebtedness."

There can be little dispute with respect to Tax Court's treatment of the $29,412 portion of the debt forgiven subsequent to the transfers of land and cash. The Commissioner stipulated that under I.R.C. § 108(a)(1)(B),[36]

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[35] Aside from being part of the restructuring agreement, the taxpayer's transfer of $6,123 cash to the PCA has little significance for the purposes of the present appeal.

[36] I.R.C. § 108(a)(1)(B) provides that "gross income does not include any amount which (but for this subsection) would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if ... the discharge occurs when the taxpayer is insolvent." ...

the so-called "insolvency exception," the taxpayers did not have to include as income any part of the indebtedness that the PCA forgave. The $29,412 represented the amount by which the land and cash transfers fell short of satisfying the outstanding debt. The Tax Court properly found this amount to be excluded.

Further, the Tax Court's treatment of the land transfers, irrespective of other portions of the restructuring agreement, cannot be criticized. Section 1001 governs the determination of gains and losses on the sale or exchange of property. Section 1001(a) provides that "[t]he gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis ..." The taxpayers contend that because the disposition of their land was compulsory and that they had no discretion with respect to the proceeds, the deeds in lieu of foreclosure are not "sales" for the purposes of § 1001. We disagree. A transfer of property by deed in lieu of foreclosure constitutes a "sale or exchange" for federal income tax purposes. *Allan v. Commissioner of Revenue*, 86 F.C. 655, 659-60, aff'd. 856 F.2d 1169, 1172 (8th Cir. 1988) (citations omitted). The taxpayers' transfers by deeds in lieu of foreclosure of their land to the PCA in partial satisfaction of the recourse debt were properly considered sales or exchanges for purposes of § 1001.

Taxpayers also appear to contend that under their circumstances, there was no "amount realized" under I.R.C. §§ 1001(a-b) and thus, no "gain" from the land transfers as the term is used in I.R.C. § 61(a)(3). Again, we must disagree. The amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(1). Simply because the taxpayers did not actually receive any cash proceeds from the land transfers does not mean there was no amount realized. Via the land transfers, they were given credit toward an outstanding recourse loan to the extent of the land's fair market value. This loan had to be paid back. It is clear that the transfers of land employed to satisfy that end must be treated the same as receiving money from a sale. In this case the land transfers were properly considered "gains derived from dealings in property" to the extent the fair market value in the land exceeded the taxpayers' basis in said land. I.R.C. §§ 61(a)(3), 1001(a).

The taxpayers' primary and fundamental argument in this case is the Tax Court's refusal to treat the entire settlement of their loan, including the land transfers, as coming within the scope of I.R.C. § 108. As previously stated, § 108 and attending Treasury Regulations act to exclude income from the discharge of indebtedness where the taxpayer thereafter remains insolvent. The taxpayers take issue with the bifurcated analysis conducted by the Tax Court and contend that, because of their continued insolvency, § 108 acts to exclude any income derived from the various transactions absolving their debt to the PCA.

As an initial consideration, the taxpayers read the insolvency exception of § 108 too broadly. I.R.C. § 61 provides an [*sic*] non-exclusive list of fifteen items which give rise to income for tax purposes, including income from discharge of indebtedness. Of the numerous potential sources of income, § 108 grants an exclusion to insolvent taxpayers only as to income from the discharge of indebtedness. It does not preclude the realization of income from other activities or sources.

While § 108 clearly applied to a portion of the taxpayers' loan restructuring agreement, the land transfers were outside the section's scope and were properly treated independently. [citation omitted]

There is ample authority to support Tax Court's bifurcated analysis and substantive decision rendered with respect to the present land transfers. The Commissioner relies heavily on Treas. Reg. § 1.1001-2 and example 8 contained therein, which provides:

> (a) Inclusion in amount realized.-(1) * * *
>
> > (2) Discharge of indebtedness. The amount realized on a sale or other disposition of property that secures a recourse

> liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). * * *
>
> (c) Examples * * *
>
> Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500-$6,000).

We believe the regulation is controlling and serves ... to provide support for the decision rendered by the Tax Court.[37]

CONCLUSION

For the reasons stated, we affirm the decision of the Tax Court.

Notes and Questions:

1. Section 61(a) presents a comprehensive definition of "gross income." However, the fifteen enumerated types or sources of income are not necessarily subject to the same rate of tax, and other provisions may exclude certain types of income from income subject to tax altogether. Naturally, taxpayers would prefer to characterize their income as of a type or from a source not subject to income tax. Under certain circumstances, § 108 excludes discharge of indebtedness income from income tax. *See* chapter 3 *infra*. For these reasons, the type or source of income *can* matter greatly.

> *Giving property as payment*: The use of appreciated (or depreciated) property to pay for something is a recognition event. Why?

2. Taxpayer may transfer a piece of

[37] Despite the technical accuracy of the decisio[n] ... government's exhaustive pursuit of this matter in view of the taxpayers' dire financial situation and continued insolvency.

appreciated (or depreciated) property to another to satisfy an obligation or make a payment. Taxpayer might alternatively have sold the property for its fmv. The gain derived from the sale would be subject to income tax. Taxpayer could then pay the cash s/he realized to the obligee or payee. The result should be no different if taxpayer simply transfers the property directly to the obligee or payee. The court recognized this when it stated:

> It is clear that the transfers of land employed to satisfy [an obligation or make a payment] must be treated the same as receiving money from a sale. In this case the land transfers were properly considered "gains derived from dealings in property" to the extent the fair market value in the land exceeded the taxpayers' basis in said land. I.R.C. §§ 61(a)(3), 1001(a).

3. Notice that if taxpayer's views in *Gehl* had prevailed, they would have realized the benefit of the appreciation in the value of their property (i.e., an accession to wealth) without that accession ever being subject to tax – contrary to the first of the three principles stated chapter 1 that you should know by now.

4. Read Reg. § 1.61-2(d)(1 and 2(i)) and § 83(a).

•Taxpayer performed accounting services over the course of one year for Baxter Realty. The fmv of these services was $15,000. Taxpayer billed Baxter Realty for $15,000. Unfortunately, Baxter Realty was short on cash and long on inventory, which included a tract of land known as Blackacre. The fmv of Blackacre was $20,000. Its cost to Baxter Realty was $11,000. Taxpayer agreed to accept Blackacre as full payment for the bill. Six months later, Taxpayer sold Blackacre to an unrelated third person for $22,000.

1. How much must Taxpayer report as gross income from the receipt of Blackacre as payment for his/her services?
2. How much must Taxpayer report as gross income derived from the sale of Blackacre?
3. How much must Baxter Realty report as gross income derived from its dealings in Blackacre?

D. Improvements to Leaseholds and the Time Value of Money

Helvering v. Bruun, 309 U.S. 461 (1940)

MR. JUSTICE ROBERTS delivered the opinion of the Court.

....

... [O]n July 1, 1915, the respondent, as owner, leased a lot of land and the building thereon for a term of ninety-nine years.

The lease provided that the lessee might at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

In 1929, the tenant demolished and removed the existing building and constructed a new one which had a useful life of not more than fifty years. July 1, 1933, the lease was cancelled for default in payment of rent and taxes, and the respondent regained possession of the land and building.

....

... [At] said date, July 1, 1933, the building which had been erected upon said premises by the lessee had a fair market value of $64,245.68, and ... the unamortized cost of the old building, which was removed from the premises in 1929 to make way for the new building, was $12,811.43, thus leaving a net fair market value as at July 1, 1933, of $51,434.25, for the aforesaid new building erected upon the premises by the lessee.

On the basis of these facts, the petitioner determined that, in 1933, the respondent realized a net gain of $51,434.25. The Board overruled his determination, and the Circuit Court of Appeals affirmed the Board's decision.

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917, the Treasury ruled that the adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease. [footnote omitted] The ruling was incorporated in two succeeding editions of the Treasury Regulations. [footnote omitted] In 1919, the Circuit Court of Appeals for the Ninth Circuit held, in *Miller v. Gearin*, 258 F.2d 5, that the regulation was invalid, as the gain, if taxable at all, must be taxed as of the year when the improvements were completed. [footnote omitted]

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently, the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned. [footnote omitted]

In 1935, the Circuit Court of Appeals for the Second Circuit decided, in *Hewitt Realty Co. v. Commissioner*, 76 F.2d 880, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the land, and, if removed, would be worthless except as bricks, iron, and mortar. It said, 76 F.2d 884:

> The question, as we view it, is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.

This decision invalidated the regulations then in force. [footnote omitted]

In 1938, this court decided *M.E. Blatt Co. v. United States*, 305 U. S. 267. There, in connection with the execution of a lease, landlord and tenant mutually agreed that each should make certain improvements to the demised premises and that those made by the tenant should become and remain the property of the landlord. The Commissioner valued the improvements as of the date they were made, allowed depreciation thereon to the termination of the leasehold, divided the depreciated value by the number of years the lease had to run, and found the landlord taxable for each year's aliquot portion thereof. His action was sustained by the Court of Claims. The judgment was reversed on the ground that the added value could not be considered rental accruing over the period of the lease; that the facts found by the Court of Claims did not support the conclusion of the Commissioner as to the value to be attributed to the improvements after a use throughout the term of the lease, and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act.

The circumstances of the instant case differentiate it from the *Blatt* and *Hewitt* cases, but the petitioner's contention that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled title, possession, and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the *Miller* case and to the reasoning in the *Hewitt* case.

The respondent insists that the realty – a capital asset at the date of the execution of the lease – remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or treated as received in exchange for the improvements which were on the land at the date of the execution of the lease; that they are therefore in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner's disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment, and may not therefore be taxed without apportionment.

We hold that the petitioner was right in assessing the gain as realized in 1933.

....

The respondent cannot successfully contend that the definition of gross income in Sec. [61(a)] [footnote omitted] is not broad enough to embrace the gain in question. ... He emphasizes the necessity that the gain be separate from the capital and separately disposable.

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer's indebtedness, relief from a liability, or other profit realized from the completion of a transaction. [footnote omitted] The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property, whereas such gain has always been recognized as realized taxable gain.

Judgment reversed.

....

Notes and Questions:

1. Aliquot: a fractional part that is contained a precise number of times in the whole.
2. Why did everyone who had anything to do with this case subtract the unamortized cost of the old building from the fmv of the new building in determining taxpayer's taxable income? After all, taxpayer does not own a building that no longer physically exists?

3. Sections 109/1019 reverse the holding of *Bruun*. Section 109 provides that taxpayer does not derive gross income upon termination of a lease by virtue of the fact that the lessee erected buildings or other improvements on the property. Section 1019 provides that taxpayer may not increase or decrease his/her/its adjusted basis in property because he/she/it received gross income that § 109 excludes. Is § 1019 necessary?
   - What is conceptually wrong with §§ 109 and 1019? Isn't there some untaxed consumption? Where?

4. Section 109 does not apply to improvements that the lessee makes which the parties intend as rent. Reg. § 1.61-8(c) ("If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor.")
   - Suppose that a retailer leases space for a period of one year in taxpayer/lessor's shopping mall. As part of the rental, lessee agrees to install various fixtures and to leave them to the lessor at the termination of the lease. The value of the fixtures is $20,000.
     - What is lessor's basis in the fixtures?
     - Exactly what does the payment of rent purchase?
     - Exactly what does a lessor "sell" by accepting a rent payment?

5. Consider each of the rules the Court considered – as well as the rule that Congress created in §§ 109/1019. Identify each rule and consider this question: what difference does it make which rule is applied?

> *The cost of deriving income and depreciation*: Taxpayer should not be subject to tax on the costs that he/she/it incurs to earn income. The costs of supplies, e.g., fuel to operate a productive machine, represent consumption from which taxpayer derives income. The Code taxes only "net" income. It accomplishes this by granting taxpayer a deduction for such consumption. § 162. Suppose that taxpayer incurs a cost to purchase an asset that will produce income for many years, e.g., a building. Taxpayer's taxable income would be subject to (enormous) distortion if he/she/it reduced his/her/its gross income by the cost of such an asset in the year he/she/it purchased it. The Code treats such a purchase as an investment – a mere conversion in the form in which taxpayer holds his/her/its wealth. A taxpayer's mere conversion of the form in which he/she/it holds wealth is not a taxable event. Taxpayer will have a basis in the asset. Taxpayer will then *consume* a portion of the asset year after year. Taxpayer may deduct such incremental consumption of a productive asset year after year. This deduction is for "depreciation" – whose name is now "cost recovery." § 168. To the extent of the depreciation deduction, taxpayer has converted investment into consumption. Hence, taxpayer must reduce his/her/its basis in the asset for such deductions. § 1016. This represents "de-investment" in the asset.

•Let's assume that the lessee did not remove a building, but simply erected a new building on the premises. Let's also put some numbers and dates into the problem for illustrative purposes. Assume that the fmv of the building in 1990 upon completion is $400,000. The building will last 40 years. The building will lose $10,000 of value every year, and this is the amount that taxpayer may claim as a depreciation/cost recovery deduction. Taxpayer must reduce his/her basis in the property (§ 1016) for depreciation deductions. The adjusted basis of the property equals its fmv. The lease upon completion of the building will run another 20 years until 2010. The lessee did not default thereby causing early termination of the lease. Immediately upon termination of the lease, taxpayer sells the property, and the portion of the selling price attributable to the building is $200,000.

Taxpayer pays income tax equal to 30% of his/her/its income from whatever taxable events occur.

(1) CIR's view, the rule of the 1917 regulations, and the Supreme Court's holding in *Helvering v. Bruun*: taxpayer derives taxable income at the termination of the lease equal to fmv − (ab in old building)

- How much gross income must taxpayer recognize for receiving the building and when?
- How much is the income tax on this item of taxpayer's gross income?
- How much gain will taxpayer realize from the sale of the building?
- How much income tax must taxpayer pay for having sold the building?
- What is taxpayer's total tax bill?

(2) *Miller v. Gearin*: taxpayer must recognize taxable income equal to the fmv of that improvement in the year of completion.

- How much gross income must taxpayer recognize for receiving the building and when?
- How much is the income tax on this item of taxpayer's gross income?
    - What will taxpayer's basis in the building be?
    - What will taxpayer's annual depreciation/cost recovery allowance be for each of the next twenty years?
    - How much will the annual depreciation/cost recovery allowance reduce taxpayer's income tax liability for each of the remaining years of the lease?
    - What will be the total reduction in taxpayer's income tax liability resulting from depreciation/cost recovery allowances?
        - What should happen to taxpayer's basis in the building for each year that he/she/it claims a depreciation/cost recovery

deduction?

•What will be taxpayer's net income tax liability for having received the building?

•How much gain will taxpayer realize from the sale of the building?

•How much income tax must taxpayer pay for having sold the building?

•What is taxpayer's total tax bill?

(3) New regulations that the Court referenced in *Bruun* that Treasury promulgated after *Miller*: taxpayer includes the discounted present value (PV) of the improvement's fmv at the termination of lease in his/her/its taxable income at the time of completion of the building.

•How much gross income must taxpayer recognize for receiving the building and when?

•How much is the income tax on this item of taxpayer's gross income?

•How much gain will taxpayer realize from the sale of the building?

•How much income tax must taxpayer pay for having sold the building?

•What is taxpayer's total tax bill?

(4) Even newer regulations and the rule of the Court of Claims's holding in *M.E. Blatt Co. v. U.S.*: taxpayer/lessor must determine what the fmv of the improvement will be at the termination of the lease and report as taxable income for each remaining year of the lease an aliquot share of that amount. In the event of premature termination, taxpayer/lessor must report as taxable income or may claim as a reduction to his/her taxable income an amount equal to (fmv at time of termination) − (amount of income previously taxed).

•How much gross income must taxpayer recognize for receiving the building and when?

•How much is the income tax on this item of taxpayer's

gross income?
•How much gain will taxpayer realize from the sale of the building?
•How much income tax must taxpayer pay for having sold the building?
•What is taxpayer's total tax bill?

(5) §§ 109/1019, *Hewitt Realty Co. v. CIR*, and Supreme Court holding in *M.E. Blatt Co. v. U.S.*
•How much gross income must taxpayer recognize for receiving the building and when?
•How much is the income tax on this item of taxpayer's gross income?
•How much gain will taxpayer realize from the sale of the building?
•How much income tax must taxpayer pay for having sold the building?
•What is taxpayer's total tax bill?

Compare the tax liability of taxpayer in (1), (2), (3), (4), and (5). Did the choice of the applicable rule affect the net income tax liability of taxpayer?

6. It is very expensive to litigate a case to a federal circuit court of appeals or all the way to the United States Supreme Court. Apparently, the prevailing rule did not affect taxpayer's net tax liability under the hypothetical facts laid down for this exercise. If the choice of rule does not alter the final tax liability of a taxpayer, *why* would parties spend serious money litigating a choice of rule question to the Supreme Court? For that matter, why would the Treasury Department use up so much ink promulgating and then changing regulations?
7. The answer (of course) lies in the fact that the right to have $1 today is worth more than the right to have $1 at some future time. The number of dollars involved in any of these transactions may not change, but their value certainly does. *Yet calculations of taxable income and income tax liability do not (often) change merely because $1 today is worth more than $1 tomorrow.* Taxpayers understand that principle very well and seek to reduce the

present value of their tax liability as much as possible. They can do this by accelerating recognition of deductions and deferring recognition of income.

•We now consider exactly how taxpayers and the CIR would value the same tax liability that taxpayers must pay (and the U.S. Treasury would receive) sooner rather than later.

8. There are formulas that incorporate the variables of time and discount rate that enable us to determine either the future value (FV) of $1 now or the present value (PV) of $1 in the future. We can use the formulas to generate easy-to-use tables that enable us to make future value and present value determinations.

•You can Google "present value tables" to find a variety of such tables.

•Some tables appear in the pages immediately following this one. *Do not forget that these tables are here. You may wish to use them from time to time.*

•**Table 1** shows what $1 today will be worth at given interest rates (across the top of the table) after a given number of years (down the left hand side of the table).

•**Table 2** shows what $1 at some given future date is worth today.

•**Table 3** shows the present value of receiving $1 at the end of every year for a given number of years. This of course is an annuity, but this table is very useful in determining the PV of any stream of payments that does not vary in amount, e.g., depreciation deductions.

•A useful approximation that you can verify by referring to table 1 is the so-called rule of 72. Simply divide 72 by the interest rate expressed as a whole number. The quotient is very close to the length of time it takes money to double in value at that interest rate.

Table 1: Future value of $1 at various interest rates, compounded annually: $FV = 1(1 + r)^t$

FV = future value; r = interest rate expressed as decimal; t = time, i.e., # of years. In the left hand column is the number of years. In the top row is the interest rate.

	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	1.01	1.02	1.03	1.04	1.05	1.06	1.07	1.08	1.09	1.1
2	1.0201	1.0404	1.0609	1.0816	1.1025	1.1236	1.1449	1.1664	1.1881	1.21
3	1.0303	1.0612	1.0927	1.1249	1.1576	1.191	1.225	1.2597	1.295	1.331
4	1.0406	1.0824	1.1255	1.1699	1.2155	1.2625	1.3108	1.3605	1.4116	1.4641
5	1.051	1.1041	1.1593	1.2167	1.2763	1.3382	1.4026	1.4693	1.5386	1.6105
6	1.0615	1.1262	1.1941	1.2653	1.3401	1.4185	1.5007	1.5869	1.6771	1.7716
7	1.0721	1.1487	1.2299	1.3159	1.4071	1.5036	1.6058	1.7138	1.828	1.9487
8	1.0829	1.1717	1.2668	1.3686	1.4775	1.5938	1.7182	1.8509	1.9926	2.1436
9	1.0937	1.1951	1.3048	1.4233	1.5513	1.6895	1.8385	1.999	2.1719	2.3579
10	1.1046	1.219	1.3439	1.4802	1.6289	1.7908	1.9672	2.1589	2.3674	2.5937
20	1.2202	1.4859	1.8061	2.1911	2.6533	3.2071	3.8697	4.661	5.6044	6.7275
30	1.3478	1.8114	2.4273	3.2434	4.3219	5.7435	7.6123	10.063	13.268	17.449

Table 2: Present Value of $1 at a future date at a given interest rate compounded annually: PV = $1/(1 + r)^t$

	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	0.9803	0.9612	0.9426	0.9246	0.907	0.89	0.8734	0.8573	0.8417	0.8264
3	0.9706	0.9423	0.9151	0.889	0.8638	0.8396	0.8163	0.7938	0.7722	0.7513
4	0.961	0.9238	0.8885	0.8548	0.8227	0.7921	0.7629	0.735	0.7084	0.683
5	0.9515	0.9057	0.8626	0.8219	0.7835	0.7473	0.713	0.6806	0.6499	0.6209
6	0.942	0.888	0.8375	0.7903	0.7462	0.705	0.6663	0.6302	0.5963	0.5645
7	0.9327	0.8706	0.8131	0.7599	0.7107	0.6651	0.6227	0.5835	0.547	0.5132
8	0.9235	0.8535	0.7894	0.7307	0.6768	0.6274	0.582	0.5403	0.5019	0.4665
9	0.9143	0.8368	0.7664	0.7026	0.6446	0.5919	0.5439	0.5002	0.4604	0.4241
10	0.9053	0.8203	0.7441	0.6756	0.6139	0.5584	0.5083	0.4632	0.4224	0.3855
20	0.8195	0.673	0.5537	0.4564	0.3769	0.3118	0.2584	0.2145	0.1784	0.1486
30	0.7419	0.5521	0.412	0.3083	0.2314	0.1741	0.1314	0.0994	0.0754	0.0573

Table 3: Present Value of a $1 Annuity Discounted by a Given Interest

rate for a Certain Number of Annual Payments: PV = (−0.1)*(1−1/(1 + i)$^{-t)}$)/i

	1%	2%	3%	4%	5%	6%	7%	8%	9%	10%
1	0.9901	0.9804	0.9709	0.9615	0.9524	0.9434	0.9346	0.9259	0.9174	0.9091
2	1.9704	1.9416	1.9135	1.8861	1.8594	1.8334	1.808	1.7833	1.7591	1.7355
3	2.941	2.8839	2.8286	2.7751	2.7232	2.673	2.6243	2.5771	2.5313	2.4869
4	3.902	3.8077	3.7171	3.6299	3.546	3.4651	3.3872	3.3121	3.2397	3.1699
5	4.8534	4.7135	4.5797	4.4518	4.3295	4.2124	4.1002	3.9927	3.8897	3.7908
6	5.7955	5.6014	5.4172	5.2421	5.0757	4.9173	4.7665	4.6229	4.4859	4.3553
7	6.7282	6.472	6.2303	6.0021	5.7864	5.5824	5.3893	5.2064	5.033	4.8684
8	7.6517	7.3255	7.0197	6.7327	6.4632	6.2098	5.9713	5.7466	5.5348	5.3349
9	8.566	8.1622	7.7861	7.4353	7.1078	6.8017	6.5152	6.2469	5.9952	5.759
10	9.4713	8.9826	8.5302	8.1109	7.7217	7.3601	7.0236	6.7101	6.4177	6.1446
20	18.046	16.351	14.877	13.59	12.462	11.47	10.594	9.8181	9.1285	8.5136
30	25.808	22.396	19.6	17.292	15.372	13.765	12.409	11.258	10.274	9.4269

9. Now: let's assume that the discount rate in our problems above is 8% and rework the answers. Compare the present value of taxpayer's $60,000 tax liability on the very same transactions in 1990 under each of the five rules:

(1) CIR's view, the of the 1917 regulations, and the Supreme Court's holding in *Bruun*: taxpayer derives taxable income at the termination of the lease equal to fmv − (ab in old building).

•In 1990, what is the present value of taxpayer's net tax liability?

(2) *Miller v. Gearin*: taxpayer must recognize taxable income equal to the fmv of that improvement in the year of completion.

•In 1990, what is the present value of taxpayer's net tax liability?

(3) New regulations that the Court referenced in *Bruun* that Treasury promulgated after *Miller*: the discounted PV of

improvement's fmv at the termination of lease is included in taxpayer's taxable income at the time of completion of the building.

- In 1990, what is the present value of taxpayer's net tax liability?

(4) Even newer regulations and the rule of the Court of Claims's holding in *M.E. Blatt Co. v. U.S.*: taxpayer/lessor must determine what the fmv of the improvement will be at the termination of the lease and report as taxable income for each remaining year of the lease an aliquot share of that depreciated amount. In the event of premature termination, taxpayer/lessor must report as taxable income or may claim as a reduction to his/her taxable income an amount equal to (fmv at time of termination) − (amount of income previously taxed).

- In 1990, what is the present value of taxpayer's net tax liability?

(5) §§ 109/1019, *Hewitt Realty Co. v. CIR*, and Supreme Court holding in *M.E. Blatt Co. v. U.S.*

- In 1990, what is the present value of taxpayer's net tax liability?

10. The time value of money is one place where taxpayers and the Commissioner now play the tax game. Look for the ways in which it affects the contentions of parties in the cases ahead. The higher the discount rate, the more taxpayer benefits from deferring payment of a tax and/or accelerating a deduction.

11. Congress can itself exploit the time value of money to pursue certain policy objectives that require taxpayers to save money in order that they make a particular consumption choice. For example, Congress may wish for taxpayers to save money throughout their working lives that they can spend in retirement. Sections 219/62(a)(7) permit taxpayers to reduce their adjusted gross income (AGI) by amounts that they save in an Individual Retirement Account (IRA). So also, Congress may wish for taxpayers to save money that they can spend on medical expenses at some

future date. Sections 223/62(a)(19) permit taxpayers to reduce their (AGI) by amounts that they save in a Health Savings Account. The money that taxpayers deposit in these accounts at a young age can grow significantly, as the tables above attest.

E. Imputed Income

Consider the following:
Mary and John are attorneys who both are in the 25% marginal tax bracket. They are equally productive and efficient in their work as attorneys. They both own houses that need a paint job. The cost of hiring a painter to paint their homes is $9000.

- John hires a painter to paint his house. In order to pay the painter, John must work six extra weekends in order to earn another $12,000. After paying $3000 in taxes, John can then pay the painter $9000. For having worked to earn an additional $12,000 and paid $3000 more in income tax, John will have a house with a $9000 paint job – which he will commence "consuming." John had to pay $3000 in income taxes in order to consume $9000.
- Mary decides to do the job herself on five successive weekends. The fmv of these services is $9000. When she has completed the job, Mary will have a house with a $9000 paint job – which she will commence "consuming." Mary paid nothing in income taxes in order to consume $9000.

Notice: John was able to earn $2000 per weekend. Mary "earned" $1800 per weekend. Mary is not as productive or as efficient a painter as she is an attorney. (Otherwise she should give up practicing law and take up house painting.) Nevertheless, Mary expended fewer resources in order to acquire a painted house than John did. How?

- The answer lies in the fact that John had to pay income tax on his "consumption," and Mary did not.
- Services that one performs for oneself give rise to "imputed income."
- As a matter of administrative practice and convenience, we do not

tax imputed income.

•As the facts of this hypothetical illustrate, not taxing imputed income causes inefficiency. Mary would create more value by practicing law on the weekends than by painting.

•Not taxing imputed income also causes distortions because from Mary's point of view, not taxing her imputed income encourages her to perform more services for herself – so long as the cost of her inefficiency is less than the income taxes that she saves.

•In addition to these inefficiencies and distortions, not taxing imputed income derived from performing services for oneself costs the U.S. Treasury money. Obviously, we should not be concerned about de minimis amounts, e.g., mowing our own lawns. But one major source of lost revenue is the non-taxation of imputed income derived by the stay-at-home parent.

Eileen and Robert are both in the 25% tax bracket. Assume that annual rental rates for a home is 10% of the home's fmv. Both Robert and Eileen have accumulated $250,000. The income necessary to accumulate this money has already been subject to income tax. Prevailing interest rates are 8%.

•Robert elects to take the $20,000 return on his investments to pay the rent on a house valued at $150,000. After paying $5000 in income taxes, he will have $15,000 with which to pay rent. His investment will not grow because he uses his entire return on investment to pay income tax plus rent.

•Eileen elects to change the form in which she holds some of her investment and to use $150,000 to purchase a house. She will still have $100,000 invested. Eileen can live in her house rent-free and will earn a 6% (i.e., 8% − (25% of 8%)) after-tax return on her investment, compounded annually. *See* table 1 in the discussion of *Bruun*, *supra*. In less than 16 years, Eileen will have $250,000 PLUS she will own a $150,000 home (assuming that it does not lose value; in fact its value might increase).

Notice: Obviously Eileen came out ahead of Robert. Both Eileen and

Robert started with the same wealth and lived in the same type of house. How did Eileen do so much better than Robert?

- Again, Robert had to pay income tax on his consumption while Eileen did not.
- The fair rental value of property that a taxpayer owns is also imputed income, and it is not subject to income tax.
- As the facts of this hypothetical illustrate, not taxing imputed income causes inefficiency because it encourages taxpayers to invest in a certain type of asset in preference to other investments only because of certain characteristics of the property.
  - In the not-so-distant past, the fmv of a house did not usually decline.
  - A house is something that a consumer can and wants to consume.
- Not taxing imputed income derived from ownership of property increases a taxpayer's return on investing in such property. Eileen received $15,000 worth of rent annually on her $150,000 investment – a tax-free return of 10%. A net after-tax return of 10% subject to 25% income tax would require a before-tax return of 13.33%.
- A major source of lost revenue to the Treasury through the non-taxation of the fair rental value of property that taxpayer owns results from Americans' widespread ownership of homes – and the ownership of homes that are more expensive than what many taxpayers would otherwise purchase.
- Perhaps the risk-adjusted return on Turkish apricot futures is greater than the 8% return Eileen and Robert so easily earn on their investments, but Eileen will not choose to maximize her investment return in this manner unless the return on such an investment is greater than 13.33%. The Tax Code assures that many taxpayers will prefer to purchase assets such as homes rather than make investments with higher after-tax returns.
  - In the event that not imputing the fair rental value of property to its owner as taxable income is not sufficient incentive to invest in homes –
    - § 163(h) permits deduction of mortgage interest on up to $1,000,000 of indebtedness incurred to purchase

a home or of interest on up to $100,000 of home equity indebtedness.

•§ 121 permits exclusion from gross income of up to $250,000 of gain from the sale or exchange of a taxpayer's principal residence under prescribed circumstances.

•§ 164(a)(1) permits a deduction for state and local, and foreign real property taxes.[38]

•Of course, these rules greatly increase demand for houses. Without question, the Tax Code has distorted the market for houses and increased their fmv.

Now consider whether taxpayer realizes less gross income upon receipt of a benefit for which his employer paid cash when he *foregoes* the opportunity to earn imputed income.

Problem: Taxpayer Koons entered into a contract of employment with Aerojet General Corporation (Aerojet) to work at its plant near Sacramento, California. Aerojet agreed to pay taxpayer's travel and moving expenses of to move himself and his family from Big Springs, Texas to Sacramento. This included the cost of hiring a moving company to move his furniture and belongings. Aerojet reimbursed Koons for his payment to the movers, whose charges were no more than their fmv. In 1959, there was no deduction or exclusion for this cost, so Koons had to include Aerojet's reimbursement in his gross income. Koons paid the income tax on the reimbursement and sued for a refund. At trial, he offered to show that the value to *him* of hiring a moving company was much less than its cost. He also offered to show that had he known that the cost of moving was taxable income, he would have rented a trailer and done most of the work himself. He had done this on five other occasions. Koons argued that he should include in his gross income only the rental cost of a trailer.

•Should a trial court judge sustain the United States's objections to his offer of proof as irrelevant?

[38] The Tax Code makes a substantial contribution to urban sprawl.

•Must taxpayer Koons include in his gross income the fmv of the services rendered, or some lesser amount?
•*See Koons v. United States*, 315 F.2d 542 (1963).
•How well does the argument "I could have done it myself for a lot less money" square with the tax rules governing imputed income? – with SHS?

III. The Constitutional and Statutory Definitions of "Gross Income:" Realization

Can a taxpayer realize income if s/he never receives it, but someone else does?

Helvering v. Horst, 311 U.S. 112 (1940)

MR. JUSTICE STONE delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor's taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935, respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son, who, in the same year, collected them at maturity. The Commissioner ruled that, under ... [§ 61], the interest payments were taxable, in the years when paid, to the respondent donor, who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. We granted certiorari because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of *Lucas v. Earl*, 281 U.S. 111, and with that of decisions by other circuit courts of appeals. *See Bishop v.*

Commissioner, 54 F.2d 298; *Dickey v. Burnet*, 56 F.2d 917, 921; *Van Meter v. Commissioner*, 61 F.2d 817.

The court below thought that, as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from *Lucas v. Earl*, *supra*, and *Burnet v. Leininger*, 285 U.S. 136, where the assignment of compensation for services had preceded the rendition of the services, and where the income was held taxable to the donor.

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together, they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning, the revenue laws have been interpreted as defining "realization" of income as the taxable event, rather than the acquisition of the right to receive it. And "realization" is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property, realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716; *Corliss v. Bowers*, 281 U.S. 376, 281 U. S. 378. *Cf. Burnet v. Wells*, 289 U.S. 670.

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer's personal receipt of money or property. [citation omitted] This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is whether, because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, *see Old Colony Trust Co. v. Commissioner*, *supra*; [citations omitted], or if he sets up a revocable trust with income payable to the objects of his bounty, §§ 166, 167 [citations omitted], he does not escape taxation because he did not actually receive the money. [citations omitted]

Underlying the reasoning in these cases is the thought that income is "realized" by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions or whether he disposes of his right to collect it as the means of procuring them. [citation omitted]

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such nonmaterial satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money, he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named. [citation omitted]

In a real sense, he has enjoyed compensation for money loaned or services rendered, and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment, and hence the realization, of the income by him who exercises it. We have had no difficulty in applying that proposition where the assignment preceded the rendition of the services, *Lucas v. Earl*, *supra*; *Burnet v. Leininger*, *supra*, for it was recognized in the *Leininger* case that, in such a case, the rendition of the service by the assignor was the means by which the income was controlled by the donor, and of making his assignment effective. But it is the assignment by which the disposition of income is controlled when the service precedes the assignment, and, in both cases, it is the exercise of the power of disposition of the interest or compensation, with the resulting payment to the donee, which is the enjoyment by the donor of income derived from them.

....

The dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the benefit of it when paid. *See Corliss v. Bowers*, *supra*, 281 U.S. 378; *Burnet v. Guggenheim*, 288 U.S. 280, 283. The tax laid by the 1934 Revenue Act upon income "derived from ... wages, or compensation for personal service, of whatever kind and in whatever form paid ... ; also from interest ..." therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

It is the statute which taxes the income to the donor although paid to his donee. *Lucas v. Earl*, *supra*; *Burnet v. Leininger*, *supra*. True, in those cases, the service which created the right to income followed the assignment, and it was arguable that, in point of legal theory, the right to the compensation vested instantaneously in the assignor when paid, although he never received it, while here, the right of the assignor to receive the income antedated the assignment which transferred the right, and thus precluded such an instantaneous vesting. But the statute affords no basis for such "attenuated subtleties." The distinction was explicitly rejected as the basis of decision in *Lucas v. Earl*. It should be rejected here, for no more than in the *Earl* case can the purpose of the statute to tax the income to him who earns or creates and enjoys it be escaped by "anticipatory arrangements ... however skilfully devised" to prevent the income from vesting even for a second in the donor.

Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions. The owner of a negotiable bond and of the investment which it represents, if not the lender, stands in the place of the lender. When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings, and, in both cases, the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. *See Lucas v. Earl*, *supra*, 281 U.S. 115.

Reversed.

The separate opinion of MR. JUSTICE McREYNOLDS.

....

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift, they became at once the absolute property of the donee, free from the donor's control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

....

... The challenged judgment should be affirmed.

THE CHIEF JUSTICE and MR. JUSTICE ROBERTS concur in this opinion.

Notes and Questions:

1. Under the rules of § 102, donors make gifts with after-tax income, and the donee may exclude the value of he gift from his/her gross income. Taxpayer Horst of course tried to reverse this.

2. No doubt, taxpayer's son was in a lower tax bracket than taxpayer was. Hence, the dividends would have been subject to a lower rate of tax if taxpayer had prevailed.

3. Consumption can take the form of directing income to another.

4. The Internal Revenue Code taxes "taxable income," §§ 1(a-e). The computation of "taxable income" begins with a summing up of all items of "gross income." The concept of "gross income" does not inherently embody a netting of gains and losses. A taxpayer may deduct losses only to the extent that the Code permits.[39] Sections 165(a and c) allow taxpayers to deduct trade or business losses and investment losses. A realization requirement applies to deductions, just as it does to gross income. To be deductible, taxpayer must have "realized" the losses. Now read *Cottage Savings Association*.

Cottage Savings Ass'n v. CIR, 499 U.S. 554 (1991)

JUSTICE MARSHALL delivered the opinion of the Court.

The issue in this case is whether a financial institution realizes tax-deductible losses when it exchanges its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. We hold that such a transaction does give rise to realized losses.

I

Petitioner Cottage Savings Association (Cottage Savings) is a savings and loan association (S & L) formerly regulated by the Federal Home Loan Bank Board (FHLBB). [footnote omitted] Like many S & L's, Cottage Savings held numerous long-term, low-interest mortgages that declined in value when interest rates surged in the late 1970's. These institutions

[39] Many gamblers have learned the hard way that there is a limit to what they can deduct from their gambling winnings. § 165(d) (wagering losses deductible only to extent of gain from wagering transactions).

would have benefited from selling their devalued mortgages in order to realize tax-deductible losses. However, they were deterred from doing so by FHLBB accounting regulations, which required them to record the losses on their books. Reporting these losses consistent with the then-effective FHLBB accounting regulations would have placed many S & L's at risk of closure by the FHLBB.

The FHLBB responded to this situation by relaxing its requirements for the reporting of losses. In a regulatory directive known as "Memorandum R-49," dated June 27, 1980, the FHLBB determined that S & L's need not report losses associated with mortgages that are exchanged for "substantially identical" mortgages held by other lenders.[40] The FHLBB's acknowledged purpose for Memorandum R-49 was to facilitate

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[40] Memorandum R-49 listed 10 criteria for classifying mortgages as substantially identical.

"The loans involved must:"

"1. involve single-family residential mortgages,"

"2. be of similar type (e.g., conventionals for conventionals),"

"3. have the same stated terms to maturity (e.g., 30 years),"

"4. have identical stated interest rates,"

"5. have similar seasoning (i.e., remaining terms to maturity),"

"6. have aggregate principal amounts within the lesser of 2 ½% or $100,000 (plus or minus) on both sides of the transaction, with any additional consideration being paid in cash,"

"7. be sold without recourse,"

"8. have similar fair market values,"

"9. have similar loan-to-value ratios at the time of the reciprocal sale, and"

"10. have all security properties for both sides of the transaction in the same state."

transactions that would generate tax losses but that would not substantially affect the economic position of the transacting S & L's.

This case involves a typical Memorandum R-49 transaction. On December 31, 1980, Cottage Savings sold "90% participation" in 252 mortgages to four S & L's. It simultaneously purchased "90% participation interests" in 305 mortgages held by these S & L's.[41] All of the loans involved in the transaction were secured by single-family homes, most in the Cincinnati area. The fair market value of the package of participation interests exchanged by each side was approximately $4.5 million. The face value of the participation interests Cottage Savings relinquished in the transaction was approximately $6.9 million.

On its 1980 federal income tax return, Cottage Savings claimed a deduction for $2,447,091, which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation interests that it received. As permitted by Memorandum R-49, Cottage Savings did not report these losses to the FHLBB. After the Commissioner of Internal Revenue disallowed Cottage Savings' claimed deduction, Cottage Savings sought a redetermination in the Tax Court. The Tax Court held that the deduction was permissible.

On appeal by the Commissioner, the Court of Appeals reversed. The Court of Appeals agreed with the Tax Court's determination that Cottage Savings had realized its losses through the transaction. However, the court held that Cottage Savings was not entitled to a deduction because its losses were not "actually" sustained during the 1980 tax year for purposes of 26 U.S.C. § 165(a).

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[41] By exchanging merely participation interests, rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S & L continued to service the loans on which it had transferred the participation interests and made monthly payments to the participation-interest holders.

Because of the importance of this issue to the S & L industry and the conflict among the Circuits over whether Memorandum R-49 exchanges produce deductible tax losses, [footnote omitted] we granted certiorari. We now reverse.

II

Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. The realization requirement is implicit in § 1001(a) of the Code, 26 U.S.C. § 1001(a), which defines "[t]he gain [or loss] from the sale or other disposition of property" as the difference between "the amount realized" from the sale or disposition of the property and its "adjusted basis." As this Court has recognized, the concept of realization is "founded on administrative convenience." *Helvering v. Horst*, 311 U.S. 112, 311 U.S. 116 (1940). Under an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the "cumbersome, abrasive, and unpredictable administrative task" of valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value. [citation omitted]. In contrast, "[a] change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer." R. MAGILL, TAXABLE INCOME 79 (rev. ed.1945).

Section 1001(a)'s language provides a straightforward test for realization: to realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property." The parties agree that the exchange of participation interests in this case cannot be characterized as a "sale" under § 1001(a); the issue before us is whether the transaction constitutes a "disposition of property." The Commissioner argues that an exchange of property can be treated as a "disposition" under § 1001(a) only if the properties exchanged are materially different. The Commissioner further submits that, because the underlying mortgages were essentially economic substitutes, the participation interests exchanged by Cottage Savings were not materially different from those received from the other S & L's. Cottage Savings, on the other hand, maintains that any exchange of property is a "disposition of property" under § 1001(a), regardless of whether the property exchanged is materially different. Alternatively, Cottage Savings contends that the participation interests exchanged were materially different because the underlying loans were secured by different properties.

We must therefore determine whether the realization principle in § 1001(a) incorporates a "material difference" requirement. If it does, we must further decide what that requirement amounts to and how it applies in this case. We consider these questions in turn.

A.

Neither the language nor the history of the Code indicates whether and to what extent property exchanged must differ to count as a "disposition of property" under § 1001(a). Nonetheless, we readily agree with the Commissioner that an exchange of property gives rise to a realization event under § 1001(a) only if the properties exchanged are "materially different." The Commissioner himself has, by regulation, construed § 1001(a) to embody a material difference requirement:

> "Except as otherwise provided ... the gain or loss realized from the conversion of property into cash, *or from the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained."

Treas. Reg. § 1.1001-1, 26 CFR § 1.1001-1 (1990) (emphasis added). Because Congress has delegated to the Commissioner the power to promulgate "all needful rules and regulations for the enforcement of [the Internal Revenue Code]," 26 U.S.C. § 7805(a), we must defer to his regulatory interpretations of the Code so long as they are reasonable, *see National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472, 440 U.S. 476-477 (1979).

We conclude that Treasury Regulation § 1.1001-1 is a reasonable interpretation of § 1001(a). Congress first employed the language that now comprises § 1001(a) of the Code in § 202(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 253; that language has remained essentially unchanged through various reenactments. [footnote omitted] And since 1934, the Commissioner has construed the statutory term "disposition of property" to include a "material difference" requirement. [footnote omitted] As we have recognized,

> "'Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.'"

United States v. Correll, 389 U.S. 299, 389 U.S. 305-306 (1967), quoting *Helvering v. Winmill*, 305 U.S. 79, 305 U.S. 83 (1938).

Treasury Regulation § 1.1001-1 is also consistent with our landmark precedents on realization. In a series of early decisions involving the tax effects of property exchanges, this Court made clear that a taxpayer realizes taxable income only if the properties exchanged are "materially" or "essentially" different. *See United States v. Phellis*, 257 U.S. 156, 257 U.S. 173 (1921); *Weiss v. Stearn*, 265 U.S. 242, 265 U.S. 253-254 (1924); *Marr v. United States*, 268 U.S. 536, 268 U.S. 540-542 (1925); *see also Eisner v. Macomber*, 252 U.S. 189, 252 U.S. 207-212 (1920) (recognizing realization requirement). Because these decisions were part of the "contemporary legal context" in which Congress enacted § 202(a) of the 1924 Act, [citation omitted], and because Congress has left undisturbed through subsequent reenactments of the Code the principles of realization established in these cases, we may presume that Congress intended to codify these principles in § 1001(a) [citations omitted]. The Commissioner's construction of the statutory language to incorporate these principles certainly was reasonable.

B

Precisely what constitutes a "material difference" for purposes of § 1001(a) of the Code is a more complicated question. The Commissioner argues that properties are "materially different" only if they differ in economic substance. To determine whether the participation interests exchanged in this case were "materially different" in this sense, the Commissioner argues, we should look to the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB. We conclude that § 1001(a) embodies a much less demanding and less complex test.

Unlike the question whether § 1001(a) contains a material difference requirement, the question of what constitutes a material difference is not one on which we can defer to the Commissioner. For the Commissioner has not issued an authoritative, prelitigation interpretation of what property exchanges satisfy this requirement. [footnote omitted] Thus, to give meaning to the material difference test, we must look to the case law from which the test derives and which we believe Congress intended to codify in enacting and reenacting the language that now comprises § 1001(a). [citation omitted].

We start with the classic treatment of realization in *Eisner v. Macomber*, *supra*. In *Macomber*, a taxpayer who owned 2,200 shares of stock in a company received another 1,100 shares from the company as part of a pro rata stock dividend meant to reflect the company's growth in value. At issue was whether the stock dividend constituted taxable income. We held that it did not, because no gain was realized. We reasoned that the stock dividend merely reflected the increased worth of the taxpayer's stock, and that a taxpayer realizes increased worth of property only by receiving "something of exchangeable value proceeding from the property," *see* 252 U.S. at 207.

In three subsequent decisions – *United States v. Phellis*, *supra*; *Weiss v. Stearn*, *supra*; and *Marr v. United States*, *supra* – we refined *Macomber*'s conception of realization in the context of property exchanges. In each case, the taxpayer owned stock that had appreciated in value since its acquisition. And in each case, the corporation in which the taxpayer held stock had reorganized into a new corporation, with the new corporation assuming the business of the old corporation. While the corporations in *Phellis* and *Marr* both changed from New Jersey to Delaware corporations, the original and successor corporations in *Weiss* both were incorporated in Ohio. In each case, following the reorganization, the stockholders of the old corporation received shares in the new corporation equal to their proportional interest in the old corporation.

The question in these cases was whether the taxpayers realized the accumulated gain in their shares in the old corporation when they received in return for those shares stock representing an equivalent proportional interest in the new corporations. In *Phellis* and *Marr*, we held that the transactions were realization events. We reasoned that, because a company incorporated in one State has "different rights and powers" from one incorporated in a different State, the taxpayers in *Phellis* and *Marr* acquired through the transactions property that was "materially different" from what they previously had. *United States v. Phellis*, 257 U.S. at 169-173; *see Marr v. United States*, *supra*, 268 U.S. at 540-542 (using phrase "essentially different"). In contrast, we held that no realization occurred in *Weiss*. By exchanging stock in the predecessor corporation for stock in the newly reorganized corporation, the taxpayer did not receive "a thing really different from what he theretofore had." *Weiss v. Stearn*, *supra*, 265 U.S. at 265 U.S. 254. As we explained in *Marr*, our determination that the reorganized company in *Weiss* was not "really different" from its predecessor turned on the fact that both companies were incorporated in the same State. *See Marr v. United States*, *supra*, 268 U.S. at 540-542 (outlining distinction between these cases).

Obviously, the distinction in *Phellis* and *Marr* that made the stock in the successor corporations materially different from the stock in the predecessors was minimal. Taken together, *Phellis*, *Marr*, and *Weiss* stand for the principle that properties are "different" in the sense that is "material" to the Internal Revenue Code so long as their respective possessors enjoy legal entitlements that are different in kind or extent. Thus, separate groups of stock are not materially different if they confer "the same proportional interest of the same character in the same corporation." *Marr v. United States*, 268 U.S. at 540. However, they are materially different if they are issued by different corporations, *id*. at 541; *United States v. Phellis*, *supra*, 257 U.S. at 173, or if they confer "differen[t] rights and powers" in the same corporation, *Marr v. United States*, *supra*, 268 U.S. at 541. No more demanding a standard than this is necessary in order to satisfy the administrative purposes underlying the realization requirement in § 1001(a). *See Helvering v. Horst*, 311 U.S. at 116. For, as long as the property entitlements are not identical, their exchange will allow both the Commissioner and the transacting taxpayer easily to fix the appreciated or depreciated values of the property relative to their tax bases.

In contrast, we find no support for the Commissioner's "economic substitute" conception of material difference. According to the Commissioner, differences between properties are material for purposes of the Code only when it can be said that the parties, the relevant market (in this case the secondary mortgage market), and the relevant regulatory body (in this case the FHLBB) would consider them material. Nothing in *Phellis*, *Weiss*, and *Marr* suggests that exchanges of properties must satisfy such a subjective test to trigger realization of a gain or loss.

Moreover, the complexity of the Commissioner's approach ill-serves the goal of administrative convenience that underlies the realization requirement. In order to apply the Commissioner's test in a principled fashion, the Commissioner and the taxpayer must identify the relevant market, establish whether there is a regulatory agency whose views should be taken into account, and then assess how the relevant market participants and the agency would view the transaction. The Commissioner's failure to explain how these inquiries should be conducted further calls into question the workability of his test.

Finally, the Commissioner's test is incompatible with the structure of the Code. Section 1001(c) ... provides that a gain or loss realized under § 1001(a) "shall be recognized" unless one of the Code's nonrecognition provisions applies. One such nonrecognition provision withholds recognition of a gain or loss realized from an exchange of properties that would appear to be economic substitutes under the Commissioner's material difference test. This provision, commonly known as the "like kind" exception, withholds recognition of a gain or loss realized

> "on the exchange of property held for productive use in a trade or business or for investment ... for property of like kind which is to be held either for productive use in a trade or business or for investment."

26 U.S.C. § 1031(a)(1). If Congress had expected that exchanges of similar properties would not count as realization events under § 1001(a), it would have had no reason to bar recognition of a gain or loss realized from these transactions.

C

Under our interpretation of § 1001(a), 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. Cottage Savings' transactions at issue here easily satisfy this test. Because the participation interests exchanged by Cottage Savings and the other S & L's derived from loans that were made to different obligors and secured by different homes, the exchanged interests did embody legally distinct entitlements. Consequently, we conclude that Cottage Savings realized its losses at the point of the exchange.

The Commissioner contends that it is anomalous to treat mortgages deemed to be "substantially identical" by the FHLBB as "materially different." The anomaly, however, is merely semantic; mortgages can be substantially identical for Memorandum R-49 purposes and still exhibit "differences" that are "material" for purposes of the Internal Revenue Code. Because Cottage Savings received entitlements different from those it gave up, the exchange put both Cottage Savings and the Commissioner in a position to determine the change in the value of Cottage Savings' mortgages relative to their tax bases. Thus, there is no reason not to treat the exchange of these interests as a realization event, regardless of the status of the mortgages under the criteria of Memorandum R-49.

III

Although the Court of Appeals found that Cottage Savings' losses were realized, it disallowed them on the ground that they were not sustained under § 165(a) of the Code, 26 U.S.C. § 165(a). ...

The Commissioner offers a minimal defense of the Court of Appeals' conclusion. ...

... In view of the Commissioner's failure to advance any other arguments in support of the Court of Appeals' ruling with respect to § 165(a), we conclude that, for purposes of this case, Cottage Savings sustained its losses within the meaning of § 165(a).

IV

For the reasons set forth above, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

So ordered.

JUSTICE BLACKMUN, with whom JUSTICE WHITE joins, concurring in part and dissenting in part – omitted.

Notes and Questions:

1. As a practical matter, what was wrong with the Commissioner's arguments?

2. What is the test of "realization" that the Court derived from *Phellis/Weiss/Marr*?

Consistency between tax and financial accounting: The FHLBB obviously intended Memorandum R-49 to enable savings and loan associations to reduce their income tax liability and thereby come closer to solvency. Of course this effort came at the expense of all other taxpayers who must "pick up the slack."

•Income tax rules often require taxpayers to maintain consistent positions with regard to financial accounting and tax accounting. On the authority of the FHLBB – not Congress or the IRS – the savings and loan associations could treat dud loans completely differently for financial accounting and tax accounting purposes.

3. In considering its earlier constructions of the "realization" requirement (part IIB of the opinion) in *Macomber/Phellis/Weiss/Marr*, the Court never mentioned the Sixteenth Amendment. Moreover, the Court stated in part IIB that administrative purposes underlie the "realization requirement." By this time – if not earlier – the Court had de-constitutionalized the "realization" requirement – a matter that is critical to the Subpart F rules governing U.S. taxation of foreign source income.

4. The Court's application of the realization requirement would seem to give taxpayers considerable control over the timing of tax gains and losses.

IV. The Constitutional and Statutory Definitions of "Gross Income:" Dominion and Control

Basically, taxpayer has dominion and control over a monetary accession to wealth if, as a practical matter, s/he may spend it. The so-called "claim of right" doctrine – which the Court first announced in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) – implements this principle.

> *Claim of Right doctrine*: Taxpayer must include in his/her gross income an item when s/he has a "claim of right" to it. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932), the Supreme Court stated the doctrine thus:
> If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Gilbert v. Commissioner, 552 F.2d 478 (CA2 1977)

LUMBARD, Circuit Judge:

The taxpayer Edward M. Gilbert appeals from a determination by the tax court that he realized taxable income on certain unauthorized withdrawals of corporate funds made by him in 1962. We reverse.

Until June 12, 1962, Gilbert was president, principal stockholder, and a director of the E. L. Bruce Company, Inc., a New York corporation which was engaged in the lumber supply business. In 1961 and early 1962 Gilbert acquired on margin substantial personal and beneficial ownership of stock in another lumber supply company, the Celotex Corporation, intending ultimately to bring about a merger of Celotex into Bruce. To this end, he persuaded associates of his to purchase Celotex stock, guaranteeing them against loss, and also induced Bruce itself to purchase a substantial number of Celotex shares. In addition, on March 5, 1962, Gilbert granted Bruce an option to purchase his Celotex shares from him at cost. By the end of May 1962, 56% of Celotex was thus controlled by Gilbert and Bruce, and negotiations for the merger were proceeding; agreement had been reached that three of the directors of Bruce would be placed on the board of Celotex. It is undisputed that this merger would have been in Bruce's interest.[42]

The stock market declined on May 28, 1962, however, and Gilbert was called upon to furnish additional margin for the Celotex shares purchased by him and his associates. Lacking sufficient cash of his own to meet this margin call, Gilbert instructed the secretary of Bruce to use corporate funds to supply the necessary margin. Between May 28 and June 6 a series of checks totalling $1,958,000 were withdrawn from Bruce's accounts and used to meet the margin call. $5,000 was repayed to Bruce on June 5. According to his testimony in the tax court, Gilbert from the outset intended to repay all the money and at all times thought he was acting in

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[42] According to undisputed testimony in the tax court, it was the consensus of the Bruce board that the Celotex assets were selling at a bargain price and also that the dovetailing of the two companies' sales operations would result in substantial economies.

the corporation's best interests as well as his own.[43] He promptly informed several other Bruce officers and directors of the withdrawals; however, some were not notified until June 11 or 12.

On about June 1, Gilbert returned to New York from Nevada, where he had been attending to a personal matter. Shortly thereafter he consulted with Shearman, Sterling & Wright, who were outside counsel to Bruce at the time, regarding the withdrawals. They, he, and another Bruce director initiated negotiations to sell many of the Celotex shares to Ruberoid Company as a way of recouping most of Bruce's outlay.

On June 8, Gilbert went to the law offices of Shearman, Sterling & Wright and executed interest-bearing promissory notes to Bruce for $1,953,000 secured by an assignment of most of his property. [(footnote omitted)]. The notes were callable by Bruce on demand, with presentment and notice of demand waived by Gilbert. The tax court found that up through June 12 the net value of the assets assigned for security by Gilbert substantially exceeded the amount owed. [(footnote omitted)].

After Gilbert informed other members of the Bruce board of directors of his actions, a meeting of the board was scheduled for the morning of June 12. At the meeting the board accepted the note and assignment but refused to ratify Gilbert's unauthorized withdrawals. During the meeting, word came that the board of directors of the Ruberoid Company had rejected the price offered for sale of the Celotex stock. Thereupon, the Bruce board demanded and received Gilbert's resignation and decided to issue a public announcement the next day regarding his unauthorized withdrawals. All further attempts on June 12 to arrange a sale of the Celotex stock fell through and in the evening Gilbert flew to Brazil, where he stayed for several months. On June 13 the market price of Bruce and Celotex stock plummeted, and trading in those shares was suspended by the Securities and Exchanges Commission.

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[43] Two years previously, Gilbert accomplished a merger with Bruce of another corporation controlled by him, Empire National Corporation, and in the process he had made some unauthorized withdrawals of Empire funds, all of which he paid back.

On June 22 the Internal Revenue Service filed tax liens against Gilbert based on a jeopardy assessment for $3,340,000, of which $1,620,000 was for 1958-1960 and $1,720,000 was for 1962. [(footnote omitted)]. Bruce, having failed to file the assignment from Gilbert because of the real estate filing fee involved,[44] now found itself subordinate in priority to the IRS and, impeded by the tax lien, has never since been able to recover much of its $1,953,000 from the assigned assets.[45] For the fiscal year ending June 30, 1962, Bruce claimed a loss deduction on the $1,953,000 withdrawn by Gilbert. Several years later Gilbert pled guilty to federal and state charges of having unlawfully withdrawn the funds from Bruce.

On these facts, the tax court determined that Gilbert realized income when he made the unauthorized withdrawals of funds from Bruce, and that his efforts at restitution did not entitle him to any offset against this income.

The starting point for analysis of this case is *James v. United States*, 366 U.S. 213 (1961), which established that embezzled funds can constitute taxable income to the embezzler.

> When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, "he has received income which he is required to return, even though it may still be claimed that he is not entitled to the money, and even though he may still be adjudged liable to restore its equivalent." *Id.* at 219 [(quoting *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932)].

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[44] When attempting to file in the New York County Clerk's office on June 13 or 14, Bruce was told that it would have to pay a mortgage tax of at least $10,000 because the assignment included real property. ...

[45] As of the date of trial in the tax court, less than $500,000 had been raised through sales of the assigned assets. Pursuant to an agreement reached between Bruce and the government in 1970, 35% of these proceeds have been paid over to the government pending the outcome of this lawsuit.

The Commissioner contends that there can never be "consensual recognition ... of an obligation to repay" in an embezzlement case. He reasons that because the corporation as represented by a majority of the board of directors was unaware of the withdrawals, there cannot have been consensual recognition of the obligation to repay at the time the taxpayer Gilbert acquired the funds. Since the withdrawals were not authorized and the directors refused to treat them as a loan to Gilbert, the Commissioner concludes that Gilbert should be taxed like a thief rather than a borrower.

In a typical embezzlement, the embezzler intends at the outset to abscond with the funds. If he repays the money during the same taxable year, he will not be taxed. *See James v. Commissioner*, *supra* at 220; *Quinn v. Commissioner*, 524 F.2d 617, 624-25 (7th Cir. 1975); Rev. Rul. 65-254, 1965 2 Cum. Bul. 50. As we held in *Buff v. Commissioner*, 496 F.2d 847 (2d Cir. 1974), if he spends the loot instead of repaying, he cannot avoid tax on his embezzlement income simply by signing promissory notes later in the same year. *See also id*. at 849-50 (Oakes, J., concurring).

This is not a typical embezzlement case, however, and we do not interpret *James* as requiring income realization in every case of unlawful withdrawals by a taxpayer. There are a number of facts that differentiate this case from *Buff* and *James*. When Gilbert withdrew the corporate funds, he recognized his obligation to repay and intended to do so.[46] The funds were to be used not only for his benefit but also for the benefit of the corporation; meeting the margin calls was necessary to maintain the possibility of the highly favorable merger. Although Gilbert undoubtedly realized that he lacked the necessary authorization, he thought he was serving the best interests of the corporation and he expected his decision to be ratified shortly thereafter. That Gilbert at no time intended to retain

[46] Quinn v. Commissioner, *supra* at 619, 623-25, relied on by the Commissioner, involved taxation of funds received without any contemporaneous recognition of the obligation to repay, and it is therefore distinguishable from the present case.

the corporation's funds is clear from his actions.[47] He immediately informed several of the corporation's officers and directors, and he made a complete accounting to all of them within two weeks. He also disclosed his actions to the corporation's outside counsel, a reputable law firm, and followed its instructions regarding repayment. In signing immediately payable promissory notes secured by most of his assets, Gilbert's clear intent was to ensure that Bruce would obtain full restitution. In addition, he attempted to sell his shares of Celotex stock in order to raise cash to pay Bruce back immediately.

When Gilbert executed the assignment to Bruce of his assets on June 8 and when this assignment for security was accepted by the Bruce board on June 12, the net market value of these assets was substantially more than the amount owed. The Bruce board did not release Gilbert from his underlying obligation to repay, but the assignment was nonetheless valid and Bruce's failure to make an appropriate filing to protect itself against the claims of third parties, such as the IRS, did not relieve Gilbert of the binding effect of the assignment. Since the assignment secured an immediate payable note, Gilbert had as of June 12 granted Bruce full discretion to liquidate any of his assets in order to recoup on the $1,953,000 withdrawal. Thus, Gilbert's net accretion in real wealth on the overall transaction was zero: he had for his own use withdrawn $1,953,000 in corporate funds but he had now granted the corporation control over at least $1,953,000 worth of his assets.

We conclude that where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals under the *James* test. When Gilbert acquired the money, there was an express consensual recognition of his

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[47] If Gilbert had been intending to abscond with the $1,953,000, it is difficult to see how he could have hoped to avoid detection in the long run. Since his equity in the corporation itself was worth well over $1,953,000, it would have been absurd for him to attempt such a theft.

obligation to repay: the secretary of the corporation, who signed the checks, the officers and directors to whom Gilbert gave contemporaneous notification, and Gilbert himself were all aware that the transaction was in the nature of a loan. Moreover, the funds were certainly not received by Gilbert "without restriction as to their disposition" as is required for taxability under *James*; the money was to be used solely for the temporary purpose of meeting certain margin calls and it was so used. For these reasons, we reverse the decision of the tax court.

Notes and Questions:

1. *James v. United States*, 366 U.S. 213 (1961) was an embezzlement case. The Supreme Court had held in *Commissioner v. Wilcox*, 327 U.S. 404 (1946) that an embezzler did not realize gross income because he was subject to an obligation to repay the embezzled funds. Taxpayer had no bona fide claim of right to the funds. *Id.* at 408. In *Rutkin v. United States*, 343 U.S. 130, 139 (1952), the Supreme Court held that taxpayer must include money that he obtained by extortion in his gross income. *James* shifted the focus of such cases from the bona fides of a claim of

Security and damage deposits: An electric utility company (IPL) requires customers with suspect credit to make a security deposit in order to assure prompt payment of utility bills. Customers are entitled to a refund of their deposit upon establishing good credit or making sufficient timely payments. The electric company treated the deposits as a current liability. So long as the company refunded the deposits when customers were entitled to them, the company could spend the money as it chose. Should the utility include the deposits in its gross income? The answer to this question turns on whether the company had "complete dominion" over the funds.
IPL hardly enjoyed 'complete dominion' over the customer deposits entrusted to it. Rather, these deposits were acquired subject to an express 'obligation to repay,' either at the time service was terminated or at the time a customer established good credit. So long as the customer fulfills his legal obligation to make timely payments, his deposit ultimately is to be refunded, and both the timing and method of that refund are largely within the control of the customer."

... In determining whether a taxpayer enjoys 'complete dominion' over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money. IPL's receipt of these deposits was accompanied by no such guarantee.

CIR v. Indianapolis Power & Light Co., 493, 203, 209-10 (1990). What facts do you think are relevant to whether a payment is a security or damage deposit? Consider what terms you would include in a lease that you drafted for a landlord.

right to consensual recognition of an obligation to repay. *Gilbert* turned on whether there was a consensual recognition of an obligation to repay.

2. When must that consensual recognition of an obligation to repay exist? Does the following excerpt from *Gilbert* answer the question?

> As we held in *Buff v. Commissioner*, 496 F.2d 847 (2d Cir. 1974), if he spends the loot instead of repaying, he cannot avoid tax on his embezzlement income simply by signing promissory notes later in the same year. *See also id*. at 849-50 (Oakes, J., concurring).

3. The withdrawals from the E.L. Bruce Company were "unauthorized." Does that mean that there could not have been a "consensual recognition of an obligation to repay?"

4. If taxpayer has acquired funds without restriction as to their disposition, s/he has a power to spend them on consumption – one of the elements of the SHS definition of income. Did taxpayer Gilbert ever feel free to spend the money as he pleased?

5. It seems that taxpayer was willing to "bet the company" and had done so before. E.L. Bruce Company evidently willingly reaped the rewards of a good bet and only fired Gilbert when he made a bad one. Is that relevant to the income tax question that the facts of *Gilbert* raise?

6. Why are loan proceeds not included in taxpayer's gross income? After all, taxpayer may act without restriction as to their disposition?

Wrap-up Questions for Chapter 2:

1. What policies does a broad definition of "gross income" implement and how?

2. What is the tax treatment of a return of capital? How does this treatment implement the principle that we tax income once?

3. In determining whether a taxpayer should include certain forms of consumption in his/her gross income, why should it matter that taxpayer has no discretion in what it is he or she must consume (for example, a trip to Germany to view Volkswagon facilities)?

4. The use of appreciated property to pay for something implements the principal that we tax all income once. How?

5. What economic distortions result from the Code's failure to tax imputed income?

Chapter 3: Exclusions from Gross Income

In this chapter, we take up exclusions from gross income. Congress has chosen – for various reasons – to permit taxpayers not to "count" certain accessions to wealth in their gross income. An exclusion is *not* the same as a deduction. A deduction is a reduction (subtraction) from what would otherwise be "taxable income." An exclusion does not even count as "gross income," and so cannot become "taxable income" – even though it usually is quite clearly an "accession to wealth." We are still focusing on the first line of the "tax formula" – only now we are examining accessions to wealth that are *not* included in gross income as opposed to those that are. Deductions come later.

The availability of exclusions may have several consequences:

- Taxpayers may feel encouragement to seek wealth in forms that the Code excludes from their gross income. They will do this at the expense (opportunity cost) of procuring wealth in a form subject to income tax.
- The fact that a taxpayer may acquire a particular form of wealth without bearing any tax burden does not mean that the taxpayer necessarily enjoys the full benefit of the exclusion. Others may "capture" some or all of the benefit.

> *The Tax Formula*:
>
> ➔ (gross income) ≈
> <u>MINUS deductions named in § 62</u>
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or itemized deductions)
> MINUS (personal exemptions)
> EQUALS (taxable income)
>
> Compute income tax liability from tables in § 1 (indexed for inflation)
> MINUS (credits against tax)

- The fact that many taxpayers find a particular benefit to be attractive will most certainly affect the market for that benefit, e.g., health care. Taxpayers acting as consumers will bid up the price of the benefit and so must spend more to acquire such forms of wealth

(benefits) than they would if all taxpayers had to purchase the benefit with after-tax dollars. The price of acquiring the tax-favored benefit will change. Entrepreneurs may be encouraged to enter fields in which their customers can purchase their goods and services with untaxed dollars. Such entrepreneurs might have created more societal value by selling other goods and services.
•The Treasury obviously must forego tax revenues simply because these accessions to wealth are not subject to income tax.

In light of these points, you should consider the net effectiveness of exclusions from gross income as a means of congressional pursuit of policy. Consider also whether there are better ways to accomplish these objectives. We will consider the parameters of some exclusions and note others. This text groups excluded benefits very roughly into three overlapping categories: those that encourage the development of the society and government that we want, those that encourage the creation of social benefits – perhaps of a sort that the government might otherwise feel obliged to provide, and those that are employment-based.

I. The Society and Government that We Want

The Code excludes from a taxpayer's gross income certain benefits that (seem to) encourage taxpayers to make certain decisions that foster development of a certain type of society and government. You might see in such provisions as §§ 102, 103, 107, and 121 the policies of generosity, federalism, spiritual growth, and home ownership. Consider:

•Whether these are policies that the government should pursue;
•Whether tax benefits are the appropriate means of pursuing these policies. After all, those who choose to avail themselves of the benefits of these tax benefits do so at the expense of taxpayers who do not;
•Whether the tax provisions by which Congress pursues these policies lead to unintended consequences and/or capture by those other than the intended beneficiaries.

A. Gifts and Inheritances: § 102

Read § 102. There has always been an exclusion for gifts and inheritances from the federal income tax in the Code. Perhaps Congress has always felt that it would be inappropriate to assess a tax on the generosity of relatives who give birthday and Christmas gifts – sometimes very expensive ones. But:

- Is it possible that this may lead to a culture of gift-giving in contexts other than the family – whose effects may not reflect generosity or affection?
- If so, is it possible that the costs of such gifts will escalate, and is it not certain that the donor will (at least try to) deduct the escalating costs of such gifts?

Commissioner v. Duberstein, 363 U.S. 278 (1960).

MR. JUSTICE BRENNAN delivered the opinion of the Court.

These two cases concern the provision of the Internal Revenue Code which excludes from the gross income of an income taxpayer "the value of property acquired by gift." [footnote omitted] ... The importance to decision of the facts of the cases requires that we state them in some detail.

No. 376, *Commissioner v. Duberstein*. The taxpayer, Duberstein, [footnote omitted] was president of the Duberstein Iron & Metal Company, a corporation with headquarters in Dayton, Ohio. For some years, the taxpayer's company had done business with Mohawk Metal Corporation, whose headquarters were in New York City. The president of Mohawk was one Berman. The taxpayer and Berman had generally used the telephone to transact their companies' business with each other, which consisted of buying and selling metals. The taxpayer testified, without elaboration, that he knew Berman "personally," and had known him for about seven years. From time to time in their telephone conversations, Berman would ask Duberstein whether the latter knew of potential customers for some of Mohawk's products in which Duberstein's company itself was not interested. Duberstein provided the names of potential customers for these items.

One day in 1951, Berman telephoned Duberstein and said that the information Duberstein had given him had proved so helpful that he wanted to give the latter a present. Duberstein stated that Berman owed him nothing. Berman said that he had a Cadillac as a gift for Duberstein, and that the latter should send to New York for it; Berman insisted that Duberstein accept the car, and the latter finally did so, protesting, however, that he had not intended to be compensated for the information. At the time, Duberstein already had a Cadillac and an Oldsmobile, and felt that he did not need another car. Duberstein testified that he did not think Berman would have sent him the Cadillac if he had not furnished him with information about the customers. It appeared that Mohawk later deducted the value of the Cadillac as a business expense on its corporate income tax return.

Duberstein did not include the value of the Cadillac in gross income for 1951, deeming it a gift. The Commissioner asserted a deficiency for the car's value against him ... [T]he Tax Court affirmed the Commissioner's determination. It said that "The record is significantly barren of evidence revealing any intention on the part of the payor to make a gift. ... The only justifiable inference is that the automobile was intended by the payor to be remuneration for services rendered to it by Duberstein." The Court of Appeals for the Sixth Circuit reversed.

No. 546, *Stanton v. United States*. The taxpayer, Stanton, had been for approximately 10 years in the employ of Trinity Church in New York City. He was comptroller of the Church corporation, and president of a corporation, Trinity Operating Company, the church set up as a fully owned subsidiary to manage its real estate holdings, which were more extensive than simply the church property. His salary by the end of his employment there in 1942 amounted to $22,500 a year. Effective November 30, 1942, he resigned from both positions to go into business for himself. The Operating Company's directors, who seem to have included the rector and vestrymen of the church, passed the following resolution upon his resignation:

> "Be it resolved that, in appreciation of the services rendered by Mr. Stanton ..., a gratuity is hereby awarded to him of Twenty Thousand Dollars, payable to him in equal instalments of Two Thousand Dollars at the end of each and every month commencing with the month of December, 1942; provided that, with the discontinuance of his services, the Corporation of Trinity Church is released from all rights and claims to pension and retirement benefits not already accrued up to November 30, 1942."

The Operating Company's action was later explained by one of its directors as based on the fact that

> "Mr. Stanton was liked by all of the Vestry personally. He had a pleasing personality. He had come in when Trinity's affairs were in a difficult situation. He did a splendid piece of work, we felt. Besides that ... , he was liked by all of the members of the Vestry personally."

And by another:

> "[W]e were all unanimous in wishing to make Mr. Stanton a gift. Mr. Stanton had loyally and faithfully served Trinity in a very difficult time. We thought of him in the highest regard. We understood that he was going in business for himself. We felt that he was entitled to that evidence of good will."

On the other hand, there was a suggestion of some ill feeling between Stanton and the directors, arising out of the recent termination of the services of one Watkins, the Operating Company's treasurer, whose departure was evidently attended by some acrimony. At a special board meeting on October 28, 1942, Stanton had intervened on Watkins' side and asked reconsideration of the matter. The minutes reflect that

> "resentment was expressed as to the 'presumptuous' suggestion that the action of the Board, taken after long deliberation, should be changed."

The Board adhered to its determination that Watkins be separated from employment ... [T]he Board voted the payment of six months' salary to Watkins in a resolution similar to that quoted in regard to Stanton, but which did not use the term "gratuity." At the meeting, Stanton announced that, in order to avoid any ... embarrassment or question at any time as to his willingness to resign if the Board desired, he was tendering his resignation ..., which ... was [eventually] accepted.

... There was undisputed testimony that there were in fact no enforceable rights or claims to pension and retirement benefits which had not accrued at the time of the taxpayer's resignation, and that the last proviso of the resolution was inserted simply out of an abundance of caution. The taxpayer received in cash a refund of his contributions to the retirement plans, and there is no suggestion that he was entitled to more. He was required to perform no further services for Trinity after his resignation.

The Commissioner asserted a deficiency against the taxpayer after the latter had failed to include the payments in question in gross income. After payment of the deficiency and administrative rejection of a refund claim, the taxpayer sued the United States for a refund in the District Court for the Eastern District of New York. The trial judge, sitting without a jury, made the simple finding that the payments were a "gift," [footnote omitted] and judgment was entered for the taxpayer. The Court of Appeals for the Second Circuit reversed.

The Government, urging that clarification of the problem typified by these two cases was necessary, and that the approaches taken by the Courts of Appeals for the Second and the Sixth Circuits were in conflict, petitioned for certiorari in No. 376, and acquiesced in the taxpayer's petition in No. 546. On this basis, and because of the importance of the question in the administration of the income tax laws, we granted certiorari in both cases.

The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute [footnote omitted] passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since. The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. [footnote omitted] Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. [citation omitted]. The meaning of the statutory term has been shaped largely by the decisional law. With this, we turn to the contentions made by the Government in these cases.

First. The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. [footnote omitted] We reject this invitation. We are of opinion that the governing principles are necessarily general, and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. The cases at bar are fair examples of the settings in which the problem usually arises. They present situations in which payments have been made in a context with business overtones – an employer making a payment to a retiring employee; a businessman giving something of value to another businessman who has been of advantage to him in his business. In this context, we review the law as established by the prior cases here.

The course of decision here makes it plain that the statute does not use the term "gift" in the common law sense, but in a more colloquial sense. This Court has indicated that a voluntarily executed transfer of his property by one to another, without any consideration or compensation therefor, though a common law gift, is not necessarily a "gift" within the meaning of the statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 279 U.S. 730. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, *Bogardus v. Commissioner*, 302 U.S. 34, 302 U.S. 41, it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." *Robertson v. United States*, 343 U.S. 711, 343 U.S. 714.[48] A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," *Commissioner v. LoBue*, 351 U.S. 243, 351 U.S. 246; "out of affection, respect, admiration, charity or like impulses." *Robertson v. United States*, *supra*, at 343 U.S. 714. And, in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." *Bogardus v. Commissioner*, 302 U.S. 34, 302 U.S. 43. "What controls is the intention with which payment, however voluntary, has been made." *Id.* at 302 U.S. 45 (dissenting opinion). [footnote omitted]

The Government says that this "intention" of the transferor cannot mean what the cases on the common law concept of gift call "donative intent." With that we are in agreement, for our decisions fully support this. Moreover, the *Bogardus* case itself makes it plain that the donor's characterization of his action is not determinative – that there must be an objective inquiry as to whether what is called a gift amounts to it in reality. It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct, in themselves, have nothing to do with the matter.

It is suggested that the *Bogardus* criterion would be more apt if rephrased in terms of "motive," rather than "intention." We must confess to some skepticism as to whether such a verbal mutation would be of any practical consequence. We take it that the proper criterion, established by decision here, is one that inquires what the basic reason for his conduct was in fact – the dominant reason that explains his action in making the transfer. Further than that we do not think it profitable to go.

Second. The Government's proposed "test," while apparently simple and precise in its formulation, depends frankly on a set of "principles" or

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[48] The cases including "tips" in gross income are classic examples of this. *See, e.g.*, Roberts v. Commissioner, 176 F.2d 221.

"presumptions" derived from the decided cases, and concededly subject to various exceptions; and it involves various corollaries, which add to its detail. Were we to promulgate this test as a matter of law, and accept with it its various presuppositions and stated consequences, we would be passing far beyond the requirements of the cases before us, and would be painting on a large canvas with indeed a broad brush. The Government derives its test from such propositions as the following: that payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment's being a deductible business expense; that a gift involves "personal" elements; that a business corporation cannot properly make a gift of its assets. The Government admits that there are exceptions and qualifications to these propositions. We think, to the extent they are correct, that these propositions are not principles of law, but rather maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated in explaining their factual determinations. Some of them simply represent truisms: it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift. Others are overstatements of possible evidentiary inferences relevant to a factual determination on the totality of circumstances in the case: it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the "gift" exclusion; nor does it draw any distinction, in terms, between transfers by corporations and individuals, as to the availability of the "gift" exclusion to the transferee. The conclusion whether a transfer amounts to a "gift" is one that must be reached on consideration of all the factors.

Specifically, the trier of fact must be careful not to allow trial of the issue whether the receipt of a specific payment is a gift to turn into a trial of the tax liability, or of the propriety, as a matter of fiduciary or corporate law, attaching to the conduct of someone else. The major corollary to the Government's suggested "test" is that, as an ordinary matter, a payment by a corporation cannot be a gift, and, more specifically, there can be no such thing as a "gift" made by a corporation which would allow it to take a deduction for an ordinary and necessary business expense. As we have said, we find no basis for such a conclusion in the statute; and if it were applied as a determinative rule of "law," it would force the tribunals trying tax cases involving the donee's liability into elaborate inquiries into the local law of corporations or into the peripheral deductibility of payments as business expenses. The former issue might make the tax tribunals the most frequent investigators of an important and difficult issue of the laws of the several States, and the latter inquiry would summon one difficult and delicate problem of federal tax law as an aid to the solution of another. [footnote omitted] Or perhaps there would be required a trial of the vexed issue whether there was a "constructive" distribution of corporate property, for income tax purposes, to the corporate agents who had sponsored the transfer. [footnote omitted] These considerations, also, reinforce us in our conclusion that, while the principles urged by the Government may, in nonabsolute form as crystallizations of experience, prove persuasive to the trier of facts in a particular case, neither they nor any more detailed statement than has been made can be laid down as a matter of law.

Third. Decision of the issue presented in these cases must be based ultimately on the application of the factfinding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the date of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact. *Baker v. Texas & Pacific R. Co.*, 359 U.S. 227; *Commissioner v. Heininger*, 320 U.S. 467, 320 U.S. 475; *United States v. Yellow Cab Co.*, 338 U.S. 338, 338 U.S. 341; *Bogardus v. Commissioner*, *supra*, at 302 U.S. 45 (dissenting opinion). [footnote omitted]

This conclusion may not satisfy an academic desire for tidiness, symmetry, and precision in this area, any more than a system based on the determinations of various factfinders ordinarily does. But we see it as implicit in the present statutory treatment of the exclusion for gifts, and in the variety of forums in which federal income tax cases can be tried. If there is fear of undue uncertainty or overmuch litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matters, as it has done in one field of the "gift" exclusion's former application, that of prizes and awards. [footnote omitted] Doubtless diversity of result will tend to be lessened somewhat, since federal income tax decisions, even those in tribunals of first instance turning on issues of fact, tend to be reported, and since there may be a natural tendency of professional triers of fact to follow one another's determinations, even as to factual matters. But the question here remains basically one of fact, for determination on a case-by-case basis.

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. [citation omitted]. Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." Fed. Rules Civ. Proc. 52(a). ... The rule itself applies also to factual inferences from undisputed basic facts citation omitted], as will on many occasions be presented in this area. [citation omitted]. And Congress has, in the most explicit terms, attached the identical weight to the findings of the Tax Court. I.R.C. § 7482(a). [footnote omitted]

Fourth. A majority of the Court is in accord with the principles just outlined. And, applying them to the *Duberstein* case, we are in agreement, on the evidence we have set forth, that it cannot be said that the conclusion of the Tax Court was "clearly erroneous." It seems to us plain that, as trier of the facts, it was warranted in concluding that, despite the characterization of the transfer of the Cadillac by the parties, and the absence of any obligation, even of a moral nature, to make it, it was, at bottom, a recompense for Duberstein's past services, or an inducement for him to be of further service in the future. We cannot say with the Court of Appeals that such a conclusion was "mere suspicion" on the Tax Court's part. To us, it appears based in the sort of informed experience with human affairs that factfinding tribunals should bring to this task.

As to *Stanton*, we are in disagreement. To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a "gift." [footnote omitted] To be sure, conciseness is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give no revelation of what the District Court's concept of the determining facts and legal standard may be. [citation omitted]. Such conclusory, general findings do not constitute compliance with Rule 52's direction to "find the facts specially and state separately ... conclusions of law thereon." While the standard of law in this area is not a complex one, we four think the unelaborated finding of ultimate fact here cannot stand as a fulfillment of these requirements. It affords the reviewing court not the semblance of an indication of the legal standard with which the trier of fact has approached his task. For all that appears, the District Court may have viewed the form of the resolution or the simple absence of legal consideration as conclusive. While the judgment of the Court of Appeals cannot stand, the four of us think there must be further proceedings in the District Court looking toward new and adequate findings of fact. In this, we are joined by MR. JUSTICE WHITTAKER, who agrees that the findings were inadequate, although he does not concur generally in this opinion.

Accordingly, in No. 376, the judgment of this Court is that the judgment of the Court of Appeals is reversed, and in No. 546, that the judgment of the Court of Appeals is vacated, and the case is remanded to the District Court for further proceedings not inconsistent with this opinion.
It is so ordered.

MR. JUSTICE HARLAN concurs in the result in No. 376. In No. 546, he would affirm the judgment of the Court of Appeals for the reasons stated by MR. JUSTICE FRANKFURTER.

MR. JUSTICE WHITTAKER, ... concurs only in the result of this opinion.

MR. JUSTICE DOUGLAS dissents, since he is of the view that, in each of these two cases, there was a gift ...

MR. JUSTICE BLACK, concurring and dissenting.

I agree with the Court that it was not clearly erroneous for the Tax Court to find as it did in No. 376 that the automobile transfer to Duberstein was not a gift, and so I agree with the Court's opinion and judgment reversing the judgment of the Court of Appeals in that case.

I dissent in No. 546, *Stanton v. United States*. ... [T]he Court of Appeals was ... wrong in reversing the District Court's judgment.

MR. JUSTICE FRANKFURTER, concurring in the judgment in No. 376 and dissenting in No. 546.

....

... While I agree that experience has shown the futility of attempting to define, by language so circumscribing as to make it easily applicable, what constitutes a gift for every situation where the problem may arise, I do think that greater explicitness is possible in isolating and emphasizing factors which militate against a gift in particular situations.

... While we should normally suppose that a payment from father to son was a gift unless the contrary is shown, in the two situations now before us, the business implications are so forceful that I would apply a presumptive rule placing the burden upon the beneficiary to prove the payment wholly unrelated to his services to the enterprise. The Court, however, has declined so to analyze the problem, and has concluded

> "that the governing principles are necessarily general, and [...] that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases."

....

... What the Court now does sets factfinding bodies to sail on an illimitable ocean of individual beliefs and experiences. This can hardly fail to invite, if indeed not encourage, too individualized diversities in the administration of the income tax law. I am afraid that, by these new phrasings, the practicalities of tax administration, which should be as uniform as is possible in so vast a country as ours, will be embarrassed. ... I agree with the Court in reversing the judgment in *Commissioner v. Duberstein*.

But I would affirm the decision of the Court of Appeals for the Second Circuit in *Stanton v. United States*. ... The business nature of the payment is confirmed by the words of the resolution, explaining the "gratuity" as

> "in appreciation of the services rendered by Mr. Stanton as Manager of the Estate and Comptroller of the Corporation of Trinity Church throughout nearly ten years, and as President of Trinity Operating Company, Inc."

Notes and Questions:

1. On remand of the *Stanton* case, the federal district court reexamined the evidence and determined that the Vestry was motivated by gratitude to a friend, good will, esteem, and kindliness. Hence the payment was a gift. *Stanton v. U.S.*, 186 F. Supp. 393, 396-97 (E.D.N.Y. 1963). The court of appeals affirmed because the determination of the federal district court was not clearly erroneous. *U.S. v. Stanton*, 287 F.2d 876, 877 (2nd Cir. 1961).

2. The Supreme Court stated:

> A gift in the statutory sense ... proceeds from a "detached and disinterested generosity" [citation omitted], "out of affection, respect, admiration, charity or like impulses." [citation omitted]. And in this regard, the most critical consideration ... is the transferor's "intention." [citation omitted].

Do people give gifts because they are detached and disinterested – or very attached and intensely interested?

3. The donee is the one who will invoke § 102. How is the donee to prove the donor's intent? Consider:

•Taxpayer first joined a bakery workers' union in 1922 and gradually rose through the ranks. In 1947, he was elected international vice president. He was an effective leader and was instrumental in the merger of several locals into one large local. Other officials of the local decided to give him and his wife a testimonial dinner at which the local would present him with sufficient funds to purchase a home. Taxpayer had nothing to do with the planning of the dinner and objected to it. The local raised money by selling insertions in a special souvenir journal. More than 1300 persons attended the dinner. There were six groups who contributed journal insertions:

•Employers of bakery workers who wanted to stay on good terms with the local made deductible payments from their business accounts. Many employers had known taxpayer for many years and were on good terms with him. Most of this group's journal insertions included a greeting such as "congratulations" and "best wishes."

•Employer trade associations made payments from assessments on employers, who in turn deducted payments that they made from their business accounts.

•Businesses who sold supplies to the baking industry and treated payments for journal insertions as deductible advertising expenses.

•Other union locals who made payments from funds accumulated from dues that they collected from members.

•Lawyers and doctors who knew taxpayer personally and were in some manner associated with union activity in the baking industry. Some of these persons deducted their expenditure.

•Employees and other individuals, many of whom purchased dinner tickets but only a few of whom purchased journal insertions. Many in this group felt friendship, admiration, affection, and respect for taxpayer.

Taxpayers (husband and wife) received nearly $61,000 from these contributions in 1956 and claimed on their income tax return that the amount was excludable as a gift.

•What issues do these facts raise after *Duberstein*? Doesn't

the opinion of *Duberstein* seem to invite such issues?
•If you represented taxpayer or the IRS, how would you undertake to address them? *See Kralstein v. Commissioner*, 38 T.C. 810 (1962), *acq.* 1963-2 C.B. 3 (1963).

4. Does Justice Frankfurter have a point when he said:

> What the Court now does sets fact-finding bodies to sail on an illimitable ocean of individual beliefs and experiences. This can hardly fail to invite, if indeed not encourage, too individualized diversities in the administration of the income tax law.

The Court combined two cases. How many possible outcomes for the two taxpayers were there? How many of them were espoused by at least one judge?
•No justice voted for Duberstein to win and Stanton to lose.
•Isn't the disparity of views pretty good evidence that Justice Frankfurter was absolutely right?

5. There probably was a business culture that developed until the 1950s of giving very substantial business gifts in settings such as these. When the marginal tax bracket of the donor is very high, e.g., 70% and maybe higher, the cost of making a very substantial gift is actually quite low if its donor may deduct its cost. Is it possible that Berman felt that if his gift was not sufficiently generous, Duberstein might pitch some of that business to others?

6. Subsequent to *Duberstein*, Congress added § 102(c)(1) and § 274(b)(1) to the Code. Read these sections.
•Would § 102(c)(1) change the result of either *Duberstein* or *Stanton*?
•Would § 274(b)(1) change the result of either *Duberstein* or *Stanton*?

7. Notice: §§ 261 to 280H do not themselves establish deduction rules, but rather limit deductions that other Code sections might provide when the expenditure is for certain items or purposes.

•In the case of gifts, § 274(b) limits the deductibility of a gift(s) given to one individual to a total of $25 if its cost is deducted under § 162 (trade or business expenses) or § 212 (expenses of producing or collecting profit or managing property held to produce income).
•In *Duberstein*, § 274(b) would have limited Mohawk Corporation's § 162 deduction to $25. If Mohawk had nevertheless purchased a Cadillac for Duberstein, *Mohawk* would have paid income tax on the cost of the gift (less $25). In essence, Mohawk would have been a surrogate taxpayer for Duberstein's accession to wealth.

- •Do you think that this cuts back on the number of Cadillacs given as business gifts?
- •No matter what the merits of particular gifts, isn't litigation of business gift issues likely to be much less frequent because of § 274(b)(1)?
- •Is congressional reaction to *Duberstein* better than the position that the Commissioner argued for in the case? Of course, the congressional solution was not one that the Commissioner would be in a position to advocate.
- •The congressional solution leaves the remainder of the *Duberstein* analysis intact.

8. Section 102's exclusion also extends to bequests. Section 102(b)(2) provides that income *from* gifted property is not excluded from a taxpayer's gross income. In *Irwin v. Gavit*, 268 U.S. 161 (1925), the Supreme Court held that the gift exclusion extended to the gift of the corpus of a trust, but not to the income from it. *Id.* at 167. An income beneficiary for life must pay income tax on that income; the remainderman does not pay income tax on the property.

•Notice that the value of a remainderman's interest is less than the fmv of the property itself because s/he will not acquire it until the income beneficiary dies.
•If the donor had simply given the corpus outright without subjecting it to a life estate, the value of the exclusion would have been more. Where did this loss in value disappear to? Shouldn't *someone* benefit from it?
•Might these points ever be important in matters of estate planning? How so?

9. Taxpayer was an attorney who entered into a contract with a client whereby he agreed to provide whatever legal services she should require for the remainder of her life without billing her. The client agreed to bequeath to taxpayer certain stock. Eventually the client died, and taxpayer received the stock. Taxpayer argued that the fmv of the stock should be excluded from his gross income under § 102(a).

- Do you agree? *See Wolder v. Commissioner*, 493 F.2d 608 (2nd Cir.), *cert. denied*, 419 U.S. 828 (1974).

10. Read §§ 74 and 274(j) carefully. This is an exercise is reading a statute.

CALI Lessons

Do the CALI Lesson, *Basic Income Taxation: Gross Income: Gifts, Bequests, Prizes, and Donative Cancellations of Indebtedness*.

11. Recall from chapter 1: *The Essence of Basis*: Adjusted basis represents money that will not again be subject to income tax, usually because it is what remains after taxpayer already paid income tax on a greater sum of money. More pithily: basis is "money that has already been taxed" (and so can't be taxed again).

- Section 1015 states a special rule governing a donee's basis in property that s/he acquired by gift. Read the first sentence of § 1015(a). What rule(s) does it state?

12. Consider this hypothetical posed by the Supreme Court in *Taft v. Bowers*, 278 U.S. 470 (1929), where the Court held that the Code's adjusted basis rules applicable to gifts is constitutional:

"In 1916, A purchased 100 shares of stock for $1000, which he held until 1923, when their fair market value had become $2000. He then gave them to B, who sold them during the year 1923 for $5000."

- (i) On how much gain must B pay income tax in 1923? *See* § 1015(a).

- (ii) Suppose that A had purchased the shares for $5000 and gave them to B when their fmv was $2000. B sold the shares in 1923 for $1000. How much loss may B claim on her income tax return for

1923?

•(iii) Suppose that A had purchased the shares for $2000 and gave them to B when their fmv was $1000. B sold the shares in 1923 for $1500. How much gain or loss must B claim on her income tax return?

•(iv) Suppose that A had purchased the shares for $2000 and gave them to B when their fmv was $1000. B sold them for $5000. On how much gain must B pay income tax in 1923?

•(v) Suppose that A had purchased the shares for $2000 and gave them to B when their fmv was $3000. B sold them for $1000. How much loss may B claim on her income tax return?

13. The federal estate and gift taxes are *in pari materia* with each other. The federal income tax is *not in pari materia* with the federal estate and gift taxes.

•What does this mean?

Mixing taxes to increase basis: When we say that "basis is money that has already been taxed (and so can't be taxed again)," we are referring to the *federal income tax*. The federal estate and gift taxes are *not* in pari materia with the federal income tax. Hence, payment of federal estate or gift tax does not affect liability for federal income tax, and vice versa. It follows that payment of federal estate or gift taxes should not affect a taxpayer's income tax basis in his/her property. *However*, § 1015(d) makes an exception to this (quite logical) rule. Read § 1015(d)(1 and 6). What rule(s) does this provision state?

14. Now consider the effect of § 1015(d)(1 and 6). Assume that the gift tax on any gift is 20% of the *fmv* of the gift. Assume also that the gift was made in 2013. How does this change your answers to the first question immediately above?

15. Now imagine: Taxpayer wanted to give $800 as a gift to his son. Assume that the gift is subject to federal gift tax. Assume that the gift tax is 20% of the fmv of the gift. Instead of giving the son $800 and paying $160 in federal gift tax, taxpayer gave his son property with a fmv of $1000 on the condition that son pay the $200 gift tax. Must *father* recognize gross income? Read

on.

Diedrich v. Commissioner, 457 U.S. 191 (1982).

CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari to resolve a Circuit conflict as to whether a donor who makes a gift of property on condition that the donee pay the resulting gift tax receives taxable income to the extent that the gift tax paid by the donee exceeds the donor's adjusted basis in the property transferred. The United States Court of Appeals for the Eighth Circuit held that the donor realized income. We affirm.

I

A

Diedrich v. Commissioner of Internal Revenue

In 1972, petitioners Victor and Frances Diedrich made gifts of approximately 85,000 shares of stock to their three children ... The gifts were subject to a condition that the donees pay the resulting federal and state gift taxes. ... The donors' basis in the transferred stock was $51,073; the gift tax paid in 1972 by the donees was $62,992. Petitioners did not include as income on their 1972 federal income tax returns any portion of the gift tax paid by the donees. After an audit, the Commissioner of Internal Revenue determined that petitioners had realized income to the extent that the gift tax owed by petitioners, but paid by the donees, exceeded the donors' basis in the property. Accordingly, petitioners' taxable income for 1972 was increased by $5,959.[49] Petitioners filed a petition in the United States Tax Court for redetermination of the deficiencies. The Tax Court held for the taxpayers, concluding that no income had been realized.

[49] Subtracting the stock basis of $51,073 from the gift tax paid by the donees of $62,992, the Commissioner found that petitioners had realized a long-term capital gain of $11,919. After a 50% reduction in long-term capital gain, 26 U.S.C. § 1202, the Diedrichs' taxable income increased by $5,959.

B

....

C

The United States Court of Appeals for the Eighth Circuit ... reversed, concluding that, "to the extent the gift taxes paid by donees" exceeded the donors' adjusted bases in the property transferred, "the donors realized taxable income." The Court of Appeals rejected the Tax Court's conclusion that the taxpayers merely had made a "net gift" of the difference between the fair market value of the transferred property and the gift taxes paid by the donees. The court reasoned that a donor receives a benefit when a donee discharges a donor's legal obligation to pay gift taxes. The Court of Appeals agreed with the Commissioner in rejecting the holding in *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (CA6 1969), and its progeny, and adopted the approach of *Johnson v. Commissioner*, 59 T.C. 791 (1973), *aff'd*, 495 F.2d 1079 (CA6), *cert. denied*, 419 U.S. 1040 (1974), and *Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (CA2 1980). We granted certiorari to resolve this conflict, and we affirm.

II

A

... This Court has recognized that "income" may be realized by a variety of indirect means. In *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), the Court held that payment of an employee's income taxes by an employer constituted income to the employee. Speaking for the Court, Chief Justice Taft concluded that

> "[t]he payment of the tax by the employe[r] was in consideration of the services rendered by the employee, and was a gain derived by the employee from his labor."

Id. at 279 U.S. 729. The Court made clear that the substance, not the form, of the agreed transaction controls. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Ibid*. The employee, in other words, was placed in a better position as a result of the employer's discharge of the employee's legal obligation to pay the income taxes; the employee thus received a gain subject to income tax.

The holding in *Old Colony* was reaffirmed in *Crane v. Commissioner*, 331 U.S. 1 (1947). In *Crane*, the Court concluded that relief from the obligation of a nonrecourse mortgage in which the value of the property exceeded the value of the mortgage constituted income to the taxpayer. The taxpayer in *Crane* acquired depreciable property, an apartment building, subject to an unassumed mortgage. The taxpayer later sold the apartment building, which was still subject to the nonrecourse mortgage, for cash plus the buyer's assumption of the mortgage. This Court held that the amount of the mortgage was properly included in the amount realized on the sale, noting that, if the taxpayer transfers subject to the mortgage,

> "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another."

Id. at 331 U.S. 14. [footnote omitted] Again, it was the "reality," not the form, of the transaction that governed. *Ibid*. The Court found it immaterial whether the seller received money prior to the sale in order to discharge the mortgage, or whether the seller merely transferred the property subject to the mortgage. In either case the taxpayer realized an economic benefit.

B

The principles of *Old Colony* and *Crane* control.[50] A common method of

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[50] ....

It should be noted that the gift tax consequences of a conditional gift will be unaffected by the holding in this case. When a conditional "net" gift is given, the gift tax attributable to the transfer is to be deducted from the value of the property in determining the value of the gift at the time of transfer. *See* Rev. Rul. 75-72, 1975-1 Cum. Bull. 310 (general formula for structuring gift transactions is for the donor to make the gift subject to the condition that the donee pay the resulting gift tax, as was done in ... the case[] now before us. When a gift is made, the gift tax liability falls on the donor under 26 U.S.C. § 2502(d).[51] When a donor makes a gift to a donee, a "debt" to the United States for the amount of the gift tax is incurred by the donor. Those taxes are as much the legal obligation of the donor as the donor's income taxes; for these purposes, they are the same kind of debt obligation as the income taxes of the employee in *Old Colony*, *supra*. Similarly, when a donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an immediate economic benefit by the donee's assumption of the donor's legal obligation to pay the gift tax.

An examination of the donor's intent does not change the character of this benefit. Although intent is relevant in determining whether a gift has been made, subjective intent has not characteristically been a factor in determining whether an individual has realized income. [footnote omitted] Even if intent were a factor, the donor's intent with respect to the condition shifting the gift tax obligation from the donor to the donee was plainly to relieve the donor of a debt owed to the United States; the choice was made because the donor would receive a benefit in relief from the obligation to pay the gift tax.[52]

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computation of gift tax on conditional gift); Rev. Rul. 71-232, 1971-1 Cum. Bull. 275.

[51] "The tax imposed by section 2501 shall be paid by the donor."

Section 6321 imposes a lien on the personal property of the donor when a tax is not paid when due. The donee is secondarily responsible for payment of the gift tax should the donor fail to pay the tax. 26 U.S.C. § 6324(b). The donee's liability, however, is limited to the value of the gift. *Ibid.* This responsibility of the donee is analogous to a lien or security. *Ibid. See also* S. Rep. No. 665, 72d Cong., 1st Sess., 42 (1932); H.R. Rep. No. 708, 72d Cong., 1st Sess., 30 (1932).

[52] ....

A conditional gift not only relieves the donor of the gift tax liability, but also may enable the donor to transfer a larger sum of money to the donee than would otherwise be possible due to

Finally, the benefit realized by the taxpayer is not diminished by the fact that the liability attaches during the course of a donative transfer. It cannot be doubted that the donors were aware that the gift tax obligation would arise immediately upon the transfer of the property; the economic benefit to the donors in the discharge of the gift tax liability is indistinguishable from the benefit arising from discharge of a preexisting obligation. Nor is there any doubt that, had the donors sold a portion of the stock immediately before the gift transfer in order to raise funds to pay the expected gift tax, a taxable gain would have been realized. 26 U.S.C. § 1001. The fact that the gift tax obligation was discharged by way of a conditional gift, rather than from funds derived from a pre-gift sale, does not alter the underlying benefit to the donors.

C

Consistent with the economic reality, the Commissioner has treated these conditional gifts as a discharge of indebtedness through a part gift and part sale of the gift property transferred. The transfer is treated as if the donor sells the property to the donee for less than the fair market value. The "sale" price is the amount necessary to discharge the gift tax indebtedness; the balance of the value of the transferred property is treated as a gift. The gain thus derived by the donor is the amount of the gift tax liability less the donor's adjusted basis in the entire property. Accordingly, income is realized to the extent that the gift tax exceeds the donor's adjusted basis in the property. This treatment is consistent with § 1001 of the Internal Revenue Code, which provides that the gain from the disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property. [footnote omitted]

III

We recognize that Congress has structured gift transactions to encourage transfer of property by limiting the tax consequences of a transfer. *See, e.g.*, 26 U.S.C. § 102 (gifts excluded from donee's gross income). Congress

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such factors as differing income tax brackets of the donor and donee.

may obviously provide a similar exclusion for the conditional gift. Should Congress wish to encourage "net gifts," changes in the income tax consequences of such gifts lie within the legislative responsibility. Until such time, we are bound by Congress' mandate that gross income includes income "from whatever source derived." We therefore hold that a donor who makes a gift of property on condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property. [footnote omitted]

The judgment of the United States Court of Appeals for the Eighth Circuit is

Affirmed.

JUSTICE REHNQUIST, dissenting.

... The Court in this case ... begs the question of whether a taxable transaction has taken place at all when it concludes that "[t]he principles of *Old Colony* and *Crane* control" this case.

In *Old Colony*, the employer agreed to pay the employee's federal tax liability as part of his compensation. The employee provided his services to the employer in exchange for compensation. The exchange of compensation for services was undeniably a taxable transaction. The only question was whether the employee's taxable income included the employer's assumption of the employee's income tax liability.

In *Crane*, the taxpayer sold real property for cash plus the buyer's assumption of a mortgage. Clearly a sale had occurred, and the only question was whether the amount of the mortgage assumed by the buyer should be included in the amount realized by the taxpayer. The Court rejected the taxpayer's contention that what she sold was not the property itself, but her equity in that property.

Unlike *Old Colony* or *Crane*, the question in this case is not the amount of income the taxpayer has realized as a result of a concededly taxable transaction, but whether a taxable transaction has taken place at all. Only after one concludes that a partial sale occurs when the donee agrees to pay the gift tax do *Old Colony* and *Crane* become relevant in ascertaining the amount of income realized by the donor as a result of the transaction. Nowhere does the Court explain why a gift becomes a partial sale merely because the donor and donee structure the gift so that the gift tax imposed by Congress on the transaction is paid by the donee, rather than the donor.

In my view, the resolution of this case turns upon congressional intent: whether Congress intended to characterize a gift as a partial sale whenever the donee agrees to pay the gift tax. Congress has determined that a gift should not be considered income to the donee. 26 U.S.C. § 102. Instead, gift transactions are to be subject to a tax system wholly separate and distinct from the income tax. *See* 26 U.S.C. § 2501 et seq. Both the donor and the donee may be held liable for the gift tax. §§ 2502(d), 6324(b). Although the primary liability for the gift tax is on the donor, the donee is liable to the extent of the value of the gift should the donor fail to pay the tax. I see no evidence in the tax statutes that Congress forbade the parties to agree among themselves as to who would pay the gift tax upon pain of such an agreement being considered a taxable event for the purposes of the income tax. Although Congress could certainly determine that the payment of the gift tax by the donee constitutes income to the donor, the relevant statutes do not affirmatively indicate that Congress has made such a determination.

I dissent.

Notes and Questions:

1. Assuming that the outcome advocated by Justice Rehnquist is what the parties wanted, is there a way for the parties in *Diedrich* to structure the gift so as to achieve that result?

2. Return to the hypothetical in the note immediately preceding *Diedrich*. Read the second paragraph of the Court's second footnote. In the hypothetical, how much gift tax should the son have to pay?

•Rev. Rul. 75-72 gives the following formula:

(tentative tax)/(1 + λ) = (true tax)

•"tentative tax" is the tax as computed on the fmv of the gifted property; λ is the tax rate; "true tax" is the actual gift tax that the donee must (actually) pay.

•Notice: In our example, application of the formula yields a "true tax" of $166.67. The net value of the gift would therefore be $833.33. 20% of $833.33 is $166.67.

•The use of a net gift enables the donor/donee, between them, to pay less gift tax. This enlarges the net gift.

•To what extent does the holding in *Diedrich* upset this planning?

3. There are times when we want to bifurcate the tax treatment of a transaction. In other words, we want to treat it as partly one thing and partly another. In part IIC of the opinion, the Court characterized the transaction as partly a gift and partly a sale. The logical way to treat a transaction that is partly one thing and partly another is to pro-rate it. A certain *portion* of the transaction is one thing and the *remaining portion* is another.

Remember that the taxpayer computes gains derived from dealings in property, § 61(a)(3), by subtracting "adjusted basis" from "amount realized," § 1001(a).

If a transaction is partly a gift and partly a sale, how should we (logically) determine what portion of the transaction is gift and what portion is sale?

•Our taxpayer is disposing of the property.

•How should we logically determine the "amount realized" and the "adjusted basis" on the sale portion of the transaction?

•How should we logically determine the "amount realized" and the "adjusted basis" on the gift portion of the transaction?

Typically, we know some information and have to compute what we don't know. In a part gift/part sale, we often know the total fmv of the property, the amount realized from the sale portion of the transaction, and the taxpayer's basis in all of the property.

•Logically, the sale portion of the transaction should be (amount realized)/(fmv of the property). That same fraction should be multiplied by taxpayer's total basis in the property.
•The balance of the "adjusted basis" and the balance of the "amount realized" determine the gain on the non-sale portion of the transaction.

Taxpayers may transfer property to a charity through a part-gift/part-sale.

How would this analysis apply to the following facts:
•Taxpayer's adjusted basis in Blackacre is $10. The fmv of Blackacre is now $100. Taxpayer sells Blackacre to State University for $20. Taxpayer may deduct the value of gifts to State University.
•On how much gain should taxpayer pay income tax?

4. Read Reg. § 1.1001-1(e)(1). This is the rule that the IRS applied in *Diedrich*. Does the logic of part IIC of the opinion support this rule? If not, why didn't the taxpayer(s) point this out?

5. Read Reg. § 1.1015-4(a *and* b). Describe the calculation of the Diedrich children's (i.e., the donees') basis in the stock that they received. Consider: did the Diedrich children pay their parents anything for the property, or did *they* give a gift to their parents, and if so, what was it?
6. Read Reg. § 1.1015-4(a *and* b) Examples 1, 2, 3, and 4.
•Now throw in some gift tax. What should be the basis of A's son in the property if gift tax of the following amounts is paid?
•$12,000 in Example 1.
•$18,000 in Example 2.
•$18,000 in Example 3.
•$6000 in Example 4.

7. Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Computation of Gain and Loss Realized*. Some of the questions present new issues, but you can reason through them.

B. Exclusion of Gain from Sale of Principal Residence: § 121

President George Bush II announced early in his presidency that he wanted America to be an "ownership society." How would (does) widespread taxpayer ownership of private homes make America a better place? We have already examined imputed income derived from ownership of property – and that is most significant with regard to ownership of principal residences.

- Read § 121.
  - What is the rule of § 121(a)?
  - Does § 121 promote an "ownership society" – or something else? Don't forget that –
    - § 163(h) permits deduction of mortgage interest on up to $1,000,000 of indebtedness incurred to purchase a home or of interest on up to $100,000 of home equity indebtedness.
    - § 164(a)(1) permits a deduction for state and local, and foreign real property taxes.
- Notice that § 121(b)(4)[(5)] and § 121(c) employ bifurcation ratios. Are the ratios what you expect them to be?

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Exclusion of Gain on the Sale of a Principal Residence*.

C. Interest on State and Local Bonds: § 103

Read §§ 103 and 141.[53]

Interest derived from a state or local bond is excluded from a taxpayer's gross income. § 103(a). This exclusion does not extend to interest derived

[53] *See generally* Committee on the Budget United States Senate 111th Cong., TAX EXPENDITURES: COMPENDIUM OF BACKGROUND MATERIAL ON INDIVIDUAL PROVISIONS, S. PRT. 111-58 at 951-56 (2010), *available at* http://budget.senate.gov/democratic/index.cfm/files/serve?File_id=8a03a030-3ba8-4835-a67b-9c4033c03ec4.

from a “private activity bond,” § 103(b)(1), or an “arbitrage bond,” § 103(b)(2).[54] This provision has always been a part of the Code. There may have been some doubt about whether Congress had the constitutional power to tax such income.

It might appear that this would encourage investors to choose to purchase the bonds of state and local governments. After all, the interest income that such bonds generate is not subject to tax, whereas other investment income is subject to federal income tax. The investor should be able to keep more of his/her income. However, both borrowers (state and local governments) and investors know that the interest on such bonds is not subject to federal income tax. Hence, state and local governments are able to borrow money at less than prevailing interest rates, i.e., the rate that any other borrower would have to pay. If the market “bids down” the interest rate to the point that taxpayers in the highest tax bracket (now 35%) are no better off than they would be if they had simply purchased a corporate bond carrying equivalent risk and paid the income tax on the interest that they receive, the exclusion would function “only” as a means by which the U.S. Treasury transfers the tax revenue that it must forego to state and local governments. There are some (potential) economic distortions that this exclusion causes:

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[54] The exclusion also does not extend to interest derived from a bond “not in registered form.” § 103(b)(3) as defined in § 149. This basically means that the bond must be offered to the public, have a maturity date more than one year after the date of issue, and not be offered exclusively to persons who are not U.S. persons and/or payable only outside of the United States. Moreover, the interest on *some* private activity bonds is excluded from a taxpayer’s gross income. *See* § 141(f) and §§ 142 to 145.

•If there are enough taxpayers in the highest tax bracket to "clear the market" for state and local bonds, the interest rate on such bonds should gravitate to $(1 - \lambda)$*(prevailing interest on corporate bonds), where λ denotes the highest marginal tax rate. If this is the case, *all* of the tax that the U.S. Treasury foregoes is transferred to state and local governments.

•*But if* there are *not* enough taxpayers in the highest tax bracket to "clear the market" for state and local bonds, state and local governments must offer an interest rate higher than $(1 - \lambda)$*(prevailing interest on corporate bonds). Perhaps it will be necessary to entice some taxpayers in the second-to-highest or even third-to-highest bracket. The effect of this is to give taxpayers in the highest tax bracket a windfall, i.e., an after-tax return on state and local bonds that is higher than the after-tax return on corporate bonds. In *this* case, not all of the foregone tax revenue is transferred from the U.S. Treasury to state and local governments; some of it is transferred to taxpayers in the highest tax bracket.

•How will this affect the market for corporate bonds?

•In effect, those who invest in state and local bonds have the power to "vote" to have some of their tax dollars go to state and local governments rather than to the federal government. Most of the (rational) voters will have high incomes.

•There is no limit to the amount of interest that a taxpayer may

> If one state has been profligate in its spending and now finds that it must borrow enormous amounts on which it will be paying interest far into the future, should taxpayers in other states care?
> •Yes.
> •Profligate states make it far more likely that the interest that state and local governments must pay will be attractive to taxpayers whose marginal tax bracket is less than the highest marginal tax bracket. This means that there will be a revenue transfer from the U.S. Treasury to those in the highest tax bracket instead of to the state and local governments.
> •As more money is transferred from the U.S. Treasury to state and local governments and to the nation's highest income earners, a tax increase becomes more likely – or a spending cut.
> •Residents of the profligate state may have enjoyed consumption that the residents of more frugal (responsible?) states did not, but now must indirectly pay for.

exclude under this provision.[55] Hence state and local governments may be encouraged to borrow more than they otherwise would. The laws of some states limit the amount that they can borrow.

•State and local governments may elect to finance "too many" capital projects – e.g., highways, schools, government buildings – by issuing bonds, as opposed either to foregoing such expenditures or by procuring necessary funds in another manner, e.g., raising taxes.

D. Scholarships: § 117

Read § 117.

What justification do you see for the exclusion(s) provided by § 117? Some of you receive scholarship assistance on which you pay no federal income tax. Others do not receive such assistance and must work to be here. The wages that such students earn *are* subject to federal income tax.

Consider:
Moldaur is the son of a professor at the Mega State University. Moldaur has enrolled at Mega State University. Tuition is $20,000 at Mega State University. Moldaur is entitled to a 50% reduction in his tuition because he is the son of a professor. In addition, Moldaur qualified for a Hilfen Scholarship under the state's lottery-to-education scholarship program. The state collects lottery revenues and divides them equally among those who qualify for scholarships. This year, each scholarship recipient was credited with $14,000 towards tuition. The result for Moldaur is that he had a $4000 account surplus, which the university refunded to him.

•Tax consequences to Moldaur? Read § 117(b)(1) and Reg. § 1.117-1(a) carefully.

•Tax consequences to Moldaur's father? Read § 117(d) carefully.

CALI Lessons

[55] However, such interest might be a "tax preference" item, § 57(a)(5) (private activity bonds), and so subject to the AMT. § 55(b)(2)(B).

Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Scholarships*.

E. Rental Value of Parsonages: § 107

Read §§ 107 and 265.

A "minister of the gospel" may exclude the housing allowance that a congregation pays to him/her. Such a taxpayer may spend some of this allowance on home mortgage interest (deductible under § 163(h)) or real estate taxes (deductible under § 164(a)(1)). Explain how this is a double dip. How might a congregation, as payor of this allowance, capture some or all of the benefit of the exclusion?

II. Social Benefits

The Code excludes from gross income payments for various benefits or the fmv of benefits taxpayer receives in kind. Who should administer government benefit programs, e.g., benefits for workplace injury? Who administers benefit "programs" when they are the product of exclusions from gross income?

A. Life Insurance Death Benefits: § 101

Section 101(a)(1) excludes from gross income "amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of death." This provision has always been a part of the Code, and the desire to avoid taxing heirs has made repeal

A bit about insurance. The basic idea of insurance, of course, is that individual persons purchase a policy that promises payment upon materialization of a specified risk. The policy is effective for a certain period, e.g., one year. The insurance company pools the premiums, and pays those for whom the risk materializes. Notice that policy-holders pay their premiums from after-tax money. We could treat the "winner" as if s/he has simply received a gift from those who contributed to the pool of money. Under such a rationale, the proceeds would be excluded from gross income by § 102.

difficult. Many people purchase life insurance so that family members will receive money at a time when they no longer have the income of the deceased insured. It could be unseemly to tax a grieving family under such circumstances.

- "If any amount excluded from gross income ... is held under an agreement to pay interest thereon, the interest payments shall be included in gross income." § 101(c).
- In the event that life insurance proceeds are paid otherwise than as a lump sum, a portion of each payment is allocated pro rata to the amount excluded and the remaining return on investment *is* subject to income tax. § 101(d)(1).

Consider: H purchased a life insurance policy on his life with a face amount of $200,000 and named W as the beneficiary. H died. W and the insurance company entered an agreement whereby the insurance company would hold $200,000 and pay her $250,000 in five years; W would have no claim of right to the funds during that time. At that time, instead of paying W $250,000, the insurance company will pay W $28,000 per year at a time when her life expectancy will be ten years.

- How would the payments to W be taxed during the first five years after H's death?
- How would the payments to W during the succeeding ten years be taxed?
    - *See* §§ 101(c and d); Reg. § 1.101-3(a); Reg. § 1.101-4(a)(1)(i); Reg. § 1.101-4(g) (Examples 1 and 5 (first two sentences only)).
        - The last provision might not be in your edition of the Regulations. Go to Westlaw or Lexis to find it.

Section 101(a)(2) provides that in the case of a transfer of a life insurance contract for valuable consideration, the exclusion is lost. The beneficiary in such a case may exclude only the amount paid for the policy (i.e., premiums) plus any subsequent payments, i.e., premiums.

- An exception to this exception is made when the transferee takes for his/her basis the basis of the transferor. § 101(a)(2)(A).
- When might a transferee take for his/her basis the basis of the transferee?
- Another exception to the exception is made when the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. § 101(a)(2)(B).
- When (why) would transfers such as those described in § 101(a)(2)(B) occur?

> *A note about life insurance*. Life insurance comes in various forms, and tax benefits can extend well beyond excluding death benefits from gross income. "Life insurance contract" is defined in § 7702 so as to preclude an investment from being a "life insurance contract." To be insurance, there must be a shifting of risk from the insured to the insurer.
> •Term insurance is insurance that promises only for the term for which it is purchased to pay upon the occurrence of death. Upon expiration of the term, the policyholder has nothing.
> •Permanent life insurance is life insurance that the insured maintains by paying a premium annually. Premiums for permanent life insurance are higher than they are for term insurance; the insurance company invests the excess on behalf of the insured. The policy builds up cash value ("inside buildup") – *tax-free*. Inside buildup can reduce premiums in future years, notably as premiums would otherwise increase because the insured is older and the risk of his/her death higher.
> •Non-taxation of inside buildup permits permanent life insurance to function as a tax shelter.

H purchased a permanent life insurance policy on his life with a face amount of $300,000. He named W as the beneficiary. When H was 63 years old and the children were grown, W died. H saw no need to continue making premium payments so he sold the policy to his employer for $100,000.

- How would you compute H’s gross income from this sale?
- How would you compute H’s gross income if instead H surrendered the policy to the insurance company for its cash value of $100,000?
- Are there additional facts that you would need to know?

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....

ISSUE

What is the amount and character of A’s income recognized upon the surrender or sale of the life insurance contracts described in the situations below?

FACTS

Situation 1

On January 1 of Year 1, A, an individual, entered into a “life insurance contract” (as defined in § 7702 ...) with cash value. Under the contract, A was the insured, and the named beneficiary was a member of A’s family. A had the right to change the beneficiary, take out a policy loan, or surrender the contract for its cash surrender value. The contract in A’s hands was ... [a capital asset].

On June 15 of Year 8, A surrendered the contract for its $78,000 cash surrender value, which reflected the subtraction of $10,000 of “cost-of-insurance” charges collected by the issuer for periods ending on or before the surrender of the contract. Through that date, A had paid premiums totaling $64,000 with regard to the life insurance contract. A had neither received any distributions under the contract nor borrowed against the contract’s cash surrender value.

....

Situation 2

The facts are the same as in Situation 1, except that on June 15 of Year 8, A sold the life insurance contract for $80,000 to B, a person unrelated to A and who would suffer no economic loss upon A's death.

Situation 3

....

LAW AND ANALYSIS

SITUATION 1

Amount of income recognized upon surrender of the life insurance contract

....

If a non-annuity amount is received ... on the complete surrender, redemption, or maturity of the contract, § 72(e)(5)(A) requires that the amount be included in gross income but only to the extent it exceeds investment in the contract. For this purpose, § 72(e)(6) defines "investment in the contract" as of any date as the aggregate amount of premiums or other consideration paid for the contract before that date, less the aggregate amount received under the contract before that date to the extent that amount was excludable from gross income.

In Situation 1, A received $78,000 on the complete surrender of a life insurance contract. A's income upon surrender of the contract is determined under § 72(e)(5). Under § 72(e)(5)(A), the amount received is included in gross income to the extent it exceeds the investment in the contract. As A paid aggregate premiums of $64,000 with regard to the contract, and neither received any distributions under the contract nor borrowed against the contract's cash surrender value prior to surrender, A's "investment in the contract" as required by § 72(e)(6) was $64,000.

Consequently, pursuant to § 72(e)(5)(A), A recognized $14,000 of income on surrender of the contract, which is the excess of $78,000 received over $64,000.

[A's gain is ordinary income.] ...

....

SITUATION 2

Section 61(a)(3) provides that gross income includes gains derived from dealings in property.

Section 1001(a) provides that the gain realized from the sale or other disposition of property is the excess of the amount realized over the adjusted basis provided in § 1011 for determining gain. Thus, to determine the amount of A's income from the sale of the life insurance contract in Situation 2, it is necessary to determine A's amount realized from the sale, and A's adjusted basis in the contract.

Pursuant to § 1001(b), A's amount realized from the sale of the life insurance contract is the sum of money received from the sale, or $80,000.

Under §§ 1011 and 1012, the adjusted basis for determining gain or loss is generally the cost of the property adjusted as provided in § 1016 ... Under § 1016(a)(1), proper adjustment must be made for expenditures, receipts, losses, or other items properly chargeable to capital account. *See also* Reg. § 1.1016-2(a). Section 72 has no bearing on the determination of the basis of a life insurance contract that is sold, because § 72 applies only to amounts received under the contract.
Both the Code and the courts acknowledge that a life insurance contract, although a single asset, may have both investment characteristics and insurance characteristics. *See, e.g.*, § 7702 (defining life insurance contract for federal income tax purposes by reference, in part, to both the cash surrender value and death benefits under the contract); [citations omitted]. To measure a taxpayer's gain upon the sale of a life insurance contract, it is necessary to reduce basis by that portion of the premium

paid for the contract that was expended for the provision of insurance before the sale.

....

In Situation 2, A paid total premiums of $64,000 under the life insurance contract through the date of sale, and $10,000 was subtracted from the contract's cash surrender value as cost-of-insurance charges. Accordingly, A's adjusted basis in the contract as of the date of sale under §§ 1011 and 1012 and the authorities cited above was $54,000 ($64,000 premiums paid less $10,000 expended as cost of insurance).

Accordingly, A must recognize $26,000 on the sale of the life insurance contract to B, which is the excess of the amount realized on the sale ($80,000) over A's adjusted basis of the contract ($54,000).

Unlike Situation 1, which involves the surrender of the life insurance contract to the issuer of the contract, Situation 2 involves an actual sale of the contract. Nevertheless some or all of the gain on the sale of the contract may be ordinary if the substitute for ordinary income doctrine applies.

....

Application of the "substitute for ordinary income" doctrine is limited to the amount that would be recognized as ordinary income if the contract were surrendered (i.e., to the inside build-up under the contract). Hence, if the income recognized on the sale or exchange of a life insurance contract exceeds the "inside build-up" under the contract, the excess may qualify as gain from the sale or exchange of a capital asset. *See, e.g.*, *Commissioner v. Phillips*, 275 F.2d 33, 36 n.3 (4th Cir. 1960).

In Situation 2, the inside build-up under A's life insurance contract immediately prior to the sale to B was $ 14,000 ($78,000 cash surrender value less $64,000 aggregate premiums paid). Hence, $14,000 of the $26,000 of income that A must recognize on the sale of the contract is ordinary income under the "substitute for ordinary income" doctrine.

Because the life insurance contract in A's hands was ... [a capital asset] and was held by A for more than one year, the remaining $12,000 of income is long-term capital gain within the meaning of § 1222(3).

SITUATION 3

....

HOLDINGS

1. In Situation 1, A must recognize $14,000 of ordinary income upon surrender of the life insurance contract.

2. In Situation 2, A must recognize $26,000 of income upon sale of the life insurance contract. Of this $26,000 of income, $14,000 is ordinary income, and $12,000 is long-term capital gain.

3. ...

Notes and Questions:

1. In the case of *surrender* of a life insurance policy, inside buildup that (helps to) pay future premiums is *not* subject to tax. In the case of a *sale* of an insurance policy, inside buildup that (helps to) pay future premiums *is* subject to tax.

2. In Situation 2, assume that the face amount of the policy was $400,000. B paid $80,000 for the policy plus another $500 per month in premiums for another six years. A died. B received $400,000 from the life insurance company. How much must B include in his/her gross income?

3. Section 72 governs the tax treatment of payouts from an annuity contract. Section 72(a)(1) provides that gross income includes "any amount received as an annuity ... under an annuity, endowment, or life insurance contract."

- Thus, annuity treatment can only apply to payments made under the named type of contracts.
- The rule of § 72(a)(1) appears to require inclusion of all amounts

that taxpayer receives under one of the named contracts. However, § 72(b) softens the blow considerably by prescribing an "exclusion ratio" by which taxpayer's basis in the contract is recovered pro rata over the contract's expected payout period.

- Taxpayer determines the amount of every annuity payment that s/he receives that s/he may exclude from gross income by multiplying (taxpayer's investment in the contract)/(expected return). Taxpayer must include the balance in his/her gross income. § 72(b)(1).
- If taxpayer outlives his/her life expectancy, taxpayer may not exclude any portion of further payments. § 72(b)(2).
- On the other hand, if taxpayer does not live as long as his/her life expectancy, the unrecovered basis is allowed as a deduction on annuitant's last tax return. § 72(b)(3)(A).

Section 72(e) states rules applicable to amounts received under an annuity, endowment, or life insurance contract that are *not* received as an annuity – *if* no other provision of this subtitle is applicable. § 72(e)(1).

- Section 1001 is a provision of "this subtitle."
    - In Situation 2, no payments were made under the contract. Instead, a third party bought the contract. For that reason, § 72(e)(1) did not apply. Instead, the ruling requires treatment of the sale as any other sale of property with adjustments to basis for prior expenditures on life insurance.
- Section 72(e)(5)(C) provides that § 72(e)(1) applies to amounts not received as an annuity under a life insurance or endowment contract.
    - This describes the payment from the insurance company to the taxpayer in Situation 1.
    - Section 72(e)(1) provides that the amount taxpayer must include in his/her gross income is the amount of the payment "to the extent it exceeds the investment in the contract." Section 72(e)(6) defines "investment in the contract" to include the aggregate of premiums or other consideration paid for the contract minus any amounts previously received that taxpayer excluded from his/her gross income.

•It is because of § 72(e)(5) that Situations 1 and 2 are resolved differently.

4. Section 101(g): Amounts that a "terminally ill" or "chronically ill" person receives under a life insurance contract may qualify for exclusion under § 101(a)(1). The same is true of the "amount realized" on the sale of a life insurance policy to a "viatical settlement provider." § 101(g)(2).

•A "terminally ill" taxpayer is one who is certified by a physician as having "an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification." § 101(g)(4)(A).

•A "chronically ill" taxpayer is one who is not "terminally ill" and is unable to perform at least two activities of daily living (i.e., eating, toileting, transferring, bathing, dressing, and continence) or requires substantial supervision to protect himself/herself "from threats to health and safety due to severe cognitive impairment." § 101(g)(4)(B), referencing § 7702B(c)(2).

•A "chronically ill" taxpayer must use the payment for unreimbursed costs of long-term care. § 101(g)(3)(A).

Section 101(g) enables an insured taxpayer to get money out of a life insurance policy at a time when s/he has a substantial need for cash and the risk of death has nearly materialized.

5. In the movie, *Capitalism: A Love Story* (2009), Michael Moore recounts how Wal-Mart purchased life insurance policies on the lives of low-paid persons. Inside buildup was free of income tax. If one of the employees died, Wal-Mart would collect the proceeds of the policy without tax. A number of businesses engaged in this practice of purchasing "corporate-owned life insurance" (COLI) and did not even inform the affected employees that it had done this. [Michael Moore lamented that Wal-Mart did not hand the money over to the family of a deceased employee.]

•In 2006 – before release of the movie – Congress enacted § 101(j) which limited the exclusion in the case of employer-owned contracts to the amounts paid for the policy. § 101(j)(1).

•There is an exception to the exception if the employee is a key employee and is notified that the employer intends to procure such insurance and the employee gives his/her consent. § 101(g)(2 and 4).

B. Compensation for Injuries or Sickness: §§ 104, 105, 106

Read § 104. Injured persons need compensation. Consider the precise extent to which the subsections of § 104 exclude compensation for injury.

•Section 104(a)(2) seems to compel taxpayers to search for a physical injury, much as a tort claim involving only emotional distress involves a search for a physical manifestation. Review part IIB of CADC's opinion in *Murphy v. Internal Revenue Service*, 493 F.3d 170 (CADC 2007), *supra*, chapter 2. The Government was correct in its reading of the "on account of" language in the statute. There must be a strong causal connection between the physical injury and the emotional distress – not the other way around – in order for it to be excluded from gross income by § 104(a)(2).

•What does § 104(a)(3) mean? What health or accident insurance payments does § 104(a)(3) reference?

- •"Health and accident" insurance includes wage continuation policies. This would be important for employees whose employers provide health insurance but not disability insurance.
- •The exclusion applies to multiple payments from more than one self-purchased policy, even though the amount received exceeds the expense against which taxpayer procured the insurance.

•Read § 105. What rule emerges from §§ 105(a and b)?

•The following two problems are derived from and answered by Rev. Rul. 69-154. What is your intuition about how they should be solved? Feel free to examine the revenue ruling.

- •C is covered by his employer's health insurance policy. C's employer pays the annual premium of $10,000. This amount is excluded from C's gross income. In addition, C paid the entire premium of $5000 for a personal health insurance policy.
  - •During the year, C had only one illness and incurred and

paid total medical expenses, as defined in § 213 of the Code, of $2700. In the same year as a result of this illness, C was indemnified $2100 under his employer's insurance policy and $1500 under his personal insurance policy.

•What is C's gross income from the insurance companies' reimbursements?

•D is covered by his employer's health insurance policy. The annual premium is $10,000, of which the employer pays $4000 and $6000 is deducted from D's wages. In addition, D paid the entire premium of $5000 for a personal health insurance policy.

•During the year, D had only one illness and paid total medical expenses, as defined in § 213 of the Code, of $2700. In the same year as a result of this illness, D was indemnified $2100 under his employer's insurance policy and $1500 under his personal insurance policy.

•What is D's gross income from these reimbursements?

•Read § 106(a).

CALI Lessons

Do: CALI Lesson, *Basic Federal Income Taxation: Gross Income: Damages and Related Receipts*

C. Social Security: § 86

Read § 86. It is not an easy read. It is an example of the drafting contortions necessary to accomplish legislative compromise. Section 86 of course is among the Code provisions that require inclusion of certain items in gross income. Section 86 limits the amount of social security benefits that a taxpayer must include in gross income. Taxpayer excludes the remainder.

•Section 86 establishes three levels of so-called "(b)(1)(A) amounts" of income – which we define momentarily.

•This amount will fall into one of three ranges that the Code defines in terms of the taxpayer's filing status. Each income range is subject to a *different* set of rules governing inclusion of social security benefits in taxpayer's gross income. The three income ranges are the following:

- •"(b)(1)(A) amount" of income that is below the statutory "base amount."
- •"(b)(1)(A) amount" of income that is above the statutory "base amount" but below the statutory "modified base amount."
- •"(b)(1)(A) amount" of income that is above the statutory "modified base amount."

Rather than try to state the computation rules, we will apply the rules through three problems involving the taxpayer "Joe the Pensioner." He is single and receives social security benefits. Consider:

•Joe the Pensioner received $20,000 of social security benefits payments last year. In addition, he received $1000 in municipal bond interest that § 103 exempts from his gross income. Joe also did some work for his old employer for which he received $6000. What is Joe's gross income? Section 86(a) with deceptive simplicity sets forth rules governing taxpayer inclusion in gross income of social security benefits. Section 86(a) requires computations of various amounts and then comparing them. Hopefully, we can reduce this to a few straight-forward "if ... then" rules. It is best[56] to begin with § 86(b) – the provision that actually defines the "Taxpayers to Whom Subsection (a) applies."

- •Section 86(b)(1)(A)(i) requires that we determine what Joe's "modified agi" is. That phrase is defined in § 86(b)(2). Joe's agi at the moment, not counting his social security benefits or tax exempt interest, is $6000. To obtain Joe's "modified agi," we do not add his benefits (§ 86(b)(2)(A) ("determined without regard to this section")) but we do add his tax exempt interest, § 86(b)(2)(B), i.e., $1000. *Joe's modified adjusted gross income is* <u>$7000</u>.
- •Section 86(b)(1)(A) requires us to add Joe's *modified adjusted gross income plus one-half of his social security benefits*. $7000 + $10,000 = <u>$17,000</u>. We will refer to this as the "(b)(1)(A) amount."

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[56] ... in my view.

•Subtract the "base amount" from $17,000. "Base amount" is defined for Joe in § 86(c)(1)(A) as $25,000. Joe's "modified agi" does not exceed this "base amount."

•Section 86(a)(1)(B) requires us to compute one-half of the excess described in § 86(b)(1)(A). In our case, that will of course be $0.

•§ 86(a)(1) requires a comparison: $0 < $10,000.

•Joe must include $0 of his Social Security benefits in his gross income.

Notice that *if* the base amount exceeds taxpayer's "modified agi" plus one-half of his/her social security benefits, *then* there will be no "excess" – a term that appears in § 86(a)(1)(B). We can state the following straight-forward rule.

1. If taxpayer's "modified agi" plus one-half of his/her social security benefits is less than the statutory "base amount," none of taxpayer's social security benefits will be subject to federal income tax.

Now suppose that Joe the Pensioner received $20,000 of social security benefit payments, $1000 in tax exempt interest, and $18,000 of payments for work he did for his old employer.

•Joe's "modified agi" plus one-half of his social security benefits plus tax exempt interest (i.e., "(b)(1)(A)" amount) equals $29,000. This is more than the statutory "base amount," i.e., $25,000, § 86(c)(1)(A).

•Section 86(b)(1) describes a taxpayer whose "(b)(1)(A) amount" is more than a "modified base amount." For Joe, that amount is $34,000. § 86(c)(2)(A). Joe's "(b)(1)(A) amount" does not exceed his "modified base amount," so § 86(a)(1) applies to him.

•According to § 86(a)(1), Joe must include in his gross income the lesser of one-half of the social security benefits that he received or one-half of the amount by which his "(b)(1)(A)" amount exceeds his "base amount."

•The first amount is $10,000. The second amount is $2000.

•Joe must include <u>$2000</u> of social security benefits in his gross income.

We can now state the second of our straight-forward rules.

2. If taxpayer's "modified agi" plus one-half of his/her social security benefits is more than the statutory "base amount" but less than the "modified base amount," taxpayer must include in his/her gross income the lesser of one-half of his/her social security benefits or one-half of the amount by which his/her "modified agi" exceeds the statutory base amount.

Now suppose that Joe the Pensioner received $20,000 of social security benefit payments, $1000 in tax exempt interest, and $30,000 of payments for work he did for his old employer.

- Joe's "(b)(1)(A) amount" is now $41,000. This is $7000 more than his "modified base amount," i.e., $34,000, § 86(c)(2)(A). This means that § 86(a)(2) applies rather than § 86(a)(1).
- Section 86(a)(2) requires us to determine two different amounts and to include the lesser in Joe's gross income.
  - The first amount (§ 86(a)(2)(A)) is –
    - 85% of the "excess," i.e., $5950, PLUS
    - the lesser of
      - the amount that would be included in Joe's gross income if our second rule (i.e., § 86(a)(1)) did apply. The lesser of one-half of Joe's social security benefits (i.e., $10,000) or one-half of the excess of Joe's "(b)(1)(A) amount" over his "base amount" (i.e., ½ of ($41,000 − $25,000) = $8000) is $8000.
      - *or*
      - one-half of the difference between Joe's "base amount" and "modified base amount." The difference between Joe's "base amount" and his "modified base amount" is $34,000 − $25,000. One-half of that amount is $4500.
      - $4500 < $8000.
    - $5940 + $4500 EQUALS <u>$10,440</u>.

- The second amount (§ 86(a)(2)(B)) is –
    - 85% of Joe's social security benefit, i.e., 85% of $20,000 = <u>$17,000</u>.
- $10,440 < $17,000. Joe must include <u>$10,440</u> in his gross income.

We state the third of our straight-forward rules.

3. If taxpayer's "modified agi" plus one-half of his/her social security benefits is more than the statutory "adjusted base amount," taxpayer must include in his/her gross income the lesser of two amounts computed according to two more rules.

D. Unemployment Benefits: § 85

A taxpayer must include in his/her gross income unemployment compensation. § 85.

Do: CALI Lesson, *Basic Federal Income Taxation: Gross Income: The Taxability of Employment Connected Payments: Fringe Benefits, Meals and Lodging, Unemployment Compensation, and Social Security Benefits*. Several of the questions are derived from the next section of the text. You should do the Lesson twice: now and when you finish reading the next section.

III. Employment-Based Exclusions from Gross Income

The employment relationship is the seat of a very substantial number of exclusions from gross income. You will find that the benefits excluded from gross income by §§ 79, 106, 119, 127, 129, 132, and 137 are only available to "an employee." Employment-based exclusions from gross income can have a powerful influence in shaping employment relationships. Be alert to the possibility that the employer may capture the benefit of the exclusion through the simple expedient of paying employees less than it otherwise would have. We should expect employees to deem employers who pay substandard wages in exchange for benefits that employees don't really want to be not particularly desirable. The converse is true also: employees should seek out employers who provide benefits that they particularly value.

There is overlap between benefits provided in the employment setting that the Code excludes from gross income and social benefits that the Code excludes from gross income. An implicit message is that the employment setting is where employees *should* seek and employers should *provide* certain social benefits. See whether you agree.

A. Group Term Life Insurance: § 79

Read § 79. What is the effect of restricting the exclusion to the purchase of group-term life insurance and not allowing discrimination in favor of a key employee? Why should there be a $50,000 ceiling on the amount of group-term life insurance whose purchase is excluded from an employee's gross income?

B. Educational Assistance Programs: § 127

Read § 127. Why might a relatively low-cost private school charge more tuition per credit hour in its night or weekend MBA programs than it does for its full-time day program?

C. Dependent Care Assistance Programs: § 129

Read § 129. Why might a highly-paid employee prefer a dependent care assistance program to a 20% credit against income tax liability? What is the maximum number of children for which the dependent care exclusion is available? What is the maximum allowable exclusion? Compare these figures with those of § 21.

- Consider: Taxpayers (married filing jointly) have three children, none of whom has reached the age of 13. They both work and earn substantial incomes. They are in the 35% income tax bracket, and their credit under § 21 is 20% of their dependent care expenses.

They incur $6000 of dependent care expenses during the year. Should they prefer an exclusion under § 129 or a tax credit under § 21?
•Same facts, except that the ages of the children are 10, 15, and 16. Should they prefer an exclusion under § 129 or a tax credit under § 21?

D. Employer Contributions to Accident and Health Plans: § 106

Read §§ 106 and 223.

During World War II, the nation lived under wage and price controls. Employers could circumvent wage controls by providing employees with certain benefits, notably pensions and health insurance. In 1954, Congress codified the employee exclusion of employer payments for accident or health plans in § 106(a). Recall that § 105(b) excludes the payments that such plans provide for care from gross income. Employers of course deduct whatever payments they make as employee compensation, § 162(a)(1). Thus most of the money that employees spend or employers spend on their behalf for health care is never subject to income tax at either the employer or employee level. Not surprisingly, in the United States health care is now a significant aspect of any employment relationship. Costs have spiraled upward, and payments for health plans have become the most costly expenditure that employers make for employee benefits. Highly distorted markets for health care services now exist in the United States. *See* William P. Kratzke, *Tax Subsidies, Third-Party Payments, and Cross-Subsidization: America's Distorted Health Care Markets*, 40 U. MEM. L. REV. 279 (2009).

Health Savings Accounts (HSA) are savings accounts established for the benefit of an individual who has a high-deductible health plan. *See* § 223. An employee taxpayer may deduct the contributions s/he makes to such an account. § 223(a). An employee taxpayer may exclude employer contributions to such an account. § 106(d). Unspent funds in an HSA grow tax-free. § 223(e)(1). There is a monthly limit to the amount that taxpayer may save in such accounts. The savings in the account can be withdrawn without income tax to pay for medical expenses, presumably for the deductible portion that the health plan will not pay for. § 213(f)(1). Employer contributions to an HSA are not subject to employment taxes, § 106(d)(1), but employee contributions are subject to employment taxes.

E. Meals or Lodging Furnished for the Convenience of the Employer: § 119

Read § 119.

Commissioner v. Kowalski, 434 U.S. 77 (1977)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

This case presents the question whether cash payments to state police troopers, designated as meal allowances, are included in gross income under § 61(a) of the Internal Revenue Code ..., 26 U.S.C. § 61(a), [footnote omitted] and, if so, are otherwise excludable under § 119 of the Code, 26 U.S.C. § 119. [footnote omitted]

I

... Respondent [footnote omitted] is a state police trooper employed by the Division of State Police of the Department of Law and Public Safety of the State of New Jersey. During 1970, the tax year in question, he received a base salary of $8,739.38, and an additional $1,697.54 [footnote omitted] designated as an allowance for meals.

... Under [the State's cash allowance] system, troopers remain on call in their assigned patrol areas during their midshift break. Otherwise, troopers are not restricted in any way with respect to where they may eat in the patrol area and, indeed, may eat at home if it is located within that area. Troopers may also bring their midshift meal to the job and eat it in or near their patrol cars.

The meal allowance is paid biweekly in advance and is included, although separately stated, with the trooper's salary. The meal allowance money is also separately accounted for in the State's accounting system. Funds are never commingled between the salary and meal allowance accounts. Because of these characteristics of the meal allowance system, the Tax Court concluded that the "meal allowance was not intended to represent additional compensation."

Notwithstanding this conclusion, it is not disputed that the meal allowance has many features inconsistent with its characterization as a simple reimbursement for meals that would otherwise have been taken at a meal station. For example, troopers are not required to spend their meal allowances on their midshift meals, nor are they required to account for the manner in which the money is spent. ... [N]o reduction in the meal allowance is made for periods when a trooper is not on patrol because, for example, he is assigned to a headquarters building or is away from active duty on vacation, leave, or sick leave. In addition, the cash allowance for meals is described on a state police recruitment brochure as an item of salary to be received in addition to an officer's base salary and the amount of the meal allowance is a subject of negotiations between the State and the police troopers' union. Finally, the amount of an officer's cash meal allowance varies with his rank, and is included in his gross pay for purposes of calculating pension benefits.

On his 1970 income tax return, respondent reported $9,066 in wages. That amount included his salary plus $326.45 which represented cash meal allowances reported by the State on respondent's Wage and Tax Statement (Form W-2). [footnote omitted] The remaining amount of meal allowance, $1,371.09, was not reported. On audit, the Commissioner determined that this amount should have been included in respondent's 1970 income, and assessed a deficiency.

Respondent sought review in the United States Tax Court, arguing that the cash meal allowance was not compensatory, but was furnished for the convenience of the employer, and hence was not "income" within the meaning of § 61(a), and that, in any case, the allowance could be excluded under § 119. ... [T]he Tax Court, with six dissents, [footnote omitted] held that the cash meal payments were income within the meaning of § 61 and, further, that such payments were not excludable under § 119. [footnote omitted]. The Court of Appeals for the Third Circuit, in a per curiam opinion, held that its earlier decision in *Saunders v. Commissioner*, 215 F.2d 768 (1954), which determined that cash payments under the New Jersey meal allowance program were not taxable, required reversal. We granted certiorari to resolve a conflict among the Courts of Appeals on the question. [footnote omitted. We reverse.

II

A

The starting point in the determination of the scope of "gross income" is the cardinal principle that Congress in creating the income tax intended "to use the full measure of its taxing power." [citations omitted]. ... In the absence of a specific exemption, therefore, respondent's meal allowance payments are income within the meaning of § 61 since, like the payments involved in *Glenshaw Glass Co.*, the payments are "undeniabl[y] accessions to wealth, clearly realized, and over which the [respondent has] complete dominion." *Commissioner v. Glenshaw Glass Co.*, [348 U.S. 426, 431 (1955)]. [citations omitted].

Respondent contends, however, that § 119 can be construed to be a specific exemption covering the meal allowance payments to New Jersey troopers. Alternatively, respondent argues that notwithstanding § 119, a specific exemption may be found in a line of lower court cases and administrative rulings which recognize that benefits conferred by an employer on an employee "for the convenience of the employer" – at least when such benefits are not "compensatory" – are not income within the meaning of the Internal Revenue Code. In responding to these contentions, we turn first to § 119. Since we hold that § 119 does not cover cash payments of any kind, we then trace the development over several decades of the "convenience of the employer" doctrine as a determinant of the tax status of meals and lodging, turning finally to the question whether the doctrine as applied to meals and lodging survives the enactment of the Internal Revenue Code of 1954.

B

Section 119 provides that an employee may exclude from income

> "the value of any meals ... furnished to him by his employer for the convenience of the employer, but only if ... the meals are furnished on the business premises of the employer ..."

By its terms, § 119 covers meals furnished by the employer, and not cash reimbursements for meals. This is not a mere oversight. As we shall explain at greater length below, the form of § 119 which Congress enacted originated in the Senate and the Report accompanying the Senate bill is very clear: "Section 119 applies only to meals or lodging furnished in kind." S. Rep. No. 1622, 83d Cong., 2d Sess., 190 (1954). *See also* Treas. Reg. § 1.119-1(c)(2) ... Accordingly, respondent's meal allowance payments are not subject to exclusion under § 119.

C

The "convenience of the employer" doctrine is not a tidy one. The phrase "convenience of the employer" first appeared in O.D. 265, 1 Cum. Bull. 71 (1919), in a ruling exempting from the income tax board and lodging furnished seamen aboard ship. The following year, T.D. 2992, 2 Cum. Bull. 76 (1920), was issued, and added a "convenience of the employer" section to Treas. Regs. 45, Art. 33 ...

While T.D. 2992 extended the "convenience of the employer" test as a general rule solely to items received in kind, O.D. 514, 2 Cum. Bull. 90 (1920), extended the "convenience of the employer" doctrine to cash payments for "supper money." [footnote omitted]

The rationale of both T.D. 2992 and O.D. 514 appears to have been that benefits conferred by an employer on an employee in the designated circumstances were not compensation for services, and hence not income. Subsequent rulings equivocate on whether the noncompensatory character of a benefit could be inferred merely from its characterization by the employer, or whether there must be additional evidence that employees are granted a benefit solely because the employer's business could not function properly unless an employee was furnished that benefit on the employer's premises. O.D. 514, for example, focuses only on the employer's characterization. [footnote omitted] Two rulings issued in 1921, however, dealing respectively with cannery workers [footnote omitted] and hospital employees, [footnote omitted] emphasize the necessity of the benefits to the functioning of the employer's business, and this emphasis was made the authoritative interpretation of the "convenience of the employer" provisions of the regulations in Mim. 5023, 1940-1 Cum. Bull. 14.[57]

Adding complexity, however, is Mim. 6472, 1950-1 Cum. Bull. 15, issued in 1950. This mimeograph states in relevant part:

> "The 'convenience of the employer' rule is simply an administrative test to be applied only in cases in which the compensatory character of ... benefits is not otherwise determinable. It follows that the rule should not be applied in any case in which it is evident from the other circumstances involved that the receipt of quarters or meals by the employee represents compensation for services rendered."

Ibid.

Mimeograph 6472 expressly modified all previous rulings which had suggested that meals and lodging could be excluded from income upon a simple finding that the furnishing of such benefits was necessary to allow an employee to perform his duties properly. [footnote omitted] However, the ruling apparently did not affect O.D. 514, which, as noted above, creates an exclusion from income based solely on an employer's characterization of a payment as noncompensatory.

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[57] "3. As a general rule, the test of 'convenience of the employer' is satisfied if living quarters or meals are furnished to an employee who is required to accept such quarters and meals in order to perform properly his duties."

1941 Cum. Bull., at 15, citing O.D. 915, *supra*, n. 18.

Coexisting with the regulations and administrative determinations of the Treasury, but independent of them, is a body of case law also applying the "convenience of the employer" test to exclude from an employee's statutory income benefits conferred by his employer.

An early case is *Jones v. United States*, 60 Ct. Cl. 552 (1925). There, the Court of Claims ruled that neither the value of quarters provided an Army officer for nine months of a tax year nor payments in commutation of quarters paid the officer for the remainder of the year were includable in income. The decision appears to rest both on a conclusion that public quarters, by tradition and law, were not "compensation received as such" within the meaning of § 213 of the Revenue Act of 1921, 42 Stat. 237, and also on the proposition that "public quarters for the housing of ... officers is as much a military necessity as the procurement of implements of warfare or the training of troops." 60 Ct. Cl. at 569; *see id.* at 565-568. ...

Subsequent judicial development of the "convenience of the employer" doctrine centered primarily in the Tax Court. In two reviewed cases decided more than a decade apart, *Benaglia v. Commissioner*, 36 B.T.A. 838 (1937), and *Van Rosen v. Commissioner*, 17 T.C. 834 (1951), that court settled on the business necessity rationale for excluding food and lodging from an employee's income.[58] *Van Rosen*'s unanimous decision is of particular

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[58] "The better and more accurate statement of the reason for the exclusion from the employee's income of the value of subsistence and quarters furnished in kind is found, we think, in *Arthur Benaglia*, 36 B.T.A. 838, where it was pointed out that, on the facts, the subsistence and quarters were not supplied by the employer and received by the employee 'for his personal convenience[,] comfort or pleasure, but solely because he could not otherwise perform the services required of him.' In other words, though there was an element of gain to the employee, in that he received subsistence and quarters which otherwise he would have had to supply for himself, he had nothing he could take, appropriate, use and expend according to his own dictates, but, rather, the ends of the employer's business dominated and controlled, just as in the furnishing of a place to work and in the supplying of the tools and machinery with which to work. The fact that certain personal wants and needs of the employee were satisfied was plainly secondary and incidental to the employment."

interest in interpreting the legislative history of the 1954 recodification of the Internal Revenue Code, since it predates that recodification by only three years. There, the Tax Court expressly rejected any reading of *Jones*, *supra*, that would make tax consequences turn on the intent of the employer, even though the employer in *Van Rosen*, as in *Jones*, was the United States, and, also as in *Jones*, the subsistence payments involved in the litigation were provided by military regulation. [footnote omitted]. In addition, *Van Rosen* refused to follow the *Jones* holding with respect to cash allowances, apparently on the theory that a civilian who receives cash allowances for expenses otherwise nondeductible has funds he can "take, appropriate, use and expend," 17 T.C. at 838, in substantially the same manner as "any other civilian employee whose employment is such as to permit him to live at home while performing the duties of his employment." *Id.* at 836; *see id.* at 839-840. It is not clear from the opinion whether the last conclusion is based on notions of equity among taxpayers or is simply an evidentiary conclusion that, since Van Rosen was allowed to live at home while performing his duties, there was no business purpose for the furnishing of food and lodging.

Two years later, the Tax Court, in an unreviewed decision in *Doran v. Commissioner*, 21 T.C. 374 (1953), returned in part to the "employer's characterization" rationale rejected by *Van Rosen*. In *Doran*, the taxpayer was furnished lodging in kind by a state school. State law required the value of the lodging to be included in the employee's compensation. Although the court concluded that the lodging was furnished to allow the taxpayer to be on 24-hour call, a reason normally sufficient to justify a "convenience of the employer" exclusion, [footnote omitted] it required the value of the lodging to be included in income on the basis of the characterization of the lodging as compensation under state law. The approach taken in *Doran* is the same as that in Mim. 6472, supra. [footnote omitted] However, the Court of Appeals for the Second Circuit, in *Diamond v. Sturr*, 221 F.2d 264 (1955), on facts indistinguishable from *Doran*, reviewed the law prior to 1954 and held that the business necessity view of the "convenience of the employer"' test, "having persisted through the interpretations of the Treasury and the Tax Court throughout

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Van Rosen v. Commissioner, 17 T.C. at 838.

years of reenactment of the Internal Revenue Code," was the sole test to be applied. 221 F.2d at 268.

D

Even if we assume that respondent's meal allowance payments could have been excluded from income under the 1939 Code pursuant to the doctrine we have just sketched, we must nonetheless inquire whether such an implied exclusion survives the 1954 recodification of the Internal Revenue Code. [citation omitted]. Two provisions of the 1954 Code are relevant to this inquiry: § 119 and § 120 [footnote omitted], now repealed [footnote omitted], which allowed police officers to exclude from income subsistence allowances of up to $5 per day.

In enacting § 119, the Congress was determined to "end the confusion as to the tax status of meals and lodging furnished an employee by his employer." H.R. Rep. No. 1337, 83d Cong., 2d Sess., 18 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 19 (1954). However, the House and Senate initially differed on the significance that should be given the "convenience of the employer" doctrine for the purposes of § 119. As explained in its Report, the House proposed to exclude meals from gross income

> "if they [were] furnished at the place of employment and the employee [was] required to accept them at the place of employment as a condition of his employment."

H.R. Rep. No. 1337, *supra*, at 18; *see* H.R. 8300, 83d Cong., 2d Sess., § 119 (1954). Since no reference whatsoever was made to the concept, the House view apparently was that a statute "designed to end the confusion as to the tax status of meals and lodging furnished an employee by his employer" required complete disregard of the "convenience of the employer" doctrine.

The Senate, however, was of the view that the doctrine had at least a limited role to play. After noting the existence of the doctrine and the Tax Court's reliance on state law to refuse to apply it in *Doran v. Commissioner*, *supra*, the Senate Report states:

> "Your committee believes that the House provision is ambiguous in providing that meals or lodging furnished on the employer's premises, which the employee is required to accept as a condition of his employment, are excludable from income whether or not furnished as compensation. Your committee has provided that the basic test of exclusion is to be whether the meals or lodging are furnished primarily for the convenience of the employer (and thus excludable), or whether they were primarily for the convenience of the employee (and therefore taxable). However, in deciding whether they were furnished for the convenience of the employer, the fact that a State statute or an employment contract fixing the terms of the employment indicate the meals or lodging are intended as compensation is not to be determinative. This means that employees of State institutions who are required to live and eat on the premises will not be taxed on the value of the meals and lodging even though the State statute indicates the meals and lodging are part of the employee's compensation."

S. Rep. No. 1622, *supra*, at 19. In a technical appendix, the Senate Report further elaborated:

> "Section 119 applies only to meals or lodging furnished in kind. Therefore, any cash allowances for meals or lodging received by an employee will continue to be includible in gross income to the extent that such allowances constitute compensation."

Id. at 190-91, U.S. Code Cong. & Admin. News 1954, p. 4825.

After conference, the House acquiesced in the Senate's version of § 119. Because of this, respondent urges that § 119, as passed, did not discard the "convenience of the employer" doctrine, but indeed endorsed the doctrine shorn of the confusion created by Mim. 6472 and cases like *Doran*. Respondent further argues that, by negative implication, the technical appendix to the Senate Report creates a class of noncompensatory cash meal payments that are to be excluded from income. We disagree.

The Senate unquestionably intended to overrule *Doran* and rulings like Mim. 6472. Equally clearly, the Senate refused completely to abandon the "convenience of the employer" doctrine as the House wished to do. On the other hand, the Senate did not propose to leave undisturbed the convenience of the employer doctrine as it had evolved prior to the promulgation of Mim. 6472. The language of § 119[59] quite plainly rejects the reasoning behind rulings like O.D. 514, *see* n. 15, *supra*, which rest on the employer's characterization of the nature of a payment. [footnote omitted]. This conclusion is buttressed by the Senate's choice of a term of art, "convenience of the employer," in describing one of the conditions for exclusion under § 119. In so choosing, the Senate obviously intended to adopt the meaning of that term as it had developed over time, except, of course, to the extent § 119 overrules decisions like *Doran*. As we have noted above, *Van Rosen v. Commissioner*, 17 T.C. 834 (1951), provided the controlling court definition at the time of the 1954 recodification, and it expressly rejected the *Jones* theory of "convenience of the employer" – and, by implication, the theory of O.D. 514 – and adopted as the exclusive rationale the business necessity theory. *See* 17 T.C. at 838-840. The business necessity theory was also the controlling administrative interpretation of "convenience of the employer" prior to Mim. 6472. *See supra* at 434 U.S. 85-86, and n 19. Finally, although the Senate Report did not expressly define "convenience of the employer," it did describe those situations in which it wished to reverse the courts and create an exclusion as those where "an employee must accept ... meals or lodging in order properly to perform his duties." S. Rep. No. 1622, *supra*, at 19.

As the last step in its restructuring of prior law, the Senate adopted an additional restriction, created by the House and not theretofore a part of the law, which required that meals subject to exclusion had to be taken on the business premises of the employer. Thus, § 119 comprehensively modified the prior law, both expanding and contracting the exclusion for meals and lodging previously provided, and it must therefore be construed as its draftsmen obviously intended it to be – as a replacement

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[59] "[T]he provisions of an employment contract ... shall not be determinative of whether ... meals ... are intended as compensation."

for the prior law, designed to "end [its] confusion."

Because § 119 replaces prior law, respondent's further argument – that the technical appendix in the Senate Report recognized the existence under § 61 of an exclusion for a class of noncompensatory cash payments – is without merit. If cash meal allowances could be excluded on the mere showing that such payments served the convenience of the employer, as respondent suggests, then cash would be more widely excluded from income than meals in kind, an extraordinary result given the presumptively compensatory nature of cash payments and the obvious intent of § 119 to narrow the circumstances in which meals could be excluded. Moreover, there is no reason to suppose that Congress would have wanted to recognize a class of excludable cash meal payments. The two precedents for the exclusion of cash – O.D. 514 and *Jones v. United States* – both rest on the proposition that the convenience of the employer can be inferred from the characterization given the cash payments by the employer, and the heart of this proposition is undercut by both the language of § 119 and the Senate Report. Finally, as petitioner suggests, it is much more reasonable to assume that the cryptic statement in the technical appendix – "cash allowances ... will continue to be includable in gross income to the extent that such allowances constitute compensation" – was meant to indicate only that meal payments otherwise deductible under § 162(a)(2) of the 1954 Code [footnote omitted] were not affected by § 119.

Moreover, even if we were to assume with respondent that cash meal payments made for the convenience of the employer could qualify for an exclusion notwithstanding the express limitations upon the doctrine embodied in § 119, there would still be no reason to allow the meal allowance here to be excluded. Under the pre-1954 "convenience of the employer" doctrine, respondent's allowance is indistinguishable from that in *Van Rosen v. Commissioner*, *supra*, and hence it is income. ... In any case, to avoid the completely unwarranted result of creating a larger exclusion for cash than kind, the meal allowances here would have to be demonstrated to be necessary to allow respondent "properly to perform his duties." There is not even a suggestion on this record of any such necessity.

Finally, respondent argues that it is unfair that members of the military may exclude their subsistence allowances from income, while respondent cannot. While this may be so, arguments of equity have little force in construing the boundaries of exclusions and deductions from income many of which, to be administrable, must be arbitrary. ...

Reversed.

MR. JUSTICE BLACKMUN, with whom THE CHIEF JUSTICE joins, dissenting.

....

I fear that state troopers the country over, not handsomely paid to begin with, will never understand today's decision. And I doubt that their reading of the Court's opinion – if, indeed, a layman can be expected to understand its technical wording – will convince them that the situation is as clear as the Court purports to find it.

Notes and Questions:

1. In the first sentence of its opinion, the Court set forth the issue it undertook resolve. How did it resolve that issue?

2. Whether meal money falls within an exclusion and whether it is gross income are separate questions. With regard to the second question, let's review: What facts were particularly bad for Officer Kowalski and why? What strings were attached to the meal money that were different than the strings attached to any worker's wages?

3. How important should the *employer's* treatment of meal money – separate accounting, no commingling of funds – be in resolution of the question of whether cash-for-meals should be included in an employee's gross income? Isn't that a red herring in determining whether taxpayer Kowalski has enjoyed an accession to wealth? The Tax Court concluded that the meal money was not intended to be additional compensation, but

was nevertheless includable in taxpayer's gross income.

4. In the second footnote of the case, the Court quoted a case that quoted *Benaglia*. Taxpayer Benaglia was given accommodations at the Royal Hawaiian Hotel and ate his meals in the hotel dining room because otherwise he could not perform the services required of him as manager of that hotel and others. Moreover, Benaglia was denied the discretion to spend this accession to wealth in any manner that he saw fit.

- Have we seen the "deprivation of discretion" theme before?
- What conclusion did it suggest?

5. Surely even a taxpayer denied a choice in his/her purchase of meals or lodging and whose employment requires that any meal that s/he does eat be taken where and when the employer orders derives *some* consumption benefit that s/he would have paid *something* for if the employer had not provided it. Does it have to be all-or-nothing?

- Section 274(n)(1)(A) limits deductions for food or beverages to 50% of the amount spent. The other 50% in essence is treated as a personal expenditure and so is subject to federal income tax – but it is the one who pays for the meal who must pay the income tax, not the one who consumes it.
- However, § 274(n)(2)(B) excepts from the 50% limitation meals that § 132(e) excludes from an employee's gross income. Section 132(e) treats employees as having paid the direct operating costs of their meal if it is excluded from their gross income under § 119.
- How important is administrative ease in this? How important is accuracy? If 50% isn't the right figure (and neither is another figure), should we revert to all-or-nothing? Perhaps 50% is simply a "least-bad" figure.

6. Should "underpayment" of a class of workers provide any support whatsoever for a conclusion that § 119 encompasses the cash payments in this case – as Justice Blackmun suggests? How many people do *not* feel that they are "underpaid?"

•Were the view of Justice Blackmun to have prevailed, the consequences would have been highly unfortunate. How so and why? What economic distortions would have resulted?

7. What interest should the State of New Jersey, Officer Kowalski's employer, have in the outcome of this case? If Officer Kowalski must pay income tax on his meal money, the State of New Jersey may find that it must increase the wages of its state troopers. It is entirely possible that the State of New Jersey captured all of the tax savings that Justice Blackmun feels all state troopers deserve.

8. Using the figures that the Court provided, Officer

Deadweight Loss: Deadweight loss is someone's loss and no one's gain. The *value* of a good or service to a person is what the person is willing to pay for it. Everyone seeks to maximize value to himself/herself through purchasing choices within the limits of his/her after-tax income. Do exclusions from gross income cause deadweight loss? Yes.

Consider: Taxpayer pays income taxes at a marginal rate of 25%. Taxpayer is willing to pay $90 for a particular benefit and no more. Taxpayer would have to earn $120 in order to pay tax on the income necessary to purchase the benefit for $90. Naturally, taxpayer would be willing to pay less. The market price of the benefit is $100. Taxpayer is rational and makes no purchases for more money than the value s/he places on an item. Producers in turn strive to provide taxpayer goods and services at a cost to them that is less the price taxpayer (and others) are willing to pay. All producers make a profit, so the markets are "sustainable." Taxpayer does not purchase this benefit, but spends his/her after-tax income in ways that maximize his/her own consumer surplus. The economy works with *allocative efficiency*.

Now suppose that the Code excludes the benefit from taxpayer's gross income if his/her employer provides it. Taxpayer's employer offers to provide the benefit to taxpayer if taxpayer will accept a $100 reduction in pay. Should taxpayer accept the offer?

From taxpayer's perspective, s/he can choose to keep the $100 in wages; this nets taxpayer $75 after taxes. Taxpayer can now rationally choose to accept the benefit because taxpayer essentially "pays" $75 for something s/he values at $90. That's $15 of consumer surplus.

Unfortunately, the producers of the things taxpayer would have bought with his/her $75 of after-tax income lose the sales. The surplus value that they and taxpayer would have created by entering value-increasing bargains is lost – and replaced by a transaction that most assuredly does not increase *after-tax* value. No one captures the net loss in surplus value. It is *deadweight loss*.

All exclusions from gross income imply some deadweight loss. Assume that you had access to any information you wanted. How would you determine whether the nation should incur such deadweight losses?

Kowalski received 13% ($1371 out of $10,437) tax-free. Naturally, this affects the amount of income tax that others must pay if the Government is to raise a certain amount of revenue. Moreover, other workers who might pay income tax on $9066 – the amount on which Officer Kowalski *did* pay income tax – who do not receive meal money that they may spend any way they wish probably would understand very well the system's discriminatory treatment of two different taxpayers' unequal accessions to wealth – contrary to Justice Blackmun's inferential suggestion that this decision is difficult for lay people to understand.

9. In a sense, the *Kowalski* case presents the tip of an iceberg. Peruse the topics that §§ 105, 106, 107, 125, 127, 129, 132, 137 cover. All of these code provisions provide for some benefit that an employer can provide employees that are not subject to income tax to either the employer or the employee. These provisions assure that like taxpayers who work for different employers are *not* taxed alike.

10. Presumably, the accessions to wealth that employers offer employees that employees may in turn exclude from their gross income empower employers to customize the type of workforce they want. Maybe that is good. Airlines can pay less-than-market wages to persons who like to travel. Retailers can give employee discounts to persons who would (enthusiastically) shop at their establishments anyway. And so on.

- Consider this proposition: instead of aspiring to horizontal *equality*, aspire to horizontal *equity* by permitting a fixed ceiling on the value of excludable benefits that employers may provide employees. *See* William P. Kratzke, *The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income*, 60 TAX LAW. 1, 3-8 (2006) (effective rate of federal income and employment taxes would be more progressive).

11. Read Reg. § 1.119-1(a)(2)(ii)(d).

- Do you think that someone lobbied to have this provision included in the regulations? Who?

12. Consider:

12a. Fishing Expeditions, Inc. provides flight services, accommodations, and guides to remote places for fishing afficionados to fish in very remote places. Its employees are small airplane pilots, guides, and cooks. The company flies fishing parties to remote cabins that it owns in Alaska. Obviously while servicing a fishing party, the employees must reside at a remote cabin and take meals there also. The employees must pay Fishing Expeditions, Inc. $200 per week, which Fishing Expeditions deducts from their paychecks. The employees must include the $200 in their gross income.

- True or false.

12b. Cicely is an employee of the Hanford Nuclear Works. The HNR is located 60 miles from the nearest structure and 70 miles from the nearest town. HNR maintains some barracks-style housing for free onsite that it provides various workers, who are typically in their 20s and single. The value of this housing is $500 per month. To be fair to the other workers, HNR pays a housing stipend of $500 per month to employees who elect to live in the nearest town and commute to the jobsite.

- Tax consequences to the workers who live onsite?
- Tax consequences to the workers who live in town?

F. Employee Fringe Benefits: § 132

Prior to 1984 – and as taxpayer Kowalski argued – there evolved an uneven patchwork of "fringe benefits" that employers and employees alike assumed were not subject to income tax. This cost the Treasury revenue and resulted in horizontal inequities. Congress addressed the problem, and in 1984, "drew a line in the sand." The following is an explanation of what Congress did and why.

H. Rep. No. 98-432 (II), 98th Cong., 2d Sess. 1984, at 412, 1984 U.S.C.C.A.N. 697, 1215, 1984 WL 37400, to accompany H.R. 4170.

....

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the committee has attempted to strike a balance between two competing objectives.

First, the committee is aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. In many cases, these practices are long established, and have been treated by employers, employees, and the IRS as not giving rise to taxable income. Although employees may receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which they sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public. In addition, the fact that the selection of goods and services usually available from a particular employer usually is restricted makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. The committee believes, therefore, that many present practices under which employers may provide to a broad group of employees, either free or at a discount, the products and services which the employer sells or provides to the public do not serve merely to replace cash compensation. These reasons support the committee's decision to codify the ability of employers to continue these practices without imposition of income or payroll taxes.

The second objective of the committee's bill is to set forth clear boundaries for the provision of tax-free benefits. ... [A]dministrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the IRS ... have increased substantially in recent years. The committee believes that it is unacceptable to allow these conditions ... to continue any longer.

In addition, the committee is concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash. A shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system above and beyond the adverse projections which the congress recently addressed in the social security amendments of 1983. Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, and among employers as well.

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the bill from income and employment taxes. Under the bill, most fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. The committee believes that it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives. Further, where benefits are limited to the highly paid, it is more likely that the benefit is being provided so that those who control the business can receive compensation in a nontaxable form; in that situation, the reasons stated above for allowing tax-free treatment would not be applicable. Also, if highly paid executives could receive free from taxation economic benefits that are denied to lower-paid employees, while the latter are compensated only in fully taxable cash, the committee is concerned that this situation would exacerbate problems of noncompliance among taxpayers. In this regard, some commentators argue that the current situation – in which the lack of clear rules for the tax treatment of nonstatutory fringe benefits encourages the nonreporting of many types of compensatory benefits – has led to nonreporting of types of cash income which are clearly taxable under present-law rules, such as interest and dividends.

In summary, the committee believes that by providing rules which essentially codify many present practices under which employers provide their own products and services tax-free to a broad group of employees ... the bill substantially improves the equity and administration of the tax system.

C. Explanation of Provisions

1. Overview

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RRTA.

....

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) and that is not excluded under another statutory fringe benefit provision of the code is taxable to the recipient under ... §§ 61 and 83, and is includible in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit.

Notes and Questions:

1. As the Report implies, the notion that fringe benefits were nontaxable had gotten out of hand. The approach of Congress was to define fringe benefits that are excludible from gross income and to draw a line in the sand: "this far and no farther."

2. Read § 132. Consider these problems:

1. Phillip works for Sports World, a mega-sporting goods store. Phillip enjoys being outdoors and so would probably spend a lot of time shopping at Sports World, even if he didn't work there. Last year, Sports World sold $10M worth of sporting goods. The cost of its merchandise was $7M, but its overhead was $2M. Sports World offers its employees a 25% employee discount on items that employees purchase. Phillip purchased a fishing boat that retails for $1000. Phillip paid $750.

- Tax consequences to Phillip?

1a. One week later, Phillip sold the fishing boat to his brother for $1050.

- Tax consequences to Phillip?
- *See* § 132(a)(2) and § 132(c).

1b. Sports World is located in a large building whose tenants once included a professional basketball team and a perennial NCAA basketball power. The oddly-shaped building stood empty for several years. Service merchants in the area (restaurants, dry cleaners, dentists, optometrists, etc.) were anxious that Sports World would occupy the building and readily entered into reciprocal arrangements whereby employees of Sports World were entitled to a 20% discount off the retail prices of these merchants' services. Sports World agreed to give only a 10% discount for the employees of these service merchants. Last week, Phillip paid $80 for dental services that normally cost $100. A nearby optometrist purchased a tent from Sports World that normally retails for $100 for only $90.

- Tax consequences to Phillip?
- Tax consequences to the optometrist?
- *See* § 132(i).

2. Mesquite Airlines is a commercial airline. It offers its employees free standby air travel. Moreover, Mesquite Airlines has entered into a reciprocal agreement with several other airlines whereby employees of Mesquite may fly standby for free on other airlines, and employees of the other airlines may fly free on Mesquite Airlines. Megan is a retired airline pilot who flew airplanes for Mesquite Airlines for 35 years. Megan flew standby on a Mesquite Airlines flight; the normal fare was $400.

- Tax consequences to Megan? *See* § 132(h).

2a. Megan flew standby on another airline. The normal fare was $400.

- Tax consequences to Megan?

2b. Without charging her, Mesquite Airlines permitted Megan to reserve her seat for two weeks from now. The normal fare was $400.

- Tax consequences to Megan?

3. The University of Memphis recently moved into a new building in downtown Memphis. The faculty members chose their offices pursuant to a system that incorporated consideration of rank and seniority. Staff offices have a rental value of $3600 per year. Professor K now has a corner office with a nice view of the Mississippi River. The rental value of the "worst" faculty office is $4800 per year. The rental value of Professor K's office is $14,400 per year.

- Tax consequences to Professor K? *See* § 132(a)(3) and § 132(d).

3a. Same facts. The Law School purchased for Professor K and one other professor (but no one else) online access to the CCH Federal Tax Reporter. The retail cost of this access is $2500 per year.

- Tax consequences to Professor K?
    - Is there any other information you need to answer this question?

> *Codes and Regulations*: By now you should have gained some facility flipping between the provisions of the Code and the Regulations. Within that context, this reminder might be appropriate. The Code is the text that Congress enacted. It is law so long as it is consistent with the Constitution. The Regulations are text that the Treasury Department adopted to construe the Code. It also is law, so long as it is consistent with the Code and the Constitution. You have already seen implementation of this hierarchy in cases that you have read.

4. Joe the Plumber, Inc. sells plumbing services to customers. It has a policy of offering employees a 25% discount on plumbing services that they purchase from Joe the Plumber, Inc. However, Joe the Plumber, Inc. offers a 40% discount to its "highly-compensated" employees. An employee purchased plumbing services that normally cost $200 for $150. One of Joe the Plumber's highly-compensated employees purchased the same services for $120.

- Tax consequences to the employee?
- Tax consequences to the highly-compensated employee?
- *See* § 132(j)(1).

5. Lotsa Refunds, Inc. is a tax return preparer that does a volume business

among unbanked, low-income persons. The corporation has ten employees. At the end of a very hectic tax season, Lotsa Refunds presented each of its employees with a $50 prepaid Mastercard cash card, in addition to their normal wages. This was because of the gratitude Lotsa Refunds felt for its employees having worked long hours against tight deadlines. Lotsa Refunds' highly-compensated employees did not receive such a card.

- Tax consequences to the employees?

5a. The employees of Lotsa Refunds, Inc. worked from 7 a.m. until 12 midnight every night between April 1 and April 15. Because of the fact that criminal activity increases after midnight, Lotsa Refunds paid cab-fare to all of its employees on those days – both from and to work in the morning. Assume that a typical cab fare is $15.

- Tax consequences to the employees? *See* Reg. § 1.132-6(d)(2)(iii)(A, B, and C).
  - Are there any more facts you might wish to know?

6. Springfield Memorial Hospital operates a cafeteria for its workers. Its prices for each food item cover the direct operating costs of selling that item. This price is less than the fmv of the item if it were sold in a for-profit cafeteria. Some of its workers are on call for emergencies at all times, even during their mealtimes. The mealtimes of these workers is 30 minutes. These employees have special passes in the cafeteria which permit them to take food equal to $7 "worth" of food. Other personnel may eat in the cafeteria, but must pay the charge listed for each food item; these persons are not on call, and many of them do not eat in the cafeteria. Overall, the cafeteria loses money because most employees in the first group do eat in the cafeteria.

- Tax consequences to the first group of employees?
- Tax consequences to the second group of employees?
- *See* § 132(e)(2), including carryout paragraph.

CALI Lessons

Do (again) CALI Lesson, *Basic Federal Income Taxation: Gross Income: The Taxability of Employment Connected Payments: Fringe Benefits, Meals and Lodging, Unemployment Compensation, and Social Security Benefits*.

Read §§ 82, 132(a)(6), 132(g), 217.

Do CALI Lesson, *Basic Federal Income Taxation: Deductions: Moving Expenses*.

G. Cafeteria Plans, § 125

Normally, a taxpayer may not avoid realizing gross income by turning his/her back on cash. Hence, if an employer were to give all employees a choice between, say, $5000 cash or $5000 of dependent care assistance, taxpayer would have to realize gross income no matter which choice s/he made. Either the employee accepted the cash (taxable) or *could have* accepted the cash (also taxable).

- *Some* of an employer's workforce might be parents whose children are in need of, say, after-school care. In order to avoid application of this "constructive receipt" doctrine, the employer would have to offer a dependent care assistance program to *all* employees.
    - The non-parents would give up wages for this benefit, even though they derive no value from it.
    - If the employer did not offer such a program, the parents could not avail themselves of the § 129 exclusion.

Section 125 mitigates these effects substantially, and gives employers and employees the power to customize a benefits package to a point – or to accept cash. A participant in a "cafeteria plan" does not realize gross income simply because s/he may choose to receive cash or among qualified benefits of the plan that the employer offers.

- Section 125(f) defines a "qualified benefit" to be any benefit which is not includible in the gross income of an employee *except* for § 106(b) (Archer MSAs), § 117 (scholarships, qualified tuition reduction), § 127 (employer educational assistance programs), and § 132 (fringe benefits).
    - However, qualified transportation fringes are treated in the same manner as other qualified benefits of a cafeteria plan, §

132(f)(4).

•Moreover, group-term life insurance (*see* ¶ 79) in excess of $50,000 is a qualified benefit.

•Reg. § 1.125-1(a)(3) lists qualified benefits that an employer may offer in a cafeteria plan.

Section 125(j) establishes "simple cafeteria plans for small businesses."

Proposed Reg. § 1.125-5(a)(1) authorizes flexible spending arrangements whereby employees agree to a reduction in their salary to be spent on a use-it-or-lose it basis on qualified benefits.

Why should an employer offer a cafeteria plan?

Wrap-up Questions for Chapter 3:

1. In what ways – good or bad – do you think exclusions from gross income affect markets? It may help to consider one example, e.g., the market for health care.

2. What does it mean that an exclusion may be "captured" by someone other than the taxpayer Congress intended to benefit? Consider the exclusion from gross income of scholarships or the rental value of parsonages.

3. Why is the receipt of cash so rarely excluded from a taxpayer's gross income? If an employer gave an employee a gift card to a particular store, should the employee be treated as having received cash for purposes of the income tax? Are there additional facts you might want to know?

4. Are there any statutory exclusions from gross income that you would like to see repealed? Which ones and why?

5. What is deadweight loss? Which exclusions do you think cause the most deadweight loss?

Chapter 4: Loans and Cancellation of Indebtedness

The Tax Formula:

➔ (gross income) ≈
MINUS deductions named in § 62
EQUALS (adjusted gross income (AGI))
MINUS (standard deduction or itemized deductions)
MINUS (personal exemptions)
EQUALS (taxable income)

Compute income tax liability from tables in § 1 (indexed for inflation)
MINUS (credits against tax)

I. Tax Consequences of Borrowing Money

In this chapter, we take up various tax consequences of borrowing money. The fact that a taxpayer has borrowed money means that he/she/it has more money to spend. However, it also means that he/she/it has incurred an obligation to repay. One precisely offsets the other. Hence, there are no tax consequences to taking out a loan. Furthermore, taxpayer is entitled to spend this addition to his/her/its "store of property rights" on investment or consumption – and we treat such a taxpayer the same as we would if he/she/it had made such a purchase or investment with after-tax income. There is no income tax upon taking funds from the taxpayer's "store of property rights" (minus) and spending them (plus), as such removal and spending precisely offset. Moreover, taxpayer's expenditure entitles him/her/it to basis in whatever asset he/she/it may have purchased.

This does not mean that taxpayer is entitled to income that is not subject to income tax. Consider how taxpayer will meet his/her/its obligation to repay the loan. Taxpayer will have to earn income

The Tax Code and Economic Growth: A taxpayer's opportunity to invest borrowed funds prior to the time that he/she/it has paid income tax on the income necessary to invest an equivalent amount has tremendous growth implications for the nation's economy. Imagine how much more slowly the economy would grow if borrowed funds were subject to income tax immediately upon receipt. No doubt, there would still be markets for credit, but the higher cost of borrowing would mean that there would be less borrowing – and slower growth.

that *is* subject to income tax to repay the loan – perhaps by working at a job, paying income tax on wages, and using what remains after payment of taxes to pay down the loan. By taking out a loan, taxpayer has in fact exercised certain future consumption choices: he/she/it has committed future taxable consumption choices to the repayment of that loan. Consistent with the principle that borrowing money is not income to the taxpayer is the rule that repayment of loan principal is not deductible.

II. Cancellation of Indebtedness

All of this assumes that taxpayer will indeed repay the full amount of the loan. Consider now what happens when we no longer make this assumption. Taxpayer does not repay the loan, and for whatever reason, no longer owes it.

- Taxpayer has enjoyed the benefits of an expenditure on consumption without an offsetting (net) reduction to his/her/its store of property rights.
- Taxpayer no longer commits his/her/its future consumption choices to the repayment of the loan.
- Should we regard this as an accession to wealth and treat it as gross income? *See* § 61(a)(12).

Or: perhaps the assets that taxpayer purchased with the borrowed funds and upon which taxpayer relies to repay the loan shrink in value so that taxpayer is no longer able to repay the loan.

- Should this excuse a failure to repay the loan because such shrinkage can hardly be regarded as an "accession to wealth?"
- If we deem such a shrinkage not to be an "accession to wealth," we effectively merge the borrowing transaction and the spending or investing of the loan proceeds into one transaction. Is this appropriate? Or should we account separately for –
    - the borrowing and repayment, and
    - the fate of the enterprise in which taxpayer spends or invests the loan proceeds?

Or: Perhaps taxpayer is able to take advantage of market conditions to satisfy his/her/its obligation by paying less than the amount that he/she/it borrowed.

What answers to these questions does this leading case suggest?

United States v. Kirby Lumber Co., 284 U.S. 1 (1931)

MR. JUSTICE HOLMES delivered the opinion of the court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year, it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of (November 23) 1921, c. 136, § 213(a), gross income includes "gains or profits and income derived from any source whatever," and, by the Treasury Regulations authorized by § 1303, that have been in force through repeated reenactments,

> "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

Article 545(1)(c) of Regulations 62, under Revenue Act of 1921. *See* Article 544(1)(c) of Regulations 45, under Revenue Act of 1918; Article 545(1)(c) of Regulations 65, under Revenue Act of 1924; Article 545(1)(c) of Regulations 69, under Revenue Act of 1926; Article 68(1)(c) of Regulations 74, under Revenue Act of 1928. We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment, the marks had fallen in value, which, so far as it went, was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here, there was no shrinkage of assets, and the taxpayer made a clear gain. As a result of its dealings, it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 282 U.S. 364.

Judgment reversed.

Notes and Questions:

1. How does it happen that Kirby Lumber Company could buy back bonds in the open market for less than it obtained when it issued the bond?

2. What is a "shrinkage of assets?" Was the holding in *Kerbaugh-Empire* wrong? Why (or why not)?

> •Evidently, there was a "shrinkage of assets" in *Kerbaugh-Empire*, but not in *Kirby Lumber*.

3. What should we make of the "made available" language of the Court?

•Suppose that taxpayer is hopelessly insolvent. Let's say that taxpayer has assets with a fmv of $152,000, but has liabilities of $379,000. Liabilities exceed assets by $227,000. One creditor settles a $110,000 debt for property worth $18,000. Now the taxpayer has assets with a fmv of $134,000 and liabilities of $269,000. Liabilities now exceed assets by $135,000, i.e., $92,000 less than before this settlement. Has this transaction really "made available" $92,000 to taxpayer?

> •No, said the Fifth Circuit in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934):
>
> > There is a reduction or extinguishment of liabilities without

> any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. ... [T]he cancellation of the respondent's past due debt ... did not have the effect of making the respondent's assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income.

• Reducing the degree by which taxpayer is insolvent from $227,000 to $135,000 is not sufficient to constitute gross income. What if the reduction had been from $227,000 to $100. Where is the line?

4. (note 3 continued) In *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 291-92 (1937), taxpayer was insolvent and had filed a petition for voluntary bankruptcy. Taxpayer's creditors wrote off $104,000 of debt in exchange for payments totaling $15,000 in order to keep taxpayer from further pursuing relief through a bankruptcy proceeding. After this exchange, the value of taxpayer's assets exceeded its liabilities by $40,000. Taxpayer's

> net assets were increased from zero to $39,596.93 as a result of the cancellation of indebtedness by its creditors, and to that extent it had assets which ceased to be offset by any liability. ... [T]he cancellation of [taxpayer's] debts had the effect of making its assets greater than they were before that transaction occurred. It is true that 'gain' or 'profit' is essential to the existence of taxable 'income' ... and we believe that 'gain', as commonly understood, was realized here when [taxpayer], who was hopelessly insolvent, received by the action of its creditors an increment to its assets clear and free of any claims of the creditors. ... [W]e conclude that the assets freed to the [taxpayer] by the composition of creditors had an exchange value. Under such facts ..., [taxpayer] realized taxable gain ...

5. The "making available assets" language meant – practically uniformly among lower courts – that an insolvent debtor realized gross income from cancellation of indebtedness *only to the extent that* such cancellation made the debtor solvent. In fact, some courts held that the cancellation of debt of an insolvent debtor was not "income" under the Sixteenth Amendment. *See* Ann K. Wooster, *Application of the 16th Amendment to U.S. Constitution – Taxation of Specific Types of Income*, 46 A.L.R. FED. 2d 301 (2010) § 12 (debt forgiveness income).

6. Back to *Kerbaugh-Empire*: A loan is a transaction. Taxpayer may use loan proceeds in another transaction. Logically, the loan and the spending or investment of proceeds are two different transactions that taxpayer should have to account for separately. In the absence of any statutory provision governing exclusion of cancellation of indebtedness income, the Code essentially required the Commissioner prior to 1954 to kick a taxpayer when he/she/it was down. We see what happened. *Dallas Transfer* and *Lakeland Grocery* focused on taxpayer's insolvency to exclude at least some coi income from taxpayer's gross income. The holding in *Kerbaugh-Empire* seemed to permit a court to focus on the success of the enterprise in which taxpayer invested loan proceeds to determine whether taxpayer had to include cancellation of indebtedness in his/her/its gross income.

- Section 108 changes this, but § 108 does *not* convert business losses into excludable cancellation of indebtedness income.
- Review the holding and rationale of *United States v. Gehl*, 50 F.3d 12, 1995 WL 115589 (8th Cir.), *cert. denied*, 516 U.S. 899 (1995), in chapter 3 of the text, *supra*.

7. In 1954, Congress added §§ 61(a)(12), 108, and 1017 to the Code.[60] Read §§ 61(a)(12), 108(a)(1)(A and B), 108(d)(1 through 3). Do you see the influence of cases such as *Dallas Transfer & Terminal Warehouse* and *Lakeland Grocery* – as well as of cases holding that the meaning of "income" in the 16th Amendment does not encompass discharge of

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[60] *See* BORIS I. BITTKER, MARTIN J. MCMAHON, JR., & LAWRENCE A. ZELENAK, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.05[2] at 4-21 (3d ed. 2002).

indebtedness (doi) when taxpayer does not thereby become solvent? *See also* Reg. § 1.61-12(b)(1) (adopted in 1957).

•Section 108(e)(1) provides that there is no insolvency exception from the general rule that gross income includes income from discharge of indebtedness other than what § 108 provides.

•When the other provisions of § 108 apply, § 108 appears to "preempt the field" – much as §§ 119 and 132 preempt their respective fields. *See* BORIS I. BITTKER, MARTIN J. MCMAHON, JR., & LAWRENCE A. ZELENAK, *supra* at 4-21 to 4-22.

8. Read § 108(b). What is a "tax attribute?"

•The Code does not define the phrase. We surmise its meaning by reading § 108(b).

•Section 108(b) lists tax consequences of various transactions that might reduce taxpayer's tax liability *in the future*. The list includes: net operating loss, general business credit, minimum tax credit, capital loss carryover, basis reduction, passive activity loss and credit carryovers, and foreign tax credit carryovers.

•What is the effect of § 108(b) on the holdings of cases such as *Dallas Transfer & Terminal Warehouse* and *Lakeland Grocery*? Define the "exclusion" from gross income that § 108 provides a taxpayer who is in bankruptcy or insolvent.

9. *Reduction of tax attributes and reductions of basis*: Section 1017 and Reg. § 1.1017-1 provide some rather technical rules governing reductions in tax attributes and bases. Tax attributes reduce a taxpayer's tax liability at some future time. Does it matter how far into the future the reduction occurs?

•The consequence of reducing a tax attribute is that taxpayer's future tax liability will not decrease.

•To the extent that a taxpayer has tax attributes, § 108 does not in fact exclude doi income from taxpayer's gross income, but instead defers the effect of its recognition to the day that a tax attribute would have reduced taxpayer's tax liability.

•The temporal sequence in which reductions of tax attributes occur might be the same as the temporal sequence in which a typical taxpayer would derive a tax benefit from the particular tax attribute. If that is true, then the Code minimizes the length of time taxpayer benefits from not immediately recognizing doi income.

Basis represents investment that is not subject to income tax. We have encountered in passing the concept of depreciation. Consider it to be a deduction that reflects the partial consumption of a productive asset that taxpayer uses to generate gross income. Because there is partial consumption of the productive asset, depreciation allowances *must* reduce taxpayer's basis in the asset. A depreciation allowance represents the taxpayer's "de-investment" in the asset. Some productive assets are not subject to depreciation because taxpayer does not actually consume them in generating gross income. Land is an obvious example. A reduction in the basis of property can affect taxpayer's tax liability on two occasions: (1) a lower basis shortens the period over which taxpayer may claim depreciation deductions; (2) a lower basis increases the gain taxpayer realizes upon sale of the asset. Consider the likely timing effect(s) of reducing the basis of particular pieces of a taxpayer's productive assets.

- What policies do you see implicit in § 1017(b)(4)?
- What policies do you see implicit in § 108(b)(5)/Reg. § 1.1017-1(c and e)?
- What policies do you see implicit in Reg. § 1.1017-1(a)?

10. Consider:

•10a. Taxpayer owns real property, fmv = $100,000, ab = $135,000. This is all of taxpayer's property. Taxpayer also has no other assets, not even cash. Taxpayer has liabilities of $120,000. Is taxpayer insolvent for purposes of § 108? By how much?

•10b. Taxpayer owns real property, fmv = $135,000, ab = $100,000. This is all of taxpayer's property. Taxpayer also has no other assets, not even cash. Taxpayer has liabilities of $120,000. Is taxpayer insolvent for purposes of § 108? By how much?

•10c. Taxpayer owns real property, ab = $80,000, fmv = $125,000. This is all of taxpayer's property, except that taxpayer also has $5000 of cash. Taxpayer's real property is subject to a debt of $110,000 that he owes to creditor. Taxpayer did not purchase the property from creditor. Taxpayer was having difficulty making payments, so creditor agreed to reduce taxpayer's debt to $95,000. How much doi income must taxpayer include in his gross income under §§ 61(a)(12)/108?

•10d. Taxpayer owns real property, ab = $80,000, fmv = $125,000. This is all of Taxpayer's property, except that Taxpayer has $20,000 of cash. Taxpayer's real property is subject to a debt of $150,000 that she owes to creditor. Taxpayer did not purchase the property from creditor. Taxpayer was having difficulty making payments. Creditor agreed to reduce taxpayer's debt from $150,000 to $130,000 in exchange for an immediate cash payment of $10,000. Taxpayer agreed and made the payment. How much doi income must taxpayer include in her gross income under §§ 61/108?

•10e. Same facts as 10d, except that taxpayer has filed for bankruptcy. The creditor makes the same arrangement with taxpayer. How much doi income must taxpayer include in her gross income under §§ 61/108? [Disregard the effect of such a payment on the bankruptcy proceeding.]

•10f. Taxpayer borrowed $1M in order to build an apartment building (i.e., depreciable real property). Taxpayer paid $1M to build the apartment building on land that otherwise was of nominal (i.e., $0) value. The apartment building secured the loan from Bank. The apartment building is subject to depreciation. Taxpayer also purchased equipment for $100,000 that it borrowed from S&L. The equipment secured the loan from S&L. The equipment is subject to depreciation. Now:

- •AB of the apartment building = $800,000, fmv = $700,000, loan balance owed to Bank = $900,000.
- •AB of equipment = $30,000, fmv = $75,000, loan balance owed to S&L = $60,000.
- •Taxpayer has cash of $50,000.

S&L agreed to discharge all of the debt taxpayer owed it to $0 in exchange for a cash payment of $35,000. Taxpayer agreed and made the payment. Discuss the tax consequences to taxpayer under §§ 61(a)(12)/108/1017/Reg. § 1.1017-1(a).

11. The reduction is made to the basis of any property held by the taxpayer at the beginning of the tax year following the tax year in which the debt discharge occurs (§ 1017(a)).

- Taxpayer need not reduce ("spend") her/his/its tax attributes on the discharge of indebtedness but rather may use them to reduce tax liability for the year.
- *Then* taxpayer may also reduce basis.

III. Is It a Loan? Is There an Accession to Wealth?

Now consider a case (and its appeal) in which the very characterization of the facts generated considerable disagreement. Included here are four opinions from the Tax Court and one from the Third Circuit Court of Appeals. Ultimately, of course, it is the opinion of the Third Circuit that prevails. Be ready to articulate the positions of the different judges as to just exactly what happened.

Zarin v. Commissioner, 92 T.C. 1084 (1989), *rev'd*, 916 F.2d 110 (3rd Cir. 1990).

Cohen, Judge:

Respondent determined deficiencies of $2,466,622 and $58,688 in petitioners' Federal income taxes for 1980 and 1981, respectively.

In the notice of deficiency, respondent ... asserted that petitioners realized ... taxable income of $2,935,000 in 1981 through cancellation of indebtedness. The sole issue for decision is whether petitioners had income from discharge of gambling indebtedness during 1981.

....

David Zarin (petitioner) was a professional engineer involved in the development, construction, and management of multi-family housing and nursing home facilities. ...

Petitioner occasionally stayed at Resorts International Hotel, Inc. (Resorts), in Atlantic City in connection with his construction activities. ... In June 1978, petitioner applied to Resorts for a $10,000 line of credit to be used for gambling. After a credit check, which included inquiries with petitioner's banks and "Credit Central," an organization that maintains records of individuals who gamble in casinos, the requested line of credit was granted, despite derogatory information received from Credit Central.

The game most often played by petitioner, craps, creates the potential of losses or gains from wagering on rolls of dice. When he played craps at Resorts, petitioner usually bet the table limit per roll of the dice. Resorts quickly became familiar with petitioner. At petitioner's request, Resorts would raise the limit at the table to the house maximum. When petitioner gambled at Resorts, crowds would be attracted to his table by the large amounts he would wager. Gamblers would wager more than they might otherwise because of the excitement caused by the crowds and the amounts that petitioner was wagering. Petitioner was referred to as a "valued gaming patron" by executives at Resorts.

By November 1979, petitioner's permanent line of credit had been increased to $200,000. Despite this increase, at no time after the initial credit check did Resorts perform any further analysis of petitioner's creditworthiness. Many casinos extend complimentary services and privileges ("comps") to retain the patronage of their best customers. Beginning in the late summer of 1978, petitioner was extended the complimentary use of a luxury three-room suite at Resorts. Resorts progressively increased the complimentary services to include free meals, entertainment, and 24-hour access to a limousine. By late 1979, Resorts was extending such comps to petitioner's guests as well. By this practice, Resorts sought to preserve not only petitioner's patronage but also the attractive power his gambling had on others.

Once the line of credit was established, petitioner was able to receive chips at the gambling table. Patrons of New Jersey casinos may not gamble with currency, but must use chips provided by the casino. Chips may not be used outside the casino where they were issued for any purpose.

Petitioner received chips in exchange for signing counter checks, commonly known as "markers." The markers were negotiable drafts payable to Resorts drawn on petitioner's bank. The markers made no reference to chips, but stated that cash had been received.

Petitioner had an understanding with Gary Grant, the credit manager at Resorts, whereby the markers would be held for the maximum period allowable under New Jersey law, which at that time was 90 days, whereupon petitioner would redeem them with a personal check. At all times pertinent hereto, petitioner intended to repay any credit amount properly extended to him by Resorts and to pay Resorts in full the amount of any personal check given by him to pay for chips or to reduce his gambling debt. Between June 1978 and December 1979, petitioner incurred gambling debts of approximately $2.5 million. Petitioner paid these debts in full.

On October 3, 1979, the New Jersey Division of Gaming Enforcement filed with the New Jersey Casino Control Commission a complaint against Resorts and several individuals, which alleged 809 violations pertaining to Resorts' casino gaming credit system, its internal procedures, and its administrative and accounting controls. Of those 809 violations, 100 were specifically identified as pertaining to petitioner and a gambling companion. Pursuant to a request for a cease and desist order contained in the complaint, a Casino Control Commissioner issued an Emergency Order on October 9, 1979. That order provided, in relevant part:

> 5. Effective immediately, Resorts shall not issue credit to any patron whose patron credit reference card indicates that the credit now outstanding exceeds the properly approved credit limit. In determining whether a credit limit has been exceeded, all yet undeposited checks received in payment of a counter check or checks shall be included as credits.

After the Emergency Order was issued, Resorts began a policy of treating petitioner's personal checks as "considered cleared." Thus, when petitioner wrote a personal check it was treated as a cash transaction, and the amount of the check was not included in determining whether he had reached his permanent credit limit. In addition, Resorts extended petitioner's credit limit by giving him temporary increases known as "this trip only" credit. Although not specifically addressed by the New Jersey Casino Control regulations in effect during 1979 and 1980, a "this trip only" credit increase was a temporary credit increase for a patron's current trip to Atlantic City, and was required to be reduced before the patron's return. Both of these practices effectively ignored the Emergency Order. Petitioner did not understand the difference between "this trip only" credit and his permanent credit line, and he thought that he no longer had a credit limit.

By January 1980, petitioner was gambling compulsively at Resorts. Petitioner was gambling 12-16 hours per day, 7 days per week in the casino, and he was betting up to $15,000 on each roll of the dice. Petitioner was not aware of the amount of his gambling debts.

On April 12, 1980, Resorts increased petitioner's permanent credit line to $215,000, without any additional credit investigation. During April 1980, petitioner delivered personal checks and markers in the total amount of $3,435,000 that were returned to Resorts as having been drawn against insufficient funds. On April 29, 1980, Resorts cut off petitioner's credit. Shortly thereafter, petitioner indicated to the Chief Executive Officer of Resorts that he intended to repay the obligations.

On November 18, 1980, Resorts filed a complaint in New Jersey state court seeking collection of $3,435,000 from petitioner based on the unpaid personal checks and markers. On March 4, 1981, petitioner filed an answer, denying the allegations and asserting a variety of affirmative defenses.

On September 28, 1981, petitioner settled the Resorts suit by agreeing to make a series of payments totaling $500,000. Petitioner paid the $500,000 settlement amount to Resorts in accordance with the terms of the agreement. The difference between petitioner's gambling obligations of $3,435,000 and the settlement payments of $500,000 is the amount that respondent alleges to be income from forgiveness of indebtedness.

On July 8, 1983, Resorts was fined $130,000 for violating the Emergency Order on at least 13 different occasions, 9 of which pertained directly to credit transactions between Resorts and petitioner.

....

Income From the Discharge of Indebtedness

In general, gross income includes all income from whatever source derived, including income from the discharge of indebtedness. § 61(a)(12). Not all discharges of indebtedness, however, result in income. [citation omitted]. The gain to the debtor from such discharge is the resultant freeing up of his assets that he would otherwise have been required to use to pay the debt. *See United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

... Petitioner argues that the settlement agreement between Resorts and himself did not give rise to ... income because, among other reasons, the debt instruments were not enforceable under New Jersey law and, in any event, the settlement should be treated as a purchase price adjustment that does not give rise to income from the discharge of indebtedness.

Petitioner argues that gambling and debts incurred to acquire gambling opportunity have always received special treatment at common law and in the Internal Revenue Code and that agreeing with respondent in this case would result in taxing petitioner on his losses. Petitioner relies on *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962), as establishing a rule that the cancellation of indebtedness doctrine is not applicable to the settlement of a gambling debt.

The parties have primarily focused their arguments on whether the debt instruments memorializing the credit transactions were legally enforceable and whether legal enforceability is of significance in determining the existence of income from discharge of indebtedness. Petitioner argues that his debt was unenforceable and thus there was no debt to be discharged and no resulting freeing up of assets because his assets were never encumbered. Petitioner relies on N.J. STAT. ANN. § 5:12-101(f) (West 1988), and *Resorts International Hotel, Inc. v. Salomone*, 178 N.J. Super. 598, 429 A.2d 1078 (App. Div. 1981), in arguing that the gambling debts were unenforceable.

... We must decide, therefore, whether legal enforceability is a prerequisite to recognition of income in this case.

Enforceability

In *United States v. Hall*, *supra*, the taxpayer transferred appreciated property in satisfaction of a gambling debt of an undetermined amount incurred in Las Vegas, Nevada. The Commissioner sought to tax as gain the difference between the amount of the discharged debt and the basis of the appreciated property. Although licensed gambling was legal in Nevada, gambling debts were nevertheless unenforceable. The Court of Appeals concluded that, under the circumstances, the amount of the gambling debt had no significance for tax purposes. The Court reasoned that, "The cold fact is that taxpayer suffered a substantial loss from gambling, the amount of which was determined by the transfer." 307 F.2d at 241. The Court of Appeals relied on the so-called "diminution of loss theory" developed by the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926). In that case, the taxpayer borrowed money that was subsequently lost in a business transaction. The debt was satisfied for less than its face amount. The Supreme Court held that the taxpayer was not required to recognize income from discharge of a debt because the transaction as a whole lost money.

The Court of Appeals for the Tenth Circuit in *Hall* quoted at length from *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956), which noted that the *Kerbaugh-Empire* case was decided before *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), and *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), and had been "frequently criticized and not easily understood." Subsequent developments further suggest that *Kerbaugh-Empire* has lost its vitality. *See Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986) ...

....

In the instant case, symmetry from year to year is not accomplished unless we treat petitioner's receipt of the loan from Resorts (i.e., the markers converted to chips) and the subsequent discharge of his obligation to repay that loan in a consistent manner. Petitioner received credit of $3,435,000 from Resorts. He treated these amounts as a loan, not reporting any income on his 1980 tax return. *Compare United States v. Rosenthal*, 470 F.2d 837 (2d Cir. 1972), and *United States v. Rochelle*, 384 F.2d 748 (5th Cir. 1967). The parties have stipulated that he intended to repay the amounts received. Although Resorts extended the credit to petitioner with the expectation that he would continue to gamble, theoretically petitioner could have redeemed the chips for cash. Certainly if he had won, rather than lost, at gambling, the amounts borrowed would have been repaid.

Petitioner argues that he did not get anything of value when he received the chips other than the "opportunity to gamble," and that, by reason of his addiction to gambling, he was destined to lose everything that he temporarily received. Thus, he is in effect arguing, based on *Hall*, that the settlement merely reduced the amount of his loss and did not result in income.

....

We have no doubt that an increase in wealth from the cancellation of indebtedness is taxable where the taxpayer received something of value in exchange for the indebtedness. ...

We conclude here that the taxpayer did receive value at the time he incurred the debt and that only his promise to repay the value received prevented taxation of the value received at the time of the credit transaction. When, in the subsequent year, a portion of the obligation to repay was forgiven, the general rule that income results from forgiveness of indebtedness, § 61(a)(12), should apply.

Legal enforceability of an obligation to repay is not generally determinative of whether the receipt of money or property is taxable. *James v. United States*, 366 U.S. 213, 219 (1961). ...

Here the timing of recognition was set when the debt was compromised. The amount to be recognized as income is the part of the debt that was discharged without payment. The enforceability of petitioner's debts under New Jersey law did not affect either the timing or the amount and thus is not determinative for Federal income tax purposes. We are not persuaded that gambling debts should be accorded any special treatment for the benefit of the gambler – compulsive or not. As the Court of Appeals in *United States v. Hall* stated, "The elimination of a gambling debt is * * * a transaction that may have tax consequences independent of the amount of the debt and certainly cannot be used as a tool to avoid a tax incident which is shielded only by the screen of its unenforceable origin." 307 F.2d at 242.

Disputed Debt

Petitioner also relies on the principle that settlement of disputed debts does not give rise to income. *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), cited with approval in *Colonial Savings Assn. v. Commissioner*, 85 T.C. 855, 862-863 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988). Prior to the settlement, the amount of petitioner's gambling debt to Resorts was a liquidated amount, unlike the taxpayer's debt in *Hall*. There is no dispute about the amount petitioner received. The parties dispute only its legal enforceability, i.e., whether petitioner could be legally compelled to pay Resorts the fixed amount he had borrowed. A genuine dispute does not exist merely because petitioner required Resorts to sue him before making payment of any amount on the debt. ... In our view, petitioner's arguments concerning his defenses to Resorts' claim, which apparently led to Resorts' agreement to discount the debt, are overcome by (1) the stipulation of the parties that, at the time the debt was created, petitioner agreed to and intended to repay the full amount, and (2) our conclusion that he received full value for what he agreed to pay, i.e., over $3 million worth of chips and the benefits received by petitioner as a "valued gambling patron" of Resorts.

Deductibility of Gambling Losses

....

Purchase Money Debt Reduction

Petitioner argues that the settlement with Resorts should be treated as a purchase price adjustment that does not give rise to income from the discharge of indebtedness. He cites the parties' stipulation, which included a statement that, "Patrons of New Jersey casinos may not gamble with currency. All gambling must be done with chips provided by the casino. Such chips are property which are not negotiable and may not be used to gamble or for any other purpose outside the casino where they were issued." Respondent argues that petitioner actually received "cash" in return for his debts.

Section 108(e)(5) was added to the Internal Revenue Code by the Bankruptcy Tax Act of 1980, Pub. L. 96-589, 94 Stat. 3389, 3393, and provides:

> (5) Purchase-money debt reduction for solvent debtor treated as price reduction. – If –
>
> > (A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,
> >
> > (B) such reduction does not occur –
> >
> > > (i) in a title 11 case, or
> > >
> > > (ii) when the purchaser is insolvent, and
> >
> > (C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,
>
> then such reduction shall be treated as a purchase price adjustment.

Section 108(e)(5) was enacted "to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reductions should be treated as discharge income or a true price adjustment." S. REPT. NO. 96-1035 (1980). Section 108(e)(5) applies to transactions occurring after December 31, 1980. S. REPT. NO. 96-1035, *supra*. The provisions of this section are not elective.

....

It seems to us that the value received by petitioner in exchange for the credit extended by Resorts does not constitute the type of property to which § 108(e)(5) was intended to or reasonably can be applied. Petitioner argued throughout his briefs that he purchased only "the opportunity to gamble" and that the chips had little or no value. We agree with his description of what he bargained for but not with his conclusion about the legal effect.

As indicated above, we are persuaded ... that petitioner received full value for his debt. ...

Petitioner purchased the opportunity to gamble as he received chips in exchange for his markers. ... Upon receipt of the chips, Petitioner immediately proceeded to gamble with these chips. * * *

....

* * *

* * * ... Petitioner, in entering into the gaming transactions with Resorts, did not receive any item of tangible value. In fact, Petitioner received nothing more than the opportunity to bet on which of 36 permutations of the dice would appear on a given roll of the dice. * * *

....

While disagreeing with petitioner's assertion as to the value of what he received, we agree that what he received was something other than normal commercial property. He bargained for and received the opportunity to gamble and incidental services, lodging, entertainment, meals, and transportation. Petitioner's argument that he was purchasing chips ignores the essence of the transaction, as more accurately described in his other arguments here quoted. The "property" argument simply overemphasizes the significance of the chips. As a matter of substance, chips in isolation are not what petitioner purchased.

The "opportunity to gamble" would not in the usual sense of the words be "property" transferred from a seller to a purchaser. The terminology used in § 108(e)(5) is readily understood with respect to tangible property and may apply to some types of intangibles. Abstract concepts of property are not useful, however, in deciding whether what petitioner received is within the contemplation of the section.

Obviously the chips in this case were a medium of exchange within the Resorts casino, and in that sense they were a substitute for cash, just as Federal Reserve Notes, checks, or other convenient means of representing credit balances constitute or substitute for cash. ...

We conclude that petitioner's settlement with Resorts cannot be construed as a "purchase-money debt reduction" arising from the purchase of property within the meaning of § 108(e)(5).

....

Decision will be entered under Rule 155.

Reviewed by the Court.

Nims, Parker, Körner, Shields, Hamblen, Clapp, Gerber, Wright, Parr, and Colvin, JJ., agree with the majority opinion.

Tannenwald, J., dissenting:

The foundation of the majority's reasoning is that Mr. Zarin realized income in an amount equal to the amount of the credit extended to him because he was afforded the "opportunity to gamble." ...

....

I think it highly significant that in all the decided cases involving the cancellation of indebtedness, the taxpayer had, in a prior year when the indebtedness was created, received a nontaxable benefit clearly measurable in monetary terms which would remain untaxed if the subsequent cancellation of the indebtedness were held to be tax free. Such is simply not the case herein. The concept that petitioner received his money's worth from the enjoyment of using the chips (thus equating the pleasure of gambling with increase in wealth) produces the incongruous result that the more a gambler loses, the greater his pleasure and the larger the increase in his wealth. [footnote omitted]. Under the circumstances, I think the issue of enforceability becomes critical. In this connection, the repeated emphasis by the majority on the stipulation that Mr. Zarin intended to repay the full amount at the time the debt was created is beside the point. If the debt was unenforceable under New Jersey law, that intent is irrelevant.

It is clear that respondent has not shown that the checks Mr. Zarin gave Resorts were enforceable under New Jersey law. New Jersey law provides that checks issued to pay for gambling are enforceable provided that a set of requirements relating to, among other things, proper payees, dating and holding periods, is met. *See* N.J. STAT. ANN. § 5:12-101 (West 1988)." Any check cashed, transferred, conveyed or given in violation of * * * [those requirements] shall be invalid and unenforceable for the purposes of collection * * *." N.J. STAT. ANN. § 5:12-101(f) (West 1988). Furthermore, strict compliance with those requirements is mandatory for a check to be enforceable. [citations omitted]. Respondent simply has not shown that the markers given Resorts by Mr. Zarin were drawn and handled in strict compliance with the statute. In fact, the number of violations of the Emergency Order asserted against Resorts by the New Jersey gambling commission, including some betting transactions with petitioner, casts substantial doubt on whether the checks [footnote omitted] were in fact so handled.

....

... I think it significant that because the debts involved herein were unenforceable from the moment that they were created, there was no freeing up of petitioners' assets when they were discharged, *see United States v. Kirby Lumber Co.*, *supra*, and therefore there was no increase in petitioners' wealth that could constitute income. *Cf. Commissioner v. Glenshaw Glass Co.*, *supra*. This is particularly true in light of the fact that the chips were given to Mr. Zarin with the expectation that he would continue to gamble and, therefore, did not constitute an increase in his wealth when he received them in the same sense that the proceeds of a non-gambling loan would. *Cf. Rail Joint Co. v. Commissioner*, 22 B.T.A. 1277 (1931), *aff'd*, 61 F.2d 751 (2d Cir. 1932) (cited in *Commissioner v. Tufts*, 461 U.S. at 209 n.6), where we held that there was no income from the discharge on indebtedness when the amount paid for the discharge was in excess of the value of what had been received by the debtor at the time the indebtedness was created even though the face amount of the indebtedness and hence the taxpayer's liability was reduced; *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600 (1954) (same holding).

I am reinforced in my conclusion by the outcome in *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962). In that case, the court held that there was no income from the discharge of gambling indebtedness because the debt was not enforceable under Nevada law, and observed that such a debt "has but slight potential and does not meet the requirements of debt necessary to justify the mechanical operation of general rules of tax law relating to cancellation of debt." 307 F.2d at 241. While a gambling debt is not unenforceable under all circumstances in New Jersey, the indebtedness involved herein was unenforceable, and I agree with the court in *Hall* that an unenforceable "gambling debt * * * has no significance for tax purposes," 307 F.2d at 242, at least where such unenforceability exists from the moment the debt is created. [footnote omitted]

I find further support for my conclusion from the application of the principle that if there is a genuine dispute as to liability on the underlying obligation, settlement of that obligation will not give rise to income from discharge of indebtedness. *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), cited with approval in *Colonial Savings Association v. Commissioner*, 85 T.C. 855, 862-863 (1985), *aff'd*, 854 F.2d 1001 (7th Cir. 1988). Respondent simply has not met his burden of showing that the dispute between Resorts and Mr. Zarin was not a genuine dispute as to Mr. Zarin's liability for the underlying obligations, and I believe that, at least as to that debt that was not entered into as required by New Jersey law and was therefore unenforceable, the dispute was in fact genuine. While there is language in *Sobel* and *Colonial Savings* indicating that *United States v. Kirby Lumber Co.*, *supra*, applies when there is a liquidated amount of indebtedness, I do not read that language as requiring that *Kirby Lumber* must apply unless the amount is unliquidated, where there is a genuine dispute as to the underlying liability.

I would hold for petitioner.

Wells, J., agrees with this dissent.

Jacobs, J., dissenting:

....

Ruwe, J., dissenting:

Although I agree with much of the majority's reasoning in this case, I dissent from that portion of the opinion which holds that § 108(e)(5) is inapplicable to the transaction at issue. I find no support in the language of the statute or the accompanying legislative history for the majority's determination that the gambling chips purchased by petitioner do not constitute "property" for purposes of § 108(e)(5). Because I believe that petitioner acquired "property" from the casino on credit and subsequently negotiated a reduction of his debt to the casino, I would apply § 108(e)(5) in this case.

....

The majority agrees that the chips had value. It correctly finds that petitioner paid for the chips by giving markers to the casino, that the markers constituted petitioner's promise to pay money to the casino, and that the chips had a value of over $3 million. The parties stipulated that the chips were "property." It is beyond question that gambling chips constitute what is commonly referred to as property. *See* BLACK'S LAW DICTIONARY, pp. 1095-1096 (5th ed. 1979).

... Having concluded that petitioner received chips having a value equivalent to his markers, it is impossible to describe the gambling chips as anything other than "property." Apparently, cognizant of this dilemma, the majority finally settles on the conclusion that the gambling chips purchased by petitioner were "something other than normal commercial property." I take this to be a finding of fact since the term "normal commercial property" does not appear in the relevant statutes, regulations, or legislative history.

The majority's legal conclusion seems to be that gambling chips, being other than "normal commercial property," do not constitute "property" within the meaning of § 108(e)(5). In deciding this legal issue of first impression, the majority fails to define either the term "property" as used in § 108(e)(5) or the term "normal commercial property."

If the term "normal commercial property" has a meaning, there is no reason why gambling chips should not be included. ...

Chips are certainly "normal commercial property" in a casino's commercial gambling business. ... In any event, neither the statute nor its legislative history restricts its application to "normal commercial property."

The majority concludes that petitioner "received full value for what he agreed to pay, i.e., over $3 million worth of chips." [footnote omitted]. However, the majority concludes that "chips in isolation are not what petitioner purchased." The majority reasons that the value of the chips is really derived from the fact that they give the holder of the chips the opportunity to gamble. This seems akin to saying that a taxpayer who purchases a 99-year leasehold to a vacant lot in midtown Manhattan has not acquired "property" because the value of the leasehold interest is derived from the lessee's "opportunity" to build a large office building. That the chips derive value from the opportunity they afford is no reason why they are not property. A person who purchases chips receives, among other things, the casino's promise to provide a gambling opportunity. In that sense, the opportunity is no different than any other valuable and assignable contract right which we would surely recognize as property. A license is nothing more than a grant of an opportunity to the licensee to do something which he would otherwise be prohibited from doing. Nevertheless, a license is considered property. *Barry v. Barchi*, 443 U.S. 55, 64 (1979) (state racing and wagering license); *Wolfe v. United States*, 798 F.2d 1241, 1245 (9th Cir. 1986) (ICC license); *Agua Bar & Lounge, Inc. v. United States*, 539 F.2d 935, 937-938 (3d Cir. 1976) (liquor license). ...

....

The term "property" as used in § 108(e)(5) is not specifically defined. However, the term "property" is generally understood to be a broad concept. ...

....

Section 108(e)(5) and the background giving rise to its enactment support its application to the facts in this case. Prior to enactment of § 108(e)(5), case law distinguished between true discharge of indebtedness situations which required recognition of income and purchase price adjustments. A purchase price adjustment occurred when a purchaser of property agreed to incur a debt to the seller but the debt was subsequently reduced because the value of the property was less than the agreed upon consideration. A mere purchase price adjustment does not result in discharge of indebtedness income. *See N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939); B. BITTKER & L. LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, ¶¶ 6-39 – 6-40 (2d ed. 1989).

Section 108(e)(5) was enacted "to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reductions should be treated as discharge income or a true price adjustment." S. REPT. NO. 96-1035 (1980). ... Its provisions are not elective. ... [O]ne of petitioner's arguments is that the value of what he received was less than the amount of debt incurred. Respondent argues, and the majority finds, that the chips petitioner received were worth the full value of the debt. Thus, this case presents the very controversy that the above-quoted legislative history says Congress tried to eliminate by enacting § 108(e)(5).

For a reduction in the amount of a debt to be treated as a purchase price adjustment under § 108(e)(5), the following conditions must be met: (1) The debt must be that of a purchaser of property to the seller which arose out of the purchase of such property; (2) the taxpayer must be solvent and not in bankruptcy when the debt reduction occurs; and (3) except for § 108(e)(5), the debt reduction would otherwise have resulted in discharge of indebtedness income. § 108(e)(5); B. BITTKER & L. LOKKEN, *supra* at ¶¶. 6-40 – 6-41; *see also Sutphin v. United States*, 14 Cl. Ct. 545, 549 (1988); *Juister v. Commissioner*, T.C. Memo. 1987-292; *DiLaura v. Commissioner*, T.C. Memo. 1987-291. [These conditions are met in this case.]

....

In addition to the literal statutory requirements, the legislative history indicates that § 108(e)(5) was intended to apply only if the following requirements are also met: (a) The price reduction must result from an agreement between the purchaser and the seller and not, for example, from a discharge as a result of the running of the statute of limitations on enforcement of the obligation; (b) there has been no transfer of the debt by the seller to a third party; and (c) there has been no transfer of the purchased property from the purchaser to a third party. S. REPT. NO. 1035, *supra*; B. BITTKER & L. LOKKEN, *supra* at ¶¶ 6-40 – 6-41.

These requirements have also been met. The settlement agreement indicates that petitioner and Resorts mutually agreed to reduce the amount of indebtedness in order to amicably resolve their differences and terminate their litigation. In that litigation, Resorts alleged a number of counts and petitioner raised a variety of affirmative defenses. The settlement agreement was the result of direct negotiations between petitioner and Resorts. [footnote omitted].

The second requirement set forth in the legislative history has been met. Resorts did not transfer petitioner's debt to a third party.

The third requirement has also been met. Petitioner did not transfer the property to a third party. Both parties in their briefs acknowledge that petitioner did transfer the property to Resorts in that the chips were lost to Resorts at the gambling tables. The legislative history, however, indicates that application of § 108(e)(5) is precluded only if the purchaser/taxpayer transfers the property to a "third party." Resorts was not a third party; Resorts was the seller/creditor.

....

Respondent[argues that] ... [a] purchase price adjustment occurs when the dispute involves contract liability for the purchase of an asset." I am unable to discern any basis or rationale for this argument. Respondent stipulated to, and his brief requests, a finding of fact that property in the form of chips was received in exchange for petitioner's markers.[61]

....

I would dispose of this case by assuming that there was discharge of indebtedness income. I would then apply § 108(e)(5) to treat the discharge as a purchase price adjustment. This would result in no taxable income. I respectfully dissent.

Chabot, Swift, Williams, and Whalen, JJ., agree with this dissent.

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[61] We have recently described a seller-financed transaction as an 'amalgam of two distinct transactions. First, there is a transfer of the asset from the seller to the buyer. Then, there is a 'loan' from the seller to the purchaser of all or a portion of the purchase price.' Finkelman v. Commissioner, T.C. Memo. 1989-72. If respondent's 'cash' argument is based on the second part of this bifurcated description of a seller-financed transaction, the result would completely nullify section 108(e)(5) since no transactions would ever qualify for section 108(e)(5) relief.

Notes and Questions:

1. What form did Zarin's consumption take?
   - gambling?
   - losing at gambling?
   - Should it make a difference?

2. Cohen and Ruwe disagreed over whether the essence of gambling chips is property or a service. The majority treated it as the sale of a service. Ruwe treated the chips as property.
   - Is Ruwe's analogy to a 99-year leasehold in midtown Manhattan sound? Were the chips income-producing property?

3. Articulate the different characterizations of the transactions occurring between Zarin and Resorts International of each of the opinion-writers.

4. What was the holding of *Hall* as the majority articulated it? What is wrong with it?

5. Notice that the rule that a settlement does not create doi income is that there must be a genuine dispute as to the liability. In this case, the burden of showing that there was *not* a genuine dispute was on the Commissioner because of the procedural posture (i.e., stipulated facts) of the case.

Zarin v. Commissioner, 916 F.2d 110 (3rd Cir. 1990).
COWEN, Circuit Judge.

David Zarin ("Zarin") appeals from a decision of the Tax Court holding that he recognized $2,935,000 of income from discharge of indebtedness resulting from his gambling activities, and that he should be taxed on the income. [footnote omitted]. ... After considering the issues raised by this appeal, we will reverse.

I.

[The court recounts the facts.]

II.

The sole issue before this Court is whether the Tax Court correctly held that Zarin had income from discharge of indebtedness. [footnote omitted]. Section 108 and § 61(a)(12) of the Code set forth "the general rule that gross income includes income from the discharge of indebtedness." I.R.C. § 108(e)(1). The Commissioner argues, and the Tax Court agreed, that pursuant to the Code, Zarin did indeed recognize income from discharge of gambling indebtedness.

Under the Commissioner's logic, Resorts advanced Zarin $3,435,000 worth of chips, chips being the functional equivalent of cash. At that time, the chips were not treated as income, since Zarin recognized an obligation of repayment. In other words, Resorts made Zarin a tax-free loan. However, a taxpayer does recognize income if a loan owed to another party is cancelled, in whole or in part. I.R.C. §§ 61(a)(12), 108(e). The settlement between Zarin and Resorts, claims the Commissioner, fits neatly into the cancellation of indebtedness provisions in the Code. Zarin owed $3,435,000, paid $500,000, with the difference constituting income. Although initially persuasive, the Commissioner's position is nonetheless flawed for two reasons.

III.

Initially, we find that §§ 108 and 61(a)(12) are inapplicable to the Zarin/Resorts transaction. Section 61 does not define indebtedness. On the other hand, § 108(d)(1), which repeats and further elaborates on the rule in § 61(a)(12), defines the term as any indebtedness "(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." I.R.C. § 108(d)(1). In order to bring the taxpayer within the sweep of the discharge of indebtedness rules, then, the IRS must show that one of the two prongs in the § 108(d)(1) test is satisfied. It has not been demonstrated that Zarin satisfies either.

Because the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law [footnote omitted], it is clearly not a debt "for which the taxpayer is liable." I.R.C. § 108(d)(1)(A). Liability implies a legally enforceable obligation to repay, and under New Jersey law, Zarin would have no such obligation.

Zarin did not have a debt subject to which he held property as required by § 108(d)(1)(B). Zarin's indebtedness arose out of his acquisition of gambling chips. The Tax Court held that gambling chips were not property, but rather, "a medium of exchange within the Resorts casino" and a "substitute for cash." Alternatively, the Tax Court viewed the chips as nothing more than "the opportunity to gamble and incidental services ..." We agree with the gist of these characterizations, and hold that gambling chips are merely an accounting mechanism to evidence debt.

... [U]nder New Jersey state law, gambling chips were Resorts' property until transferred to Zarin in exchange for the markers, at which point the chips became "evidence" of indebtedness (and not the property of Zarin).

Even were there no relevant legislative pronouncement on which to rely, simple common sense would lead to the conclusion that chips were not property in Zarin's hands. Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves were of little use to Zarin, other than as a means of facilitating gambling. ...

Although the Tax Court found that theoretically, Zarin could have redeemed the chips he received on credit for cash and walked out of the casino, the reality of the situation was quite different. Realistically, before cashing in his chips, Zarin would have been required to pay his outstanding IOUs. New Jersey state law requires casinos to "request patrons to apply any chips or plaques in their possession in reduction of personal checks or Counter Checks exchanged for purposes of gaming prior to exchanging such chips or plaques for cash or prior to departing from the casino area." N.J. ADMIN. CODE tit. 19k, § 19:45–1.24(s) (1979) (currently N.J. ADMIN. CODE tit. 19k, § 19:45–1.25(*o*) (1990) (as amended)). Since his debt at all times equalled or exceeded the number of chips he possessed, redemption would have left Zarin with no chips, no cash, and certainly nothing which could have been characterized as property.

Not only were the chips non-property in Zarin's hands, but upon transfer to Zarin, the chips also ceased to be the property of Resorts. Since the chips were in the possession of another party, Resorts could no longer do with the chips as it pleased, and could no longer control the chips' use. Generally, at the time of a transfer, the party in possession of the chips can gamble with them, use them for services, cash them in, or walk out of the casino with them as an Atlantic City souvenir. The chips therefore become nothing more than an accounting mechanism, or evidence of a debt, designed to facilitate gambling in casinos where the use of actual money was forbidden. [footnote omitted]. Thus, the chips which Zarin held were not property within the meaning of I.R.C. § 108(d)(1)(B). [footnote omitted].

In short, because Zarin was not liable on the debt he allegedly owed Resorts, and because Zarin did not hold "property" subject to that debt, the cancellation of indebtedness provisions of the Code do not apply to the settlement between Resorts and Zarin. As such, Zarin cannot have income from the discharge of his debt.

IV.

Instead of analyzing the transaction at issue as cancelled debt, we believe the proper approach is to view it as disputed debt or contested liability. Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded for both loss and debt accounting purposes. Thus, if a taxpayer took out a loan for $10,000, refused in good faith to pay the full $10,000 back, and then reached an agreement with the lender that he would pay back only $7000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was $7000. When the taxpayer tenders the $7000 payment, he will have been deemed to have paid the full amount of the initially disputed debt. Accordingly, there is no tax consequence to the taxpayer upon payment.

The seminal "contested liability" case is *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939). In *Sobel*, the taxpayer exchanged a $21,700 note for 100 shares of stock from a bank. In the following year, the taxpayer sued the bank for recision [sic], arguing that the bank loan was violative of state law, and moreover, that the bank had failed to perform certain promises. The parties eventually settled the case in 1935, with the taxpayer agreeing to pay half of the face amount of the note. In the year of the settlement, the taxpayer claimed the amount paid as a loss. The Commissioner denied the loss because it had been sustained five years earlier, and further asserted that the taxpayer recognized income from the discharge of half of his indebtedness.

The Board of Tax Appeals held that since the loss was not fixed until the dispute was settled, the loss was recognized in 1935, the year of the settlement, and the deduction was appropriately taken in that year. Additionally, the Board held that the portion of the note forgiven by the bank "was not the occasion for a freeing of assets and that there was no gain ..." *Id*. at 1265. Therefore, the taxpayer did not have any income from cancellation of indebtedness.

There is little difference between the present case and *Sobel*. Zarin incurred a $3,435,000 debt while gambling at Resorts, but in court, disputed liability on the basis of unenforceability. A settlement of $500,000 was eventually agreed upon. It follows from *Sobel* that the settlement served only to fix the amount of debt. No income was realized or recognized. When Zarin paid the $500,000, any tax consequence dissolved.[62]

Only one other court has addressed a case factually similar to the one before us. In *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962), the taxpayer owed an unenforceable gambling debt alleged to be $225,000. Subsequently, the taxpayer and the creditor settled for $150,000. The taxpayer then transferred cattle valued at $148,110 to his creditor in

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[62] Had Zarin not paid the $500,000 dollar settlement, it would be likely that he would have had income from cancellation of indebtedness. The debt at that point would have been fixed, and Zarin would have been legally obligated to pay it.

satisfaction of the settlement agreement. A jury held that the parties fixed the debt at $150,000, and that the taxpayer recognized income from cancellation of indebtedness equal to the difference between the $150,000 and the $148,110 value affixed to the cattle. Arguing that the taxpayer recognized income equal to the difference between $225,000 and $148,000, the Commissioner appealed.

The Tenth Circuit rejected the idea that the taxpayer had any income from cancellation of indebtedness. Noting that the gambling debt was unenforceable, the Tenth Circuit said, "The cold fact is that taxpayer suffered a substantial loss from gambling, the amount of which was determined by the transfer." *Id*. at 241. In effect, the Court held that because the debt was unenforceable, the amount of the loss and resulting debt cognizable for tax purposes were fixed by the settlement at $148,110. Thus, the Tenth Circuit lent its endorsement to the contested liability doctrine in a factual situation strikingly similar to the one at issue.[63]

The Commissioner argues that *Sobel* and the contested liability doctrine only apply when there is an unliquidated debt; that is, a debt for which the amount cannot be determined. *See Colonial Sav. Ass'n v. Commissioner*, 85 T.C. 855, 862–863 (1985) (*Sobel* stands for the proposition that "there must be a liquidated debt"), *aff'd*, 854 F.2d 1001 (7th Cir.1988). *See also N. Sobel, Inc. v. Commissioner*, 40 B.T.A. at 1265 (there was a dispute as to "liability and the amount" of the debt). Since Zarin contested his liability based on the unenforceability of the entire debt, and did not dispute the amount of the debt, the Commissioner would have us adopt the reasoning

[63] The Commissioner argues that the decision in Hall was based on United States Supreme Court precedent since overruled, and therefore Hall should be disregarded. Indeed, the Hall court devoted a considerable amount of time to Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926), a case whose validity is in question. We do not pass on the question of whether or not Bowers is good law. We do note that Hall relied on *Bowers* only for the proposition that "'a court need not in every case be oblivious to the net effect of the entire transaction.'" United States v. Hall, 307 F.2d at 242, *quoting* Bradford v. Commissioner, 233 F.2d 935, 939 (6th Cir. 1956). Hall's reliance on Bowers did not extend to the issue of contested liability, and even if it did, the idea that "Courts need not apply mechanical standards which smother the reality of a particular transaction," *id.* at 241, is hardly an exceptional concept in the tax realm. *See* Commissioner v. Tufts, 461 U.S. 300 (1983); Hillsboro Nat'l Bank v. Commissioner, 460 U.S. 370 (1983).

of the Tax Court, which found that Zarin's debt was liquidated, therefore barring the application of Sobel and the contested liability doctrine. *Zarin*, 92 T.C. at 1095 (Zarin's debt "was a liquidated amount" and "[t]here is no dispute about the amount [received].").

We reject the Tax Court's rationale. When a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute. Although a debt may be unenforceable, there still could be some value attached to its worth. This is especially so with regards to gambling debts. In most states, gambling debts are unenforceable, and have "but slight potential ..." *United States v. Hall*, 307 F.2d 238, 241 (10th Cir.1962). Nevertheless, they are often collected, at least in part. For example, Resorts is not a charity; it would not have extended illegal credit to Zarin and others if it did not have some hope of collecting debts incurred pursuant to the grant of credit.

Moreover, the debt is frequently incurred to acquire gambling chips, and not money. Although casinos attach a dollar value to each chip, that value, unlike money's, is not beyond dispute, particularly given the illegality of gambling debts in the first place. This proposition is supported by the facts of the present case. Resorts gave Zarin $3.4 million dollars of chips in exchange for markers evidencing Zarin's debt. If indeed the only issue was the enforceabilty of the entire debt, there would have been no settlement. Zarin would have owed all or nothing. Instead, the parties attached a value to the debt considerably lower than its face value. In other words, the parties agreed that given the circumstances surrounding Zarin's gambling spree, the chips he acquired might not have been worth $3.4 million dollars, but were worth something. Such a debt cannot be called liquidated, since its exact amount was not fixed until settlement.

To summarize, the transaction between Zarin and Resorts can best be characterized as a disputed debt, or contested liability. Zarin owed an unenforceable debt of $3,435,000 to Resorts. After Zarin in good faith disputed his obligation to repay the debt, the parties settled for $500,000, which Zarin paid. That $500,000 settlement fixed the amount of loss and the amount of debt cognizable for tax purposes. Since Zarin was deemed to have owed $500,000, and since he paid Resorts $500,000, no adverse tax consequences attached to Zarin as a result. [footnote omitted].

V.

In conclusion, we hold that Zarin did not have any income from cancellation of indebtedness for two reasons. First, the Code provisions covering discharge of debt are inapplicable since the definitional requirement in I.R.C. § 108(d)(1) was not met. Second, the settlement of Zarin's gambling debts was a contested liability. We reverse the decision of the Tax Court and remand with instructions to enter judgment that Zarin realized no income by reason of his settlement with Resorts.

STAPLETON, Circuit Judge, dissenting.

[C.J. Stapleton wrote an opinion agreeing with the Tax Court's majority opinion.]

Notes and Questions:

1. *Any* other person would have had to pay $3.4M for 3.4M chips. How can the majority conclude that their value is in dispute?

2. Zarin's gambling attracted crowds, which was good for the business of Resorts International. Could the chips be regarded as compensation?

   • It would go too far to argue that the "dominant purpose" of Resorts International in giving chips to Zarin was to benefit itself by attracting such crowds. *Cf. Gotcher*.

3. Does a compulsive gambler such as Mr. Zarin realize an accession to wealth or "value" by gambling more?

4. Taxpayer argued that "discharge of his gambling debt was income from gambling against which he may offset his losses."

   • This does not treat the loan and use of the chips as separate transactions.

5. Should borrowing from a casino to purchase the casino's chips be different than borrowing from a furniture store to buy the store's furniture or from a car dealership to buy one of the dealership's cars?

6. Articulate the policies behind state laws that make debts unenforceable? Do any of these policies suggest anything about whether there was an accession to wealth?

- unconscionable contracts are not enforceable because of unequal bargaining power;
- illegal contracts are not enforceable because the state will not lend its assistance to enforce an illegal bargain;
- some contracts are unenforceable because the state deems normal presumptions about rationality and the ability to know what is beneficial to oneself inapplicable in certain circumstances, e.g., contract with a minor or incompetent.

7. The majority relies heavily on § 108(d)(1). Why? Is this provision applicable to the case at all?

8. What is left of the liquidated debt doctrine?

- What if the debtor reaches a compromise with the creditor, but never actually disputed that s/he/it owed the creditor a sum certain? *See Melvin v. Commissioner*, T.C. Memo 2009-199, 2009 WL 2869816 (2009); *Rood v. Commissioner*, TC Memo 1996-248, 1996 WL 280899 (1996) (gambling debt).

9. You should be aware of the rule of § 108(e)(5) for purchase price reductions. How does that rule apply when the seller of a service lends money to a customer to purchase the service?

10. Consider:

- 10a. Taxpayer engaged the services of Attorney and incurred a bill of $1000. The fmv of taxpayer's assets is $10,000, and taxpayer has $5000 of cash. Taxpayer has liabilities of $25,000. Taxpayer was most interested in not parting with any cash and so entered an agreement to do 80 hours of filing and word processing for Attorney. After taxpayer performed these services, Attorney told taxpayer that "you owe me nothing." Now taxpayer's liabilities are $24,000, and she has assets with fmv = $10,000 plus $5000 cash. How much doi income must Taxpayer report?

> •*See Canton v. United States*, 226 F.2d 313, 317-18 (8th Cir. 1955), *cert. denied*, 350 U.S. 965 (1956).

•10b. Taxpayer borrowed $25,000 from her uncle to pay for her third year of law school at one of America's "Best Value Law Schools" (according to preLaw Magazine). Taxpayer and her uncle formalized the arrangement in writing, taxpayer to pay 6% interest on her declining balance once she began making payments to her uncle after law school. At Taxpayer's commencement day party, her uncle announced to her that "I forgive the loan I made to you. You are free and clear as far as I'm concerned." At the time, Taxpayer's liabilities (including the $25,000 owed to her uncle) did *not* exceed the fmv of her assets. How much doi income must taxpayer report?

•10c. Taxpayer, a highly skilled craftsman, entered into a contract to produce a custom-made table for Customer's dining room. Customer paid Taxpayer $2000 on the day they entered the agreement with a promise to pay $2000 more on delivery. Taxpayer was to deliver the table six months after signing. Taxpayer never got around to producing the table. At first, Customer patiently waited past the contractual deadline for the table, but finally sued for a refund of the $2000. Customer had waited more than 6 years to bring the suit, so it was dismissed as not having been brought within the limitation period.

> •True or false: Taxpayer does not have doi income because the debt is unenforceable.
>
> •*See, e.g.*, *Securities Co. v. United States*, 85 F. Supp. 532, (S.D.N.Y. 1948).

•10d. Taxpayer took his automobile to Repair Shop to have some routine maintenance work done. Repair Shop promised to do the work for $300. When Taxpayer returned to pick up his automobile, he told Repair Shop that he only had $250 in cash, but would get the rest by tomorrow. Repair Shop manager responded by saying, "Gimme the $250 and forget the rest." Taxpayer is solvent throughout. How much doi income must Taxpayer report?

•10e. Bank is a debtor to its depositors. The agreement between Bank and depositors provides for a penalty on early withdrawals of certificates of deposit by depositors. The penalty is assessed at the time of withdrawal by simply reducing the interest rate that the Bank had previously promised to pay depositor from 3% to 1.75%. Hence Bank pays depositor less than it had promised to pay depositor at the time the certificate of deposit was purchased. May Bank report the early withdrawal penalties that it "collects" as doi income?

•*See United States v. Centennial Savings Bank FSB*, 499 U.S. 573 (1991).

IV. Section 108(a)'s Other Provisions

Section 108 codifies and limits court-developed rules that govern the discharge of indebtedness of debtors who are in bankruptcy or insolvent. Section 108 also provides rules governing discharge of indebtedness of a (1) taxpayer's qualified farm indebtedness (§ 108(a)(1)(C)), (2) a non-subchapter C taxpayer's qualified real property business indebtedness (§ 108(a)(1)(D)), and (3) a taxpayer's qualified principal residence indebtedness discharged before January 1, 2013 (§ 108(a)(1)(D)).

•"Qualified farm indebtedness" is debt (but not purchase money debt) that a taxpayer incurred "in connection with" taxpayer's operation of a farming trade or business, § 108(g)(1). The lender – and so the party discharging the debt – must be a government agency or an unrelated person engaged in the business of lending, § 108(g)(1)(B) (referencing § 49(a)(1)(D)(iv)). After making adjustments to tax attributes under the insolvency provisions of § 108, § 108(g)(3)(D), a solvent taxpayer may exclude debt that the lender discharges up to the sum of taxpayer's adjusted tax attributes plus the aggregate adjusted bases of trade or business property or property held for the production of income. §§ 108(g)(3)(A), 108(g)(3)(C). Taxpayer then reduces tax attributes as per § 108(b) and § 108(g)(3)(B). Section 1017(b)(4) governs the bases reduction(s). The "qualified farm indebtedness" rules give solvent farmers many of the benefits that § 108 gives to insolvent debtors.

•"Qualified real property business indebtedness" is debt (other than "qualified farm indebtedness") that taxpayer incurs or assumes "in connection with" real property that secures the debt that taxpayer uses in a trade or business. § 108(c)(3)(A). The amount discharged reduces the bases of taxpayer's "depreciable real property" to the extent that the loan principal immediately before the discharge exceeds the adjusted bases of such property (less the principal amount of any other loans that the same property secures). § 108(c)(2)(A). Section 1017(b)(3)(F) governs the bases reduction(s). The amount of such basis reduction(s) cannot in the aggregate exceed the adjusted bases of all of taxpayer's depreciable real property determined after reduction of tax attributes because of insolvency or bankruptcy or for reduction of qualified farm indebtedness. § 108(c)(2)(B). This provision should reduce the incentive of a taxpayer to walk away from encumbered property that is (or was) "under water," despite the fact that a lender has been willing to discharge some of the debt.

•"Qualified principal residence indebtedness" is up to $2M of debt that taxpayer incurred to acquire, construct, or substantially improve taxpayer's principal residence, which secures the loan. § 108(h)(2), § 108(h)(5). The amount discharged reduces taxpayer's basis in the home, but not below $0. § 108(h)(1). Congress enacted § 108(a)(1)(E) in response to the financial crisis and to encourage homeowners not to default on their home mortgages when they are "under water." Notice that unlike the case of "qualified real property business indebtedness," the amount of permissible basis reduction is the taxpayer's basis in the home, not the amount by which taxpayer's basis exceeds the property's fmv. This provision will not apply to discharges of "qualified principal residence indebtedness" that occur after December 31, 2012.

•Another measure that Congress adopted in response to the financial crisis is § 108(i). During the ongoing financial crisis, corporations may engage in *Kirby Lumber*-type transactions, i.e., they may purchase their own debt for less than the amount that they borrowed. Corporations and other taxpayers engaged in a trade or business may restructure their debts by acquiring them for cash, for another (modified) debt instrument, or for an equity interest. A business with serious cash flow problems – which gave rise to the restructuring in the first place – may not be in a position to pay income tax on resulting doi income because doi income is not income that a taxpayer realizes in cash. Section 108(i) permits taxpayers with doi income resulting from the reacquisition of debt during 2009 and 2010 to defer recognition until 2014 *and then* to recognize a ratable portion of that debt over a five-year period. § 108(a)(1).

V. Transactions Involving Property Subject to a Loan

Taxpayer may use the proceeds of a loan – perhaps from the seller of property or from a third-party lender – to purchase property and to give the property so purchased as security or collateral for the loan. Such property is "encumbered by" or "subject to" the outstanding principal amount of the loan. Can borrower count the money that she/he/it borrowed as part of her/his/its basis when in fact taxpayer did not purchase the property with after-tax money?

•Yes. Borrower has an obligation to repay the loan and will repay it with money that has been subject to income tax. It does not matter whether borrower borrowed the money from the seller or a third party.

•When borrower sells the property subject to the loan, the buyer will pay the fmv of the property minus the loan balance. The buyer is treated as having paid the borrower/seller cash equal to the amount of the loan balance. Thus, the seller must include the loan

balance in her/his/its "amount realized" under § 1001(a).
•Once we permit the borrower to use untaxed borrowed funds to obtain basis in property, the rest of the analysis must follow.
•We assume that the borrower will honor his/her/its obligation to repay the loan.
•Consider:

- •Taxpayer owns Blackacre. She bought it for $10,000, and its ab = $10,000. At a time when the fmv of Blackacre was $50,000, Taxpayer borrowed $30,000 and put up Blackacre as collateral. Taxpayer sold Blackacre to Buyer who paid her $20,000 cash and assumed the $30,000 loan secured by Blackacre. What is Taxpayer's taxable gain?
    - •May taxpayer treat the amount borrowed as part of his/her/its adjusted basis in the property? Why?

- •Taxpayer borrows $30,000 from Bank. Taxpayer uses the borrowed money to purchase Whiteacre for $30,000; taxpayer also gives a mortgage to Bank. Taxpayer sold Whiteacre to Buyer for $20,000 cash plus assumption of the $30,000 loan. What is taxpayer's taxable gain?
    - •May taxpayer treat the amount borrowed as part of his/her/its adjusted basis in the property? Why?

- •When do loan proceeds count in basis? When do they not count in basis? What does the Supreme Court say about this in *Tufts*, *infra*? Keep track of the amount of gross income on which taxpayer *should* have paid income tax.

•Consider the following two arrangements by which lender and borrower might structure a loan:

Recourse obligation: A recourse obligation is one for which the borrower is *personally liable*. In the event that the borrower defaults and the collateral that the borrower put up to obtain the loan is insufficient to satisfy the borrower's obligation, the lender may pursue other assets of the borrower in order to satisfy the debt. The risk that a loss may occur because the fmv of the property decreases prior to default thus falls on the borrower.

•This point may encourage a borrower to pay down a loan, even when its principal amount is greater than the fmv of the property securing the loan. Otherwise, the borrower may lose other assets that he/she/it owns.

•If the creditor accepts the collateral as full payment, taxpayer must recognize gain on the disposition of the collateral as if he/she/it had sold it for its fmv.

•If the creditor accepts the collateral as full payment *and* the fmv of the property is less than the principal amount of the loan, the difference is doi income. *Gehl*, *supra*.

Nonrecourse obligation: A nonrecourse obligation is one for which the borrower is *not personally liable*. Thus, in the event of the borrower's default, the lender may pursue only the property offered as collateral for the loan. The risk that a loss may occur because the fmv of the property decreases prior to default thus falls entirely on the lender.

•When the fmv of the property is greater than the loan amount, the borrower has an economic incentive to continue making payments on the loan. A borrower should willingly repay a nonrecourse loan of $80 in order to obtain property whose fmv is $100.

•But: if the fmv of the property is less than the outstanding balance of a nonrecourse loan, the borrower may (should?) profitably "walk away." After all, why should a borrower pay down a nonrecourse loan of $100 in order to obtain a piece of property whose fmv is $80?

•This point provides encouragement for lenders to reduce the amount of nonrecourse debt that borrowers owe them when the value of the underlying collateral decreases. *Cf.* § 108(a)(1)(C, D, E).

•If a nonrecourse borrower defaults on a loan and surrenders the property he/she/it put up as collateral whose fmv is less than the loan principal, exactly how much doi results from a *freeing of assets*?

•This question may arise when a borrower sells or surrenders property subject to a nonrecourse obligation at a time when the fmv of the underlying property is less than the principal of the nonrecourse obligation.

•What would be the rule if the obligation were a recourse obligation?

•Arguably, a taxpayer who sells or surrenders property subject to a nonrecourse obligation should be permitted to deduct loss to the extent § 165 permits. The loss on the sale or surrender of property subject to a non-recourse obligation would be the adjusted basis in the property minus its fmv. Prior to *Tufts*, this was the position many taxpayers took upon sale or surrender of property subject to a nonrecourse obligation because

> [t]he return of a note which represents no personal liability of a taxpayer does not free any assets except those from which the note might otherwise have been paid. Since the underlying theory of income from cancellation of indebtedness is the freeing of the debtor's assets from liability for the debt, any such income is limited to the amount of assets freed by the cancellation.

Collins v. CIR, T.C. Memo 1963-285, 1963 WL 613 (1963).

•How does the treatment that taxpayers routinely accorded loss property subject to a nonrecourse obligation violate the first guiding principle of the income tax noted in chapter 1, *supra*?

•Notice the contention of the taxpayer in the following important case.

Commissioner v. Tufts, 461 U.S. 300 (1983).

JUSTICE BLACKMUN delivered the opinion of the Court.

Over 35 years ago, in *Crane v. Commissioner*, 331 U.S. 1 (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.

I

On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. Six days later, the partnership entered into a mortgage loan agreement with the Farm & Home Savings Association (F&H). Under the agreement, F&H was committed for a $1,851,500 loan for the complex. In return, the partnership executed a note and a deed of trust in favor of F&H. The partnership obtained the loan on a nonrecourse basis: neither the partnership nor its partners assumed any personal liability for repayment of the loan. Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership.

The construction of the complex was completed in August, 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was $44,212. In each tax year, all partners claimed as income tax deductions their allocable shares of ordinary losses and depreciation. The deductions taken by the partners in 1971 and 1972 totalled $439,972. Due to these contributions and deductions, the partnership's adjusted basis in the property in August, 1972, was $1,455,740.

In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of workers. As a result, the partnership's rental income was less than expected, and it was unable to make the payments due on the mortgage. Each partner, on August 28, 1972, sold his partnership interest to an unrelated third party, Fred Bayles. As consideration, Bayles agreed to reimburse each partner's sale expenses up to $250; he also assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed $1,400,000. Each partner reported the sale on his federal income tax return and indicated that a partnership loss of $55,740 had been sustained.[64] The Commissioner of Internal Revenue, on audit, determined that the sale resulted in a partnership capital gain of approximately $400,000. His theory was that the partnership had realized the full amount of the nonrecourse obligation.[65]

Relying on *Millar v. Commissioner*, 577 F.2d 212, 215 (CA3), *cert. denied*, 439 U.S. 1046 (1978), the United States Tax Court, in an unreviewed decision, upheld the asserted deficiencies. The United States Court of Appeals for the Fifth Circuit reversed. That court expressly disagreed with the *Millar* analysis, and, in limiting *Crane v. Commissioner*, *supra*, to its facts, questioned the theoretical underpinnings of the *Crane* decision. We granted certiorari to resolve the conflict.

II

... Section 1001 governs the determination of gains and losses on the disposition of property. Under § 1001(a), the gain or loss from a sale or other disposition of property is defined as the difference between "the

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[64] The loss was the difference between the adjusted basis, $1,455,740, and the fair market value of the property, $1,400,000. ... [You should recognize that this was the treatment that the Tax Court accorded such transactions in *Collins*, *supra*.]

[65] The Commissioner determined the partnership's gain on the sale by subtracting the adjusted basis, $1,455,740, from the liability assumed by Bayles, $1,851,500. Of the resulting figure, $395,760, the Commissioner treated $348,661 as capital gain, pursuant to § 741 of the Internal Revenue Code of 1954, and $47,099 as ordinary gain under the recapture provisions of § 1250 of the Code. The application of § 1250 in determining the character of the gain is not at issue here.

amount realized" on the disposition and the property's adjusted basis. Subsection (b) of § 1001 defines "amount realized:"

> "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

At issue is the application of the latter provision to the disposition of property encumbered by a nonrecourse mortgage of an amount in excess of the property's fair market value.

A

In *Crane v. Commissioner*, *supra*, this Court took the first and controlling step toward the resolution of this issue. Beulah B. Crane was the sole beneficiary under the will of her deceased husband. At his death in January, 1932, he owned an apartment building that was then mortgaged for an amount which proved to be equal to its fair market value, as determined for federal estate tax purposes. The widow, of course, was not personally liable on the mortgage. She operated the building for nearly seven years, hoping to turn it into a profitable venture; during that period, she claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make payments upon the mortgage principal. In computing her basis for the depreciation deductions, she included the full amount of the mortgage debt. In November, 1938, with her hopes unfulfilled and the mortgagee threatening foreclosure, Mrs. Crane sold the building. The purchaser took the property subject to the mortgage and paid Crane $3,000; of that amount, $500 went for the expenses of the sale.

Crane reported a gain of $2,500 on the transaction. She reasoned that her basis in the property was zero (despite her earlier depreciation deductions based on including the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received. The Commissioner disputed this claim. He asserted that Crane's basis in the property, under [what is now § 1014] was the property's fair market value at the time of her husband's death, adjusted for depreciation in the interim, and that the amount realized was the net cash received plus the amount of the outstanding mortgage assumed by the purchaser.

> *Taxpayer's equity in property*: Taxpayer's "equity in property" is the value of taxpayer's ownership interest. If the property is subject to a liability, then taxpayer's equity interest EQUALS the fmv of the property MINUS the liability to which the property is subject.

In upholding the Commissioner's interpretation of § [1014] [footnote omitted], the Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each payment on the mortgage. The Court rejected Crane's claim that any loss due to depreciation belonged to the mortgagee. The effect of the Court's ruling was that the taxpayer's basis was the value of the property undiminished by the mortgage.

The Court next proceeded to determine the amount realized under [what is now § 1001(b)]. In order to avoid the "absurdity," of Crane's realizing only $2,500 on the sale of property worth over a quarter of a million dollars, the Court treated the amount realized as it had treated basis, that is, by including the outstanding value of the mortgage. To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss. The Court refused to construe one section of the Revenue Act so as "to frustrate the Act as a whole."

> *Boot*: The term "boot" comes from the idiomatic phrase "to boot." This common idiom has become an important concept in much of tax law. In this case, there was an exchange of property for assumption of a mortgage, plus a little cash "to boot." Depending on how much tax law you study, this is most certainly not the last time or the only context in which you will encounter the word.

Crane, however, insisted that the nonrecourse nature of the mortgage required different treatment. The Court, for two reasons, disagreed. First, excluding the nonrecourse debt from the amount realized would result in the same absurdity and frustration of the Code. Second, the Court concluded that Crane obtained an economic benefit from the purchaser's assumption of the mortgage identical to the benefit conferred by the cancellation of personal debt. Because the value of the property in that case exceeded the amount of the mortgage, it was in Crane's economic interest to treat the mortgage as a personal obligation; only by so doing could she realize upon sale the appreciation in her equity represented by the $2,500 boot. The purchaser's assumption of the liability thus resulted in a taxable economic benefit to her, just as if she had been given, in addition to the boot, a sum of cash sufficient to satisfy the mortgage.[66] In a footnote, pertinent to the present case, the Court observed:

> "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case."

331 U.S. at 14, n. 37.

B

This case presents that unresolved issue. We are disinclined to overrule *Crane*, and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies *Crane*'s holdings that the amount

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[66] Crane also argued that, even if the statute required the inclusion of the amount of the nonrecourse debt, that amount was not Sixteenth Amendment income because the overall transaction had been "by all dictates of common sense ... a ruinous disaster." The Court noted, however, that Crane had been entitled to and actually took depreciation deductions for nearly seven years. To allow her to exclude sums on which those deductions were based from the calculation of her taxable gain would permit her "a double deduction ... on the same loss of assets." The Sixteenth Amendment, it was said, did not require that result.

of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.

When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under § 1012, is part of the taxpayer's cost of the property. Although a different approach might have been taken with respect to a nonrecourse mortgage loan,[67] the Commissioner has chosen to accord it the same treatment he gives to a recourse mortgage loan. The

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[67] The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1514 (1982); Lurie, *Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability*, 6 TAX L. REV. 319, 323 (1951); *cf.* Brief for Respondents 16 (nonrecourse debt resembles preferred stock). Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis. Note, 82 COLUM. L. REV. at 1515; *cf.* Gibson Products Co. v. United States, 637 F.2d 1041, 1047-1048 (CA5 1981) (contingent nature of obligation prevents inclusion in basis of oil and gas leases of nonrecourse debt secured by leases, drilling equipment, and percentage of future production).

... We note only that the Crane Court's resolution of the basis issue presumed that, when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. 331 U.S. at 6. Under the Crane approach, the mortgagee is entitled to no portion of the basis. *Id.* at 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. *But see* Note, 82 COLUM. L. REV. at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that Crane departed from traditional analysis that basis is taxpayer's investment in property).

Court approved that choice in *Crane*, and the respondents do not challenge it here. The choice and its resultant benefits to the taxpayer are predicated on the assumption that the mortgage will be repaid in full.

When encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized. [footnote omitted]. *See United States v. Hendler*, 303 U.S. 564, 566-567 (1938). Because no difference between recourse and nonrecourse obligations is recognized in calculating basis [footnote omitted], *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended, and will have received an unwarranted increase in the basis of his property. [footnote omitted]. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.

C

The Commissioner, in fact, has applied this rule even when the fair market value of the property falls below the amount of the nonrecourse obligation. Reg. § 1.1001-2(b) [footnote omitted]; Rev. Rul. 76-111. Because the theory on which the rule is based applies equally in this situation, *see Millar v. Commissioner*, 67 T.C. 656, 660 (1977), *aff'd on this* *issue*, 577 F.2d 212, 215-216 (CA3), *cert. denied*, 439 U.S. 1046 (1978);[68] *Mendham Corp. v. Commissioner*, 9 T.C. 320, 323-324 (1947); *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688-689 (1943), we have no reason, after *Crane*, to question this treatment.[69]

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[68] The Court of Appeals for the Third Circuit, in Millar, affirmed the Tax Court on the theory that inclusion of nonrecourse liability in the amount realized was necessary to prevent the taxpayer from enjoying a double deduction. 577 F.2d at 215; *cf.* n 4, *supra*. Because we resolve the question on another ground, we do not address the validity of the double deduction rationale.

[69] Professor Wayne G. Barnett, as amicus in the present case, argues that the liability and property portions of the transaction should be accounted for separately. Under his view, there was a transfer of the property for $1.4 million, and there was a cancellation of the $1.85 million obligation for a payment of $1.4 million. The former resulted in a capital loss of $50,000, and the latter in the realization of $450,000 of ordinary income. Taxation of the ordinary income might be deferred under § 108 by a reduction of respondents' bases in their partnership interests.

Although this indeed could be a justifiable mode of analysis, it has not been adopted by the Commissioner. Nor is there anything to indicate that the Code requires the Commissioner to adopt it. We note that Professor Barnett's approach does assume that recourse and nonrecourse debt may be treated identically.

The Commissioner also has chosen not to characterize the transaction as cancellation of indebtedness. We are not presented with, and do not decide, the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here – an obligation to repay – but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation. *See* Commissioner v. Jacobson, 336 U.S. 28, 38-40 (1949); United States v. Kirby Lumber Co., 284 U.S. 1, 284 U.S. 3 (1931). According to that view, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. *See* Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519, 520 (1934). Because that interpretation attributes income only when assets are freed, however, an insolvent debtor realizes income just to the extent his assets exceed his liabilities after the cancellation. Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289, 292 (1937). Similarly, if the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled, because the tax law has not recognized negative basis.

Although the economic benefit prong of Crane also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach. In the context of a sale or disposition of property

Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. The only difference between that mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. [footnote omitted]. If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.

This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free, and included them in his basis on the understanding that he had an obligation to repay the full amount. *See Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357, 359 (CA2 1952); Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, at 284 n.7 (1978). When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received, and thus realizes value to that extent within the meaning of § 1001(b). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.

Moreover, this approach avoids the absurdity the Court recognized in *Crane*. Because of the remedy accompanying the mortgage in the nonrecourse situation, the depreciation in the fair market value of the property is relevant economically only to the mortgagee, who, by lending on a nonrecourse basis, remains at risk. To permit the taxpayer to limit his

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under § 1001, the extinguishment of the obligation to repay is not ordinary income; instead, the amount of the canceled debt is included in the amount realized, and enters into the computation of gain or loss on the disposition of property. According to Crane, this treatment is no different when the obligation is nonrecourse: the basis is not reduced as in the cancellation-of-indebtedness context, and the full value of the outstanding liability is included in the amount realized. Thus, the problem of negative basis is avoided.

realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss. [footnote omitted]. Such a result would be to construe "one section of the Act ... so as ... to defeat the intention of another or to frustrate the Act as a whole." 331 U.S. at 13.

In the specific circumstances of *Crane*, the economic benefit theory did support the Commissioner's treatment of the nonrecourse mortgage as a personal obligation. The footnote in *Crane* acknowledged the limitations of that theory when applied to a different set of facts. *Crane* also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan. We therefore hold that a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis. Nothing in either § 1001(b) or in the Court's prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property. [citation omitted].

III

....

IV

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. The fair market value of the property is irrelevant to this calculation. We find this interpretation to be consistent with *Crane v. Commissioner*, 331 U.S. 1 (1947), and to implement the statutory mandate in a reasonable manner. [citation omitted].

The judgment of the Court of Appeals is therefore reversed.

It is so ordered.

JUSTICE O'CONNOR, concurring.

I concur in the opinion of the Court, accepting the view of the Commissioner. I do not, however, endorse the Commissioner's view. Indeed, were we writing on a slate clean except for the decision in *Crane v. Commissioner*, 331 U.S. 1 (1947), I would take quite a different approach – that urged upon us by Professor Barnett as amicus.

Crane established that a taxpayer could treat property as entirely his own, in spite of the "coinvestment" provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any way tie nonrecourse debt to the cost of property or to the proceeds upon disposition. I see no reason to treat the purchase, ownership, and eventual disposition of property differently because the taxpayer also takes out a mortgage, an independent transaction. In this case, the taxpayer purchased property, using nonrecourse financing, and sold it after it declined in value to a buyer who assumed the mortgage. There is no economic difference between the events in this case and a case in which the taxpayer buys property with cash; later obtains a nonrecourse loan by pledging the property as security; still later, using cash on hand, buys off the mortgage for the market value of the devalued property; and finally sells the property to a third party for its market value.

The logical way to treat both this case and the hypothesized case is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan. Under *Crane*, the fair market value of the property on the date of acquisition – the purchase price – represents the taxpayer's basis in the property, and the fair market value on the date of disposition represents the proceeds on sale. The benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than the fair market value of the property, for that is all the mortgagee can expect to collect on the mortgage. His gain or loss on the disposition of the property equals the difference between the proceeds and the cost of acquisition. Thus, the taxation of the transaction in property reflects the economic fate of the property. If the property has declined in value, as was the case here, the taxpayer recognizes a loss on the disposition of the property. The new purchaser then takes as his basis the fair market value as of the date of the sale. [citations omitted].

In the separate borrowing transaction, the taxpayer acquires cash from the mortgagee. He need not recognize income at that time, of course, because he also incurs an obligation to repay the money. Later, though, when he is able to satisfy the debt by surrendering property that is worth less than the face amount of the debt, we have a classic situation of cancellation of indebtedness, requiring the taxpayer to recognize income in the amount of the difference between the proceeds of the loan and the amount for which he is able to satisfy his creditor. 26 U.S.C. § 61(a)(12). The taxation of the financing transaction then reflects the economic fate of the loan.

The reason that separation of the two aspects of the events in this case is important is, of course, that the Code treats different sorts of income differently. A gain on the sale of the property may qualify for capital gains treatment, §§ 1202, 1221, while the cancellation of indebtedness is ordinary income, but income that the taxpayer may be able to defer. §§ 108, 1017. Not only does Professor Barnett's theory permit us to accord appropriate treatment to each of the two types of income or loss present in these sorts of transactions, it also restores continuity to the system by making the taxpayer-seller's proceeds on the disposition of property equal to the purchaser's basis in the property. Further, and most important, it allows us to tax the events in this case in the same way that we tax the economically identical hypothesized transaction.

Persuaded though I am by the logical coherence and internal consistency of this approach, I agree with the Court's decision not to adopt it judicially. We do not write on a slate marked only by *Crane*. The Commissioner's longstanding position, Rev. Rul. 76-111, is now reflected in the regulations. Reg. § 1.1001-2 (1982). In the light of the numerous cases in the lower courts including the amount of the unrepaid proceeds of the mortgage in the proceeds on sale or disposition [citations omitted], it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. As the Court's opinion demonstrates, his interpretation is defensible. One can reasonably read §

1001(b)'s reference to "the amount realized from the sale or other disposition of property" (emphasis added) to permit the Commissioner to collapse the two aspects of the transaction. As long as his view is a reasonable reading of § 1001(b), we should defer to the regulations promulgated by the agency charged with interpretation of the statute. [citations omitted]. Accordingly, I concur.

Notes and Questions:

> *Tax Shelters*: Tax shelters create a mismatch in timing between claiming deductions and reporting taxable gain. Taxpayer claims deductions against borrowed money and reports taxable gain only upon sale of the property. What might this mismatch in timing of deductions and taxable gain be worth? *See* present value tables, chapter 2, *supra*?

1. Notice that taxpayers' allowable depreciation deductions reduced their adjusted basis in the property. Why is it absolutely necessary that this be the rule?

> *Taxpayer's* ***Minimum Gain***: After *Tufts*, irrespective of the fmv of the property, taxpayer's *minimum* gain on its disposition is the amount of the nonrecourse loan assumed by the purchaser MINUS the adjusted basis of the property. Taxpayer simply will not realize less gain than that upon disposition of property subject to a nonrecourse loan. Do you see why?

- Aside from computation of gain under § 1001, what significance is there in the fact that taxpayer includes borrowed money in determining his/her/its adjusted basis in property?

2. What was in this for Fred Bayles? How was he going to profit by assuming a nonrecourse obligation that was greater than the fmv of the property?

3. Does this case unmoor cancellation of indebtedness income from the necessity of establishing a "freeing of assets" or a "shrinking of assets?"

- The Court's opinion does not treat *any* of the loan as having been cancelled. It is *all* included in "amount realized."

4. Read Reg. § 1.1001-2. It seems to apply Justice O'Connor's/Professor

Barnett's theory to discharge of *recourse* liability when the fmv of the property is less than the outstanding principal of the loan. Why the difference?

- Did the lender in *Tufts* discharge any indebtedness?

5. Property that is subject to depreciation is *not* a capital asset. § 1221(a)(2). A special wartime measure, § 1231, allows taxpayer to treat such property held for more than one year to be treated as a capital asset if a sale or disposition produces gain.

Rev. Rul. 90-16

....

Property transfer by insolvent taxpayer in satisfaction of debt secured by property. A transfer of property to a bank in satisfaction of a debt on which the taxpayer is personally liable and which is secured by the property is a disposition upon which gain is recognized under §§ 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the property exceeds the taxpayer's adjusted basis in the property.

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer's basis in satisfaction of a debt for which the taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under §§ 1001(c) and 61(a)(3) of the Internal Revenue Code?

FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, X obtained a loan from an unrelated bank. X was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of § 108(d)(3) of the Code) and defaulted on the debt. X negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released X from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000x dollars, X's adjusted basis in the subdivision was 8,000x dollars, and the amount due on the debt was 12,000x dollars, which did not represent any accrued but unpaid interest. After the transaction X was still insolvent.

LAW AND ANALYSIS

Sections 61(a)(3) and 61(a)(12) of the Code provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which § 108(a)(1)(B) applies, the amount excluded under § 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in § 108(d)(3)).

Reg. § 1.61-6(a) provides that the specific rules for computing the amount of gain or loss from dealings in property under § 61(a)(3) are contained in § 1001 and the regulations thereunder.

Section 1001(a) of the Code provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain.

Section 1001(b) of the Code provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Reg. § 1.1001-2(a)(1) provides that, except as provided in § 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under § 61(a)(12). Example (8) under § 1.1001-2(c) illustrates these rules as follows:

> Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 − $6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under § 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under § 108(a)(1)(B) of the Code, the full amount of X's discharge of indebtedness income is excluded from gross income because that amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a 'disposition' within the scope of the gain or loss provisions of § 1001 of the Code. *See Helvering v. Hammel*, 311 U.S. 504 (1941); *Electro- Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941); and *Danenberg v. Commissioner*, 73 T.C. 370 (1979), *acq*., 1980-2 C.B. 1.

HOLDING

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under §§ 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the subdivision transferred exceeds X's adjusted basis. Subject to the application of § 108 of the Code, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.

Notes and Questions:

1. What would have been the result if the adjusted basis of the property had been $7000x?

2. Why is it so important to this revenue ruling that taxpayer is insolvent?

3. You should recognize that the holding in *Gehl* is in exact accord with the IRS's position in this revenue ruling.

4. Read Reg. § 1.1001-3. You might have to get this regulation on Westlaw or Lexis. A "material modification" of a debt instrument results in an exchange for purposes of § 1001(a). What is the effect of this treatment?

5. Would the result have been the same if the loan had been without recourse? Read on.

Rev. Rul. 91-31
DISCHARGE OF INDEBTEDNESS

...

ISSUE

If the principal amount of an undersecured nonrecourse debt is reduced by the holder of the debt who was not the seller of the property securing the debt, does this debt reduction result in the realization of discharge of indebtedness income for the year of the reduction under § 61(a)(12) of the Internal Revenue Code or in the reduction of the basis in the property securing the debt?

FACTS

In 1988, individual A borrowed $1,000,000 from C and signed a note payable to C for $1,000,000 that bore interest at a fixed market rate payable annually. A had no personal liability with respect to the note, which was secured by an office building valued at $1,000,000 that A acquired from B with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was $800,000 and the outstanding principal on the note was $1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to $800,000. The modified note bore adequate stated interest within the meaning of § 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by § 108(a) do not apply.

LAW AND ANALYSIS

Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness. Reg. § 1.61-12(a) provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer's residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under § 61(a)(12) of the Code, whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm's length transaction at less than their face amount.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. *See* § 1.1001-2(c), Example 7, of the Income Tax Regulations.

In *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of $250,000 for a $40,000 cash payment (rather than surrender of the $2,500 collateral) resulted in $210,000 of discharge of indebtedness income. The court, following the *Tufts* holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in *Gershkowitz* where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes $200,000 of discharge of indebtedness income in 1989 as a result of the modification of A's note payable to C.

In an earlier Board of Tax Appeals decision, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer's gain or loss upon the sale of the property in a later year, held that the taxpayer's basis in the property should have been reduced by the amount of the mortgage debt forgiven in the earlier year.

The *Tufts* and *Gershkowitz* decisions implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. *Fulton Gold*, interpreted in this manner, is inconsistent with *Tufts* and *Gershkowitz*. Therefore, that interpretation is rejected and will not be followed.

HOLDING

The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under § 61(a)(12) of the Code.

Notes and Questions:

1. *Compare Gershkowitz* (summarized in Rev. Rul. 91-31) and *Tufts*. When and why does it matter whether taxpayer is relieved of a nonrecourse obligation through doi or through realization of the amount of the obligation?

2. What is the rule of Rev. Rul. 82-202, as stated in Rev. Rul. 91-31?

3. If the creditor *is* the seller of the property – i.e., the debt was purchase money debt – the revenue ruling implies that the holding might be different.

- What do you think should be the result in such a case?
    - No doi income, but a reduction of basis?
    - A purchase price (and basis) reduction if taxpayer is solvent?
- *See* Reg. § 1.1001-2(c), Example 7.

4. To what extent should taxpayer take into account nonrecourse debt in determining whether he/she/it is insolvent for purposes of applying § 108? In Rev. Rul. 92-53, the IRS stated that

> the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of § 108(d)(3) of the Code, but only to the extent that the excess nonrecourse debt is discharged.

Nonrecourse debt up to the fmv of the property is taken into account. Why shouldn't the full excess of the amount of the nonrecourse debt over the fmv of the property – even that which is not discharged – be taken into account? How does the IRS's treatment of nonrecourse debt preserve taxpayer's "fresh start" – but no more?

VI. Transactions Treated as Loans

The use of borrowed money is not free. A person pays for the use of another's money by paying interest, and the amount of interest depends on the length of time the borrower does not repay the borrowed money. The payment and receipt of interest have certain tax consequences. Payment of interest might be deductible from a taxpayer's ordinary income. *See* § 163. The recipient of interest realizes gross income. *See* 61(a)(4). Lenders and borrowers usually create loans with another transaction in mind, e.g., purchase of property, investment. *Those* transactions generate certain tax consequences that may differ from the tax consequences of payment of interest, e.g., taxation of capital gains at a rate lower than the tax rate on ordinary income (*see* chapter 10, *infra*), realization of gain or loss only upon sale or exchange of the underlying asset rather than on an annual basis (*see* chapter 9, *infra*). The Code has certain provisions that create and carve out an interest element in various transactions.

Consider: (1) Clifton Corporation issued $10M worth of bonds on January 1, 2006. For each $10,000 bond that an investor purchased, Clifton Corporation promised to pay $15,007.30 on January 1, 2012. Taxpayer Linda invested $10,000 on January 1, 2006 in Clifton Corporation bonds. She held the Clifton Corporation bonds until their maturity on January 1, 2012 at which time Clifton Corporation paid her $15,007.30. Obviously, Linda realized $5007.30 of interest income. When? Obviously, Clifton Corporation paid $5007.30 in interest. When?

(1a) Suppose that Linda had sold the Clifton Corporation bond on January 1, 2009 for $13,000. Obviously (?) Linda realized a total of $3000 of income. When? How much of it was interest income and how much of it was gain derived from dealing in property? The Buyer would have a $13,000 basis in the bond. How should Buyer treat his/her/its eventual receipt of $15,007.30? When?

(2) Seller agreed to sell Blackacre to Buyer for $3,500,000. Seller's basis in Blackacre was $2,500,000. The terms of the agreement were that Buyer would pay Seller $350,000 every year for ten years. The parties stated no other terms of their agreement. Assume that Buyer made all of the required payments. Upon fulfillment of all of his/her/its obligations, what is Buyer's basis in blackacre? How much interest income must Seller recognize in each of years 1 through 10? How much must Seller recognize as gain derived from dealing in property?

These transactions all involve the unstated payment and receipt of interest. Sections 1271 to 1288 and 483[70] deal with variations of the issues that these hypothetical fact patterns raise. Our concern is with basic principles and not the details of implementation. These provisions essentially "read into" the parties' agreements the payment and receipt of interest annually and require tax treatment to track such an inclusion of interest. The effect of such requirements is that the parties must account for interest on a compounding basis. The amount of interest will increase over time; it will be less than the straight-line amount in the early years and more than the straight-line amount in the later years.

The terms of these arrangements all required performance of obligations at different times and thereby raised time value of money issues. The Code sections create an interest rate and prescribe a certain compounding period – essentially semi-annual. We will note the compounding period that the sections relevant to this discussion requires, *but we will borrow from the tables in chapter 2* that follow the *Bruun* case. Those tables reflect compounding interest on an annual basis.

- In the event you find working with formulas in a spreadsheet to be somewhat frightening, the following website (and certainly there are others) has links to several useful calculators: http://www.pine-grove.com/online-calculators/

Examples (1) and (1a): Section 1272(a)(1) provides for inclusion of interest income in the gross income of a holder of a debt instrument as the interest accrues, i.e., taxpayer Linda in Example (1) must include in her gross income interest as if Clifton had actually paid it and it was compounded semi-annually (§ 1272(a)(5)).

- Section 1273(a)(1) defines "original issue discount" to be the redemption price at maturity minus the issue price.
- In Example (1) above, the "original issue discount" would be $15,007.30 − $10,000 = $5007.30. This happens to be the interest that would be paid if the interest rate were 7%. Use that figure when

[70] We will not consider § 483, but its rules are similar to those we examine here for the transactions to which it applies.

working from table 1 in chapter 2.[71]

•By using table 1, we learn that Linda's should include $700 in her gross income one year after making her investment. Because she has paid income tax on $700, Linda's basis in the bond increases to $10,700. § 1272(d)(2).

•Section 163(e)(1) provides for the same measurement of any allowable interest deduction for the Clifton Corporation.

•After two years, Linda's interest income will total $1449. Because she already included $700 in her gross income, her interest income for year 2 that she must include in her gross income is $749.[72] Notice that it was more than it was in year 1.

After three years, Linda would have paid tax on a total of $2250 of interest income. She must include $801 of interest income in her gross income for year 3 – again, more than her interest income in year 2. The basis in her bond would be $12,250. She would realize $750 of gain from dealing in property upon its sale for $13,000. *See* Example (1a).

•Buyer paid a "premium," i.e., Buyer paid $750 more than Linda's adjusted basis in the bond. Buyer will step into Linda's shoes and recognize interest income on the bond. However, Buyer will reduce the interest based upon a similar calculation of the $750 premium spread over the time remaining to maturity of the bond. § 1272(a)(7).

Example 2: Section 1274 provides that when a debt instrument is given in exchange for property (§ 1274(c)(1)), the interest must be at least the "applicable federal rate" (AFR). If it is not, then the debt payments are structured as if the interest rate is the AFR.

•The AFR depends on the term of the debt instrument – whether short-term, mid-term, or long-term. The Treasury Department determines AFRs monthly. § 1274(d).

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[71] Table 1 in chapter 2 provides values that are compounded annually. Hence, these values are not quite accurate in the context of § 1272, which requires daily compounding.

[72] Technically, § 1272(a)(3 and 4) requires a recalculation of interest based upon an increasing "issue price" and a decreasing length of time until redemption.

•The *imputed principal* amount of a debt instrument is the sum of the present values of all future payments. The present value is determined on the basis of the AFR compounded semi-annually. § 1274(b)(1 and 2).
•In Example 2, assume again that the interest rate is 7%. Refer to table 3[73] in the materials following *Bruun*, i.e., the table that gives the present value of a fixed annuity payment. The multiplier for ten years is 7.0236. The annual payment is $350,000. $350,000 x 7.0236 = $2,458,260.
•Since Seller will receive a total of $3,500,000, the difference between that amount and $2,458,260 must be interest, i.e., $1,041,740. The parties will allocate it on the same yield-to-maturity principles of § 1272 applicable to OID.
•Even though Seller will have $1M of income from the transaction, Seller actually *lost* money on the sale. Seller will realize substantial interest income – which is subject to a higher tax rate than long-term capital gain.

Wrap-up Questions for Chapter 4

1. What is wrong with the shrinkage of assets doctrine? Why should a loan and the use of loan proceeds be treated as separate transactions?

2. What should be the applicability of the "disputed debt doctrine" to cases where the amount of a debt is fixed and determined, but its enforceability (in a court) is highly unlikely? Taxpayer borrows money in order to engage in an illegal transaction.

3. The Bankruptcy Code, 11 U.S.C. § 523(a)(8) makes discharge of a student loan quite difficult, i.e., bankrupt must show "undue hardship on the debtor and the debtor's dependents." Section 108(f)(1) of the I.R.C. excludes doi income from a taxpayer's gross income when "discharge was pursuant to a provision of such loan under which all or part of the

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[73] Table 3 in chapter 2 provides values that are compounded annually. Hence, these values are not quite accurate in the context of § 1274, which requires semiannual compounding.

indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers." What should be the effect of these provisions?

4. What reasons might support treating receipt of loan proceeds as gross income and treating repayment of the loan as deductible? What would be the effects on the economy?

5. You have seen that various types of loans fall within § 108 and are therefore subject to the favorable treatment that that section provides. Are there others? Some argue that *any* forgiveness of a student loan should be excluded from gross income. Do you agree?

Chapter 5: Assignment of Income

The Tax Formula:

(gross income)
MINUS deductions named in § 62
EQUALS (adjusted gross income (AGI))
MINUS (standard deduction or itemized deductions)
MINUS (personal exemptions)
EQUALS (taxable income)

➔Compute income tax liability from tables in § 1 (indexed for inflation) ≥
MINUS (credits against tax)

The principle of progressive taxation is that tax rates applicable to increments of taxable income increase. Currently there are seven marginal brackets – eight if we count income that is below the threshold of taxable income.[74] If a taxpayer can spread his/her income among other taxpayers, more of taxpayer's income will be subject to lower marginal rates of tax.

The following table represents the computation of the income tax burden of a person whose taxable income is $210,000. Imaginary marginal tax brackets are as noted. The total tax burden of this taxpayer is $50,000.

Income range	Marginal Tax Rate	Tax
$0 to $10,000	0%	$0
$10,000 to $60,000	10%	$5000
$60,000 to $110,000	20%	$10,000
$110,000 to $160,000	30%	$15,000
$160,000 to $210,000	40%	$20,000
Total		$50,000

[74] The personal exemption and the standard deduction assure that some income is not subject to any income tax.

Our taxpayer might try to reduce his/her tax burden by "assigning" some of his/her taxable income to persons s/he controls – perhaps two children. Our taxpayer might decide that s/he and each of the two children should receive $70,000 of the original $210,000 total. The new tax computation table would be the following:

Income range	Marginal Tax Rate	Tax
$0 to $10,000	0%	$0
$10,000 to $60,000	10%	$5000
$60,000 to $110,000	20%	$2000[75]
Total		$7000 x 3 = $21,000

The total tax burden of three different persons, each with taxable income of $70,000, would be less than half the tax burden of one person with taxable income of $210,000. This characteristic of progressive tax rates has led taxpayers to create many schemes to "split income" so that more of it would be subject to lower rates of income tax.

The courts have created the "assignment of income"[76] doctrine to prevent abusive income splitting. In addition, Congress has created some statutory rules that limit assignments of income. We begin with the leading case.

I. Compensation for Services

Lucas v. Earl, 281 U.S. 111 (1930).

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[75] Only $10,000 of each taxpayer's taxable income would be subject to the 20% rate of income tax.

[76] This is really a misnomer. The "assignment of income" doctrine prevents assignment of income. A more accurate name would be the "non-assignment of income" doctrine.

JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the circuit court of appeals. A writ of certiorari was granted by this Court.

By the contract, made in 1901, Earl and his wife agreed

> "that any property either of us now has or may hereafter acquire ... in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship."

The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 approved February 24, 1919, c. 18, §§ 210, 211, 212(a), 213(a), 40 Stat. 1057, 1062, 1064, 1065, imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service ... of whatever kind and in whatever form paid," § 213(a). The provisions of the Revenue Act of 1921, c. 136, 42 Stat. 227, 233, 237, 238, in sections bearing the same numbers are similar to those of the above. A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that, taking the question more technically, the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because, however the matter might stand between husband and wife, he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them, and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skillfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us, and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

Notes and Questions:

1. This case is the origin of the "assignment of income" doctrine, i.e., a taxpayer cannot assign his/her income tax liability to another by assigning as yet unearned income to another.

2. The Earls entered their contract 1901 – at a time when most people believed that a federal personal income tax was unconstitutional and fifteen years before Congress enacted the income tax statute. This "anticipatory assignment" could hardly have had as a purpose the avoidance of federal income tax liability.

- In fact, Guy Earl probably utilized the contract as an estate planning device. He was not in good health, and by this simple contract, he was able to pass half of his property – already owned or to be acquired – to his wife without need of probate. At the time, there was no right of survivorship in California community property. *See* Patricia A. Cain, *The Story of* Earl*: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, in TAX STORIES 305, 315 (Paul Caron, ed., 2d ed. 2009).

3. Is Mr. Earl subject to income tax in this case because he earned the

income or because he exercised a right to assign its receipt prospectively?

4a. Consider: Taxpayer sold life insurance for several years. As such, he was entitled to "renewal commissions" when the purchaser of a policy paid premiums in later years in order to keep the policy in effect. Taxpayer sold his/her insurance agency business to another company, and the company paid $100,000 to Taxpayer for Taxpayer's right to "renewal commissions." Tax consequences to Taxpayer? How is this case different in essence from *Lucas v. Earl*?

- *See Hodges v. Commissioner*, 50 T.C. 428 (1968); *cf. Helvering v. Eubank*, 311 U.S. 122 (1941), *infra*.

4b. Taxpayer was a waitress at a restaurant and collected tips from customers. At the end of each shift, she would "tip out" various other restaurant employees, including busboys, bartenders, cooks, and other waitresses and waiters who assisted her during particularly busy times.

- The Commissioner argues that Taxpayer must report *all* of the tip income. Taxpayer may deduct as a trade or business expense what she pays other employees.
- Taxpayer argued that what she paid other employees was not even gross income to her.
- Why does one characterization rather than the other matter? Read §§ 62(a)(1), 67.
- What result?
- *See, e.g.*, *Brown v. Commissioner*, T.C. Memo 1996-310, 1996 WL 384904 (1996).

4c. Taxpayer was a partner in a partnership. Partnerships do not pay income taxes. Rather, individual partners are liable for income tax on their individual distributive shares of partnership profits. Taxpayer and his wife entered an agreement whereby she was made a full and equal partner with him. Wife performed no services and the other partners were not a party to this agreement.

- Taxpayer argued that he should be taxed on one half of his partnership distributive share, and his wife should be taxed on one half of his distributive share. This case predates married filing jointly tax returns.

- What result?
- *See Burnet v. Leininger*, 285 U.S. 136, 142 (1932).

5. How useful is the tree-fruits metaphor in resolving difficult questions of assignment of income?
    - Taxpayer works for Mega Corporation. Taxpayer was personally responsible for generating $1M of new business for Mega. Mega paid taxpayer his usual salary of $100,000. Next year, Mega will give taxpayer a 50% raise. On how much income should taxpayer be liable for income tax –
        - in year 1?
        - in year 2?

Poe v. Seaborn, 282 U.S. 101 (1930).

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Seaborn and his wife, citizens and residents of the State of Washington, made for the year 1927 separate income tax returns as permitted by the Revenue Act of 1926, c. 27, § 223 (U.S.C.App., Title 26, § 964).

During and prior to 1927, they accumulated property comprising real estate, stocks, bonds and other personal property. While the real estate stood in his name alone, it is undisputed that all of the property, real and personal, constituted community property, and that neither owned any separate property or had any separate income.

The income comprised Seaborn's salary, interest on bank deposits and on bonds, dividends, and profits on sales of real and personal property. He and his wife each returned one-half the total community income as gross income, and each deducted one-half of the community expenses to arrive at the net income returned.

The Commissioner of Internal Revenue determined that all of the income should have been reported in the husband's return, and made an additional assessment against him. Seaborn paid under protest, claimed a refund, and, on its rejection, brought this suit.

The district court rendered judgment for the plaintiff; the Collector appealed, and the circuit court of appeals certified to us the question whether the husband was bound to report for income tax the entire income, or whether the spouses were entitled each to return one-half thereof. This Court ordered the whole record to be sent up.
The case requires us to construe §§ 210(a) and 211(a) of the Revenue Act of 1926 (44 Stat. 21, U.S.C.App. Tit. 26, §§ 951 and 952), and apply them, as construed, to the interests of husband and wife in community property under the law of Washington. These sections lay a tax upon the net income of every individual. [footnote omitted] The Act goes no farther, and furnishes no other standard or definition of what constitutes an individual's income. The use of the word "of" denotes ownership. It would be a strained construction, which, in the absence of further definition by Congress, should impute a broader significance to the phrase.

The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the law of the state as to a wife's ownership of or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor?

The answer is found in the statutes of the state [footnote omitted] and the decisions interpreting them.

These statutes provide that, save for property acquired by gift, bequest, devise, or inheritance, all property however acquired after marriage by either husband or wife or by both is community property. On the death of either spouse, his or her interest is subject to testamentary disposition, and, failing that, it passes to the issue of the decedent, and not to the surviving spouse. While the husband has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co owner. The wife may borrow for community purposes and bind the community property. [citation omitted]. Since the husband may not discharge his separate obligation out of community property, she may, suing alone, enjoin collection of his separate debt out of community property. [citation omitted]. She may prevent his making substantial gifts out of community property without her consent. [citation omitted]. The community property is not liable for the husband's torts not committed in carrying on the business of the community. [citation omitted].

The books are full of expressions such as "the personal property is just as much hers as his" [citation omitted]; "her property right in it [(an automobile)] is as great as his" [citation omitted]; "the title of the spouse therein was a legal title, as well as that of the other" [citation omitted].

Without further extending this opinion, it must suffice to say that it is clear the wife has, in Washington, a vested property right in the community property equal with that of her husband, and in the income of the community, including salaries or wages of either husband or wife, or both. ...

The taxpayer contends that, if the test of taxability under Sections 210 and 211 is ownership, it is clear that income of community property is owned by the community, and that husband and wife have each a present vested one-half interest therein.

The Commissioner contends, however, that we are here concerned not with mere names, nor even with mere technical legal titles; that calling the wife's interest vested is nothing to the purpose, because the husband has such broad powers of control and alienation that, while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered for the purposes of §§ 210 and 211. He points out that, as to personal property, the husband may convey it, may make contracts affecting it, may do anything with it short of committing a fraud on his wife's rights. And though the wife must join in any sale of real estate, he asserts that the same is true, by virtue of statutes, in most states which do not have the community system. He asserts that control without accountability is indistinguishable from ownership, and that, since the husband has this, quoad community property and income, the income is that "of" the husband under §§ 210, 211 of the income tax law.

We think, in view of the law of Washington above stated, this contention is unsound. The community must act through an agent. This Court has said with respect to the community property system [citation omitted] that

quoad: as to; as long as; until
acquet: property

> "property acquired during marriage with community funds became an acquet of the community, and not the sole property of the one in whose name the property was bought, although by the law existing at the time the husband was given the management, control, and power of sale of such property. This right being vested in him not because he was the exclusive owner, but because, by law, he was created the agent of the community."

....

The obligations of the husband as agent of the community are no less real because the policy of the state limits the wife's right to call him to account in a court. Power is not synonymous with right. Nor is obligation coterminous with legal remedy. The law's investiture of the husband with broad powers by no means negatives the wife's present interest as a co-owner.

We are of opinion that, under the law of Washington, the entire property and income of the community can no more be said to be that of the husband than it could rightly be termed that of the wife.

....

The Commissioner urges that we have, in principle, decided the instant question in favor of the government. He relies on [citations omitted] and *Lucas v. Earl*, 281 U. S. 111.

....

In the *Earl* case, a husband and wife contracted that any property they had or might thereafter acquire in any way, either by earnings (including salaries, fees, etc.) or any rights by contract or otherwise, "shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants. ..." We held that assuming the validity of the contract under local law, it still remained true that the husband's professional fees, earned in years subsequent to the date of the contract, were his individual income, "derived from salaries, wages, or compensation for personal service" under § 210, 211, 212(a) and 213 of the Revenue Act of 1918. The very assignment in that case was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which if could operate. That case presents quite a different question from this, because here, by law, the earnings are never the property of the husband, but that of the community.

Finally the argument is pressed upon us that the Commissioner's ruling will work uniformity of incidence and operation of the tax in the various states, while the view urged by the taxpayer will make the tax fall unevenly upon married people. This argument cuts both ways. When it is remembered that a wife's earnings are a part of the community property equally with her husband's, it may well seem to those who live in states where a wife's earnings are her own that it would not tend to promote uniformity to tax the husband on her earnings as part of his income. The answer to such argument, however, is that the constitutional requirement of uniformity is not intrinsic, but geographic. [citations omitted]. And differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. [citation omitted].

The district court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective incomes, and its judgment is

Affirmed.

THE CHIEF JUSTICE and MR. JUSTICE STONE took no part in the consideration or decision of this case.

Notes and Questions:

1. Is the distinction of ownership by reason of state law rather than operation of a contract convincing? Would you expect the same resolution of the conflict to be applied to partnership allocations of income embodied in a partnership agreement, i.e., in a contract? Why the difference?

2. When taxpayer lawfully performed services for which insurance commissions were paid but which taxpayer could not legally receive, the Supreme Court held that taxpayer did not have sufficient dominion over the income to be required to include it in its gross income. *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 405 (1972) ("We think that fairness requires the tax to fall on the party that actually receives the premiums, rather than on the party that cannot.").

3. State law often effectively dictates the ownership of property for purposes of federal income tax. Recall the role of Ohio law of treasure trove in *Cesarini*. If state law recognizes same-sex marriages, should federal tax law consequences follow? *See* William P. Kratzke, *The Defense of Marriage Act (DOMA) Is Bad Income Tax Policy*, 35 U. MEM. L. REV. 399 (2005).

CALI Lessons

4. Do the CALI Lesson, *Basic Federal Income Taxation: Assignment of Income: Services*.

- Do not worry about question 14.

II. Income Splitting and the Joint Return

The following excerpt from a legislative report reviews ebb and flow of policy in the choice of tax bracket breakpoints for different filing statuses.

Joint Committee on Taxation, *The Income Tax Treatment of Married Couples* *and Single Persons* 3-7 (April 2, 1980).

Under the initial version of the modern individual income tax, enacted in 1913, married couples were taxed as separate individuals. In 1930, the Supreme Court ruled that State community property laws were to be given effect for income tax purposes, which meant that, in the States with such laws, married couples could equally divide income considered community property, the split which minimizes a couple's combined tax burden in a progressive tax system. After the large increase in tax rates enacted to finance World War II, many States enacted community property laws in order to give their citizens the tax benefit of this income splitting.

To stop this community property epidemic, in 1948 Congress provided that all married couples could enjoy the benefits of income splitting by filing joint returns. Separate filing by married persons was allowed, but the loss of income splitting meant that this almost always led to a tax increase. Single persons were required to use the same rate schedules as married couples and received no special treatment to offset the married couples' benefit from income splitting; therefore, marriage almost always resulted in a tax reduction for married couples and divorce in a tax increase.

In 1951, Congress enacted the head-of-household rate schedule for single persons who maintain households for certain relatives. This provided a "divorce bonus" to married couples with children if they had relatively equal incomes.

In 1969, Congress enacted a special rate schedule for single persons to give them about one-half the benefit of income splitting and adjusted the head-of-household rate schedule to give these taxpayers about three-fourths of the benefit of income splitting. These changes increased the divorce bonus provided by the head-of-household rate schedule and created a "marriage penalty" when single persons with relatively equal incomes married each other.

Issues

The proper tax treatment of married couples and single persons involves judgments about equity, economic efficiency and complexity.

Equity

The first question is what should be the tax unit, the group whose income and deductions are pooled in determining tax liability. Many people believe that the tax system should be "marriage neutral;" that is, a married couple should have the same tax burden as two single persons, each of whom has the same income as one of the spouses. Many people, however, also believe that, because most married couples pool their income and spend as a unit, fairness requires that the tax burden of a married couple not depend on how their combined income is distributed between them. A third widely held proposition is that the tax system should be progressive; that is, as income rises, tax burdens should increase as a percentage of income. Many Americans, if asked, would express agreement with all three of these principles of tax equity: marriage neutrality, equal taxation of couples with equal incomes, and progressivity.

One problem with devising a satisfactory method of taxing married couples is that these three principles of tax equity are logically inconsistent. A tax system generally can have any two of them, but not all three. A progressive tax system that treats the individual, not the couple, as a tax unit preserves marriage neutrality but sacrifices equal taxation of couples with equal incomes because couples with unequal incomes would pay a larger combined tax than couples with relatively equal incomes. The present income tax sacrifices marriage neutrality, but maintains equal taxation of couples with equal incomes and progressivity. A proportional income tax could have both marriage neutrality and equal taxation of couples with equal incomes, but it would sacrifice progressivity ... Which of these three principles ought to be sacrificed is a subjective question.

A second equity issue is how the overall tax burden should be distributed between single persons, single heads of households, one-earner married couples and two-earner married couples. This too is essentially a subjective judgment. The enactment of income splitting in 1948 shifted the tax burden away from one-earner married couples and other couples with relatively unequal incomes. The special rate schedules for heads of households and for single persons shifted the burden away from these classes of taxpayers. Recent proposals to reduce the marriage penalty involve shifting the burden away from two-earner couples. Any proposal that shifts the tax burden away from one of these groups means increasing the relative burden on the others.

Efficiency

Considerations of economic efficiency dictate that tax rates be lowest on persons whose work effort would be most responsive to lower taxes. Virtually all statistical studies of the issue conclude that a wife's work effort is more responsive to reduced taxes than her husband's. Therefore, the present system of taxing both spouses' earnings at the same marginal tax rate is economically inefficient compared to a system with lower tax rates on the wife's earnings. (The marginal tax rate is the rate applicable to the next dollar of income.) However, the present system may have countervailing benefits to the extent society gains from uncompensated work performed by wives.

....

Alternative Proposals

Three basic proposals to change the current system have received most attention in recent years: mandatory separate filing by married couples using the same rate schedule as single persons; optional separate filing by married couples using the same rate schedule as single persons; and retention of the present system with *ad hoc* changes to reduce the marriage penalty, such as a deduction or credit for married couples based on the earnings of the spouse with the lower amount of earnings. ...

....

Relief for second earners

Another group of proposals involves *ad hoc* relief for two-earner married couples, designed to reduce the marriage penalty and marginal tax rates on second earners while retaining the basic system of joint filing. Such relief could take the form of a deduction or credit equal to a percentage of the earnings of the spouse with the lower amount of earnings. ...

A deduction or credit for second earners is one of the simplest ways to reduce the marriage penalty and the marginal tax rates on second earners. Per dollar of revenue loss, a deduction would be more effective in these respects; however, a credit gives more benefit to lower income couples than a deduction. If either a deduction or credit were adopted, the system would be characterized neither by marriage neutrality nor by equal taxation of couples with equal incomes.

Notes and Questions:

1. How would you resolve these conflicts? You can imagine that there are many interest groups that have their own views of what is fair – but the point is well-taken that the Code cannot, consistently with *Poe v. Seaborn*, please everyone.

2. For a time, the Code provided a credit to married couples when both husband and wife worked. The credit was based upon the income earned by the spouse who earned less.

Now: Imagine several possible taxpaying units and some possible distributions of $70,000 of taxable income within those units. Review determinations of the tax liability of each unit using the tax tables found in § 1 *before* temporary reductions and indexing.

1. Husband and wife (man and woman) together earn $70,000. Couple files married filing jointly.

- H earns $35,000, W earns $35,000
    - Tax burden = 5535 + 9268 = $14,803

2. Husband and wife (man and woman) together earn $70,000. Couple files married filing jointly.

- H earns $70,000, W earns $0.
    - Tax Burden = $14,803

3. Same sex partners, or unmarried cohabiting man and woman together earn $70,000. Each partner files as unmarried individual.

- Both partners each earns $35,000
    - Tax Burden = 3315 + 3612 = 6927, x2 = $13,854

4. Same sex partners, or unmarried cohabiting man and woman together earn $70,000. Each partner files as unmarried individual.

- One partner earns $70,000, the other partner earns $0.
    - Tax Burden = 12,107 + 5115 = $17,222

5. Divorced mother with child earns $70,000

Tax Burden = 4440 + 11,312 = $15,752

Observe:

•The first two couples pay the same tax. The Code does not discriminate among married couples, irrespective of who earns taxable income.

•However the first two couples pay more income tax than the third couple. This is the marriage penalty.

•The first two couples pay less than the fourth couple. This is the marriage bonus.

•The fifth taxpayer pays less than the fourth couple, but more than the first two couples.

Are these results this fair?

Recompute the tax liabilities of these taxpaying units using the current tables found at the very front of your Code.

- •What has happened to the brackets that leads to such dramatically different results?
- •Look at the bottom two tax brackets in tables 1 and 3. Notice the relationship between the lowest bracket in table 1 and the lowest bracket in table 3. Notice the relationship between the second lowest bracket in table 1 and the second lowest bracket in table 3.
- •To whom did Congress respond when it created these relationships in 2001? Perhaps the same people who supported adoption of the Child Tax Credit in 1997 (§ 24)?

III. Income Derived from Property

Re-read *Helvering v. Horst* in chapter 2. Why did taxpayer Horst lose?

Helvering v. Eubank, 311 U.S. 122 (1940).

MR. JUSTICE STONE delivered the opinion of the Court.

This is a companion case to *Helvering v. Horst*, ... and presents issues not distinguishable from those in that case.

Respondent, a general life insurance agent, after the termination of his agency contracts and services as agent, made assignments in 1924 and 1928, respectively, of renewal commissions to become payable to him for services which had been rendered in writing policies of insurance under two of his agency contracts. The Commissioner assessed the renewal commissions paid by the companies to the assignees in 1933 as income taxable to the assignor in that year ... The Court of Appeals for the Second Circuit reversed the order of the Board of Tax Appeals sustaining the assessment. We granted certiorari.

No purpose of the assignments appears other than to confer on the assignees the power to collect the commissions, which they did in the taxable year. ...

For the reasons stated at length in the opinion in the *Horst* case, we hold that the commissions were taxable as income of the assignor in the year when paid. The judgment below is

Reversed.

The separate opinion of MR. JUSTICE McREYNOLDS.

...

“The question presented is whether renewal commissions payable to a general agent of a life insurance company after the termination of his agency and by him assigned prior to the taxable year must be included in his income despite the assignment.”

“During part of the year 1924, the petitioner was employed by The Canada Life Assurance Company as its branch manager for the state of Michigan. His compensation consisted of a salary plus certain commissions. His employment terminated on September 1, 1924. Under the terms of his contract, he was entitled to renewal commissions on premiums thereafter collected by the company on policies written prior to the termination of his agency, without the obligation to perform any further services. In November, 1924, he assigned his right, title and interest in the contract, as well as the renewal commissions, to a corporate trustee. From September 1, 1924 to June 30, 1927, the petitioner and another, constituting the firm of Hart & Eubank, were general agents in New York City for the Aetna Life Assurance Company, and from July 1, 1927, to August 31, 1927, the petitioner individually was general agent for said Aetna Company. The Aetna contracts likewise contained terms entitling the agent to commissions on renewal premiums paid after termination of the agency, without the performance of any further services. On March 28, 1928, the petitioner assigned to the corporate trustee all commissions to become due him under the Aetna contracts. During the year 1933, the trustee collected by virtue of the assignments renewal commissions payable under the three agency contracts above mentioned amounting to some $15,600. These commissions were taxed to the petitioner by the commissioner, and the Board has sustained the deficiency resulting therefrom."

The court below declared –

> "In the case at bar, the petitioner owned a right to receive money for past services; no further services were required. Such a right is assignable. At the time of assignment, there was nothing contingent in the petitioner's right, although the amount collectible in future years was still uncertain and contingent. But this may be equally true where the assignment transfers a right to income from investments, as in *Blair v. Commissioner*, 300 U.S. 5, and *Horst v. Commissioner*, 107 F.2d 906, or a right to patent royalties, as in *Nelson v. Ferguson*, 56 F.2d 121, *cert. denied*, 286 U.S. 565. By an assignment of future earnings, a taxpayer may not escape taxation upon his compensation in the year when he earns it. But when a taxpayer who makes his income tax return on a cash basis assigns a right to money payable in the future for work already performed, we believe that he transfers a property right, and the money, when received by the assignee, is not income taxable to the assignor.

Accordingly, the Board of Tax Appeals was reversed, and this, I think, is in accord with the statute and our opinions.

The assignment in question denuded the assignor of all right to commissions thereafter to accrue under the contract with the insurance company. He could do nothing further in respect of them; they were entirely beyond his control. In no proper sense were they something either earned or received by him during the taxable year. The right to collect became the absolute property of the assignee, without relation to future action by the assignor.

A mere right to collect future payments for services already performed is not presently taxable as "income derived" from such services. It is property which may be assigned. Whatever the assignor receives as consideration may be his income, but the statute does not undertake to impose liability upon him because of payments to another under a contract which he had transferred in good faith under circumstances like those here disclosed.

....

THE CHIEF JUSTICE and MR. JUSTICE ROBERTS concur in this opinion.

Notes and Questions:

1. The Court's majority says that this case presents issues like those in *Horst*, *supra*?

- Is that accurate?

2. Should the right to collect compensation income for services performed become property simply by the passage of time, e.g., one year?

- Should the tax burden fall upon the one who earns the income only if that person receives the compensation in the same year?

3. Do you see any latent problems of horizontal equity in the opinion of Justice McReynolds? Taxpayers have endeavored from the beginning to convert compensation income from ordinary income into property. Courts are very careful about permitting this to occur. Does not Justice McReynolds undermine the principles of *Lucas v. Earl*?

- Maybe the principles of *Lucas v. Earl* need undermining.
- Why do you think that taxpayer wanted to transfer his rights to receive future renewal commission to a corporation that he controlled? Were there tax advantages to doing this?

Blair v. Commissioner, 300 U.S. 5 (1937)

MR. CHIEF JUSTICE HUGHES delivered the opinion of the Court.

This case presents the question of the liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the tax years and which the trustees had paid to them accordingly.

The trust was created by the will of William Blair, a resident of Illinois who died in 1899, and was of property located in that State. One-half of the net income was to be paid to the donor's widow during her life. His son, the petitioner Edward Tyler Blair, was to receive the other one-half and, after the death of the widow, the whole of the net income during his life. In 1923, after the widow's death, petitioner assigned to his daughter, Lucy Blair Linn, an interest amounting to $6,000 for the remainder of that calendar year, and to $9,000 in each calendar year thereafter, in the net income which the petitioner was then or might thereafter be entitled to receive during his life. At about the same time, he made like assignments of interests, amounting to $9,000 in each calendar year, in the net income of the trust to his daughter Edith Blair and to his son, Edward Seymour Blair, respectively. In later years, by similar instruments, he assigned to these children additional interests, and to his son William McCormick Blair other specified interests, in the net income. The trustees accepted the assignments and distributed the income directly to the assignees.

....

... [T]he trustees brought suit in the superior court of Cook county, Illinois, to obtain a construction of the will ... [and the Illinois courts] found the assignments to be "voluntary assignments of a part of the interest of said Edward Tyler Blair in said trust estate" and, as such, adjudged them to be valid.

At that time, there were pending before the Board of Tax Appeals proceedings involving the income of the trust for the years 1924, 1925, 1926, and 1929. The Board ... [applied] the decision of [the Illinois courts and] overruled the Commissioner's determination as to the petitioner's liability. The Circuit Court of Appeals ... reversed the Board. That court recognized the binding effect of the decision of the state court as to the validity of the assignments, but decided that the income was still taxable to the petitioner upon the ground that his interest was not attached to the corpus of the estate, and that the income was not subject to his disposition until he received it.

Because of an asserted conflict with the decision of the state court, and also with decisions of circuit courts of appeals, we granted certiorari. ...

First. [Res judicata does not bar this case.]

Second. The question of the validity of the assignments is a question of local law. The donor was a resident of Illinois, and his disposition of the property in that State was subject to its law. By that law, the character of the trust, the nature and extent of the interest of the beneficiary, and the power of the beneficiary to assign that interest in whole or in part are to be determined. The decision of the state court upon these questions is final. *Spindle v. Shreve*, 111 U.S. 542, 547-548; *Uterhart v. United States*, 240 U.S. 598, 603; *Poe v. Seaborn*, 282 U.S. 101, 110; *Freuler v. Helvering*, *supra*, 291 U.S. 45. ... In this instance, it is not necessary to go beyond the obvious point that the decision was in a suit between the trustees and the beneficiary and his assignees, and the decree which was entered in pursuance of the decision determined as between these parties the validity of the particular assignments. ...

....

Third. The question remains whether, treating the assignments as valid, the assignor was still taxable upon the income under the federal income tax act. That is a federal question.

Our decisions in *Lucas v. Earl*, 281 U.S. 111, and *Burnet v. Leininger*, 285 U.S. 136, are cited. In the *Lucas* case, the question was whether an attorney was taxable for the whole of his salary and fees earned by him in the tax years, or only upon one-half by reason of an agreement with his wife by which his earnings were to be received and owned by them jointly. We were of the opinion that the case turned upon the construction of the taxing act. We said that

> "the statute could tax salaries to those who earned them, and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skilfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it."

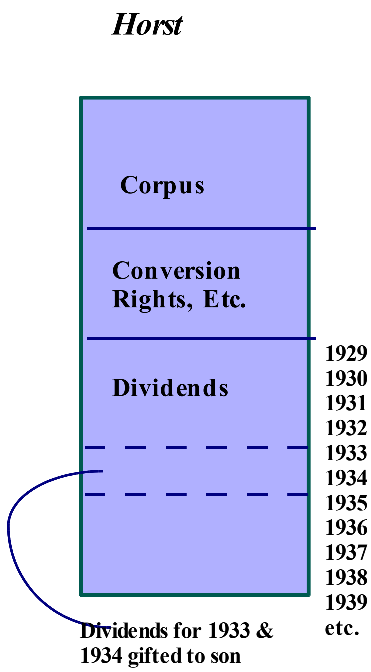
That was deemed to be the meaning of the statute as to compensation for personal service, and the one who earned the income was held to be subject to the tax. In *Burnet v. Leininger*, *supra*, a husband, a member of a firm, assigned future partnership income to his wife. We found that the revenue act dealt explicitly with the liability of partners as such. The wife did not become a member of the firm; the act specifically taxed the distributive share of each partner in the net income of the firm, and the husband, by the fair import of the act, remained taxable upon his distributive share. These cases are not in point. The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716; [citations omitted]. There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer's retention of control. *Corliss v. Bowers*, 281 U.S. 376; *Burnet v. Guggenheim*, 288 U.S. 280.

In the instant case, the tax is upon income as to which, in the general application of the revenue acts, the tax liability attaches to ownership. *See Poe v. Seaborn*, *supra*; [citation omitted].

The Government points to the provisions of the revenue acts imposing upon the beneficiary of a trust the liability for the tax upon the income distributable to the beneficiary. But the term is merely descriptive of the one entitled to the beneficial interest. These provisions cannot be taken to preclude valid assignments of the beneficial interest, or to affect the duty of the trustee to distribute income to the owner of the beneficial interest, whether he was such initially or becomes such by valid assignment. The one who is to receive the income as the owner of the beneficial interest is to pay the tax. If, under the law governing the trust, the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary, and is entitled to rights and remedies accordingly. We find nothing in the revenue acts which denies him that status.

The decision of the Circuit Court of Appeals turned upon the effect to be ascribed to the assignments. The court held that the petitioner had no interest in the corpus of the estate, and could not dispose of the income until he received it. Hence, it was said that "the income was his," and his assignment was merely a direction to pay over to others what was due to himself. The question was considered to involve "the date when the income became transferable." The Government refers to the terms of the assignment – that it was of the interest in the income "which the said party of the first part now is, or may hereafter be, entitled to receive during his life from the trustees." From this, it is urged that the assignments "dealt only with a right to receive the income," and that "no attempt was made to assign any equitable right, title or interest in the trust itself." This construction seems to us to be a strained one. We think it apparent that the conveyancer was not seeking to limit the assignment so as to make it anything less than a complete transfer of the specified interest of the petitioner as the life beneficiary of the trust, but that, with ample caution, he was using words to effect such a transfer. That the state court so construed the assignments appears from the final decree which described them as voluntary assignments of interests of the petitioner "in said trust estate," and it was in that aspect that petitioner's right to make the assignments was sustained.

The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property. *Brown v. Fletcher*, 235 U.S. 589, 598-599; *Irwin v. Gavit*, 268 U.S. 161, 167-168; *Senior v. Braden*, 295 U.S. 422, 432; *Merchants' Loan & Trust Co. v. Patterson*, 308 Ill. 519, 530, 139 N.E. 912. By virtue of that interest, he was entitled to enforce the trust, to have a breach of trust enjoined, and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. [citations omitted]. The beneficiary may thus transfer a part of his interest, as well as the whole. *See* RESTATEMENT OF THE LAW OF TRUSTS, §§ 130, 132 et seq. The assignment of the beneficial interest is not the assignment of a chose in action, but of the "right, title, and estate in and to property." *Brown v. Fletcher*, *supra*; *Senior v. Braden*, *supra*. *See* BOGERT, TRUSTS AND TRUSTEES, vol. 1, § 183, pp. 516, 517; 17 COLUMBIA LAW REVIEW, 269, 273, 289, 290.



We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income, and that, as to these interests, they, and not the petitioner, were taxable for the tax years in question. The judgment of the Circuit Court of Appeals is reversed, and the cause is remanded with direction to affirm the decision of the Board of Tax Appeals.

It is so ordered.

Notes and Questions:

1. On what basis did the court of appeals hold for the Commissioner? Compare that to the language of *Horst*.

2. The Court spent several paragraphs establishing that Edward Tyler Blair had the power to dispose of his interest as he wished. Why was the exercise of this discretion sufficient in this case to shift the tax burden to the recipient when it was not sufficient in *Helvering v. Horst*?

3. William Blair died. Through his will, he devised *part* of his property to a trust. We are not told who received the remainder of his property. Edward Tyler William Blair was an income beneficiary of *part* of the trust. We are not told of the final disposition of the corpus of the trust. We are

told that Edward had no interest in the corpus of the estate. Edward assigned fractional interests "in each calendar year thereafter, in the net income which [Edward] was then or might thereafter be entitled to receive during his life." It appears that Edward's *entire* interest was as a beneficiary of the trust. He then assigned to various sons and daughters a *fraction* of his *entire interest*.

- *Exactly* what interest did William Blair, Jr. *retain* after these dispositions?
- Compare this to what the taxpayer in *Helvering v. Horst*, *supra*, chapter 3, retained.
- Is this difference a sound basis upon which the Court may reach different results?

4. Think of the ownership of "property" as the ownership of a "bundle of sticks." Each stick represents some particular right. For example, a holder of a bond may own several sticks, e.g., the right to receive an interest payment in each of ten consecutive years might ten sticks, the right to sell the bond might be another stick, the right to the proceeds upon maturity might be another stick. Imagine that we lay the sticks comprising a bond, one on top of the other. Then we slice off a piece of the property. We might slice horizontally – and thereby take all or a portion of only one or a few sticks. Or we might slice vertically – and thereby take an identically proportional piece of every stick.

Consider the accompanying diagrams of *Horst* and *Blair*. Do they suggest an analytical model in "assignment of income derived from property" cases?

- Slice vertically rather than horizontally?

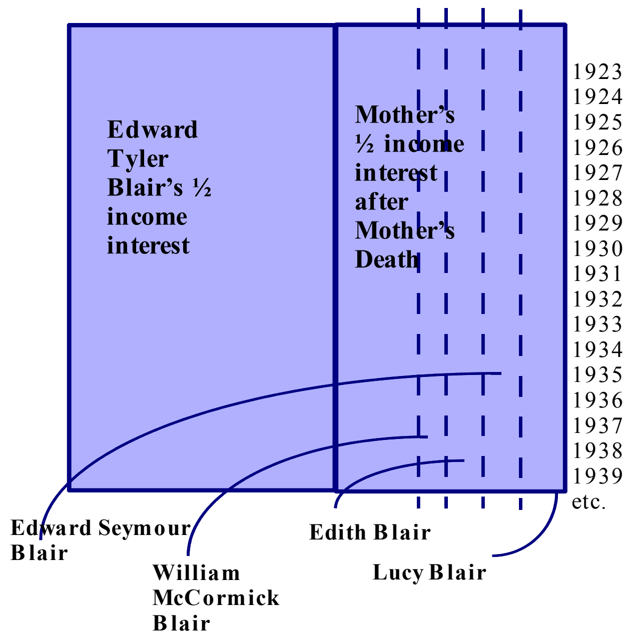
5. Taxpayer was the life beneficiary of a testamentary trust. In December 1929, she assigned a specified number of dollars from the income of the trust to certain of her children for 1930. The trustee paid the specified children as per Taxpayer's instructions.

- *Exactly* what interest did Taxpayer *retain* after these dispositions?
- Should Taxpayer-life beneficiary or the children that she named to receive money in 1930 be subject to income tax on the trust income paid over to the children? *See Harrison v. Schaffner*, 312 U.S. 579,

582-83 (1941).

6. Taxpayer established a trust with himself as trustee and his wife as beneficiary. The trust was to last for five years unless either Taxpayer or his wife died earlier. Taxpayer placed securities that he owned in the trust. The trust's net income was to be held for Taxpayer's wife. Upon termination of the trust, the corpus was to revert to Taxpayer and any accumulated income was to be paid to his wife.

Blair



•*Exactly* what interest did Taxpayer *retain* after these dispositions?

•Should Taxpayer-settlor-trustee or his wife be subject to income tax on the trust income paid over to Taxpayer's wife? *See Helvering v. Clifford*, 309 U.S. 331, 335 (1940).

6a. Now suppose that Taxpayer placed property in trust, the income from which was to be paid to his wife until she died and then to their children. Taxpayer "reserved power 'to modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created[.]?'" Taxpayer did *not* in fact exercise this power, and the trustee paid income to Taxpayer's wife.

•*Exactly* what interest did Taxpayer *retain* after this disposition?

•Should the trust income be taxable income to Taxpayer or to his wife?

•*See Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

7. Again: is the tree-fruits analogy useful in difficult cases? Consider what happens when the fruit of labor is property from which income may be

derived.

Heim v. Fitzpatrick, 262 F.2d 887 (2nd Cir. 1959).

Before SWAN and MOORE, Circuit Judges, and KAUFMAN, District Judge.

SWAN, Circuit Judge.

This litigation involves income taxes of Lewis R. Heim, for the years 1943 through 1946. On audit of the taxpayer's returns, the Commissioner of Internal Revenue determined that his taxable income in each of said years should be increased by adding thereto patent royalty payments received by his wife, his son and his daughter. The resulting deficiencies were paid under protest to defendant Fitzpatrick, Collector of Internal Revenue for the District of Connecticut. Thereafter claims for refund were filed and rejected. The present action was timely commenced ... It was heard upon an agreed statement of facts and supplemental affidavits. Each party moved for summary judgment. The plaintiff's motion was denied and the defendant's granted. ...

Plaintiff was the inventor of a new type of rod end and spherical bearing. In September 1942 he applied for a patent thereon. On November 5, 1942 he applied for a further patent on improvements of his original invention. Thereafter on November 17, 1942 he executed a formal written assignment of his invention and of the patents which might be issued for it and for improvements thereof to The Heim Company.[77] This was duly recorded in the Patent Office and in January 1945 and May 1946 plaintiff's patent applications were acted on favorably and patents thereon were issued to the Company. The assignment to the Company was made pursuant to an oral agreement, subsequently reduced to a writing dated July 29, 1943, by which it was agreed (1) that the Company need pay no royalties on

[77] The stock of The Heim Company was owned as follows: plaintiff 1%, his wife 41%, his son and daughter 27% each, and his daughter-in-law and son-in-law 2% each

bearings manufactured by it prior to July 1, 1943; (2) that after that date the Company would pay specified royalties on 12 types of bearings; (3) that on new types of bearings it would pay royalties to be agreed upon prior to their manufacture; (4) that if the royalties for any two consecutive months or for any one year should fall below stated amounts, plaintiff at his option might cancel the agreement and thereupon all rights granted by him under the agreement and under any and all assigned patents should revert to him, his heirs and assigns; and (5) that this agreement is not transferable by the Company.

In August 1943 plaintiff assigned to his wife 'an undivided interest of 25 per cent in said agreement with The Heim Company dated July 29, 1943, and in all his inventions and patent rights, past and future, referred to therein and in all rights and benefits of the First Party (plaintiff) thereunder * * *.' A similar assignment was given to his son and another to his daughter. Plaintiff paid gift taxes on the assignments. The Company was notified of them and thereafter it made all royalty payments accordingly. As additional types of bearings were put into production from time to time the royalties on them were fixed by agreement between the Company and the plaintiff and his three assignees.

The Commissioner of Internal Revenue decided that all of the royalties paid by the Company to plaintiff's wife and children during the taxable years in suit were taxable to him. This resulted in a deficiency which the plaintiff paid ...

The appellant contends that the assignments to his wife and children transferred to them income-producing property and consequently the royalty payments were taxable to his donees, as held in *Blair v. Commissioner*, 300 U.S. 5. [footnote omitted]. Judge Anderson, however, was of opinion that (151 F. Supp. 576):

> 'The income-producing property, i.e., the patents, had been assigned by the taxpayer to the corporation. What he had left was a right to a portion of the income which the patents produced. He had the power to dispose of and divert the stream of this income as he saw fit.'

Consequently he ruled that the principles applied by the Supreme Court in *Helvering v. Horst*, 311 U.S. 112 and *Helvering v. Eubank*, 311 U.S. 122 required all the royalty payments to be treated as income of plaintiff.

The question is not free from doubt, but the court believes that the transfers in this case were gifts of income-producing property and that neither *Horst* nor *Eubank* requires the contrary view. In the *Horst* case the taxpayer detached interest coupons from negotiable bonds, which he retained, and made a gift of the coupons, shortly before their due date, to his son who collected them in the same year at maturity. *Lucas v. Earl*, 281 U.S. 111, which held that an assignment of unearned future income for personal services is taxable to the assignor, was extended to cover the assignment in *Horst*, the court saying,

> 'Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions.'

In the *Eubank* case the taxpayer assigned a contract which entitled him to receive previously earned insurance renewal commissions. In holding the income taxable to the assignor the court found that the issues were not distinguishable from those in *Horst*. No reference was made to the assignment of the underlying contract.[78]

In the present case more than a bare right to receive future royalties was assigned by plaintiff to his donees. Under the terms of his contract with The Heim Company he retained the power to bargain for the fixing of royalties on new types of bearings, i.e., bearings other than the 12

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[78] These decisions were distinguished by Judge Magruder in Commissioner v. Reece, 1 Cir., 233 F.2d 30. In that case, as in the case at bar, the taxpayer assigned his patent to a corporation in return for its promise to pay royalties, and later made a gift of the royalty contract to his wife. It was held that this was a gift of income-producing property and was effective to make the royalties taxable to her. *See also* Nelson v. Ferguson, 56 F.2d 121 (3rd Cir.), *cert. denied*, 286 U.S. 565; Commissioner v. Hopkinson, 126 F.2d 406 (2d Cir.); and 71 HARVARD LAW REVIEW 378.

products on which royalties were specified. This power was assigned and the assignees exercised it as to new products. Plaintiff also retained a reversionary interest in his invention and patents by reason of his option to cancel the agreement if certain conditions were not fulfilled. This interest was also assigned. The fact that the option was not exercised in 1945, when it could have been, is irrelevant so far as concerns the existence of the reversionary interest. We think that the rights retained by plaintiff and assigned to his wife and children were sufficiently substantial to justify the view that they were given income-producing property.

In addition to Judge Anderson's ground of decision appellee advances a further argument in support of the judgment, namely, that the plaintiff retained sufficient control over the invention and the royalties to make it reasonable to treat him as owner of that income for tax purposes. *Commissioner v. Sunnen*, 333 U.S. 591 is relied upon. There a patent was licensed under a royalty contract with a corporation in which the taxpayer-inventor held 89% of the stock. An assignment of the royalty contract to the taxpayer's wife was held ineffective to shift the tax, since the taxpayer retained control over the royalty payments to his wife by virtue of his control of the corporation, which could cancel the contract at any time. The argument is that, although plaintiff himself owned only 1% of The Heim Company stock, his wife and daughter together owned 68% and it is reasonable to infer from depositions introduced by the Commissioner that they would follow the plaintiff's advice. Judge Anderson did not find it necessary to pass on this contention. But we are satisfied that the record would not support a finding that plaintiff controlled the corporation whose active heads were the son and son-in-law. No inference can reasonably be drawn that the daughter would be likely to follow her father's advice rather than her husband's or brother's with respect to action by the corporation.

...

For the foregoing reasons we hold that the judgment should be reversed and the cause remanded with directions to grant plaintiff's motion for summary judgment.

So ordered.

Notes and Questions:

1. *Eubank* involved labor that created an identifiable and assignable right to receive income in the future. How does *Heim v. Fitzpatrick* differ from *Eubank*? After all, a patent is the embodiment of (considerable) work.

2. It is also a capital asset, even to the "individual whose efforts created" it, that the holder has presumptively held for more than one year. § 1235(a), (b)(1). However, this rule does not apply to loss transfers between related persons under §§ 267(b) or 707(b).

- Does the existence of § 1235 lend inferential support to the court's holding in *Heim*?

Contingent fee arrangements: What happens when a taxpayer-plaintiff enters a contingent fee arrangement with his/her attorney? Has taxpayer entered an "anticipatory arrangement" to which the assignment-of-income doctrine should apply? Or has taxpayer partially assigned income-producing property?

- Is the contingent-fee attorney a joint owner of the client's claim?
- Does it matter that the relationship between client and attorney is principal and agent?
- No and yes, said the Supreme Court in CIR v. Banks, 543 U.S. 426 (2005). State laws that may protect the attorney do not change this, so long as it does not alter the fundamental principal-agent relationship.
- If taxpayer-plaintiff must include whatever damages s/he receives in his/her gross income, taxpayer-plaintiff must include the contingent fee that s/he pays his/her attorney.

Assume that plaintiff must include whatever damages s/he receives in his/her gross income. The expenses of producing taxable income are deductible. What difference does it make? See §§ 67 and 55(a), 56(b)(1)(A)(i) (alternative minimum tax). And see § 62(a)(20). When would § 62(a)(20) affect your answer?

3. Do the CALI Lesson, *Basic Federal Income Taxation: Assignment of Income: Property*.

- Do not worry about questions 3 and 19.

IV. Interest Free Loans and Unstated Interest

Consider these scenarios:

•Father has a large savings account, and daughter is 18 years old. Daughter is enrolled at Private University and in need of tuition money. Father and mother have planned for many years for this day and saved an ample amount to pay for Daughter's tuition. They now have $1M saved, and the annual interest income on this amount is $80,000. Father and mother are in the 35% marginal income tax bracket. Daughter is in the 0% marginal income tax bracket. An income of $80,000 would place Daughter in the 25% marginal tax bracket – although some of that income would not be subject to any tax, some would be subject to 10% tax, and some would be subject to 15% tax. Father and mother decide to loan Daughter $1M interest free. Daughter would deposit the money in an interest bearing account and use the interest income to pay her tuition and other expenses for four years. With diploma in hand, Daughter will repay the loan.

- •Are there any income tax problems with this?
- •Read § 7872(a)(1), (c)(1)(A), (e), (f)(2), (f)(3).
  - •[By the way, § 7872 applies both to the income tax and to the gift tax.]
- •What result under these provisions.

•Corporation very much wants to hire Star Employee and has made a generous salary offer. To sweeten the deal, Corporation offers to loan $1M to Star Employee interest free so that Star Employee can purchase a house in an otherwise expensive housing market. Star Employee will repay the loan at the rate of $40,000 per year for the next 25 years.

- •Are there any income tax problems with this?
- •Read § 7872(b), (c)(1)(B), (e), (f)(2), (f)(5), (f)(6).
- •What result under these provisions?

•Closely-held Corporation is owned by four shareholders. If the corporation pays dividends to shareholders, the dividend income is subject to income tax for the shareholders. The payments are not deductible to Corporation. Corporation loans each shareholder $100,000 interest free. Shareholders will repay the loans at the rate of $1000 per year for the next 100 years.

- Are there any income tax problems with this?
- Read § 7872(b), (c)(1)(C), (e), (f)(1), (f)(2).
- What result under these provisions?

• Alpha owns a vacant piece of land (capital asset). Alpha's AB in the land is $700,000. Alpha wanted to sell the land, but bank financing is very tight. In order to sell the land, Alpha entered a contract with Beta whereby Beta would pay $1M for the property exactly four years from taking possession.

- Are there any income tax problems with this?
- Read § 7872(b), (c)(1)(E), (e), (f)(1), (f)(2).
- What is the likely result under these provisions?

Father and Mother are the proud parents of a 1-year old. Knowing that a college education costs a lot, they place $100,000 in the child's e-Trade account that he entirely manages and controls. The account earned $9000 this year. This is unearned income. Child is of course the dependent of Mother and Father.

- Tax consequences to Father, Mother, and Child?
  - Assume Father and Mother are in the 30% tax bracket.
- Read § 1(g) very carefully and § 63(c)(5).
  - Check the latest revenue procedure to determine the standard deduction "for an individual who may be claimed as a dependent by another taxpayer." For tax year 2012, it is $950 or the sum of $300 and the individual's earned income. Rev. Proc. 2011-52, § 3.11(2).

CALI Lessons

Do:

CALI Lesson, *Basic Federal Income Taxation: Deductions: Below Market Loans*

CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Taxation of Minor Children's Income*

•Note: the § 63(c)(5)(A) amount is indexed. Assume for purposes of this Lesson that the amount is $900, not $500.

Wrap-Up Questions for Chapter 5

1. It has been observed that the actual federal tax[79] burdens among different American taxpayers are not very progressive. Federal tax burdens could be made more progressive simply by capping a taxpayer's total allowable exclusions, deductions, and credits. Perhaps a cap of $25,000 would be appropriate. Maybe it should be more, maybe less. What do you think of the idea of increasing progressivity by enacting such caps?

2. At what point does it not pay to spend money in order to gain income that will not be subject to federal income tax?

3. When the IRS in its enforcement mission must come up with an interest rate, it turns to the "applicable Federal rate." What might be wrong with reliance on such a uniform rate?

4. Congress has made the tax burden on the combined income of taxpayers who file married filing jointly exactly twice the tax burden on single persons with half the income of the couple. This reduced the tax bracket on married persons from what it was before Congress enacted this change. Is that preferable to giving relief only to those couples where both spouses work, as was the case when the Code provided for a credit based on the amount of income earned by the spouse who earned less?

5. Comment on the following rough outline of a flat tax: Remove all deductions, exclusions, and credits from the Code. Retain only those associated with the production of income so that the income tax is a tax only on "net" income. All taxpayers would be entitled to a $40,000

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[79] ... including social security, medicare, and unemployment taxes, as well as income taxes.

exemption. The tax would be a flat rate on all taxpayers to the extent their gross income exceeds $40,000.

Chapter 6: Deductions: Business Expenses

> *The Tax Formula*:
>
> (gross income)
> ➔MINUS deductions named in § 62 ≥
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or
> ➔itemized deductions)≥
> MINUS (personal exemptions)
> EQUALS (taxable income)
>
> Compute income tax liability from tables in § 1 (indexed for inflation)
> MINUS (credits against tax)

Our income tax system taxes only "net income." Hence it is important that the Code incorporate principles that prevent taxing as income the expenses of deriving that income. Section 162 provides a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business[.]" Read § 162(a).

The Code does not provide a definition of "trade or business."[80] The Supreme Court observed the following when it held that a full-time gambler was engaged in a "trade or business:"

> Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and "transactions entered into for profit but not connected with ... business or trade," on the other. *See* Revenue Act of 1916, § 5(a), Fifth, 39 Stat. 759. Congress "distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business." We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic

[80] *See generally* Paula Wolff, Annot.,*What constitutes trade or business under Internal Revenue Code (U.S.C.A. Title 26)*, 161 A.L.R. FED. 245 (2008).

activity, a hobby, or an amusement diversion does not qualify.[81]

This excerpt informs that there is a distinction between a "trade or business" and "transactions entered into for profit but not connected with" a trade or business. For most taxpayers, investing fits this description. Moreover, there is another distinction between a "trade or business" and a hobby or amusement. The Code limits deductions for an activity "not engaged in for profit" to the gross income derived from the activity.[82]

Congress extended the principles of § 162(a) to "expenses for the production of income" when it added § 212 to the Code. However, expenses for the production of income – as contrasted with a trade or business – are not deductible "above the line." § 62(a)(1). In addition, § 163(a) allows a deduction for interest paid or accrued. Section 165(a) allows a deduction for losses.

Section 162 allows a deduction only for expenses of "carrying on" a trade or business. Hence, the costs of searching for a business to purchase, pre-opening organization costs, etc. are not deductible. § 195. On the other hand, an existing business that incurs the same expenses in order to expand its business may deduct them. Whether an existing business is seeking merely to expand or to enter a new trade or business "depends on the facts and circumstances of each case."[83]

Taxpayer may purchase an input that enables him/her/it to earn income

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[81] Commissioner v. Groetzinger, 480 U.S. 23, 35 (1987) (alternative minimum tax; citation omitted).

[82] §§ 183(a) and (b)(2). Furthermore, a taxpayer must attribute a share of deductions allowable without regard to whether an activity is engaged in for profit, e.g., real estate taxes, to the activity, § 183(b)(1). This has the effect of reducing by displacement the allowable deduction for expenses attributable to the hobby or amusement activity. Moreover, the deductions are "below-the-line" and subject to the 2% floor of § 67 for miscellaneous deductions. A presumption in favor of the taxpayer to the effect that the "activity is engaged in for profit" arises if s/he derives gross income from the activity greater than deductions attributable to it for three of the previous five consecutive tax years. § 183(d).

[83] Letter Ruling 9331001.

and immediately consume that item in the production of taxable income. We would expect that such expenditures would be immediately deductible in full. We sometimes call this treatment "expensing."

Alternatively, taxpayer may purchase an input that enables him/her/it to earn income for more than the current tax year. For example, taxpayer might purchase a machine that will enable him/her/it to generate income for the next ten years. Taxpayer has made an "investment" rather than an expenditure on an item that he/she/it immediately consumes. A mere change in the form in which taxpayer holds wealth is not a taxable event; we implement this principle by crediting taxpayer with basis equal to the money removed from his/her/its store of property rights in order to make the investment (i.e., purchase). Taxpayer (might) then consume only a part of the item that he/she/it purchased in order to generate income, i.e., to "de-invest" it. The Code implements in several places a scheme that (theoretically) matches such consumption with the income that the expenditure actually generates. The Code permits a deduction for such partial consumption under the headings of depreciation, amortization, or more recently, cost recovery. Since such consumption represents a deinvestment, taxpayer must adjust his/her/its basis in the productive asset downward. We sometimes call this tax treatment of the purchase and use of a productive asset "capitalization."

The Code also implements such a matching principle when taxpayer derives gross income by selling from inventory. Taxpayer may not build up deductions by purchasing inventory in advance of the time he/she/it actually makes sales.

Yet another possibility is that taxpayer may purchase an input that enables him/her/it to produce income but never in fact consumes that input, e.g., land. There should logically be no deduction – immediately or in the future – for such expenditures. Taxpayer will have a basis in such an asset, but could only recover it for income purposes upon sale of the asset. Some of these assets may not even be capable of sale, e.g., a legal education or other investments in human capital. We sometimes also call this tax treatment of the purchase and use of such an asset "capitalization."

Both the Commissioner and taxpayers are aware of the time value of money. For this reason, taxpayer usually wants to classify purchases of inputs that enable him/her/it to generate income in a manner that permits the greatest immediate deduction. The Commissioner of course wants the opposite result.

In the materials ahead, we very roughly consider first the placement of particular expenditures into one group or another – whether expense or capital. We then consider some of the basic principles and recurring issues in each of these groups.

I. Expense or Capital

The following cases involve the proper treatment of particular expenditures to purchase income-producing assets – whether immediately deductible, deductible over their useful life, or not deductible because taxpayer never consumes the item.

Welch v. Helvering, 290 U.S. 114 (1933)

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922, petitioner was the secretary of the E.L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to reestablish his relations with customers whom he had known when acting for the Welch

Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfillment of that resolve, he made payments of substantial amounts during five successive years. ... The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital expenditures, an outlay for the development of reputation and goodwill. The Board of Tax Appeals sustained the action of the Commissioner and the Court of Appeals for the Eighth Circuit affirmed. The case is here on certiorari. ...

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. [citation omitted]. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is nonetheless a variable affected by time and place and circumstance. "Ordinary" in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser v. United States*, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times, there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning [citations omitted], we should have to say that payment in such circumstances, instead of being ordinary, is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree, and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. [citations omitted]. Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the goodwill of an old partnership. [citation omitted]. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations at times with border-line conclusions. Typical illustrations are cited in the margin.[84]

The decree should be

Affirmed.

Notes and Questions:

1. With this case, if not before, the word "ordinary" as used in the phrase "ordinary and necessary" provides a line of demarcation between expenditures currently deductible and those that are either never deductible or deductible only over time, i.e., through depreciation or

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[84] Ordinary expenses: Commissioner v. People's Pittsburgh Trust Co., 60 F.2d 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; American Rolling Mill Co. v. Commissioner, 41 F.2d 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen ...; Corning Glass Works v. Lucas, 59 App. D.C. 168, 37 F.2d 798, donations to a hospital by a corporation whose employees with their dependents made up two-thirds of the population of the city; Harris & Co. v. Lucas, 48 F.2d 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. *Cf.* Lucas v. Ox Fibre Brush Co., 281 U.S. 115, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered.

Not ordinary expenses: Hubinger v. Commissioner, 36 F.2d 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; Lloyd v. Commissioner, 55 F.2d 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; One Hundred Five West Fifty-Fifth Street v. Commissioner, 42 F.2d 849, and Blackwell Oil & Gas Co. v. Commissioner, 60 F.2d 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; White v. Commissioner, 61 F.2d 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.

amortization allowances.

- •Since the expenses were not "ordinary," the next question is whether taxpayer could deduct them over time through depreciation or amortization.
- •What should be relevant in making this determination?
- •Do you think that the expenses in *Welch v. Helvering* should be recoverable through depreciation or amortization allowances?
- •In the second paragraph of the Court's footnote, the Court cited several cases. Which expenditures should taxpayer be able to deduct as depreciation or amortization, and which should taxpayer not be able deduct at all – probably ever?

2. Consider these three rationales of the Court's opinion: the expenditures were too personal to be deductible, were too bizarre to be ordinary, and were capital so not deductible.

- •Personal: Welch felt a moral obligation, as many in Minnesota in such circumstances did at the time, to pay the corporation's debts. In fact, Welch repaid the debts on the advice of bankers. This would seem to make business the motivation for repaying these debts.
- •Bizarre: Others in Minnesota had done exactly the same thing, i.e., repay the debts of a bankrupt predecessor.
- •Capital: The expenditures were no doubt capital in nature. However, they were arguably only an investment designed to generate income for a finite period of time. As such, the expenditures should be depreciable or amortizable.
- •*See* Joel S. Newman, *The Story of* Welch*: The Use (and Misuse) of the "Ordinary and Necessary" Test for Deducting Business Expenses*, in TAX STORIES 197-224 (Paul Caron ed., 2d ed. 2009).

3. What should be the tax consequences of making payments to *create* goodwill? What should be the tax consequences of *maintaining or repairing goodwill*?

4. By paying the debts of a bankrupt, no-longer-in-existence corporation, was Thomas Welch trying to *create* goodwill or to *maintain or repair* it? Whose goodwill?

•Consider: Conway Twitty (actually Harold Jenkins) is a famous country music singer. He formed a chain of fast food restaurants ("Twitty Burger, Inc."). He persuaded seventy-five friends in the country music business to invest with him. The venture failed. Twitty was concerned about the effect of the adverse publicity on his *country music* career. He repaid the investors himself.

- •If Twitty were trying to protect the reputation of Twitty Burger, the expenditures would surely have been nondeductible. Twitty Burger after all was defunct.
- •The court found as a fact that one's reputation in the country music business is very important.
- •Deductible? *See Harold L. Jenkins v. Commissioner*, T.C. Memo 1983-667, 1983 WL 14653.

5. What should be the tax treatment of expenditures incurred to acquire property that has an indefinite useful life?

Woodward v. Commissioner, 397 U.S. 572 (1970)

MR. JUSTICE MARSHALL delivered the opinion of the Court.

....

Taxpayers owned or controlled a majority of the common stock of the Telegraph-Herald, an Iowa publishing corporation. The Telegraph-Herald was incorporated in 1901, and its charter was extended for 20-year periods in 1921 and 1941. On June 9, 1960, taxpayers voted their controlling share of the stock of the corporation in favor of a perpetual extension of the charter. A minority stockholder voted against the extension. Iowa law requires "those stockholders voting for such renewal . . . [to] purchase at its real value the stock voted against such renewal." Iowa Code § 491.25 (1966).

Taxpayers attempted to negotiate purchase of the dissenting stockholder's shares, but no agreement could be reached on the "real value" of those shares. Consequently, in 1962, taxpayers brought an action in state court to appraise the value of the minority stock interest. The trial court fixed a value, which was slightly reduced on appeal by the Iowa Supreme Court, [citations omitted]. In July, 1965, taxpayers purchased the minority stock interest at the price fixed by the court.

During 1963, taxpayers paid attorneys', accountants', and appraisers' fees of over $25,000, for services rendered in connection with the appraisal litigation. On their 1963 federal income tax returns, taxpayers claimed deductions for these expenses, asserting that they were "ordinary and necessary expenses paid ... for the management, conservation, or maintenance of property held for the production of income" deductible under § 212 ... The Commissioner of Internal Revenue disallowed the deduction "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation." The Tax Court sustained the Commissioner's determination, with two dissenting opinions, and the Court of Appeals affirmed. We granted certiorari to resolve the conflict over the deductibility of the costs of appraisal proceedings between this decision and the decision of the Court of Appeals for the Seventh Circuit in *United States v. Hilton Hotels Corp*., [397 U.S. 580 (1970)].[85] We affirm.

Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible. [footnote omitted] *See* § 263. Such expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold. If an expense is capital, it cannot be deducted as "ordinary and necessary," either as a business expense under § 162 of the Code or as an expense of "management, conservation, or maintenance" under § 212.[86]

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[85] Other federal court decisions on the point are in conflict. [citations omitted].

[86] The two sections are in pari materia with respect to the capital-ordinary distinction, differing only in that § 212 allows deductions for the ordinary and necessary expenses of nonbusiness profitmaking activities. *See* United States v. Gilmore, 372 U.S. 39, 44-45 (1963). ...

It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by a longstanding Treasury regulation, Reg. § 1.263(a)-2(e), and as approved by this Court in *Helvering v. Winmill*, 305 U.S. 79 (1938), and *Spreckels v. Commissioner*, 315 U.S. 626 (1942). The Court recognized that brokers' commissions are "part of the acquisition cost of the securities," *Helvering v. Winmill*, *supra*, at 305 U.S. 84, and relied on the Treasury regulation, which had been approved by statutory reenactment, to deny deductions for such commissions even to a taxpayer for whom they were a regular and recurring expense in his business of buying and selling securities.

The regulations do not specify other sorts of acquisition costs, but rather provide generally that "[t]he cost of acquisition ... of ... property having a useful life substantially beyond the taxable year" is a capital expenditure. Reg. § 1.263(a)-2(a). Under this general provision, the courts have held that legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of such property are capital expenditures. *See, e.g.*, *Spangler v. Commissioner*, 323 F.2d 913, 921 (C.A. 9th Cir.1963); *United States v. St. Joe Paper Co.*, 284 F.2d 430, 432 (C.A. 5th Cir.1960). [citation omitted]. The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.

More difficult questions arise with respect to another class of capital expenditures, those incurred in "defending or perfecting title to property." Reg. § 1.263(a)-2(c). In one sense, any lawsuit brought against a taxpayer may affect his title to property – money or other assets subject to lien. [footnote omitted] The courts, not believing that Congress meant all litigation expenses to be capitalized, have created the rule that such expenses are capital in nature only where the taxpayer's "primary purpose" in incurring them is to defend or perfect title. *See, e.g.*, *Rassenfoss v. Commissioner*, 158 F.2d 764 (C.A. 7th Cir.1946); *Industrial Aggregate Co. v. United States*, 284 F.2d 639, 645 (C.A. 8th Cir.1960). This test hardly draws a bright line, and has produced a melange of decisions which, as the Tax

Court has noted, "[i]t would be idle to suggest ... can be reconciled." *Ruoff v. Commissioner*, 30 T.C. 204, 208 (1958). [footnote omitted]

Taxpayers urge that this "primary purpose" test, developed in the context of cases involving the costs of defending property, should be applied to costs incurred in acquiring or disposing of property as well. And if it is so applied, they argue, the costs here in question were properly deducted, since the legal proceedings in which they were incurred did not directly involve the question of title to the minority stock, which all agreed was to pass to taxpayers, but rather was concerned solely with the value of that stock. [footnote omitted]

We agree with the Tax Court and the Court of Appeals that the "primary purpose" test has no application here. That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be "defending or perfecting title." Such uncertainty is not called for in applying the regulation that makes the "cost of acquisition" of a capital asset a capital expense. In our view, application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.

A test based upon the taxpayer's "purpose" in undertaking or defending a particular piece of litigation would encourage resort to formalism and artificial distinctions. For instance, in this case, there can be no doubt that legal, accounting, and appraisal costs incurred by taxpayers in negotiating a purchase of the minority stock would have been capital expenditures. *See Atzingen-Whitehouse Dairy Inc. v. Commissioner*, 36 T.C. 173 (1961). Under whatever test might be applied, such expenses would have clearly been "part of the acquisition cost" of the stock. *Helvering v. Winmill*, *supra*. Yet the appraisal proceeding was no more than the substitute that state law provided for the process of negotiation as a means of fixing the price at which the stock was to be purchased. Allowing deduction of expenses incurred in such a proceeding, merely on the ground that title was not directly put in question in the particular litigation, would be anomalous.

Further, a standard based on the origin of the claim litigated comports with this Court's recent ruling on the characterization of litigation expenses for tax purposes in *United States v. Gilmore*, 372 U.S. 39 (1963). This Court there held that the expense of defending a divorce suit was a nondeductible personal expense, even though the outcome of the divorce case would affect the taxpayer's property holdings, and might affect his business reputation. The Court rejected a test that looked to the consequences of the litigation, and did not even consider the taxpayer's motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer, and found that the claim arose out of the personal relationship of marriage.

The standard here pronounced may, like any standard, present borderline cases, in which it is difficult to determine whether the origin of particular litigation lies in the process of acquisition. [footnote omitted] This is not such a borderline case. Here state law required taxpayers to "purchase" the stock owned by the dissenter. In the absence of agreement on the price at which the purchase was to be made, litigation was required to fix the price. Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price.[87] Thus, the expenses incurred in that litigation were properly treated as part of the cost of the stock that the taxpayers acquired.

Affirmed.

Notes and Questions:

1. Will taxpayers be permitted to claim

Start-up Expenses of a Business: No deduction is permitted for the start-up expenses of a proprietorship (§ 195), corporation (§ 248), or partnership (§ 709) – except as specifically provided. What would be the rationale of this treatment?

[87] ... [W]herever a capital asset is transfe... upon or determined by law to be a fair qu... there is no reason why the costs of determining the amount of that payment should be considered capital in the case of the negotiated price and yet considered deductible in the case of the price fixed by law. *See* Isaac G. Johnson & Co. v. United States, 149 F.2d 851 (C.A.2d Cir.1945) (expenses of litigating amount of fair compensation in condemnation proceeding held capital expenditures).

depreciation or amortization deductions for the expenditures in question? Why or why not?

2. M owned certain real estate in Memphis, Tennessee. In 2011, M entered into contracts to lease the properties for a term of fifty years, and in 2011 paid commissions and fees to a real estate broker and attorney for services in obtaining the contracts.

- For tax purposes, how should M treat the real estate brokerage commissions?
- *See Renwick v. United States*, 87 F.2d 123, 125 (7th Cir. 1936); *Meyran v. Commissioner*, 63 F.2d 986 (3rd Cir. 1933).

3. S owned stock in several different companies. He sold 100 shares of IBM stock for a nice profit and incurred a brokerage commission of $500. For tax purposes, how should S treat the brokerage commissions?

- Does it make any difference whether S treats the brokerage commission as an ordinary and necessary expense of investment activity or as a decrease in his "amount realized?"
- *See Spreckels v. Commissioner*, 315 U.S. 626 (1942).

4. W purchased the IBM stock that S sold, *supra*. W incurred a brokerage commission of $500. For tax purposes, how should W treat the brokerage commissions?

- Does it make any difference whether W treats the brokerage commission as an ordinary and necessary expense of investment activity or as an increase in his basis?
- *See Helvering v. Winmill*, 305 U.S. 79 (1938).

A. Expense or Capital: Cost of Constructing a *Tangible* Capital Asset

What should be the tax treatment of the cost of taxpayer's self-construction of a productive asset for it to use in its own business? Should there be a parallel between such activity and the tax treatment we accord imputed income?

Commissioner v. Idaho Power Co., 418 U.S. 1 (1974)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents the sole issue whether, for federal income tax purposes, a taxpayer is entitled to a deduction from gross income, under [I.R.C.] § 167(a) ...[88] ... for depreciation on equipment the taxpayer owns and uses in the construction of its own capital facilities, or whether the capitalization provision of § 263(a)(1) of the Code[89] ..., bars the deduction.

The taxpayer claimed the deduction, but the Commissioner ... disallowed it. The Tax Court ... upheld the Commissioner's determination. The United States Court of Appeals for the Ninth Circuit, declining to follow a Court of Claims decision, *Southern Natural Gas Co. v. United States*, 412 F.2d 1222, 1264-1269 (1969), reversed. We granted certiorari in order to resolve the apparent conflict between the Court of Claims and the Court of Appeals.

I

... The taxpayer-respondent, Idaho Power Company, ... is a public utility engaged in the production, transmission, distribution, and sale of electric energy. The taxpayer keeps its books and files its federal income tax returns on the calendar year accrual basis. The tax years at issue are 1962 and 1963.

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[88] § 167. Depreciation.

> (a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –
>
> > (1) of property used in the trade or business, or
> >
> > (2) of property held for the production of income.

[89] § 263. Capital expenditures.

> (a) General rule. No deduction shall be allowed for –
>
> > (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities. [footnote omitted]. The major work has consisted of transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

During 1962 and 1963, the tax years in question, taxpayer owned and used in its business a wide variety of automotive transportation equipment, including passenger cars, trucks of all descriptions, power-operated equipment, and trailers. Radio communication devices were affixed to the equipment, and were used in its daily operations. The transportation equipment was used in part for operation and maintenance and in part for the construction of capital facilities having a useful life of more than one year.

....

... [O]n its books, in accordance with Federal Power Commission-Idaho Public Utilities Commission prescribed methods, the taxpayer capitalized the construction-related depreciation, but, for income tax purposes, that depreciation increment was [computed on a composite life of ten years under straight-line and declining balance methods, and] claimed as a deduction under § 167(a). [footnote omitted]

Upon audit, the Commissioner ... disallowed the deduction for the construction-related depreciation. He ruled that that depreciation was a nondeductible capital expenditure to which § 263(a)(1) had application. He added the amount of the depreciation so disallowed to the taxpayer's adjusted basis in its capital facilities, and then allowed a deduction for an appropriate amount of depreciation on the addition, computed over the useful life (30 years or more) of the property constructed. A deduction for depreciation of the transportation equipment to the extent of its use in day-to-day operation and maintenance was also allowed. The result of these adjustments was the disallowance of depreciation, as claimed by the taxpayer on its returns, in the net amounts of $140,429.75 and $96,811.95 for 1962 and 1963, respectively. This gave rise to asserted deficiencies in taxpayer's income taxes for those two years of $73,023.47 and $50,342.21.

The Tax Court agreed with the [Commissioner.] ...

The Court of Appeals, on the other hand, perceived in the ... Code ... the presence of a liberal congressional policy toward depreciation, the underlying theory of which is that capital assets used in business should not be exhausted without provision for replacement. The court concluded that a deduction expressly enumerated in the Code, such as that for depreciation, may properly be taken, and that "no exception is made should it relate to a capital item." Section 263(a)(1) ... was found not to be applicable, because depreciation is not an "amount paid out," as required by that section. ...

The taxpayer asserts that its transportation equipment is used in its "trade or business," and that depreciation thereon is therefore deductible under § 167(a)(1) ... The Commissioner concedes that § 167 may be said to have a literal application to depreciation on equipment used in capital construction,[90] but contends that the provision must be read in light of § 263(a)(1), which specifically disallows any deduction for an amount "paid out for new buildings or for permanent improvements or betterments." He argues that § 263 takes precedence over § 167 by virtue of what he calls the "priority-ordering" terms (and what the taxpayer describes as "housekeeping" provisions) of § 161 of the Code[91] ... and that sound

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[90] For purposes of the issue here presented, the key phrase of § 167(a)(1) is "property used in the trade or business." ...

Since the Commissioner appears to have conceded the literal application of § 167(a) to Idaho Power's equipment depreciation, we need not reach the issue whether the Court of Appeals has given the phrase "used in the trade or business" a proper construction. For purposes of this case, we assume, without deciding, that § 167(a) does have a literal application to the depreciation of the taxpayer's transportation equipment used in the construction of its capital improvements.

[91] § 161. Allowance of deductions. In computing taxable income under § 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (§§ 261 and following, relating to items not deductible)."

principles of accounting and taxation mandate the capitalization of this depreciation.

It is worth noting the various items that are not at issue here. ... There is no disagreement as to the allocation of depreciation between construction and maintenance. The issue thus comes down primarily to a question of timing, ... that is, whether the construction-related depreciation is to be amortized and deducted over the shorter life of the equipment or, instead, is to be amortized and deducted over the longer life of the capital facilities constructed.

II

Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time, a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted.[92] As the process of consumption continues, and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. The Court stated in *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960):

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[92] The Committee on Terminology of the American Institute of Certified Public Accountants has discussed various definitions of depreciation and concluded that:

> These definitions view depreciation, broadly speaking, as describing not downward changes of value regardless of their causes, but a money cost incident to exhaustion of usefulness. The term is sometimes applied to the exhaustion itself, but the committee considers it desirable to emphasize the cost concept as the primary, if not the sole, accounting meaning of the term: thus, depreciation means the cost of such exhaustion, as wages means the cost of labor.

2 APB Accounting Principles, Accounting Terminology Bulletin No. 1 -- Review and Resume 48, p. 9512 (1973) (emphasis in original).

> [T]he purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset.

[citations omitted]. When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.

The Court of Appeals opined that the purpose of the depreciation allowance under the Code was to provide a means of cost recovery, *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, 13-14 (1909), and that this Court's decisions, *e.g.*, *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943), endorse a theory of replacement through "a fund to restore the property." Although tax-free replacement of a depreciating investment is one purpose of depreciation accounting, it alone does not require the result claimed by the taxpayer here. Only last Term, in *United States v. Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973), we rejected replacement as the strict and sole purpose of depreciation:

> Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is ... [depreciation] reflects the cost of an existing capital asset, not the cost of a potential replacement.

Id. at 415. Even were we to look to replacement, it is the replacement of the constructed facilities, not the equipment used to build them, with which we would be concerned. If the taxpayer now were to decide not to construct any more capital facilities with its own equipment and employees, it, in theory, would have no occasion to replace its equipment to the extent that it was consumed in prior construction.

Accepted accounting practice[93] and established tax principles require the capitalization of the cost of acquiring a capital asset. In *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), the Court observed:

> It has long been recognized, as a general matter, that costs incurred in the acquisition ... of a capital asset are to be treated as capital expenditures.

This principle has obvious application to the acquisition of a capital asset by purchase, but it has been applied, as well, to the costs incurred in a taxpayer's construction of capital facilities. [citations omitted]. [footnote omitted]

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) ... But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized, and are then entitled to be amortized over the life of the capital asset so acquired. [citations omitted].

Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of

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[93] The general proposition that good accounting practice requires capitalization of the cost of acquiring a capital asset is not seriously open to question. The Commissioner urges, however, that accounting methods, as a rule, require the treatment of construction-related depreciation of equipment as a capital cost of the facility constructed. Indeed, there is accounting authority for this. *See, e.g.*, W. PATON, ASSET ACCOUNTING 188, 192-193 (1952); H. FINNEY & H. MILLER, PRINCIPLES OF ACCOUNTING – INTRODUCTORY 246-247 (6th ed. 1963) (depreciation as an expense should be matched with the production of income); W. PATON, ACCOUNTANTS' HANDBOOK 652 (3d ed. 1943); Note, 1973 DUKE L.J. 1377, 1384; Note, 52 N.C. L. REV. 684, 692 (1974).

construction equipment does not represent the final disposition of the taxpayer's investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer's cost or investment in the capital asset. ... By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. [citations omitted].

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers, because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost, including depreciation charged to it by the contractor.

....

[Taxpayer argued that the language of § 263(a)(1), which denies a current deduction for "new buildings or for permanent improvements or betterments," only applies when taxpayer has "paid out" an "amount." Depreciation, taxpayer argued, represented a decrease in value – not an "amount ... paid out." The Court rejected this limitation on § 263's applicability. Instead, the Court accepted the IRS's administrative construction of that phrase to mean "cost incurred." Construction-related depreciation is such a cost.] In acquiring the transportation equipment, taxpayer "paid out" the equipment's purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in *Brooks v. Commissioner*, 50 T.C. at 935, "depreciation – inasmuch as it represents a using up of capital – is as much an expenditure' as the using up of labor or other items of direct cost."

Finally, the priority-ordering directive of § 161 – or, for that matter, ... § 261[94] – requires that the capitalization provision of § 263(a) take precedence, on the facts here, over § 167(a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are "subject to the exceptions provided in part IX." Part VI includes § 167, and Part IX includes § 263. The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere (as, for example, in § 404, relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

The Court of Appeals concluded, without reference to § 161, that § 263 did not apply to a deduction, such as that for depreciation of property used in a trade or business, allowed by the Code even though incurred in the construction of capital assets. [footnote omitted] We think that the court erred in espousing so absolute a rule, and it obviously overlooked the contrary direction of § 161. To the extent that reliance was placed on the congressional intent, in the evolvement of the 1954 Code, to provide for "liberalization of depreciation," H.R. Rep. No. 1337, 83d Cong., 2d Sess., 22 (1954), that reliance is misplaced. The House Report also states that the depreciation provisions would "give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting." *Id*. at 24. To be sure, the 1954 Code provided for new and accelerated methods for depreciation, resulting in the greater depreciation deductions currently available. These changes, however, relate primarily to computation of depreciation. Congress certainly did not intend that provisions for accelerated depreciation should be construed as enlarging

[94] § 261. General rule for disallowance of deductions. In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

the class of depreciable assets to which § 167(a) has application or as lessening the reach of § 263(a). [citation omitted].

We hold that the equipment depreciation allocable to taxpayer's construction of capital facilities is to be capitalized.

The judgment of the Court of Appeals is reversed.

It is so ordered.

MR. JUSTICE DOUGLAS, dissenting. [omitted].

Notes and Questions:

1. The Court noted that the net of taxpayer's disallowed depreciation deductions were $140,429.75 and $96,811.95 for 1962 and 1963 respectively. The useful life of the items that taxpayer was constructing was three or more times as long as the useful life of the equipment it used to construct those items. This case is about the fraction of the figures noted here that taxpayer may deduct – after the item is placed in service.

Taxpayer's books and taxpayer's tax books: Distinguish between taxpayer's books ("its books") and taxpayer's tax books ("for federal income tax purposes"). For what purposes does taxpayer keep each set of books? Do you think that they would ever be different? Why or why not?

2. Why do we allow deductions for depreciation? Is it that –

- "capital assets used in business should not be exhausted without provision for replacement"?
- physical consumption of a capital asset reduces its value and utility and allowing a depreciation deduction is implicit recognition of this fact?
    - obsolescence may reduce the usefulness of an asset, even if the asset could still function, e.g., a twenty-year old personal computer?
- it is necessary "to allocate the expense of using an asset to the various periods which are benefitted by that asset"?

•How does your view of depreciation apply to a case where taxpayer consumes depreciable assets in the construction of income-producing capital assets?

3. Aside from the Code's mandate in § 1016(a)(2), why must a taxpayer reduce its adjusted basis in an asset subject to depreciation?

> *Sections 161 and 261*: How does the language of §§ 161 and 261 create an ordering rule? What deductions do §§ 262 to 280H create?

4. How did the Court's treatment of depreciation in this case prevent the distortion of income?

5. The case demonstrates again how important the time value of money is.

6. The cost of services that are embodied in an asset must themselves be capitalized.

7. Why might Congress *want* to mismatch the timing of income and expenses and thereby distort income?

B. Expense or Capital: Cost of "Constructing" an *Intangible* Capital Asset

What should be the rule when taxpayer self-creates an *intangible* asset that it can use to generate taxable income? Are there any (obvious) difficulties to applying the rule of *Idaho Power* to such a situation? Identify what taxpayer in *INDOPCO* argued was the rule of *Lincoln Savings*? Would taxpayer's statement of that rule solve those difficulties?

INDOPCO v. Commissioner, 503 U.S. 79 (1992)
JUSTICE BLACKMUN delivered the opinion of the Court. In this case we must decide whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that

corporation as “ordinary and necessary” business expenses under § 162(a) of the Internal Revenue Code.

I

... Petitioner INDOPCO, Inc., formerly named National Starch and Chemical Corporation and hereinafter referred to as National Starch, ... manufactures and sells adhesives, starches, and specialty chemical products. In October 1977, representatives of Unilever United States, Inc., ... (Unilever), [footnote omitted] expressed interest in acquiring National Starch, which was one of its suppliers, through a friendly transaction. National Starch at the time had outstanding over 6,563,000 common shares held by approximately 3,700 shareholders. The stock was listed on the New York Stock Exchange. Frank and Anna Greenwall were the corporation’s largest shareholders and owned approximately 14.5% of the common. The Greenwalls, getting along in years and concerned about their estate plans, indicated that they would transfer their shares to Unilever only if a transaction tax free for them could be arranged.

Lawyers representing both sides devised a “reverse subsidiary cash merger” that they felt would satisfy the Greenwalls’ concerns. Two new entities would be created – National Starch and Chemical Holding Corp. (Holding), a subsidiary of Unilever, and NSC Merger, Inc., a subsidiary of Holding that would have only a transitory existence. ...

In November 1977, National Starch’s directors were formally advised of Unilever’s interest and the proposed transaction. At that time, Debevoise, Plimpton, Lyons & Gates, National Starch’s counsel, told the directors that under Delaware law they had a fiduciary duty to ensure that the proposed transaction would be fair to the shareholders. National Starch thereupon engaged the investment banking firm of Morgan Stanley & Co., Inc., to evaluate its shares, to render a fairness opinion, and generally to assist in the event of the emergence of a hostile tender offer.

Although Unilever originally had suggested a price between $65 and $70 per share, negotiations resulted in a final offer of $73.50 per share, a figure Morgan Stanley found to be fair. Following approval by National Starch’s board and the issuance of a favorable private ruling from the Internal Revenue Service that the transaction would be tax free ... for those National Starch shareholders who exchanged their stock for Holding preferred, the transaction was consummated in August 1978.[95]

Morgan Stanley charged National Starch a fee of $2,200,000, along with $7,586 for out-of-pocket expenses and $18,000 for legal fees. The Debevoise firm charged National Starch $490,000, along with $15,069 for out-of-pocket expenses. National Starch also incurred expenses aggregating $150,962 for miscellaneous items – such as accounting, printing, proxy solicitation, and Securities and Exchange Commission fees – in connection with the transaction. No issue is raised as to the propriety or reasonableness of these charges.

On its federal income tax return ... National Starch claimed a deduction for the $2,225,586 paid to Morgan Stanley, but did not deduct the $505,069 paid to Debevoise or the other expenses. Upon audit, the Commissioner of Internal Revenue disallowed the claimed deduction and issued a notice of deficiency. Petitioner sought redetermination in the United States Tax Court, asserting, however, not only the right to deduct the investment banking fees and expenses but, as well, the legal and miscellaneous expenses incurred.

The Tax Court, in an unreviewed decision, ruled that the expenditures were capital in nature and therefore not deductible under § 162(a) in the 1978 return as "ordinary and necessary expenses." The court based its holding primarily on the long-term benefits that accrued to National Starch from the Unilever acquisition. The United States Court of Appeals for the Third Circuit affirmed, upholding the Tax Court's findings that "both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch." In so doing, the Court of Appeals rejected National Starch's contention that, because the disputed expenses did not "create or enhance

[95] Approximately 21% of National Starch common was exchanged for Holding preferred. The remaining 79% was exchanged for cash.

... a separate and distinct additional asset," see *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354 (1971), they could not be capitalized and therefore were deductible under § 162(a). We granted certiorari to resolve a perceived conflict on the issue among the Courts of Appeals.[96]

II

Section 162(a) ... allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In contrast, § 263 ... allows no deduction for a capital expenditure – an "amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." § 263(a)(1). The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. *See* 26 U.S.C. §§ 167(a) and 336(a); Reg. § 1.167(a) (1991). Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. *See, e. g.*, *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (CA ll 1982), *cert. denied*, 463 U.S. 1207 (1983).

In exploring the relationship between deductions and capital

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[96] *Compare* the Third Circuit's opinion, 918 F.2d at 430, *with* NCNB Corp. v. United States, 684 F.2d 285, 293-294 (4th Cir. 1982) (bank expenditures for expansion-related planning reports, feasibility studies, and regulatory applications did not "create or enhance separate and identifiable assets," and therefore were ordinary and necessary expenses under § 162(a)), *and* Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782 (2d Cir. 1973) (suggesting that *Lincoln Savings* "brought about a radical shift in emphasis," making capitalization dependent on whether the expenditure creates or enhances a separate and distinct additional asset). *See also* Central Texas Savings & Loan Assn. v. United States, 731 F.2d 1181, 1184 (5th Cir. 1984) (inquiring whether establishment of new branches "creates a separate and distinct additional asset" so that capitalization is the proper tax treatment).

expenditures, this Court has noted the "familiar rule" that "an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. *See* §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a "complete list of nondeductible expenditures," *Lincoln Savings*, 403 U.S. at 358, § 263 serves as a general means of distinguishing capital expenditures from current expenses. *See Commissioner v. Idaho Power Co.*, 418 U.S. at 16. For these reasons, deductions are strictly construed and allowed only "as there is a clear provision therefor." *New Colonial Ice Co. v. Helvering*, 292 U.S., at 440; *Deputy v. Du Pont*, 308 U.S., at 493. [footnote omitted]

The Court also has examined the interrelationship between the Code's business expense and capital expenditure provisions. [footnote omitted.] In so doing, it has had occasion to parse § 162(a) and explore certain of its requirements. For example, in *Lincoln Savings*, we determined that, to qualify for deduction under § 162(a), "an item must (1) be 'paid or incurred during the taxable year,' (2) be for 'carrying on any trade or business,' (3) be an 'expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." 403 U.S. at 352. *See also Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (the term "necessary" imposes "only the minimal requirement that the expense be 'appropriate and helpful' for 'the development of the [taxpayer's] business,'" quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933)); *Deputy v. Du Pont*, 308 U.S. at 495 (to qualify as "ordinary," the expense must relate to a transaction "of common or frequent occurrence in the type of business involved"). The Court has recognized, however, that the "decisive distinctions" between current expenses and capital expenditures "are those of degree and not of kind," *Welch v. Helvering*, 290 U.S. at 114, and that because each case "turns on its special facts," *Deputy v. Du Pont*, 308 U.S. at 496, the cases sometimes appear difficult to harmonize. *See Welch v. Helvering*, 290 U.S. at 116.

National Starch contends that the decision in *Lincoln Savings* changed these familiar backdrops and announced an exclusive test for identifying capital expenditures, a test in which “creation or enhancement of an asset” is a prerequisite to capitalization, and deductibility under § 162(a) is the rule rather than the exception. We do not agree, for we conclude that National Starch has overread *Lincoln Savings*.

In *Lincoln Savings*, we were asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under § 162(a), as Lincoln Savings argued and the Court of Appeals had held, or capital expenditures under § 263, as the Commissioner contended. We found that the “additional” premiums, the purpose of which was to provide FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, “serv[e] to create or enhance for Lincoln what is essentially a separate and distinct additional asset.” 403 U.S. at 354. “[A]s an inevitable consequence,” we concluded, “the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a).” *Ibid*.

Lincoln Savings stands for the simple proposition that a taxpayer’s expenditure that “serves to create or enhance ... a separate and distinct” asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure. *See General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (CA8) (although expenditures may not “resul[t] in the acquisition or increase of a corporate asset, ... these expenditures are not, because of that fact, deductible as ordinary and necessary business expenses”), *cert. denied*, 379 U.S. 832 (1964).

Nor does our statement in *Lincoln Savings*, 403 U.S. at 354, that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure.[97] Although the mere presence of an incidental future benefit – "some future aspect" – may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. *See United States v. Mississippi Chemical Corp*., 405 U.S. 298, 310 (1972) (expense that "is of value in more than one taxable year" is a nondeductible capital expenditure); *Central Texas Savings & Loan Assn. v. United States*, 731 F.2d 1181, 1183 (CA5 1984) ("While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item"). Indeed, the text of the Code's capitalization provision, § 263(a)(1), which refers to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

III

In applying the foregoing principles to the specific expenditures at issue in this case, we conclude that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under § 162(a).

Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as "entirely speculative" or "merely incidental," the Tax Court's and the Court of Appeals' findings

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[97] Petitioner contends that, absent a separate-and-distinct-asset requirement for capitalization, a taxpayer will have no "principled basis" upon which to differentiate business expenses from capital expenditures. We note, however, that grounding tax status on the existence of an asset would be unlikely to produce the bright-line rule that petitioner desires, given that the notion of an "asset" is itself flexible and amorphous. *See* Johnson, 53 TAX NOTES, at 477-478.

that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record. For example, in commenting on the merger with Unilever, National Starch's 1978 "Progress Report" observed that the company would "benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology." (Unilever "provides new opportunities and resources"). Morgan Stanley's report to the National Starch board concerning the fairness to shareholders of a possible business combination with Unilever noted that National Starch management "feels that some synergy may exist with the Unilever organization given a) the nature of the Unilever chemical, paper, plastics and packaging operations ... and b) the strong consumer products orientation of Unilever United States, Inc."

In addition to these anticipated resource-related benefits, National Starch obtained benefits through its transformation from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever. The Court of Appeals noted that National Starch management viewed the transaction as "'swapping approximately 3500 shareholders for one.'" Following Unilever's acquisition of National Starch's outstanding shares, National Starch was no longer subject to what even it terms the "substantial" shareholder-relations expenses a publicly traded corporation incurs, including reporting and disclosure obligations, proxy battles, and derivative suits. The acquisition also allowed National Starch, in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares of preferred and to reduce the total number of authorized shares of common from 8,000,000 to 1,000.

Courts long have recognized that expenses such as these, "'incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.'" *General Bancshares Corp. v. Commissioner*, 326 F. 2d, at 715 (quoting *Farmers Union Corp. v. Commissioner*, 300 F.2d 197, 200 (CA9), *cert. denied*, 371 U.S. 861 (1962)). *See also* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 5-33 to 5-36 (5th ed. 1987) (describing "well-established rule" that expenses incurred in reorganizing or restructuring corporate entity are not deductible under § 162(a)).

Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure.[98] Although support for these decisions can be found in the specific terms of § 162(a), which require that deductible expenses be "ordinary and necessary" and incurred "in carrying on any trade or business,"[99] courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." *General Bancshares Corp. v. Commissioner*, 326 F. 2d at 715. *See also Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (CA2 1953). The rationale behind these decisions applies equally to the professional charges at issue in this case.

IV

The expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as "ordinary and necessary" business expenses under § 162(a). The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

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[98] *See, e.g.* McCrory Corp. v. United States, 651 F.2d 828 (2d Cir. 1981) (statutory merger under 26 U.S.C. § 368(a)(1)(A)); Bilar Tool & Die Corp. v. Commissioner, 530 F.2d 708 (6th Cir. 1976) (division of corporation into two parts); E. I. du Pont de Nemours & Co. v. United States, 432 F. 2d 1052 (3rd Cir. 1970) (creation of new subsidiary to hold assets of prior joint venture); General Bancshares Corp. v. Commissioner, 326 F.2d 712, 715 (8th Cir.) (stock dividends), *cert. denied*, 379 U.S. 832 (1964); Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953) (recapitalization).

[99] *See, e.g.*, Motion Picture Capital Corp. v. Commissioner, 80 F.2d 872, 873-874 (CA2 1936) (recognizing that expenses may be "ordinary and necessary" to corporate merger, and that mergers may be "ordinary and necessary business occurrences," but declining to find that merger is part of "ordinary and necessary business activities," and concluding that expenses are therefore not deductible); Greenstein, *The Deductibility of Takeover Costs After* National Starch, 69 TAXES 48, 49 (1991) (expenses incurred to facilitate transfer of business ownership do not satisfy the "carrying on [a] trade or business" requirement of § 162(a)).

The judgment of the Court of Appeals is affirmed.

It is so ordered.

Notes and Questions:

1. The *INDOPCO* decision was not well received in the business community. Why not?

   •Should taxpayer in *INDOPCO* amortize the intangible that it purchased? – over what period of time?

2. Capitalization of expenditures to construct a tangible asset followed by depreciation, amortization, or cost recovery works more predictably than when expenditures are directed towards the "construction" of an intangible asset. Why do you think that this is so?

   •Perhaps because a tangible asset physically deteriorates over time and so its useful life is more easily determinable.

   •A marketing campaign requires current and future expenditures, but the "asset" it creates (consumer loyalty? brand recognition?) should endure past the end of the campaign. It is not even possible to know when this asset no longer generates income – as would be the case with an asset as tangible as, say, a building. A rational approach to depreciation, amortization, or cost recovery requires that we not only be able to recognize when an expenditure no longer generates income, but also be able to predict how long that would be.

      •Consider expenditures for advertising. Not only do these problems emerge, but answers would be different from one taxpayer to the next.

      •The compliance costs of a rule that requires taxpayer to capitalize expenditures that generate income into the future can be enormous. At least one case was litigated all the way to the Supreme Court. *Cf. Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993) (at-will subscription list is not goodwill and purchaser of newspaper permitted to depreciate it upon proof of value and useful life).

•In light of these considerations, perhaps there is something to be said for National Starch's contention that capitalization required the "creation or enhancement of a separate and distinct asset." Moreover, its statement in the second footnote ("absent a separate-and-distinct-asset requirement for capitalization, a taxpayer will have no 'principled basis' upon which to differentiate business expenses from capital expenditures") just might be accurate. The Court dismissed this argument in the next sentence of the footnote by observing that its position essentially is no worse than taxpayer's.

•"Deduction rather than capitalization becomes more likely as the link between the outlay and a readily identifiable asset decreases, and as the asset to which the outlay is linked becomes less and less tangible." Joseph Bankman, *The Story of* INDOPCO*: What Went Wrong in the Capitalization v. Deduction Debate*, in TAX STORIES 228 (Paul Caron ed., 2d ed. 2009).

•"Deduction also becomes more likely for expenses that are recurring, or fit within a commonsense definition of ordinary and necessary." *Id.*

•Lower courts gradually began to read *Lincoln Savings* as *requiring* the creation or enhancement of a separate and distinct asset. *Id.* at 233.

•Nevertheless, the Supreme Court was correct in its reading of *Lincoln Savings* to the effect "that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure."

•On the other hand, does the Court announce that the presence of "some future benefit" is a sufficient condition to classification as a capital expenditure?

3. The *INDOPCO* holding called into question many long-standing

positions that taxpayers had felt comfortable in taking. The cost of complete and literal compliance with every ramification of the holding would have been enormous. The IRS produced some (favorable to the taxpayer) clarifications in revenue rulings concerning the deductibility of particular expenditures. *See* Joseph Bankman, *The Story of* INDOPCO*: What Went Wrong in the Capitalization v. Deduction Debate*, in TAX STORIES 244-45 (Paul Caron ed., 2d ed. 2009). In 2004, the IRS published final regulations. *Guidance Regarding Deduction and Capitalization of Expenditures*, 69 Fed. Reg. 436 (Jan. 5, 2004). The regulations represented an IRS effort to allay fears and/or provide predictability to the application of capitalization rules. In its "Explanation and Summary of Comments Concerning § 1.263(a)-4," the IRS wrote:

> The final regulations identify categories of intangibles for which capitalization is required. ... [T]he final regulations provide that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure. If the IRS publishes guidance requiring capitalization of an expenditure that produces future benefits for the taxpayer, such guidance will apply prospectively. ...

Id. at 436. This positivist approach severely limits application of the "significant future benefits" theory to require capitalization of untold numbers of expenditures.

4. The "capitalization list" appears in Regs. §§ 1.263(a)-4(b)(1) and 1.263(a)-5(a).

- an amount paid to another party to acquire an intangible;
- an amount paid to create an intangible specifically named in Reg. § 1.263(a)-4(d);
- an amount paid to create or enhance a separate and distinct intangible asset;
- an amount paid to create or enhance a future benefit that the IRS has specifically identified in published guidance;

•an amount paid to "facilitate" (as that term is specifically defined) an acquisition or creation of any of the above-named intangibles; and
•amounts paid or incurred to facilitate acquisition of a trade or business, a change in the capital structure of a business entity, and various other transactions.

5. Moreover, Reg. § 1.263(a)-4(f)(1) states a 12-month rule, i.e., that
a taxpayer is not required to capitalize ... any right or benefit for the taxpayer that does not extend beyond the earlier of –

> (i) 12 months after the first date on which the taxpayer realizes the right or benefit; or
> (ii) The end of the taxable year following the taxable year in which the payment is made.

6. When taxpayers incur recurring expenses intended to provide future benefits – notably advertising – what is gained by strict adherence to capitalization principles?
•In *Encyclopaedia Britannica, Inc. V. Commissioner*, 685 F.2d 212, ___ (7th Cir. 1982), Judge Posner wrote:

> If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period (conventionally one year, [citation omitted]) in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from. [citation omitted]. It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great. The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be.

7. (Note 6, continued): Imagine: An author spends $5 every year for on pen and paper with which the author will write books. Each book will generate income for the author for 5 years. Let's assume that "the rules" permit such a taxpayer to deduct $1 of that $5 expenditure in each of the succeeding five years. This tax treatment matches the author's expenses with his income. The following table demonstrates that this taxpayer will (eventually) be deducting $5 every year.

year # ☞ amt spent	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
$5	1	1	1	1	1											
$5		1	1	1	1	1										
$5			1	1	1	1	1									
$5				1	1	1	1	1								
$5					1	1	1	1	1							
$5						1	1	1	1	1						
$5							1	1	1	1	1					
$5								1	1	1	1	1				
$5									1	1	1	1	1			
$5										1	1	1	1	1		
$5											1	1	1	1	1	
$5												1	1	1	1	1
$5													1	1	1	1
$5														1	1	1
year by year total	1	2	3	4	5	5	5	5	5	5	5	5	5	5	.....	.....

Beginning in year 5, how much does the year by year total change? Does this table suggest that there is an easier way to handle recurring capital expenditures than to require taxpayer to capitalize and depreciate each and every such expenditure?

8. You are expected to recognize a capitalization of intangibles issue – but the details of the regulations are left to a more advanced tax course.

C. Expense or Capital: Protecting Stock Investment or Protecting Employment

United States v. Generes, 405 U.S. 93 (1972)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.
A debt a closely held corporation owed to an indemnifying shareholder employee became worthless in 1962. The issue in this federal income tax refund suit is whether, for the shareholder employee, that worthless obligation was a business or a nonbusiness bad debt within the meaning and reach of §§ 166(a) and (d) of the ... Code[100] and of the implementing

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[100] § 166. Bad debts.

(a) General rule. –

(1) Wholly worthless debts. – There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

* * * *

(d) Nonbusiness debts. –

(1) General rule. – In the case of a taxpayer other than a corporation –

(A) subsections (a) and (c) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined. – For purposes of paragraph (1), the term 'nonbusiness debt' means a debt other than –

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

Regulations § 1.166-5.[101]

The issue's resolution is important for the taxpayer. If the obligation was a business debt, he may use it to offset ordinary income and for carryback purposes under § 172 of the Code ... On the other hand, if the obligation is a nonbusiness debt, it is to be treated as a short-term capital loss subject to the restrictions imposed on such losses by § 166(d)(1)(B) and §§ 1211 and 1212, and its use for carryback purposes is restricted by § 172(d)(4). The debt is one or the other in its entirety, for the Code does not provide for its allocation in part to business and in part to nonbusiness.

In determining whether a bad debt is a business or a nonbusiness obligation, the Regulations focus on the relation the loss bears to the taxpayer's business. If, at the time of worthlessness, that relation is a "proximate" one, the debt qualifies as a business bad debt and the aforementioned desirable tax consequences then ensue.

The present case turns on the proper measure of the required proximate relation. Does this necessitate a "dominant" business motivation on the part of the taxpayer, or is a "significant" motivation sufficient?

Tax in an amount somewhat in excess of $40,000 is involved. The

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[101] Reg. § 1.166-5 Nonbusiness debts.

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> (b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than –
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> >
> > (2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business. The question whether a debt is a nonbusiness debt is a question of fact in each particular case. ...
> >
> > For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. ...

taxpayer, Allen H. Generes, [footnote omitted] prevailed in a jury trial in the District Court. On the Government's appeal, the Fifth Circuit affirmed by a divided vote. Certiorari was granted to resolve a conflict among the circuits. [footnote omitted.]

I

The taxpayer, as a young man in 1909, began work in the construction business. His son-in law, William F. Kelly, later engaged independently in similar work. During World War II, the two men formed a partnership in which their participation was equal. The enterprise proved successful. In 1954, Kelly Generes Construction Co., Inc., was organized as the corporate successor to the partnership. It engaged in the heavy-construction business, primarily on public works projects.

The taxpayer and Kelly each owned 44% of the corporation's outstanding capital stock. The taxpayer's original investment in his shares was $38,900. The remaining 12% of the stock was owned by a son of the taxpayer and by another son-in law. Mr. Generes was president of the corporation, and received from it an annual salary of $12,000. Mr. Kelly was executive vice-president, and received an annual salary of $15,000.

The taxpayer and Mr. Kelly performed different services for the corporation. Kelly worked full time in the field, and was in charge of the day-to-day construction operations. Generes, on the other hand, devoted no more than six to eight hours a week to the enterprise. He reviewed bids and jobs, made cost estimates, sought and obtained bank financing, and assisted in securing the bid and performance bonds that are an essential part of the public project construction business. Mr. Generes, in addition to being president of the corporation, held a full-time position as president of a savings and loan association he had founded in 1937. He received from the association an annual salary of $19,000. The taxpayer also had other sources of income. His gross income averaged about $40,000 a year during 1959-1962.

Taxpayer Generes from time to time advanced personal funds to the corporation to enable it to complete construction jobs. He also guaranteed loans made to the corporation by banks for the purchase of construction machinery and other equipment. In addition, his presence with respect to the bid and performance bonds is of particular significance. Most of these were obtained from Maryland Casualty Co. That underwriter required the taxpayer and Kelly to sign an indemnity agreement for each bond it issued for the corporation. In 1958, however, in order to eliminate the need for individual indemnity contracts, taxpayer and Kelly signed a blanket agreement with Maryland whereby they agreed to indemnify it, up to a designated amount, for any loss it suffered as surety for the corporation. Maryland then increased its line of surety credit to $2,000,000. The corporation had over $14,000,000 gross business for the period 1954 through 1962.

In 1962, the corporation seriously underbid two projects and defaulted in its performance of the project contracts. It proved necessary for Maryland to complete the work. Maryland then sought indemnity from Generes and Kelly. The taxpayer indemnified Maryland to the extent of $162,104.57. In the same year, he also loaned $158,814.49 to the corporation to assist it in its financial difficulties. The corporation subsequently went into receivership and the taxpayer was unable to obtain reimbursement from it.

In his federal income tax return for 1962 the taxpayer took his loss on his direct loans to the corporation as a nonbusiness bad debt. He claimed the indemnification loss as a business bad debt and deducted it against ordinary income.[102] Later, he filed claims for refund for 1959-1961, asserting net operating loss carrybacks under § 172 to those years for the portion, unused in 1962, of the claimed business bad debt deduction.

In due course, the claims were made the subject of the jury trial refund suit in the United States District Court for the Eastern District of Louisiana. At the trial, Mr. Generes testified that his sole motive in signing the indemnity agreement was to protect his $12,000-a-year employment with the corporation. The jury, by special interrogatory, was asked to

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[102] This difference in treatment between the loss on the direct loan and that, on the indemnity is not explained. *See, however*, Whipple v. Commissioner, 373 U. S. 193 (1963).

determine whether taxpayer's signing of the indemnity agreement with Maryland "was proximately related to his trade or business of being an employee" of the corporation. The District Court charged the jury, over the Government's objection, that significant motivation satisfies the Regulations' requirement of proximate relationship.[103] The court refused the Government's request for an instruction that the applicable standard was that of dominant, rather than significant, motivation.[104]
... [T]he jury found that the taxpayer's signing of the indemnity agreement was proximately related to his trade or business of being an employee of the corporation. Judgment on this verdict was then entered for the taxpayer.

The Fifth Circuit majority approved the significant motivation standard so specified and agreed with a Second Circuit majority in *Weddle v. Commissioner*, 325 F.2d 849, 851 (1963), in finding comfort for so doing in the tort law's concept of proximate cause. Judge Simpson dissented. 427 F.2d at 284. He agreed with the holding of the Seventh Circuit in *Niblock v. Commissioner*, 417 F.2d 1185 (1969), and with Chief Judge Lumbard, separately concurring in *Weddle*, 325 F.2d at 852, that dominant and primary motivation is the standard to be applied.

II

A. The fact responsible for the litigation is the taxpayer's dual status relative to the corporation. Generes was both a shareholder and an

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[103] "A debt is proximately related to the taxpayer's trade or business when its creation was significantly motivated by the taxpayer's trade or business, and it is not rendered a non-business debt merely because there was a non-qualifying motivation as well, even though the non-qualifying motivation was the primary one."

[104] "You must, in short, determine whether Mr. Generes' dominant motivation in signing the indemnity agreement was to protect his salary and status as an employee or was to protect his investment in the Kelly Generes Construction Co."

"Mr. Generes is entitled to prevail in this case only if he convinces you that the dominant motivating factor for his signing the indemnity agreement was to insure the receiving of his salary from the company. It is insufficient if the protection or insurance of his salary was only a significant secondary motivation for his signing the indemnity agreement. It must have been his dominant or most important reason for signing the indemnity agreement."

employee. These interests are not the same, and their differences occasion different tax consequences. In tax jargon, Generes' status as a shareholder was a nonbusiness interest. It was capital in nature, and it was composed initially of tax-paid dollars. Its rewards were expectative, and would flow not from personal effort, but from investment earnings and appreciation. On the other hand, Generes' status as an employee was a business interest. Its nature centered in personal effort and labor, and salary for that endeavor would be received. The salary would consist of pre-tax dollars.

Thus, for tax purposes, it becomes important and, indeed, necessary to determine the character of the debt that went bad and became uncollectible. Did the debt center on the taxpayer's business interest in the corporation or on his nonbusiness interest? If it was the former, the taxpayer deserves to prevail here. [citations omitted.]

B. Although arising in somewhat different contexts, two tax cases decided by the Court in recent years merit initial mention. In each of these cases, a major shareholder paid out money to or on behalf of his corporation and then was unable to obtain reimbursement from it. In each, he claimed a deduction assertable against ordinary income. In each, he was unsuccessful in this quest:

1. In *Putnam v. Commissioner*, 352 U. S. 82 (1956), the taxpayer was a practicing lawyer who had guaranteed obligations of a labor newspaper corporation in which he owned stock. He claimed his loss as fully deductible ... The Court ... held that the loss was a nonbusiness bad debt subject to short-term capital loss treatment ... The loss was deductible as a bad debt or not at all. *See* Rev. Rul. 60-48, 1961 Cum. Bull. 112.

2. In *Whipple v. Commissioner*, 373 U. S. 193 (1963), the taxpayer had provided organizational, promotional, and managerial services to a corporation in which he owned approximately an 80% stock interest. He claimed that this constituted a trade or business, and, hence, that debts owing him by the corporation were business bad debts when they became worthless in 1953. The Court also rejected that contention, and held that Whipple's investing was not a trade or business, that is, that "[d]evoting one's time and energies to the affairs of a corporation is not, of itself, and

without more, a trade or business of the person so engaged." 373 U.S. at 202. The rationale was that a contrary conclusion would be inconsistent with the principle that a corporation has a personality separate from its shareholders, and that its business is not necessarily their business. The Court indicated its approval of the Regulations' proximate relation test:

> Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. *Compare Trent v. Commissioner*, [291 F.2d 669 (CA2 1961)].

373 U.S. at 204. The Court also carefully noted the distinction between the business and the nonbusiness bad debt for one who is both an employee and a shareholder.[105]

These two cases approach, but do not govern, the present one. They indicate, however, a cautious, and not a free-wheeling, approach to the business bad debt. Obviously, taxpayer Generes endeavored to frame his case to bring it within the area indicated in the above quotation from *Whipple v. Commissioner*.

III

We conclude that, in determining whether a bad debt has a "proximate" relation to the taxpayer's trade or business, as the Regulations specify, and thus qualifies as a business bad debt, the proper measure is that of dominant motivation, and that only significant motivation is not sufficient. We reach this conclusion for a number of reasons:

A. The Code itself carefully distinguishes between business and nonbusiness items. It does so, for example, in § 165 with respect to losses, in § 166 with respect to bad debts, and in § 162 with respect to expenses. It

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[105] "Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business." 373 U.S. at 202.

gives particular tax benefits to business losses, business bad debts, and business expenses, and gives lesser benefits, or none at all, to nonbusiness losses, nonbusiness bad debts, and nonbusiness expenses. It does this despite the fact that the latter are just as adverse in financial consequence to the taxpayer as are the former. But this distinction has been a policy of the income tax structure ever since the Revenue Act of 1916 ...

The point, however, is that the tax statutes have made the distinction, that the Congress therefore intended it to be a meaningful one, and that the distinction is not to be obliterated or blunted by an interpretation that tends to equate the business bad debt with the nonbusiness bad debt. We think that emphasis upon the significant rather, than upon the dominant, would have a tendency to do just that.

B. Application of the significant motivation standard would also tend to undermine and circumscribe the Court's holding in *Whipple*, and the emphasis there that a shareholder's mere activity in a corporation's affairs is not a trade or business. As Chief Judge Lumbard pointed out in his separate and disagreeing concurrence in *Weddle*, *supra*, 325 F.2d at 852-853, both motives – that of protecting the investment and that of protecting the salary – are inevitably involved, and an inquiry whether employee status provides a significant motivation will always produce an affirmative answer and result in a judgment for the taxpayer.

C. The dominant motivation standard has the attribute of workability. It provides a guideline of certainty for the trier of fact. The trier then may compare the risk against the potential reward and give proper emphasis to the objective, rather than to the subjective. As has just been noted, an employee-shareholder, in making or guaranteeing a loan to his corporation, usually acts with two motivations, the one to protect his investment and the other to protect his employment. By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and however insignificant, from controlling the tax result at the taxpayer's convenience. This is of particular importance in a tax system that is so largely dependent on voluntary compliance.

D. The dominant motivation test strengthens, and is consistent with, the mandate of § 262 of the Code, ... that "no deduction shall be allowed for personal, living, or family expenses" except as otherwise provided. It prevents personal considerations from circumventing this provision.

E. The dominant motivation approach to § 166(d) is consistent with that given the loss provisions in § 165(c)(1), *see*, for example, *Imbesi v. Commissioner*, 361 F.2d 640, 644 (CA3 1966), and in § 165(c)(2), *see Austin v. Commissioner*, 298 F.2d 583, 584 (CA2 1962). In these related areas, consistency is desirable. *See also Commissioner v. Duberstein*, 363 U. S. 278, 363 U. S. 286 (1960).

F. ...

G. The Regulations' use of the word "proximate" perhaps is not the most fortunate, for it naturally tempts one to think in tort terms. The temptation, however, is best rejected, and we reject it here. In tort law, factors of duty, of foreseeability, of secondary cause, and of plural liability are under consideration, and the concept of proximate cause has been developed as an appropriate application and measure of these factors. It has little place in tax law, where plural aspects are not usual, where an item either is or is not a deduction, or either is or is not a business bad debt, and where certainty is desirable.

IV

The conclusion we have reached means that the District Court's instructions, based on a standard of significant, rather than dominant, motivation are erroneous, and that, at least, a new trial is required. We have examined the record, however, and find nothing that would support a jury verdict in this taxpayer's favor had the dominant motivation standard been embodied in the instructions. Judgment n.o.v. for the United States, therefore, must be ordered. *See Neely v. Eby Construction Co.*, 386 U. S. 317 (1967).

As Judge Simpson pointed out in his dissent, 427 F.2d at 284-285, the only real evidence offered by the taxpayer bearing upon motivation was his own testimony that he signed the indemnity agreement "to protect my job," that "I figured, in three years' time, I would get my money out," and that "I never once gave it [his investment in the corporation] a thought." [footnote omitted]

The statements obviously are self-serving. In addition, standing alone, they do not bear the light of analysis. What the taxpayer was purporting to say was that his $12,000 annual salary was his sole motivation, and that his $38,900 original investment, the actual value of which, prior to the misfortunes of 1962, we do not know, plus his loans to the corporation, plus his personal interest in the integrity of the corporation as a source of living for his son-in law and as an investment for his son and his other son-in law, were of no consequence whatever in his thinking. The comparison is strained all the more by the fact that the salary is pre-tax and the investment is tax-paid. With his total annual income about $40,000, Mr. Generes may well have reached a federal income tax bracket of 40% or more for a joint return in 1958-1962. §§ 1 and 2 of the 1954 Code ... The $12,000 salary thus would produce for him only about $7,000 net after federal tax and before any state income tax. This is the figure, and not $12,000, that has any possible significance for motivation purposes, and it is less than 1/5 of the original stock investment. [footnote omitted]

We conclude on these facts that the taxpayer's explanation falls of its own weight, and that reasonable minds could not ascribe, on this record, a dominant motivation directed to the preservation of the taxpayer's salary as president of Kelly Generes Construction Co., Inc.

The judgment is reversed, and the case is remanded with direction that judgment be entered for the United States.

It is so ordered.

MR. JUSTICE POWELL and MR. JUSTICE REHNQUIST took no part in the consideration or decision of this case.

MR. JUSTICE MARSHALL, concurring (omitted).

MR. JUSTICE WHITE, with whom MR. JUSTICE BRENNAN joins.

While I join Parts I, II, and III of the Court's opinion and its judgment of reversal, I would remand the case to the District Court with directions to hold a hearing on the issue of whether a jury question still exists as to whether taxpayer's motivation was "dominantly" a business one in the relevant transactions ...

MR. JUSTICE DOUGLAS, dissenting. [omitted.]

Notes and questions:

1. What were the stakes in the outcome of the case? *See* §§ 1211(b) ($1000 limit at the time the Court decided *Generes*), 1212(b).

2. What information should be critical to the valuation of taxpayer's stock? In a closely-held corporation in which shareholders, officers, employees, and creditors are usually the same people who wear different hats on different occasions – is it ever realistic to say that a bad debt is "one or the other in its entirety?"

D. Expense or Capital: Repair vs. Improvement

Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950).

....

ARUNDELL, Judge:

The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under § [162(a)] ... on the theory it was an expenditure for a repair ...

The respondent [Commissioner] has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes. Treasury Regulations 111, from which we quote in the margin,[106] is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In *Illinois Merchants Trust Co., Executor*, 4 B.T.A. 103, 106, we discussed this subject in some detail and in our opinion said:

> It will be noted that the first sentence of the [regulation] ... relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

... [F]or some 25 years prior to the taxable year [(1943)] petitioner [Midland Empire] had used the basement rooms of its plant [situated in Billings near the Yellowstone River] as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the

[106] [The regulation that the court quoted is now in substance Reg. § 1.162-4.]

water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery [of the Yale Oil Corporation] had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oilproof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work [, $4,868.81,] which it seeks to deduct as a repair. The basement was not enlarged by this work [and in fact petitioner's operating space contracted], nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

[Midland charged the $4,868.81 to repair expense on its regular books and deducted that amount on its tax returns as an ordinary and necessary business expense for the fiscal year 1943. The Commissioner, in his notice of deficiency, determined that the cost of oilproofing was not deductible ... as an ordinary and necessary expense ... in 1943.]

While it is conceded on brief that the expenditure was 'necessary,' respondent contends that the encroachment of the oil nuisance on petitioner's property was not an 'ordinary' expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of 'ordinary' ... Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

....

[The petitioner thereafter filed suit against Yale, on April 22, 1944, in a cause of action sounding in tort ... This action was to recover damages for the nuisance created by the oil seepage. ... Petitioner subsequently settled its cause of action against Yale for $11,659.49 and gave Yale a complete release of all liability. This release was dated October 23, 1946.]

In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. ...

Notes and Questions:

1. Read Reg. § 1.162-4 (again?). What legal standard does the regulation establish in determining whether an expenditure is to repair rather than improve an asset?

2. The court said: "It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes."

- What facts convinced the court to place the expenditure on the "repair" side of the line?

3. In the fifth-to-last paragraph of the case, the court stated conclusions taken almost verbatim from the regulation. Does this give you any idea of the type of evidence that taxpayer must have presented and its relation to Reg. § 1.162-4?

4. The Yale Oil Corporation owned a nearby oil-refining plant and storage area and its discharges caused the problems that Midland Empire had to address. Yale Oil made a payment to Midland Empire to settle the nuisance suit brought against it. May Yale Oil deduct the amount it paid to settle the case, or should it capitalize that amount? *Cf. Mt. Morris Drive-In*, *infra*?

> *War-time and shortly thereafter*: During WW I and WW II, tax rates were considerably higher than they were in peacetime. In what ways did this make timing an especially important matter?

- What tax treatment should Midland accord the $11,659.49 payment it received from Yale?

5. Consider: X owns a small retail shop. In 2008, a storm damaged the roof of X's shop by displacing numerous wooden shingles. X decided to replace all the wooden shingles on the roof and hired a contractor to replace all the shingles on the roof with new wooden shingles. Assume the shop building and its structural components are the unit of property. The event necessitating the expenditure was the storm. Prior to the storm, the retail shop was functioning for its intended use.

- May X deduct the expenses of the roof replacement, or must X capitalize the expenditure?
- *See* Prop. Reg. 1.263(a)-3(f)(3), Example 9.

5a. Assume the same facts, except that, instead of replacing the wooden shingles with asphalt shingles, X decided to replace all the wooden shingles with shingles made of lightweight composite materials that are maintenance-free and do not absorb moisture. The new shingles have a 50-year warranty and a Class A fire rating instead of a 15-year warranty and a Class B fire rating.

- May X deduct the expenses of the roof replacement, or must X capitalize the expenditure?
- *See* Prop. Reg. 1.263(a)-3(f)(3), Example 11.

Mt. Morris Drive-In Theatre Co. v. Commissioner, 25 T.C. 272 (1955), *aff'd*, 238 F.2d 85 (CA6 1956)

....

FINDINGS OF FACT.

....

In 1947 petitioner purchased 13 acres of farm land located on the outskirts of Flint, Michigan, upon which it proceeded to construct a drive-in or outdoor theatre. Prior to its purchase by the petitioner the land on which the theatre was built was farm land and contained vegetation. The slope of the land was such that the natural drainage of water was from the southerly line to the northerly boundary of the property and thence onto the adjacent land, owned by David and Mary D. Nickola, which was used both for farming and as a trailer park. The petitioner's land sloped sharply from south to north and also sloped from the east downward towards the west so that most of the drainage from the petitioner's property was onto the southwest corner of the Nickolas' land. The topography of the land purchased by petitioner was well known to petitioner at the time it was purchased and developed. The petitioner did not change the general slope of its land in constructing the drive-in theatre, but it removed the covering vegetation from the land, slightly increased the grade, and built aisles or ramps which were covered with gravel and were somewhat raised so that the passengers in the automobiles would be able to view the picture on the large outdoor screen.

As a result of petitioner's construction on and use of this land rain water falling upon it drained with an increased flow into and upon the adjacent property of the Nickolas. This result should reasonably have been anticipated by petitioner at the time when the construction work was done.

The Nickolas complained to the petitioner at various times after petitioner began the construction of the theatre that the work resulted in an acceleration and concentration of the flow of water which drained from the petitioner's property onto the Nickolas' land causing damage to their crops and roadways. On or about October 11, 1948, the Nickolas filed a suit against the petitioner ... asking for an award for damages done to their property by the accelerated and concentrated drainage of the water and for a permanent injunction restraining the defendant from permitting such drainage to continue. ... [T]he suit was settled by an agreement dated June 27, 1950. This agreement provided for the construction by the petitioner of a drainage system to carry water from its northern boundary across the Nickolas' property and thence to a public drain. The cost of maintaining the system was to be shared by the petitioner and the Nickolas, and the latter granted the petitioner and its successors an easement across their land for the purpose of constructing and maintaining the drainage system. The construction of the drain was completed in October 1950 under the supervision of engineers employed by the petitioner and the Nickolas at a cost to the petitioner of $8,224, which amount was paid by it in November 1950. The performance by the petitioner on its part of the agreement to construct the drainage system and to maintain the portion for which it was responsible constituted a full release of the Nickolas' claims against it. The petitioner chose to settle the dispute by constructing the drainage system because it did not wish to risk the possibility that continued litigation might result in a permanent injunction against its use of the drive-in theatre and because it wished to eliminate the cause of the friction between it and the adjacent landowners, who were in a position to seriously interfere with the petitioner's use of its property for outdoor theatre purposes. A settlement based on a monetary payment for past damages, the petitioner believed, would not remove the threat of claims for future damages.

On its 1950 income and excess profits tax return the petitioner claimed a deduction of $822.40 for depreciation of the drainage system for the period July 1, 1950, to December 31, 1950. The Commissioner disallowed without itemization $5,514.60 of a total depreciation expense deduction of $19,326.41 claimed by the petitioner. In its petition the petitioner asserted that the entire amount spent to construct the drainage system was fully deductible in 1950 as an ordinary and necessary business expense incurred in the settlement of a lawsuit, or, in the alternative, as a loss, and claimed a refund of part of the $10,591.56 of income and excess profits tax paid by it for that year.

The drainage system was a permanent improvement to the petitioner's property, and the cost thereof constituted a capital expenditure.

....

KERN, Judge:

When petitioner purchased, in 1947, the land which it intended to use for a drive-in theatre, its president was thoroughly familiar with the topography of this land which was such that when the covering vegetation was removed and graveled ramps were constructed and used by its patrons, the flow of natural precipitation on the lands of abutting property owners would be materially accelerated. Some provision should have been made to solve this drainage problem in order to avoid annoyance and harassment to its neighbors. If petitioner had included in its original construction plans an expenditure for a proper drainage system no one could doubt that such an expenditure would have been capital in nature.

Within a year after petitioner had finished its inadequate construction of the drive-in theatre, the need of a proper drainage system was forcibly called to its attention by one of the neighboring property owners, and under the threat of a lawsuit filed approximately a year after the theatre was constructed, the drainage system was built by petitioner who now seeks to deduct its cost as an ordinary and necessary business expenses, or as a loss.

We agree with respondent that the cost to petitioner of acquiring and constructing a drainage system in connection with its drive-in theatre was a capital expenditure.

Here was no sudden catastrophic loss caused by a 'physical fault' undetected by the taxpayer in spite of due precautions taken by it at the time of its original construction work as in *American Bemberg Corporation*, 10 T.C. 361; no unforeseeable external factor as in *Midland Empire Packing Co.*, 14 T.C. 635; and no change in the cultivation of farm property caused by improvements in technique and made many years after the property in question was put to productive use as in *J. H. Collingwood*, 20 T.C. 937. In the instant case it was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner's capital investment was incomplete. In addition, it should be emphasized that here there was no mere restoration or rearrangement of the original capital asset, but there was the acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system.

That this drainage system was acquired and constructed and that payments therefor were made in compromise of a lawsuit is not determinative of whether such payments were ordinary and necessary business expenses or capital expenditures. 'The decisive test is still the character of the transaction which gives rise to the payment.' *Hales-Mullaly v. Commissioner*, 131 F.2d 509, 511, 512.

In our opinion the character of the transaction in the instant case indicates that the transaction was a capital expenditure.

Reviewed by the Court.

Decision will be entered for the respondent.

RAUM, J. concurring:

... [I]f provision had been made in the original plans for the construction of a drainage system there could hardly be any question that its cost would have been treated as a capital outlay. The character of the expenditure is not changed merely because it is made at a subsequent time, and I think it wholly irrelevant whether the necessity for the drainage system could have been foreseen, or whether the payment therefor was made as a result of the pressure of a law suit.

FISHER, J., agrees with this concurring opinion.

RICE, J. dissenting:

... [T]he expenditure which petitioner made was an ordinary and necessary business expense, which did not improve, better, extend, increase, or prolong the useful life of its property. The expenditure did not cure the original geological defect of the natural drainage onto the Nickolas' land, but only dealt with the intermediate consequence thereof. ... I cannot agree with the majority that the expenditure here was capital in nature.

OPPER, JOHNSON, BRUCE, and MULRONEY, JJ., agree with this dissent.

Notes and Questions:

1. Upon reading the three opinions here, do you get the feeling that repair vs. improvement – at least in close cases – comes down to who can argue facts that fit within certain considerations better?

2. Consider the following: In 2008, X purchased a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. Assume that the parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X was not aware of the contamination at the time of purchase. In 2009, X discovered the contamination and incurred costs to remediate the soil.

- May X deduct the expenses of soil remediation, or must X capitalize the expenditure?
- *See* Prop. Reg. 1.263(a)-3(f)(3), Example 1.

2a. X owned a building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. In 2008, X determined that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X decided to remove the asbestos-containing insulation from the building and replace it with new insulation that was safer to employees, but no more efficient or effective than the asbestos insulation.

- May X deduct the expenses of removal of the asbestos and replacement with safer insulation, or must X capitalize the expenditure?

•*See* Prop. Reg. 1.263(a)-3(f)(3), Example 2.

2b. In January 2008, X purchased a used machine for use in its manufacturing operations. The machine has a class life of 10 years. The machine was fully operational at the time X purchased it; X immediately placed it in service in its business. At the time X placed it in service, X expected to perform manufacturer-recommended scheduled maintenance on the machine every three years. The scheduled maintenance includes cleaning and oiling the machine, inspecting parts for defects, and replacing minor items such as springs, bearings, and seals with comparable and commercially available and reasonable replacement parts. The scheduled maintenance did not result in any material additions or material increases in capacity, productivity, efficiency, strength or quality of the machine or the output of the machine. At the time X purchased the machine, it was approaching the end of a three-year scheduled maintenance period. As a result, in February 2008, X incurred costs to perform the manufacturer- recommended scheduled maintenance to keep the machine in its ordinarily efficient operating condition.

•May X deduct the expenses of servicing the machine, or must X capitalize the expenditure?

•*See* Prop. Reg. 1.263(a)-3(f)(3), Example 3 (i and ii).

2c. In January 2009, X acquired a building for use in its business of providing assisted living services. Before and after the purchase, the building functioned as an assisted living facility. However, at the time of the purchase, X was aware that the building was in a condition below the standards that it requires for facilities used in its business. Beginning in 2009 and over the next two years, while X continued to use the building as an assisted living facility, X incurred costs for repairs, maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work included repainting; replacing flooring materials, windows, and tiling and fixtures in bathrooms; replacing window treatments, furniture, and cabinets; and repairing or replacing roofing materials, heating and cooling systems.

•May X deduct the expenses of bringing the facility into high-

quality condition, or must X capitalize the expenditure?
•*See* Prop. Reg. 1.263(a)-3(f)(3), Example 5 (i and ii).

II. Deductibility Under §§ 162 or 212

After determining that an expense is *not* a capital expenditure, § 162 (and § 212), coupled with § 274 define and delimit the precise scope of expenses of generating income that taxpayer may deduct. Read § 162(a). How many types of trade or business expenses are deductible?

•We will consider several § 162 issues, but we will not consider them in the sequence in which they appear in the Code.

A. Travel Expenses

Read § 162(a)(2).

Commissioner v. Flowers, 326 U.S. 465 (1946)

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of § [162(a)(2)] of the Internal Revenue Code, [footnote omitted] allowing a deduction for income tax purposes of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business."

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There, he has paid taxes, voted, schooled his children, and established social and religious connections. He built a house in Jackson nearly thirty years ago, and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.

In 1906, the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927, he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927, and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter, he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice-president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of general solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally, and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of time he would spend in each of the two cities, and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile, but not in Jackson. When he worked in Jackson, his law firm provided him with office space, although he no longer participated in the firm’s business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary’s expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer’s participation was advisory only, and was no different from his participation in the railroad’s legal business in other areas.

The taxpayer's principal post of business was at the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson, and the taxpayer participated in that litigation.

During 1939, he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940, he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted $900 in his 1939 income tax return and $1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile.[107] The Commissioner disallowed the deductions, which action was sustained by the Tax Court. But the Fifth Circuit Court of Appeals reversed the Tax Court's judgment, and we granted certiorari because of a conflict between the decision below and that reached by the Fourth Circuit Court of Appeals in *Barnhill v. Commissioner*, 148 F.2d 913.

The portion of § [162(a)(2)] authorizing the deduction of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business" is one of the specific examples given by Congress in that section of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It is to be contrasted with the provision of § [262(a)] of the Internal Revenue Code, disallowing any deductions for "personal, living, or family expenses." ... In pertinent part, [the applicable regulation] states that

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[107] No claim for deduction was made by the taxpayer for the amounts spent in traveling from Mobile to Jackson. ...

> "Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, the railroad fares are personal expenses, and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses. ... Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. ... Commuters' fares are not considered as business expenses, and are not deductible."

Three conditions must thus be satisfied before a traveling expense deduction may be made under § [162(a)(2)]:

(1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.

(2) The expense must be incurred "while away from home."

(3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

Whether particular expenditures fulfill these three conditions so as to entitle a taxpayer to a deduction is purely a question of fact in most instances. See *Commissioner v. Heininger*, 320 U. S. 467, 475. And the Tax Court's inferences and conclusions on such a factual matter, under established principles, should not be disturbed by an appellate court. *Commissioner v. Scottish American Co.*, 323 U. S. 119; *Dobson v. Commissioner*, 320 U. S. 489.

In this instance, the Tax Court, without detailed elaboration, concluded that

> "The situation presented in this proceeding is, in principle, no different from that in which a taxpayer's place of employment is in one city and, for reasons satisfactory to himself, he resides in another."

It accordingly disallowed the deductions on the ground that they represent living and personal expenses, rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court's findings of fact, but reversed its judgment on the basis that it had improperly construed the word "home" as used in the second condition precedent to a traveling expense deduction under § [162(a)(2)] The Tax Court, it was said, erroneously construed the word to mean the post, station, or place of business where the taxpayer was employed – in this instance, Mobile – and thus erred in concluding that the expenditures in issue were not incurred "while away from home." The Court below felt that the word was to be given no such "unusual" or "extraordinary" meaning in this statute, that it simply meant "that place where one in fact resides" or "the principal place of abode of one who has the intention to live there permanently." Since the taxpayer here admittedly had his home, as thus defined, in Jackson, and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word "home" in § [162(a)(2)] with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. 4 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942) § 25.82. The Tax Court [footnote omitted] and the administrative rulings[108] have consistently defined it as the equivalent of

[108] [The pertinent regulation] does not attempt to define the word "home," although the Commissioner argues that the statement therein contained to the effect that commuters' fares are not business expenses, and are not deductible "necessarily rests on the premise that home,' for tax purposes, is at the locality of the taxpayer's business headquarters." Other administrative rulings have been more explicit in treating the statutory home as the abode at the taxpayer's regular post of duty. *See, e.g.*, O.D. 1021, 5 Cum. Bull. 174 (1921); I.T. 1264, I-1 Cum. Bull. 122 (1922); I.T. 3314, 1939-2 Cum. Bull. 152; G.C.M. 23672, 1943 Cum. Bull. 66.

the taxpayer's place of business. *See Barnhill v. Commissioner*, *supra*. On the other hand, the decision below and *Wallace v. Commissioner*, 144 F.2d 407, have flatly rejected that view, and have confined the term to the taxpayer's actual residence. [citation omitted].

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court's opinion, as we read it, was grounded neither solely nor primarily upon that agency's conception of the word "home." Its discussion was directed mainly toward the relation of the expenditures to the railroad's business, a relationship required by the third condition of the deduction. Thus, even if the Tax Court's definition of the word "home" was implicit in its decision, and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad's business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. ...

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer's employer, the railroad. Jackson was his regular home. Had his post of duty been in that city, the cost of maintaining his home there and of commuting or driving to work concededly would be nondeductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer's post of duty was in Mobile, thereby increasing the costs of transportation, food, and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad's business as were his personal and living costs in Jackson. They were incurred solely as the result of the taxpayer's desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad's legal business. The railroad did not require him to travel on business from Jackson to Mobile, or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer's work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of § [162(a)(2)] could arise only when the railroad's business forced the taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business, rather than the personal conveniences and necessities of the traveler, must be the motivating factors. Such was not the case here.

It follows that the court below erred in reversing the judgment of the Tax Court.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

MR. JUSTICE RUTLEDGE, dissenting.

I think the judgment of the Court of Appeals should be affirmed. When Congress used the word "home" in § [162] of the Code, I do not believe it meant "business headquarters." And, in my opinion, this case presents no other question.

Congress allowed the deduction for "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business." [A Treasury Regulation] also provides: "Commuters' fares are not considered as business expenses and are not deductible." By this decision, the latter regulation is allowed, in effect, to swallow up the deduction for many situations where the regulation has no fit application.

....

It seems questionable whether ... the Tax Court has not confused the taxpayer's principal place of employment with his employer's. For, on the facts, Jackson, rather than Mobile, would seem more appropriately to be found his business headquarters. ...

....

[The majority treats taxpayer as a commuter. The word "commuter"] has limitations unless it also is made a tool for rewriting the Act. The ordinary, usual connotation, [citation omitted], does not include irregular, although frequent journeys of 350 miles, requiring Pullman accommodations and some twelve to fifteen hours, one way.

Congress gave the deduction for traveling away from home on business. The commuter's case, rightly confined, does not fall in this class. One who lives in an adjacent suburb or City and by usual modes of commutation can work within a distance permitting the daily journey and return, with time for the day's work and a period at home, clearly can be excluded from the deduction on the basis of the section's terms equally with its obvious purpose. ... If the line may be extended somewhat to cover doubtful cases, it need not be lengthened to infinity or to cover cases as far removed from the prevailing connotation of commuter as this one. Including it pushes "commuting" too far, even for these times of rapid transit.[109]

Administrative construction should have some bounds. It exceeds what are legitimate when it reconstructs the statute to nullify or contradict the plain meaning of nontechnical terms not artfully employed. ...

By construing "home" as "business headquarters;" by reading "temporarily" as "very temporarily" into § [162]; by bringing down "ordinary and necessary" from its first sentence into its second;[110] by finding "inequity" where Congress has said none exists; by construing "commuter" to cover long distance, irregular travel, and by conjuring from the "statutory setting" a meaning at odds with the plain wording of the clause, the Government makes over understandable ordinary English into highly technical tax jargon. ...

Notes and Questions:

1. Reg. § 1.162-2 is now the regulation covering "traveling expenses" whose provisions have not materially changed those quoted by the Court in *Flowers*.

2. Can commuting expenses *ever* meet the third requirement of

> *Reimbursement of Non-deductible Expenditures*: Taxpayer paid his expenses and tried to deduct them. What result if taxpayer's employer had paid for taxpayer's train tickets, hotels, and meals while in Mobile? Would (should) that have solved taxpayer's problems – or made them worse? *See* discussion of *Brandl v. Commissioner*, *infra*.

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[109] Conceivably men soon may live in Fl back. Possibly they will be regarded as c case and, in any event, neither situation was comprehended by Congress when § [162] was enacted.

[110] The language is:

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business. . . ."

§ [162(a)], Internal Revenue Code.

deductibility, i.e., "a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer?"

3. Does Justice Rutledge have a point? After all, the Court later construed the word "gift" in its ordinary sense in *Duberstein*.

4. Upon application of the Court's standards, why will taxpayer's home usually be the "post, station, or place of business where the taxpayer [is] employed?"

5. Robert Rosenspan was a jewelry salesman who worked on a commission basis and paid his own traveling expenses without reimbursement. In 1964 he was the employee of two New York City jewelry manufacturers. For 300 days during the year he traveled by automobile through an extensive sales territory in the Middle West. He stayed at hotels and motels and ate at restaurants. Five times during the year he returned to New York and spent several days at his employers' offices. There he performed a variety of services essential to his work, i.e., cleaned up his sample case, checked orders, discussed customers' credit problems, recommended changes in stock, attended annual staff meetings, and the like. He used his brother's Brooklyn home as a personal residential address. He kept some clothing and other belongings there. He voted, and filed his income tax returns from that address. On his trips to New York City,"out of a desire not to abuse his welcome at his brother's home, he stayed more often" at an inn near the John F. Kennedy Airport.

- What tax issue(s) do these facts raise? How should they be resolved?
- *See Rosenspan v. United States*, 438 F.2d 905 (2d Cir.), *cert. denied*, 404 U.S. 864 (1971).

5a. Folkman, an airline pilot, was stationed in San Francisco International Airport as an employee of Pan American World Airways. He flew infrequently as a pilot with Pan American because of his low seniority. His principal work was that of navigator. This work gave him little opportunity to keep up basic flying skills. To maintain his proficiency as a jet pilot, and to earn extra income, Folkman enlisted in a military reserve program. The closest Air National Guard unit that had openings for pilots of jet aircraft was in Reno, Nevada, about 250 miles from San Francisco. As a condition of membership, the Nevada Air National Guard required all pilots to reside in the Reno area. Folkman and his family moved from their home near the San Francisco airport, to Reno. Folkman divided his time between flying with Pan American from his San Francisco base and flying for the Nevada Air National Guard. During an average month Folkman spent 10 to 13 days performing services for Pan American and four to seven days fulfilling his military reserve flying obligations. Whether or not he was scheduled to fly for the National Guard on a given day, Folkman routinely returned to Reno immediately after his Pan American flights. Folkman spent more time in Reno than in San Francisco, but derived approximately 85% of his earnings from his Pan American employment.

- What tax issue(s) do these facts raise? How do you think they should be resolved and why?
- *See Folkman v. United States*, 615 F.2d 493 (9th Cir. 1980).

5b. Taxpayer Brandl was employed by Strong Electric Co. as a traveling technical representative of the marketing department. His duties consisted of visiting, assisting and selling to Strong dealers throughout the United States. Taxpayer did a great deal of traveling. Strong's headquarters are in Toledo, Ohio. Taxpayer neither owned nor rented an apartment or house in Toledo. When Taxpayer was in Toledo he either stayed at a motel or with his brother and sister-in-law. When Taxpayer stayed with his brother he paid no rent but did help pay for groceries and household items, and worked around the house doing maintenance and remodeling. Generally he was away from Toledo visiting customers from four to six weeks at a time, but on occasion up to three months. When Taxpayer traveled he stayed in hotels. When Taxpayer was at Strong headquarters in Toledo he took care of paper work, wrote letters to customers he had visited, and helped with general office work of the marketing department. During the tax year, Taxpayer spent a total of three months in Toledo. Taxpayer received personal mail at his brother's home in Toledo, and he had an Ohio driver's license. For the tax year in question, Strong paid Taxpayer $8,288.68 for his travel expenses. Taxpayer did not include that amount in income. Taxpayer did not claim a deduction for traveling expenses while away from home.

- Must Taxpayer Brandl include the $8288.68 in his taxable income?
- If so, may he deduct that amount as a "travel expense" under § 162(a)(2)?
- *See Brandl v. Commissioner*, T.C. Memo 1974-160 (1974).

> *Reimbursement or Other Expense Allowance Arrangement*: An *employee* may deduct his/her trade or business expenses. However, the employee may only claim that deduction if s/he itemizes deductions, *and* trade or business deductions of an employee are subject to the 2% floor for "miscellaneous deductions." *See* § 67. The effect of this treatment is to reduce, if not deny, an employee's trade or business expense deduction. Employee must include any employer reimbursement in his/her gross income.
>
> However, § 62(a)(2)(A) permits taxpayer to reduce his/her agi by trade or business expenditures (i.e., deduct "above-the-line") if his/her employer (or the employer's agent or a third party) has a "reimbursement or other expense allowance arrangement." *See also* Reg. § 1.62-2. The net effect of such employer reimbursement of employee trade or business expenses is a wash. The arrangement must require substantiation of deductible expenditures so that such arrangements do not become a means by which employees can receive compensation without paying income tax on it.

5c. Taxpayers were employees at the Nevada Test Site, a nuclear testing facility. Las Vegas, Nevada, the closest habitable community to the Test Site, is 65 miles south of the Camp Mercury control point, located at the southernmost boundary of the Test Site, and 130 miles from the northernmost boundary of the Test Site. Because of the potential dangers arising out of the activities conducted at the Test Site, the government chose this location precisely because of its remoteness from populated areas. All of the taxpayers assigned to the Test Site received, in addition to their regular wages, a per diem allowance for each day they reported for work at the Test Site. The amount of the allowance varied. Employees reporting to Camp Mercury received $5 per day; those reporting to any forward area received $7.50 per day. Employees received these allowances without regard to the actual costs incurred by them for transportation, meals, or lodging. A private contractor maintained meal and lodging facilities onsite. Employees were responsible for procuring transportation, meals, and occasionally overnight lodging when they had to work overtime.

- •Should Taxpayers be permitted to *exclude* their per diem allowances? *See Commissioner v. Kowalski*, 434 U.S. 77 (1977), *supra*.
- •Should Taxpayers be permitted to *deduct* the cost of their travel?
- •Should Taxpayers be permitted to *deduct* the cost of their meals?
- •Should Taxpayers be permitted to *deduct* the cost of their lodging?
- •*See Coombs v. Commissioner*, 608 F.2d 1269 (0th Cir. 1979).

United States v. Correll, 389 U.S. 299 (1967)

MR. JUSTICE STEWART delivered the opinion of the Court.

The Commissioner of Internal Revenue has long maintained that a taxpayer traveling on business may deduct the cost of his meals only if his trip requires him to stop for sleep or rest. The question presented here is the validity of that rule.

The respondent in this case was a traveling salesman for a wholesale grocery company in Tennessee. [footnote omitted] He customarily left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner. In his income tax returns for 1960 and 1961, he deducted the cost of his morning and noon meals as "traveling expenses" incurred in the pursuit of his business "while away from home" under [I.R.C.] § 162(a)(2) ...[111] Because the respondent's daily trips

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[111] "(a) In General.– There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including –"

"****"

> "(2) traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business...."

§ 162(a)(2) of the Internal Revenue Code of 1954, 26 U.S.C. § 162(a)(2) (1958 ed.).

required neither sleep nor rest, the Commissioner disallowed the deductions, ruling that the cost of the respondent's meals was a "personal, living" expense under § 262 [footnote omitted], rather than a travel expense under § 162(a)(2). The respondent paid the tax, sued for a refund in the District Court, and there received a favorable jury verdict.[112]

The Court of Appeals for the Sixth Circuit affirmed, holding that the Commissioner's sleep or rest rule is not "a valid regulation under the present statute." In order to resolve a conflict among the circuits on this recurring question of federal income tax administration, [footnote omitted] we granted certiorari.

Under § 162(a)(2), taxpayers "traveling ... away from home in the pursuit of trade or business" may deduct the total amount "expended for meals

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[112] After denying the Government's motion for a directed verdict, the District Judge charged the jury that it would have to "determine under all the facts of this case whether or not" the Commissioner's rule was "an arbitrary regulation as applied to these plaintiffs under the facts in this case." He told the jury to consider whether the meal expenses were "necessary for the employee to properly perform the duties of his work."

> "Should he have eaten them at his home, rather than . . . away from home, in order to properly carry on this business or to perform adequately his duties as an employee of this produce company[?]"
>
> "You are instructed that the cost of meals while on one-day business trips away from home need not be incurred while on an overnight trip to be deductible, so long as the expense of such meals ... proximately results from the carrying on the particular business involved and has some reasonable relation to that business."

Under these instructions, the jury found for the respondent. The District Court denied the Government's motion for judgment notwithstanding the verdict.

and lodging."[113] As a result, even the taxpayer who incurs substantial hotel and restaurant expenses because of the special demands of business travel receives something of a windfall, for at least part of what he spends on meals represents a personal living expense that other taxpayers must bear without receiving any deduction at all.[114] Not surprisingly, therefore, Congress did not extend the special benefits of § 162(a)(2) to every conceivable situation involving business travel. It made the total cost of meals and lodging deductible only if incurred in the course of travel that takes the taxpayer "away from home." The problem before us involves the meaning of that limiting phrase.

In resolving that problem, the Commissioner has avoided the wasteful litigation and continuing uncertainty that would inevitably accompany any purely case-by-case approach to the question of whether a particular taxpayer was "away from home" on a particular day. [footnote omitted] Rather than requiring "every meal-purchasing taxpayer to take pot luck in the courts," [footnote omitted] the Commissioner has consistently construed travel "away from home" to exclude all trips requiring neither sleep nor rest,[115] regardless of how many cities a given trip may have

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[113] Prior to the enactment in 1921 of what is now § 162(a)(2), the Commissioner had promulgated a regulation allowing a deduction for the cost of meals and lodging away from home, but only to the extent that this cost exceeded "any expenditures ordinarily required for such purposes when at home." Treas. Reg. 45 (1920 ed.), Art. 292, 4 Cum. Bull. 209 (1921). Despite its logical appeal, the regulation proved so difficult to administer that the Treasury Department asked Congress to grant a deduction for the "entire amount" of such meal and lodging expenditures. *See* Statement of Dr. T. S. Adams, Tax Adviser, Treasury Department, in Hearings on H.R. 8245 before the Senate Committee on Finance, 67th Cong., 1st Sess., at 50, 234-235 (1921). Accordingly § 214(a)(1) of the Revenue Act of 1921, c. 136, 42 Stat. 239, for the first time included that language that later became § 162(a)(2). ...

[114] Because § 262 makes "personal, living, or family expenses" nondeductible, the taxpayer whose business requires no travel cannot ordinarily deduct the cost of the lunch he eats away from home. But the taxpayer who can bring himself within the reach of § 162(a)(2) may deduct what he spends on his noontime meal although it costs him no more, and relates no more closely to his business, than does the lunch consumed by his less mobile counterpart.

[115] The Commissioner's interpretation, first expressed in a 1940 ruling, I.T. 3395, 1910-2 Cum. Bull. 64, was originally known as the overnight rule. *See* Commissioner v. Bagley, [374 F.2d 204,] 205.

touched, [footnote omitted] how many miles it may have covered,[116] or how many hours it may have consumed. [footnote omitted] By so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application, but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who, of course, cannot deduct the cost of the meals they eat on the road. *See Commissioner v. Flowers*, 326 U.S. 465.

Any rule in this area must make some rather arbitrary distinctions [footnote omitted], but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury. [footnote omitted] And the Commissioner's rule surely makes more sense than one which would allow the respondent in this case to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office.

The Court of Appeals nonetheless found in the "plain language of the statute" an insuperable obstacle to the Commissioner's construction. We disagree. The language of the statute – "meals and lodging ... away from home" – is obviously not self-defining. [footnote omitted] And to the extent that the words chosen by Congress cut in either direction, they tend to support, rather than defeat, the Commissioner's position, for the statute speaks of "meals and lodging" as a unit, suggesting – at least arguably – that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well. [footnote omitted] Ordinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of

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[116] The respondent seldom traveled farther than 55 miles from his home, but he ordinarily drove a total of 150 to 175 miles daily.

his business travel,[117] and Congress might well have thought that only taxpayers in that category should be permitted to deduct their living expenses while on the road.[118] ...

Alternatives to the Commissioner's sleep or rest rule are, of course, available. [footnote omitted] Improvements might be imagined. [footnote omitted] But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Commissioner v. Stidger*, 386 U.S. 287, 296. The role of the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner. Because the rule challenged here has not been shown deficient on that score, the Court of Appeals should have sustained its validity. The judgment is therefore

Reversed.

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[117] The taxpayer must ordinarily "maintain a home for his family at his own expense even when he is absent on business," Barnhill v. Commissioner, 148 F.2d 913, 917, and if he is required to stop for sleep or rest, "continuing costs incurred at a permanent place of abode are duplicated." James v. United States, 308 F.2d 204, 206. The same taxpayer, however, is unlikely to incur substantially increased living expenses as a result of business travel, however far he may go, so long as he does not find it necessary to stop for lodging. ...

[118] The court below thought that,

> "[i]n an era of supersonic travel, the time factor is hardly relevant to the question of whether or not ... meal expenses are related to the taxpayer's business. ..."

369 F.2d 87, 89-90. But that completely misses the point. The benefits of § 162(a)(2) are limited to business travel "away from home," and all meal expenses incurred in the course of such travel are deductible, however unrelated they may be to the taxpayer's income-producing activity. To ask that the definition of "away from home" be responsive to the business necessity of the taxpayer's meals is to demand the impossible.

MR. JUSTICE MARSHALL took no part in the consideration or decision of this case.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE BLACK and MR. JUSTICE FORTAS concur, dissenting.

The statutory words "while away from home," § 162(a)(2), may not, in my view, be shrunken to "overnight" by administrative construction or regulations. "Overnight" injects a time element in testing deductibility, while the statute speaks only in terms of geography. As stated by the Court of Appeals:

> "In an era of supersonic travel, the time factor is hardly relevant to the question of whether or not travel and meal expenses are related to the taxpayer's business, and cannot be the basis of a valid regulation under the present statute."

Correll v. United States, 369 F.2d 87, 89-90.

I would affirm the judgment below.

Notes and Questions:

1. Is this an appropriate area for a bright line rule that may unfairly "catch" some taxpayers?

2. Read the instruction that the federal district court gave to the jury (in a footnote). Does it seem that the standard resembles the standard that the Court later adopted for § 119?

3. Under § 162(a)(2), how strong must the nexus be between the meals and a business purpose? *See* the Court's last footnote. Does your answer make the approach of the commissioner seem more reasonable?

4. F.M. Williams was a railroad conductor with more than forty years of service with the Atlanta and West Point Railroad and the Western Railway of Alabama. Every other day Williams got up shortly after five in

the morning, left his house in Montgomery, Alabama, in time to arrive at the railroad station about 6:45 a.m., attended to duties at the station, left Montgomery on the Crescent at 7:40 a.m., arrived in Atlanta, Georgia, at 12:15 p.m., took six hours off, returned to duty in time to leave Atlanta at 6:15 p.m. on the Piedmont, pulled in to Montgomery at 10:15 p.m., left the Piedmont, and reached home about midnight. It is a long, hard day. The railroad never ordered Williams to rent a room in Atlanta, nor required him to sleep during the layover period. For years, however, because he felt he needed sleep and rest in Atlanta before his return run, Williams rented a reasonably priced room in the Gordon Hotel, a small hotel near the railroad station. At the hotel he had lunch and dinner, rested and slept, bathed and freshened up before boarding the Piedmont. He had the same room for eight years. His superiors knew that he could always be reached in Atlanta at the Gordon Hotel; taxpayer was subject to call at all times. In 1955 Captain Williams incurred expenses of $796 for meals, lodging, and tips at the Gordon Hotel during his layover in Atlanta.

- Should Williams be permitted to deduct the expenses that he incurred at the Gordon Hotel?
- What issues (sub-issues) do these facts raise?
- *See Williams v. Patterson*, 286 F.2d 333 (5th Cir. 1961).

4a. Taxpayer B was a ferryboat captain. He worked in the Puget Sound area of Washington State. During the summer months, he typically worked 18-hour days for seven consecutive days. Then he would have seven consecutive days off. His schedule was the same in the winter, except that he would typically captain a ship from Seattle to Victoria. The return voyage would be six hours later. During the six-hour layover, he would take a nap on a cot provided by his employer. He would also purchase one or two meals.

- Should taxpayer B be permitted to deduct the cost of his meals?
- *See Bissonnette v. Commissioner*, 127 T.C. 124 (2006).

Hantzis v. Commissioner, 638 F.2d 248 (1st Cir.), *cert. denied*, 452 U.S. 962 (1981)

LEVIN H. CAMPBELL, Circuit Judge.

The Commissioner of Internal Revenue (Commissioner) appeals a decision of the United States Tax Court that allowed a deduction under § 162(a)(2) (1976) for expenses incurred by a law student in the course of her summer employment. ...

In the fall of 1973 Catharine Hantzis (taxpayer), formerly a candidate for an advanced degree in philosophy at the University of California at Berkeley, entered Harvard Law School in Cambridge, Massachusetts, as a full-time student. During her second year of law school she sought unsuccessfully to obtain employment for the summer of 1975 with a Boston law firm. She did, however, find a job as a legal assistant with a law firm in New York City, where she worked for ten weeks beginning in June 1975. Her husband, then a member of the faculty of Northeastern University with a teaching schedule for that summer, remained in Boston and lived at the couple's home there. At the time of the Tax Court's decision in this case, Mr. and Mrs. Hantzis still resided in Boston.

On their joint income tax return for 1975, Mr. and Mrs. Hantzis reported the earnings from taxpayer's summer employment ($3,750) and deducted the cost of transportation between Boston and New York, the cost of a small apartment rented by Mrs. Hantzis in New York and the cost of her meals in New York ($3,204). The deductions were taken under § 162(a)(2), which provides:

> " § 162. Trade or business expenses
> (a) In general. There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including
>
> (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business ...."

The Commissioner disallowed the deduction on the ground that taxpayer's home for purposes of § 162(a)(2) was her place of employment and the cost of traveling to and living in New York was therefore not "incurred ... while away from home." The Commissioner also argued that the expenses were not incurred "in the pursuit of a trade or business." Both positions were rejected by the Tax Court, which found that Boston was Mrs. Hantzis' home because her employment in New York was only temporary and that her expenses in New York were "necessitated" by her employment there. The court thus held the expenses to be deductible under § 162(a)(2). [footnote omitted]

In asking this court to reverse the Tax Court's allowance of the deduction, the Commissioner has contended that the expenses were not incurred "in the pursuit of a trade or business." We do not accept this argument; nonetheless, we sustain the Commissioner and deny the deduction, on the basis that the expenses were not incurred "while away from home."

I.

Section 262 of the Code, declares that "except as otherwise provided in this chapter, no deductions shall be allowed for personal, living, or family expenses." Section 162 provides less of an exception to this rule than it creates a separate category of deductible business expenses. This category manifests a fundamental principle of taxation: that a person's taxable income should not include the cost of producing that income. [citation omitted]; *Commissioner v. Flowers*, 326 U.S. 465, 469 (1946); [citation omitted].

The test by which "personal" travel expenses subject to tax under § 262 are distinguished from those costs of travel necessarily incurred to generate income is embodied in the requirement that, to be deductible under § 162(a)(2), an expense must be "incurred ... in the pursuit of a trade or business." In *Flowers* the Supreme Court read this phrase to mean that "(t)he exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors." 326 U.S. at

474.[119] Of course, not every travel expense resulting from business exigencies rather than personal choice is deductible; an expense must also be "ordinary and necessary" and incurred "while away from home." § 162(a)(2); *Flowers*, 326 U.S. at 470. But the latter limitations draw also upon the basic concept that only expenses necessitated by business, as opposed to personal, demands may be excluded from the calculation of taxable income.

With these fundamentals in mind, we proceed to ask whether the cost of taxpayer's transportation to and from New York, and of her meals and lodging while in New York, was incurred "while away from home in the pursuit of a trade or business."

II.

The Commissioner has directed his argument at the meaning of "in pursuit of a trade or business." He interprets this phrase as requiring that a deductible traveling expense be incurred under the demands of a trade or business which predates the expense, i.e., an "already existing" trade or business. [The court rejected the commissioner's contention.]

In other contexts the phrase "in the pursuit of a trade or business" may permit the interpretation urged upon us by the Commissioner,[120] but to require under § 162(a)(2) that a travel expense be incurred in connection with a preexisting trade or business is neither necessary nor appropriate to effectuating the purpose behind the use of that phrase in the provision.

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[119] Flowers denied a deduction claimed by the taxpayer as not involving expenses required by the taxpayer's employer's business. It is now established, however, that a taxpayer may be in the trade or business of being an employee. *See, e.g.*, Primuth v. Commissioner, 54 T.C. 374, 377-78 (1970) (citing cases); Rev. Rul. 77-16; Rev. Rul. 60-16. Thus, expenses necessitated by the exigencies of an employee's occupation, without regard to the demands of the employer's business, are also deductible.

[120] Under the general provision of § 162(a), no deduction is allowed for expenses incurred in preparing to enter a new business and the phrase "in the pursuit of a trade or business" has in cases concerned with such expenses been read to "presuppose ( ) an existing business with which (the taxpayer) is connected." Frank v. Commissioner, 20 T.C. 511, 513-14 (1953). *See, e.g.*, Weinstein v. United States, 420 F.2d 700 (Ct. Cl.1970).

Accordingly, we turn to the question whether, in the absence of the Commissioner's proposed threshold limit on deductibility, the expenses at issue here satisfy the requirements of § 162(a)(2) as interpreted in *Flowers v. Commissioner*.

III.

As already noted, *Flowers* construed § 162(a)(2) to mean that a traveling expense is deductible only if it is (1) reasonable and necessary, (2) incurred while away from home, and (3) necessitated by the exigencies of business. Because the Commissioner does not suggest that Mrs. Hantzis' expenses were unreasonable or unnecessary, we may pass directly to the remaining requirements. Of these, we find dispositive the requirement that an expense be incurred while away from home. As we think Mrs. Hantzis' expenses were not so incurred, we hold the deduction to be improper.

The meaning of the term "home" in the travel expense provision is far from clear. When Congress enacted the travel expense deduction now codified as § 162(a)(2), it apparently was unsure whether, to be deductible, an expense must be incurred away from a person's residence or away from his principal place of business. [citation omitted] This ambiguity persists and courts, sometimes within a single circuit, have divided over the issue. *Compare Six v. United States*, 450 F.2d 66 (2d Cir. 1971) (home held to be residence) and *Rosenspan v. United States*, 438 F.2d 905 (2d Cir.), *cert. denied*, 404 U.S. 864 (1971) and *Burns v. Gray*, 287 F.2d 698 (6th Cir. 1961) and *Wallace v. Commissioner*, 144 F.2d 407 (9th Cir. 1944) with *Markey v. Commissioner*, 490 F.2d 1249 (6th Cir. 1974) (home held to be principal place of business) and *Curtis v. Commissioner*, 449 F.2d 225 (5th Cir. 1971) and *Wills v. Commissioner*, 411 F.2d 537 (9th Cir. 1969).[121] It has been suggested that these conflicting definitions are due to the enormous

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[121] The Tax Court has, with a notable exception, consistently held that a taxpayer's home is his place of business. See Daly v. Commissioner, 72 T.C. 190 (1979); Foote v. Commissioner, 67 T.C. 1 (1976); Montgomery v. Commissioner, 64 T.C. 175 (1975), *aff'd*, 532 F.2d 1088 (6th Cir. 1976); Blatnick v. Commissioner, 56 T.C. 1344 (1971). The exception, of course, is the present case.

factual variety in the cases. [citations omitted]. We find this observation instructive, for if the cases that discuss the meaning of the term "home" in § 162(a)(2) are interpreted on the basis of their unique facts as well as the fundamental purposes of the travel expense provision, and not simply pinioned to one of two competing definitions of home, much of the seeming confusion and contradiction on this issue disappears and a functional definition of the term emerges.

We begin by recognizing that the location of a person's home for purposes of § 162(a)(2) becomes problematic only when the person lives one place and works another. Where a taxpayer resides and works at a single location, he is always home, however defined; and where a taxpayer is constantly on the move due to his work, he is never "away" from home. (In the latter situation, it may be said either that he has no residence to be away from, or else that his residence is always at his place of employment. *See* Rev. Rul. 60-16.) However, in the present case, the need to determine "home" is plainly before us, since the taxpayer resided in Boston and worked, albeit briefly, in New York.

We think the critical step in defining "home" in these situations is to recognize that the "while away from home" requirement has to be construed in light of the further requirement that the expense be the result of business exigencies. The traveling expense deduction obviously is not intended to exclude from taxation every expense incurred by a taxpayer who, in the course of business, maintains two homes. Section 162(a)(2) seeks rather "to mitigate the burden of the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses." [citations omitted]. Consciously or unconsciously, courts have effectuated this policy in part through their interpretation of the term "home" in § 162(a)(2). Whether it is held in a particular decision that a taxpayer's home is his residence or his principal place of business, the ultimate allowance or disallowance of a deduction is a function of the court's assessment of the reason for a taxpayer's maintenance of two homes. If the reason is perceived to be personal, the taxpayer's home will generally be held to be his place of employment rather than his residence and the deduction will be denied. [citations omitted]. If the reason is felt to be business exigencies, the person's home will usually be held to be his residence and the deduction will be allowed. *See, e.g.*, *Frederick v. United States*, 603 F.2d 1292 (8th Cir. 1979); [citations omitted]. We understand the concern of the concurrence that such an operational interpretation of the term "home" is somewhat technical and perhaps untidy, in that it will not always afford bright line answers, but we doubt the ability of either the Commissioner or the courts to invent an unyielding formula that will make sense in all cases. The line between personal and business expenses winds through infinite factual permutations; effectuation of the travel expense provision requires that any principle of decision be flexible and sensitive to statutory policy.

Construing in the manner just described the requirement that an expense be incurred "while away from home," we do not believe this requirement was satisfied in this case. Mrs. Hantzis' trade or business did not require that she maintain a home in Boston as well as one in New York. Though she returned to Boston at various times during the period of her employment in New York, her visits were all for personal reasons. It is not contended that she had a business connection in Boston that necessitated her keeping a home there; no professional interest was served by maintenance of the Boston home as would have been the case, for example, if Mrs. Hantzis had been a lawyer based in Boston with a New York client whom she was temporarily serving. The home in Boston was kept up for reasons involving Mr. Hantzis, but those reasons cannot substitute for a showing by Mrs. Hantzis that the exigencies of her trade or business required her to maintain two homes.[122] Mrs. Hantzis' decision to keep two homes must be seen as a choice dictated by personal, albeit wholly reasonable, considerations and not a business or occupational

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[122] In this respect, Mr. and Mrs. Hantzis' situation is analogous to cases involving spouses with careers in different locations. Each must independently satisfy the requirement that deductions taken for travel expenses incurred in the pursuit of a trade or business arise while he or she is away from home. *See* Chwalow v. Commissioner, 470 F.2d 475, 477-78 (3d Cir. 1972) ("Where additional expenses are incurred because, for personal reasons, husband and wife maintain separate domiciles, no deduction is allowed."); Hammond v. Commissioner, 213 F.2d 43, 44 (5th Cir. 1954); Foote v. Commissioner, 67 T.C. 1 (1976); Coerver v. Commissioner, 36 T.C. 252 (1961). This is true even though the spouses file a joint return. Chwalow, *supra*, 470 F.2d at 478.

necessity. We therefore hold that her home for purposes of § 162(a)(2) was New York and that the expenses at issue in this case were not incurred "while away from home."[123]

We are not dissuaded from this conclusion by the temporary nature of Mrs. Hantzis' employment in New York. Mrs. Hantzis argues that the brevity of her stay in New York excepts her from the business exigencies requirement of § 162(a)(2) under a doctrine supposedly enunciated by the Supreme Court in *Peurifoy v. Commissioner*, 358 U.S. 59 (1958) (per curiam).[124] The Tax Court here held that Boston was the taxpayer's home because it would have been unreasonable for her to move her residence to New York for only ten weeks. At first glance these contentions may seem

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[123] The concurrence reaches the same result on essentially the same reasoning, but under what we take to be an interpretation of the "in pursuit of business" requirement. We differ from our colleague, it would seem, only on the question of which precondition to deductibility best accommodates the statutory concern for "'the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses.'" *See supra*. Neither the phrase "away from home" nor "in pursuit of business" effectuates this concern without interpretation that to some degree removes it from "the ordinary meaning of the term." (Keeton, J., concurring). However, of the two approaches, we find that of the concurrence more problematic than that adopted here.

[124] In Peurifoy, the Court stated that the Tax Court had "engrafted an exception" onto the requirement that travel expenses be dictated by business exigencies, allowing "a deduction for expenditures ... when the taxpayer's employment is 'temporary' as contrasted with 'indefinite' or 'indeterminate.'" 358 U.S. at 59. Because the Commissioner did not challenge this exception, the Court did not rule on its validity. It instead upheld the circuit court's reversal of the Tax Court and disallowance of the deduction on the basis of the adequacy of the appellate court's review. The Supreme Court agreed that the Tax Court's finding as to the temporary nature of taxpayer's employment was clearly erroneous. *Id.* at 60-61.

> Despite its inauspicious beginning, the exception has come to be generally accepted. Some uncertainty lingers, however, over whether the exception properly applies to the "business exigencies" or the "away from home" requirement. [citations omitted]. In fact, it is probably relevant to both. [citations omitted].
>
> Because we treat these requirements as inextricably intertwined, *see supra*, we find it unnecessary to address this question: applied to either requirement, the temporary employment doctrine affects the meaning of both.

to find support in the court decisions holding that, when a taxpayer works for a limited time away from his usual home, § 162(a)(2) allows a deduction for the expense of maintaining a second home so long as the employment is "temporary" and not "indefinite" or "permanent." [citations omitted]. This test is an elaboration of the requirements under § 162(a)(2) that an expense be incurred due to business exigencies and while away from home. Thus it has been said,

> "Where a taxpayer reasonably expects to be employed in a location for a substantial or indefinite period of time, the reasonable inference is that his choice of a residence is a personal decision, unrelated to any business necessity. Thus, it is irrelevant how far he travels to work. The normal expectation, however, is that the taxpayer will choose to live near his place of employment. Consequently, when a taxpayer reasonable (sic) expects to be employed in a location for only a short or temporary period of time and travels a considerable distance to the location from his residence, it is unreasonable to assume that his choice of a residence is dictated by personal convenience. The reasonable inference is that he is temporarily making these travels because of a business necessity."

Frederick, *supra*, 603 F.2d at 1294-95 (citations omitted).

The temporary employment doctrine does not, however, purport to eliminate any requirement that continued maintenance of a first home have a business justification. We think the rule has no application where the taxpayer has no business connection with his usual place of residence. If no business exigency dictates the location of the taxpayer's usual residence, then the mere fact of his taking temporary employment elsewhere cannot supply a compelling business reason for continuing to maintain that residence. Only a taxpayer who lives one place, works another and has business ties to both is in the ambiguous situation that the temporary employment doctrine is designed to resolve. In such circumstances, unless his employment away from his usual home is temporary, a court can reasonably assume that the taxpayer has abandoned his business ties to that location and is left with only personal reasons for maintaining a residence there. Where only personal needs require that a travel expense be incurred, however, a taxpayer's home is defined so as to leave the expense subject to taxation. *See supra*. Thus, a taxpayer who pursues temporary employment away from the location of his usual residence, but has no business connection with that location, is not "away from home" for purposes of § 162(a)(2). [citations omitted].

On this reasoning, the temporary nature of Mrs. Hantzis' employment in New York does not affect the outcome of her case. She had no business ties to Boston that would bring her within the temporary employment doctrine. By this holding, we do not adopt a rule that "home" in § 162(a)(2) is the equivalent of a taxpayer's place of business. Nor do we mean to imply that a taxpayer has a "home" for tax purposes only if he is already engaged in a trade or business at a particular location. Though both rules are alluringly determinate, we have already discussed why they offer inadequate expressions of the purposes behind the travel expense deduction. We hold merely that for a taxpayer in Mrs. Hantzis' circumstances to be "away from home in the pursuit of a trade or business," she must establish the existence of some sort of business relation both to the location she claims as "home" and to the location of her temporary employment sufficient to support a finding that her duplicative expenses are necessitated by business exigencies. This, we believe, is the meaning of the statement in *Flowers* that "(b)usiness trips are to be identified in relation to business demands and the traveler's business headquarters." 326 U.S. at 474 254 (emphasis added). On the uncontested facts before us, Mrs. Hantzis had no business relation to Boston; we therefore leave to cases in which the issue is squarely presented the task of elaborating what relation to a place is required under § 162(a)(2) for duplicative living expenses to be deductible. Reversed.

KEETON, District Judge, concurring in the result.

Although I agree with the result reached in the court's opinion, and with much of its underlying analysis, I write separately because I cannot join in the court's determination that New York was the taxpayer's home for purposes of § 162(a)(2). In so holding, the court adopts a definition of "home" that differs from the ordinary meaning of the term and therefore unduly risks causing confusion and misinterpretation of the important principle articulated in this case.

In adopting § 162(a)(2), Congress sought "to mitigate the burden of the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses." [citations omitted]. In the present case, the taxpayer does not contend that she maintained her residence in Boston for business reasons. Before working in New York, she had attended school near her home in Boston, and she continued to do so after she finished her summer job. In addition, her husband lived and worked in Boston. Thus, on the facts in this case, I am in agreement with the court that the taxpayer's deductions must be disallowed because she was not required by her trade or business to maintain both places of residence. However rather than resting its conclusion on an interpretation of the language of § 162(a)(2) taken as a whole, which allows a deduction for ordinary and necessary expenses incurred "while away from home in the pursuit of trade or business," the court reaches the same result by incorporating the concept of business-related residence into the definition of "home," thereby producing sometimes, but not always, a meaning of "home" quite different from ordinary usage.

....

... I read the opinion as indicating that in a dual residence case, the Commissioner must determine whether the exigencies of the taxpayer's trade or business require her to maintain both residences. If so, the Commissioner must decide that the taxpayer's principal residence is her "home" and must conclude that expenses associated with the secondary residence were incurred "while away from home," and are deductible. If not, as in the instant case, the Commissioner must find that the taxpayer's principal place of business is her "home" and must conclude that the expenses in question were not incurred "while away from home." The conclusory nature of these determinations as to which residence is her "home" reveals the potentially confusing effect of adopting an extraordinary definition of "home."

A word used in a statute can mean, among the cognoscenti, whatever authoritative sources define it to mean. Nevertheless, it is a distinct disadvantage of a body of law that it can be understood only by those who are expert in its terminology. Moreover, needless risks of misunderstanding and confusion arise, not only among members of the public but also among professionals who must interpret and apply a statute in their day-to-day work, when a word is given an extraordinary meaning that is contrary to its everyday usage.

The result reached by the court can easily be expressed while also giving "home" its ordinary meaning, and neither Congress nor the Supreme Court has directed that "home" be given an extraordinary meaning in the present context. *See Flowers*, *supra*, *Stidger*, *supra*, and *Peurifoy*, *supra*. In *Rosenspan v. United States*, *supra*, Judge Friendly, writing for the court, rejected the Commissioner's proposed definition of home as the taxpayer's business headquarters, concluding that in § 162(a)(2) "'home' means 'home.'" *Id*. at 912.

> When Congress uses a non-technical word in a tax statute, presumably it wants administrators and courts to read it in the way that ordinary people would understand, and not "to draw on some unexpressed spirit outside the bounds of the normal meaning of words." *Addison v. Holly Hill Fruit Prods., Inc*., 322 U.S. 607, 617 (1944).

Id. at 911. [citation omitted].

In analyzing dual residence cases, the court's opinion advances compelling reasons that the first step must be to determine whether the taxpayer has business as opposed to purely personal reasons for maintaining both residences. This must be done in order to determine whether the expenses of maintaining a second residence were, "necessitated by business, as opposed to personal, demands," and were in this sense incurred by the taxpayer "while away from home in pursuit of trade or business." Necessarily implicit in this proposition is a more limited corollary that is sufficient to decide the present case: When the taxpayer has a business relationship to only one location, no traveling expenses the taxpayer incurs are "necessitated by business, as opposed to personal demands," regardless of how many residences the taxpayer has, where they are located, or which one is "home."

In the present case, although the taxpayer argues that her employment required her to reside in New York, that contention is insufficient to compel a determination that it was the nature of her trade or business that required her to incur the additional expense of maintaining a second residence, the burden that § 162(a)(2) was intended to mitigate. Her expenses associated with maintaining her New York residence arose from personal interests that led her to maintain two residences rather than a single residence close to her work.[125] While traveling from her principal residence to a second place of residence closer to her business, even though "away from home," she was not "away from home in pursuit of business." Thus, the expenses at issue in this case were not incurred by the taxpayer "while away from home in pursuit of trade or business." In the contrasting case in which a taxpayer has established that both residences were maintained for business reasons, § 162(a)(2) allows the deduction of expenses associated with travel to, and maintenance of, one of the residences if they are incurred for business reasons and that abode is not the taxpayer's home. A common sense meaning of "home" works well to achieve the purpose of this provision.

In summary, the court announces a sound principle that, in dual residence cases, deductibility of traveling expenses depends upon a showing that both residences were maintained for business reasons. If that principle is understood to be derived from the language of § 162(a)(2) taken as a whole, "home" retains operative significance for determining which of the business-related residences is the one the expense of which can be treated as deductible. In this context, "home" should be given its ordinary meaning to allow a deduction only for expenses relating to an abode that is not the taxpayer's principal place of residence. On the undisputed facts

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[125] For reasons explained by the court, the temporary nature of her employment does not bring the case within those as to which Congress was mitigating the burden of duplicative expenses when enacting § 162(a)(2).

in this case, the Tax Court found that Boston was the taxpayer's "home" in the everyday sense, i.e., her principal place of residence. Were the issue relevant to disposition of the case, I would uphold the Tax Court's quite reasonable determination on the evidence before it. However, because the taxpayer had no business reason for maintaining both residences, her deduction for expenses associated with maintaining a second residence closer than her principal residence to her place of employment must be disallowed without regard to which of her two residences was her "home" under § 162(a)(2).

Notes and Questions:

1. Obviously, the meaning of "home" is not to be determined by the ordinary use of the term.

2. Does the court's opinion conflate the second and third requirements of *Flowers*?

3. On which of the *Flowers* requirements does Judge Keeton rely to deny taxpayers a deduction?

4. Taxpayer owned and operated a very successful swimming pool construction business in Lynnfield, Massachusetts. He also owned and operated a very successful horse breeding and racing business in Lighthouse Point, Florida. From November through April, he resided in Florida. From May through October, he resided in Massachusetts. Taxpayer owned a home in both Florida and Massachusetts and traveled between them in order to tend to his businesses.

- •Does Taxpayer have two tax homes so that he may deduct the travel expenses associated with neither of them?
- •What guidance do the opinions in *Hantzis* offer in answering this question?
- •*See Andrews v. Commissioner*, 931 F.2d 132 (1St Cir. 1991) ("major" post of duty; "minor" post of duty).

4a. For the past five years, Taxpayers (Mr. and Mrs. Chwalow) have maintained a residence in Bala Cynwyd, Pennsylvania. Mrs. Chwalow is a teacher in the Philadelphia public school system and specializes in working with deaf children. Dr. Chwalow is a physicist whose specialty is military optics and electrooptics encompassing areas such as night vision, laser range finding, missile guidance, aerial reconnaissance, etc. Dr. Chwalow works for IBM in Washington, D.C., where he rents an apartment. He uses public transportation to get to his job. Mrs. Chwalow continues to live in Bala Cynwyd, Pennsylvania.

- May either Mr. or Mrs. Chwalow deduct meal and lodging expenses as "travel expenses" under § 162(a)(2)?
- *See Chwalow v. Commissioner*, 470 F.2d 475 (3rd Cir. 1972).

4b. Taxpayer Dews was a coach on the staff of the Atlanta Braves baseball team. He and his wife lived in Albany, Georgia. In the course of over 20 years in professional baseball, Dews had 37 different assignments, including as a manager of farm teams in the Atlanta organization. During one 4-year period, he was a coach for the Atlanta team. He maintained an apartment in Atlanta.

- May Dews deduct the expenses of traveling between Albany and Atlanta? May he deduct the expenses of living in Atlanta?
- *See Dews v. Commissioner*, T.C. Memo. 1987-353, *available at* 1987 WL 40405.

5. Read the second sentence of the carryout paragraph that ends § 162(a). It refers to § 162(a)(2). Also read § 274(m)(3). Then do the following CALI Lesson: *Basic Federal Income Taxation: Deductions: Traveling Expenses*.

CALI Lessons

B. Reasonable Salaries

Read § 162(a)(1). How would you determine the reasonableness of salaries? What constraints exist outside of the Code that prevent payment of excessive salaries or other compensation? What conditions make it more (or less) likely that a taxpayer is paying a greater-than-reasonable salary?

- Notice that the approach of the Code is to deny a deduction to the one who pays an excessive salary. Hence, both the recipient of the salary and the employer would pay tax on the amount paid in salary that the employer may not deduct.

Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir. 1999).
POSNER, Chief Judge.

This appeal from a judgment by the Tax Court, requires us to interpret and apply § 162(a)(1), which allows a business to deduct from its income its "ordinary and necessary" business expenses, including a "reasonable allowance for salaries or other compensation for personal services actually rendered." In 1993 and 1994, Exacto Spring Corporation, a closely held corporation engaged in the manufacture of precision springs, paid its cofounder, chief executive, and principal owner, William Heitz, \$1.3 and \$1.0 million, respectively, in salary. The Internal Revenue Service thought this amount excessive, that Heitz should not have been paid more than \$381,000 in 1993 or \$400,000 in 1994, with the difference added to the corporation's income, and it assessed a deficiency accordingly, which Exacto challenged in the Tax Court. That court found that the maximum reasonable compensation for Heitz would have been \$900,000 in the earlier year and \$700,000 in the later one – figures roughly midway between his actual compensation and the IRS's determination – and Exacto has appealed.

In reaching its conclusion, the Tax Court applied a test that requires the consideration of seven factors, none entitled to any specified weight relative to another. The factors are, in the court's words, "(1) the type and extent of the services rendered; (2) the scarcity of qualified employees; (3) the qualifications and prior earning capacity of the employee; (4) the contributions of the employee to the business venture; (5) the net earnings of the employer; (6) the prevailing compensation paid to employees with comparable jobs; and (7) the peculiar characteristics of the employer's business." It is apparent that this test, though it or variants of it (one of which has the astonishing total of 21 factors, *Foos v. Commissioner*, 41 T.C.M. (CCH) 863, 878-79 (1981)), are encountered in many cases, *see, e.g.* Edwin's Inc. v. United States, 501 F.2d 675, 677 (7th Cir.1974); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5th Cir.1987); *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6th Cir.1949); 1 BORIS I. BITTKER

& LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS ¶ 22.2.2, p. 22-21 (3d ed.1999), leaves much to be desired – being, like many other multi-factor tests, "redundant, incomplete, and unclear." *Palmer v. City of Chicago*, 806 F.2d 1316, 1318 (7th Cir.1986).

To begin with, it is nondirective. No indication is given of how the factors are to be weighed in the event they don't all line up on one side. And many of the factors, such as the type and extent of services rendered, the scarcity of qualified employees, and the peculiar characteristics of the employer's business, are vague.

Second, the factors do not bear a clear relation either to each other or to the primary purpose of § 162(a)(1), which is to prevent dividends (or in some cases gifts), which are not deductible from corporate income, from being disguised as salary, which is. *E.g.*, *Rapco, Inc. v. Commissioner*, 85 F.3d 950, 954 n. 2 (2d Cir.1996). Suppose that an employee who let us say was, like Heitz, a founder and the chief executive officer and principal owner of the taxpayer rendered no services at all but received a huge salary. It would be absurd to allow the whole or for that matter any part of his salary to be deducted as an ordinary and necessary business expense even if he were well qualified to be CEO of the company, the company had substantial net earnings, CEOs of similar companies were paid a lot, and it was a business in which high salaries are common. The multi-factor test would not prevent the Tax Court from allowing a deduction in such a case even though the corporation obviously was seeking to reduce its taxable income by disguising earnings as salary. The court would not allow the deduction, but not because of anything in the multi-factor test; rather because it would be apparent that the payment to the employee was not in fact for his services to the company. Reg. § 1.162-7(a); 1 BITTKER & LOKKEN, *supra*, ¶ 22.2.1, p. 22-19.

Irruption: a breaking or bursting in; a violent incursion or invasion.

Third, the seven-factor test invites the Tax Court to set itself up as a superpersonnel department for closely held corporations, a role unsuitable for courts, as we have repeatedly noted in the Title VII context, e.g., *Jackson v. E.J. Brach Corp.*, 176

F.3d 971, 984 (7th Cir. 1999), and as the Delaware Chancery Court has noted in the more germane context of derivative suits alleging excessive compensation of corporate employees. *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996). The test – the irruption of "comparable worth" thinking (see, e.g., *American Nurses' Ass'n v. Illinois*, 783 F.2d 716 (7th Cir. 1986)) in a new context – invites the court to decide what the taxpayer's employees should be paid on the basis of the judges' own ideas of what jobs are comparable, what relation an employee's salary should bear to the corporation's net earnings, what types of business should pay abnormally high (or low) salaries, and so forth. The judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no judges are.

Fourth, since the test cannot itself determine the outcome of a dispute because of its nondirective character, it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb. The Tax Court in this case essentially added the IRS's determination of the maximum that Mr. Heitz should have been paid in 1993 and 1994 to what he was in fact paid, and divided the sum by two. It cut the baby in half. One would have to be awfully naive to believe that the seven-factor test generated this pleasing symmetry.

Fifth, because the reaction of the Tax Court to a challenge to the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in determining a level of compensation that may be indispensable to the success of their business.

The drawbacks of the multi-factor test are well illustrated by its purported application by the Tax Court in this case. With regard to factor (1), the court found that Heitz was "indispensable to Exacto's business" and "essential to Exacto's success." Heitz is not only Exacto's CEO; he is also the company's chief salesman and marketing man plus the head of its research and development efforts and its principal inventor. The company's entire success appears to be due on the one hand to the research and development conducted by him and on the other hand to his marketing of these innovations (though he receives some additional compensation for his marketing efforts from a subsidiary of Exacto). The court decided that factor (1) favored Exacto.

Likewise factor (2), for, as the court pointed out, the design of precision springs, which is Heitz's specialty, is "an extremely specialized branch of mechanical engineering, and there are very few engineers who have made careers specializing in this area," let alone engineers like Heitz who have "the ability to identify and attract clients and to develop springs to perform a specific function for that client.... It would have been very difficult to replace Mr. Heitz." Notice how factors (1) and (2) turn out to be nearly identical.

Factors (3) and (4) also supported Exacto, the court found. "Mr Heitz is highly qualified to run Exacto as a result of his education, training, experience, and motivation. Mr. Heitz has over 40 years of highly successful experience in the field of spring design." And his "efforts were of great value to the corporation." So factor (4) duplicated (2), and so the first four factors turn out to be really only two.

With regard to the fifth factor – the employer's (Exacto's) net earnings – the Tax Court was noncommittal. Exacto had reported a loss in 1993 and very little taxable income in 1994. But it conceded having taken some improper deductions in those years unrelated to Heitz's salary. After adjusting Exacto's income to remove these deductions, the court found that Exacto had earned more than $1 million in each of the years at issue net of Heitz's supposedly inflated salary.
The court was noncommital with regard to the sixth factor – earnings of comparable employees – as well. The evidence bearing on this factor had been presented by expert witnesses, one on each side, and the court was critical of both. The taxpayer's witness had arrived at his estimate of Heitz's maximum reasonable compensation in part by aggregating the salaries that Exacto would have had to pay to hire four people each to wear one of Heitz's "hats," as chief executive officer, chief manufacturing executive, chief research and development officer, and chief sales and marketing executive. Although the more roles or functions an employee performs the more valuable his services are likely to be, *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 102-03 (2d Cir.1998); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-46 (9th Cir.1983), an employee who

performs four jobs, each on a part-time basis, is not necessarily worth as much to a company as four employees each working full time at one of those jobs. It is therefore arbitrary to multiply the normal full-time salary for one of the jobs by four to compute the reasonable compensation of the employee who fills all four of them. Anyway salaries are determined not by the method of comparable worth but, like other prices, by the market, which is to say by conditions of demand and supply. Especially in the short run, salaries may vary by more than any difference in the "objective" characteristics of jobs. An individual who has valuable skills that are in particularly short supply at the moment may command a higher salary than a more versatile, better-trained, and more loyal employee whose skills are, however, less scarce.

The Internal Revenue Service's expert witness sensibly considered whether Heitz's compensation was consistent with Exacto's investors' earning a reasonable return (adjusted for the risk of Exacto's business), which he calculated to be 13%. But in concluding that Heitz's compensation had pushed the return below that level, he neglected to consider the concessions of improper deductions, which led to adjustments to Exacto's taxable income. The Tax Court determined that with those adjustments the investors' annual return was more than 20% despite Heitz's large salary. The government argues that the court should not have calculated the investors' return on the basis of the concessions of improper deductions, because when Heitz's compensation was determined the corporation was unaware that the deductions would be disallowed. In other words, the corporation thought that its after-tax income was larger than it turned out to be. But if the ex ante perspective is the proper one, as the government contends, it favors the corporation if when it fixed Heitz's salary it thought there was more money in the till for the investors than has turned out to be the case.

What is puzzling is how disallowing deductions and thus increasing the taxpayer's tax bill could increase the investors' return. What investors care about is the corporate income available to pay dividends or be reinvested; obviously money paid in taxes to the Internal Revenue Service is not available for either purpose. The reasonableness of Heitz's compensation thus depends not on Exacto's taxable income but on the corporation's profitability to the investors, which is reduced by the disallowance of deductions – if a corporation succeeds in taking phantom deductions, shareholders are better off because the corporation's tax bill is lower. But the government makes nothing of this. Its only objection is to the Tax Court's having taken account of adjustments made after Heitz's salary was fixed. Both parties, plus the Tax Court, based their estimates of investors' returns on the after-tax income shown on Exacto's tax returns, which jumped after the deductions were disallowed, rather than on Exacto's real profits, which declined. The approach is inconsistent with a realistic assessment of the investors' rate of return, but as no one in the case questions it we shall not make an issue of it.

Finally, under factor (7) ("peculiar characteristics"), the court first and rightly brushed aside the IRS's argument that the low level of dividends paid by Exacto (zero in the two years at issue, but never very high) was evidence that the corporation was paying Heitz dividends in the form of salary. The court pointed out that shareholders may not want dividends. They may prefer the corporation to retain its earnings, causing the value of the corporation to rise and thus enabling the shareholders to obtain corporate earnings in the form of capital gains taxed at a lower rate than ordinary income. The court also noted that while Heitz, as the owner of 55% of Exacto's common stock, obviously was in a position to influence his salary, the corporation's two other major shareholders, each with 20% of the stock, had approved it. They had not themselves been paid a salary or other compensation, and are not relatives of Heitz; they had no financial or other incentive to allow Heitz to siphon off dividends in the form of salary.

Having run through the seven factors, all of which either favored the taxpayer or were neutral, the court reached a stunning conclusion: "We have considered the factors relevant in deciding reasonable compensation for Mr. Heitz. On the basis of all the evidence, we hold that reasonable compensation for Mr. Heitz" was much less than Exacto paid him. The court's only effort at explaining this result when Exacto had passed the seven-factor test with flying colors was that "we have balanced Mr. Heitz' unique selling and technical ability, his years of experience, and the difficulty of replacing Mr. Heitz with the fact that the corporate entity would have shown a reasonable return for the equity holders, after considering petitioners' concessions." *Id*. But "the fact that the corporate entity would have shown a reasonable return for the equity holders" after the concessions is on the same side of the balance as the other factors; it does not favor the Internal Revenue Service's position. The government's lawyer was forced to concede at the argument of the appeal that she could not deny the possibility that the Tax Court had pulled its figures for Heitz's allowable compensation out of a hat.

The failure of the Tax Court's reasoning to support its result would alone require a remand. But the problem with the court's opinion goes deeper. The test it applied does not provide adequate guidance to a rational decision. We owe no deference to the Tax Court's statutory interpretations, its relation to us being that of a district court to a court of appeals, not that of an administrative agency to a court of appeals. 26 U.S.C. § 7482(a)(1); [citations omitted]. The federal courts of appeals, whose decisions do of course have weight as authority with us even when they are not our own decisions, have been moving toward a much simpler and more purposive test, the "independent investor" test. *Dexsil Corp. v. Commissioner*, *supra*; *Elliotts, Inc. v. Commissioner*, *supra*, 716 F.2d at 1245-48; *Rapco, Inc. v. Commissioner*, *supra*, 85 F.3d at 954-55. We applaud the trend and join it.

Because judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, the cases we have just cited prefer to say (as in *Dexsil* and *Rapco*) that the "independent investor" test is the "lens" through which they view the seven (or however many) factors of the orthodox test. But that is a formality. The new test dissolves the old and returns the inquiry to basics. The Internal Revenue Code limits the amount of salary that a corporation can deduct from its income primarily in order to prevent the corporation from eluding the corporate income tax by paying dividends but calling them salary because salary is deductible and dividends are not. (Perhaps they should be, to avoid double taxation of corporate earnings, but that is not the law.) In the case of a publicly held company, where the salaries of the highest executives are fixed by a board of directors that those executives do not control, the danger of siphoning corporate earnings to executives in the form of salary is not acute. The danger is much greater in the case of a closely held corporation, in which ownership and management tend to coincide; unfortunately, as the opinion of the Tax Court in this case illustrates, judges are not competent to decide what business executives are worth.

There is, fortunately, an indirect market test, as recognized by the Internal Revenue Service's expert witness. A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg. The Service's expert believed that investors in a firm like Exacto would expect a 13% return on their investment. Presumably they would be delighted with more. They would be overjoyed to receive a return more than 50% greater than they expected – and 20%, the return that the Tax Court found that investors in Exacto had obtained, is more than 50% greater than the benchmark return of 13%.

When, notwithstanding the CEO's "exorbitant" salary (as it might appear to a judge or other modestly paid official), the investors in his company are obtaining a far higher return than they had any reason to expect, his salary is presumptively reasonable. We say "presumptively" because we can imagine cases in which the return, though very high, is not due to the CEO's exertions. Suppose Exacto had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from $50,000 a year to $1.3 million. The presumption of reasonableness would be rebutted. There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was merely the titular chief executive and the company was actually run by someone else, which would be another basis for rebuttal.

The government could still have prevailed by showing that while Heitz's salary may have been no greater than would be reasonable in the circumstances, the company did not in fact intend to pay him that amount as salary, that his salary really did include a concealed dividend though it need not have. This is material (and the "independent investor" test, like the multi-factor test that it replaces, thus incomplete, though invaluable) because any business expense to be deductible must be, as we noted earlier, a bona fide expense as well as reasonable in amount. The fact that Heitz's salary was approved by the other owners of the corporation, who had no incentive to disguise a dividend as salary, goes far to rebut any inference of bad faith here, which in any event the Tax Court did not draw and the government does not ask us to draw.

The judgment is reversed with directions to enter judgment for the taxpayer. Reversed.

Notes and Questions:

1. Judge Posner is right in describing what is probably still the prevailing standard as a multi-factor test – with all of the problems that go with it. *See* E.L. Kellett, Annot., *Reasonableness of Compensation Paid to Officers or Employees, so as to Warrant Deduction Thereof in Computing Employer's Income Tax*, 10 A.L.R. FED.3d 125.

2. For what reasons would a taxpayer "pay," i.e., compensate, an employee more than a reasonable amount of salary?

- The court observed that a shareholder derivative suit is a "more germane context" in which to evaluate excessive

What's at stake? A corporation pays its shareholders dividends from the profits it has earned over and above its (deductible) expenses. A corporation may not deduct the amount of dividends that it pays to shareholders. Shareholders who receive dividends must pay income tax on them. Thus, corporate profits that a corporation distributes to shareholders are subject to income taxation twice – once at the corporate level and once at the shareholder level.

A corporation may deduct salaries that it pays. § 162(a)(1). Thus, a salary is subject to tax only at the employee level.

compensation? Why would this be true?

3. Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Reasonable Compensation, Miscellaneous Business Deductions, and Business Losses*. You will find that the law involves "comparable" salaries.

- Read §§ 274(a), (*l*), (n), 162(e), 165(a and b).
- Do not worry about whether you get the correct answer to the two questions involving a "golden parachute," § 280G, but do not be afraid of learning something. Also, do not worry about the costs of military clothing. Do not worry about § 280B, but you should still get the right answer to question 17.

C. Ordinary and Necessary Expenses

Section 162(a) allows taxpayer to deduct all ordinary and necessary expenses paid or incurred in carrying on any trade or business. Sections 162 and 274 also limit trade or business deductions incurred for certain purposes.

Section 212 allows a similar deduction for the ordinary and necessary expenses that taxpayer pays or incurs –

- for the production or collection of income,
- for the management, conservation, or maintenance of property held for the production of income, or
- in connection with the determination, collection, or refund of any tax.

Do the CALI Lesson, *Basic Federal Income Taxation: Deductions for Income-Producing Activities* after reading §§ 212, 215, 62(a)(10).

We consider here a few recurring issues.

1. Personal vs. Trade or Business

We have already seen that § 162(a)(2) implicitly treats taxpayer's choice of where to live as a personal one. Hence, taxpayer may not deduct expenditures associated with that choice. The Code also implicitly treats certain other choices as "personal."

Smith v. Commissioner, 40 B.T.A. 1038 (1939), *aff'd* 113 F.2d 114 (2d Cir. 1940).

....

OPINION – OPPER

Respondent determined a deficiency of $23.62 in petitioner's 1937 income tax. This was due to the disallowance of a deduction claimed by petitioners, who are husband and wife, for sums spent by the wife in employing nursemaids to care for petitioners' young child, the wife, as well as the husband, being employed. ...

Petitioners would have us apply the 'but for' test. They propose that but for the nurses the wife could not leave her child; but for the freedom so secured she could not pursue her gainful labors; and but for them there would be no income and no tax. This thought evokes an array of interesting possibilities. The fee to the doctor, but for whose healing service the earner of the family income could not leave his sickbed; [footnote omitted] the cost of the laborer's raiment, for how can the world proceed about its business unclothed; the very home which gives us shelter and rest and the food which provides energy, might all by an extension of the same proposition be construed as necessary to the operation of business and to the creation of income. Yet these are the very essence of those 'personal' expenses the deductibility of which is expressly denied. [citation omitted]

We are told that the working wife is a new phenomenon. This is relied on to account for the apparent inconsistency that the expenses in issue are now a commonplace, yet have not been the subject of legislation, ruling, or adjudicated controversy. But if that is true it becomes all the more necessary to apply accepted principles to the novel facts. We are not prepared to say that the care of children, like similar aspects of family and household life, is other than a personal concern. The wife's services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal and not susceptible of deduction. [citation omitted] Here the wife has chosen to employ others to discharge her domestic function and the services she performs are rendered outside the home. They are a source of actual income and taxable as such. But that does not deprive the same work performed by others of its personal character nor furnish a reason why its cost should be treated as an offset in the guise of a deductible item.

We are not unmindful that, as petitioners suggest, certain disbursements normally personal may become deductible by reason of their intimate connection with an occupation carried on for profit. In this category fall entertainment [citation omitted], and traveling expenses [citation omitted], and the cost of an actor's wardrobe [citation omitted]. The line is not always an easy one to draw nor the test simple to apply. But we think its principle is clear. It may for practical purposes be said to constitute a distinction between those activities which, as a matter of common acceptance and universal experience, are 'ordinary' or usual as the direct accompaniment of business pursuits, on the one hand; and those which, though they may in some indirect and tenuous degree relate to the circumstances of a profitable occupation, are nevertheless personal in their nature, of a character applicable to human beings generally, and which exist on that plane regardless of the occupation, though not necessarily of the station in life, of the individuals concerned. *See Welch v. Helvering*, 290 U.S. 111.

In the latter category, we think, fall payments made to servants or others occupied in looking to the personal wants of their employers. [citation omitted]. And we include in this group nursemaids retained to care for infant children.

Decision will be entered for the respondent.

Notes and Questions:

1. The B.T.A. says that the expenses of a nursemaid “are the very essence of those ‘personal expenses the deductibility of which is expressly denied.’”

- What was the personal choice that taxpayer made in this case that made these expenses non-deductible?

2. We have already noted §§ 21 and 129. These provisions reverse the *result* of *Smith*, but not its construction of § 162.

- What do these provisions say about the underlying rationale of *Smith*, in particular the role of the wife and mother?

3. Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Dependent Care Credit*.

2. Limitations on Deductibility of Ordinary and Necessary Expenses

Consider the sources of limitation on the deductibility of expenses that taxpayer incurs in order to generate income that the following cases consider:

Commissioner v. Tellier, 383 U.S. 687 (1966).

MR. JUSTICE STEWART delivered the opinion of the Court.

The question presented in this case is whether expenses incurred by a taxpayer in the unsuccessful defense of a criminal prosecution may qualify for deduction from taxable income under § 162(a), which allows a deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. ...” [footnote omitted] The respondent Walter F. Tellier was engaged in the business of underwriting the public sale of stock offerings and purchasing securities for resale to customers. In 1956, he was brought to trial upon a 36-count indictment that charged him with violating the fraud section of the Securities Act of 1933 [footnote omitted] and the mail fraud statute, [footnote omitted] and with conspiring to violate those statutes. [footnote omitted] He was found guilty on all counts, and was sentenced to pay an $18,000 fine and to serve four and a half years in prison. The judgment of conviction was affirmed on appeal. [footnote omitted] In his unsuccessful defense of this criminal prosecution, the respondent incurred and paid $22,964.20 in legal expenses in 1956. He claimed a deduction for that amount on his federal income tax return for that year. The Commissioner disallowed the deduction, and was sustained by the Tax Court. The Court of Appeals for the Second Circuit reversed in a unanimous en banc decision, and we granted certiorari. We affirm the judgment of the Court of Appeals.

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. In *United States v. Gilmore*, 372 U.S. 39, we held that

> “the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was ‘business’ or ‘personal’”

within the meaning of § 162(a). *Cf. Kornhauser v. United States*, 276 U.S. 145; *Deputy v. du Pont*, 308 U.S. 488. The criminal charges against the respondent found their source in his business activities as a securities dealer. The respondent’s legal fees, paid in defense against those charges, therefore clearly qualify under *Gilmore* as “expenses paid or incurred ... in carrying on any trade or business” within the meaning of § 162(a).

The Commissioner also concedes that the respondent’s legal expenses were “ordinary” and “necessary” expenses within the meaning of § 162(a).

Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business." *Welch v. Helvering*, 290 U.S. 111; *cf. Kornhauser v. United States*, *supra*, at 276 U.S. 152; *Lilly v. Commissioner*, 343 U.S. 90, 93-94; *Commissioner v. Heininger*, 320 U.S. 467, 320 U.S. 471; *McCulloch v. Maryland*, 4 Wheat. 316, 17 U.S. 413-415. The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset. *Welch v. Helvering*, *supra*, at 290 U.S. 113-116. [footnote omitted] The legal expenses deducted by the respondent were not capital expenditures. They were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset. Our decisions establish that counsel fees comparable to those here involved are ordinary business expenses, even though a "lawsuit affecting the safety of a business may happen once a lifetime." *Welch v. Helvering*, *supra*, at 290 U.S. 114. *Kornhauser v. United States*, *supra*, at 276 U.S. 152-153; *cf. Trust of Bingham v. Commissioner*, 325 U.S. 365. [footnote omitted]

It is therefore clear that the respondent's legal fees were deductible under § 162(a) if the provisions of that section are to be given their normal effect in this case. The Commissioner and the Tax Court determined, however, that, even though the expenditures meet the literal requirements of § 162(a), their deduction must nevertheless be disallowed on the ground of public policy. That view finds considerable support in other administrative and judicial decisions.[126] It finds no support, however, in any regulation or statute or in any decision of this Court, and we believe

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[126] *See* Sarah Backer, 1 B.T.A. 214; Norvin R. Lindheim, 2 B.T.A. 229; Thomas A. Joseph, 26 T.C. 562; Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (C.A.2d Cir.); Commissioner v. Schwartz, 232 F.2d 94 (C.A.5th Cir.); Acker v. Commissioner, 258 F.2d 568 (C.A.6th Cir.); Bell v. Commissioner, 320 F.2d 953 (C.A.8th Cir.); Peckham v. Commissioner, 327 F.2d 855, 856 (C.A.4th Cir.); Port v. United States, 163 F.Supp. 645. *See also* Note, *Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code*, 72 YALE L.J. 108; 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.49 ff. *Compare* Longhorn Portland Cement Co., 3 T.C. 310; G.C.M. 24377, 1944 Cum. Bull. 93; Lamont, *Controversial Aspects of Ordinary and Necessary Business Expense*, 42 TAXES 808, 833-834.

no such "public policy" exception to the plain provisions of § 162(a) is warranted in the circumstances presented by this case.

We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes. Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources. "[T]he fact that a business is unlawful [does not] exempt it from paying the taxes that if lawful it would have to pay." *United States v. Sullivan*, 274 U.S. 259. *See James v. United States*, 366 U.S. 213.

With respect to deductions, the basic rule, with only a few limited and well defined exceptions, is the same. During the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to those incurred in a "legitimate" or "lawful" trade or business. Senator Williams, who was in charge of the bill, stated on the floor of the Senate that

> "[T]he object of this bill is to tax a man's net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men's moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon 'futures,' but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way."

50 Cong. Rec. 3849.[127]

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[127] In challenging the amendments, Senator Williams also stated:

> "In other words, you are going to count the man as having money which he has not

The application of this principle is reflected in several decisions of this Court. As recently as *Commissioner v. Sullivan*, 356 U.S. 27, we sustained the allowance of a deduction for rent and wages paid by the operators of a gambling enterprise, even though both the business itself and the specific rent and wage payments there in question were illegal under state law. In rejecting the Commissioner's contention that the illegality of the enterprise required disallowance of the deduction, we held that, were we to

> "enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it."

Id. at 356 U.S. 29. In *Lilly v. Commissioner*, 343 U.S. 90, the Court upheld deductions claimed by opticians for amounts paid to doctors who prescribed the eyeglasses that the opticians sold, although the Court was careful to disavow "approval of the business ethics or public policy involved in the payments. ..." 343 U.S. at 97. And in *Commissioner v. Heininger*, 320 U.S. 467, a case akin to the one before us, the Court upheld deductions claimed by a dentist for lawyer's fees and other expenses incurred in unsuccessfully defending against an administrative fraud order issued by the Postmaster General.

Deduction of expenses falling within the general definition of § 162(a) may, to be sure, be disallowed by specific legislation, since deductions "are a matter of grace and Congress can, of course, disallow them as it

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> got, because he has lost it in a way that you do not approve of."

50 Cong. Rec. 3850.

chooses." *Commissioner v. Sullivan*, 356 U.S. at 28.[128] The Court has also given effect to a precise and longstanding Treasury Regulation prohibiting the deduction of a specified category of expenditures; an example is lobbying expenses, whose nondeductibility was supported by considerations not here present. *Textile Mills Securities Corp. v. Commissioner*, 314 U.S. 326; *Cammarano v. United States*, 358 U.S. 498. But where Congress has been wholly silent, it is only in extremely limited circumstances that the Court has countenanced exceptions to the general principle reflected in the *Sullivan*, *Lilly*, and *Heininger* decisions. Only where the allowance of a deduction would "frustrate sharply defined national or state policies proscribing particular types of conduct" have we upheld its disallowance. *Commissioner v. Heininger*, 320 U.S. at 473. Further, the "policies frustrated must be national or state policies evidenced by some governmental declaration of them." *Lilly v. Commissioner*, 343 U.S. at 97. (Emphasis added.) Finally, the "test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction." *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35. In that case, as in *Hoover Motor Express Co. v. United States*, 356 U.S. 38, we upheld the disallowance of deductions

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[128] Specific legislation denying deductions for payments that violate public policy is not unknown. *E.g.*, Internal Revenue Code of 1954, § 162(c) (disallowance of deduction for payments to officials and employees of foreign countries in circumstances where the payments would be illegal if federal laws were applicable; *cf.* Reg. § 1.162-18); § 165(d) (deduction for wagering losses limited to extent of wagering gains). *See also* Stabilization Act of 1942, § 5(a), 56 Stat. 767, 50 U.S.C. App. § 965(a) (1946 ed.), Defense Production Act of 1950, § 405(a), 64 Stat. 807, *as amended*, c. 275, § 104(i), 65 Stat. 136 (1951), 50 U.S.C. App. § 2105(a) (1952 ed.), and Defense Production Act of 1950, § 405(b), 64 Stat. 807, 50 U.S.C. App. § 2105(b) (1952 ed.) (general authority in President to prescribe extent to which payments violating price and wage regulations should be disregarded by government agencies, including the Internal Revenue Service; *see* Rev. Rul. 56-180). *Cf.* § 1.162-1(a), which provides that

> "Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income;"

Joint Committee on Internal Revenue Taxation, Staff Study of Income Tax Treatment of Treble Damage Payments under the Antitrust Laws, Nov. 1, 1965, p. 16 (proposal that § 162 be amended to deny deductions for certain fines, penalties, treble damage payments, bribes, and kickbacks).

claimed by taxpayers for fines and penalties imposed upon them for violating state penal statutes; to allow a deduction in those circumstances would have directly and substantially diluted the actual punishment imposed.

The present case falls far outside that sharply limited and carefully defined category. No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not "proscribed conduct." It is his constitutional right. *Chandler v. Fretag*, 348 U.S. 3. *See Gideon v. Wainwright*, 372 U.S. 335. In an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him.

Congress has authorized the imposition of severe punishment upon those found guilty of the serious criminal offenses with which the respondent was charged and of which he was convicted. But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed.[129] To deny a deduction for expenses incurred in the unsuccessful defense of a criminal prosecution would impose such a burden in a measure dependent not on the seriousness of the offense or the actual sentence imposed by the court, but on the cost of the defense and the defendant's particular tax bracket. We decline to distort the income tax laws to serve a purpose for which

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[129] *Cf.* Paul, *The Use of Public Policy by the Commissioner in Disallowing Deductions*, 1954 SO. CALIF. TAX INST. 715, 730-731:

> "... Section 23(a)(1)(A) [the predecessor of § 162(a)] is not an essay in morality, designed to encourage virtue and discourage sin. It 'was not contrived as an arm of the law to enforce State criminal statutes. ...' Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with 'commercial net income' – a businessman's net accretion in wealth during the taxable year after due allowance for the operating costs of the business. ... There is no evidence in the Section of an attempt to punish taxpayers ... when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates 'in a vacuum' if it serves its own vital function and leaves other problems to other statutes."

Deductibility of Legal Expenses: In both *Woodward*, *supra*, and *Tellier*, the Court cited *United States v. Gilmore*, 372 U.S. 39 (1963). In *Gilmore*, taxpayer and his wife cross-claimed for divorce. Taxpayer owned the controlling stock interests of three corporations, each of which owned a General Motors dealership. He received a substantial income from these corporations. His wife made sensational allegations, and had she prevailed, she could receive more than half of the stock and/or GM would terminate the corporations' franchises. Fearing such consequences of losing, taxpayer expended large sums to fight his wife's allegations and eventually prevailed. Taxpayer sought to deduct his legal expenses attributable to successful resistance of his wife's claims under § 212 (expenses of conserving property held for production of income). The Commissioner argued that such expenses were personal or family expenses. The court of claims allocated 20% of the fees to the divorce and 80% to conservation of property. The CIR argued that deductibility under either § 162 or § 212 turned "not upon the consequences to respondent of a failure to defeat his wife's community property claims, but upon the origin and nature of the claims themselves." The Court agreed: "[T]he characterization, as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim[.]" The Court stated its "origin of the claim" test thus: "[T]he origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was 'business' or 'personal[.]'" None of taxpayer's legal expenses were deductible. "It is enough to say that … the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity."

they were neither intended nor designed by Congress.

The judgment is

Affirmed.

Notes and Questions:

1. Why should the standard of "necessary" under § 162 be a minimal one, i.e., appropriate and helpful? Are there forces other than the rules of § 162 that will provide controls on the amounts that a taxpayer spends to further his/her/its business?

- Recall the statement in *Welch v. Helvering*: Taxpayer "certainly thought [payments to creditors of a bankrupt corporation were necessary], and we should be slow to override his judgment."

2. The income tax is a tax only on net income. The one exception to this – explicitly stated in the Code – is § 280E. The expenses of carrying on the trade or business of trafficking in controlled substances are not deductible.

- Is § 280E constitutional?
- Who would want to know?

3. What norms does a refusal to incorporate public policy into the Code further?

- A refusal to incorporate public policy into the Code hardly means that there is no public policy limitation on deductibility under § 162. Rather, those limitations must be explicitly stated in the statute itself.
- *See* Court's discussion of the point and its third footnote.
- Note the topics covered in §§ 162(b, c, e, f, g, k, *l*, and m).

4. The term “ordinary” has a relatively special meaning as used in § 162. What is it?

5. In *Tellier*, taxpayer was a criminal. He nevertheless could deduct the”ordinary and necessary” trade or business expenses arising from this character flaw.

- Should taxpayer be permitted to deduct the ordinary and necessary expenses associated with mental “flaws?” Is *Gilliam* distinguishable from *Tellier*?

Gilliam v. Commissioner, 51 T.C. Memo. 515 (1986), *available at* 1986 WL 21482.

MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, JUDGE:

FINDINGS OF FACT

....

Gilliam was born in Tupelo, Mississippi, in 1933, and raised in Louisville, Kentucky. In 1961, he received a master of arts degree in painting from the University of Louisville.

Gilliam is, and was at all material periods, a noted artist. His works have been exhibited in numerous art galleries throughout the United States and Europe, including the Corcoran Gallery of Art, Washington, D.C.; the Philadelphia Museum of Art, Philadelphia, Pennsylvania; the Karl Solway Gallery, Cincinnati, Ohio; the Phoenix Gallery, San Francisco, California; and the University of California, Irvine, California. His works have also been exhibited and sold at the Fendrick Gallery, Washington, D.C. In addition, Gilliam is, and was at all material periods, a teacher of art. On occasion, Gilliam lectured and taught art at various institutions.

Gilliam accepted an invitation to lecture and teach for a week at the Memphis Academy of Arts in Memphis, Tennessee. On Sunday, February 23, 1975, he flew to Memphis to fulfill this business obligation.

Gilliam had a history of hospitalizations for mental and emotional disturbances and continued to be under psychiatric care until the time of his trip to Memphis. In December 1963, Gilliam was hospitalized in Louisville; Gilliam had anxieties about his work as an artist. For periods of time in both 1965 and 1966, Gilliam suffered from depression and was unable to work. In 1970, Gilliam was again hospitalized. In 1973, while Gilliam was a visiting artist at a number of university campuses in California, he found it necessary to consult an airport physician; however, when he returned to Washington, D.C., Gilliam did not require hospitalization.

Before his Memphis trip, Gilliam created a 225-foot painting for the Thirty-fourth Biennial Exhibition of American Painting at the Corcoran Gallery of Art (hereinafter sometimes referred to as 'the Exhibition'). The Exhibition opened on Friday evening, February 21, 1975. In addition, Gilliam was in the process of preparing a giant mural for an outside wall of the Philadelphia Museum of Art for the 1975 Spring Festival in Philadelphia. The budget plans for this mural were due on Monday, February 24, 1975.

On the night before his Memphis trip, Gilliam felt anxious and unable to rest. On Sunday morning, Gilliam contacted Ranville Clark (hereinafter sometimes referred to as 'Clark'), a doctor Gilliam had been consulting intermittently over the years, and asked Clark to prescribe some medication to relieve his anxiety. Clark arranged for Gilliam to pick up a prescription of the drug Dalmane on the way to the airport. Gilliam had taken medication frequently during the preceding 10 years. Clark had never before prescribed Dalmane for Gilliam.

On Sunday, February 23, 1975, Gilliam got the prescription and at about 3:25 p.m., he boarded American Airlines flight 395 at Washington National Airport, Washington, D.C., bound for Memphis. Gilliam occupied a window seat. He took the Dalmane for the first time shortly after boarding the airplane.

About one and one-half hours after the airplane departed Washington National Airport, Gilliam began to act in an irrational manner. He talked of bizarre events and had difficulty in speaking. According to some witnesses, he appeared to be airsick and held his head. Gilliam began to feel trapped, anxious, disoriented, and very agitated. Gilliam said that the plane was going to crash and that he wanted a life raft. Gilliam entered the aisle and, while going from one end of the airplane to the other, he tried to exit from three different doors. Then Gilliam struck Seiji Nakamura (hereinafter sometimes referred to as 'Nakamura'), another passenger, several times with a telephone receiver. Nakamura was seated toward the rear of the airplane, near one of the exits. Gilliam also threatened the navigator and a stewardess, called for help, and cried. As a result of the attack, Nakamura sustained a one-inch laceration above his left eyebrow which required four sutures. Nakamura also suffered ecchymosis of the left arm and pains in his left wrist. Nakamura was treated for these injuries at Methodist Hospital in Memphis.

On arriving in Memphis, Gilliam was arrested by Federal officials. On March 10, 1975, Gilliam was indicted. He was brought to trial in the United States District Court for the Western District of Tennessee, Western Division, on one count of violation of 49 U.S.C. § 1472(k) (relating to certain crimes aboard an aircraft in flight) and two counts of violation 49 U.S.C. § 1472(j) (relating to interference with flight crew members or flight attendants). Gilliam entered a plea of not guilty to the criminal charges. ... After Gilliam presented all of his evidence, the district court granted Gilliam's motion for a judgment of acquittal by reason of temporary insanity.

Petitioners paid $8250 and $8600 for legal fees in 1975 and 1976, respectively, in connection with both the criminal trial and Nakamura's civil claim. In 1975, petitioners also paid $3800 to Nakamura in settlement of the civil claim.

Petitioners claimed deductions for the amounts paid in 1975 and 1976 on the appropriate individual income tax returns. Respondent disallowed the amounts claimed in both years attributable to the incident on the airplane. [footnote omitted].

* * *

Gilliam's trip to Memphis was a trip in furtherance of his trades or businesses.
Petitioners' expenses for the legal fees and claim settlement described, *supra*, are not ordinary expenses of Gilliam's trades or businesses.

OPINION

Petitioners contend that they are entitled to deduct the amounts paid in defense of the criminal prosecution and in settlement of the related civil claim under § 162. [footnote omitted]. Petitioners maintain that the instant case is directly controlled by our decision in *Dancer v. Commissioner*, 73 T.C. 1103 (1980). According to petitioners, '[t]he clear holding of *Dancer* is *** that expenses for litigation arising out of an accident which occurs during a business trip are deductible as ordinary and necessary business expenses. ' Petitioners also contend that *Clark v. Commissioner*, 30 T.C. 1330 (1958), is to the same effect as *Dancer*.

Respondent maintains that *Dancer* and *Clark* are distinguishable. Respondent contends that the legal fees paid are not deductible under either § 162 or § 212 because the criminal charges against Gilliam were neither directly connected with nor proximately resulted from his trade or business and the legal fees were not paid for the production of income. Respondent maintains that 'the criminal charges which arose as a result of *** (the incident on the airplane), could hardly be deemed 'ordinary,' given the nature of (Gilliam's) profession.' Respondent contends 'that the provisions of § 262 control this situation.' As to the settlement of the related civil claim, respondent asserts that since Gilliam committed an intentional tort, the settlement of the civil claim constitutes a nondeductible personal expense.

We agree with respondent that the expenses are not ordinary expenses of Gilliam's trade or business.

Section 162(a) [footnote omitted] allows a deduction for all the ordinary and necessary expenses of carrying on a trade or business. In order for the expense to be deductible by a taxpayer, it must be an ordinary expense, it must be a necessary expense, and it must be an expense of carrying on the taxpayer's trade or business. If any one of these requirements is not met, the expense is not deductible under § 162(a). *Deputy v. du Pont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933); *Kornhauser v. United States*, 276 U.S. 145 (1928). In *Deputy v. du Pont*, the Supreme Court set forth a guide for application of the statutory requirement that the expense be 'ordinary', as follows (308 U.S. at 494-497):

> In the second place, these payments were not 'ordinary' ones for the conduct of the kind of business in which, we assume arguendo, respondent was engaged. [...] Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happens but once in the taxpayer's lifetime. *Cf. Kornhauser v. United States*, *supra*. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. *Welch v. Helvering*, *supra*, 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under [§ 162(a)] does not necessarily make it such in connection with another business. *** As stated in *Welch v. Helvering*, *supra*, pp. 113-114: '... What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance.' 22 F. Supp. 589, 597.
>
> One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.
>
> Review of the many decided cases is of little aid since each turns on its special facts. But the principle is clear. [...] [T]he fact that the

> payments might have been necessary ... is of no aid. For Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary. *Welch v. Helvering*, *supra*.

... It undoubtedly is ordinary for people in Gilliam's trades or businesses to travel (and to travel by air) in the course of such trades or businesses; however, we do not believe it is ordinary for people in such trades or businesses to be involved in altercations of the sort here involved in the course of any such travel. The travel was not itself the conduct of Gilliam's trades or businesses. Also, the expenses here involved are not strictly a cost of Gilliam's transportation. Finally, it is obvious that neither the altercation nor the expenses were undertaken to further Gilliam's trades or businesses.

We conclude that Gilliam's expenses are not ordinary expenses of his trades or businesses.

It is instructive to compare the instant case with *Dancer v. Commissioner*, *supra*, upon which petitioners rely. In both cases, the taxpayer was traveling on business. In both cases, the expenses in dispute were not the cost of the traveling, but rather were the cost of an untoward incident that occurred in the course of the trip. In both cases, the incident did not facilitate the trip or otherwise assist the taxpayer's trade or business. In both cases, the taxpayer was responsible for the incident; in neither case was the taxpayer willful. In *Dancer*, the taxpayer was driving an automobile; he caused an accident which resulted in injuries to a child. The relevant expenses were the taxpayer's payments to settle the civil claims arising from the accident. 73 T.C. at 1105. In the instant case, Gilliam was a passenger in an airplane; he apparently committed acts which would have been criminal but for his temporary insanity, and he injured a fellow passenger. Gilliam's expenses were the costs of his successful legal defense, and his payments to settle Nakamura's civil claim.

In *Dancer*, we stated as follows (73 T.C. at 1108-1109):

> It is true that the expenditure in the instant case did not further petitioner's business in any economic sense; nor is it, we hope, the type of expenditure that many businesses are called upon to pay. Nevertheless, neither factor lessens the direct relationship between the expenditure and the business. Automobile travel by petitioner was an integral part of this business. *As rising insurance rates suggest, the cost of fuel and routine servicing are not the only costs one can expect in operating a car. As unfortunate as it may be, lapses by drivers seem to be an inseparable incident of driving a car. Anderson v. Commissioner* (81 F.2d 457 (CA10 1936)). Costs incurred as a result of such an incident are just as much a part of overall business expenses as the cost of fuel. (Emphasis supplied.)

Dancer is distinguishable.

In *Clark v. Commissioner*, *supra*, also relied on by petitioners, the expenses consisted of payments of (a) legal fees in defense of a criminal prosecution and (b) amounts to settle a related civil claim. In this regard, the instant case is similar to *Clark*. In *Clark*, however, the taxpayer's activities that gave rise to the prosecution and civil claim were activities directly in the conduct of Clark's trade or business. In the instant case, Gilliam's activities were not directly in the conduct of his trades or businesses. Rather, the activities merely occurred in the course of transportation connected with Gilliam's trades or businesses. And, as we noted in *Dancer v. Commissioner*, 73 T.C. at 1106, 'in cases like this, where the cost is an adjunct of and not a direct cost of transporting an individual, we have not felt obliged to routinely allow the expenditure as a transportation cost deduction.'

Petitioners also rely on *Commissioner v. Tellier*, 383 U.S. 687 (1966), in which the taxpayer was allowed to deduct the cost of an unsuccessful criminal defense to securities fraud charges. The activities that gave rise to the criminal prosecution in *Tellier* were activities directly in the conduct of Tellier's trade or business. Our analysis of the effect of *Clark v. Commissioner*, applies equally to the effect of *Commissioner v. Tellier*.

In sum, Gilliam's expenses were of a kind similar to those of the taxpayers in *Tellier* and *Clark*; however the activities giving rise to Gilliam's expenses were not activities directly in the conduct of his trades or businesses, while Tellier's and Clark's activities were directly in the conduct of their respective trades or businesses. Gilliam's expenses were related to his trades or businesses in a manner similar to those of the taxpayer in *Dancer*; however Gilliam's actions giving rise to the expenses were not shown to be ordinary, while Dancer's were shown to be ordinary. *Tellier*, *Clark*, and *Dancer* all have similarities to the instant case; however, *Tellier*, *Clark*, and *Dancer* are distinguishable in important respects. The expenses are not deductible under § 162(a). [footnote omitted].

We hold for respondent.

Notes and Questions:

1. What is it about flying to Memphis that makes people ...?

> *If not "ordinary" ...*: In *Welch*, the opposite of an "ordinary" expense was a capital expense. What is the opposite of "ordinary" in *Gilliam*?

2. Were the expenses incurred by taxpayer "necessary?"

3. By what means did the court in fact implement a public policy limitation on taxpayer's trade or business expense? Why were the deductions that taxpayer claimed denied?

- because they were "extraordinary" in light of taxpayer's trade or business?
  - If so, are there trades or businesses in which such expenditures would not be extraordinary?
  - What if airline employees hit taxpayer and incurred tort damages and legal expenses? These expenses would be the very type of expenses that Gilliam could not deduct.

4. Even when taxpayer incurs ordinary and necessary trade or business expense, taxpayer might not be entitled to deduct them.

Walliser v. Commissioner, 72 T.C. 433 (1979).

TANNENWALD, Judge:

....

FINDINGS OF FACT

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During the taxable years 1973 and 1974, James [Walliser] was vice president and branch manager of the First Federal Savings & Loan Association (First Federal) of Dallas, Tex., Richardson branch office. James began his career at First Federal as a trainee in mortgage lending and an appraiser. He later became a branch manager and a loan production officer. Subsequent to the taxable years at issue, James was made the head of the interim loan department of First Federal. Prior to his initial association with First Federal in 1964, James was primarily engaged in the business of home building in Dallas County, Tex.

As branch manager of the Richardson office of First Federal, James supervised all aspects of the branch's operations, but his primary responsibility was the marketing of permanent and interim loans. James was assigned loan production quotas, and he expected to receive annual raises in his salary if he met his yearly quotas, although First Federal was under no commitment to give James a raise in salary or a bonus if a quota was met. ... James met his quotas and received salary raises at the end of 1973 and 1974.

During the taxable years at issue, petitioners traveled abroad in tour groups organized primarily for people involved in the building industry. In 1973, petitioners took two such trips. The first was to Rio de Janeiro and was sponsored by General Electric Co. (General Electric). It began on March 23, 1973, and ended on March 31, 1973. Their second trip, to London and Copenhagen, was sponsored by Fedders Co. (Fedders) and ran from October 3, 1973, to October 15, 1973.

In 1974, petitioners went to Santo Domingo on a tour organized by

Fedders which began on September 27, 1974, and ended on October 4, 1974.

....

The majority of the people on a General Electric or Fedders builders' tour were builders and developers from Texas and their spouses. The group also included lenders, title company personnel, and other users and distributors of the sponsor's product. The dealers and builders who participated in the Fedders builders' tours did so as part of the Fedders incentive program through which they were able to earn the cost of the tours in whole or in part by purchasing or selling a certain amount of central air conditioning equipment in a particular year. Fedders presented awards during the tours to some people it considered outstanding in its sales and promotional programs but conducted no business meetings.

The builders' tours were arranged as guided vacation trips, with sightseeing and other recreational activities. Petitioners, however, went on the tours because James found that they provided an unusual opportunity to associate with many potential and actual customers and believed that the tours would generate business, thereby helping him to meet his loan production quotas and obtain salary raises. He spent as much time as possible talking with builders whom he already knew and getting acquainted with builders he had not previously met to make them aware of First Federal's services and of his own skills. His conversations frequently centered on conditions in the building industry and the availability of loans for builders, but he did not negotiate specific business transactions on the tours or conduct formal business meetings. Social relationships formed or renewed on the tours between petitioners and builders and their spouses resulted in a substantial amount of loan business for First Federal.

....

Prior to 1973, First Federal had paid for James to participate in builders' tours. During 1973 and 1974, First Federal stopped reimbursing employees for a variety of previously reimbursed expenses as part of a program of overall budget cutbacks. During the taxable years in issue, First Federal's policy was to pay entertainment costs directly, or to provide reimbursement for expenses, when an officer of First Federal entertained current customers of the company at civic, social, or business meetings. The company did not customarily reimburse officers for the costs of goodwill meetings or trips for current customers along with prospective customers; however, the board of directors expected the officers, especially vice presidents in charge of marketing activities, to be active in cultivating new customers. First Federal did not reimburse petitioners for any travel expenses incurred in connection with the Fedders and General Electric tours taken by them in 1973 and 1974. James was, however, given leave with pay, in addition to his normal 2-week paid vacation, in order to participate in the tours.

....

On their 1973 and 1974 tax returns, petitioners deducted, as employee business expenses, one-half of the price of each of the tours (the portion attributable to James' travel) ...

OPINION

Initially, we must determine whether petitioners are entitled, under § 162, to deduct as employee business expenses costs incurred by James in connection with his travel on tours for builders organized by General Electric and Fedders. If we hold that the requirements of that section are satisfied, then we must face the further question as to the extent to which the limitations of § 274 apply.

Section 162(a)(2) allows a deduction for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including traveling expenses incurred while away from home in the pursuit of a trade or business. The question is essentially one of fact. [citations omitted] Petitioners must show that the expenses were incurred primarily for business rather than social reasons and that there was a proximate relation between the cost of the builders' tours and James' business as an officer of First Federal. [citations omitted].

James' primary responsibility as an officer of First Federal was marketing loans. He was assigned loan production quotas and considered yearly increases in his salary to be contingent upon meeting those quotas. The participants in the General Electric and Fedders tours were not a random group of Texas vacationers. On the contrary, they were largely builders and developers from Texas, the area in which First Federal operated. Thus, the tours were a useful means of maintaining relations with existing customers of First Federal and reaching prospective customers. Indeed, the record indicated that some of the participants considered the social relationships with James, including their association with him on the tours, as an influencing factor in their decisions to seek loans from First Federal.

The fact that, during the years at issue, First Federal did not reimburse James for the costs of his travel does not render his expenses nondeductible. Where a corporate officer personally incurs expenditures which enable him to better perform his duties to the corporation and which have a direct bearing on the amount of his compensation or his chances for advancement, unreimbursed expenses may be deductible under § 162. [citations omitted].[130]

First Federal expected its officers in charge of marketing activities to participate in public or social functions without reimbursement and examined their performance in this regard when evaluating their compensation and overall value to the company. [citation omitted]. James met his loan quotas in 1973 and 1974 and received raises in his salary at the end of those years. In a later year, he became head of First Federal's interim loan department.

Moreover, the evidence tends to show that First Federal considered the

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[130] The rule is otherwise where the corporate employee is entitled to, but does not seek, reimbursement from the corporation. Stolk v. Commissioner, 40 T.C. 345, 357 (1963), *aff'd. per curiam* 326 F.2d 760 (2d Cir. 1964); Coplon v. Commissioner, T.C. Memo. 1959-34, *aff'd. per curiam* 277 F.2d 534 (6th Cir. 1960).

trips valuable in generating goodwill. Although First Federal, which was in the midst of a program of budget cutbacks in 1973 and 1974, did not reimburse James for the tours as it had done in prior years, it continued to grant him additional leave with pay for the time he was on the tours.

Finally, the testimony of petitioners, and particularly of Carol, which we found straightforward and credible, tended to show that the tours were strenuous, and not particularly enjoyable, experiences because of the amount of time expended in cultivating business and, therefore, that petitioners did not undertake the tours for primarily personal reasons. [They took family vacations to other destinations.]

We conclude that, under the circumstances of this case, the requisite proximate relation has been shown to constitute James' travel expenses as "ordinary and necessary" business expenses within the meaning of § 162(a)(2).

We now turn our attention to the applicability of § 274, the issue on which respondent has concentrated most of his fire. That section disallows a deduction in certain instances for expenses which would otherwise be deductible under § 162. Respondent argues that the requirements of § 274 are applicable here and have not been satisfied in that petitioners have failed: (1) To show that James' trips were "directly related" to the active conduct of his business (§ 274(a)) ...

Section 274(a) provides in part:

> (a) ENTERTAINMENT, AMUSEMENT, OR RECREATION.—
> (1) IN GENERAL. – No deduction otherwise allowable under this chapter shall be allowed for any item—
>
> > (A) ACTIVITY. – With respect to an activity which is of a type generally considered to constitute entertainment, amusement, or recreation, unless the taxpayer establishes that the item was directly related to, or, in the case of an item directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), that such item was associated

> with, the active conduct of the taxpayer's trade or business, ***
>
> and such deduction shall in no event exceed the portion of such item directly related to, or, in the case of an item described in subparagraph (A) directly preceding or following a substantial and bona fide business discussion (including business meetings at a convention or otherwise), the portion of such item associated with, the active conduct of the taxpayer's trade or business.

Petitioners urge that the "directly related" test of § 274(a) is not applicable because the expenditures at issue were incurred for travel, not entertainment. We disagree.

Section 274(a) relates to activities of a type generally considered to constitute "entertainment, amusement, or recreation." Reg. § 1.274-2(b) defines "entertainment, amusement, or recreation" as follows:

> (b) Definitions – (1) Entertainment defined – (i) In general. For purposes of this section, the term "entertainment" means any activity which is of a type generally considered to constitute entertainment, amusement, or recreation, such as entertaining at night clubs, cocktail lounges, theaters, country clubs, golf and athletic clubs, sporting events, and on hunting, fishing, vacation and similar trips, including such activity relating solely to the taxpayer or the taxpayer's family. ***
>
> (ii) Objective test. An objective test shall be used to determine whether an activity is of a type generally considered to constitute entertainment. Thus, if an activity is generally considered to be entertainment, it will constitute entertainment for purposes of this section and § 274(a) regardless of whether the expenditure can also be described otherwise, and even though the expenditure relates to the taxpayer alone. This objective test precludes arguments such as that "entertainment" means only entertainment of others or that an expenditure for entertainment should be characterized as an expenditure for advertising or public relations.

(Emphasis added.)

This regulation is squarely based on the language of the legislative history of § 274 and we find it to be valid as it relates to the issue herein.[131]

This regulation and the Congressional committee reports from which it is derived leave no doubt that the deductibility of an expenditure for travel, on what would objectively be considered a vacation trip, is subject to the limitations of subsection 274(a), even where the expenditure relates solely to the taxpayer himself. [citations omitted]. Furthermore, Reg. § 1.274-2(b)(1)(iii) provides that "any expenditure which might generally be considered *** either for travel or entertainment, shall be considered an expenditure for entertainment rather than for *** travel." This regulation too has a solid foundation in the statute, which provides, in § 274(h), authority for the promulgation of regulations necessary to carry out the purpose of § 274 [footnote omitted] and in the committee reports, which provide that rules be prescribed for determining whether § 274(a) should govern where another section is also applicable. H. REPT. 1447, *supra*; S. REPT. 1881, *supra*.

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131 S. REPT. 1881, 87th Cong., 2d Sess. (1962) states in part:

> "Entertaining guests at night clubs, country clubs, theaters, football games, and prizefights, and on hunting, fishing, vacation and similar trips are examples of activities that constitute 'entertainment, amusement, and recreation.' ***"
>
> "An objective standard also will overrule arguments such as the one which prevailed in Sanitary Farms Dairy, Inc. (25 T.C. 463 (1955)) that a particular item was incurred, not for entertainment, but for advertising purposes. That case involved a big-game safari to Africa. *** Under the bill, if the activity typically is considered to be entertainment, amusement, or recreation, it will be so treated under this provision regardless of whether the activity can also be described in some other category of deductible items. This will be so even where the expense relates to the taxpayer alone."

(Emphasis added.) *See also* H. REPT. 1447, 87th Cong., 2d Sess. (1962).

Although the participants in the tours that petitioners took were drawn, for the most part, from the building industry, their activities – sightseeing, shopping, dining – were the same as those of other tourists. Fedders presented some awards to persons considered outstanding in its sales or promotional programs on the tours but did not conduct any business meetings. Nor is there any evidence that any business meetings were conducted on the 1973 General Electric tour; on the itinerary for the 1974 tour, for which petitioners canceled their reservation, only 1 hour out of 10 days of guided tours, dinners, and cocktail parties, was set aside for a business meeting. Under the objective test set forth in the regulations, it is irrelevant that petitioners did not regard the trips as vacations or did not find them relaxing. Clearly, the tours were of a type generally considered vacation trips and, thus, under the objective test, constituted entertainment for the purposes of § 274(a). Therefore, the requirements of that section must be satisfied.

For a deduction to be allowed for any item under § 274(a)(1)(A), the taxpayer must establish that the item was directly related to the active conduct of the taxpayer's trade or business or, in the case of an item directly preceding or following a substantial and bona fide business discussion, that such item was associated with the active conduct of the taxpayer's trade or business.

The "directly related" test requires that a taxpayer show a greater degree of proximate relationship between an expenditure and the taxpayer's trade or business than that required by § 162. [citations omitted]. Reg. § 1.274-2(c)(3) provides that, for an expenditure to be directly related to the active conduct of the taxpayer's trade or business, it must be shown that the taxpayer had more than a general expectation of deriving some income or business benefit from the expenditure, other than the goodwill of the person or persons entertained. While the language of this regulation is awkward and not completely apt in a situation where the entertainment expenditure relates to the taxpayer alone, it is clear, nevertheless, that more than a general expectation of deriving some income at some indefinite future time is necessary for an expenditure to be deductible under § 274(a). [citations omitted].

The record shows that petitioners participated in the builders' tours because they provided an opportunity for James to meet new people who might be interested in the services he, and First Federal, had to offer and to maintain good personal relations with people already using those services. While James discussed business continually during the tours, his wife testified that this was typical of his behavior during all social activities. He engaged in general discussions about business conditions and the services he could provide to a builder but did not engage in business meetings or negotiations on the tours. James could not directly connect particular business transactions with specific discussions which occurred during the trips. [footnote omitted]. In short, petitioners' purpose in taking the trips was to create or maintain goodwill for James and First Federal, his employer, in order to generate some future business. Although the evidence tends to indicate that the trips did, in fact, enhance goodwill and contribute to James' success in loan production and otherwise constituted ordinary and necessary business expenses deductible under § 162, we hold, nevertheless, that Congress intended, by means of the more stringent standard of the "directly related" test in § 274(a), to disallow deductions for this type of activity, which involves merely the promotion of goodwill in a social setting. [citation omitted].

We also hold that the petitioners' trips do not qualify as entertainment "associated with" the active conduct of a trade or business. To be deductible, entertainment "associated with" the active conduct of a trade or business must directly precede or follow a substantial business discussion. In *St. Petersburg Bank & Trust Co. v. United States*, [362 F. Supp. 674 (M.D. Fla. 1973), *aff'd in an unpublished order*, 503 F.2d 1402 (5th Cir. 1974)], a decision affirmed by the Fifth Circuit, the District Court concluded that the phrase "directly preceding or following" in § 274(a)(1)(A) should be read restrictively in cases in which entertainment expenditures are related to the taxpayer's trade or business only in that they promote goodwill. [footnote omitted]. In view of the legislative history, which reveals that the "associated with" test is an exception to the general rule intended to limit deductions for entertainment which has as its sole business purpose the promotion of goodwill [footnote omitted], we agree with the District Court's conclusion. Accordingly, we do not consider the costs of the vacation trips to be deductible under §

274(a)(1)(A) as entertainment directly preceded or followed by a substantial and bona fide business discussion merely because James had general discussions of a business nature intended to promote goodwill during the course of the trips. [citation omitted].

We conclude that § 274(a) bars a deduction for the costs of James' trips. ...

Decision will be entered for the respondent.

Notes and Questions:

1. Is it appropriate that § 274 denies this taxpayer a deduction when § 162 permits it?

2. Suppose that taxpayer Walliser could prove that he actually closed a lending deal (except for documentary formalities) with a person he met and conversed with extensively about his bank's lending services. The borrower came by the bank three days after the end of the tour and signed the necessary documents. Would (should) the result be different?

- Suppose that at the end of the signing formalities, Walliser gave the borrower two tickets which cost $25 each to that night's baseball game. The borrower happily accepted. Walliser did not attend the game with the borrower. Should Walliser be permitted to deduct the cost of the baseball tickets?
- Would it make any difference if the tickets cost $60 each?

Moss v. Commissioner, 758 F.2d 211 (7th Cir. 1985)

POSNER, Circuit Judge

The taxpayers, a lawyer named Moss and his wife, appeal from a decision of the Tax Court disallowing federal income tax deductions of a little more than $1,000 in each of two years, representing Moss's share of his law firm's lunch expense at the Café Angelo in Chicago. The Tax Court's decision in this case has attracted some attention in tax circles because of its implications for the general problem of the deductibility of business meals. *See, e.g.*, McNally, *Vulnerability of Entertainment and Meal Deductions Under the* Sutter *Rule*, 62 TAXES 184 (1984).

Moss was a partner in a small trial firm specializing in defense work, mostly for one insurance company. Each of the firm's lawyers carried a tremendous litigation caseload, averaging more than 300 cases, and spent most of every working day in courts in Chicago and its suburbs. The members of the firm met for lunch daily at the Café Angelo near their office. At lunch the lawyers would discuss their cases with the head of the firm, whose approval was required for most settlements, and they would decide which lawyer would meet which court call that afternoon or the next morning. Lunchtime was chosen for the daily meeting because the courts were in recess then. The alternatives were to meet at 7:00 a.m. or 6:00 p.m., and these were less convenient times. There is no suggestion that the lawyers dawdled over lunch, or that the Café Angelo is luxurious.

The framework of statutes and regulations for deciding this case is simple, but not clear. Section 262 of the Internal Revenue Code disallows, "except as otherwise expressly provided in this chapter," the deduction of "personal, family, or living expenses." Section 119 excludes from income the value of meals provided by an employer to his employees for his convenience, but only if they are provided on the employer's premises; and § 162(a) allows the deduction of '"all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including – ... (2) traveling expenses (including amounts expended for meals ...) while away from home....'" Since Moss was not an employee but a partner in a partnership not taxed as an entity, since the meals were not served on the employer's premises, and since he was not away from home (that is, on an overnight trip away from his place of work, *see United States v. Correll*, 389 U.S. 299 (1967)), neither § 119 nor § 162(a)(2) applies to this case. The Internal Revenue Service concedes, however, that meals are deductible under § 162(a) when they are ordinary and necessary business expenses (provided the expense is substantiated with adequate records, *see* § 274(d)) even if they are not within the express permission of any other provision and even though the expense of commuting to and from work, a traveling expense but not one incurred away from home, is not deductible. Reg. § 1.262-1(b)(5); *Fausner v.*

Commissioner, 413 U.S. 838 (1973) (per curiam).

The problem is that many expenses are simultaneously business expenses in the sense that they conduce to the production of business income and personal expenses in the sense that they raise personal welfare. This is plain enough with regard to lunch; most people would eat lunch even if they didn't work. Commuting may seem a pure business expense, but is not; it reflects the choice of where to live, as well as where to work. Read literally, § 262 would make irrelevant whether a business expense is also a personal expense; so long as it is ordinary and necessary in the taxpayer's business, thus bringing § 162(a) into play, an expense is (the statute seems to say) deductible from his income tax. But the statute has not been read literally. There is a natural reluctance, most clearly manifested in the regulation disallowing deduction of the expense of commuting, to lighten the tax burden of people who have the good fortune to interweave work with consumption. To allow a deduction for commuting would confer a windfall on people who live in the suburbs and commute to work in the cities; to allow a deduction for all business-related meals would confer a windfall on people who can arrange their work schedules so they do some of their work at lunch.

Although an argument can thus be made for disallowing any deduction for business meals, on the theory that people have to eat whether they work or not, the result would be excessive taxation of people who spend more money on business meals because they are business meals than they would spend on their meals if they were not working. Suppose a theatrical agent takes his clients out to lunch at the expensive restaurants that the clients demand. Of course he can deduct the expense of their meals, from which he derives no pleasure or sustenance, but can he also deduct the expense of his own? He can, because he cannot eat more cheaply; he cannot munch surreptitiously on a peanut butter and jelly sandwich brought from home while his client is wolfing down tournedos Rossini followed by souffle au grand marnier. No doubt our theatrical agent, unless concerned for his longevity, derives personal utility from his fancy meal, but probably less than the price of the meal. He would not pay for it if it were not for the business benefit; he would get more value from using the same money to buy something else; hence the meal confers on him less utility than the cash equivalent would. The law could require him to pay tax on the fair value of the meal to him; this would be (were it not for costs of administration) the economically correct solution. But the government does not attempt this difficult measurement; it once did, but gave up the attempt as not worth the cost, see *United States v. Correll*, *supra,* 389 U.S. at 301 n. 6. The taxpayer is permitted to deduct the whole price, provided the expense is '"different from or in excess of that which would have been made for the taxpayer's personal purposes.'" *Sutter v. Commissioner*, 21 T.C. 170, 173 (1953).

Because the law allows this generous deduction, which tempts people to have more (and costlier) business meals than are necessary, the Internal Revenue Service has every right to insist that the meal be shown to be a real business necessity. This condition is most easily satisfied when a client or customer or supplier or other outsider to the business is a guest. Even if Sydney Smith was wrong that '"soup and fish explain half the emotions of life,'" it is undeniable that eating together fosters camaraderie and makes business dealings friendlier and easier. It thus reduces the costs of transacting business, for these costs include the frictions and the failures of communication that are produced by suspicion and mutual misunderstanding, by differences in tastes and manners, and by lack of rapport. A meeting with a client or customer in an office is therefore not a perfect substitute for a lunch with him in a restaurant. But it is different when all the participants in the meal are coworkers, as essentially was the case here (clients occasionally were invited to the firm's daily luncheon, but Moss has made no attempt to identify the occasions). They know each other well already; they don't need the social lubrication that a meal with an outsider provides – at least don't need it daily. If a large firm had a monthly lunch to allow partners to get to know associates, the expense of the meal might well be necessary, and would be allowed by the Internal Revenue Service. *See Wells v. Commissioner*, 36 T.C.M. 1698, 1699 (1977), *aff'd without opinion*, 626 F.2d 868 (9th Cir. 1980). But Moss's firm never had more than eight lawyers (partners and associates), and did not need a daily lunch to cement relationships among them.

It is all a matter of degree and circumstance (the expense of a testimonial dinner, for example, would be deductible on a morale-building rationale);

and particularly of frequency. Daily – for a full year – is too often, perhaps even for entertainment of clients, as implied by *Hankenson v. Commissioner*, 47 T.C.M. 1567, 1569 (1984), where the Tax Court held nondeductible the cost of lunches consumed three or four days a week, 52 weeks a year, by a doctor who entertained other doctors who he hoped would refer patients to him, and other medical personnel.

We may assume it was necessary for Moss's firm to meet daily to coordinate the work of the firm, and also, as the Tax Court found, that lunch was the most convenient time. But it does not follow that the expense of the lunch was a necessary business expense. The members of the firm had to eat somewhere, and the Café Angelo was both convenient and not too expensive. They do not claim to have incurred a greater daily lunch expense than they would have incurred if there had been no lunch meetings. Although it saved time to combine lunch with work, the meal itself was not an organic part of the meeting, as in the examples we gave earlier where the business objective, to be fully achieved, required sharing a meal.

The case might be different if the location of the courts required the firm's members to eat each day either in a disagreeable restaurant, so that they derived less value from the meal than it cost them to buy it, *cf. Sibla v. Commissioner*, 611 F.2d 1260, 1262 (9th Cir. 1980); or in a restaurant too expensive for their personal tastes, so that, again, they would have gotten less value than the cash equivalent. But so far as appears, they picked the restaurant they liked most. Although it must be pretty monotonous to eat lunch the same place every working day of the year, not all the lawyers attended all the lunch meetings and there was nothing to stop the firm from meeting occasionally at another restaurant proximate to their office in downtown Chicago; there are hundreds.

An argument can be made that the price of lunch at the Café Angelo included rental of the space that the lawyers used for what was a meeting as well as a meal. There was evidence that the firm's conference room was otherwise occupied throughout the working day, so as a matter of logic Moss might be able to claim a part of the price of lunch as an ordinary and necessary expense for work space. But this is cutting things awfully fine;

in any event Moss made no effort to apportion his lunch expense in this way.

AFFIRMED.

Notes and Questions:

1. *Walliser* was a § 274 case. *Moss* was not. Why not?

2. What requirement of deductibility under § 162 did taxpayer fail to meet?

3. If this firm had only monthly lunches, the court seems to say that the cost of those lunches might have been deductible. Why should such meals be treated differently than the daily lunches at Café Angelo?

4. Another limitation on §§ 162 and 212 is § 280A, which limits taxpayer's deductions for business use of a home.

Section 280A limits deductions for business use of a dwelling unit that taxpayer (individual or S corporation) uses as a residence. Section 280A(a) provides taxpayer is entitled to *no deduction for such use* "[e]xcept as otherwise provided in" § 280A itself. Section 280A(c) provides those exceptions.

- Section 280A(c)(1) permits deductions when taxpayer regularly uses a portion of the dwelling "exclusively"
    - as a principal place of business, including a place that taxpayer uses for administrative or management activities of taxpayer's trade or business, and there is no other fixed location where taxpayer conducts substantial management or administrative activities,
    - as a place of business that patients, clients, or customers use to meet with taxpayer "in the normal course of his trade or business," OR
    - in connection with taxpayer's trade or business "in the case of a separate structure which is not attached to the dwelling unit."

•Section 280A(c)(2) permits deductions when taxpayer regularly uses space in the dwelling unit to store inventory or product samples that taxpayer sells at retail or wholesale, provided the dwelling unit is the only fixed location of taxpayer's trade or business.

•Section 280A(c)(3) permits deductions when they are attributable to rental of the dwelling unit.

•Section 280A(c)(4) permits deductions attributable to use of a portion of the dwelling unit for licensed child or dependent care services.

Section 280A(c)(5) limits the amount of any deductions attributable to business use of the home to the gross income that taxpayer derives from such use. § 280A(c)(5)(A). Section 280A(c)(5) and Prop. Reg. § 1-280A(*i*) provide a sequence in which taxpayer may claim deductions attributable to the business activity.

1. the gross income that taxpayer derives from use of a dwelling unit in a trade or business does not include "expenditures required for the activity but not allocable to use of the unit itself, such as expenditures for supplies and compensation paid to other persons." Prop. Reg. § 1.280A-2(*i*)(2)(iii).
2. deductions attributable to such trade or business and allocable to the portion of the dwelling unit that taxpayer uses that the Code would allow taxpayer even if he/she/it did not conduct a trade or business in the dwelling unit, e.g., real property taxes, § 164(a)(1), mortgage interest, § 163(h)(2)(D).
3. deductions attributable to such trade or business use that do not reduce basis, e.g., utilities, homeowners' insurance.
4. basis-reducing deductions, i.e., depreciation.

If taxpayer's deductions exceed his/her/its gross income derived from the business use of the dwelling unit that he/she/it uses as a home, taxpayer may carry those deductions forward to succeeding years.

•Notice that unless taxpayer operates a trade or business in the home that is genuine, in the sense that it is profitable, it is unlikely that taxpayer will ever be able to exploit all of the deductions that business use of a home would generate. A taxpayer who does not carry on a profitable trade or business in the home will likely carry forward unused deductions forever.

•Notice also that the sequence of deductions that § 280A(c)(5) and Prop. Reg. § 1.280A-2(*i*) mandate requires taxpayer to "use up" the deductions to which he/she/it would be entitled – even if taxpayer did not use his/her/its dwelling unit for business activities, i.e., direct expenses of the business itself followed by deductions to which taxpayer is entitled in any event.

•The deductions that might motivate taxpayer to claim business use of a home are the ones to which he/she/it would not otherwise be entitled to claim, e.g., a portion of homeowners' insurance, utilities, other expenses of home ownership, and (perhaps most importantly) depreciation. Those deductions may be effectively out of reach.

CALI Lessons

5. Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Trade or Business Deductions*. Hopefully, you will find some of it to be in the nature of review.

3. Education Expenses

CALI Lessons

Do CALI Lesson, *Basic Federal Income Taxation: Deductions: Education Expenses*

•Read Reg. § 1.162-5.

•Read §§ 274(m)(2), 274(n).

A taxpayer may incur expenses for various educational activities, e.g., training, that he/she/it may deduct as ordinary and necessary business expenses. Recall that in *Welch v. Helvering*, the Court indicated that investment in one's basic education is a nondeductible investment in human capital. Not surprisingly, then, the regulations draw lines around education undertaken to meet the minimum requirements of a particular trade or business or to qualify for a new trade or business. Reg. § 1.162-5 implements these distinctions.

Reg. § 1.162-5(a) states the general rule that expenditures made for education are deductible, even when those expenditures may lead to a degree, if the education –

> "(1) Maintains or improves skills required by the individual in his employment or other trade or business, or
>
> (2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship status, or rate of compensation."

Id. However, *even expenditures that meet one of these two conditions* are nevertheless not deductible if –

- the expenditures are "made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. ... The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed." Reg. § 1.162-5(b)(2)(i). OR

- the expenditures are "made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business." Reg. § 1.162-5(b)(3)(i).

Consider:
Pere Alegal works for a downtown Memphis law firm. He works under the supervision of attorneys, but in many respects he does the same type of work that attorneys do. The firm's partners advise Alegal that if he does not obtain a law license, he will not be retained. Alegal therefore enrolled in one of the nation's best-value law schools. Pere will continue to work for the firm. Alegal incurs costs for tuition, books, etc. At the end

of the educational program, Alegal passed the bar examination and obtained a license to practice law. Alegal continues to work for the firm and in fact his job functions did not change at all.

- •If Alegal sought to deduct the expenses of his legal education, could he argue that his job functions did not change at all once he obtained his law license?
- •Is it relevant that a law license did not cause Alegal to take up a new trade or business?

4. Section 172

The costs of earning taxable income are offset against that income. Ours is a system that taxes only "net income." The Tax Code requires an annual accounting of income and deductible expenses. A taxpayer's income may fluctuate between losses and profitability from one year to the next. This could raise serious problems of fairness if losses cannot offset gross income. Section 172 permits some netting of business gains and losses between different tax years.

- •Read § 172(c). It defines a "net operating loss" (NOL) to be the excess of deductions allowed over gross income.
- •Read § 172(d). Its effect is to limit the deductions that would "take taxpayer's taxable income negative" to essentially trade or business expenses. For individual taxpayers, capital losses are deductible only to the extent of capital gains, § 172(d)(2)(A); no deduction is allowed for personal exemptions, § 172(d)(3); nonbusiness deductions are allowed only to the extent of taxpayer's non-trade or business income, § 172(d)(4); the § 199 domestic production deduction is not allowed, § 172(d)(7).
- •Section 172(a) permits NOL carryovers and carrybacks to reduce taxpayer's taxable income.
  - •An NOL carryback is first allowed against the taxable income of each of the two taxable years preceding the taxable year of the net loss. § 172(b)(1)(A)(i).
  - •An NOL carryover is allowed against the taxable income of each of the 20 years following the taxable year of the net loss.

§ 172(b)(1)(A)(ii).[132]

•A taxpayer must use carrybacks and carryovers beginning with the earliest taxable year and then apply them to each succeeding year. § 172(b)(2). The taxable income against which an NOL may be used is computed without regard to capital losses or personal exemptions. § 172(b)(2)(A). A taxpayer may waive the entire carryback period. § 172(b)(3).

•The carryback period is extended to three years in the case of NOLs caused by casualties, federally declared disasters, and certain farming losses. § 172(b)(1)(F).

> •The effect of any extension of the carry*back* period is to get money into the pockets of the affected taxpayer(s) quickly. A casualty or natural disaster likely causes significant losses to the affected taxpayer in the year of the disaster. A carryforward deduction will only benefit such taxpayers in the future. Such taxpayers may have been (quite) profitable in the immediately preceding years and paid a significant amount in federal income tax. An extension of the carryback period permits affected taxpayers to recoup more of such income taxes paid sooner.

•One measure to deal with the economic crisis is § 172(b)(1)(H). This provision permits a taxpayer to extend the carryback period to 3, 4, or 5 years for an operating loss occurring in 2008 or 2009. § 172(b)(1)(H)(i and ii). Taxpayer may make this election only with respect to one taxable year. § 172(b)(1)(H)(iii)(I).

> •A 5-year carryback is limited to 50% of the taxpayer's taxable income as of the carryback year, computed without regard to the NOL for the loss year or any other succeeding loss year whose NOL would be carried back. § 172(b)(2)(H)(iv)(I).
>
> •Presumably, a taxpayer would choose a carryback

[132] There are various rules that alter – either by extending or eliminating – the carryback loss period. *See* § 172(b)(1)(B, C, D, and E).

period that would maximize his/her refund.

Consider:
In 2011, taxpayer had net losses of $500,000. Redetermine taxpayer's taxable income under the rules of § 172 if taxpayer's taxable income would otherwise have been the following amounts for the years in question.

- 2009: $50,000
- 2010: $75,000
- 2011: ?
- 2012: $110,000
- 2013: $165,000
- 2014: $200,000
- 2015: $100,000
- 2016: $60,000

D. Special Rules to Encourage Manufacturing and Exploitation of Natural Resources

1. Section 199: Income Attributable to Domestic Production Activities

In order to encourage taxpayers to engage in manufacturing trades or businesses in the United States, Congress enacted § 199. Section 199(a) allows a deduction of 9% of a taxpayer's "qualified production activities income" or the taxpayer's taxable income determined without regard to § 199 – whichever is less. A taxpayer's "qualified production activities income" is taxpayer's net (§ 199(c)(1)) income derived from " any lease, rental, license, sale, exchange, or other disposition of" (§ 199(c)(4)(A)(i))

- tangible personal property, computer software, or sound recording, § 199(c)(5),
- a film if at least 50% of the compensation relating to its production is for services performed in the United States, §§ 199(c)(A)(i)(II), 199(c)(6), or
- "electricity, natural gas, or potable water produced by the taxpayer in the United States. § 199(c)(4)(A)(i)(III).

Such income also includes income derived from –

- "construction of real property performed in the United States by the taxpayer in the ordinary course of" his/her/its trade or business, § 199(c)(4)(A)(ii), or
- engineering or architectural services performed in the United States by the taxpayer in the ordinary course of his/her/its trade or business, § 199(c)(4)(iii).

A § 199 deduction is limited to 50% of the taxpayer's W-2 wages paid during the taxable year.

Section 199 is not part of the Code's methods for determining a taxpayer's net income. Rather, it is a reward for doing something that Congress wants taxpayers to do, i.e., to engage in manufacturing activities in the United States. *And*: the more profit a taxpayer can derive from engaging in manufacturing activities, the greater his/her/its deduction. *But* taxpayer is only entitled to a § 199 deduction in an amount up to half what he/she/it paid in U.S. wages.

Section 199 represents an effort to make U.S. manufacturers more competitive vis-a-vis foreign competition. It is also intended to encourage exports. By rewarding successful manufacturers, Congress is (likely to be) rewarding exporters.

Congress has pursued this objective in other legislation, but the World Trade Organization found that such legislation violated the General Agreement on Tariffs and Trade.

2. Section 611: The Depletion Deduction

Section 611(a) provides for a deduction in computing taxable income for depletion. This deduction is available for "mines, oil and gas wells, other natural deposits, and timber[.]"[133] *Id.* The depletion allowance deduction is similar to the depreciation deduction, *infra*, in that both deductions are a

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133 I.R.C. § 611(a).

form of cost recovery of capital investments. Unlike the depreciation deduction, which is an allowance for the gradual consumption of an asset that the taxpayer *uses to produce a product* (or to provide a service), the depletion allowance deduction is an allowance for the cost recovery of wasting assets that *are* the product.[134] The depletion allowance is part of the cost of the thing that the taxpayer sells.

Congress enacted the depletion allowance deduction as a means for fossil fuel companies and mine operators to deduct an amount equal to the reduction in value of their mineral reserves as they extracted and sold the mineral. § 611(a). The deduction allows a taxpayer to recover its capital investment so that the investment will not diminish as the minerals are extracted and sold.[135] Despite this purpose, there is no requirement that the taxpayer invest any money in the mineral rights,[136] and taxpayer does not have to have legal title to take advantage of the deduction.[137] First codified in 1913, the depletion allowance deduction was originally limited to mines – and only 5% of the gross value of a mine's reserves could be deducted in a year.[138] Over time, the depletion allowance deduction has expanded to include resources other than mining – such as oil, gas, and timber – and to allow for deductions greater than 5%.

Anyone with an "economic interest" may share[139] in the depletion

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[134] Commissioner v. Southwest Exploration Co., 350 U.S. 308, 312 (1956) (depletion allowance "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit").

[135] *Id.* at 312.

[136] *Id.*

[137] *Id.*

[138] 5 WILLIAM H. BYRNES, IV & CHRISTOPHER M SOVE, MERTENS LAW OF FED. INCOME TAX'N § 24:132 (rev. 2013), *available* on Westlaw.

[139] *See, e.g.,* Commissioner v. Southwest Exploration Co., 350 U.S. 308, 309 (1956) (Court granted cert "because both the drilling company and the upland owners cannot be entitled to depletion on the same income").

allowance deduction.[140] "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital."[141] A broad range of economic interests exists whose owners may claim the depletion allowance deduction.

There are now two ways to calculate a depletion allowance deduction, and taxpayer chooses the one that yields the greater deduction. However, taxpayer may not choose percentage depletion in the case of an interest in timber.[142]

Cost Depletion: Under cost depletion, taxpayer allocates annually an equal amount of basis[143] to each recoverable unit.[144] Taxpayer may claim the deduction when it sells the unit[145] or cuts the timber.[146] Depletion allowance deductions – allowed or allowable – reduce taxpayer's basis in the property until the basis is $0.[147] At that time, taxpayer may shift to

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[140] *See* Palmer v. Bender, 257 U.S. 551, 557 (1933) (conveyance of leased property in exchange for cash bonus, future payment, plus 1/8 royalty sufficient to claim depletion allowance deduction, irrespective of fact that taxpayer may have retained no legal interest in the mineral content of the land).

[141] Reg. § 1.611-1(b)(1).

[142] I.R.C. § 613(a) (percentage method applicable to "mines, wells, and [certain] other natural deposits").

[143] I.R.C. § 612 (same as adjusted basis in § 1011 for "purpose of determining gain upon sale or other disposition of" the property).

[144] Reg. § 1.611-2(a)(1) (mines, oil and gas wells, and other natural deposits); Reg. § 1.611-3(b) (timber).

[145] Reg. § 1.611-2(a)(1) (mines, oil and gas wells, and other natural deposits).

[146] Reg. § 1.611-3(b)(1) (timber).

[147] I.R.C. § 1016(a)(1)(2); Reg. § 1.611-2(b)(2) (cost depletion for mines, oil and gas wells, and other natural deposits); Reg. § 1.611-3(c)(1) (timber).

percentage depletion, except when taxpayer claims depletion allowance deductions for timber. Recapture of depletion allowance deductions upon sale or exchange of the property is subject to income taxation at ordinary income rates.[148]

Percentage Depletion: Percentage depletion is a deduction based on a specified percentage of taxpayer's *gross* income from the activity[149] up to 50% of *the taxable* income from the activity.[150] The limit is 100% of taxable income from oil and gas properties.[151] However, Sections 613(d) and 613A disallow any depletion allowance deduction for oil and gas wells, except for some small independent producers and royalty owners of domestic oil and gas.[152] Their percentage depletion allowance deduction is 15%[153] of gross income, limited to 65% of taxable income.[154] A percentage depletion allowance deduction is available even though taxpayer has no basis remaining in the asset.

The percentage depletion method serves to encourage the further development and exploitation of certain natural resources. This is important in a time when we believe that preservation of natural resources should be national policy.[155] In recent years, depletion allowance deductions have increased significantly: in 2003, total

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148 I.R.C. § 1254(a).

149 I.R.C. § 613(a and b) (the percentages range from 5% to 22%)..

150 I.R.C. § 613(a).

151 *Id. But see* §§ 613(d), 613A.

152 *See* Reg. § 1.613A-3 (details of exemption for independent producers and royalty owners).

153 I.R.C. § 613A(c)(1).

154 I.R.C. § 613A(d)(1).

155 For an argument that the depletion deduction provides a tax incentive for companies that extract minerals but does little to preserve the environment from which the minerals were extracted, *see* Wendy B. Davis, *Elimination of the Depletion Deduction for Fossil Fuels*, 26 SEATTLE U. L. REV. 197 (2002).

corporate depletion allowance deductions were nearly $10.2 billion, while in 2009, total corporate depletion allowance deductions rose to more than $21.5 billion.[156]

III. Depreciation, Amortization, and Cost Recovery

We have encountered at several points the principle that taxpayer's consumption of only a part of a productive asset in order to generate taxable income entitles taxpayer to a deduction for only that amount of consumption. Such consumption represents a taxpayer's de-investment in the asset and results in a reduction of basis. We take up here the actual mechanics of some of the Code's depreciation provisions. The following case provides a good review of depreciation principles and congressional tinkering with them as means of pursuing certain economic policies.

Liddle v. Commissioner, 65 F.3d 329 (3rd Cir. 1995)

McKEE, Circuit Judge:

In this appeal from a decision of the United States Tax Court we are asked to decide if a valuable bass viol can be depreciated under the Accelerated Cost Recovery System when used as a tool of trade by a professional musician even though the instrument actually increased in value while the musician owned it. We determine that, under the facts before us, the taxpayer properly depreciated the instrument and therefore affirm the decision of the Tax Court.

I.

Brian Liddle, the taxpayer here, is a very accomplished professional musician. Since completing his studies in bass viol at the Curtis Institute

[156] The IRS now publishes *Statistics of Income* historical and data tables only online. The relevant tables are at http://www.irs.gov/file_source/pub/irs-soi/histab13e.xls.

of Music in 1978, he has performed with various professional music organizations, including the Philadelphia Orchestra, the Baltimore Symphony, the Pennsylvania ProMusica and the Performance Organization.

In 1984, after a season with the Philadelphia Orchestra, he purchased a 17th century bass viol made by Francesco Ruggeri (c. 1620-1695), a luthier who was active in Cremona, Italy. Ruggeri studied stringed instrument construction under Nicolo Amati, who also instructed Antonio Stradivari. Ruggeri's other contemporaries include the craftsmen Guadanini and Guarneri. These artisans were members of a group of instrument makers known as the Cremonese School.

Liddle paid $28,000 for the Ruggeri bass, almost as much as he earned in 1987 working for the Philadelphia Orchestra. The instrument was then in an excellent state of restoration and had no apparent cracks or other damage. Liddle insured the instrument for its then-appraised value of $38,000. This instrument was his principal instrument and he used it continuously to earn his living, practicing with it at home as much as seven and one-half hours every day, transporting it locally and out of town for rehearsals, performances and auditions. Liddle purchased the bass because he believed it would serve him throughout his professional career – anticipated to be 30 to 40 years.

Despite the anticipated longevity of this instrument, the rigors of Liddle's profession soon took their toll upon the bass and it began reflecting the normal wear and tear of daily use, including nicks, cracks, and accumulations of resin. At one point, the neck of the instrument began to pull away from the body, cracking the wood such that it could not be played until it was repaired. Liddle had the instrument repaired by renown [sic] artisans. However, the repairs did not restore the instrument's "voice" to its previous quality. At trial, an expert testified for Liddle that every bass loses mass from use and from oxidation and ultimately loses its tone, and therefore its value as a performance instrument decreases. Moreover, as common sense would suggest, basses are more likely to become damaged when used as performance instruments than when displayed in a museum. Accordingly, professional musicians who use valuable instruments as their performance instruments are exposed to financial risks that do not threaten collectors who regard such instruments as works of art, and treat them accordingly.

There is a flourishing market among nonmusicians for Cremonese School instruments such as Mr. Liddle's bass. Many collectors seek primarily the "label", i.e., the maker's name on the instrument as verified by the certificate of authenticity. As nonplayers, they do not concern themselves with the physical condition of the instrument; they have their eye only on the market value of the instrument as a collectible. As the quantity of these instruments has declined through loss or destruction over the years, the value of the remaining instruments as collectibles has experienced a corresponding increase.

Eventually, Liddle felt the wear and tear had so deteriorated the tonal quality of his Ruggeri bass that he could no longer use it as a performance instrument. Rather than selling it, however, he traded it for a Domenico Busan 18th century bass in May of 1991. The Busan bass was appraised at $65,000 on the date of the exchange, but Liddle acquired it not for its superior value, but because of the greater tonal quality.

Liddle and his wife filed a joint tax return for 1987, and claimed a depreciation deduction of $3,170 for the Ruggeri bass under the Accelerated Cost Recovery System ("ACRS"), § 168. [footnote omitted] The Commissioner disallowed the deduction asserting that the "Ruggeri bass in fact will appreciate in value and not depreciate." Accordingly, the Commissioner assessed a deficiency of $602 for the tax year 1987. The Liddles then filed a petition with the Tax Court challenging the Commissioner's assertion of the deficiency. A closely divided court entered a decision in favor of the Liddles. This appeal followed. [footnote omitted]

II.

The Commissioner originally argued that the ACRS deduction under § 168 is inappropriate here because the bass actually appreciated in value. However, the Commissioner has apparently abandoned that theory, presumably because an asset can appreciate in market value and still be subject to a depreciation deduction under tax law. *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 277 (1966) ("tax law has long recognized the accounting concept that depreciation is a process of estimated allocation which does not take account of fluctuations in valuation through market appreciation."); *Noyce v. Commissioner*, 97 T.C. 670, 1991 WL 263146 (1991) (taxpayer allowed to deduct depreciation under § 168 on an airplane that appreciated in economic value from the date of purchase to the time of trial).

Here, the Commissioner argues that the Liddles can claim the ACRS deduction only if they can establish that the bass has a determinable useful life. Since Mr. Liddle's bass is already over 300 years old, and still increasing in value, the Commissioner asserts that the Liddles can not establish a determinable useful life and therefore can not take a depreciation deduction. In addition, the Commissioner argues that this instrument is a "work of art" which has an indeterminable useful life and is therefore not depreciable.

... Prior to 1981, § 167 governed the allowance of depreciation deductions with respect to tangible and intangible personality. Section 167 provided, in relevant part, as follows:

> Sec. 167. DEPRECIATION
> (a) General Rule. – There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –
> (1) of property used in the trade or business, or
> (2) of property held for the production of income.

26 U.S.C. § 167(a). The regulations promulgated under § 167 provided that in order to qualify for the depreciation deduction, the taxpayer had to establish that the property in question had a determinable useful life. Reg. § 1.167(a)-1(a) and (b). The useful life of an asset was not necessarily the useful life "inherent in the asset but [was] the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business...." Reg. § 1.167(a)-1(b). Nonetheless, under § 167 and its

attendant regulations, a determinable useful life was the sine qua non for claiming the deduction. *See*, *Harrah's Club v. United States*, 661 F.2d 203, 207 (1981) ("Under the regulation on depreciation, a useful life capable of being estimated is indispensable for the institution of a system of depreciation.").

Under § 167, the principal method for determining the useful life of personalty was the Asset Depreciation Range ("ADR") system. Personalty eligible for the ADR system was grouped into more than 100 classes and a guideline life for each class was determined by the Treasury Department. *See* Reg. § 1.167(a)-11. A taxpayer could claim a useful life up to 20% longer or shorter than the ADR guideline life. Reg.§ 1.167(a)-11(4)(b). The ADR system was optional with the taxpayer. Reg. § 1.167(a)-11(a). For personalty which was not eligible for ADR, and for taxpayers who did not choose to use ADR, the useful life of an asset was determined according to the unique circumstances of the particular asset or by an agreement between the taxpayer and the Internal Revenue Service. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 97th Cong. ...

In 1981, convinced that tax reductions were needed to ensure the continued economic growth of the country, Congress passed the Economic Recovery Tax Act of 1981, P. L. 97-34 ("ERTA"). *Id*. It was hoped that the ERTA tax reduction program would "help upgrade the nation's industrial base, stimulate productivity and innovation throughout the economy, lower personal tax burdens and restrain the growth of the Federal Government." *Id*. Congress felt that prior law and rules governing depreciation deductions need to be replaced "because they did not provide the investment stimulus that was felt to be essential for economic expansion." *Id*. Further, Congress believed that the true value of the depreciation deduction had declined over the years because of high inflation rates. *Id*. As a result, Congress believed that a "substantial restructuring" of the depreciation rules would stimulate capital formation, increase productivity and improve the country's competitiveness in international trade. *Id*. Congress also felt that the prior rules concerning the determination of a useful life were "too complex", "inherently uncertain" and engendered "unproductive disagreements between taxpayers and the Internal Revenue Service." *Id*. To remedy the situation, Congress decided

> that a new capital cost recovery system should be structured which de-emphasizes the concept of useful life, minimizes the number of elections and exceptions and is easier to comply with and to administer.

Id.

Accordingly, Congress adopted the Accelerated Cost Recovery System ("ACRS") in ERTA. The entire cost or other basis of eligible property is recovered under ACRS eliminating the salvage value limitation of prior depreciation law. GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 at 1450. ACRS was codified in I.R.C. § 168, which provided, in relevant part, as follows:

> Sec. 168. Accelerated cost recovery system
> (a) Allowance of Deduction. – There shall be allowed as a deduction for any taxable year the amount determined under this section with respect to recovery property.
>
> (b) Amount of Deduction.--
>
> (1) In general. – Except as otherwise provided in this section, the amount of the deduction allowable by subsection (a) for any taxable year shall be the aggregate amount determined by applying to the unadjusted basis of recovery property the applicable percentage determined in accordance with the following table:
>
> * * * * * *
>
> (c) Recovery Property. – For purposes of this title –
>
> (1) Recovery Property Defined. – Except as provided in subsection (e), the term "recovery property" means tangible property of a character subject to the allowance for depreciation –
>
> (A) used in a trade or business, or

(B) held for the production of income.

26 U.S.C. § 168. ACRS is mandatory and applied to "recovery property" placed in service after 1980 and before 1987.[157]

Section 168(c)(2) grouped recovery property into five assigned categories: 3-year property, 5-year property, 10-year property, 15-year real property and 15-year public utility property. Three year property was defined as § 1245 property[158] with a class life of 4 years or less. Five year property is all § 1245 property with a class life of more than 4 years. Ten year property is primarily certain public utility property, railroad tank cars, coal-utilization property and certain real property described in I.R.C. § 1250(c). Other long-lived public utility property is in the 15-year class. § 168(a)(2)(A), (B) and (C). Basically, 3-year property includes certain short-lived assets such as automobiles and light-duty trucks, and 5-year property included all other tangible personal property that was not 3-year property. Most eligible personal property was in the 5-year class.

The Commissioner argues that ERTA § 168 did not eliminate the pre-ERTA § 167 requirement that tangible personalty used in a trade or business must also have a determinable useful life in order to qualify for the ACRS deduction. She argues that the phrase "of a character subject to the allowance for depreciation" demonstrates that the pre-ERTA § 167 requirement for a determinable useful life is the threshold criterion for claiming the § 168 ACRS deduction.

Much of the difficulty inherent in this case arises from two related problems. First, Congress left § 167 unmodified when it added § 168; second, § 168 contains no standards for determining when property is "of a character subject to the allowance for depreciation." In the absence of

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[157] In the Tax Reform Act of 1986, P. L. 99-514, Sec. 201, Congress made substantial changes to I.R.C. § 168. In particular, Congress deleted the "recovery property" concept from the statute.

[158] Section 1245 property is, inter alia, any personal property which is or has been property of a character subject to allowance for depreciation provided in § 167. § 1245(a)(3).

any express standards, logic and common sense would dictate that the phrase must have a reference point to some other section of the Internal Revenue Code. Section 167(a) would appear to be that section. As stated above, that section provides that "[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear ... of property used in a trade or business...." The Commissioner assumes that all of the depreciation regulations promulgated under § 167 must, of necessity, be imported into § 168. That importation would include the necessity that a taxpayer demonstrate that the asset have a demonstrable useful life, and (the argument continues) satisfy the phrase "tangible property of a character subject to the allowance for depreciation" in § 168.

However, we do not believe that Congress intended the wholesale importation of § 167 rules and regulations into § 168. Such an interpretation would negate one of the major reasons for enacting the Accelerated Cost Recovery System. Rather, we believe that the phrase "of a character subject to the allowance for depreciation" refers only to that portion of § 167(a) which allows a depreciation deduction for assets which are subject to exhaustion and wear and tear. Clearly, property that is not subject to such exhaustion does not depreciate. Thus, we hold that "property of a character subject to the allowance for depreciation" refers to property that is subject to exhaustion, wear and tear, and obsolescence. However, it does not follow that Congress intended to make the ACRS deduction subject to the § 167 useful life rules, and thereby breathe continued life into a regulatory scheme that was bewildering, and fraught with problems, and required "substantial restructuring."

We previously noted that Congress believed that prior depreciation rules and regulations did not provide the investment stimulus necessary for economic expansion. Further, Congress believed that the actual value of the depreciation deduction declined over the years because of inflationary pressures. In addition, Congress felt that prior depreciation rules governing the determination of useful lives were much too complex and caused unproductive disagreements between taxpayers and the Commissioner. Thus, Congress passed a statute which "de-emphasizes the concept of useful life." GENERAL EXPLANATION OF THE ECONOMIC

RECOVERY TAX ACT OF 1981 at 1449. Accordingly, we decline the Commissioner's invitation to interpret § 168 in such a manner as to re-emphasize a concept which Congress has sought to "de-emphasize."

The Commissioner argues that de-emphasis of useful life is not synonymous with abrogation of useful life. As a general statement, that is true. However, the position of the Commissioner, if accepted, would reintroduce unproductive disputes over useful life between taxpayers and the Internal Revenue Service. Indeed, such is the plight of Mr. Liddle.

Congress de-emphasized the § 167 useful life rules by creating four short periods of time over which taxpayers can depreciate tangible personalty used in their trade or business. These statutory "recovery periods ... are generally unrelated to, but shorter than, prior law useful lives." GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 at 1450. The four recovery periods are, in effect, the statutorily mandated useful lives of tangible personalty used in a trade or business.

The recovery periods serve the primary purpose of ERTA. Once a taxpayer has recovered the cost of the tangible personalty used in a trade or business, i.e., once the taxpayer has written off the asset over the short recovery period, his or her basis in that asset will be zero and no further ACRS deduction will be allowed. To avail himself or herself of further ACRS deductions, the taxpayer will have to purchase a new asset. Thus, because the recovery period is generally shorter than the pre-ERTA useful life of the asset, the taxpayer's purchase of the new asset will increase capital formation and new investment and, as a result, promote the Congressional objective for continued economic expansion.

Thus, in order for the Liddles to claim an ACRS deduction, they must show that the bass is recovery property as defined in § 168(c)(1). It is not disputed that it is tangible personalty which was placed in service after 1980 and that it was used in Brian Liddle's trade or business. What is disputed is whether the bass is "property of a character subject to the allowance for depreciation." We hold that that phrase means that the Liddles must only show that the bass was subject to exhaustion and wear and tear. The Tax Court found as a fact that the instrument suffered wear and tear during the year in which the deduction was claimed. That finding was not clearly erroneous. Accordingly, the Liddles are entitled to claim the ACRS deduction for the tax year in question.

Similarly, we are not persuaded by the Commissioner's "work of art" theory, although there are similarities between Mr. Liddle's valuable bass, and a work of art. The bass, is highly prized by collectors; and, ironically, it actually increases in value with age much like a rare painting. Cases that addressed the availability for depreciation deductions under § 167 clearly establish that works of art and/or collectibles were not depreciable because they lacked a determinable useful life. *See Associated Obstetricians and Gynecologists, P.C. v. Commissioner*, 762 F.2d 38 (6th Cir.1985) (works of art displayed on wall in medical office not depreciable); *Hawkins v. Commissioner*, 713 F.2d 347 (8th Cir.1983) (art displayed in law office not depreciable); *Harrah's Club v. United States*, 661 F.2d 203 (1981) (antique automobiles in museum not depreciable). *See also*, Rev. Rul. 68-232 ("depreciation of works of art generally is not allowable because '[a] valuable and treasured art piece does not have a determinable useful life.'").

... In Brian Liddle's professional hands, his bass viol was a tool of his trade, not a work of art. It was as valuable as the sound it could produce, and not for its looks. Normal wear and tear from Liddle's professional demands took a toll upon the instrument's tonal quality and he, therefore, had every right to avail himself of the depreciation provisions of the Internal Revenue Code as provided by Congress.

III.

Accordingly, for the reasons set forth above, we will affirm the decision of the tax court.

Notes and Questions:

1. Note the court's account of the evolution of depreciation law. In its first footnote, the court noted that "recovery property" is no longer part of § 168. Section 168 now applies to "any tangible property."

2. The Second Circuit reached a similar result in *Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), *Nonacq.* 1996-29 I.R.B. 4, 1996-2 C.B. 1, 1996 WL 33370246 (cost recovery allowance for a violin bow).

Note: *Sections 167 and 168*

Section 167 still governs depreciation. It has been supplemented – to the point that it has actually been replaced – by § 168 for *tangible* property – but not for *intangible* property. The allowable depreciation deduction of § 167(a) is what is described in § 168 when it is applicable. § 168(a). When § 168 is applicable, its application is mandatory. § 168(a) ("shall be determined"). Application of § 168 is much more mechanical and predictable than application of § 167. The Third Circuit described the mechanics of applying § 167 – and of course, the greater accuracy that § 167 (may have) yielded came at a high administrative cost, both to the taxpayer and to the IRS. The Commissioner's argument that taxpayer must demonstrate that an asset has a "determinable useful life" in order to claim a deduction for depreciation is an accurate statement of the law of § 167. Applying § 167 required placing an asset in an "Asset Depreciation Range" (ADR), deriving its useful life, determining its future "salvage value," and then calculating the actual depreciation deduction according to an allowable method. The court in *Liddle* described this system as "bewildering, and fraught with problems[.]" While ADRs are no longer law, they are still used to determine the "class life" of an asset which in turn determines the type of property that it is – whether 3-year, 5-year, 7-year, 10-year, 15-year, or 20-year property. § 168(e)(1).

The late 1970s and early 1980s was a time of slow economic growth and very high inflation. The court describes the congressional response, i.e., the Economic Recovery Tax Act of 1981 (ERTA). Clearly, Congress – at the urging of President Reagan – was using the tax rules as a device to stimulate the economy. Congress modified the system so that property placed in service in 1986 and after would be subject to the "Modified Accelerated Cost Recovery System" (MACRS). Sufficient time has passed that we do not often have to distinguish between ACRS and MACRS;

often we simply refer to the current system as ACRS. Notice that § 168 uses the phrase "accelerated cost recovery system" (ACRS) – implying that we no longer consider this to be depreciation. As we see in the succeeding paragraphs, taxpayers who place property in service to which § 168 applies may "write it off" much faster than they could under the old rules. The Third Circuit in *Liddle* explained what Congress was trying to accomplish by adopting these rules.

Section 168(e) requires that we identify the "classification of property." Certain property is classified as 3-year property, 5-year property, 7-year property, 10-year property, 15-year property, and 20-year property. § 168(e)(3). Property not otherwise described is first defined according to the old class life rules, § 168(e)(1), § 168(i)(1), and then placed into one of these classifications. For such properties, the recovery period corresponds to the classification of the property. *See* § 168(c). In addition, § 168(b)(3) names certain properties whose recovery period is prescribed in § 168(c).

- You should read through these sub-sections – particularly (and in this order) § 168(e)(3), § 168(e)(1), § 168(b)(3), and § 168(c).
- Notice that § 168(e)(3)(C)(v) provides that property without a class life and not otherwise classified is classified as 7-year property. Section 168(e)(3)(C)(v) thus serves as a sort of "default" provision when taxpayers purchase items such as bass viols. At the time the Liddles filed their tax return, the default period was five years.

Section 168(b)(4) treats salvage value as zero. This completely eliminates one point of dispute between taxpayers and the IRS. The basis for depreciation is the adjusted basis provided in § 1011. § 167(c)(1).

Section 168(d) prescribes certain "conventions." We generally treat all property to which § 168 applies as if it were placed in service *or* disposed of at the midpoint of the taxpayer's taxable year. § 168(d)(1 and 4(A) ("half-year convention")). In the case of real property, we treat it as if it were placed in service or disposed of at the midpoint of the month in which it actually was placed in service or disposed of. § 168(d)(2 and (4)(B) ("mid-month convention")). A special rule precludes the abuse of these conventions through back-loading. We treat all property to which §

168 applies as if it were placed in service at the midpoint of the quarter in which it was placed in service *if* more than 40% of the aggregate bases of such property was placed in service during the last quarter of the taxpayer's tax year. § 168(d)(3)(A). In making this 40% determination, taxpayer does not count nonresidential real property, residential rental property, a railroad grading or tunnel bore, and property placed in service and disposed of during the same taxable year. § 168(d)(3)(B).

Section 168(b) prescribes three cost recovery methods. The straight-line method applies to any property for which the recovery period is *more than* 20 years. § 168(b)(3). This of course means that taxpayer divides the item's basis by the applicable recovery period. In the first and last year of ownership, taxpayer applies the applicable convention to determine his/her/its "cost recovery" deduction. A faster method of cost recovery applies to property whose classification is 15 or 20 years, i.e., 150% of declining balance. § 168(b)(2)(A). This method also applies to specifically named property. § 168(b)(2)(B and C). A faster method still of cost recovery applies to 3-year, 5-year, 7-year, and 10-year property, i.e., 200% of declining balance. § 168(a).

- A taxpayer may irrevocably elect to apply one of the slower methods of cost recovery to one or more classes of property. § 168(b)(2)(D), § 168(b)(3)(D), § 168(b)(5).
- Rather than work through the 150% and 200% of declining balance methods of cost recovery, we are fortunate that the IRS has promulgated Rev. Proc. 87-57. This revenue procedure has several tables that provide the appropriate multiplier year by year for whatever the recovery period for certain property is. The tables incorporate and apply the depreciation method and the appropriate convention.
- Familiarize yourself with these tables.

Section 168(g)(2) provides an "alternate depreciation system" which provides for straight-line cost recovery over a longer period than the rules of § 168 noted thus far. Taxpayer may irrevocably elect to apply the "alternate depreciation system" to *all of the property in a particular class* placed in service during the taxable year. § 168(g)(7). Taxpayer may make this election separately with respect to each nonresidential real property or residential rental property. § 168(f)(7).

- A taxpayer might make such an election in order to avoid paying the alternative minimum tax. *See* § 56(a)(1).

Accelerating cost recovery is one policy tool that Congress has to encourage investment in certain types of property at certain times. *See* § 168(k).

Consider:

1. Taxpayer purchased a racehorse on January 2, 2011 for $10,000 and "placed it in service" immediately. Taxpayer purchased no other property subject to ACRS allowances during the year.

- What is Taxpayer's ACRS allowance for 2011?

Taxpayer sold the horse on December 31, 2013 for $9000.

- What is Taxpayer's adjusted basis in the racehorse?
- What is Taxpayer's taxable gain from this sale?

2. Taxpayer purchased a "motorsports entertainment complex" on October 1, 2011 for $10M. *See* § 168(e)(3)(C)(ii). Assume that there is no backloading problem.

- What is Taxpayer's ACRS allowance for 2011?
- What is Taxpayer's ACRS allowance for 2012?
- What is Taxpayer's ACRS allowance for 2013?
- What is Taxpayer's ACRS allowance for 2014?
- What is Taxpayer's ACRS allowance for 2015?
- What is Taxpayer's ACRS allowance for 2016?
- What is Taxpayer's ACRS allowance for 2017?
- What is Taxpayer's ACRS allowance for 2018?

Section 179

Section 179 permits a taxpayer to treat "the cost of any § 179 property as an expense which is not chargeable to capital account." §179(a). The limit of this deduction for 2011 is $500,000. § 179(b)(1)(B). In 2010 and 2011, the limit falls to $125,000, § 179(b)(1)(C), and then to $25,000 after that, §

179(b)(1)(D). The limit is reduced dollar for dollar by the amount by which the cost of § 179 property that taxpayer places into service exceeds $2,000,000 in 2011. § 179(b)(2)(B), $500,000 in 2011, § 179(b)(2)(C), and $200,000 in 2012, § 179(b)(2)(C). Moreover, the § 179 deduction is limited to the amount of taxable income that taxpayer derived from the active conduct of a trade or business (computed without regard to any § 179 deduction) during the taxable year. § 179(b)(3)(A). Taxpayers whose § 179 deduction is subject to one of these limitations may carry it forward to succeeding years. § 179(b)(3)(B).

- Thus it seems that Congress intends § 179 to benefit small business taxpayers.
- In an effort to encourage small business investment during the recent recession, Congress has dramatically increased the § 179 limit to the figures noted. Hopefully, the recession will have passed by tax year 2013 when the limit falls back to $25,000.
- § 179 property is tangible property to which § 168 applies or § 1245 property purchased "for use in the active conduct of a trade or business." § 179(d)(1). Prior to 2013, § 179 property also includes computer software. § 179(d)(1)(A)(ii).
- After taking a § 179 deduction, taxpayer may apply the rules of § 168 to his/her/its remaining basis.

Other Code Provisions Providing for Cost Recovery or Amortization

Other provisions of the Code state rules applicable to specific investments – generally with the intent of encouraging them. For example, § 174 permits the expensing of research or experimental expenditures. § 174(a)(1).

Section 197

Section 197 permits the amortization of § 197 intangibles. § 197(a). A § 197 includes such intangibles as goodwill, going concern value, intellectual property, a license or permit granted by a government, etc. § 197(d)(1). Section 197 permits ratable amortization over 15 years of the *purchase* (as opposed to self-creation) of such intangibles. § 197(a), § 197(c)(2).

- Congress intended that § 197 put an end to expensive contests between the IRS and taxpayers over whether such items could be amortized at all, and if so, the applicable useful life. Now a "one-size-fits-all" approach applies to all such intangibles.

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Basic Depreciation, ACRS, and MACRS Concepts*.

Section 280F: Mixing Business and Pleasure

A taxpayer may make expenditures to purchase items that are helpful in earning income *and* useful in taxpayer's personal life as well. An automobile may fit this description. So also may a personal computer. These points may lead some taxpayers to purchase items that they might not otherwise purchase, or to purchase items that are more expensive than they might otherwise purchase. Congress has addressed these points in § 280F. It provides limitations on deductions associated with purchase and use of so-called "listed property."

Section 280F(d)(4)(A) defines "listed property" to be a passenger automobile, any property used as a means of transportation, any property generally used for entertainment, recreation, or amusement, and any other property that the Secretary specifies.

Section 280F(d)(3)(A) denies "employee" deductions for use of listed property unless "such use is for the convenience of the employer and required as a condition of employment."

Section 280F provides the following types of limitations on cost recovery and § 179 expensing deductions: an absolute dollar limit on such deductions for listed property, a percentage limitation on such deductions for listed property, and a combination of a percentage limitation on an absolute dollar limit on such deductions.

•Absolute dollar limit on cost recovery and § 179 expensing deductions for listed property: Sections 280F(a)(1)(A and B) place an absolute limit on the amount of depreciation allowable for any passenger automobile. The amounts are indexed for inflation. § 280F(d)(7). Nevertheless, the allowable amounts would place a severe limitation on a taxpayer's choice of automobile.

•Read §§ 280F(a)(1)(A and B). Consider this to be 1988. Taxpayer was a real estate agent and purchased a Mercedes-Benz for $100,000 in order to squire clients around from property-to-property. An automobile is 5-year property. § 168(e)(3)(B)(i). Assume that taxpayer uses the automobile only for trade or business purposes. Assume also that Taxpayer will not be using any § 179 expensing deduction. What would have been taxpayer's cost recovery deduction in 1988? – in 1989? – in 1990? When would taxpayer have recovered all of the cost of the automobile?

•Percentage limitation on cost recovery and § 179 expensing deductions for listed property: If a taxpayer uses property partly for business and partly for personal purposes, he/she/it must determine the percentage of total use that is trade or business use. *See* §§ 280F(d)(6)(A and B). Only the trade or business use portion of the allowable accelerated cost recovery or § 179 expensing amount is deductible *if* the percentage of total use is more than 50% for trade or business. *See* § 280F(b)(3). If the percentage of total use is not more than 50% trade or business, then Section 280F(b)(1) provides that the alternative depreciation system of § 168(g) applies. Sections 168(g) of course prescribes less favorable straight-line cost recovery over a longer time period. If taxpayer who has used an item predominantly for trade or business and elected to use an accelerated method of cost recovery subsequently makes a use that is not predominantly for trade or business, then taxpayer must recapture the cost recovery in excess of what would have been allowed under § 168(g). § 280F(b)(2).

•Consider: Taxpayer purchased a Hummer – which is not a passenger automobile. *See* § 280F(d)(5)(A). However, it is property used for transportation. Assume that a Hummer is 7-year property under § 168(e)(3)(B) with a class life of 10 years. Taxpayer paid $100,000 for the Hummer. Taxpayer used the Hummer 75% for trade or business in both 2011 and 2012. In 2013, Taxpayer used the Hummer 25% for trade or business. In 2014, and all subsequent years, Taxpayer used the Hummer 75% for trade or business. What is Taxpayer's cost recovery allowance for 2011? – 2012? 2013? 2014? – 2015? – 2016? – 2017? – 2018? – 2019? – 2020? – 2021?

•Perhaps we have discovered another reason to elect cost recovery under the alternative depreciation system of § 168(g).

Computation of cost recovery allowances in any year is based on an assumption that all of a taxpayer's use of listed property was for trade or business purposes. § 280F(d)(2). Thus, a pro rata reduction of allowable cost recovery for less than predominantly business use does not merely extend the cost recovery period.

•Combination of a percentage limitation on an absolute dollar limit on cost recovery deductions: In the case of passenger automobiles, the absolute dollar limit on cost recovery deductions is applied first. Then subsequent limitations based on less-than-predominantly trade or business use are applied. § 280F(a)(2).

Wrap-Up Questions for Chapter 6

1. What is the relationship between depreciation and basis? Why does the relationship have to be what it is? Feel free to state your answer in Haig-Simons terms.

2. This chapter has offered three different tax treatments of expenses. What are they? What are the rationales for adopting any one of them in a given case?

3. We tax net income? What economic distortions would occur if we taxed gross receipts?

4. What economic distortions occur if we accelerate depreciation allowances? – if we give deductions to certain activities when they are profitable, for example § 199?

5. Do depletion allowances encourage (too much) exploitation of natural resources?

Chapter 7: Personal Deductions

> *The Tax Formula*:
>
> (gross income)
> <u>MINUS deductions named in § 62</u>
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or
> ➔itemized deductions)≥
> MINUS (personal exemptions)
> EQUALS (taxable income)
>
> Compute income tax liability from tables in § 1 (indexed for inflation)
> ➔MINUS (credits against tax)≥

In this chapter, we consider the Code's provisions for deductions and credits for certain personal expenditures. We select only a few[159] such provisions to examine, namely § 165's allowance of a deduction for casualty losses, § 213's allowance of a deduction for medical and dental expenses, § 170's allowance of a deduction for charitable contributions, §§ 164/275's allowance and disallowance for payment of certain taxes, and §§ 82/132/217's, allowance of a deduction for moving expenses or exclusion from gross income.

Consider why there should be an allowable deduction of, exclusion of, or credit for any personal expenses. We might preliminarily observe that there are three basic purposes:

1. We want to encourage taxpayers to make a particular type of personal expenditure. We may choose to make a "tax expenditure." In this group, we should place deductions, credits, or exclusions for charitable contributions, for home mortgage interest, and for adoption expenses.

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[159] Among the provisions that we do not cover are § 163(h)'s allowance of a deduction for home mortgage interest and §§ 221/62(a)(17)'s above-the-line deduction for interest paid on education loans. We also do not consider deductions/exclusions/deferrals on various pension-funding vehicles. We do not consider in detail the credits for dependent care services necessary for gainful employment, § 21, the Hope and Lifetime Learning Credits, § 25A, the Earned Income Credit, § 32, and the Adoption Expenses Credit, § 38. Obviously these are important topics, and they raise interesting issues. Hopefully, a student can read the Code sections noted and gain sufficient understanding of those topics, at least for the time being.

2. We want to provide some relief to those taxpayers whose personal expenditures result from the exercise of choice among unappealing alternatives. When discretion among consumption choices is absent, a court is less likely to find that a taxpayer's accession to wealth is in fact gross income. *Cf. Gotcher*; *Benaglia*, *supra*. Conversely, when taxpayers may spend an accession to wealth any way they choose – as when they receive cash – they have realized gross income. *See Kowalski*, *supra*. However, taxpayers must on occasion make some expenditures that we feel do not result from meaningful choices. The Code names some occasions when the absence of such discretion entitles a taxpayer to deduct (or exclude) an expenditure from his/her gross income. Examples include casualty losses and medical expenses.

3. We want to enlarge the tax base. Some taxpayer expenditures are not necessarily trade or business expenses, but they in fact enhance a taxpayer's ability to generate taxable income. If they do that, they would also increase tax revenues. We should encourage taxpayers to make such expenditures. In this group, we place the Code's provisions for moving expenses and child care.

I. "Tax Expenditures"

Congress may use the tax code to encourage[160] (at least not to discourage) taxpayers to make certain types of expenditures. In § 170, Congress allows taxpayers a deduction for charitable contributions. This, coupled with the exemption from income tax that many charities enjoy,[161] may provide sufficient incentive for some taxpayers to support the good work certain charities do.

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[160] *See* National Federation of Business v. Sebelius, 567 U.S. ___, ___, 132 S. Ct. 2566, 2596 (2012) (congress may shape individual decisions through exercise of taxing power).

[161] *See* § 501(a).

In § 164, Congress has allowed a deduction for certain taxes that taxpayer has paid or accrued. Section 275 specifically disallows a deduction for certain taxes that taxpayer may have paid or accrued. This pattern may encourage some taxpayers to engage in activities subject to a deductible tax, most notably, owning property.

With respect to both charitable contributions and payment of taxes, a taxpayer may try to characterize payments that provide a benefit for the taxpayer as either a charitable contribution or as payment of a tax. For example, a taxpayer might contribute money to a university on the condition that the university grant a scholarship to taxpayer's daughter. Or a taxpayer may pay his or her share of a condominium-owners' association's assessment to remodel the association's common areas. In neither case should taxpayer be permitted to claim a deduction. Instead the taxpayer has simply "purchased something." These are easy cases. How do we determine whether taxpayer has merely bought something – or has made a charitable contribution or paid a tax?

A. Charitable Contributions

Consider: Taxpayers entered into an agreement to purchase certain property contingent on the City Council rezoning it to permit use for a trailer court and shopping center. To assure access to the portion intended for a mobile home development the rezoning proposal provided for dedication of a strip of the property for a public road. The road would also provide access or frontage for a public school, for a church, and for a home for the aged. Taxpayers completed their purchase and made the contemplated transfer to the city. The City Council formally adopted the rezoning ordinance.

- •Should taxpayers be permitted a charitable deduction for the value of the land it donated to the city to be used for a road?
    - •Should the fact that the City of Tucson benefitted from taxpayer's having provided the land, irrespective of taxpayer's motive in making the donation, be sufficient in itself to permit taxpayer a deduction?

- Would it matter if the dedication of the land to the City did not in fact increase the value of Taxpayers' property?
- *See Stubbs v. United States*, 428 F.2d 885 (9th Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971).

If a charitable contribution deduction turns on a weighing of benefits against the taxpayer's cost, whose benefit should be relevant – benefit to the public or benefit to the taxpayer?

Rolfs v. Commissioner, 668 F.3d 888 (7th Cir. 2012)

HAMILTON, Circuit Judge.

Taxpayers Theodore R. Rolfs and his wife Julia Gallagher (collectively, the Rolfs) purchased a three-acre lakefront property in the Village of Chenequa, Wisconsin. Not satisfied with the house that stood on the property, they decided to demolish it and build another. To accomplish the demolition, the Rolfs donated the house to the local fire department to be burned down in a firefighter training exercise. The Rolfs claimed a $76,000 charitable deduction on their 1998 tax return for the value of their donated and destroyed house. The IRS disallowed the deduction, and that decision was upheld by the United States Tax Court. *Rolfs v. Comm'r of Internal Revenue*, 135 T.C. 471 (2010). The Rolfs appeal. To support the deduction, the Rolfs needed to show a value for their donation that exceeded the substantial benefit they received in return. The Tax Court found that they had not done so. We agree and therefore affirm.

Charitable deductions for burning down a house in a training exercise are unusual but not unprecedented. By valuing their gifts as if the houses were given away intact and without conditions, taxpayers like the Rolfs have claimed substantial deductions from their taxable income. But this is not a complete or correct way to value such a gift. When a gift is made with conditions, the conditions must be taken into account in determining the fair market value of the donated property. As we explain below, proper consideration of the economic effect of the condition that the house be destroyed reduces the fair market value of the gift so much that no net value is ever likely to be available for a deduction, and certainly not here.

What is the fair market value of a house, severed from the land, and donated on the condition that it soon be burned down? There is no evidence of a functional market of willing sellers and buyers of houses to burn. Any valuation must rely on analogy. The Rolfs relied primarily on an appraiser's before-and-after approach, valuing their entire property both before and after destruction of the house. The difference showed the value of the house as a house available for unlimited use. The IRS, on the other hand, presented experts who attempted to value the house in light of the condition that it be burned. The closest analogies were the house's value for salvage or removal from the site intact.

The Tax Court first found that the Rolfs received a substantial benefit from their donation: demolition services valued by experts and the court at approximately $10,000. The court then found that the Rolfs' before-and-after valuation method failed to account for the condition placed on the gift requiring that the house be destroyed. The court also found that any valuation that did account for the destruction requirement would certainly be less than the value of the returned benefit. We find no error in the court's factual or legal analysis. The IRS analogies provide reasonable methods for approximating the fair market value of the gift here. The before-and-after method does not.

I. Legal Background Concerning Charitable Donations Under Section 170(a)

The legal principles governing our decision are well established, and the parties focus their dispute on competing valuation methodologies. We briefly review the relevant law, addressing some factual prerequisites along the way.

The requirements for a charitable deduction are governed by statute. Taxpayers may deduct from their return the verifiable amount of charitable contributions made to qualified organizations. 26 U.S.C. § 170(a)(1). Everyone agrees that the Village of Chenequa and its volunteer fire department are valid recipients of charitable contributions as defined under section 170(c). To qualify for deduction, contributions must also be unrequited—that is, made with "no expectation of a financial return commensurate with the amount of the gift." *Hernandez v. Comm'r of Internal Revenue*, 490 U.S. 680, 690 (1989). The IRS and the courts look to the objective features of the transaction, not the subjective motives of the donor, to determine whether a gift was intended or whether a commensurate return could be expected as part of a quid pro quo exchange. *Id*. at 690–91.

The Treasury regulations implement the details of section 170, instructing taxpayers how to prove a deduction to the IRS and how to value donated property using its fair market value. Under section 1.170A–1(c) of the regulations, fair market value is to be determined as of the time of the contribution and under the hypothetical willing buyer/willing seller rule, wherein both parties to the imagined transaction are assumed to be aware of relevant facts and free from external compulsion to buy or sell. 26 C.F.R. § 1.170A–1(c). As with the question of the purpose of the claimed gift, fair market value requires an objective, economic inquiry and is a question of fact.

We can assume, as the record suggests, that the Rolfs were subjectively motivated at least in part by the hope of deducting the value of the demolished house on their tax return. Applying the objective test, however, we treat their donation the same as we would if it were motivated entirely by the desire to further the training of local firefighters. Objectively, the purpose of the transaction was to make a charitable contribution to the fire department for a specific use. ... The Tax Court found ... that when the transaction was properly evaluated, the Rolfs (a) received a substantial benefit in exchange for the donated property and (b) did not show that the value of the donated property exceeded the value of the benefit they received. We also agree with these findings. There was no net deductible value in this donation in light of the return benefit to the Rolfs.

A charitable contribution is a "transfer of money or property without adequate consideration." *United States v. American Bar Endowment*, 477 U.S. 105, 118 (1986). A charitable deduction is not automatically disallowed if the donor received any consideration in return. Instead, as the Supreme

Court observed in *American Bar Endowment*, some donations may have a dual purpose, as when a donor overpays for admission to a fund-raising dinner, but does in fact expect to enjoy the proverbial rubber-chicken dinner and accompanying entertainment. Where "the size of the payment is clearly out of proportion to the benefit received," taxpayers can deduct the excess, provided that they objectively intended it as a gift. *Id*. at 116–18 (...). In practice then, the fair market value of any substantial returned benefit must be subtracted from the fair market value of the donation.

This approach differs from that of the Tax Court in *Scharf v. Comm'r of Internal Revenue*, T.C.M. 1973-265, an earlier case that allowed a charitable deduction for property donated to a fire department to be burned. In *Scharf*, a building had been partially burned and was about to be condemned. The owner donated the building to the fire department so it could burn it down the rest of the way. The Tax Court compared the value of the benefit obtained by the donor (land cleared of a ruined building) to the value of the public benefit in the form of training for the firefighters, and found that the public benefit substantially exceeded the private return benefit. Thus, the donation was deemed allowable as a legitimate charitable deduction, and the court proceeded to value the donation using the established insurance loss figure for the building. The *Scharf* court did not actually calculate a dollar value for the public benefit, and if it had tried, it probably would have found the task exceedingly difficult. Although *Scharf* supports the taxpayers' claimed deduction here, its focus on public benefit measured against the benefit realized by the donor is not consistent with the Supreme Court's later reasoning in *American Bar Endowment*. The Supreme Court did not rely on amorphous concepts of public benefit at all, but focused instead on the fair market value of the donated property relative to the fair market value of the benefit returned to the donor. 477 U.S. at 116–18. The Tax Court ruled correctly in this case that the *Scharf* test "has no vitality" after *American Bar Endowment*. 135 T.C. at 487.

With this background, the decisive legal principle for the Tax Court and for us is the common-sense requirement that the fair market valuation of donated property must take into account conditions on the donation that affect the market value of the donated property. This has long been the law. *See Cooley v. Comm'r of Internal Revenue*, 33 T.C. 223, 225 (1959) ("property otherwise intrinsically more valuable which is encumbered by some restriction or condition limiting its marketability must be valued in light of such limitation"). ...

II. Valuation Methods

As this case demonstrates, however, knowing that one must account for a condition in a valuation opens up a second tier of questions about exactly how to do so. The Tax Court weighed conflicting evidence on valuation and rejected the taxpayers' evidence claiming that the donated house had a value of $76,000. The Tax Court found instead that the condition requiring destruction of the house meant that the donated property had essentially no value. 135 T.C. at 494. The Tax Court did not err.

In this case there is no evidence of an actual market for, and thus no real or hypothetical willing buyers of, doomed houses as firefighter training sites. ... Sometimes fire departments ... conduct exercises using donated or abandoned property, but there is also no record evidence of any fire departments paying for such property. Without comparators from any established markets, the parties presented competing experts who advocated different valuation methods. The taxpayers relied on the conventional real estate market, as if they had given the fire department fee ownership of the house. The IRS relied on the salvage market and the market for relocated houses, attempting to account for the conditions proposed in the gift.

The taxpayers' expert witness is a residential appraiser. ... The taxpayers argued that the "before-and-after" method should be applied. Their appraiser started with an estimated value of $675,000 for the land and house together, based on comparisons to recent sales of similar properties in the area. Using the same method, he estimated a value of $599,000 for the land alone, without any house on it. He subtracted the latter from the former to estimate $76,000 as the value of the house alone.

The before-and-after approach is used most often to value conservation easements, where it is hard to put a value on the donated conservation use. Experts can estimate both the value of land without the encumbrance and the value of the land if sold with the specified use limitations, using the difference to estimate the value of the limitations imposed by the donor. As we explain below, there are significant differences between the Rolfs' donation and a conservation easement. While this approach might superficially seem like a reasonable way to back into an answer for the house's value apart from the underlying land, the before-and-after method cannot properly account for the conditions placed on the recipient with a gift of this type. The Tax Court properly rejected use of the before-and-after method for valuing a donation of property on the condition that the property be destroyed.

... The IRS asserted that a comparable market could be sales of houses, perhaps historically or architecturally important structures, where the buyer intends to have the house moved to her own land. Witness Robert George is a professional house mover who has experience throughout Wisconsin lifting houses from their foundations and transporting them to new locations. He concluded that it would cost at least $100,000 to move the Rolfs' house off of their property. Even more important, he opined that no one would have paid the owners more than nominal consideration to have moved this house. In his expert opinion, the land in the surrounding area was too valuable to warrant moving such a modest house to a lot in the neighborhood. George also opined that the salvage value of the component materials of the house was minimal and would be offset by the labor cost of hauling them away. ... Based on this testimony, the IRS argued that since the house would have had negligible value if sold under the condition that it be separated from the land and moved away, the house must also have had negligible value if sold under the condition that it be burned down.

The Tax Court found that the parties to the donation understood that the house must be promptly burned down, and the court credited testimony by the fire chief that he knew the house could be put to no other use by the department. The court rejected the taxpayers' before-and-after method as an inaccurate measure of the value of the house "as donated" to the department. The taxpayers' method measured the value of a house that remained a house, on the land, and available for residential use. The conditions of the donation, however, required that the house be severed from the land and destroyed. The Tax Court, accepting the testimony of the IRS experts, concluded that a house severed from the land had no substantial value, either for moving off-site or for salvage. Moving and salvage were analogous situations that the court found to be reasonable approximations of the actual scenario. We agree with these conclusions, which follow the *Cooley* principle by taking into account the economic effect of the main condition that the taxpayers put on their donation. The Tax Court correctly required, as a matter of law, that the valuation must incorporate any reduction in market value resulting from a restriction on the gift. We review the Tax Court's findings of fact for clear error and its conclusions of law de novo. *Freda v. Comm'r of Internal Revenue*, 656 F.3d 570, 573 (7th Cir. 2011). We find no clear error in the factual findings and conclude further that it would have been an error of law to ascribe any weight to the taxpayers' before-and-after valuation evidence.

....
... The taxpayers here gave away only the right to come onto their property and demolish their house, a service for which they otherwise would have paid a substantial sum. ... The demolition condition placed on the donation of the house reduced the fair market value of the house to a negligible amount, well enough approximated by its negligible salvage value.

The authorities the taxpayers cite to support the before-and-after valuation method relate to conservation easements and other restrictive covenants, but the features of this donation are quite different from such an easement. When an easement is granted, part of the landowners' rights are carved out and transferred to the recipient. For example, the Forest Service might be given the right to manage undeveloped land, or a conservation trust might be given the right to control disposition of property. Because it can be difficult to measure the value of this sort of right in isolation, experts instead estimate the difference in sale price for property with and without similar encumbrances. Here, in contrast, the initial value of the home can be estimated with the before-and-after method, but the donation destroyed that residential value rather than transferred it.

That's why conservation easements provide a poor model for the situation here, and other possible valuation models suffer from a lack of supporting evidence. The value of the training exercises to the fire department is not in evidence. The fire chief testified in the Tax Court that he could not assign a specific value to the significant public benefit of the training—but in any event, we know from *American Bar Endowment* that trying to measure the benefit to the charity is not the appropriate approach. ...

The Tax Court also undertook a fair market valuation of the benefit received by the taxpayers. The expert witnesses for the IRS both agreed with Mr. Rolfs' own testimony (based on his investigation) that the house would cost upwards of $10,000 to demolish. ... We see no error in the Tax Court's factual determination, based on the available evidence and testimony, that the Rolfs received a benefit worth at least $10,000.

When property is donated to a charity on the condition that it be destroyed, that condition must be taken into account when valuing the gift. In light of that condition, the value of the gift did not exceed the fair market value of the benefit that the donating taxpayers received in return. Accordingly, the judgment of the Tax Court is Affirmed. [footnote omitted]

Notes and Questions:

1. How does the test of *American Bar Endowment* as the court articulates it differ from the test that the Tax Court (evidently) applied in *Scharf*?

- Basis is how a taxpayer keeps score with the government. No one's argument in *Rolfs* concerning an allowable charitable contribution deduction involved consideration of the house's pro-rated share of the overall basis of the property. Why not?

2. Why should taxpayer be able to claim the fmv of the property as the amount to be deducted when that amount is greater than the adjusted basis of the property?

- Shouldn't taxpayer be limited to a deduction equal to the property's adjusted basis? *See* § 170(e)(1)(A).

3. The Supreme Court construed the meaning of the phrase "to or for the use of" in § 170(c) in *Davis v. United States*, 495 U.S. 472 (1990). Taxpayers' sons were missionaries for the Church of Jesus Christ of Latter-Day Saints. Taxpayers deposited amounts into the individual accounts of their sons. The Church had requested the payments and set their amounts. The Church issued written guidelines, instructing that the funds be used exclusively for missionary work. In accordance with the guidelines, petitioners' sons used the money primarily to pay for rent, food, transportation, and personal needs while on their missions. Taxpayers claimed that these amounts were deductible under § 170. The Supreme Court denied the deductibility of such payments and adopted the IRS's interpretation of the phrase. "[W]e conclude that a gift or contribution is 'for the use of' a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement." *Id.* at 485. "[B]ecause petitioners did not donate the funds in trust for the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated 'for the use of' the Church for purposes of § 170." *Id.* at 486. And while "the Service's interpretation does not require that the qualified organization take actual possession of the contribution, it nevertheless reflects that the beneficiary [(organization)] must have significant legal rights with respect to the disposition of donated funds." *Id.* at 483.

4. In 1971, the IRS issued Rev. Rul. 71-447 in which it stated the position that a private school that does not have a racially non-discriminatory policy as to students is not "charitable" within the common-law concepts reflected in §§ 170 and 501(c)(3). The IRS relied on this position to revoke the tax-exempt status of two private schools. The United States Supreme Court upheld this determination:

> There can thus be no question that the interpretation of § 170 and § 501(c)(3) announced by the IRS in 1970 was correct. That it may be seen as belated does not undermine its soundness. It would be wholly incompatible with the concepts underlying tax exemption to grant the benefit of tax-exempt status to racially discriminatory educational entities, which "exer[t] a pervasive influence on the

> entire educational process." [citation omitted] Whatever may be the rationale for such private schools' policies, and however sincere the rationale may be, racial discrimination in education is contrary to public policy. Racially discriminatory educational institutions cannot be viewed as conferring a public benefit within the "charitable" concept discussed earlier, or within the Congressional intent underlying § 170 and § 501(c)(3).

Bob Jones University v. United States, 461 U.S. 574, 595-96 (1983). The schools' tax-exempt status was lost. Donors could not claim a charitable contribution deduction for contributing money to it.

- This is one area where public policy *is* a part of income tax law.

5. There are limits to the amount of a charitable contribution that a taxpayer may deduct. Section 170's rules are complex.

- An individual has a "contribution base," i.e., adjusted gross income without regard to an NOL carryback. § 170(b)(1)(G).
- A taxpayer may deduct in a taxable year only a certain percentage of his/her "contribution base," the percentage limit dependent on the type of charity to which the contribution is made.

6. Section 170(c) describes five numbered types of charities.

- The Code creates so-called "A" charities, § 170(b)(1)(A), and "B" charities, § 170(b)(1)(B).
- *Generally*,[162] "A" charities include churches, educational organizations, an organization whose principal purpose is medical research or education, university endowment funds, governmental units if the gift is for public purposes, publicly supported organizations with certain specified purposes, certain private foundations, and organizations that support certain other tax-exempt organizations. § 170(b)(1)(A).
- "B" charities are all other charities. § 170(b)(1)(B). This *generally*[163] includes veterans' organizations, fraternal societies,

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[162] This paragraph is a generalization and omits a daunting number of details that a course in non-profit organizations covers.

[163] *Id.*

nonprofit cemeteries, and certain nonoperating foundations.

7. A charitable contribution may take one of several forms:

•A charitable contribution may be of "capital gain property," i.e., a "capital asset the sale of which at its fair market value at the time of the contribution would have resulted in gain which would have been long-term capital gain" (LTCG) or § 1231 property. § 170(b)(1)(C)(iv).

•The *fmv* of the property is the amount of the allowable deduction. Reg. § 1.170A-1(c)(1). This means that the LTCG on such property *is never taxed* – thus creating a true loophole.[164]

•If the donee's use of the property is unrelated to the charity's purpose, the charity disposes of the property before the last day of the taxable year, the charity is a certain type of private foundation, the property was intellectual property, or the property is self-created taxidermy property – then the deduction is limited to the taxpayer's basis in the property or its fmv, whichever is lower. § 170(e)(1)(B).

•A charitable contribution may be of property, the gain on whose sale would *not* be long-term capital gain.

•The taxpayer's deduction is limited to his/her adjusted basis in the property or its fmv, whichever is less. § 170(e)(1)(A).

•If a charitable contribution of property is partly a sale, then the taxpayer's basis in the property is allocated pro rata according to the amount realized on the sale portion of the transaction and the fmv of the property. § 170(e)(2); Reg. § 1011-2. Taxpayer recognizes gain on the sale portion of such a transaction.

•Of course a charitable contribution may take the form of cash.

8. A taxpayer's allowable contributions are subject to the following limitations:

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164 Unlike the exclusion from gross income for interest income derived from state and municipal bonds, the market for "capital gain" property does not drive the price down to reflect the tax benefits of owning such property.

•Taxpayer may deduct up to 50% of his/her contribution base to "A" charities, § 170(b)(1)(A);
•Taxpayer may carry excess contributions to "A" charities to each of the succeeding five tax years in sequence, § 170(d)(1)(A);
•Taxpayer may deduct up to 30% of his/her contribution base to "B" charities, § 170(b)(1)(B);
•Taxpayer may carry excess contributions to "B" charities to each of the succeeding five tax years in sequence, §§ 170(d)(1)(B), 170(d)(1)(A).
•Taxpayer may deduct up to 30% of his/her contribution base to "A" charities of "capital gain property," § 170(b)(1)(C)(i);
•Taxpayer may carry excess contributions of "capital gain property" to "A" charities to each of the succeeding five tax years in sequence, §§ 170(b)(1)(C)(ii), 170(d)(1)(A);
•Taxpayer may deduct up to 20% of his/her contribution base to "B" charities of "capital gain property, § 170(b)(1)(D)(i);
•Taxpayer may carry excess contributions of "capital gain property" to "B" charities to each of the succeeding five tax years in sequence, §§ 170(b)(1)(D)(ii), 170(d)(1)(A).

Very wealthy taxpayers: The "Giving Pledge" is a campaign to encourage the wealthiest people in the United States to give to philanthropic causes. What problems do § 170's contribution limitations create for persons who accumulated vast wealth but whose income is no longer what it was? Bill Gates, Warren Buffett, and Mark Zuckerberg have signed on.

•These limitations are presented in a certain order. Every type of contribution is subject to the limitations imposed on gifts above it.
•Example: Taxpayer contributed 40% of her contribution base in cash to an "A" charity. Taxpayer also contributed "capital gain property" with a fmv equal to 20% of her contribution base to "A" charities. Taxpayer must carry half of her "capital gain property" contributions to the next succeeding tax year as a contribution of "capital gain property" to an "A" charity.

•Moreover, as the sequence of the list implies, carryovers may be used only subject to the contribution limits of the succeeding year. § 170(d)(1)(A)(i). The carryforward period is five years. § 170(d)(1)(A). This may discourage particularly generous taxpayers from making contributions in excess of the limits any more frequently than once every five years.

9. *Corporations*: A corporation may deduct only 10% of its taxable income as charitable contributions. § 170(b)(2)(A). A corporation may not circumvent this limitation by recharacterizing a contribution or gift that qualifies as a charitable contribution as a business expenditure. § 162(b). A corporation computes its taxable income for purposes of calculating this limit without regard to any dividends-received deduction, NOL carryback, § 199 deduction for domestic production activities, and capital loss carryback. § 170(b)(2)(C). A corporation may carry over an excess contribution to each of the next succeeding five tax years. § 170(d)(2)(A). The carryover cannot operate to increase an NOL in a succeeding year. § 170(d)(2)(B).

10. Taxpayer made a $1000 contribution to WKNO-FM, the local public radio station. WKNO-FM is an "A" organization. Because Taxpayer gave "at the $1000 level," WKNO-FM presented Taxpayer with a HD radio. WKNO-FM had purchased several such radios for its fund-raising drive at a cost of $163 each. The fmv of the radio was $200. Taxpayer already owned an HD radio so s/he put the new one – still in the box it came in – in the attic. How much may Taxpayer deduct as a charitable contribution?

> •*See Shoshone-First National Bank v. United States*, 29 A.F.T.R.2d 72-323, 72-1 USTC (CCH) ¶ 9119, 1971 WL 454 (D. Wyo. 1971).

10a. Playhouse on the Circle will "sell the house" to any organization willing to pay $2500 to see a private showing on a Sunday afternoon of the play it is currently showing. A ticket to see the same play on Saturday night – the immediately preceding night – normally costs $35. Many charities engage Playhouse on the Circle to raise funds for their organization. St. Marlboro, an "A" organization engaged in medical research to determine the consequences of smoking only a few cigarettes a day, has "bought the house" and is selling tickets for $35/each. If Taxpayer purchased four tickets at a total cost of $140, how much should Taxpayer be permitted to deduct as a charitable contribution if Taxpayer throws the tickets away because s/he is not the least bit interested in seeing the play that Playhouse is currently showing?

•*See* Rev. Rul. 67-246 (Example 3).

10b. Taxpayer has $200,000 of adjusted gross income and no NOL carryback. Taxpayer made the following charitable contributions:

•$20,000 cash to her church, an "A" charity;

•"long-term capital gain property" to her favorite university, an "A" charity, ab = $10,000, fmv = $80,000;

•"long-term capital gain property" to the sorority of which she was a member during her years in college, a "B" organization, ab = $15,000, fmv = $40,000.

What is Taxpayer's allowable charitable contribution deduction? What charitable contribution carryovers will Taxpayer have?

10c. Taxpayer has $200,000 of adjusted gross income and no NOL carryback. Taxpayer made no charitable contributions except for the following transaction:

•Taxpayer sold to a "B" charity some stock that he purchased many years ago for $10,000. Its current fmv = $50,000. Taxpayer sold the stock to the charity for $10,000.

What are the tax consequences to Taxpayer?

CALI Lessons

11. Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Charitable Contribution Deductions: Basic Concepts and Computations*.

B. Taxes Paid

Section 164 names some taxes that are deductible, irrespective of the circumstances of the taxpayer. The payments do not have to be connected with a trade or business, or for the production of income. They are deductible simply because taxpayer paid them. Section 275 names certain taxes that are not deductible.

There is of course an involuntary element of paying any of the taxes that § 164 names. However, there is also an element of choice involved in the sense that some taxes are simply the cost of owning property – wherever situated – or making income in one place rather than another. Moreover, the taxes named support governments other than the federal government. Thus the taxpayer's costs of taxes associated with the choices that taxpayer makes are borne at least in part by the federal government.

Some important points about §§ 164/275 are the following:

- To be deductible, a "personal property tax" must be an ad valorem tax, § 164(b)(1), i.e., "substantially in proportion to the value of the personal property." Reg. § 1.164-3(c)(1). Thus payment of a uniform "wheel tax" imposed on automobiles is not deductible.
- A taxpayer may deduct *either* state and local income taxes *or* state and local sales taxes. § 164(b)(5)(A). For a time, state and local sales taxes were not deductible.
    - What are the fairness implications of these current and former rules for taxpayers who reside in states that raise most of their revenue through income taxes, through sales taxes, or through a combination of income and sales taxes?
- Section 164(c)(1) provides in part: "Taxes assessed against local benefits of a kind tending to increase the value of the property assessed" are not deductible. Reg. § 1.164-4(a) provides in part: "A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction."
    - If a property owner may not deduct an assessment for the

construction of, say, sidewalks in his/her neighborhood, should the property owner be permitted to add the amount of the assessment to his/her basis in his/her property?

•If real property is sold during a tax year, § 164(d) pro rates the real property tax allocable to seller and buyer by the number of days each owned the property. The seller is treated as owning the property up to the day before the sale. § 164(d)(1)(A).

•How should a seller treat real estate taxes that the seller has already paid and for which s/he received reimbursement from the buyer? *See* § 1001(b)(1).

•How should a seller treat real estate taxes that are the obligation of the seller but which the purchaser pays, perhaps because they are only due after the date of sale? *See* § 1001(b)(2).

•The last sentence of § 164(a) provides that taxes paid in connection with the sale or acquisition of property are to be treated as amount realized or cost.

•If this treatment of such taxes does not (ultimately) alter taxpayer's taxable income, what difference does it make to deduct a payment as opposed to reducing the amount realized or increasing the cost?

Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Deductions for Taxes*.

II. Denial of Discretion in Choosing How or What to Consume

A. Medical and Dental Expenses

Section 213(a) allows a taxpayer to deduct expenses of medical care "paid during the taxable year, not compensated for insurance or otherwise" to the extent such expenses exceed 10% of the taxpayer's adjusted gross income. This includes the expenses of *prescription* drugs. § 213(b). Section 213(d)(1)(A) defines "medical care" expenses to include expenditures "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." Medical care expenses also includes the expenses of transportation "primarily for and essential to medical care," certain long-term care services, and insurance that covers "medical care" as so defined.

> •Why should there be a floor on the deductibility of medical expenses? Why should the determinant of that floor be a taxpayer's adjusted gross income? *See* William P. Kratzke, *The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income*, 60 THE TAX LAWYER 1, 24-25 (2006).
> •Think: What is the profile of taxpayers most likely to claim a medical expense deduction? *See id.* What type of medical expenditures are such taxpayers likely to make?

We are met once again by the chicken-and-egg question of when taxpayer's personal circumstances can support a deduction for certain expenditures. *Why* did taxpayer have little choice in making the expenditure?

Ochs v. Commissioner, 195 F.2d 692 (2d Cir.), *cert. denied*, 344 U.S. 827 (1952)

The question raised by this appeal is whether the taxpayer Samuel Ochs was entitled under § [213] of the Internal Revenue Code to deduct the sum of $1,456.50 paid by him for maintaining his two minor children in day school and boarding school as medical expenses incurred for the benefit of his wife. ...

The Tax Court made the following findings:

> 'During the taxable year petitioner was the husband of Helen H. Ochs. They had two children, Josephine age six and Jeanne age four.
>
> 'On December 10, 1943, a thyroidectomy was performed on petitioner's wife. A histological examination disclosed a papillary

carcinoma of the thyroid with multiple lymph node metastases, according to the surgeon's report. During the taxable year the petitioner maintained his two children in day school during the first half of the year and in boarding school during the latter half of the year at a cost of $1,456.50. Petitioner deducted this sum from his income for the year 1946 as a medical expense under § [213] ...

'During the taxable year, as a result of the operation on December 10, 1943, petitioner's wife was unable to speak above a whisper. Efforts of petitioner's wife to speak were painful, required much of her strength, and left her in a highly nervous state. Petitioner was advised by the operating surgeon that his wife suffered from cancer of the throat, a condition which was fatal in many cases. ... Petitioner became alarmed when, by 1946, his wife's voice had failed to improve ... Petitioner and his wife consulted a reputable physician and were advised by him that if the children were not separated from petitioner's wife she would not improve and her nervousness and irritation might cause a recurrence of the cancer. Petitioner continued to maintain his children in boarding school after the taxable year here involved until up to the end of five years following the operation of December 10, 1943, petitioner having been advised that if there was no recurrence of the cancer during that time his wife could be considered as having recovered from the cancer.

'During the taxable year petitioner's income was between $5,000 and $6,000. Petitioner's two children have not attended private school but have lived at home and attended public school since a period beginning five years after the operation of December 10, 1943. Petitioner's purpose in sending the children to boarding school during the year 1946 was to alleviate his wife's pain and suffering in caring for the children by reason of her inability to speak above a whisper and to prevent a recurrence of the cancer which was responsible for the condition of her voice. He also thought it would be good for the children to be away from their mother as much as possible while she was unable to speak to them above a whisper.

> 'Petitioner's wife was employed part of her time in 1946 as a typist and stenographer. On account of the impairment which existed in her voice she found it difficult to hold a position and was only able to do part-time work. At the time of the hearing of this proceeding in 1951, she had recovered the use of her voice and seems to have entirely recovered from her throat cancer.'

The Tax Court said in its opinion that it had no reason to doubt the good faith and truthfulness of the taxpayer ..., but it nevertheless held that the expense of sending the children to school was not deductible as a medical expense under the provisions of § [213] ...

In our opinion the expenses incurred by the taxpayer were non-deductible family expenses within the meaning of § [262(a)] of the Code rather than medical expenses. Concededly the line between the two is a difficult one to draw, but this only reflects the fact that expenditures made on behalf of some members of a family unit frequently benefit others in the family as well. The wife in this case had in the past contributed the services – caring for the children – for which the husband was required to pay because, owing to her illness, she could no longer care for them. If, for example, the husband had employed a governess for the children, or a cook, the wages he would have paid would not be deductible. Or, if the wife had died, and the children were sent to a boarding school, there would certainly be no basis for contending that such expenses were deductible. The examples given serve to illustrate that the expenses here were made necessary by the loss of the wife's services, and that the only reason for allowing them as a deduction is that the wife also received a benefit. We think it unlikely that Congress intended to transform family expenses into medical expenses for this reason. The decision of the Tax Court is further supported by its conclusion that the expenditures were to some extent at least incurred while the wife was acting as a typist in order to earn money for the family. ...

The decision is affirmed.

FRANK, Circuit Judge (dissenting).

....

... The Commissioner argued, successfully in the Tax Court, that, because the money spent was only indirectly for the sake of the wife's health and directly for the children's maintenance, it could not qualify as a 'medical expense.' Much is made of the fact that the children themselves were healthy and normal – and little of the fact that it was their very health and normality which were draining away the mother's strength. The Commissioner seemingly admits that the deduction might be a medical expense if the wife were sent away from her children to a sanitarium for rest and quiet, but asserts that it never can be if, for the very same purpose, the children are sent away from the mother – even if a boarding school for the children is cheaper than a sanitarium for the wife. I cannot believe that Congress intended such a meaningless distinction, that it meant to rule out all kinds of therapeutic treatment applied indirectly rather than directly – even though the indirect treatment be 'primarily for the *** alleviation of a physical or mental defect or illness.' [footnote omitted]. The cure ought to be the doctor's business, not the Commissioner's.

The only sensible criterion of a 'medical expense' – and I think this criterion satisfies Congressional caution without destroying what little humanity remains in the Internal Revenue Code – should be that the taxpayer, in incurring the expense, was guided by a physician's bona fide advice that such a treatment was necessary to the patient's recovery from, or prevention of, a specific ailment.

....

In the final analysis, the Commissioner, the Tax Court and my colleagues all seem to reject Mr. Ochs' plea because of the nightmarish spectacle of opening the floodgates to cases involving expense for cooks, governesses, baby-sitters, nourishing food, clothing, frigidaires, electric dish-washers – in short, allowances as medical expenses for everything 'helpful to a convalescent housewife or to one who is nervous or weak from past illness.' I, for one, trust the Commissioner to make short shrift of most such claims. [footnote omitted] The tests should be: Would the taxpayer, considering his income and his living standard, normally spend money in this way regardless of illness? Has he enjoyed such luxuries or services in the past? Did a competent physician prescribe this specific expense as an indispensable part of the treatment? Has the taxpayer followed the physician's advice in most economical way possible? Are the so-called medical expenses over and above what the patient would have to pay anyway for his living expenses, i.e., room, board, etc? Is the treatment closely geared to a particular condition and not just to the patient's general good health or well-being?

My colleagues are particularly worried about family expenses, traditionally nondeductible, passing as medical expenses. They would classify the children's schooling here as a family expense, because, they say, it resulted from the loss of the wife's services. I think they are mistaken. The Tax Court specifically found that the children were sent away so they would not bother the wife, and not because there was no one to take care of them. Och's expenditures fit into the Congressional test for medical deductions because he was compelled to go to the expense of putting the children away primarily for the benefit of his sick wife. Expenses incurred solely because of the loss of the patient's services and not as a part of his cure are a different thing altogether. *Wendell v. Commissioner*, 12 T.C. 161, for instance, disallowed a deduction for the salary of a nurse engaged in caring for a healthy infant whose mother had died in childbirth. The case turned on the simple fact that, where there is no patient, there can be no deduction.

Thus, even here, expense attributed solely to the education, at least of the older child, should not be included as a medical expense. *See Stringham v. Commissioner*, *supra*. Nor should care of the children during that part of the day when the mother would be away, during the period while she was working part-time. *Smith v. Commissioner*, 40 B.T.A. 1038, *aff'd* 2d Cir., 113 F.2d 114. The same goes for any period when the older child would be away at public school during the day. In so far as the costs of this private schooling are thus allocable, I would limit the deductible expense to the care of the children at the times when they would otherwise be around the mother. ...

...

Notes and Questions:

1. Is the rationale offered by the court consistent with the tax rules concerning imputed income?

  •Does the rationale seem a bit reminiscent of the rationale in *Smith*?

2. What caused taxpayer to have to incur the expenses on his relatively modest income of sending the children to boarding school?

  •Would taxpayers have had to bear these expenses if they did not have children?

  •Would taxpayers have had to bear these expenses if Mrs. Ochs did not have throat cancer?

3. How much discretion did taxpayer have in incurring the particular expense in *Ochs*? If taxpayer had paid for Mrs. Ochs to reside in a sanitarium, that expense would qualify as a medical expense.

4. Consider: Prior to 1962 Mrs. Gerstacker had a history of emotional-mental problems which had grown gradually worse. In 1962 she ran away from mental hospitals twice after voluntarily entering them. Her doctors advised Mr. Gerstacker that successful treatment required continuing control of the doctors so that Mrs. Gerstacker could not leave and disrupt her therapy. They recommended guardianship proceedings and hospitalization in Milwaukee Sanitarium, Wauwautosa, Wisconsin. Mr. Gerstacker instituted guardianship proceedings. Both Mr. and Mrs. Gerstacker employed attorneys. The court appointed guardians. Mrs. Gerstacker was hospitalized from 1962 until the latter part of 1963 when she was released by her doctors for further treatment on an out-patient basis. The guardianship was then terminated on the recommendation of her doctors because it was no longer necessary due to improved condition of the patient.

  •Should the legal expenses for establishing, conducting, and terminating the guardianship be deductible as medical expenses? For whose benefit were the expenses incurred?

  •*See Gerstacker v. Commissioner*, 414 F.2d 448 (6th Cir. 1969).

5. Do the CALI Lesson, *Basic Federal Income Taxation: Medical Expense Deductions*.

B. Casualty Losses

Read § 165(c)(3), § 165(e), § 165(h), § 165(i).

Losses caused by "fire, storm, shipwreck, or other casualty, or from theft" do not usually result from personal consumption choices. Hence, a deduction seems appropriate. From the beginning, a problem has been to distinguish between a "bad hair day" and the type of damage that represents such a deprivation of consumption choice that a taxpayer should be permitted to share his/her burden with other taxpayers. This has not proved to be an easy line to draw – and one does not have to search the digests very hard to find contradictory results.

Courts have had great difficulty defining "casualty," and there is no definition in the regulations. Certain considerations seem relevant:

- •Not every loss should be treated as resulting from a casualty. We drop a plate, and it breaks. It's called "life," not a casualty.
- •There are certain risks that we may willingly assume. When something untoward materializes, we are in no position to complain. We own a cat and an expensive vase and put both of them in the same room at the same time. The cat knocks the vase over, and it breaks. *See Dyer v. Commissioner*, T.C. Memo. 1961-141, 1961 WL 424 (1961).
- •We certainly should not complain when the casualty is the result of our deliberate conduct. The arsonist should not be permitted to claim a casualty loss deduction when he burns down his own house, even though his loss was quite literally caused by "fire." *See Blackmun v. Commissioner*, 88 T.C. 677, 681 (1987), *aff'd*, 867 F.2d 605 (1st Cir. 1988) (violation of public policy).
- •We engage in a business where a certain amount of breakage is predictable. Taxpayer operates a fleet of taxicabs, and a few of

them are damaged in traffic accidents.
•There are risks that we should be expected to address. When damage occurs over a period of time, perhaps taxpayer should be expected to take measures to address the problem. There are many cases involving damage that termites caused, and the results are not entirely consistent.

What clues does the IRS provide in the following revenue ruling to help determine just what is a deductible casualty loss?

Rev. Rul. 76-134

CASUALTY LOSS DUE TO FLOOD DAMAGE

....

The questions presented are (1) whether losses from damage to property resulting from abnormally high water levels on bodies of water and (2) amounts expended for the construction of protective works or for moving homes back from their original locations to prevent probable losses from future storms are deductible as casualty losses under § 165 of the Internal Revenue Code of 1954.

Section 165(a) of the Code provides the general rule that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise. Section 165(c) provides, in part, that in the case of an individual, the deduction is limited to (1) losses incurred in a trade or business, (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business, and (3) losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft. In respect of property not connected with a trade or business, a loss shall be allowed only to the extent that the amount of loss to such individual arising from each casualty, or from each theft, exceeds $100.

Section 263 of the Code provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

Court decisions and revenue rulings have established standards for the application of the above provisions, and have developed the overall concept that the term 'casualty' as used in such provisions refers to an identifiable event of a sudden, unexpected, or unusual nature and that damage or loss resulting from progressive deterioration of property through a steadily operating cause would not be a casualty loss. [citations omitted].

Accordingly, losses due to physical damage to property, such as buildings, docks, seawalls, etc., as a result of wave action and wind during a storm are deductible as casualty losses under § 165 of the Code. Similarly, losses due to flooding of buildings and basements as a result of a storm and the complete destruction of buildings, occurring as a result of storm damage, are deductible casualty losses.

However, there are situations in which damage or expenditures may be incurred due to high water on bodies of water that may not be casualty losses under § 165 of the Code such as damage or loss of value due to gradual erosion or inundation occurring at still water levels. The term 'still water levels' as used herein means normal seasonal variations in the water level of a body of water.

These variations are not such sudden and identifiable events that the gradual erosion resulting therefrom may be attributed to a specific period of time. The rise and fall of the water levels of a body of water is a normal process, and damage resulting from normal high water levels alone lacks the characteristics of a casualty loss under § 165. Thus, where the taxpayer's loss was due to progressive deterioration rather than some sudden, unexpected, or unusual cause, such loss is not a deductible casualty loss for Federal income tax purposes.

Another situation involves expenditures by taxpayers for the construction of protective works or for moving their homes back from their original locations to prevent probable losses from future storms. In such cases, no casualty loss deduction is allowable under § 165 of the Code because § 165(c) expressly limits a casualty loss deduction to losses of property. Such expenditures are within the purview of § 263, which provides that no deduction shall be allowed for any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of the property.

Where a casualty loss is allowed for the loss of property, the amount of loss deductible is measured by the excess of the value of the property just before the casualty over its value immediately after the casualty (but not more than the cost or other adjusted basis of the property), reduced by any insurance or compensation received. In the case of property not used in a trade or business, such amount is further reduced by $100 for each casualty.

....

Notes and Questions:

1. For which of the following do you think there should be an allowable deduction for a casualty loss?

- moth damage to a fur coat?
- damage caused by a quarry blast?
- freezing and bursting of water pipes?
- damage from disease and insect attack to a tree?
- damage to automobile engine caused by freezing conditions?
- damage to automobile caused by taxpayer's negligent driving?
- damage to automobile caused by rusting and corrosion?

See generally STANDARD FEDERAL INCOME TAX REPORTER (2011), ¶ 10,005.023.

2. Upon what narrow ground does Revenue Ruling 76-134 deny a casualty loss deduction? What tax treatment does the Revenue Ruling specify for such expenditures?

3. *Calculation of the personal casualty loss deduction*.

- Section 165(h) limits the losses that an individual may deduct as casualty losses.
- Reg. § 1.165-7(b)(1) limits *all* casualty losses – whether trade or business, transactions entered into for profit, or personal – to the lesser of the property's fmv before the casualty reduced by the fmv of the property after the casualty OR the property's adjusted basis.
    - If the property is used in a trade or business or held for the production of income AND it is totally destroyed by the casualty, the allowable loss is limited to the adjusted basis of the property.
    - What is the theoretical underpinning of these limitations?
- Section 165(h)(1) limits the deductibility of the personal loss for *each* casualty to the amount by which the loss exceeds $100.
- Section 165(h)(4)(A) defines "personal casualty gain" to be "recognized gain from any involuntary conversion of property" resulting from a casualty. Section 165(h)(4)(B) defines "personal casualty loss" to be a casualty loss after reduction by $100.
- Section 165(h)(2) limits the deductibility of all personal casualty losses to the amount by which they exceed personal casualty gains and by which this net amount exceeds 10% of a taxpayer's adjusted gross income. Taxpayer may reduce his/her adjusted gross income by the net personal casualty loss in making this 10% determination. § 165(h)(5)(A).
    - In the event personal casualty gains exceed personal casualty losses, taxpayer must treat all such gains and all such losses as if they resulted from the sales or exchanges of capital assets. § 165(h)(2)(B).

4. A taxpayer suffering a casualty loss in a federally declared disaster area may elect to claim the casualty loss deduction for the taxable year immediately preceding the taxable year in which the disaster occurred. § 165(i)(1). The casualty loss is then treated as having occurred in the year in which the deduction is claimed. § 165(i)(2). This provision may help get funds into the hands of the victims of federally declared disasters quickly.

5. Do CALI Lesson, *Basic Federal Income Taxation: Deductions: Personal Casualty Loss Deduction: Computation, Limitations*.

III. Creating a More Efficient and Productive Economy

There are some deductions that the Code permits that promote a more efficient or productive economy. Under this heading, we might include dependent care expenses incurred so that taxpayer can work. We have already examined such expenditures. We should also include provisions that give taxpayers credits against tax liability for investing in making themselves more productive, i.e., in education, and for working. Also under this heading are the expenses of moving to a better – and presumably more valuable – job.

A. Moving Expenses

Read §§ 82, 217, 62(a)(15), 132(a)(6), and 132(g). These provisions interlock to assure that a taxpayer does not pay income tax on certain moving expenses, as § 217 defines and limits them.

- •Section 82 provides that a taxpayer who receives, directly or indirectly, payment for or reimbursement of moving expenses must include such payment in his/her gross income.
- •Section 217 permits taxpayer to deduct certain expenses of moving. § 217(b). This deduction is above-the-line, i.e., it reduces taxpayer's agi. § 62(a)(15).
    - •Thus taxpayer must include in his/her gross income an employer's payment of taxpayer's moving expenses, but paying or incurring moving expenses named in § 217(b) entitles taxpayer to a deduction. These amounts could offset.
    - •Of course, if an employer pays for expenses that are not included in the statutory definition of "moving expenses," the net result is that those amounts will be included in taxpayer's gross income as compensation income.
    - •If an employer does not pay for all of the expenses that are

included in the statutory definition of "moving expenses," the net result is that taxpayer may deduct these unreimbursed amounts, and these deductions will reduce his/her adjusted gross income.

•Sections 132(a)(6) and 132(g) exclude an employer's direct or indirect payment of an individual's moving expenses, to the extent those expenses are within § 217(b), from the individual's gross income.

Section 217(c) establishes the rules for deductibility/excludability of moving expenses.

•Taxpayer's new "principal place of work" must be "at least 50 miles farther from his former residence than was his former principal place of work," § 217(c)(1)(A), OR if taxpayer had no former principal place of work, then his/her new "principal place of work" must be at least 50 miles from his/her former residence, § 217(c)(1)(B).

•Taxpayer need not have a job in the place that s/he leaves. Moving expenses are deductible if incurred to travel to a new job or to become self-employed full-time.

•The regulations also create a "reasonable proximity" requirement concerning the new residence with respect to both time and distance. Reg. § 1.217-2(a)(3)(i).

•Moving expenses incurred within one year of the date of commencing work at the new location are presumed to be reasonably proximate. Reg. § 1.217-2(a)(3)(i).

•Generally, a taxpayer's commute at the new location may not be longer than his/her commute at the old location. Reg. § 1.217-2(a)(3)(i).

•Taxpayer must be a *full-time employee* for at least 39 weeks during the 12-month period immediately following his/her arrival in the general location of his/her principal place or work, § 217(c)(2)(A), OR during the 24 month period immediately following his/her arrival, must be a *full-time employee or self-employed* on a full-time basis during at least 78 weeks, not less than 39 of which are during the 12-month period immediately following arrival in the general location of his/her principal place of work, § 217(c)(2)(B).

•If a taxpayer has not fulfilled the employment requirements at the time of filing the return for the taxable year during which s/he paid or incurred moving expenses but may yet satisfy them, then taxpayer may elect to deduct them. § 217(d)(2).
•However, if taxpayer makes such an election and later fails to fulfill the employment requirements, taxpayer must recapture the amount previously deducted as gross income. § 217(d)(3).

Section 217(b) names the moving expenses that taxpayer may deduct/exclude. These include the expenses "of moving household goods and personal effects from the former residence to the new residence[.]" § 217(b)(1)(A). "Moving expenses" also include travel expenses, including lodging, but not meal expenses. § 217(b)(1)(B). Taxpayer may deduct as "moving expenses" the moving expenses of any member of the taxpayer's household who has both the "former residence and the new residence as his principal place of abode[.]" § 217(b)(2).

Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Moving Expenses*

B. Credits Against Tax

The Code provides that certain expenditures count as credits against the taxpayer's tax liability. Some of these credits promote a more efficient or productive economy, i.e., the credit for dependent care services necessary for gainful employment (§ 21) and the Hope and Lifetime Learning Credits for some educational expenses (§ 25A). They are subject to income phasedowns (§ 21) or phaseouts (§ 25A). This implies that taxpayers with higher incomes do not need strong incentives or do not need incentives at all in order to incur such expenses. These credits are not refundable, meaning that they can reduce taxpayer's tax liability to $0, but no more.

The earned income credit (§ 32) is available to lower-income taxpayers who work. The tax credit first increases with earned income and then phases out completely. The idea here is to encourage lower-income taxpayers to work and to earn more. This credit is refundable, meaning that taxpayer is entitled to a refund if the credit is for more than taxpayer's tax liability.

Note About Tax Credits

We should note that Congress can use credits to target tax benefits to certain taxpayers. Congress can target tax benefits by phasing out or phasing down entitlement to them as taxpayer's adjusted gross income increases. Congress can also target greater benefits to those in certain tax brackets, even if a tax credit is not subject to a phasedown or phaseout. We earlier noted the "upside down" effect of progressive tax rates on deductions. Higher income taxpayers benefit more from a deduction than lower income taxpayers. A credit can reverse this. The amount of a tax credit can be dependent on the amount that taxpayer spends on a certain item, e.g., 20%. That percentage will provide a greater benefit to those taxpayers whose marginal tax bracket is lower than 20% than a deduction would. The converse is true for those taxpayers whose marginal tax bracket is above 20%; those whose tax brackets are more than 20% would have benefit more from a deduction.

Consider this example: Taxpayer has $100,000 of taxable income on which s/he pays $20,000 of income tax. Congress wishes to "reward" Taxpayer for having spent the last $1000 that Taxpayer earned on a particular item. The net after-tax cost to the Taxpayer for having spent the money in this way would be the following for taxpayers in each of the current tax brackets with either a deduction or a credit.

Taxpayer's Tax Bracket	Net Cost of Benefit with a Deduction	Net Cost of Benefit with a 20% Tax Credit
10%	$900	$800
15%	$850	$800
25%	$750	$800
28%	$720	$800
33%	$670	$800
35%	$650	$800
39.6%	$604	$800

You can see from the table that taxpayers in the 10% and 15% brackets should prefer a credit. Taxpayers in the brackets above 20% should prefer a deduction or exclusion. By setting the credit amount between the marginal tax rates, Congress can favor those taxpayers whose tax brackets are lower than the credit amount, and disfavor those taxpayers whose tax brackets are higher than the credit amount.

Do you think that Congress should make more use of tax credits? Less use? Why?

Wrap-Up Questions for Chapter 7

1. Describe how § 170(e)(1)(A), which permits a deduction of the fmv of gifts of property to charity rather than the adjusted basis of the property creates a "true" loophole.

2. Why should state and local property taxes and/or state and local income or sales taxes be deductible? What policies do such deductions pursue?

3. Congress recently increased the floor for medical deductions from 7.5% of agi to 10% of agi. The floor used to be 3%. The general trend of this

floor has been upward. How are these movements in the floor likely to affect who may take the medical expense deduction and how big a deduction they may take?

4. When a taxpayer is entitled to deduct moving expenses, why should a taxpayer be permitted to deduct the expense associated with a move of kenneling a dog but not the cost of a meal while en route to taxpayer's new home?

5. Should Congress implement its tax policy with greater use of credits against tax liability rather than deductions or exclusions from gross income? Why?

Chapter 8: Tax Consequences of Divorce and Intra-Family Transactions

I. Introduction

The tax consequences of marriage, support of a family, and divorce turn on how we choose to apply the basic principles that we tax income once and only once and that expenditures for personal consumption are not deductible. Taxpayer chooses whether to have a spouse or a child, so expenditures for the support of a spouse or a child presumably are not deductible. The Supreme Court's decision in *Poe v. Seaborn* assured that the legal ownership of income within a family unit would be an important issue. We consider now the extent to which we recognize the family as a taxpaying unit.

> *The Tax Formula*:
>
> (gross income)
> ➔<u>MINUS § 62 deductions</u> ≥
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or
> itemized deductions)
> ➔MINUS (personal exemptions)≥
> EQUALS (taxable income)
>
> Compute income tax liability from tables in § 1 (indexed for inflation)
> MINUS (credits against tax)

We already know that the filing status "married filing jointly" implies that married persons are in fact one taxpaying unit, whether one or both contribute to its taxable income. The fact that a taxpayer provides financial support to another person may give that other person the tax status of "dependent" and entitle taxpayer to a dependent deduction. We learn shortly that whether taxpayer may claim another as a dependent usually turns on the existence of a family relationship.

State law defines marriage[165] – who is and who is not married. State law defines the rights that husband and wife have with respect to their property and income

[165] ... except for the Defense of Marriage Act, 1 U.S.C. § 7, which states in part that "the word 'marriage' means only a union between one man and one woman as husband and wife ..."

before, within, and after the marriage. State law governs adoptions and so is determinative of who is a “child” of the taxpayer. State (or local) law also governs the placement of foster children. State law defines the obligations that family members have towards each other – notably that parents have obligations of support for their children up to a certain age. This may affect whether one person is a dependent of a taxpayer.

We consider here the tax ramifications of marriage and family – before, during, and after.

II. Before Marriage

The Code treats a married husband and wife as a single taxpayer – although they may elect to be taxed separately. *Until* they are married, they remain separate taxpayers – although one might be a dependent of the other. Taxpayers may enter certain transactions with each other in contemplation of marriage., but presumptively such transactions are arm’s-length transactions.

Farid-es-Sultaneh v. Commissioner, 160 F.2d 812 (2d Cir. 1947)

CHASE, Circuit Judge.
The problem presented by this petition is to fix the cost basis to be used by the petitioner in determining the taxable gain on a sale she made in 1938 of shares of corporate stock. She contends that it is the adjusted value of the shares at the date she acquired them because her acquisition was by purchase. The Commissioner’s position is that she must use the adjusted cost basis of her transferor because her acquisition was by gift. The Tax Court agreed with the Commissioner and redetermined the deficiency accordingly.

....

The petitioner is an American citizen who filed her income tax return for the calendar year 1938 ... and ... reported sales during that year of 12,000 shares of the common stock of the S.S. Kresge Company at varying prices per share, for the total sum of $230,802.36 which admittedly was in excess of their cost to her. ...

In December 1923 when the petitioner, then unmarried, and S.S. Kresge, then married, were contemplating their future marriage, he delivered to her 700 shares of the common stock of the S.S. Kresge Company which then had a fair market value of $290 per share. The shares ... were to be held by the petitioner "for her benefit and protection in the event that the said Kresge should die prior to the contemplated marriage between the petitioner and said Kresge." The latter was divorced from his wife on January 9, 1924, and on or about January 23, 1924 he delivered to the petitioner 1800 additional common shares of S.S. Kresge Company which were also ... to be held by the petitioner for the same purposes as were the first 700 shares he had delivered to her. On April 24, 1924, and when the petitioner still retained the possession of the stock so delivered to her, she and Mr. Kresge executed a written ante-nuptial agreement wherein she acknowledged the receipt of the shares "as a gift made by the said Sebastian S. Kresge, pursuant to this indenture, and as an ante-nuptial settlement, and in consideration of said gift and said ante-nuptial settlement, in consideration of the promise of said Sebastian S. Kresge to marry her, and in further consideration of the consummation of said promised marriage" she released all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife. They were married in New York immediately after the ante-nuptial agreement was executed and continued to be husband and wife until the petitioner obtained a final decree of absolute divorce from him on, or about, May 18, 1928. No alimony was claimed by, or awarded to, her.

The stock so obtained by the petitioner from Mr. Kresge had a fair market value of $315 per share on April 24, 1924, and of $330 per share on, or about May 6, 1924, when it was transferred to her on the books of the corporation. She held all of it for about three years, but how much she continued to hold thereafter is not disclosed except as that may be shown by her sales in 1938. Meanwhile her holdings had been increased by a stock dividend of 50%, declared on April 1, 1925; one of 10 to 1 declared on January 19, 1926; and one of 50%, declared on March 1, 1929. Her adjusted basis for the stock she sold in 1938 was $10.66⅔ per share computed on the basis of the fair market value of the shares which she obtained from Mr. Kresge at the time of her acquisition. His adjusted basis for the shares she sold in 1938 would have been $0.159091.

When the petitioner and Mr. Kresge were married he was 57 years old with a life expectancy of 16½ years. She was then 32 years of age with a life expectancy of 33¾ years. He was then worth approximately $375,000,000 and owned real estate of the approximate value of $100,000,000.

The Commissioner determined the deficiency on the ground that the petitioner's stock obtained as above stated was acquired by gift within the meaning of that word as used in § [102] and, as the transfer to her was after December 31, 1920, used as the basis for determining the gain on her sale of it the basis it would have had in the hands of the donor. This was correct if the just mentioned statute is applicable, and the Tax Court held it was on the authority of *Wemyss v. Commissioner*, 324 U.S. 303, and *Merrill v. Fahs*, 324 U.S. 308.

The issue here presented cannot, however, be adequately dealt with quite so summarily. The *Wemyss* case determined the taxability to the transferor as a gift, under [the Federal Gift Tax] ... of property transferred in trust for the benefit of the prospective wife of the transferor pursuant to the terms of an ante-nuptial agreement. It was held that the transfer, being solely in consideration of her promise of marriage, and to compensate her for loss of trust income which would cease upon her marriage, was not for an adequate and full consideration in money or money's worth ... [and] was not one at arm's length made in the ordinary course of business. But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law.

In *Merrill v. Fahs*, *supra*, it was pointed out that the estate and gift tax statutes are in pari materia and are to be so construed. *Estate of Sanford v.*

Commissioner, 308 U.S. 39, 44. The estate tax provisions in the Revenue Act of 1916 required the inclusion in a decedent's gross estate of transfers made in contemplation of death, or intended to take effect in possession and enjoyment at or after death except when a transfer was the result of "a bona fide sale for a fair consideration in money or money's worth." [citation omitted]. The first gift tax became effective in 1924, and provided *inter alia*, that where an exchange or sale of property was for less than a fair consideration in money or money's worth the excess should be taxed as a gift. [citation omitted]. While both taxing statutes thus provided, it was held that a release of dower rights was a fair consideration in money or money's worth. *Ferguson v. Dickson*, 3 Cir., 300 F. 961, *cert. denied*, 266 U.S. 628; *McCaughn v. Carver*, 3 Cir., 19 F.2d 126. Following that, Congress in 1926 replaced the words "fair consideration" in the 1924 Act limiting the deductibility of claims against an estate with the words "adequate and full consideration in money or money's worth" and in 1932 the gift tax statute as enacted limited consideration in the same way. Rev.Act 1932, § 503. Although Congress in 1932 also expressly provided that the release of marital rights should not be treated as a consideration in money or money's worth in administering the estate tax law, Rev. Act of 1932, § 804, 26 U.S.C.A. ..., and failed to include such a provision in the gift tax statute, it was held that the gift tax law should be construed to the same effect. *Merrill v. Fahs*, *supra*.

We find in this decision no indication, however, that the term "gift" as used in the income tax statute should be construed to include a transfer which, if made when the gift tax were effective, would be taxable to the transferor as a gift merely because of the special provisions in the gift tax statute defining and restricting consideration for gift tax purposes. A fortiori, it would seem that limitations found in the estate tax law upon according the usual legal effect to proof that a transfer was made for a fair consideration should not be imported into the income tax law except by action of Congress.

In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes. They are aimed at the gathering of revenue by taking for public use given percentages of what the statute fixes as net taxable income. Capital gains and losses are, to the required or permitted extent, factors in determining net taxable income. What is known as the basis for computing gain or loss on transfers of property is established by statute in those instances when the resulting gain or loss is recognized for income tax purposes and the basis for succeeding sales or exchanges will, theoretically at least, level off tax-wise any hills and valleys in the consideration passing either way on previous sales or exchanges. When Congress provided that gifts should not be treated as taxable income to the donee there was, without any correlative provisions fixing the basis of the gift to the donee, a loophole which enabled the donee to make a subsequent transfer of the property and take as the basis for computing gain or loss its value when the gift was made. Thus it was possible to exclude from taxation any increment in value during the donor's holding and the donee might take advantage of any shrinkage in such increment after the acquisition by gift in computing gain or loss upon a subsequent sale or exchange. It was to close this loophole that Congress provided that the donee should take the donor's basis when property was transferred by gift. Report of Ways and Means Committee (No. 350, P. 9, 67th Cong., 1st Sess.). This change in the statute affected only the statutory net taxable income. The altered statute prevented a transfer by gift from creating any change in the basis of the property in computing gain or loss on any future transfer. In any individual instance the change in the statute would but postpone taxation and presumably would have little effect on the total volume of income tax revenue derived over a long period of time and from many taxpayers. Because of this we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise. Though such a consideration as this petitioner gave for the shares of stock she acquired from Mr. Kresge might not have relieved him from liability for a gift tax, had the present gift tax then been in effect, it was nevertheless a fair consideration which prevented her taking the shares as a gift under the income tax law since it precluded the existence of a donative intent.

Although the transfers of the stock made both in December 1923, and in the following January by Mr. Kresge to this taxpayer are called a gift in the ante-nuptial agreement later executed and were to be for the protection of his prospective bride if he died before the marriage was consummated, the “gift” was contingent upon his death before such marriage, an event that did not occur. Consequently, it would appear that no absolute gift was made before the ante-nuptial contract was executed and that she took title to the stock under its terms, *viz*: in consideration for her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage. Her inchoate interest in the property of her affianced husband greatly exceeded the value of the stock transferred to her. It was a fair consideration under ordinary legal concepts of that term for the transfers of the stock by him. *Ferguson v. Dickson*, *supra*; *McCaughn v. Carver*, *supra*. She performed the contract under the terms of which the stock was transferred to her and held the shares not as a donee but as a purchaser for a fair consideration.

....
Decision reversed.

CLARK, Circuit Judge (dissenting) (omitted).

Notes and questions:

1. Did the Commissioner lose out on taxing any transactions in 1923 and 1924? Which ones?

- Remember: the use of property whose value has appreciated or depreciated to pay for something is a recognition event. Why?
- What did the parties buy and sell in this case?

Estate and Gift Tax: The estate and gift taxes are in pari materia with each other. Neither is in pari materia with the income tax. What does this mean?

2. What did taxpayer give as consideration in this case? What did she pay for it? When was the money that she used to pay for it

S.S. Kresge: Who was S.S. Kresge? What did he do to make stock in his corporation go up so much in value?

subject to income tax?

•How is this contrary to the sale-of-blood cases – where the amount realized is taxed in full?

3. If there had been no ante-nuptial agreement, would the court's holding have been the same?

•What if the parties had married and *then* executed a post-nuptial agreement with the same terms as the ante-nuptial agreement?

III. During Marriage

A. Tax Consequences of Support Obligations

Consider this variation of *Cidis v. White*, 71 Misc. 2d 481, 336 N.Y.S.2d 362 (Dist. Ct. Nassau Cty., 1972): Dependent daughter without her parents' knowledge made an appointment with Dr. White to be fitted for contact lenses. Dr. White ordered the contact lenses, and they were of no use to anyone except for daughter Cidis. Daughter Cidis was a minor, and her contracts were voidable under state law. Father Cidis elected to void the contract. Dr. White sued for quasi-contract and restitution.

•Assume that Father Cidis has an obligation to provide Daughter Cidis with "necessaries."

•Should Father Cidis be liable for the fmv of the contact lenses – not on the theory that there was a contract that was admittedly voidable, but because Dr. White provided his daughter with a "necessary?"

  •Are contact lenses one of life's "necessaries" if Daughter Cidis does not see very well?

  •Would it matter that contact lenses are cheaper than spectacles?

•If contact lenses are a "necessary" and neither Father Cidis nor Daughter Cidis pays for the contact lenses and Dr. White finally gives up trying to collect from either, does *Father Cidis* have gross income? Why or why not?

B. Filing Status

We know that the "filing status" of a taxpayer determines the tax rate applicable to particular increments of income. We also know that there are such things as a "marriage bonus" and a "marriage penalty" – depending on the relative income levels of husband and wife. We have already considered the relative burdens of each of the filing statuses. Now we briefly consider the rules that place a taxpayer in one filing status or another.

Married Filing Jointly and *Married Filing Separately*: Section 1(a) provides that married persons who file a single tax return and certain surviving spouses must pay an income tax at the tax brackets specified. For income tax purposes, state law – subject to the provision of the Defense of Marriage Act, 1 U.S.C. § 7, that a marriage can only be between a man and a woman – determines whether two persons are married.

- Section 7703 states various rules concerning application of tax rules to marriage and separation. Read it.
    - What is the rule established by § 7703(a)(1)?
    - What is the rule established by § 7703(a)(2)?
    - What is the rule established by § 7703(b)?

- Section 2(a) defines "surviving spouse." Read it.

Section 1(d) provides that married persons who do not file a single tax return jointly (i.e., they are "married filing separately") must pay an income tax at the tax brackets specified.

Head of Household: Section 1(b) provides that a "head of household" must pay an income tax at the tax brackets specified.

- Section 2(b) defines "head of household." Read it.
    - Can a married person be a "head of household?"
    - Can a surviving spouse be a "head of household?"

Unmarried Individuals: Section 1(c) provides that every unmarried individual – other than a surviving spouse or head of household – must pay an income tax at the tax brackets specified.

CALI Lessons

Do the CALI Lesson *Basic Federal Income Taxation: Filing Status*

C. Dependents

Section 151(a) entitles a taxpayer who is an "individual" to a deduction of an "exemption amount" for each "dependent," § 151(c). In addition, a taxpayer who files "married filing jointly" may claim a deduction of the exemption amount for both himself/herself and his/her spouse. Reg. § 1.151-1(b) (third sentence, two exemptions allowed). A taxpayer who is married but does not file a joint return may claim a deduction of the exemption amount for a spouse who has no gross income and is not the dependent of another taxpayer, § 151(b). The "exemption amount" is a fixed amount per dependent, *see* § 151(d)(1), indexed for inflation, § 151(d)(4). A taxpayer may not deduct an "exemption amount" for any person for whom a dependency deduction is allowable to another taxpayer, § 151(d)(2).

Section 152 defines "dependent."

- A dependent may not claim another as a dependent. § 152(b)(1).
- A spouse who files a joint return cannot be the dependent of another taxpayer. § 152(b)(2).
- A dependent must be a citizen, national, resident of the United States, or resident of a country contiguous with the United States. § 152(b)(3)(A). This limitation does not apply to an adopted child who has the same principal place of abode as a taxpayer and is a member of the taxpayer's household, provided that the taxpayer is a citizen or national of the United States. § 152(b)(3)(B).
- A "dependent" must be either a "*qualifying child*" or a "*qualifying relative*." § 152(a).

Qualifying Child: A "qualifying child" is an individual who meets certain requirements of relationship, place of abode, age, support, and filing status. § 152(c)(1).

•*Relationship*: A "qualifying child" can be –

•a child of the taxpayer, § 152(c)(1), i.e., son, daughter, stepson, stepdaughter, or a foster child placed by an authorized placement agency or under court order (§152(f)(1)(A and C)) or a descendant of such an individual, § 152(c)(2)(A). Taxpayer's legal adoption of a son, daughter, stepson, or stepdaughter renders a person a child of the taxpayer by blood. § 152(f)(1)(B).

•a brother, sister, stepbrother, or stepsister or a descendant of any such relative. § 152(c)(2)(B). This includes a half-brother or half-sister. § 152(f)(4).

•*Abode*: A "qualifying child" must have "the same principal place of abode as the taxpayer for more than one-half" of the year. § 152(c)(1)(B).

•There are special rules when the "qualifying child" is the child of divorced parents. If the "qualifying child" receives over one-half of his/her support during the year from his/her parents (including as a parent's contribution the contribution of a new spouse, § 152(e)(6)) who either –

•are divorced, § 152(e)(1)(A)(i),

•are separated under a written separation agreement, § 152(e)(1)(A)(ii), or

•live apart for all of the last six months of the calendar year, § 152(e)(1)(A)(iii),

•*and* the child is in the custody of one or both of the parents for more than one-half of the calendar year, then the custodial parent (i.e., the parent having custody for the greater portion of the calendar year, § 152(e)(4)(A)), may claim the child as a dependent, *unless*

•The custodial parent executes a Form 8332 by which the custodial parent declares that he/she will not claim the child as a dependent, § 152(e)(2)(A), and

•The noncustodial parent attaches Form 8332 to his/her tax return. § 152(e)(2)(B).

•These special rules for divorced parents do not apply to any case where the child received over one-half of his/her support under a so-called "multiple support agreement." § 152(e)(5).

- *Age*: A "qualifying child" must be younger than the taxpayer (§ 152(c)(3)(A)) and –
    - not yet 19 years old, § 152(c)(3)(i), *unless*
        - the individual is permanently and totally disabled at any time during the year, § 152(c)(3)(B), *or*
        - the child is a student who is not yet 24 years old, § 152(c)(3)(A)(ii). A "student" who is an individual who is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training. § 152(f)(2).

- *Support*: A "qualifying child" is one who did not provide more than one-half of his/her own support. § 152(c)(1)(D). Scholarships are not taken into account. § 152(f)(5).

- *Filing status*: A "qualifying child" may not file a joint return other than for the purpose of claiming a refund with his/her spouse. § 152(c)(1)(E).

It can happen that two or more persons can claim the same "qualifying child" as a dependent. In such a case, the "qualifying child" is treated as the "qualifying child" of –

- a parent, § 152(c)(4)(A)(i):
    - In the event that more than one parent can claim the "qualifying child" and the parents do not file a joint return, § 152(c)(4)(B), the child is the "qualifying child" of –
        - the parent with whom the child resided the longest during the taxable year, § 152(c)(4)(B)(i), or
        - if the child resided with each parent an equal amount of time, the parent with the highest adjusted gross income. § 152(c)(4)(B)(ii).
    - In the event the child *is* a "qualifying child" with respect to a parent but no parent claims the "qualifying child", another taxpayer may claim the child as a dependent *if* that

taxpayer's adjusted gross income is higher than the highest adjusted gross income of a parent. § 152(c)(4)(C).

•If the child *is not* a "qualifying" child as to a parent, the taxpayer with the highest adjusted gross income for whom the individual is a "qualifying child" may claim the child as a dependent. § 152(c)(4)(A)(ii).

Qualifying Relative: A "qualifying relative" is an individual who meets certain requirements of relationship, gross income, support, and status.

•*Relationship*: A "qualifying relative" with respect to the taxpayer may be –

•a child or descendant of a child, § 152(d)(2)(A), i.e., son, daughter, stepson, stepdaughter, or a foster child placed by an authorized placement agency or under court order (§152(f)(1)(A and C)) or a descendant of such an individual, § 152(c)(2)(A). Taxpayer's legal adoption of a son, daughter, stepson, or stepdaughter renders such a person a child of the taxpayer by blood. § 152(f)(1)(B);
•a brother, sister, stepbrother, or stepsister. 152(d)(2)(B). This includes a half-brother or half-sister. § 152(f)(4);
•a father or mother or ancestor of a father or mother; § 152(d)(2)(C);
•a stepfather or stepmother, § 152(d)(2)(D);
•a son or daughter of a brother or sister (i.e., nephew or niece), § 152(d)(2)(E);
•a brother or sister of the father or mother (i.e., uncle or aunt), § 152(d)(2)(F);
•a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law, § 152(d)(2)(G);
•an individual other than one who was at any time during the taxable year a spouse who for the taxable year has the same principal place of abode as the taxpayer and is a member of the taxpayer's household. § 152(d)(2)(H).

•An individual is not a member of taxpayer's household if at any time during the taxable year the relationship between the individual and the taxpayer is in violation of local law. § 152(f)(3).

•*Gross Income*: The gross income of a "qualifying relative" may not be equal to or more than the exemption amount. § 152(d)(1)(B).

- •The gross income of a permanently and totally disabled individual does not include income attributable to services rendered at a charitable institution that provides special instruction or training designed to alleviate the disability, § 152(d)(4)(B), and the individual's principal reason for his/her presence there is the availability of medical care and the income arises only from activities at the institution incident to such medical care, § 152(d)(4)(A). § 152(d)(4).

•*Support*: Taxpayer must provide over one-half of the individual's support for the calendar year. § 152(d)(1)(C).

- •An alimony payment that the recipient includes in his/her gross income is not counted as payment for support of a dependent. § 152(d)(5).
- •*Multiple Support Agreements*: If there is no taxpayer who contributed over one-half of an individual's support, § 152(d)(3)(A),
    - •a taxpayer for whom the individual would otherwise have been a "qualifying individual," § 152(d)(3)(B), and
    - •who contributed more than 10% of the individual's support, § 152(d)(3)(C),
    - •may claim the individual as a dependent provided that all others who contributed more than 10% of the individual's support file a declaration that they will not claim the individual as a dependent, § 152(d)(3)(D).
- •The rules governing treatment of an individual whose parents are divorced that govern the individual's abode apply as well to determinations between the parents with respect to support. § 152(e)(1).

•*Status*: A "qualifying relative" may not be a "qualifying child" of the taxpayer or of any other taxpayer. § 152(d)(1)(D).

Do the CALI Lesson *Basic Federal Income Taxation: Taxable Income and Tax Computation: Personal and Dependency Exemptions*

- The exemption amount for 2008 was $3500
- Tip: Question 11 is set in 2008; there is no longer a phase-out of dependency deductions.

D. Intra-Family Transactions

In various sections, the Tax Code creates presumptions that the members of a family share a common interest and addresses that presumption.[166]

- We may choose to ignore every tax aspect of a transaction between family members. In many respects, § 1041 (discussed *infra*) has this effect.
- We may curtail the tax advantages of transactions where close relationships could lead to abuse.
- Read §§ 267(a)(1), 267(b)(1), 267(c)(2), 267(c)(4), 267(d).[167]

Consider:

1. Taxpayer owned Greenacre. Taxpayer's adjusted basis in Greenacre was $25,000. Taxpayer sold Greenacre to his grandson for $15,000, its fmv.

- How much loss may Taxpayer deduct under § 165(a and c(2))? *See* §§ 267(a)(1), 267(b)(1), 267(c)(4).
- What is grandson's basis in Greenacre? *See* § 1012.
- Now suppose that Grandson sold Greenacre to Clive for –
  - $10,000. How much loss could Grandson deduct?
  - $20,000. How much gain (loss?) must Grandson report? *See* § 267(d).

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[166] We defer discussion of some of these presumptions to more advanced courses. *See* § 318.

[167] These selected parts of § 267 apply to transactions between family members. Be aware that the scope of § 267 is broader than merely transactions involving family members. We defer discussion of these other transactions to later tax courses.

•$30,000. How much gain must Grandson report? *See* § 267(d).

•Have we seen this pattern of gain and loss recognition before?

•Would your answers be different if Taxpayer had sold Greenacre to his uncle? – grandmother? – nephew? – the daughter of his step-mother?

•Would your answers be different if Taxpayer had sold Greenacre to his wife? *See* § 1041.

IV. After Marriage: Tax Consequences of Divorce

Divorce renders husband and wife separate taxpayers with interests that should (at some point) no longer be presumed to be the same. Various rights and obligations may ensue, and their origins might be –

- •ownership of property,
- •a legal duty, or
- •an agreement.

How should the source of a right or obligation affect its tax treatment?

We might suppose that the event of divorce should vest (or re-vest) each ex-spouse with property rights that can be bought and sold – with all of the tax consequences that should naturally flow from such transactions.

•*Should* the event of divorce cause us to treat rights that can only exist between a husband and a wife as property that can be bought and sold in commercial transactions? How should we value such rights?[168]

United States v. Davis, 370 U.S. 65 (1962)

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[168] Farid-es-Sultaneh examined some of these same questions in the pre-marriage context.

MR. JUSTICE CLARK delivered the opinion of the Court.

These cases involve the tax consequences of a transfer of appreciated property by Thomas Crawley Davis [footnote omitted] to his former wife pursuant to a property settlement agreement executed prior to divorce ... The Court of Claims upset the Commissioner's determination that there was taxable gain on the transfer ... We granted certiorari on a conflict in the Courts of Appeals and the Court of Claims on the taxability of such transfers.[169] We have decided that the taxpayer did have a taxable gain on the transfer ...

In 1954, the taxpayer and his then wife made a voluntary property settlement and separation agreement calling for support payments to the wife and minor child in addition to the transfer of certain personal property to the wife. Under Delaware law, all the property transferred was that of the taxpayer, subject to certain statutory marital rights of the wife including a right of intestate succession and a right upon divorce to a share of the husband's property. [footnote omitted] Specifically, as a "division in settlement of their property," the taxpayer agreed to transfer to his wife, *inter alia*, 1000 shares of stock in the E. I. du Pont de Nemours & Co. The then Mrs. Davis agreed to accept this division

> "in full settlement and satisfaction of any and all claims and rights against the husband whatsoever (including but not by way of limitation, dower and all rights under the laws of testacy and intestacy). ..."

Pursuant to the above agreement, which had been incorporated into the divorce decree, one-half of this stock was delivered in the tax year involved, 1955, and the balance thereafter. Davis' cost basis for the 1955 transfer was $74,775.37, and the fair market value of the 500 shares there transferred was $82,250. ...

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[169] The holding in the instant case is in accord with Commissioner v. Marshman, 279 F.2d 27 (CA6 1960), but is contra to the holdings in Commissioner v. Halliwell, 131 F.2d 642 (CA2 1942), and Commissioner v. Mesta, 123 F.2d 986 (CA3 1941).

I

The determination of the income tax consequences of the stock transfer described above is basically a two-step analysis: (1) was the transaction a taxable event? (2) if so, how much taxable gain resulted therefrom? ...

II

We now turn to the threshold question of whether the transfer in issue was an appropriate occasion for taxing the accretion to the stock. There can be no doubt that Congress, as evidenced by its inclusive definition of income subject to taxation, i.e., "all income from whatever source derived, including ... [g]ains derived from dealings in property," [footnote omitted] intended that the economic growth of this stock be taxed. The problem confronting us is simply when is such accretion to be taxed. Should the economic gain be presently assessed against taxpayer, or should this assessment await a subsequent transfer of the property by the wife? The controlling statutory language, which provides that gains from dealings in property are to be taxed upon "sale or other disposition," [footnote omitted] is too general to include or exclude conclusively the transaction presently in issue. Recognizing this, the Government and the taxpayer argue by analogy with transactions more easily classified as within or without the ambient of taxable events. The taxpayer asserts that the present disposition is comparable to a nontaxable division of property between two co-owners [footnote omitted], while the Government contends it more resembles a taxable transfer of property in exchange for the release of an independent legal obligation. Neither disputes the validity of the other's starting point.

In support of his analogy, the taxpayer argues that to draw a distinction between a wife's interest in the property of her husband in a common law jurisdiction such as Delaware and the property interest of a wife in a typical community property jurisdiction would commit a double sin; for such differentiation would depend upon "elusive and subtle casuistries which ... possess no relevance for tax purposes," *Helvering v. Hallock*, 309 U.S. 106, 309 U.S. 118 (1940), and would create disparities between common law and community property jurisdictions in contradiction to

Congress' general policy of equality between the two. The taxpayer's analogy, however, stumbles on its own premise, for the inchoate rights granted a wife in her husband's property by the Delaware law do not even remotely reach the dignity of co-ownership. The wife has no interest – passive or active – over the management or disposition of her husband's personal property. Her rights are not descendable, and she must survive him to share in his intestate estate. Upon dissolution of the marriage, she shares in the property only to such extent as the court deems "reasonable." 13 Del. Code Ann. § 1531(a). What is "reasonable" might be ascertained independently of the extent of the husband's property by such criteria as the wife's financial condition, her needs in relation to her accustomed station in life, her age and health, the number of children and their ages, and the earning capacity of the husband. [citation omitted].

This is not to say it would be completely illogical to consider the shearing off of the wife's rights in her husband's property as a division of that property, but we believe the contrary to be the more reasonable construction. Regardless of the tags, Delaware seems only to place a burden on the husband's property, rather than to make the wife a part owner thereof. In the present context, the rights of succession and reasonable share do not differ significantly from the husband's obligations of support and alimony. They all partake more of a personal liability of the husband than a property interest of the wife. The effectuation of these marital rights may ultimately result in the ownership of some of the husband's property as it did here, but certainly this happenstance does not equate the transaction with a division of property by co-owners. Although admittedly such a view may permit different tax treatment among the several States, this Court in the past has not ignored the differing effects on the federal taxing scheme of substantive differences between community property and common law systems. *E.g.*, *Poe v. Seaborn*, 282 U.S. 101 (1930). To be sure, Congress has seen fit to alleviate this disparity in many areas, e.g., Revenue Act of 1948, 62 Stat. 110, but in other areas the facts of life are still with us.

Our interpretation of the general statutory language is fortified by the longstanding administrative practice as sounded and formalized by the settled state of law in the lower courts. The Commissioner's position was adopted in the early 40's by the Second and Third Circuits, and, by 1947, the Tax Court had acquiesced in this view. This settled rule was not disturbed by the Court of Appeals for the Sixth Circuit in 1960 or the Court of Claims in the instant case, for these latter courts, in holding the gain indeterminable, assumed that the transaction was otherwise a taxable event. Such unanimity of views in support of a position representing a reasonable construction of an ambiguous statute will not lightly be put aside. It is quite possible that this notorious construction was relied upon by numerous taxpayers, as well as the Congress itself, which not only refrained from making any changes in the statutory language during more than a score of years, but reenacted this same language in 1954.

III

Having determined that the transaction was a taxable event, we now turn to the point on which the Court of Claims balked, *viz*., the measurement of the taxable gain realized by the taxpayer. The Code defines the taxable gain from the sale or disposition of property as being the "excess of the amount realized therefrom over the adjusted basis. ..." I.R.C. § 1001(a). The "amount realized" is further defined as "the sum of any money received plus the fair market value of the property (other than money) received." I.R.C. § 1001(b). In the instant case, the "property received" was the release of the wife's inchoate marital rights. The Court of Claims, following the Court of Appeals for the Sixth Circuit, found that there was no way to compute the fair market value of these marital rights, and that it was thus impossible to determine the taxable gain realized by the taxpayer. We believe this conclusion was erroneous.

It must be assumed, we think, that the parties acted at arm's length, and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. Absent a readily ascertainable value, it is accepted practice where property is exchanged to hold, as did the Court of Claims in *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 189 (1954), that the values "of the two properties exchanged in an arms-length transaction are either equal in fact or are presumed to be equal." *Accord*, *United States v. General Shoe Corp*., 282 F.2d 9 (CA6 1960); *International Freighting Corp. v.*

Commissioner, 135 F.2d 310 (CA 1943). To be sure, there is much to be said of the argument that such an assumption is weakened by the emotion, tension, and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. [citation omitted].

Moreover, if the transaction is to be considered a taxable event as to the husband, the Court of Claims' position leaves up in the air the wife's basis for the property received. In the context of a taxable transfer by the husband, [footnote omitted] all indicia point to a "cost" basis for this property in the hands of the wife. [footnote omitted] Yet, under the Court of Claims' position, her cost for this property, i.e., the value of the marital rights relinquished therefor, would be indeterminable, and, on subsequent disposition of the property, she might suffer inordinately over the Commissioner's assessment which she would have the burden of proving erroneous, *Commissioner v. Hansen*, 360 U.S. 446, 468 (1959). Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, i.e., the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.

Finally, it must be noted that here, as well as in relation to the question of whether the event is taxable, we draw support from the prior administrative practice and judicial approval of that practice. We therefore conclude that the Commissioner's assessment of a taxable gain based upon the value of the stock at the date of its transfer has not been shown erroneous. [footnote omitted]

IV

....

Reversed in part and affirmed in part.

Notes and questions:

1. What answer did the Court give to the question posed at the outset of this section of the text, i.e., the effect of the source of a right or obligation on its tax consequences?

2. There are some rights or interests for which there is simply no market. When a transaction entailing those rights or interests must occur, there is nowhere to look to determine the value of those rights or interests. How did the Court deal with these valuation problems?

> *Section 1041*: Does § 1041 create opportunities to save divorcing spouses income taxes? What if the tax brackets of the divorcing spouses are not going to be the same?

3. In the second-to-last paragraph of the case, how does the Court implicitly treat the exchange that *Mrs.* Davis made? What should be the basis of her "inchoate marital rights?"

4. Congress responded to *Davis*.

- •Read § 1041. The division of property between divorcing spouses is now a non-recognition event.
- •How would the result in *Davis* have been different if § 1041 were the law at the time the case was decided?
- •In what ways does § 1041 differ from § 1015?

5. The "law" imposes various duties upon persons. The source of a duty may be a relationship. For example, a parent may have a duty to provide "necessaries" for his/her minor child.

- •If a parent fails in that duty and a third person steps up and pays money to fulfill that duty, does the parent realize gross income?
- •If a family member has a duty to another that requires some payment of money to fulfill, should such payment give rise to a deduction?
  - •What answers do cases such as *Flowers*, *Hantzis*, *Smith*, and

Ochs imply?

- Consider –

Gould v. Gould, 245 U.S. 151 (1917)

MR. JUSTICE McREYNOLDS delivered the opinion of the Court.

A decree of the Supreme Court for New York County entered in 1909 forever separated the parties to this proceeding, then and now citizens of the United States, from bed and board, and further ordered that plaintiff in error pay to Katherine C. Gould during her life the sum of $3000 every month for her support and maintenance. The question presented is whether such monthly payments during the years 1913 and 1914 constituted parts of Mrs. Gould's income within the intendment of the act of Congress approved October 3, 1913, 38 Stat. 114, 166, and were subject as such to the tax prescribed therein. The court below answered in the negative, and we think it reached the proper conclusion.

....

In *Audubon v. Shufeldt*, 181 U.S. 575, 577-578, we said:

> "Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on a contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction. ... Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled than as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings. ... "

The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court's order, and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.

The judgment of the court below is

Affirmed.

Notes and questions:

1. What basis of the obligation to pay alimony does the Court recognize?

2. The holding in *Gould* was the rule until World War II. At that time, tax brackets increased so much that many men came out below $0 when they paid alimony and the income tax on the alimony. Congress acted.

3. Read § 61(a)(8), § 71, § 215, and § 62(a)(10).
   - Does it not seem – at least implicitly – that the source of a duty to pay alimony is no longer law or morals but rather agreement (or quasi-agreement)?

A. Alimony and Property Settlement

A property settlement divides marital property – assets as well as debts. Presumably, the spouses purchased assets with after-tax dollars and so its allocation to one spouse or the other should *not* be the occasion for another layer of income tax.
   - What role does § 1041 play in a property settlement?
   - Does the rule of § 1041 suggest how parties might agree to divide property in which there is unrealized loss? – unrealized gain?

Alimony is an allowance that one party pays the other for maintenance and support. The Code treats alimony as income to the recipient and deductible to the payor. It is income that only one ex-spouse receives and so pays income tax on, the marital union having been dissolved. When the tax brackets of the parties are different, there is an opportunity to "enlarge the pie." If the pie is larger, then each can have a bigger slice.

Consider: H's tax bracket is (going to be) 35%. W's tax bracket is (going to be 10%). W wants to receive $100 that is not subject to tax.

- •To satisfy W's wishes, how much before-tax income will this cost H?
- •If W is willing to pay the income tax on some amount so long as she is left with $100, what is the minimum amount she could accept?
- •What is the range within which the parties should settle, assuming that H can deduct whatever payment he makes, and W must include that amount in her gross income?

You should see that characterization of transfers between divorcing spouses presents an opportunity to "enlarge the pie" at the expense of the Treasury. Divorcing spouses may agree between themselves to require payments that they label "alimony" that in fact more accurately represent a division of marital property. And of course, the ex-spouse who makes a payment may simply wish to claim a deduction – irrespective of the source of his/her obligation to make the payment. For these reasons, Congress enacted § 71 to set the parameters of what is and what is not "alimony."

Section 71(b) sets forth the elements of "alimony." They are –

- •a payment in cash
- •received by or on behalf of a spouse under a divorce or separation instrument
- •that does not designate a payment as not includible in the gross income of the recipient and not allowable as a deduction for the payor.
- •An individual legally separated from his spouse under a decree of divorce or separate maintenance cannot together with his spouse be members of the same household at the time of making a payment.
- •There can be no liability to make any payment (or a substitute for payment) after the death of the payee spouse.

If any one of these elements is not present, a payment is not "alimony." The tone of § 71(b) seems strict, but in fact the parties have considerable discretion to label a payment "alimony" or not. The third condition enables them to designate in the divorce or separation instrument whether a payment is alimony.

Excess front-loading is a characteristic of what parties may label as alimony that is in fact a property settlement. It refers to the phenomenon of an obligor undertaking to meet most of a property settlement obligation over a very few years. Alimony does not have the characteristic of terminating after only a few years.

- Performance of obligations under a property settlement would usually occur relatively quickly after the divorce.
- An alimony obligation, on the other hand, may last a long time.
- If a divorce or separation agreement requires very high payments for a short period followed by greatly reduced payments, it is likely that the parties are trying to make a property settlement appear to be alimony.
    - The phrase for this phenomenon is "excess front-loading of alimony payments."

The Code adopts a mechanical[170] approach to identifying whether payments are alimony or property settlements. § 71(f). The Code takes a "wait-and-see" approach, allowing the parties to characterize payments as "alimony" for three tax years and requiring "recapture" only if "excess front-loading" actually occurred.

Section 71(f)(1)(A) states that if there are excess alimony payments, the payor spouse must include such excess in the third post-separation year and the payee spouse may deduct such excess from his/her adjusted gross income. § 71(f)(1). Section 71(f)(2) defines "excess alimony payments" to be "excess payments" for the first post-separation year plus "excess payments" for the second post-separation year.

- The first post-separation years" means the first calendar year in which the payor spouse actually paid to the payee spouse alimony or separate maintenance payments. § 71(f)(6). The second and third post-separation years are the first and second succeeding years. *Id.*
- Computation of the excess payments for the first post-separation

[170] This is not synonymous with "simple."

year requires that taxpayer know what the excess payment is for the second post-separation year. *See* § 71(f)(3).

• *Excess alimony payments for the second post-separation year*: Excess alimony payments for the second post-separation year are (§ 71(f)(4)) –

> (alimony or separate maintenance paid during 2nd post-separation year) MINUS [(alimony or separate maintenance paid during 3rd post-separation year) + $15,000]

• *Excess alimony payments for the first post-separation year*: Excess alimony payments for the first post-separation year are (§ 71(f)(3)) –

> (alimony or separate maintenance payments paid during 1st post-separation year) MINUS [(alimony or separate maintenance paid during 2nd post-separation year) MINUS (excess payment for 2nd post-separation year) PLUS (alimony or separate maintenance paid during 3rd post-separation year)/2 + $15,000]

• There are no "excess alimony payments" if either spouse dies before the close of the third post-separation year or if the payee spouse remarries before the close of the third post-separation year and the payments cease by reason of such death or remarriage. § 71(f)(5)(A).

• The term "alimony" for purposes of these calculations does not include any payment to the extent it is made pursuant to a continuing liability over not less than three years to pay a fixed portion of income from a business, property, or compensation (whether as employee or as self-employer). § 71(f)(5)(C).

• Payments made pursuant a decree requiring payments for support or maintenance, but not pursuant to a decree of divorce or separate maintenance or incident to such a decree, are not "alimony or separate maintenance" for purposes of these calculations. § 71(f)(5)(B) (referencing § 71(b)(2)(C)).

Section 71(f) focuses on how precipitously alimony or separate maintenance payments decline from the first post-separation year to the second post-separation year and from the second post-separation year to the third post-separation year. Some other matters to notice or consider:

- •Excess front-loading only occurs with respect to alimony payments that the payor actually makes, not those that s/he may owe.
- •The definition of first "post-separation years" is the first calendar year "in which the payor spouse paid to the payee spouse[.]" § 71(f)(6). If payment obligations are monthly and the payor spouse makes the first payment late in the year, the first year payment may in fact be quite small.
- •The numbers work out so that if the decrease from the first to second post-separation years is $7500 or less and the decrease from the second post-separation to the third post-separation years is $15,000 or less, there is no excess front-loading problem.
- •There will always be an excess front-loading problem if the decrease from the second to the third post-separation year is more than $15,000.
- •For every $1 difference between the first and second post-separation years in excess of $7500, the difference between the second and third post-separation year must be reduced by $2 to avoid an excess front loading recapture income/deduction problem.

Do the CALI Lesson *Basic Federal Income Taxation: Gross Income: Alimony and Alimony Recapture*

B. Child Support

Child support represents the fulfillment of a parental obligation. Both parents have this obligation. Fulfillment of this obligation does not create any right to a deduction, but only to a dependent deduction of the exemption amount. The same is true after dissolution of the marriage. The Code has some special rules for allocation of the dependent deduction in its definitions of "qualifying child" and "qualifying relative," *supra*. Furthermore, receipt of child support payments is not gross income to the payee. *See* § 71(c)(1).

Taxpayer may try to exploit the treatment of alimony and so characterize child support payments as alimony. The Code has some rules for identifying a portion of payments the parties may label as alimony that are in fact child support. § 71(c)(2) (carryout ¶). A characteristic of child support is that its amount should decrease (or disappear) on certain occasions in the *child's* life, notably attaining a certain age. Thus –

- if the divorce instrument specifies that payments will be decreased on the happening of a contingency relating to the child (e.g., attaining a certain age, marrying, dying, leaving school (as well as leaving the spouse's household or gaining employment, Reg. § 1.71-1T(c) (Q&A 17)), then the amount of the decrease will be treated as child support. § 71(c)(2)(A).
- if the divorce instrument specifies that payments will be decreased at a time "which can clearly be associated with a contingency" of the sort just noted, then the amount of the decrease will be treated as child support. § 71(c)(2)(B).
    - Reg. § 1.72-1T(c) (Q&A 18) creates presumptions about whether a reduction occurs "at a time which can clearly be associated with the happening of a contingency relating to a child of the payor[.]" Rebuttal of either presumption may occur "by showing that the time at which the payments are to be reduced was determined independently of any contingencies relating to the children of the payor." For example, a presumption may be rebutted "by showing that alimony payments are to be made for a period customarily provided in the local jurisdiction, such as a period equal to one-half the duration of the marriage."
        - Payments that are to be reduced not more than six months before or after attaining the age of 18, 21, or the local age of majority are presumptively "clearly associated with the happening of a contingency relating to a child of the payor."
            - This presumption is conclusively rebutted by

showing that the "reduction is a complete cessation of alimony or separate maintenance payments during the sixth post-separation year ... or upon the expiration of a 72-month period." *Id.*

- Payments that are to be reduced on two or more occasions which occur not more than one year before or after a different child of payor spouse attains an age between 18 and 24 are presumptively "clearly associated with the happening of a contingency relating to a child of the payor."

When reading the following case and revenue ruling, consider whether you feel the issues are resolved correctly – and why.

Faber v. Commissioner, 264 F.2d 127 (3rd Cir. 1959)

BIGGS, Chief Judge.

This case comes before us on a petition to review a decision of the Tax Court, 1958, 29 T.C. 1095. The issue presented is: Is the taxpayer, Faber, entitled to deduct under § 23(u) [now §§ 215/62(a)(10)] , Internal Revenue Code of 1939, a portion of an annual $5,000 payment, made to his divorced wife, Ada, namely $2,700, designated in the separation agreement incorporated in the divorce decree for the support of his divorced wife's son?

The taxpayer and his wife, Ada, were divorced in 1952. The former Ada Faber had been previously married and had a son by this former marriage, William Black, who adopted his stepfather's surname but was never legally adopted by his stepfather. The taxpayer and his wife entered into a separation agreement which was made part of the final decree of divorce. The agreement provided in pertinent part:

> 'The Husband covenants and agrees to pay to the Wife in settlement of her property rights and the obligation of the Husband

> for her future care, support and maintenance, and for the care of the Wife's child, William, the sum of Fifty-five thousand dollars ($55,000), payable Five thousand dollars ($5,000) annually, beginning the first day of January, 1952, to and including the first day of July, 1962, or for a period of eleven years. * * * ...
>
> 'Said payment or payments are to be allocated Two thousand three hundred dollars ($2,300) annually for the Wife, and Two thousand seven hundred dollars $(2,700) annually for the support and care of his Wife's son, William.
>
> 'In the event that the Wife or her son die before all payments have been made, then the allocated part of the payment, as above set forth, shall cease, and the future payments reduced, and the estate of the one so dying shall have no claim against the Husband for future 'payments'.' [footnote omitted].

The taxpayer paid Ada $5,000 in 1952. He deducted the $5,000 as an alimony payment in his individual tax return for that calendar year. The Commissioner allowed $2,300 but disallowed the remaining $2,700 as a deduction on the ground that this amount represented 'payment for care, support and maintenance of William Faber, under § 23(u) of the Internal Revenue Act of 1939.'

The pertinent statutory provisions of the Internal Revenue Code of 1939 are set out in the footnote.[171]

Whether the taxpayer may deduct, under § 23(u), the amount of any payment to his wife depends on whether the payment is properly includible in the wife's income under § 22(k) [now § 61(a)(8)]. *Eisinger v. C.I.R.*, 9 Cir., 1957, 250 F.2d 303, *cert. denied*, 1958, 356 U.S. 913.

The taxpayer contends that the second sentence of § 22(k) is exclusionary in effect and meaning and that William Faber is not within the classification of 'minor child.' We agree. William was a stepchild of the taxpayer and was not the taxpayer's child.[172] But it does not follow, as the taxpayer contends, relying on our decision in *Feinberg v. C.I.R.*, 3 Cir., 1952, 198 F.2d 260, that since the exception contained in the second sentence of § 22(k) does not apply, the full amount of $5,000 automatically must be included in the wife's income and hence must be deducted from the husband's. The *Feinberg* decision does not support the taxpayer's view for if the whole payment is to be considered as income to the wife the requirements of the first sentence of § 22(k) must be satisfied

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[171] '§ 22. Gross income * * * (k) Alimony, etc., Income. In the case of a wife who is divorced or legally separated from her husband under a decree of divorce or of separate maintenance, periodic payments (whether or not made at regular intervals) received subsequent to such decree in discharge of, or attributable to property transferred (in trust or otherwise) in discharge of, a legal obligation which, because of the marital or family relationship, is imposed upon or incurred by such husband under such decree or under a written instrument incident to such divorce or separation shall be includible in the gross income of such wife, and such amounts received as are attributable to property so transferred shall not be includible in the gross income of such husband. This subsection shall not apply to that part of any such periodic payment which the terms of the decree or written instrument fix, in terms of an amount of money or a portion of the payment, as a sum which is payable for the support of minor children of such husband * * *'§ 23. Deductions from gross income. In computing net income there shall be allowed as deductions: * * * (u) Alimony, etc., payments. In the case of a husband described in § 22(k), amounts includible under § 22(k) in the gross income of his wife, payment of which is made within the husband's taxable year. ...

[172] The Commissioner urges upon the court the argument that the taxpayer stood in loco parentis to William after as well as before the divorce and separation, and that, therefore, the payments in question for William's support were fixed 'for the support of minor children of such husband. * * *' This argument is without merit. One has no continuing obligation to support a stepchild to whom he stands in loco parentis. 67 C.J.S. *Parent and Child* 1950, § 80; Schneider v. Schneider, Ch., 1947, 25 N.J.Misc. 180, 52 A.2d 564.

independently. The *Feinberg* decision does not hold that those requirements do not have to be met. The second sentence of § 22(k) deals only with one specific type of payment which is not includible in the wife's income.

It remains to be determined whether under the first sentence of 22(k) the entire $5,000 should constitute income to Ada Faber. The Tax Court has concluded that 'the amounts paid to William were purely voluntary on the part of the petitioner so far as this record shows, and therefore not within the intendment of Subsection 22(k).' With this conclusion we cannot agree.

Suppose that in this case it was clear that Ada had the legal obligation to support William[173] and the agreement had recited that the amount for William's care was for and in Ada's behalf. It would then be apparent that $2,700 would have been includible in Ada's income and deductible from the taxpayer's. *Robert Lehman*, 1951, 17 T.C. 652.[174] Here, a recital to such effect is missing but the mere absence of the appropriate language from the agreement does not resolve the issue and it becomes pertinent to inquire whether the payment of the $2,700 was made for and in behalf of Ada. Relevant to this inquiry is the answer to the question whether Ada acquired an economic benefit of such nature that the payment may be said to be for and in her behalf. In *Mandel v. C.I.R.*, 7 Cir., 1956, 229 F.2d 382, the taxpayer-husband agreed to pay his wife $18,000 a year, the separation agreement further providing that should she remarry, the payment would be reduced to $833.33 per month, $10,000 a year, and that if a child, there being two children of the marriage, should marry, or on reaching 21 live apart from the wife, the husband could elect to pay directly to the child $416.66 per month, $5,000 per year.

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[173] We may assume for the moment that Ada had such a legal obligation. Hippodrome Building Co. v. Irving Trust Co., 2 Cir., 1937, 91 F.2d 753.

[174] *See also* Treasury Regulations § 118, 39.22(k)-1(d): 'Except in cases of a designated amount or portion for the support of the husband's minor children, periodic payments described in § 22(k) received by the wife for herself and any other person or persons are includible in whole in the wife's income, whether or not the amount or portion for such other person or persons is designated.'

Before the tax years in question, Mandel's wife remarried, and the two children of Mandel had married and were living apart from their mother, the wife. Mandel paid to his former wife amounts as specified in the separation agreement which she in turn paid to the two children. The court did not allow the taxpayer to deduct the amounts so paid, since the amounts were not income to the wife. The court stressed the point that, by the terms of the agreement and under the circumstances, the wife had received no economic or personal benefit from the payments made to her after her remarriage and the emancipation of the two children. 'No legal obligation to support the children after they arrived at their majority was imposed upon Edna.' 229 F.2d at 387. In the case at bar the existence of a legal obligation of the wife to support her son has been assumed by us to be present. [footnote omitted] Under this assumption aid in the satisfaction of Ada's obligation by the payments of the separation agreement was for her benefit and hence was 'for and in behalf of' Ada. *Lehman*, *supra*, 17 T.C. at 653. That the payment also benefits another person, William, does not remove it from the ambiency of § 22(k). This payment was made in discharge of a legal obligation, which because of the 'marital or family relationship,' was incurred by the taxpayer. *Lehman*, *supra*. *Cf*. Treasury Regulations 118, 39.22(k)-1(a)(5). Accordingly, under this assumption, the entire $5,000 would be includible in Ada's income.

....

Merely because Ada's obligation, if it exists, may be limited to the providing of necessaries for William, it does not follow that only the amount required for necessaries is to be includible in her income. The provisions of § 22(k) do not limit includible alimony payments to the wife to necessaries and we cannot say that payments to another person on her behalf should be so limited. While Ada may not be legally responsible for more than necessaries, it may still be to her economic advantage to have funds supplied which exceed the legally required amount. We cannot say that the payment is so large that it becomes unrelated to the economic advantage which is Ada's by virtue of the payment of $2,700 made for William.

....[175]

Accordingly, the decision of the Tax Court will be vacated and the case remanded in order to determine whether Ada had, in the Tax year in question, an obligation to support her son William. If it be found to be a fact that Ada had such an obligation, the Tax Court should enter its decision in favor of the taxpayer. If it be found that Ada had no such obligation the Tax Court should again enter its decision in favor of the Commissioner. Section 2106, Title 28 U.S.C. *See also* § 7482, Title 26 U.S.C.

Notes and questions"

1. A parent has some obligation to support his/her minor children. If someone else fulfills that obligation, it seems that the parent has realized gross income. When that "someone" is a former spouse, the former spouse may treat it as alimony – provided all of the other elements of alimony are present.

2. What were the distinguishing facts in *Mandel* that made the result in that case different?

3. Change the facts of *Faber*: instead of a person with no parental obligation *making* payments, it is a person *with* a parental obligation who *fails* to make payments (an all-too-frequent occurrence). It is the former spouse who must make up the difference.

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[175] The Tax Court states: 'The only significant factual difference which distinguishes Leon Mandel, *supra*, (23 T.C. 81, *aff'd* (7 Cir., 1956, 229 F.2d 382) from the instant case is the designation of the ultimate payee. The substantive distinction is that whereas in the instant case petitioner's former wife, Ada, owed a legal obligation to support her minor son, William, in the Mandel case the husband's former wife owed no obligation to support her adult children. This distinction was pointed out by the Court of Appeals in the Mandel case as follows: 'No legal obligation to support the children after they arrived at their majority was imposed upon *** (the wife). The payments in controversy made to her thereafter were for and on their behalf and represented no economic or financial gain or benefit to her. We conclude that they were not includible in her gross income under 22(k). ***''

Rev. Rul. 93-27

ISSUE

Is a taxpayer entitled to a nonbusiness bad debt deduction under § 166(a)(1) of the Code for the amount of the taxpayer's own payment in support of the taxpayer's children caused by an arrearage in court-ordered child support payments owed by a former spouse?

FACTS

The taxpayer, A, was divorced in 1989 from B and was granted custody of their two minor children. Pursuant to a property settlement and support agreement that was incorporated into the divorce decree, B agreed to pay to A $500 per month for child support. During 1991, B failed to pay $5,000 of this obligation. Because of B's arrearage, A had to spend $5,000 of A's own funds in support of A's children.

LAW AND ANALYSIS

Section 166(a)(1) of the Code allows as a deduction any debt that becomes worthless within the taxable year.

Section 166(b) of the Code provides that for purposes of § 166(a), the amount of the deduction for any worthless debt is the adjusted basis provided in § 1011 for determining the loss from the sale or other disposition of property.

Section 1011 of the Code generally provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, is the basis as determined under § 1012.

Section 1012 of the Code provides that the basis of property is the cost of the property.

In *Swenson v. Commissioner*, 43 T.C. 897 (1965), the taxpayer claimed a bad debt deduction under § 166(a)(1) of the Code for an uncollectible arrearage in child support payments from a former spouse. The Tax Court denied the deduction on the ground that § 166(b) precluded any deduction because the taxpayer had no basis in the debt created by the child support obligation. The taxpayer had argued that her basis consisted of the expenditures for child support she was forced to make from her own funds as a result of the father's failure to make his required payments. The court pointed out, however, that the father's obligation to make the payments had been imposed by the divorce court and was not contingent on the taxpayer's support expenditures. It stated that those expenditures neither created the arrearage nor constituted its cost to the taxpayer. *Swenson*, at 899.

The Tax Court has followed the decision in *Swenson* on similar facts in *Perry v. Commissioner*, 92 T.C. 470 (1989); *Meyer v. Commissioner*, T.C.M. 1984-487; Pierson v. Commissioner, T.C.M. 1984-452; and *Diez-Arguellos v. Commissioner*, T.C.M. 1984-356.

In the present case, as in those above, B's obligation to make the child support payments to A was imposed directly by the court. A's own child support expenditures did not create or affect B's obligation to A under the divorce decree. Accordingly, A did not have any basis in B's obligation to pay child support, and A may not claim a bad debt deduction under § 166(a)(1) of the Code with regard to an arrearage in those payments.

....

HOLDING

A taxpayer is not entitled to a bad debt deduction under § 166(a)(1) of the Code for the amount of the taxpayer's own payment in support of the taxpayer's children caused by an arrearage in court-ordered child support payments owed by a former spouse.

Notes and questions:

1. A problem for "A" is that she wants a deduction but no other taxpayer realizes an equal amount of gross income.

- If the Commissioner determined that B should include $5000 in his gross income, should a court uphold the Commissioner's position?

2. Aside from the technical requirements of § 71(f), is there any way that "A" could argue that she has paid "B" alimony by paying to support his children? If so, could the parties draft a sufficiently limited decree ("contingent alimony?") that called for such treatment in the event he does not pay?

3. Could taxpayer or the Commissioner invoke the principles of § 7872(a)(1) and hypothesize a transfer from B to A and a retransfer from A to B?

- The transfer from B to A would be non-deductible child support.
- The retransfer from A to B would be a payment of alimony, deductible to A and taxable income to B.

Wrap-Up Questions for Chapter 8

1. The basis of *Davis* was that taxpayer's wife's interest partook "more of a personal liability of the husband than a property interest of the wife." Hence, taxpayer merely fulfilled his obligation by giving up appreciated property – a recognition event. Was Congress right to reverse the holding?

2. Mr. Davis would have benefited from § 1041. Exactly how does § 1041 affect Mrs. Davis's basis in her inchoate marital rights?

3. Dissolution of marriage is a matter of state law. Often, the Code yields to state law in such matters as status, property ownership, and legal duties. Why should the Code (so forcefully) intervene in determining whether payments between ex-spouses are alimony, child support, or property settlement?

4. Can you argue that the holding of Revenue Ruling 93-27 is incorrect?

5. What should happen if H and W jointly own all of the stock of a corporation that owns a McDonald's franchise. They divorce. McDonald's does not allow divorced spouses to own jointly a franchise. As part of their property settlement, H and W agree that the *corporation* will redeem W's stock. For this, W must pay tax on the gain. In reaching this agreement, the parties carefully considered its tax consequences. Specifically, a large chunk of cash would go to W, and she would pay income tax on capital gains rate – much lower than on ordinary income – on a very substantial amount of capital gain. W decides not to pay the tax on the gain and to argue in court that the corporation, a third party, was paying the property settlement obligation of H. Hence, *he* should be subject to income tax on dividend income. What result? *See Arnes v. United States*, 981 F.2d 456 (9th Cir. 1992) and *Commissioner v. Arnes*, 102 T.C. 522 (1994).

Chapter 9: Timing of Income and Deductions: Annual Accounting and Accounting Principles

I. Annual Accounting

The Tax Formula:

➔(gross income)≥
MINUS § 62 deductions
EQUALS (adjusted gross income (AGI))
➔MINUS (standard deduction or itemized deductions)≥
MINUS (personal exemptions)
EQUALS (taxable income)

Compute income tax liability from tables in § 1 (indexed for inflation)
MINUS (credits against tax)

After *Glenshaw Glass* (chapter 2, *supra*), we know that one element of "gross income" that taxpayer must recognize is that the taxpayer must have dominion and control of it. After *Cottage Savings & Loan* (chapter 2, *supra*), we are aware that a realization requirement applies to deductions as well as to income. Taxpayer's "dominion and control" will occur at a particular point in time. It is not always obvious what that point in time is. Consider some possible problematic scenarios:

- Taxpayer has "dominion and control" over money that clearly would count as "gross income" but in a subsequent year learns that s/he must give the money back.
- Taxpayer has "dominion and control" over money but knows that s/he *might* have to return it if certain contingencies occur. For example, taxpayer has been paid money but the judgment on which his/her receipt of money was based has been appealed.

Claim of Right doctrine: Taxpayer must include in his/her gross income an item when s/he has a "claim of right" to it. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932), the Supreme Court stated the doctrine thus:
If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Taxpayer might lose the appeal and have to return the money. In the meantime, taxpayer may spend the money anyway s/he chooses.

•Taxpayer has entered into a contract that calls for various acts of performance to occur over more than one year, perhaps many years. The taxpayer pays expenses in some years and receives payments in some years. However, in any given year, there is no matching of expenditures and receipts by *transaction.* In some years, expenses are very high; in other years receipts are very high. When taxpayer does receive money, s/he may spend it any s/he chooses.

The Internal Revenue Code requires taxpayers to compute their taxable income annually. *See* § 441. This can prove to be quite inconvenient for a taxpayer – and even a bit misleading if we apply this principle to the third scenario above, i.e., where taxpayer enters into a contract calling for performance over a long period of time. Should there be any principle by which we can mitigate the failure to match the expenses and income derived from a particular *transaction*?

Burnet v. Sanford & Brooks, 282 U.S. 369 (1931)

MR. JUSTICE STONE delivered the opinion of the Court.

In this case, certiorari was granted, 281 U.S. 707, to review a judgment of the court of appeals for the Fourth Circuit, reversing an order of the Board of Tax Appeals, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

From 1913 to 1915, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the payments received by $176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915, work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of warranty of the character of the material to be dredged. Judgment for the claimant was affirmed by this Court in 1920. *United States v. Atlantic Dredging Co.*, 253 U.S. 1. It held that the recovery was upon the contract, and was "compensatory of the cost of the work, of which the government got the benefit." From the total recovery, petitioner received in that year the sum of $192,577.59, which included the $176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to $16,305.71. Respondent having failed to include these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

The court of appeals ruled that only the item of interest was properly included, holding, erroneously, as the government contends, that the item of $176,271.88 was a return of losses suffered by respondent in earlier years, and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years. Respondent insists that, as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent's contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, *see Eisner v. Macomber*, 252 U.S. 189; *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179, the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under ... the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. ... [G]ross income

> "includes ... income derived from ... business ... or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under § 212(b). *See United States v. Anderson*, 269 U.S. 422; *Aluminum Castings Co. v. Rotzahn*, 282 U.S. 92.

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent's business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. *See Doyle v. Mitchell Brothers Co.*, *supra*, 247 U.S. at 185.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer's return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of § 213(a) and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent's net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

....

But respondent insists that, if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss, but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. [citations omitted]. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been, in actual operation, within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer's being required to pay a tax on income in one period exceeded by net losses in another.

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. One was by returns on the accrual basis ..., which provides that a taxpayer keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect its income, may, subject to regulations of the Commissioner, make its return upon the basis upon which its books are kept. *See United States v. Anderson*, and *Aluminum Castings Co. v. Routzahn*, *supra*. The other was under Treasury Regulations (Article 121 of Reg. 33 of Jan. 2, 1918 ... providing that, in reporting the income derived from certain long-term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed or report in each year the percentage of the estimated profit corresponding to the percentage of the total estimated expenditures which was made in that year.

... [R]espondent [does not] assert, that it ever filed returns in compliance either with these regulations ... or otherwise attempted to avail itself of their provisions; nor, on this record, do any facts appear tending to support the burden, resting on the taxpayer, of establishing that the Commissioner erred in failing to apply them. *See Niles Bement Pond Co. v.*

United States, 281 U.S. 357, 361.

The assessment was properly made under the statutes. Relief from their alleged burdensome operation, which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

Notes and questions:

1. Taxpayer was a dredger. It was hired by the government to do some dredging of a channel in the Delaware River. The Government represented that its probes of the river bottom had shown that the material to be removed was mainly mud and fine sand, but it did not guarantee the accuracy of its findings and indicated that bidders should perform their own tests. In fact, the Government probes had also revealed the presence of "impenetrable" materials. This is what caused taxpayer to cease work on the contract and to sue in the Court of Claims.

- In the absence of tax rules, parties would presumably enter into the most efficient contract possible insofar as matters of payments and performance are concerned.
- Do you think that the holding in this case would affect the terms of future contracts that may require more than one year to perform?
- What exactly was taxpayer's contention?

2. The Court held out the possibility that taxpayer might keep accounts on the accrual basis or on a percentage-of-completion basis in the case of long-term contracts. What do you think these methods are? Would one or the other of these methods have been better for taxpayer? Why?

3. The Code of course now has one more mechanism by which a transaction in one year may offset a transaction in another: the net operating loss (§ 172). Taxpayers may use losses up to two years back and twenty years forward to offset income. *See* chapter 6, *supra*.

4. Interesting questions involving the impact of annual accounting on

particular taxpayers arise when tax rates change. Tax rates often change because of war – they increase because of the war and decrease after the war.

United States v. Lewis, 340 U.S. 590 (1951)

MR. JUSTICE BLACK delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: in his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment, he returned approximately $11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts, the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. *See* G.C.M. 16730, XV-1 CUM. BULL. 179 (1936). The Court of Claims, however, relying on its own case, *Greenwald v. United States*, 57 F. Supp. 569, held that the excess bonus received "under a mistake of fact" was not income in 1944, and ordered a refund based on a recalculation of that year's tax. We granted certiorari because this holding conflicted with many decisions of the courts of appeals, *see, e.g.*, *Haberkorn v. United States*, 173 F.2d 587, and with principles announced in *North American Oil Consolidated v. Burnet*, 286 U.S. 417.

In the *North American Oil* case, we said:

> "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is

> required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent."

286 U.S. at 424. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim. ...

Income taxes must be paid on income received (or accrued) during an annual accounting period. *Cf.* I.R.C. §§ 41, 42, and *see Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. *See* cases collected in 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 12.103. We see no reason why the Court should depart from this well settled interpretation merely because it results in an advantage or disadvantage to a taxpayer. [footnote omitted]

Reversed.

MR. JUSTICE DOUGLAS, dissenting.

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been, because the taxpayer claimed it as of right. Some years later, however, it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due, but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.

Notes and questions:

1. Marginal tax brackets decreased after the end of WWII. Hence,

taxpayer's deduction in 1946 did not save as much in income tax as the same amount of income in 1944 cost him.

2. Congress has enacted § 1341 to mitigate the effect of the *Lewis* rule. When § 1341 applies, taxpayer is required to pay a tax in the year of repayment that is the lesser of

- tax liability computed in that year with the repayment treated as a deduction, or
- tax liability computed by applying a credit equal in amount to the increase in tax liability caused by payment of income tax in the year of inclusion in gross income.

Notice that § 1341 does *not* reopen taxpayer's tax return from the earlier tax year, thereby maintaining the integrity of the principle of annual accounting.

4. Read § 1341. Note carefully the conditions of its applicability.

CALI Lessons

5. Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Claim of Right Doctrine*.

6. Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Claim of Right Mitigation Doctrine*.

7. We might consider *Lewis* to be a case of "income first/deduction later." What if we reverse that: "deduction first/income later?"

Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Ct. Cl. 1967)

COLLINS, Judge.

Plaintiff ... brings this action to recover an alleged overpayment in its 1957 income tax. During that year, there was returned to taxpayer two parcels of realty, each of which it had previously donated and claimed as a charitable contribution deduction. The first donation had been made in

1939; the second, in 1940. Under the then applicable corporate tax rates, the deductions claimed ($4,243.49 for 1939 and $4,463.44 for 1940) yielded plaintiff an aggregate tax benefit of $1,877.49.[176]

Each conveyance had been made subject to the condition that the property be used either for a religious or for an educational purpose. In 1957, the donee decided not to use the gifts; they were therefore reconveyed to plaintiff. Upon audit of taxpayer's income tax return, it was found that the recovered property was not reflected in its 1957 gross income. The Commissioner of Internal Revenue disagreed with plaintiff's characterization of the recovery as a nontaxable return of capital. He viewed the transaction as giving rise to taxable income and therefore adjusted plaintiff's income by adding to it $8,706.93 – the total of the charitable contribution deductions previously claimed and allowed. This addition to income, taxed at the 1957 corporate tax rate of 52%, resulted in a deficiency assessment of $4,527.60. After payment of the deficiency, plaintiff filed a claim for the refund of $2,650.11, asserting this amount as overpayment on the theory that a correct assessment could demand no more than the return of the tax benefit originally enjoyed, i.e., $1,877.49. The claim was disallowed.

This court has had prior occasion to consider the question which the present suit presents. In *Perry v. United States*, 160 F. Supp. 270 (1958) (Judges Madden and Laramore dissenting), it was recognized that a return to the donor of a prior charitable contribution gave rise to income to the extent of the deduction previously allowed. The court's point of division – which is likewise the division between the instant parties – was whether the "gain" attributable to the recovery was to be taxed at the rate applicable at the time the deduction was first claimed or whether the proper rate was that in effect at the time of recovery. The majority, concluding that the Government should be entitled to recoup no more than that which it lost, held that the tax liability arising upon the return of a charitable gift should equal the tax benefit experienced at time of donation. Taxpayer urges that the *Perry* rationale dictates that a like result be reached in this case.

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[176] The tax rate in 1939 was 18 percent; in 1940, 24 percent.

The Government, of course, assumes the opposite stance. Mindful of the homage due the principle of stare decisis, it bids us first to consider the criteria under which judicial reexamination of an earlier decision is justifiable. [The court considered standards upon which it was appropriate to reexamine a rule announced in an earlier decision ... and decided not to defer to its holding in *Perry*.] ...

....

A transaction which returns to a taxpayer his own property cannot be considered as giving rise to "income" – at least where that term is confined to its traditional sense of "gain derived from capital, from labor, or from both combined." *Eisner v. Macomber*, 252 U.S. 189, 207 (1920). Yet the principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. *Rothensies v. Electric Storage Battery Co.*, 329 U.S. 296 (1946); *Estate of Block v. Commissioner*, 39 B.T.A. 338 (1939), *aff'd sub nom*. *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), *cert. denied*, 311 U.S. 658 (1940). The only limitation upon that principle is the so-called "tax-benefit rule." This rule permits exclusion of the recovered item from income so long as its initial use as a deduction did not provide a tax saving. *California & Hawaiian Sugar Ref. Corp. v. United States*, *supra*; *Central Loan & Inv. Co. v. Commissioner*, 39 B.T.A. 981 (1939). But where full tax use of a deduction was made and a tax saving thereby obtained, then the extent of saving is considered immaterial. The recovery is viewed as income to the full extent of the deduction previously allowed.[177]

Formerly the exclusive province of judge-made law, the tax-benefit concept now finds expression both in statute and administrative regulations. Section 111 of the Internal Revenue Code of 1954 [prior to

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[177] The rationale which supports the principle, as well as its limitation, is that the property, having once served to offset taxable income (i.e., as a tax deduction) should be treated, upon its recoupment, as the recovery of that which had been previously deducted. *See* Plumb, *The Tax Benefit Rule Today*, 57 HARV. L. REV. 129, 131 n. 10 (1943).

later amendment] accords tax-benefit treatment [only] to the recovery of bad debts, prior taxes, and delinquency amounts. [footnote omitted] Treasury regulations have "broadened" the rule of exclusion by extending similar treatment to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years ***" [footnote omitted] [except for depreciation recapture.]

Drawing our attention to the broad language of this regulation, the Government insists that the present recovery ... should be taxed in a manner consistent with the treatment provided for like items of recovery, i.e., that it be taxed at the rate prevailing in the year of recovery. We are compelled to agree.

....

... [The tax-benefit rule] is clearly adequate to embrace a recovered charitable contribution. *See California & Hawaiian Sugar Ref. Corp.*, *supra*, 311 F.2d at 239. But the regulation does not specify which tax rate is to be applied to the recouped deduction, and this consideration brings us to the matter here in issue.

Ever since *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured. "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." 282 U.S. at 365. To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates. And absent specific statutory authority sanctioning a departure from this principle, it may only be said of *Perry* that it achieved a result which was more equitably just than legally correct.[178]

Since taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income. We therefore sustain the Government's position and grant its motion for summary judgment. *Perry v. United States*, *supra*, is hereby overruled, and plaintiff's petition is dismissed.

Notes and questions:

1. Congress has not taken up Judge Collins's invitation, stated in the last footnote of the case, to enact the principle of *Perry* – as it did in the reverse situation through § 1341.

2. Read § 111.

3. Consider: In 2010, taxpayer's total itemized deductions were $12,000. A portion of the itemized deductions was for his contribution of a parcel of land to his church, fmv = $7000, "so long as used for church purposes." Taxpayer filed single. The standard deduction in 2010 for single persons was $6000. In 2013, the church decided not to use the land for church purposes and returned it to taxpayer.

- How much income must taxpayer include in his 2013 tax return?

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[178] This opinion represents the views of the majority and complies with existing law and decisions. However, in the writer's personal opinion, it produces a harsh and inequitable result. Perhaps, it exemplifies a situation "where the letter of the law killeth; the spirit giveth life." The tax-benefit concept is an equitable doctrine which should be carried to an equitable conclusion. Since it is the declared public policy to encourage contributions to charitable and educational organizations, a donor, whose gift to such organizations is returned, should not be required to refund to the Government a greater amount than the tax benefit received when the deduction was made for the gift. Such a rule would avoid a penalty to the taxpayer and an unjust enrichment to the Government. However, the court cannot legislate and any change in the existing law rests within the wisdom and discretion of the Congress.

3a. Same as #3, but the fmv of the land in 2010 was only $4000?

•How much income must taxpayer include in his 2013 tax return?

3b. Same as #3, but the fmv of the land was $3000 and taxpayer's total itemized deductions were otherwise $5000.

•How much income must taxpayer include in his 2013 tax return?

II. Deferral Mechanisms

A. Realization

We have already observed that the realization requirement of gross income gives taxpayer some discretion to defer recognition of income – and in *Cottage Savings & Loan*, to accelerate the recognition of losses.

CALI Lessons

•You may wish to do again the CALI Lesson *Basic Federal Income Taxation: Gross Income: Realization Concepts in Gross Income.*

B. Installment Method and Other Pro-rating of Basis

There are occasions when taxpayer has an accession to wealth, but does not receive any cash with which to pay the income tax due on the gain. Perhaps a purchaser did not have cash to make the purchase and could not procure a bank loan. Taxpayer agrees to permit the purchaser to make installment payments over the course of several years plus interest on the declining balance (§ 163(b)). Section 453 requires taxpayer to defer recognition of "income"[179] until receipt of installment payments. § 453(a). Taxpayer may elect out of the installment method of reporting income. § 453(d)(1).

[179] The installment method does not apply to recognition of losses.

- The installment method applies to an "installment sale." An "installment sale" is one where at least one payment is to be received after the close of the taxable year of disposition of the property. § 453(b)(1).
    - However, the installment method does *not* apply to a "dealer disposition" or to sales of "inventory." § 453(b)(2).
    - Moreover, the installment method does *not* apply to property dispositions where the seller will have the wherewithal to pay the income tax due on gain.
        - Section 453 does not apply to a disposition of personal property under a revolving credit plan. § 453(k)(1).
        - Section 453 does not apply to a disposition of stock or securities traded on an established securities market. § 453(k)(2)(A). Such property is so liquid that it is its own source of cash.
- The "installment" method is a "method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profits (realized or to be realized when payment is completed) bears to the total contract price." § 453(c).
    - Multiply every payment received by this ratio:

        (AR − AB)/(Contract Price)

    where AR is the amount taxpayer will eventually realize upon fulfillment of the contract.
        - Include the product in gross income in the year of payment of the installment.

    - There are some important definitions in the regulations. *See* Reg. § 15A.453-1(b).
        - The "contract price" is the total selling price
            - reduced by the debt that the buyer assumes
            - *which does not exceed the seller's basis in the property*. Reg. § 15A.453-1(b)(2)(iii). Hence, if the debt exceeds the seller's basis, the contract price is reduced by the seller's basis, not the

amount of the debt. AND: the amount by which the debt exceeds basis is treated as a payment. Reg. § 15A.453-3(i) (11th sentence).

•You can see that the effect of the installment method is to pro-rate the recovery of basis according to the portion of the amount realized of the total selling price.

•Section 453B(a) provides that the disposition of an installment obligation is a recognition event to the one who disposed of it. That person would determine his/her basis in the obligation disposed of and subtract that amount from the amount s/he realizes to determine gain or loss.

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Timing: Fundamentals of Installment Sales*

•Do not worry about question 19 on wrap-around mortgages.

The installment method of § 453 enables a taxpayer to defer recognition of gain until s/he has the wherewithal to pay the tax. However, when taxpayer enters into transactions with related persons with a view towards avoiding income tax, the Code denies the benefits of the installment method.

•Consider: Father (a high bracket taxpayer) sells daughter (a low bracket taxpayer) Blackacre. Father's basis in Blackacre is $20,000. The selling price is $100,000. Daughter is to make annual payments of $10,000 plus interest on the declining balance. Daughter makes no payments and one week later, sells Blackacre to a third party for $100,000 cash.

•Notice: daughter has no gain/loss to recognize. She also has $100,000 cash in hand with which to fulfill her obligation to pay father $10,000 per year for the next nine years.

•Father has essentially sold Blackacre at a substantial gain. A person related to him holds the cash from the sale. Father may spread recognition of gain over the ensuing ten years.

Section 453(e) addresses so-called "second dispositions by related persons."

- •Section 453(e)(1) requires taxpayer to treat the amount realized in the "second disposition" (i.e., sale by daughter in the example) as received by the person making the "first disposition" (i.e., father in the example).
  - •Thus in our example, father would be treated as realizing $100,000 upon daughter's sale of Blackacre.

- •This rule applies only to a disposition made within two years after the first disposition. § 453(e)(2). However, the running of this two-year period is suspended in the event the risk of loss to the transferee is substantially diminished – as defined.

- •A person is "related" if he or she bears a relationship to the transferor described in either § 318(a) or § 267(b). § 453(f)(1).

- •Section 453(e)(3) limits the amount realized by the transferor making the first disposition to

  the lesser of the amount realized in the second disposition, or the total contract price for the first disposition

  MINUS

  the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received under § 453(e).

- •Installment payments received after the second disposition are not treated as payments with respect to the first disposition to the extent that such payments are less than the amount treated as received on the second disposition. Further payments are treated as payments with respect to the first disposition. § 453(e)(5).
  - •Example: Same facts as above. Daughter sells Blackacre in year 1 for $80,000. Father is treated as realizing $80,000. Daughter makes payments under the installment contract. The first eight payments are not treated as payments with

respect to the first disposition. Father will pay no income tax for receiving these payments. The last two payments will produce taxable income for father as before.

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Timing Installment Sales: Second Dispositions by Related Parties and Contingent Payments*

- Do not worry about questions 8-16 on contingent payments.

A note on annuities: § 72:

The installment method is a method by which taxpayer recovers basis over time on a pro-rated basis. Annuity income is not the result of any deferral mechanism, but the Code employs the same principle of permitting an annuitant to pro-rate recovery of basis over time. For that reason, we take up the income taxation of annuity income in summary fashion here.

A taxpayer may invest after-tax dollars in an annuity contract. As with life insurance contracts, the inside buildup of an annuity contract is not subject to income tax. At a certain point in time, the taxpayer begins to receive a stream of payments from the investment and the income that the annuity has accumulated. [You should see immediately that taxpayer will be receiving some of his/her own after-tax money and some not-yet-taxed investment income.] There may be a fixed number of payments or the stream of payments may terminate only on the death of the taxpayer. Section 72 allocates a portion of each payment to taxpayer's recovery of basis and a portion to not-yet-taxed inside buildup.

- Section 72(c)(1) defines taxpayer's "investment in the contract."
- Section 72(c)(4) defines "annuity starting date" as "the first day of the first period for which an amount is received as an annuity under the contract[.]"
- Section 72(a)(1) provides that taxpayer must include in gross income "any amount received as an annuity[.]"
- Section 72(b)(1) excepts from "amounts received as an annuity" a pro-rated amount of taxpayer's basis in the contract. This requires

a determination of taxpayer's "expected return under the contract."
•If the "expected return" depends on the life expectancy of one or more individuals, taxpayer determines the "expected return" in accordance with actuarial tables that the Secretary of the Treasury has prescribed. These tables are in the regulations, *see* Reg. § 1.72-9.

•Simply multiply the number of payments taxpayer can expect based on these actuarial tables by the amount of each payment. This product is the "expected return."

•Divide the taxpayer's investment in the contract by the "expected return." Taxpayer multiplies this product by "any amount received as an annuity" to determine the amount that s/he excludes from gross income.

If taxpayer outlives what the actuaries predicted …: Once taxpayer has excluded his/her investment in the annuity contract from his/her gross income, taxpayer may no longer exclude any "amount received as an annuity" from his/her gross income. § 72(b)(2).

If taxpayer dies before the actuaries predicted s/he would …: On the other hand, should payments cease because taxpayer died prior to recovery of taxpayer's investment in the contract, taxpayer may deduct the amount of the unrecovered investment for his/her last taxable year. § 72(b)(3)(A).

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Annuities and Life Insurance Proceeds*. You may have to read some portions of the Code to answer all of the questions. That would be a good thing. However, do not worry about the consequences of a *tax-deferred* corporate reorganization.

C. Deferral Until Consumption

An "income tax" is a tax on income. A "consumption tax" is a tax on consumption. We have largely regarded the Code as one creating an income tax. In fact the Code creates a hybrid whereby income that a taxpayer spends on certain specific items of consumption is not subject to income tax – if at all – until taxpayer in fact spends it on those forms of consumption. Consider two examples:

Individual Retirement Accounts: Sections 219/62(a)(7) permit taxpayer to deduct above-the-line up to $5000, § 219(b)(5)(A), indexed for inflation, § 219(b)(5)(D), for payments to an individual retirement account. Income on the account is not currently subject to income tax. § 408(e)(1). The payee or distributee must include in his/her gross income payments from the account in the manner provided under § 72 (annuities). § 408(d)(1). Section 72(t)(1) generally imposes a 10% penalty tax – in addition to the income tax due – on an early distribution from an IRA. A distribution is not early if it occurs on or after taxpayer attains the age of 59½, §§ 72(t)(2)(A)(i), 72(t)(5); distributions *must* begin no later than April 1 of the calendar year after taxpayer turns 70½, § 408(a)(6) (incorporating rules of § 401(a)(9)(C)(i)). Thus, deducted amounts that a taxpayer saves in a "traditional"[180] individual retirement account plus returns on the investment *are* subject to tax – but at a time when taxpayer will be spending it on consumption in retirement.

Health Savings Accounts: Sections 223/62(a)(19) permit taxpayer to deduct above-the-line amounts contributed to a "health savings account." A condition of this deduction is that taxpayer must purchase a "high-deductible health plan, § 223(c)(1)(A), a phrase that the Code defines, § 223(c)(2). Taxpayer may deduct contributions to such accounts – subject to limitations, § 223(c)(b)(2). Taxpayer may use funds in the account exclusively to pay "qualified medical expenses,"[181] § 223(d)(1). The account is exempt from income tax, so long as it remains a "health savings account." §§ 223(e)(1), 223(f)(1). A "health savings account" acquired by a surviving spouse continues to be a "health savings account." The health savings account provisions of the Code permit taxpayers not to pay any income tax on expenditures for consumption of certain medical services on the condition that taxpayers purchase high-deductible health plans.

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[180] ... as opposed to a Roth IRA.

[181] ... defined in § 223(d)(2)(A).

Congress may use the tool of providing special income tax treatment – whether deferral or exemption – of the income that taxpayer saves for certain forms of consumption to encourage taxpayers to save current income for such future consumption.

III. Basic Accounting Rules

Taxpayer must account for his/her income annually. Here we consider *how* taxpayer accounts for it. Section 446(a) provides that: "Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books." There are some caveats to this facially permissive statement.

Section 446(b) establishes the standard that taxpayer's method of accounting must "clearly reflect income." Section 446(c) establishes "permissible methods" of accounting. We will consider only two of them: "cash receipts and disbursements method" and "accrual method." The regulations define these phrases. Reg. § 1.446-1(c)(1)(i and ii) provide in part:

> (i) *Cash receipts and disbursements method.* – Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually made. …
>
> (ii) *Accrual method.* – (A) Generally, under an accrual method, income is to be included for the

Rule of Thumb (and no more than that):
Cash method: follow the money. Income is not income unless taxpayer has received money, property, or services. When taxpayer has received money, property, or services, it *is* income – even if taxpayer may not yet have actually "earned" it. The same is true of deductions. Taxpayer is not entitled to a deduction unless he/she has actually paid the deductible expense.
Accrual method: follow the obligation. Taxpayer must recognize income when he/she is *entitled* to receive it – even if taxpayer has not actually received payment. Similarly, taxpayer is entitled to a deduction when he/she is obligated to pay an expense – even if taxpayer has not actually paid the expense. Section 461(h) also requires that "economic performance" occur before taxpayer may claim a deduction.

taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken in to account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. ...

In the next subsections of the text, we consider a few of the principles that these accounting methods incorporate.

Section 446(d) provides that a "taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business." However –

- A C corporation or a partnership with a C corporation partner whose average gross receipts for the last 3-taxable year period exceeds $5M may not use the cash receipts and disbursements method of accounting. §§ 448(a)(1 and 2), 448(b)(3), 448(c)(1).
- A tax shelter may not use the cash receipts and disbursements method of accounting. § 448(a)(3).
- A taxpayer who uses an inventory must use the accrual method "with regard to purchases and sales[.]" Reg. § 1.446-1(c)(2)(ii).

A. Cash Method

The virtue of the cash method is that it is easy. It does not always present an accurate picture of the taxpayer's economic well-being. It can also be highly manipulable. If a taxpayer wants to increase his/her deductions, taxpayer simply prepays deductible expenses – perhaps years in advance.

- Section 461(g) addresses prepayment of interest.
- Don't forget that § 263 (capitalization) covers intangibles that will help to produce income past the end of the current tax year. *See* Reg. § 1.263(a)-4(c)(1) (list of intangibles – includes insurance contract and lease).

If a taxpayer does not want to pay income tax on income, all taxpayer must do is defer its receipt. Various rules address these points.

1. Cash Equivalent

A check is considered to be the equivalent of cash. So is a credit card charge. Hence receipt of the check or credit card charge constitutes income to the taxpayer. On the payment side, payment by check is made when taxpayer delivers it in the manner that taxpayer normally does, e.g., by mail. Payment by credit card is made when the charge is incurred.

In an important case, the United States Court of Appeals for the Fifth Circuit considered whether a promissory note or contract right is a "cash equivalent" and said:

> A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a solvent obligor is unconditional and assignable, not subject to set-offs, and is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

Cowden v. Commissioner, 249 F.2d 20, 24 (5th Cir. 1961). A "promissory note" is treated as "property" and so its receipt is income to the extent of its fmv. What are the factors that make receipt of a promissory note "gross income?"

On the other hand, giving a promissory note is *not* the equivalent of payment, and so a promissory note does not entitle the maker to a deduction, even if the recipient of the note must include the fmv of the note in his/her gross income. *See Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579 (1977). "The promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets. A check, on the other hand, is a direction to the bank for immediate payment, is a medium of exchange, and has come to be treated for federal tax purposes as a conditional payment of cash." *Id.* at 582-83.

2. Constructive Receipt

Reg. § 1.451-2(a) provides in part:

> **Constructive receipts of income.** – (a) *General rule*. – Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. ...

Consider:
Taxpayer Paul Hornung played in the NFL championship game on December 31, 1961. The game was in Green Bay, Wisconsin and ended at 4:30 p.m. The editors of Sport Magazine named him the most valuable player of the game and informed him of this fact. Taxpayer would be given a Corvette automobile, but the editors had neither title nor keys to the automobile at that time. They would present them to taxpayer at a luncheon in New York City on January 3, 1962. Sport Magazine could have presented Mr. Hornung with keys and title on December 31, 1961 – but the automobile was actually in New York.

- Did taxpayer constructively receive the automobile in 1961? *See Hornung v. Commissioner*, 47 T.C. 428 (1967) (*acq.*).

Taxpayer is a prisoner. The Champion Transportation Services Inc. Profit

Sharing and 401(k) Plan mailed a cashier's check for $25,000 to his personal residence in 1997. A "house-sitter" lived at the residence during the taxpayer's period of incarceration. Taxpayer had access to a telephone. Taxpayer was released in 1998 and cashed the check at that time.

•Did taxpayer constructively receive $25,000 in 1997? *See Roberts v. Commissioner*, T.C. Memo. 2002-281, 2002 WL 31618544.

3. Economic Benefit

A cash method taxpayer must include in his/her gross income the value of an "economic benefit."

> Under the economic-benefit theory, an individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor's debtors.

Pulsifer v. Commissioner, 64 T.C. 245, 246 (1975) (taxpayer realized economic benefit even though winners of Irish Sweepstakes unable to claim prize held in Bank of Ireland until they reached age of 21 or legal representative applied for the funds).

Rev. Rul. 60-31

SECTION 451. – GENERAL RULE FOR TAXABLE YEAR OF INCLUSION, 26 CFR 1.451-1: General rule for taxable year of inclusion

Discussion of the application of the doctrine of constructive receipt to certain deferred compensation arrangements.

Advice has been requested regarding the taxable year of inclusion in gross income of a taxpayer, using the cash receipts and disbursements method of accounting, of compensation for services received under the circumstances described below.

(1) On January 1, 1958, the taxpayer and corporation X executed an employment contract under which the taxpayer is to be employed by the corporation in an executive capacity for a period of five years. Under the contract, the taxpayer is entitled to a stated annual salary and to additional compensation of 10x dollars for each year. The additional compensation will be credited to a bookkeeping reserve account and will be deferred, accumulated, and paid in annual installments equal to one-fifth of the amount in the reserve as of the close of the year immediately preceding the year of first payment. The payments are to begin only upon (a) termination of the taxpayer's employment by the corporation; (b) the taxpayer's becoming a part-time employee of the corporation; or (c) the taxpayer's becoming partially or totally incapacitated. Under the terms of the agreement, corporation X is under a merely contractual obligation to make the payments when due, and the parties did not intend that the amounts in the reserve be held by the corporation in trust for the taxpayer.

The contract further provides that if the taxpayer should fail or refuse to perform his duties, the corporation will be relieved of any obligation to make further credits to the reserve (but not of the obligation to distribute amounts previously contributed); but, if the taxpayer should become incapacitated from performing his duties, then credits to the reserve will continue for one year from the date of the incapacity, but not beyond the expiration of the five-year term of the contract. There is no specific provision in the contract for forfeiture by the taxpayer of his right to distribution from the reserve; and, in the event he should die prior to his receipt in full of the balance in the account, the remaining balance is distributable to his personal representative at the rate of one-fifth per year for five years, beginning three months after his death.

(2) ...

....

(3) On October 1, 1957, the taxpayer, an author, and corporation Y, a

publisher, executed an agreement under which the taxpayer granted to the publisher the exclusive right to print, publish and sell a book he had written. This agreement provides that the publisher will (1) pay the author specified royalties based on the actual cash received from the sale of the published work, (2) render semiannual statements of the sales, and (3) at the time of rendering each statement make settlement for the amount due. On the same day, another agreement was signed by the same parties, mutually agreeing that, in consideration of, and notwithstanding any contrary provisions contained in the first contract, the publisher shall not pay the taxpayer more than 100x dollars in any one calendar year. Under this supplemental contract, sums in excess of 100x dollars accruing in any one calendar year are to be carried over by the publisher into succeeding accounting periods; and the publisher shall not be required either to pay interest to the taxpayer on any such excess sums or to segregate any such sums in any manner.

(4) In June 1957, the taxpayer, a football player, entered into a two-year standard player's contract with a football club in which he agreed to play football and engage in activities related to football during the two-year term only for the club. In addition to a specified salary for the two-year term, it was mutually agreed that as an inducement for signing the contract the taxpayer would be paid a bonus of 150x dollars. The taxpayer could have demanded and received payment of this bonus at the time of signing the contract, but at his suggestion there was added to the standard contract form a paragraph providing substantially as follows:

> The player shall receive the sum of 150x dollars upon signing of this contract, contingent upon the payment of this 150x dollars to an escrow agent designated by him. The escrow agreement shall be subject to approval by the legal representatives of the player, the Club, and the escrow agent.

Pursuant to this added provision, an escrow agreement was executed on June 25, 1957, in which the club agreed to pay 150x dollars on that date to the Y bank, as escrow and the escrow agent agreed to pay this amount, plus interest, to the taxpayer in installments over a period of five years. The escrow agreement also provides that the account established by the escrow agent is to bear the taxpayer's name; that payments from such account may be made only in accordance with the terms of the agreement; that the agreement is binding upon the parties thereto and their successors or assigns; and that in the event of the taxpayer's death during the escrow period the balance due will become part of his estate.

(5) The taxpayer, a boxer, entered into an agreement with a boxing club to fight a particular opponent at a specified time and place. The place of the fight agreed to was decided upon because of the insistence of the taxpayer that it be held there. The agreement was on the standard form of contract required by the state athletic commission and provided, in part, that for his performance taxpayer was to receive 16x% of the gross receipts derived from the match. Simultaneously, the same parties executed a separate agreement providing for payment of the taxpayer's share of the receipts from the match as follows: 25% thereof not later than two weeks after the bout, and 25% thereof during each of the three years following the year of the bout in equal semiannual installments. Such deferments are not customary in prize fighting contracts, and the supplemental agreement was executed at the demand of the taxpayer. ...

....

As previously stated, the individual concerned in each of the situations described above, employs the cash receipts and disbursements method of accounting. Under that method, ... he is required to include the compensation concerned in gross income only for the taxable year in which it is actually or constructively received. Consequently, the question for resolution is whether in each of the situations described the income in question was constructively received in a taxable year prior to the taxable year of actual receipt.

A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method. [citations omitted]. *See Zittle v. Commissioner*, 12 B.T.A. 675, in which, holding a salary to be taxable when received, the Board said: 'Taxpayers on a receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more.'

This should not be construed to mean that under the cash receipts and disbursements method income may be taxed only when realized in cash. For, under that method a taxpayer is required to include in income that which is received in cash or cash equivalent. *Henritze v. Commissioner*, 41 B.T.A. 505. And, as stated in the above quoted provisions of the regulations, the 'receipt' contemplated by the cash method may be actual or constructive.

....

... [U]nder the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. [citation omitted]. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another. [citation omitted].

However, the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment. *See*, for example, *Amend v. Commissioner*, 13 T.C. 178, *acq*., C.B. 1950-1, and *Gullett v. Commissioner*, 31 B.T.A. 1067, in which the court, citing a number of authorities for its holding, stated:

> It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.

Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the specific factual situation involved.

Applying the foregoing criteria to the situations described above, the following conclusions have been reached:

> (1) The additional compensation to be received by the taxpayer under the employment contract concerned will be includible in his gross income only in the taxable years in which the taxpayer actually receives installment payments in cash or other property previously credited to his account. To hold otherwise would be contrary to the provisions of the regulations and the court decisions mentioned above,
>
> (2) ...

In arriving at this conclusion ..., consideration has been given to section 1.402(b)-1 of the Income Tax Regulations and to Revenue Ruling 57-37, C.B. 1957-1, 18, as modified by Revenue Ruling 57-528, C.B. 1957-2, 263. Section 1.402(b)-1(a)(1) provides in part, with an exception not here relevant, that any contribution made by an employer on behalf of an employee to a trust during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt under § 501(a) of the Code, shall be included in income of the employee for his taxable year during which the contribution is made if his interest in the contribution is nonforfeitable at the time the contribution is made. Revenue Ruling 57-37, as modified by Revenue Ruling 57-528, held, inter alia, that certain contributions conveying fully vested and nonforfeitable interests made by an employer into separate independently controlled trusts for the purpose of furnishing unemployment and other benefits to its eligible employees constituted additional compensation to the employees includible, under § 402(b) of the Code and § 1.402(b)-1(a)(1) of the regulations, in their income for the taxable year in which such contributions were made. These Revenue Rulings are distinguishable from case[] '(1)' ... in that, under all the facts and circumstances of these cases, no trusts for the benefit of the taxpayers were created and no contributions are to be made thereto. Consequently, § 402(b) of the Code and § 1.402(b)-1(a)(1) of the regulations are inapplicable.

> (3) Here the principal agreement provided that the royalties were

> payable substantially as earned, and this agreement was supplemented by a further concurrent agreement which made the royalties payable over a period of years. This supplemental agreement, however, was made before the royalties were earned; in fact, in [sic] was made on the same day as the principal agreement and the two agreements were a part of the same transaction. Thus, for all practical purposes, the arrangement from the beginning is similar to that in (1) above. Therefore, it is also held that the author concerned will be required to include the royalties in his gross income only in the taxable years in which they are actually received in cash or other property.
>
> (4) In arriving at a determination as to the includibility of the 150x dollars concerned in the gross income of the football player, under the circumstances described, in addition to the authorities cited above, consideration also has been given to ... the decision in *Sproull v. Commissioner*, 16 T.C. 244.

....

In *Sproull v. Commissioner*, 16 T.C. 244, *aff'd*, 194 Fed.(2d) 541, the petitioner's employer in 1945 transferred in trust for the petitioner the amount of $10,500. The trustee was directed to pay out of principal to the petitioner the sum of $5,250 in 1945 and the balance, including income, in 1947. In the event of the petitioner's prior death, the amounts were to be paid to his administrator, executor, or heirs. The petitioner contended that the Commissioner erred in including the sum of $10,500 in his taxable income for 1945. In this connection, the court stated:

> *** it is undoubtedly true that the amount which the Commissioner has included in petitioner's income for 1945 was used in that year for his benefit *** in setting up the trust of which petitioner, or, in the event of his death then his estate, was the sole beneficiary ***.
>
> The question then becomes *** was 'any economic or financial benefit conferred on the employee as compensation' in the taxable year. If so, it was taxable to him in that year. This question we must

> answer in the affirmative. The employer's part of the transaction terminated in 1945. It was then that the amount of the compensation was fixed at $10,500 and irrevocably paid out for petitioner's sole benefit. ***.'

Applying the principles stated in the *Sproull* decision to the facts here, it is concluded that the 150x-dollar bonus is includible in the gross income of the football player concerned in 1957, the year in which the club unconditionally paid such amount to the escrow agent.

(5) In this case, the taxpayer and the boxing club, as well as the opponent whom taxpayer had agreed to meet, are each acting in his or its own right, the proposed match is a joint venture by all of these participants, and the taxpayer is not an employee of the boxing club. The taxpayer's share of the gross receipts from the match belong to him and never belonged to the boxing club. Thus, the taxpayer acquired all of the benefits of his share of the receipts except the right of immediate physical possession; and, although the club retained physical possession, it was by virtue of an arrangement with the taxpayer who, in substance and effect, authorized the boxing club to take possession and hold for him. The receipts, therefore, were income to the taxpayer at the time they were paid to and retained by the boxing club by his agreement and, in substance, at his direction, and are includible in his gross income in the taxable year in which so paid to the club. *See* the *Sproull* case, *supra*, and *Lucas v. Earl*, 281 U.S. 111.

....

Notes and questions:

1. A "mere promise to pay" is not included in gross income. It should be apparent that at least some of the taxpayers did plan or could have planned their receipt of money in such a way as to reduce their tax liability.

- Taxpayers in cases 4 and 5 would have lost. How would you restructure the bargains that they entered?
- Does such a restructuring create other risks?

2. Read the excerpt from *Pulsifer* again carefully. Is there not considerable overlap between constructive receipt and economic benefit?

3. Recall our discussion of § 83.

B. Accrual Method

In *United States v. Anderson*, 269 U.S. 422, 441 (1926), the United States Supreme Court stated that a taxpayer using the accrual method of accounting must claim a deduction when "all the events [have occurred] which fix the amount of the [liability] and determine the liability of the taxpayer to pay it."

The regulations provide an "all events test" for deductions and another "all events test" for recognition of gross income. Not surprisingly, the regulations are stingier about permitting deductions than requiring recognition of gross income.

Deductions: Reg. § 1.461-1(a)(2) provides in part:

> Under an accrual method of accounting, a liability ... is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

Section 461(h) defines "economic performance." Its effect will be to defer recognition of deductions. Read it.

Income: Reg. § 1.451-1(a) provides in part:

> Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined

> with reasonable accuracy. ... Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. ... If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

An important condition that the Supreme Court permitted the Commissioner to incorporate into the accrual method of recognizing income is that taxpayer's receipt of *cash* in exchange for its promise to render services to members of a club who might need them at some undetermined future time gave rise to gross income upon receipt of the cash, *American Automobile Assoc. v. United States*, 367 U.S. 687 (1961), irrespective of what Generally Accepted Accounting Principles (GAAP) may prescribe. *Id.* at 693.

- *Compare* § 455 (prepaid subscription income).

The IRS has come around to the following accommodation of its position in *AAA* and that of taxpayers who, under the accrual method, may be expected to pay income tax on money that they received at a time that is (quite) different from when they are expected to earn it by performing services.

Rev. Proc. 2004-34

This procedure provides a method of accounting under which taxpayers using an accrual method of accounting may defer including all or part of certain advance payments in gross income until the year after the year the payment is received. ...

SECTION 1. PURPOSE

This revenue procedure allows taxpayers a limited deferral beyond the taxable year of receipt for certain advance payments. Qualifying taxpayers generally may defer to the next succeeding taxable year the inclusion in gross income for federal income tax purposes of advance payments (as defined in § 4 of this revenue procedure) to the extent the advance payments are not recognized in revenues (or, in certain cases, are not earned) in the taxable year of receipt. ... [T]his revenue procedure does not permit deferral to a taxable year later than the next succeeding taxable year. ...

....

SECTION 2. BACKGROUND AND CHANGES

.01 In general, § 451 of the Internal Revenue Code provides that the amount of any item of gross income is included in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, the amount is to be properly accounted for as of a different period. Section 1.451-1(a) provides that, under an accrual method of accounting, income is includible in gross income when all the events have occurred that fix the right to receive the income and the amount can be determined with reasonable accuracy. All the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever happens earliest. *See* Rev. Rul. 84-31, 1984-1 C.B. 127.

.02 Section 1.451-5 generally allows accrual method taxpayers to defer the inclusion in gross income for federal income tax purposes of advance payments for goods until the taxable year in which they are properly accruable under the taxpayer's method of accounting for federal income tax purposes if that method results in the advance payments being included in gross income no later than when the advance payments are recognized in revenues under the taxpayer's method of accounting for financial reporting purposes.

....

SECTION 3. SCOPE

This revenue procedure applies to taxpayers using or changing to an overall accrual method of accounting that receive advance payments as defined in § 4 of this revenue procedure.

SECTION 4. DEFINITIONS

The following definitions apply solely for purposes of this revenue procedure --

.01 Advance Payment. Except as provided in § 4.02 of this revenue procedure, a payment received by a taxpayer is an "advance payment" if –

> (1) including the payment in gross income for the taxable year of receipt is a permissible method of accounting for federal income tax purposes (without regard to this revenue procedure);
>
> (2) the payment is recognized by the taxpayer (in whole or in part) in revenues in its ... financial statement ... for a subsequent taxable year (or, for taxpayers without an applicable financial statement ..., the payment is earned by the taxpayer (in whole or in part) in a subsequent taxable year); and
>
> (3) the payment is for –
>
>> (a) services;
>>
>> (b) the sale of goods (other than for the sale of goods for which the taxpayer uses a method of deferral provided in § 1.451-5(b)(1)(ii));
>>
>> ....
>>
>> (f) guaranty or warranty contracts ...;

....

(h) memberships in an organization (other than memberships for which an election under § 456 is in effect);
...
....

....

SECTION 5. PERMISSIBLE METHODS OF ACCOUNTING FOR ADVANCE PAYMENTS

.01 Full Inclusion Method. A taxpayer within the scope of this revenue procedure that includes the full amount of advance payments in gross income for federal income tax purposes in the taxable year of receipt is using a proper method of accounting under § 1.451-1, regardless of whether the taxpayer recognizes the full amount of advance payments in revenues for that taxable year for financial reporting purposes and regardless of whether the taxpayer earns the full amount of advance payments in that taxable year.

.02 Deferral Method.
(1) In general.

(a) A taxpayer within the scope of this revenue procedure that chooses to use the Deferral Method described in this § 5.02 is using a proper method of accounting under § 1.451-1. Under the Deferral Method, for federal income tax purposes the taxpayer must –

(i) include the advance payment in gross income for the taxable year of receipt ... to the extent provided in § 5.02(3) of this revenue procedure, and

(ii) ... include the remaining amount of the advance payment in gross income for the next succeeding taxable year.

....

(3) Inclusion of advance payments in gross income.

(a) Except as provided in paragraph (b) of this § 5.02(3), a taxpayer using the Deferral Method must –

(i) include the advance payment in gross income for the taxable year of receipt ... to the extent recognized in revenues in its applicable financial statement ... for that taxable year, and

(ii) include the remaining amount of the advance payment in gross income in accordance with § 5.02(1)(a)(ii) of this revenue procedure.

....

(4) Allocable payments.

(a) General rule. A taxpayer that receives a payment that is partially attributable to an item or items described in § 4.01(3) of this revenue procedure may use the Deferral Method for the portion of the payment allocable to such item or items and, with respect to the remaining portion of the payment, may use any proper method of accounting (including the Deferral Method if the remaining portion of the advance payment is for an item or items described in § 4.01(3) of this revenue procedure with a different deferral period (based on the taxpayer's applicable financial statement or the earning of the payment, as applicable)), provided that the taxpayer's method for determining the portion of the payment allocable to such item or items is based on objective criteria.

....

.03 Examples. In each example below, the taxpayer uses an accrual method of accounting for federal income tax purposes and files its returns on a calendar year basis. ...

Example 1. On November 1, 2004, A, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2004 and another 35 lessons in 2005. In its ... financial statement, A recognizes 1⁄6 of the payment in revenues for 2004, and 5⁄6 of the payment in revenues for 2005. A uses the Deferral Method. For federal income tax purposes, A must include 1/6 of the payment in gross income for 2004, and the remaining 5⁄6 of the payment in gross income for 2005.

Example 2. Assume the same facts as in Example 1, except that the advance payment is received for a 2-year contract under which up to 96 lessons are provided. A provides eight lessons in 2004, 48 lessons in 2005, and 40 lessons in 2006. In its ... financial statement, A recognizes 1⁄12 of the payment in revenues for 2004, 6⁄12 of the payment in revenues for 2005, and 5⁄12 of the payment in gross revenues for 2006. For federal income tax purposes, A must include 1⁄12 of the payment in gross income for 2004, and the remaining 11⁄12 of the payment in gross income for 2005.

....

Example 4. On July 1, 2004, C, in the business of selling and repairing television sets, receives an advance payment for a 2-year contract under which C agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer’s television set if those parts fail to function properly. In its ... financial statement, C recognizes 1⁄4 of the payment in revenues for 2004, 1⁄2 of the payment in revenues for 2005, and 1⁄4 of the payment in revenues for 2006. C uses the Deferral Method. For federal income tax purposes, C must include 1⁄4 of the payment in gross income for 2004 and the remaining 3⁄4 of the payment in gross income for 2005.

Example 5. On December 2, 2004, D, in the business of selling and repairing television sets, sells for $200 a television set with a 90-day warranty on parts and labor (for which D, rather than the manufacturer, is the obligor). D regularly sells televisions sets without the warranty for $188. In its applicable financial statement, D allocates $188 of the sales price to the television set and $12 to the 90-day warranty, recognizes 1⁄3 of the amount allocable to the warranty ($4) in revenues for 2004, and recognizes the remaining 2⁄3 of the amount allocable to the warranty ($8) in revenues for 2005. D uses the Deferral Method. For federal income tax purposes, D must include the $4 allocable to the warranty in gross income for 2004 and the remaining $8 allocable to the warranty in gross income for 2005.

Example 6. E, in the business of photographic processing, receives advance payments for mailers and certificates that oblige E to process photographic film, prints, or other photographic materials returned in the mailer or with the certificate. E tracks each of the mailers and certificates with unique identifying numbers. On July 20, 2004, E receives payments for 2 mailers. One of the mailers is submitted and processed on September 1, 2004, and the other is submitted and processed on February 1, 2006. In its ... financial statement, E recognizes the payment for the September 1, 2004, processing in revenues for 2004 and the payment for the February 1, 2006, processing in revenues for 2006. E uses the Deferral Method. For federal income tax purposes, E must include the payment for the September 1, 2004, processing in gross income for 2004 and the payment for the February 1, 2006, processing in gross income for 2005.

....

Example 12. On December 1, 2004, I, in the business of operating a chain of “shopping club” retail stores, receives advance payments for membership fees. Upon payment of the fee, a member is allowed access for a 1-year period to I’s stores, which offer discounted merchandise and services. In its ... financial statement, I recognizes 1⁄12 of the payment in revenues for 2004 and 11⁄12 of the payment in revenues for 2005. I uses the Deferral Method. For federal income tax purposes, I must include 1⁄12 of the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 13. In 2004, J, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2005. Under the agreement, J charters a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. In its ... financial statement, J recognizes the payments in revenues for 2005. J uses the Deferral Method. For federal income tax purposes, J must include the payments in gross income for 2005.

....

Notes and questions:

1. According to the revenue procedure, when must an accrual method taxpayer include income in his/her/its gross income?

2. Why was taxpayer in Example 13 able to defer recognition of income for tax purposes, but taxpayers in the other examples were not?

> •In *Artnell v. Commissioner*, 400 F.2d 981 (7th Cir. 1968), the owner of the Chicago White Sox, an accrual method taxpayer, sold tickets in late fall of one year for games scheduled to be played the following spring and summer. [There's never been much October baseball in Chicago.] Taxpayer sought to defer recognition of this ticket income until the following year. What result?

CALI Lessons

Do the CALI Lesson, *Basic Federal Income Taxation: Timing: Cash and Accrual Methods of Accounting*

> Don't worry about question 9.
> Don't worry about question 17, 18, and 19 (points on a mortgage).

C. Inventory

A taxpayer's accounting method must clearly reflect income. § 446(b). Reg. § 1.471-1(a) provides in part:

> In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

A taxpayer who sells from inventory who uses the cash method can too easily manipulate the cost of the goods that he/she/it sells. Hence the regulations require that such taxpayers match the cost of goods sold with the actual sale of the goods. Reg. § 1.446-1(c)(2)(i) provides:

> In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized ...

Reg. § 1.61-3(a) provides in part:

> *In general*: In a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold ...

Thus, a formula for determining gross income for sales from inventory is the following:

GR MINUS **COGS** EQUALS **GI**

or

GR − COGS = GI

GR = gross revenue
COGS = cost of goods sold
GI= gross income.

The formula for determining COGS is the following:

OI PLUS **P** MINUS **CI** = **COGS**

or

OI + P − CI = COGS

OI = opening inventory
P = purchases of or additions to inventory
CI = closing inventory.

The Code presumes that taxpayer makes sales from the first of the items that he/she/it purchased and placed in inventory, i.e., "first-in-first-out" or FIFO. § 472. However, taxpayer may elect to treat sales as made from the last inventory items purchased, i.e., "last-in-first-out" of LIFO.

Simple illustration:

1. On December 31, 2011, taxpayer opened a retail store for business and spent $10,000 to acquire 2000 toolboxes at $5 each. During 2012, taxpayer paid $6000 to acquire 1000 more toolboxes at $6 each. Taxpayer sold 2500 toolboxes for $10 each.

- Taxpayer's gross revenue was $25,000, i.e., 2500 x $10.
- Taxpayer's opening inventory was $10,000. Taxpayer's purchases were $6000.
- At the end of the year, taxpayer's had 500 toolboxes in remaining in inventory.
- If we use the FIFO method, we presume that taxpayer sold the toolboxes that he/she/it already had at the beginning the year plus the ones he/she/it purchased earliest in the year. Hence taxpayer presumptively sold the 2000 toolboxes that he/she/it had on hand at the first of the year plus 500 more that he/she/it purchased.

  COGS = $10,000 + $6000 − $3,000 = $13,000

  GI = $25,000 − $13,000 = $12,000.

- The value of the opening inventory of 500 toolboxes at the beginning of the next year is $3000, i.e., 500 x $6.

2. Now suppose that taxpayer has adopted the LIFO method.

- Taxpayer's gross revenue remains $25,000.
- Taxpayer's opening inventory remains $10,000, and taxpayer's purchases remain $6000.
- At the end of the year, taxpayer still has 500 toolboxes on hand.
- Under the LIFO method, we presume that taxpayer sold the toolboxes that he/she/it purchased last in time. Thus, we presume that taxpayer sold (in order) the 1000 toolboxes that he/she/it purchased during the years plus 1500 that he/she/it had on hand at the first of the year.

  COGS = $10,000 + $6000 − $2500 = $13,500.

  GI = $25,000 − $13,500 = $11,500.

- The value of the opening inventory of 500 toolboxes at the beginning the next year is $2500.

Taxpayer's gross income was less when the price of inventory increased during the year using the LIFO method rather than the FIFO method.

Reg. § 1.471-2(c) permits a FIFO-method taxpayer to elect to value inventory at cost or market, whichever is lower.

3. Same facts as number 1, except that the fmv of toolboxes fell to $4 by the end of the year. $4 is less than $6, so taxpayer will value the toolboxes in inventory at $4 rather than $6.

- Taxpayer's closing inventory = 500 x $4 = $2000.
- Now:

  COGS = $10,000 + $6000 − $2000 = $14,000

  GI = $25,000 − $13,000 = $11,000.

If taxpayer anticipates a loss on inventory before it is sold, he/she/it might elect cost or market valuation of inventory, whichever is lower.

Wrap-Up Questions for Chapter 9:

1. Why do you think that Congress has never enacted a counterpart to § 1341 and imposed a tax rate on recovery of tax benefit items equal to the rate applicable at the time of the deduction?

2. Taxpayer has $5000 of before-tax income to save in an IRA. Taxpayer anticipates that his/her tax bracket will never change. Will taxpayer come out ahead with a Roth IRA or a traditional IRA?

3. How should Health Savings Accounts bring down the cost of medical care in a sustainable manner?

4. Consider: Congress should permit taxpayers to save money tax-free for a variety of future needs, i.e., to implement a consumption tax model for various needs. In addition to saving for retirement and future health care, Congress permits saving for future educational expenses. Can you think of other objectives that Congress should pursue through this consumption model? What criteria should govern these decisions?

5. How would you structure a retirement plan using Revenue Ruling 60-31 to defer income tax for taxpayers, yet make the payments as secure as possible?

Chapter 10: Character of Income and Computation of Tax

Recall that there are three principles that guide us through every question of income tax. *See* chapter 1. The first of these principles is that "[w]e tax income of a particular taxpayer once and only once." A good bit of our study to this point has been to identify inconsistencies or anomalies with this principle, i.e., exclusions from gross income and certain deductions. In this chapter, we refine the notion of taxing all income once by adding this caveat: not all income is taxed the same. Taxable income has a "character" that determines the tax burden to which it is subject. Under § 1(h), an individual's tax liability is actually the sum of the taxes of different rates on income of several different characters.

> *The Tax Formula*:
>
> (gross income)
> <u>MINUS deductions named in § 62</u>
> EQUALS (adjusted gross income (AGI))
> MINUS (standard deduction or
> itemized deductions)
> MINUS (personal exemptions)
> EQUALS (taxable income)
>
> ➔Compute income tax liability from tables in § 1 (indexed for inflation)≥
> MINUS (credits against tax)

We have also seen that the Code states rules whose effect is to match income and expenses over *time*. *See Idaho Power*, *Encyclopaedia Britannica*, *supra*. We now find that the Code requires taxpayers – with only quite limited exceptions – to match income, gains, losses, and expenses with respect to *character*. Taxpayers who perceive these points may try to manipulate the character of income and associated expenses, and the Code addresses these efforts. Generally, a taxpayer prefers gains to be subject to a lower rate of tax, and deductions to be taken against income subject to a higher rate of tax.

We consider here incomes of the following characters: long-term capital gain (and its variations), short-term capital gain, depreciation recapture, § 1231 gain, dividends, and passive income.

I. Capital Gain

We have already seen that § 61(a)(3) includes within the scope of "gross income" "gains derived from dealings in property." Section 1001(a) informed us that taxpayer measures such gains (and losses) by subtracting "adjusted basis" from "amount realized." Gains from the sale or exchange of "capital assets" *might* be subject to tax rates lower than those applicable to "ordinary income."

So we begin with a definition of "capital asset."

A. *"Capital Asset:" Property Held by the Taxpayer*

Read § 1221(a). Notice the structure of the definition, i.e., *all* property *except* ... Do not the first two lines of this section imply that "capital asset" is a broad concept? Is there a common theme to the exceptions – at least to some of them?

In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), taxpayer was a manufacturer of products made from corn. Its profitability was vulnerable to price increases for corn. In order to protect itself against price increases and potential shortages, taxpayer "took a long position in corn futures[[182]]" at harvest time when prices were "favorable." *Id.* at 48. If no shortage appeared when taxpayer needed corn, it would take delivery on as much corn as it needed and sell the unneeded futures. However, if there were a shortage, it would sell the futures only as it was able to purchase corn on the spot market. In this manner, taxpayer protected itself against seasonal increases in the price of corn. Taxpayer was concerned only with losses resulting from price increases, not from price decreases. It evidently purchased futures to cover (much) more than the corn it would actually need. *See id.* at 49 n.5. Hence, taxpayer sold

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[182] A "future" entitles the holder to purchase the commodity in the future for a fixed price.

corn futures at a profit or loss. Over a period when its gains far exceeded its losses, taxpayer treated these sales as sales of capital assets. This would subject its gains to tax rates lower than the tax rate on its ordinary income. At the time, the Code did not expressly exclude transactions of this nature from property constituting a capital asset. The Commissioner argued that taxpayer's transactions in corn futures were hedges that protected taxpayer from price increases of a commodity that was "'integral to its manufacturing business[.]'" *Id.* at 51. The Tax Court agreed with the Commissioner as did the United States Court of Appeals for the Second Circuit. The United States Supreme Court affirmed. The Court said:

> Admittedly, [taxpayer's] corn futures do not come within the literal language of the exclusions set out in that section. They were not stock in trade, actual inventory, property held for sale to customers or depreciable property used in a trade or business. But the capital-asset provision ... must not be so broadly applied as to defeat rather than further the purpose of Congress. [citation omitted]. Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The [Code's] preferential treatment [of capital gains] applies to transactions in property which are not the normal source of business income. It was intended 'to relieve the taxpayer from * * * excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions.' [citation omitted]. Since this section is an exception from the normal tax requirements of the Internal Revenue Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly. This is necessary to effectuate the basic congressional purpose.

Id. at 51-52. Subsequent to this case, Congress amended § 1221 by adding what is now § 1221(a)(7). A "capital asset" does not include "any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into ..."

In other cases, taxpayers successfully argued that a futures transaction that proved profitable involved a "capital asset," whereas a futures transaction that proved unprofitable was a hedge against price fluctuations in a commodity that was definitionally not a "capital asset." Losses therefore could offset ordinary income. This "head-I-win-tails-you-lose" whipsaw of the Commissioner should have ended with the holding in *Corn Products*. The Commissioner won in *Corn Products*. Should the Commissioner be happy about that? Do you think that hedge transactions of the sort described in *Corn Products* more often produce profit or loss?

- The statutory embodiment of the *Corn Products* rule creates the presumption that a hedge *is* a capital asset transaction *unless* the taxpayer identifies it as an "ordinary income transaction" at the time taxpayer enters the transaction. How does this scheme prevent the whipsaw of the Commissioner?

Corn Products is also important for its statements concerning how to construe § 1221. While the structure of § 1221 implies that "capital asset" is a broad concept, i.e., "all property except ...", the Court stated that the exceptions were to be construed broadly – thereby eroding the scope of the phrase "capital asset." Furthermore, we might surmise that a major point of *Corn Products* is that a transaction that is a "surrogate" for a "non-capital" transaction is in fact a non-capital transaction.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), taxpayer was a diversified holding company that purchased approximately 65% of the stock of a Dallas bank. The bank needed more capital and so over the course of five years, taxpayer tripled its investment in the bank without increasing its percentage interest. During that time, the financial health of the bank declined significantly. Taxpayer sold the bulk of its stock, retaining only a 14.7% interest. It claimed an ordinary loss on the sale of this stock, arguing that its ownership of the stock was for business purposes rather than investment purposes. The Commissioner argued that the loss was a capital loss. Taxpayer argued that *Corn Products* supported the position that property purchased with a business motive was not a capital asset. The Tax Court agreed with this analysis and applied it to the individual blocks of stock that taxpayer had purchased, evidently finding that the motivation for different purchases was different. The United States Court of Appeals for the Eighth Circuit reversed, finding that the bank stock was clearly a capital asset. The Supreme Court affirmed. The Court refused to define "capital asset" so as to exclude the entire class of assets purchased for a business purpose. "The broad definition of the term 'capital asset' explicitly makes irrelevant any consideration of the property's connection with the taxpayer's business ..." *Id.* at 217. The Court held that the list of exceptions to § 1221's broad definition of "capital asset" is exclusive. *Id.* at 217-18. The Court (perhaps) narrowed its approach to "capital asset" questions in *Corn Products* to a broad application of the inventory exception rather than a narrow reading of the phrase "property held by the taxpayer[.]" *Id.* at 220. The corn futures in *Corn Products* were surrogates for inventory.

- Thus, "capital asset" is indeed "all property" except for the items – broadly defined – specifically named in § 1221(a).
- Read § 1221(a)'s list of exceptions to "capital assets" again. Is (are) there a general theme(s) to these exceptions?
    - Read again the excerpt from *Corn Products*, above.
- The phrase "capital asset" certainly includes personal use property. Thus if a taxpayer sells his/her personal automobile for a gain, the gain is subject to tax as capital gain.

CALI Lessons

Do the CALI Lesson *Basic Federal Income Taxation: Property Transactions: Capital Asset Identification*

- Note: The author of this casebook disagrees with the answer to #3.

B. Other Terms Relating to Capital Gains and Losses: Long Term and Short Term Gains and Losses

Read § 1222. You will see that the Code distinguishes between sales or exchanges of capital assets held for one year or less, and sales or exchanges of capital assets held for more than one year.[183] Sections 1221(3 and 4) inform us that *every single sale or exchange of a capital asset* gives rise

[183] One year is not more than one year.

to one of the following:

- short-term capital gain (STCG);
- short-term capital loss (STCL);
- long-term capital gain (LTCG);
- long-term capital loss (LTCL).

Sections 1221(5, 6, 7, and 8) direct us to net all short-term transactions and to net all long-term transactions.

- net short-term capital gain (NSTCG) = STCG − STCL, but not less than zero;
- net short-term capital loss (NSTCL) = STCL − STCG, but not less than zero;
- net long-term capital gain (NLTCG) = LTCG − LTCL, but not less than zero;
- net long-term capital loss (NLTCL) = LTCL − LTCG, but not less than zero.

Notice the precise phrasing of §§ 1221(9, 10, and 11). The definitions of these phrases is in § 1222, but other code sections assign specific tax consequences to them. Section 1222(11) defines "net capital gain" to be

NLTCG − NSTCL

We defer for the moment the definition of "net capital loss" to the discussion of capital loss carryovers.[184]

Notice that the definitions of § 1222

Net capital gain: the point of mismatching NLTCG and NSTCL: It *might* appear that § 1222(11)'s definition of "net capital gain" requires some advantageous mismatching of income and losses with different characters. The opposite is true. We know that reductions in taxable income, whether by exclusion or deduction, "work" only as hard as taxpayer's marginal bracket to reduce his/her tax liability. We learn momentarily that a taxpayer's tax bracket on net capital gain is *always* less than his/her tax bracket on ordinary income. Since NSTCG does not figure into a taxpayer's "net capital gain," it is subject to tax at taxpayer's marginal rate on ordinary income. However, NSTCL reduces income that would otherwise be taxed at a rate lower than taxpayer's ordinary rate. Hence, such losses "work" no harder than taxpayer's marginal rate on his/her "*net capital gain*" at reducing his/her tax liability – not as hard as taxpayer's marginal rate on his/her ordinary income.

Mismatch of NSTCL and different types of LTCG: We shall momentarily see that different types of LTCG combine to make up net capital gain, and that these types are not all subject to the same tax rates to an individual taxpayer. NSTCL reduces first LTCG of the same type, e.g., collectible losses first offset collectible gains. Then in sequence, NSTCL reduces LTCG that would otherwise be subject to successively lower rates of tax, i.e., NSTCL first reduces "net capital gain" subject to a tax rate of 28%, then to a tax rate of 25%, and then to a tax rate of 15%. *See* §§ 1(h)(4)(B)(ii), 1(h)(6)(A)(ii)(I).

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184 We defer altogether the definition of "capital gain net inc

implement, at least initially, a matching principle to gains and losses. Short-term losses offset only short-term gains. Long-term losses offset only long-term gains.

Net short-term capital loss offsets net long-term capital gain. Section 1222 does not allow any other mismatching. The matching principle is very important because only the LTCG that remains after allowable offsets (LTCL and NSTCL) is subject to tax at reduced rates; other income is subject to tax at higher "ordinary income" rates.

C. Deductibility of Capital Losses and Capital Loss Carryforwards

Section 1211(b) provides that a taxpayer other than a corporation[185] may claim capital losses only to the extent of capital gains *plus* the lesser of $3000 or the excess of such losses over gains. This is one of very few places in the Code where taxpayer may mismatch what might be NLTCL against income subject to ordinary income rates, whether STCG or otherwise.

In the event taxpayer incurred losses greater than those allowed by § 1211(b), i.e., a "net capital loss, § 1222(10), taxpayer may carry them forward until he/she dies. § 1212(b). Section 1212(b) treats a capital loss-carryover as if it were one of the transactions described in §§ 1222(3 or 4) in the next succeeding year.

- The Code creates a pecking order of capital loss carryovers by requiring taxpayer – before calculating his/her capital loss carryovers – to add a (hypothetical) STCG equal to the lesser of taxpayer's § 1211(b) deduction or taxpayer's "adjusted taxable income." § 1212(b)(2)(A).[186]
- If the "net capital loss" results from NLTCL and NSTCL, the taxpayer first reduces the NSTCL by the amount of his/her §

[185] A corporation may claim losses from the sale or exchange of capital assets only to the extent of its capital gains. § 1211(a).

[186] "Adjusted taxable income" equals: (taxable income) + (§ 1211(b) deduction) + (personal exemption deductions) − ((deductions allowed) − (gross income) [but not less than $0]). § 1212(b)(2)(B).

1211(b) deduction, second reduces the NLTCL by the balance (if any) of his/her § 1211(b) deduction. Taxpayer carries forward all of the NLTCL and reduces the NSTCL by the amount deducted. § 1212(b)(2)(A).

•If NSTCL > NLTCG, taxpayer carries forward the "net capital loss" as a STCL transaction. § 1212(b)(1)(A) and § 1212(b)(2)(A).

•If NLTCL > NSTCG, taxpayer carries forward the "net capital loss" as a LTCL transaction. §§ 1212(b)(1)(B) and 1212(b)(2)(A).

Example 1: Taxpayer has $100,000 of ordinary income. Taxpayer does his/her § 1222 calculations. For the tax year, taxpayer has $5000 of NSTCL and $4000 of NLTCL. What is taxpayer's § 1211(b) deduction, and what is taxpayer's § 1212(b) capital loss carryover?

•Taxpayer's capital losses exceed his/her capital gains by $9000. Taxpayer's § 1211(b) deduction is $3000. Taxpayer's "net capital loss" (§ 1222(10)) is $6000.

•We calculate taxpayer's capital loss carryovers by first adding $3000 (the amount of taxpayer's § 1211(b) deduction) to his/her NSTCL. Taxpayer's NSTCL becomes $2000; taxpayer's NLTCL is $4000. Taxpayer will carry these amounts forward. In the succeeding year, taxpayer will include $2000 as a STCL and include $4000 as a LTCL.

2. Taxpayer has $100,000 of ordinary income. Taxpayer does his/her § 1222 calculations. For the year, taxpayer has $7000 of NSTCL and $2000 of NLTCG.

•Taxpayer's capital losses exceed his/her capital gains by $5000. Taxpayer's § 1211(b) deduction is $3000. Taxpayer's "net capital loss" is $2000.

•We calculate taxpayer's capital loss carryover by first adding $3000 to his/her NSTCL. Taxpayer's NSTCL becomes $4000. Taxpayer will carry this amount forward. In the succeeding year, taxpayer will include $4000 as a STCL.

3. Taxpayer has $100,000 of ordinary income. Taxpayer does his/her § 1222 calculations. For the year, taxpayer has $11,000 of NSTCG and $18,000 of NLTCL.

•Taxpayer's capital losses exceed his/her capital gains by $7000. Taxpayer's § 1211(b) deduction is $3000. Taxpayer's "net capital loss" is $4000.
•We calculate taxpayer's capital loss carryover by first adding $3000 to his/her NSTCG. Taxpayer's NSTCG becomes $14,000. Subtract $14,000 from $18,000. Taxpayer will carry forward $4000 forward to the succeeding year as a LTCG. § 1212(b)(1)(B).

Matching the character of gains and losses: Aside from §§ 1211 and 1212, the Code strictly implements a matching regime with respect to ordinary gains and losses, and capital gains and losses. A taxpayer who regularly earns substantial amounts of ordinary income and incurs very large investment losses can use those losses only at the rate prescribed by § 1211(b) in the absence of investment gains.[187]

Do the CALI Lesson *Basic Federal Income Taxation: Property Transactions: Capital Loss Mechanics*

D. Computation of Tax

We already know that § 1 imposes income taxes on individuals.[188] Section 1(h) creates income "baskets" that are subject to different rates of income tax. Section 1(h) refers to "net capital gain," which we determined under § 1222 by netting gains and losses from sales or exchanges of

Dividends: For many years, dividend income that individual taxpayers received was taxed as ordinary income. Dividend income comes from corporate profits on which the corporation pays income tax. The corporation may not deduct dividends that it pays to shareholders. Hence, dividend income that a shareholder actually receives is subject to two levels of income tax. This double tax has been subject to criticism from the beginning. Nevertheless, it is constitutional. A legislative compromise between removing one level of tax and retaining the rules taxing dividends as ordinary income is § 1(h)(11). An individual adds "qualified dividend income" to his/her net capital gain. § 1(h)(11)(A). "Qualified dividend income" includes dividends paid by domestic corporations and by "qualified foreign corporations." § 1(h)(11)(B)(i). A "qualified foreign corporation" is one incorporated in a possession of the United States or in a country that is eligible for certain tax-treaty benefits, or one whose stock "is readily tradable on an established securities market in the United States." § 1(h)(11)(C).

The effect of treating dividend income as "net capital gain" is to subject dividend income to the reduced rates that § 1(h) imposes on "net capital gain." However, placement of this rule in § 1(h) means that capital losses do not offset dividend income.

[187] For a spectacular application of this principle, *s*

[188] Section 11 imposes income taxes on corporatio

various capital assets. This concept figures prominently in defining the income that belongs in each "basket." Once an income "basket" has been subject to a particular rate of tax, the principle that we tax income once applies.

In addition to subjecting income of different characters to different rates of income tax, § 1(h) supplies more definitions, most of which refine the concept of "net capital gain." The importance of placing definitions in § 1(h) rather than another section such as § 1222 is that the particular definition only applies to individuals[189] – not to corporations.

Sections 1(h)(1)(B, C, D, and E) impose different rates of tax on different forms of "net capital gain." These rates are dependent on the rate of tax imposed on a taxpayer's ordinary income – *viz.*, they increase when a taxpayer's marginal rate on ordinary income reaches 25%.

Section 1(h)(1)(A) isolates "ordinary income"[190] and subjects it to the progressive tax brackets of § 1(a).[191] Section 1(h)(1)(A) also assures that the "net capital gain" of a taxpayer is subject to the lower rates of tax on only so much of the gain otherwise necessary for a taxpayer's

From "Net Capital Gain" to "Adjusted Net Capital Gain:" Not all capital gain is taxed alike, but no capital gain should be taxed at a rate higher than the rate applicable to a taxpayer's ordinary income. To implement this principle, § 1(h) distinguishes between "net capital gain" and "adjusted net capital gain." Section 1(h)(3) defines the phrase "adjusted net capital gain" to be "net capital gain" MINUS "unrecaptured § 1250 gain," MINUS "28-percent rate gain," PLUS "qualified dividend income."

Section 1(h) will carve out the "adjusted net capital gain" of taxpayers whose ordinary income alone is not sufficient to put the taxpayer in the 25% tax bracket. "Unrecaptured § 1250 gain" and "28-percent rate gain" is subject to tax at such taxpayer's lower ordinary income rates instead of the higher rates otherwise applicable to such income.

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[189] ... and estates and trusts.

[190] "Ordinary income" is the income subject to the highest rates imposed on individual taxpayers. It includes gains from the sale or exchanges of non-capital and non-§ 1231 assets, offset by allowable losses on the sales of the same assets. §§ 64, 65.

[191] ... as modified in § 1(i) and as indexed for inflation, *id*.

total taxable income to reach the 25% bracket.

The next "basket" of income is "adjusted net capital gain" (*see* accompanying box). Section 1(h)(1)(B) subjects the "adjusted net capital gain" of a taxpayer whose marginal rate on ordinary income is less than 25% to a 0% tax. If a taxpayer's ordinary income plus "adjusted net capital gain" is less than the 25% bracket threshold, to that extent the elements that distinguish "adjusted net capital gain" from "net capital gain" (*see* accompanying box) are subject to tax at ordinary income rates.

Section 1(h)(1)(C) subjects the "adjusted net capital gain" of taxpayers whose marginal rate on ordinary income is 25% or more to a tax rate of 15%. Section 1(h)(1)(D) subjects unrecaptured depreciation on real property up to the amount of net § 1231 gain to a maximum rate of 25%. Section 1(h)(1)(E) subjects "28-percent rate gain" property to a maximum rate of (surprise) 28%.

Unrecaptured § 1250 gain and 28-percent rate gain: "Unrecaptured § 1250 gain" is the depreciation that taxpayer has claimed on real property. It will be included in taxpayer's net § 1231 gain, otherwise taxed at net capital gain rates. "28-percent rate gain" property is the net of collectibles gains and losses PLUS § 1202 gain, i.e., half of the gain from the sale of certain small business stock held for more than five years. § 1(h)(4). A "collectible" is essentially any work of art, rug or antique, metal or gem, stamps or certain coins, an alcoholic beverage, and anything else that the Secretary of the Treasury designates. § 408(m)(2).

Taxpayer's tax liability is the sum of the taxes imposed on these income baskets.

Do the CALI Lesson *Basic Federal Income Taxation: Property Transactions: Capital Gain Mechanics* (Do not worry about the questions on "capital gain net income").

II. Sections 1245 and 1250: Depreciation Recapture

The basis of an allowance for depreciation is the notion that a taxpayer consumes a portion, but only a portion, of an asset that enables him/her/it to generate income over a period longer than one year. The Code treats that bit of "consumption" the same as any other consumption that enables a taxpayer to generate income, i.e., a deduction from ordinary income. *See* §§ 162, 212. Such an allowance requires an equal reduction in taxpayer's basis in the asset. *See* § 1016(a)(2).
We learn shortly that the Code treats gain upon the sale of most assets subject to depreciation – and therefore not capital assets, § 1222(a)(2) – that taxpayer has held for more than one year as LTCG. This would mean that whatever gain taxpayer realizes that is attributable to basis reductions resulting from deductions for depreciation would be subject to a lower rate of tax than the income against which taxpayer claimed those deductions.[192] The Code addresses this mismatch of character of income and deductions through "depreciation recapture" provisions, i.e., §§ 1245[193] and 1250.[194]

A. *Section 1245*

Section 1245 provides that a taxpayer realizes *ordinary income* upon a disposition[195] of "section 1245 property" to be measured by subtracting its adjusted basis from the lesser of the property's "recomputed basis" or the

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192 Taxpayers could engage in such systematic mismatching prior to 1962.

193 Congress enacted § 1245 in 1962. Revenue Act of 1962, P.L. 87-834, § 13(a).

194 Congress enacted § 1250 in 1964. Revenue Act of 1964, P.L. 88-272, § 231(a).

195 "Disposition" is a broader term than "sale" or "exchange." A corporation that distributes property to a shareholder has not sold or exchanged it, but has disposed of it. Such a disposition triggers a tax on the gain computed as if the corporation had sold the property to the shareholder. § 311(b). Some or all of that gain might be depreciation recapture.

amount realized.[196] § 1245(a)(1).

- A property's "recomputed basis" is its adjusted basis plus all "adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization." § 1245(a)(2)(A).
  - Taxpayer may establish "by adequate records or other sufficient evidence" that the amount allowed for depreciation or amortization was less than the amount allowable. § 1245(a)(2)(B).
  - Deductions allowed by provisions other than § 167 and § 168 – notably expensing provisions that reduce taxpayer's basis in the property – are also considered to be "amortization," § 1245(a)(2)(C), and so become a part of the property's "recomputed basis."

"Section 1245 property" is property that is subject to an allowance for depreciation under § 167 (which of course includes § 168) and is –

- personal property, § 1245(a)(3)(A),
- other tangible property – not including a building or structural components – that was used as an "integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services," § 1245(a)(3)(B)(i), that constituted a research facility in connection with these activities, § 1245(a)(3)(B)(ii), or that constituted a facility used in connection with such activities for the bulk storage of fungible commodities, § 1245(a)(3)(B)(iii),
- real property subject to depreciation *and* whose basis reflects the benefit of certain special or rapid depreciation provisions, § 1245(a)(3)(C),
- a "single purpose agricultural or horticultural structure," § 1245(a)(3)(D),
- a "storage facility (not including a building or its structural

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[196] Actually, if the disposition is other than by sale, exchange, or involuntary conversion, gain taxable as ordinary income is measured by subtracting adjusted basis from the lesser of recomputed basis or the fmv of the property. § 1245(a)(1).

components) used in connection with the distribution of petroleum" products, § 1245(a)(3)(E), or
•a "railroad grading or tunnel bore," § 1245(a)(3)(F).

Example:
•Taxpayer is a professional violinist who plays the violin for the local symphony orchestra. She purchased a violin bow for $100,000 in May 2011. Treat a violin bow as 7-year property. In January 2013, she sold the bow for $110,000. What is the taxable gain on which taxpayer must pay tax and what is the character of that gain?

•Taxpayer will deduct a depreciation allowance under § 168. She will apply the half-year convention to both the year in which she placed the bow in service and the year of sale. § 168(d)(4).

•Go to the tables at the front of your Code. In 2011, she will deduct 14.29% of $100,000, or $14,290. In 2012, she will deduct 24.49% of $100,000, or $24,490. In 2013, she will deduct half of 17.49% of $100,000, or $8745.
•Taxpayer's remaining basis in the violin bow is $52,475.
•Taxpayer's "recomputed basis" is $100,000. It is less than the amount realized. Hence, taxpayer has depreciation recapture income of $47,525. This is ordinary income. The balance of taxpayer's gain (i.e., $10,000) is § 1231 gain, which will be subject to tax as if it were long term capital gain.

•Suppose that taxpayer sold the violin bow for $90,000.

•Now the amount realized is less than taxpayer's recomputed basis.
•Hence, taxpayer's depreciation recapture income is $37,525. This income is subject to tax as ordinary income.

Section 1245 provides specific rules governing certain dispositions.

•Section 1245 does not apply to a disposition by gift. § 1245(b)(1). Instead, the donee takes the donor's basis for purposes of determining gain – and includes recapture income in his/her income upon disposition of the gifted property.
•Section 1245 does not apply to a transfer at death. § 1245(b)(2).

Since there is a basis step-up on property acquired from a decedent, § 1014(a), depreciation recapture is not subject to tax at all upon such a disposition.

•In certain tax-free dispositions of property between a subsidiary and its parent corporation, shareholders and a corporation, and partners and a partnership – there is no recognition of depreciation recapture. § 1245(b)(3). Instead, the recipient – who takes a carryover basis – will recognize depreciation recapture income upon disposition of the property.

•In a tax-deferred like-kind exchange (§ 1031) or involuntary conversion (§ 1033), depreciation recapture is subject to tax only to the extent the acquisition of property not qualifying for tax-deferred treatment is subject to tax plus the fmv of non-section 1245 property acquired. § 1245(b)(4). Instead gain on the disposition of the replacement property attributable to depreciation allowances on both the original and the replacement properties is depreciation recapture income.

•Section 1245 does not apply to a tax-deferred distribution of partnership property to a partner. § 1245(b)(5)(A). The partner will recognize depreciation recapture income upon his/her/its disposition of the property (subject to some very technical adjustments).

•Section 1245 does not apply to a disposition to a tax-exempt organization, § 1245(b)(3), unless the organization immediately uses the property in a trade or business unrelated to its exemption, § 1245(b)(6)(A). If the tax exempt organization later ceases to use the property for a purpose related to its exemption, *it* is treated as having made a disposition on the date of such cessation. § 1245(b)(6)(B).

•Special amortization rules apply to reforestation expenditures. § 194. An 84-month amortization period applies. § 194(a)(1). Ten years after acquiring the "amortizable basis" for incurring reforestation expenditures, gain on the disposition of such assets is no longer considered to be depreciation recapture. § 1245(b)(7).

•If taxpayer disposes of more than one amortizable section 197 intangible in one or more related transactions, all section 197 intangibles are considered to be one section 1245 property. §

1245(b)(8)(A). However, this rule does not apply to a section 197 intangible whose fmv is less than its adjusted basis. § 1245(b)(8)(B).

Section 1245(d) provides that § 1245 applies "notwithstanding any other provision of this subtitle." This means that except to the extent § 1245 itself excepts its own applicability, depreciation recapture will be carved out of the gain on any disposition of depreciable or amortizable property and be subject to tax as ordinary income. This important provision limits taxpayer opportunity to mismatch the character of income against which his/she/it claims deductions with the character of subsequent resulting gain.

B. Section 1250

Section 1250 treats as ordinary income, § 1250(a)(1)(A), the recapture of so-called "additional depreciation," i.e., the excess of depreciation adjustments over straight-line adjustments on "section 1250 property" held for more than one year. § 1250(b)(1). Section 1250 property is real property to which § 1245 does not apply. Since § 168 allowances on real property are all straight-line, the applicability of § 1250 is limited. Nevertheless, depreciation allowances on real property are recaptured for individual taxpayers to an extent through the (complicated) interplay of § 1(h)(6) (*supra*) and § 1231 (*infra*).

III. Section 1231: Some Limited Mismatching

During World War II, the nation moved to a war economy. The Government seized many of the nation's productive assets in order to convert them to production of items critical to the war effort. The Fifth Amendment to the Constitution of course requires that the owners of such properties be justly compensated. However, the owners of businesses may not have particularly wished to sell their assets to the Government and then to pay income tax (at wartime rates) on the taxable gains they were forced to recognize. Congress responded by enacting § 1231 – a sort of "heads-I-win-tails-you-lose" measure for taxpayers who found themselves with (substantial amounts of) unplanned-for taxable income. Basically, net gains from such transactions would be *treated as capital* gains; net losses from such transactions would be treated as *ordinary* losses. World War II ended a long time ago, but § 1231 is still with us. It has become a very important provision in the sale of a business's productive assets.

Section 1231 applies to "property used in the trade or business" and to any capital asset held for more than one year in connection with a trade or business or a transaction entered into for profit. § 1231(a)(3). Section 1231(b) provides a definition of "property used in the trade or business." Such property is essentially "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year[.]" § 1231(b)(1). Such property is the same as the property that § 1221(a)(2) describes – with the caveats that it does not encompass property that § 1221(a)(1, 3, and 5) describes, and the taxpayer must have held the property for more than one year. § 1231(b)(1).

Section 1231 initially adopts the "heads-I-win-tails-you-lose" principle for "involuntary conversions" and casualty losses. If a taxpayer's gains and losses from "involuntary conversions" and casualty losses net to a loss, then § 1231 does not apply to any such gains and losses. § 1231(a)(4)(carryout paragraph). The upshot of this "inapplicability" is that such gains and losses are treated as realized on the disposition of non-capital assets, so the net loss will be an ordinary loss. Some writers refer to this "preliminary" netting of casualty gains and losses and involuntary conversion gains and losses as the "firepot."

Section 1231 requires a netting of "section 1231 gains" and "section 1231 losses." "Section 1231 gain" is gain recognized on the sale or exchange of "property used in the trade or business" plus *gain* recognized on the compulsory or involuntary conversion, or casualty of "property used in the trade or business" or a "capital asset held for more than 1 year" that "is held in connection with a trade or business or a transaction entered into for profit." § 1231(a)(3)(A). Such gain does *not* include depreciation recapture. § 1245(d), § 1250(h), Reg. § 1.1245-6(a), Reg. § 1.1250-1(e)(1). "Section 1231 loss" is loss recognized on such conversions. Some writers refer to this netting as the "hotchpot."

- If the "preliminary firepot" produces a net gain, gains and losses from compulsory or involuntary conversions, or from casualties will figure into the determination of section 1231 gains or losses.

Section 1231(a)(1 and 2) implements the "heads-I-win-tails-you-lose" principle.

- If section 1231 gains for any taxable year exceed section 1231 losses, such gains and losses are treated as LTCG or LTCL as the case may be. § 1231(a)(1).
- If section 1231 gains do not exceed[197] section 1231 losses for the taxable year, then such gains and losses are not treated as gains and losses derived from sales or exchanges of capital assets. § 1231(a)(2).

A provision so taxpayer-friendly would be subject to some abuse. With only a little planning, a taxpayer may dispose of section 1231 "winners" in one taxable year and section 1231 "losers" in a different taxable year. Hence, § 1231(c) creates a so-called "5-year lookback rule." For any year in which taxpayer recognizes net section 1231 gains, such gains are taxed as ordinary income to the extent taxpayer recognized section 1231 losses during the five most recent preceding taxable years. § 1231(c).

CALI Lessons

Do the CALI Lesson *Basic Federal Income Taxation: Property Transactions: Identification of Section 1231 Property*

Do the CALI Lesson *Basic Federal Income Taxation: Property Transactions: Section 1231 Mechanics*

- Note: the author of this casebook disagrees with Question 14.

[197] This would include cases where section 1231 gains equal section 1231 losses.

IV. Some Basis Transfer Transactions: §§ 1031, 1033

Congress has identified some transactions in which it does not want taxpayers to "recognize" gain even though a taxpayer may have "realized" gain. The "technique" by which Congress accomplishes this is the basis transfer. Taxpayer simply keeps as the basis in the asset he/she/it acquires the basis in the asset he/she/it gave up. Some examples include –

- Like-kind exchanges under § 1031: Under certain defined conditions, taxpayer does not recognize gain or loss upon the exchange of property for other property of like kind. Instead, taxpayer has the same basis in the acquired property as he/she/it had in the property exchanged. § 1031(d) (with adjustments for receipt of and taxation of non-like kind property received).
- Involuntary conversions under § 1033: If taxpayer's property is compulsorily or involuntarily converted because of theft, seizure, requisition or condemnation, taxpayer may, by complying with the rules of § 1033, elect to spend money received because of such conversion on replacement property. Taxpayer does not recognize the gain realized on such a conversion. Instead, taxpayer has the same basis in the replacement property that he/she/it had in the property compulsorily or involuntarily converted. § 1033(b) (with various adjustments).
- The gain or loss that a partner "realizes" upon contributions of property to a partnership in exchange for a partnership interest are not "recognized." § 721. The partner's basis in his/her/its partnership interest is the basis he/she/it had in the property contributed. § 722.
- The gain or loss that a shareholder "realizes" upon contributing property to a corporation in exchange for shares of stock in the corporation are not "recognized" if the conditions of § 351(a) are met. Shareholder's basis in his/her/its shares is the basis of the property he/she/it contributed. § 358(a).

In these transactions and many more, tax on gain is not forgiven. It is merely deferred until the time when taxpayer disposes of the asset acquired in a taxable transaction.

V. More Matching

The following materials should make the point that matching income and expenses with respect to character is more than simply the rule of some Code sections: it is a principle that pervades construction of the Code.

Arrowsmith v. Commissioner, 344 U.S. 6 (1952)

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts ... In 1937, two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937-1940 returns there is no dispute. But, in 1944, a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. [citations omitted]. Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. ... The Commissioner viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss, just as the taxpayers had treated the original dividends as capital gains. Disagreeing with the Commissioner, the Tax Court classified the 1944 payment as an ordinary business loss. Disagreeing with the Tax Court, the Court of Appeals reversed, treating the loss as "capital." This latter holding conflicts with the Third Circuit's holding in *Commissioner v. Switlik*, 184 F.2d 299. Because of this conflict, we granted certiorari.

I.R.C. § 23(g) [(1222)], treats losses from sales or exchanges of capital assets as “capital losses,” and I.R.C. § 115(c) [(331)] requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of “capital losses” contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that, had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

It is contended, however, that this payment, which would have been a capital transaction in 1940, was transformed into an ordinary business transaction in 1944 because of the well established principle that each taxable year is a separate unit for tax accounting purposes. *United States v. Lewis*, 340 U.S. 590; *North American Oil Consolidated v. Burnet*, 286 U.S. 417. But this principle is not breached by considering all the 1937-1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

....

Affirmed.

MR. JUSTICE DOUGLAS, dissenting. [omitted]

MR. JUSTICE JACKSON, whom MR. JUSTICE FRANKFURTER joins, dissenting.
This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto this problem under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution, which would have reduced the liquidating dividends proportionately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation's own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us, and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

....

I find little aid in the choice of alternatives from arguments based on equities. One enables the taxpayer to deduct the amount of the judgment against his ordinary income which might be taxed as high as 87%, while, if the liability had been assessed against the corporation prior to liquidation, it would have reduced his capital gain which was taxable at only 25% (now 26%). The consequence may readily be characterized as a windfall (regarding a windfall as anything that is left to a taxpayer after the collector has finished with him).

On the other hand, adoption of the contrary alternative may penalize the taxpayer because of two factors: (1) since capital losses are deductible only against capital gains plus $1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond $5,000, and, (2) had the liability been discharged by the corporation, a portion of it would probably, in effect, have been paid by the Government, since the corporation could have taken it as a deduction, while here, the total liability comes out of the pockets of the stockholders.
....

Notes and Questions:

1. Upon liquidation of a corporation, the corporation distributes its assets to its shareholders in exchange for their stock. Shareholders treat this as a sale or exchange of a capital asset. § 331(a). Recall from our discussion of *Gilliam* that payment of a tort judgment would have been an ordinary and necessary business expense, deductible under § 162(a).

2. The opinion of Justice Jackson spells out just what is at stake. First, recognition of capital losses would save taxpayers less than recognition of the same losses as ordinary. Second, long term capital losses are – except to the narrow extent permitted by § 1211 – only offset by long-term capital gains. If a taxpayer does not or cannot recognize long-term capital gains, the long-term capital losses simply become a useless asset to the taxpayer.

3. Two policies came into conflict in *Arrowsmith*. The Tax Court and Justice Jackson bought into the annual accounting principle. The other principle that permeates the Code is that a taxpayer may not change the character of income or loss – whether capital or ordinary. This is a *very* strong policy that only rarely loses to another policy. Often times, taxpayers' machinations are much more deliberate than they were in this case.

A. Matching Tax-Exempt Income and Its Costs

Ours is an income tax system that taxes net income. But what if certain income is not subject to tax because it falls within an exception to the first of our three guiding principles? Logically, such expenses should not be deductible – and this is indeed a rule that the Code implements in at least two places.

Section 265 denies deductions for the costs of realizing tax exempt income. Section 264(a)(1) provides that a life insurance contract beneficiary's premium payment is not deductible. Of course, the life insurance payment by reason of death is excluded from the beneficiary's gross income. § 101(a)(1). This same principle generally applies to interest incurred to pay life insurance contract premiums. § 264(a)(4).

B. More Matching: Investment Interest

Section 163(d)(1) limits the interest deduction for investment income to the taxpayer's "net investment income ... for the taxable year." Taxpayer may carry forward any investment interest disallowed to the succeeding taxable year.

C. Passive Activities Losses and Credits

A passive activity is a trade or business in which the taxpayer does not "materially participate." § 469(c)(1). An individual taxpayer may not deduct aggregate passive activity losses in excess of his/her passive activity income, nor claim credits in excess of the tax attributable to the aggregate of his/her net income from passive activities. §§ 469(a)(1), 469(d). We defer discussion of the details of § 469 to a course in partnership tax. The important point here is that there is absolutely no mis-matching of losses derived from passive activities with any other type of income – whether ordinary income or portfolio (investment) income – until taxpayer has sold all of his/her interests in passive activities.

D. General Comment about Matching Principles

Perhaps it does not seem very significant that implementation of matching principles results in disallowance of a deduction, loss, or credit because usually there is a carryover. Your attitude may be "pick it up next year." Reality may be quite different. When losses are "locked inside" a particular activity or type of income, it probably is the case that circumstances are not going to change radically for a taxpayer from one year to the next. The investor who loses a deduction because of insufficient income of a particular type is not likely suddenly to receive a lot of that type of income during the next year. The effect of implementing matching principles in reality *may be* that the excess expense or loss is simply disallowed – forever. However, forewarned is forearmed. Taxpayers may choose their activities or transactions so that he/she/it will have gains against which losses can be can be matched.

Wrap-Up Questions for Chapter 10

1. What policy (policies) is served by the exceptions to the definition of "capital asset" in §§ 1221(a)(1, 2, 3, 4, 6, 7, 8)?

2. In *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272 (1966), the Supreme Court held that a taxpayer was entitled to depreciation deduction up to the date it sold an asset. In the days before § 1245 (but after § 1231), why would this have been important?

3. Why should capital loss carryovers expire – and simply disappear – on the death of the taxpayer?

4. In what ways does § 1231 help facilitate growth within our economy?

5. Why should a taxpayer not be permitted to deduct the cost of obtaining tax-exempt income?