# U.S. Federal Income Taxation of Individuals 2017


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## About the Author

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Geier is a member of the American Law Institute and has served both as a member of the Executive Committee and as Chair of the Tax Section of the Association of American Law Schools. She has also served as an Academic Adviser to the staff of the Joint Committee on Taxation (comprised of the members of the House Ways and Means Committee and Senate Finance Committee) in connection with a tax simplification study and has testified before the Senate Finance Committee in connection with the tax consequences of home mortgage foreclosures.

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Erik M. Jensen, 58 Tax Notes 1257 (1993) and Praeger.

Roberton Williams, chart from 134 Tax Notes 251 (2012).

Alice G. Abreu & Richard Greenstein, 11 Fla. Tax Rev. 306 (2011).

University of Florida Frederic G. Levin College of Law, Florida Tax Review, 11 Fla. Tax Rev. 306 (2011).

Jotwell: The Journal of Things We Like (Lots) and Neil H. Buchanan, Professor Buchanan's book review excerpted in Chapter 3 and elsewhere.

Tax Foundation – chart appearing in Chapter 3 and elsewhere.

# Preface

As one, lone law professor, I have little direct ability to reduce tuition costs for my students. When writing this textbook, however, I decided to decline expressions of interest from the legacy legal publishers in favor of making this textbook available as a free download over the internet (in ePub format for iPads, Mobi format for Kindles, and pdf and Word format for laptops). Fortunately, eLangdell (a division of CALI, the Center for Computer-Assisted Legal Instruction) has been an ideal partner in this regard. Because this textbook is published under a Creative Commons Attribution-NonCommercial-ShareAlike 3.0 Unported License, law schools can make at-cost softbound copies for students (and teachers) who prefer the printed page.

In addition to eliminating (or lowering) student cost, this mode of publication permits me to quickly and fully update the book each December, incorporating expiring provisions, inflation adjustments for the coming calendar year, new Treasury Regulations, *etc.*, in time for use in the spring semester, an approach that avoids cumbersome annual supplements. This publication method also makes the textbook suitable for use as a free study aid for students whose professors adopt another textbook, as this textbook walks the student through the law with many more fact patterns and examples than do many other textbooks. While this practice adds length, I believe that it also makes the book more helpful to students in confronting what can be daunting material. Finally, having the textbook easily accessible to foreign students enrolled in a course examining the U.S. Federal income taxation of individuals is important to me, and having the textbook available as a free internet download succeeds well in that regard.

A Teacher's Manual is available for professors who adopt the book (or parts of it) for use in their course.

This textbook is not intended to be an exhaustive treatise; rather, it is intended to be far more useful than that for beginning tax law students by equipping the novice not merely with unmoored detail but rather with a rich blueprint that illuminates the deeper structural framework on which that detail hangs (sometimes crookedly). Chapter 1 outlines the conceptual meaning of the term "income" for uniquely *tax* purposes (as opposed to financial accounting or trust law purposes, for example) and examines the Internal Revenue Code provisions that translate this larger conceptual construct into positive law. Chapter 2 explores various forms of consumption taxation because the modern Internal Revenue Code is best perceived as a hybrid income-consumption tax that also contains many provisions—for wise or unwise nontax policy reasons—that are inconsistent with *both* forms of taxation. Chapter 3 then provides students with the story of how we got to where we are today, important context about the distribution of the tax burden, the budget, and economic trends, as well as material on ethical debates, economic theories, and politics as they affect taxation.

Armed with this larger blueprint, students are then in a much better position to see how the myriad pieces that follow throughout the remaining 19 chapters fit into this bigger picture, whether comfortably or uncomfortably. For example, they are in a better position to appreciate how applying the income tax rules for debt to a debt-financed investment afforded more favorable consumption tax treatment creates tax arbitrage problems. Congress and the courts then must combat these tax shelter opportunities with both statutory and common law weapons. Stated another way, students are in a better position to appreciate how the tax system can sometimes be used to generate (or combat) unfair and economically inefficient rent-seeking behavior.

The term "economic rents" here has a special meaning to economists that has nothing to do with the common meaning of that word to those who pay money to a landlord to live in a flat. One way to define "rents" in this sense is to say that they are wealth accessions enjoyed by a person (the rentier) that would not have occurred in a perfectly competitive and transparent economy. Rent, in this special sense, represents the mere shift of wealth from others to the rentier (rather than the creation of new wealth) through a manipulation of the social or economic environment to enrich oneself or, in the pithy words of the The Economist magazine, "[c]utting yourself a bigger slice of the cake rather than making the cake bigger."[1] Blackmail is a form of illegal rent-seeking behavior, but much rent-seeking behavior is perfectly legal. In the tax environment, it can mean a "profit" that is nothing more than a transfer, in effect, from the Treasury (other taxpayers) to the rentier, a phenomenon that raises not only economic efficiency concerns but fairness concerns. Rent-seeking behavior is a significant problem in today's economy—both inside and outside the tax system[2]—but the tax system can also provide policy makers with a ready tool to combat such behavior (if they wish to use it).

The underlying conceptual framework, context, and ethical and economic theories provided early on are then referenced throughout the book, providing the common thread with respect to every topic studied.

In addition to providing a solid grounding in the conceptual and policy underpinnings of the income tax imposed on individuals, this textbook explores a sufficient amount of detail to teach students how to continue learning on their own. Indeed, so much of law school is guiding students in *learning how to learn* so that they can practice effectively over the course of their careers as the law ever evolves. Such an approach should well equip the students who go on to take upper-level tax classes (who will add even more detail to the structural framework learned here), as well as those who wish merely to be aware of the fundamental tax issues that might arise in their nontax practices (so that they know to do more research when the time comes or to seek help from a tax specialist where necessary).

I also have a third audience in mind for this book, however: legislators, judges, policymakers, and those who simply wish to be better equipped as citizens in evaluating what they read about in the popular press about taxation in the U.S. Because this textbook does not merely recite and apply rules but explores the deeper internal logic (and evolution and policy) underlying the entire structure of the Federal income tax, readers should leave with a more sophisticated understanding of the often unspoken context underlying popular debates. In particular, Chapters 1, 2, and 3 may be good vehicles to use as an introductory unit in a Tax Policy Seminar course—especially because the book can be downloaded for free.

Indeed, I think that one reason why taxation is such a fascinating subject (no sniggers, please) is that it affects everyone in society, whether directly or indirectly—everyone from the single mother trying to make ends meet, to the bright student putting herself through college and incurring large debts to do so, to the entrepreneur with a good idea, to the Fortune 500 company contemplating a merger. As Professor Michael Graetz (Columbia University) once observed, many

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[1] www.economist.com/economics-a-to-z/r.

[2] *Cf.* Adam Liptak, *First Amendment, "Patron Saint"of Protester, Is Embraced by Corporations*, at http://www.nytimes.com/2015/03/24/us/first-amendment-patron-saint-of-protesters-is-embraced-by-corporations.html?_r=0 (quoting Professor John Coates of Harvard as writing, "Concentrated, moneyed interests … are … increasing the share of the economy devoted to rent-seeking rather than productive activity").

more people file tax returns than vote in Presidential elections.[3] How we choose to tax ourselves says a lot about how we view ourselves as a country and as members of a community that are inextricably interrelated, as tax dollars create the common physical and intangible infrastructure that permits the flourishing of both human capital and the economy. Fascinating stuff!

In addition to text, cases, and other primary authority (and problems), this textbook is unusual in including not only charts and graphs but also links to a few New York Times articles that help to illuminate contrasting viewpoints, to provide relevant data or history in a very short space, or to reveal useful context surrounding the issue under study. I publicly thank the New York Times Company for permitting links to articles without charge. (I would have done the same with articles from other sources if they had similarly permitted such use without charge.)

**I have provided hyperlinks to certain Internal Revenue Code sections and Treasury Regulations where I thought it would be helpful or appropriate (*e.g.*, the first time a Code section is cited on a page or when I specifically instruct the reader to consult the source). Those with a hyperlink are underlined.** Those without hyperlinks are not underlined. The hyperlinks take you to the Legal Information Institute's web page (Cornell University), which is an open access site.

Case excerpts are often abbreviated to be more manageable as pedagogical tools (especially in light of the many demands on student time). Case footnotes that are included use their original numbering and are enclosed in brackets. My own original footnotes are not bracketed.

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Senator Everett Dirksen is famously thought to have once said: "A billion here, a billion there, and pretty soon you're talking about real money."[4] At different points in this book, some very large numbers are inevitably used, including millions, billions, and trillions. As they all use the same word ending, sometimes it is easy to lose sight of the magnitude of differences among them. For example, studies show that many people unconsciously estimate 1 billion to be about a third larger than 1 million because it contains three additional zeros when written in numerals (1,000,000,000 versus 1,000,000), but one billion is actually 1,000 millions. And one trillion is 1,000 billions.

Here is a helpful tool that aids in visualizing the vast differences among 1 million, 1 billion, and 1 trillion. One million seconds is only about 11.5 days. One billion seconds is almost 32 years. One trillion seconds is more than 31,688 years.

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Finally, you will learn in the Introduction that Congress enacts our tax laws, as signed by the President. Here is one bit of context to keep in mind as you move through the course: in 2011 the average wealth (the value of assets *less* debt) of U.S. Senators was $11.9 million, and the average wealth of House members was $6.5 million.[5] While a few outliers can skew averages, even median net worth exceeded $1 million in each of the House and Senate in 2012—a milestone.[6] "If the idea

[3] Jeffrey Y. Yablon, *100 Years of the Tax Code: 100 Tax Quotes*, 140 TAX NOTES 1617 (2013).
[4] Although many claim to have heard Senator Dirksen speak this phrase, it has never been documented. *See* www.dirksencenter.org/print_emd_billionhere.htm.
[5] Richard Rubin, *Second-Home Deduction Future Depends on Congress Using It*, at www.bloomberg.com/news/2013-07-23/second-home-deduction-future-depends-on-congress-using-it.html.
[6] *See* Eric Lipton, *Half of Congress Members Are Millionaires, Report Says* at

of Congress was that you have the butcher, baker, candlestick maker representing the people, we've come to a system where we certainly don't have that anymore."[7]

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I would like to thank several tax law professors who served as peer reviewers for many of the chapters in this book. Their comments were substantive and insightful, and they resulted in material changes in the course of my final revisions that substantially improved the book. After working on this textbook for nearly two and one-half years, I was so close to it that I could no longer see some of the ways in which it could be improved, and I deeply appreciate the time and effort that they took in their careful reviews. In alphabetical order, they are Ellen Aprill, Neil Buchanan, Pat Cain, Adam Chodorow, Leandra Lederman, Roberta Mann, and Kerry Ryan. Many thanks!

I would like to dedicate this textbook to the many, many Cleveland-Marshall College of Law students that I have had the pleasure of having in my classroom since I began teaching law in 1989. You rock!

The 1.0 version of this textbook was published in 2014, the 2.0 version in 2015, and the 3.0 version in 2016. This 4.0 version is current as of January 1, 2017. Happy journey!

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www.nytimes.com/2014/01/10/us/politics/more-than-half-the-members-of-congress-are-millionaires-analysis-finds.html?_r=0.

[7] Rubin, *supra* note 5.

# Table of Contents



## Unit I: The Core Structures of Income and Consumption Taxation and Tax Policy

## Unit II: Two Types of Gross Income: Compensation and Residual Gross Income

## Unit III: The Possibilities for Income Shifting

## Unit IV: Everything You Ever Wanted To Know About Debt but Were Afraid To Ask

## Unit V: The Ownership and Disposition of Property

## Unit VI: Distinguishing Between Income-Producing Activities and Personal Consumption and the Personal Consumption Tax Expenditures

## Unit VII: The Taxable Year and Methods of Accounting

# Introduction

Congratulations, law student, on your smart decision to take the introductory course exploring the U.S. Federal income taxation of individuals! Nervous? Don't be. I want to take some time to dispel several misapprehensions about the study and practice of tax law.

Some law students believe that tax lawyers spend their time filling out annual income tax returns. Even John Grisham—a lawyer (though not a tax lawyer) before becoming a novelist—wrote the following opening paragraph in Chapter 29 of his novel *The Firm*, the hero of which was (wait for it) a tax lawyer.

> A week before April 15, the workaholics at Bendini, Lambert & Locke [a boutique tax firm] reached maximum stress and ran at full throttle on nothing but adrenaline. And fear. Fear of missing a deduction or a write-off or some extra depreciation that would cost a rich client an extra million or so. Fear of picking up the phone and calling the client and informing him that the return was now finished and, sorry to say, an extra eight hundred thousand was due. Fear of not finishing by the fifteenth and being forced to file extensions and incurring penalties and interest. The parking lot was full by 6 a.m. The secretaries worked twelve hours a day. Tempers were short. Talk was scarce and hurried.[1]

A good read—but an absolutely *ridiculous* description of tax law practice! How *boring* that would be. The only annual tax return I have ever completed is my own, and I know some tax lawyers who do not even do that. While some tax lawyers (particularly in smaller firms) may complete annual tax returns for their clients as an ancillary service to them, most tax lawyers in law firms (and tax lawyers providing tax consulting services in accounting firms, as opposed to compliance services) typically are *transactional* lawyers who advise clients in structuring transactions in a tax-efficient manner—whether the "transaction" is a personal one, such as a divorce, or a business one, such as a corporate merger. Tax practice is, therefore, forward-looking and can be very creative. Other tax lawyers work in resolving tax disputes between taxpayers and the Federal government, first through Internal Revenue Service (IRS) internal appeals processes and second, if necessary, through litigation.

In addition, some students worry that they will be at a significant disadvantage in this course if they believe themselves to be bad at math (or "maths," as my British friends say) or if they never took accounting or business classes as an undergraduate. Balderdash! My undergraduate major was Psychology, and I was a Registered Nurse in Maternity Surgery for seven years, as well. Yet, I practiced tax law with the Wall Street firm of Sullivan & Cromwell. (I would have laughed out loud if anyone had told me on the first day of law school that I would become a tax lawyer, but I took my first tax law class and was hooked.) Moreover, I am living proof that you need not be a math whiz to be a tax lawyer. While simple math (such as addition, subtraction, multiplication, and division) is often necessary to illustrate the underlying *principle* at stake, tax law is actually a deeply conceptual body of law based on primary principles surrounding the meaning of the word "income" for tax purposes. Tax law practice is not financial accounting and has little to do with "generally accepted accounting principles." Indeed, what makes perfect sense in creating an

[1] JOHN GRISHAM, THE FIRM 363 (Dell Publishing paperback ed. 1991).

"income" statement for financial accounting purposes can violate fundamental income tax principles by inadvertently providing consumption tax treatment through the backdoor—an irrelevant concern for financial accounting purposes—or even providing better-than-consumption-tax treatment in the form of tax shelter "profits." Where accounting majors might have a teensy-weensy *initial* advantage is in familiarity with some of the nomenclature (if they have heard tax terms of art before), but that is quickly overcome. Just as your first-year law professors assumed that you had no prior knowledge of contracts, torts, or criminal law, this book assumes no prior knowledge. *Here* is where you are expected to learn about the subject matter. Some of the best tax law students, in my opinion, are English majors because they have had lengthy practice in *reading language carefully*, which brings me to my next point.

One of the best reasons to take tax (even if you have absolutely no intention of considering tax as a specialty area of law practice) is because it is the best course, in my opinion, in which to practice the skill of reading, pulling apart, and making sense of complex statutory language. While the U.S. still considers itself a common law country, most of the law that you will practice today is actually embedded in statutes and their related administrative materials. Even much of the formative common law in such areas as contracts, property, and criminal law has now been codified. The skill of pulling apart the clauses and subclauses of statutory language and understanding their complex sentence structures is not intuitive. It takes practice. After having practiced this skill in tax, you should be in a much better position to pull apart the language in statutes enacted in the future (and in other areas of law) that are not even a glimmer in the eye of any current legislator today.

Finally, tax law *will* affect your civil practice. Whether you are advising the divorcing couple who will be dividing property and arranging cash payments from one to the other, drafting a complaint for an injured person who is wondering whether damage awards are includable in Gross Income, discussing with the entrepreneur the considerations to take into account in choosing the best entity form through which to start her new business, and more, tax issues will arise in your practice. If only to get a tax lawyer involved at the right time (ideally *before* the event), you need to be aware of potential tax issues, and this is the course in which to begin forming that awareness.

This textbook focuses on the Federal income tax as it applies to the individual, whether that individual is an employee of another, the sole proprietor of a business, or the sole owner of a limited liability company (LLC), an entity created under state law through which the business is conducted. To explore the latter two categories, think of a plumber who "works for himself," as the saying goes. The plumber may choose to operate his plumbing business directly, without creating any state law entity (a sole proprietorship), or he may choose to house the business in an LLC that he creates under state law. So long as our plumber owns 100% of the LLC ownership interests, the existence of the LLC is usually ignored for Federal income tax purposes, as though the owner did not create the state law entity but rather runs the business directly as a sole proprietor. In tax jargon, single-owner LLCs are "disregarded entities." Thus, the LLC's Gross Income and allowable deductions appear on the sole owner's individual tax return.

Many of you may go on to other tax courses, such as the course examining the income tax consequences of operating a business through a corporation, partnership, or multi-owner LLC. Some will take the course exploring the Federal income tax consequences of international transactions or the course examining the gift and estate tax consequences of wealth transfers from one generation to the next. Some will take the course examining tax procedures, penalties, and crimes or the course considering the taxation of tax-exempt organizations. This course provides

the solid foundation for them all (and others).

As a tax lawyer, I cannot resist dropping a quotation from the late Erwin N. Griswold, former tax lawyer, former Solicitor General of the United States, and former Dean of the Harvard Law School, who once wrote:

> It is high time that tax lawyers rise up to defend themselves against the charge that tax work is narrowing and stifling. On the contrary, it seems difficult to find a field which leads practitioners more widely through the whole fabric of the law. A tort lawyer is a tort lawyer, and a corporation lawyer is a corporation lawyer. But a tax lawyer must deal constantly not only with statutes and committee reports and regulations, but also with questions of property, contracts, agency, partnerships, corporations, equity, trusts, insurance, procedure, accounting, economics, ethics, philosophy. [They] must be broad in [their] background and in [their] outlook, if [they are] to deal with the manifold problems which make up the modern field of tax law.[2]

Although written in 1944, the sentiment is truer today than ever before in "the modern field of tax law."

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Federal tax law involves all three branches of government, which means that the study of tax law is a study in administrative law, as well.

***The legislative branch***

Congress enacts tax statutes, which are periodically re-codified in Title 26 of the U.S. Code, commonly referred to as the *Internal Revenue Code of 1986, as amended* (though a few non-codified tax statutes can be found outside Title 26).[3] Under the origination clause of the U.S. constitution,[4] tax bills must originate in the House of Representatives, though the clause adds that "the Senate may propose or concur with Amendments as on other Bills." Because of the last-quoted phrase, "in practice the Senate's power to amend is generally understood to be so broad that the Senate can replace the entire text of a bill that technically originates in the House."[5] Thus, today the origination clause may mean little more than that the bill must have an H.R. number (for House of Representatives) rather than an S. number (for Senate).

The most important (and powerful) Congressional committees when it comes to tax matters are the Ways and Means Committee in the House and the Finance Committee in the Senate, both of which have jurisdiction over tax matters. If the bills passed by the House and Senate, respectively, differ (as they virtually always do), a Conference Committee is appointed to hammer out the differences. Once the conference bill is passed by both houses and signed by the President, it becomes law.

***The executive branch***

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[2] Erwin N. Griswold, *The Need for a Court of Tax Appeals*, 57 HARV. L. REV. 1153, 1183-84 (1944).
[3] The year 1986 saw the latest recodification if the Internal Revenue Code. Prior to 1986, the Code was referred to as the Internal Revenue Code of 1954, as amended. The 1986 recodification accompanied fundamental reforms enacted in the Tax Reform Act of 1986, which you will read about in Chapter 3.
[4] Article I, § 7, clause 1.
[5] ERIK M. JENSEN, THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 171 (2005).

The law that Congress enacts is not self-executing but rather must be administered by the executive branch, primarily through the Treasury Department and the Internal Revenue Service, with the latter being a semi-autonomous institution within the former. The Treasury Department, through its Assistant Secretary for Tax Policy, played a particularly important role in tax reform efforts in the 1980s, though its role in tax reform appears to be less pronounced today.

**Treasury Regulations.** One of the most important functions of the Treasury is to draft and issue Treasury Regulations. Most of these regulations are issued under the general authority found in § 7805 of the Code, which empowers the Treasury to issue "all needful rules and regulations for the enforcement of this title, including all rules and regulations as may be necessary by reason of any alteration in law in relation to internal revenue." Some commentators refer to § 7805 regulations as "interpretive" regulations because they further interpret the law enacted by Congress by providing examples, resolving ambiguity, and filling in gaps. For example, you will learn in Chapter 5 that § 119 allows employees to exclude from Gross Income the value of meals and lodgings provided to them in kind by their employers *only* if they are furnished for the "convenience of the employer," but Congress does not further define "convenience of the employer" in the statute. Thus, Treasury defines those terms in Treas. Reg. § 1.119-1 and provides several examples.

In addition, Congress sometimes specifically directs the Treasury in a particular Code section to issue regulations that, in effect, create the law where Congress has not, referred to by some commentators as "substantive" or "legislative" regulations (as opposed to interpretive regulations issued under § 7805). The best example of this is found in § 1502, which delegates broad authority to the Treasury to create the rules under which a group of commonly owned corporations can file a single, consolidated tax return instead of separate returns. These regulations, found in Treas. Reg. § 1.1502, are quite long, detailed, and comprehensive. Another good example is § 482, which empowers the Treasury to issue regulations that allocate income, deductions, credits, *etc.*, among related entities in order to "clearly reflect the income" of each. Those of you who go on to the course examining the Federal income tax consequences of international transactions will encounter the complex "transfer pricing" regulations issued under this authority in Treas. Reg. § 1.482, which seek to prevent cross-border income shifting between related entities through manipulated sales, services, royalty, and interest rates and prices—particularly when it results in a shift to a tax haven that does not have any real economic connection to the underlying business activities.

As these examples imply, the Treasury regulations pertaining to a particular Code section are usually preceded by the number "1" and a period, though you will see a few preceded by a different number (such as 301, 305, 31, 35, *etc.*) followed by a period (for procedural reasons).

Treasury regulations are often issued in proposed form for public notice and comment in the Federal Register before being made final. Tax lawyers are often very active in commenting on proposed regulations, both as individuals and as members of professional organizations, such as the American Bar Association Section of Taxation and the New York State Bar Association Section of Taxation. The Treasury may (or may not) amend the proposed regulations before finalizing them in reaction to suggestions from the practicing bar. Under § 7805(b), final regulations can be made applicable retroactive to the date on which first proposed to the public, though the Treasury may decide to make them prospective only if the final regulations make significant changes to the proposed regulations.

Some proposed regulations are also issued simultaneously as Temporary regulations if

immediate guidance is needed. Unlike proposed regulations, Temporary regulations are effective immediately, but they automatically sunset in three years under § 7805(e)(2) if not made final by then. Temporary regulations are indicated with the letter T in its notation, such as § 1.263(a)-2T—a regulation that lost its "T" in 2013 when it was made final.

While the statute enacted by Congress is the supreme source of legal authority (and thus is your best authority to cite in a legal memorandum or brief), Treasury regulations are not far behind. Nevertheless, taxpayers sometimes argue in court that a particular Treasury regulation imposing an unfavorable outcome is invalid as beyond Treasury's interpretive authority or as inconsistent with its related statutory language. Such cases are very difficult, though not impossible, to win, but they raise a subsidiary question. What level of judicial deference is accorded to Treasury regulations by courts? More specifically, does the administrative law analysis provided in *Chevron v. Natural Resources Defense Council*[6] govern judicial review of Treasury regulations? Under *Chevron*, the first question is whether Congress has "directly addressed the precise question at issue," and this inquiry is made using the "traditional tools of statutory construction." If the reviewing court believes that Congress has done so, the court must abide by the answer provided by Congress, even if different from that provided in the regulation under review. If the court determines that Congress has not directly answered the question, the second inquiry is "whether the agency's answer is based on a permissible construction of the statute." Under this inquiry, the court must defer to a "permissible" construction of the statute provided in the regulation, even if the construction is not one that the court would adopt on its own in the absence of the regulation.

Prior to the Supreme Court's 2011 ruling in *Mayo Foundation v. United States*,[7] some academics and practitioners clung to a belief in tax exceptionalism, under which tax-specific, pre-*Chevron* cases called for greater deference to legislative or substantive regulations than to interpretive regulations and used different language to test the validity of each type.[8] *Mayo* put an end to such speculation, stating that "we are not inclined to carve out an approach to administrative review good for tax law only. To the contrary, we have expressly '[r]ecogniz[ed] the importance of maintaining a uniform approach to judicial review of administrative action.'"[9] Thus, it is now fairly clear that *Chevron's* two-step analysis governs judicial review of the validity of a Treasury regulation.

The national office of the IRS Office of Chief Counsel (essentially, the IRS's lawyer) also issues various forms of guidance to the public, although this guidance—unlike most Treasury regulations—is not published in the Federal Register for notice and comment. Today, the most important of these are Revenue Rulings and Revenue Procedures, various forms of Chief Counsel Advice (including email Chief Counsel Advice), Private Letter Rulings, and Technical Advice Memorandums. Each of these is briefly described below.

**Revenue Rulings and Revenue Procedures.** Revenue Rulings and Revenue Procedures are sometimes referred to as "public rulings" to differentiate them from private rulings issued to an individual taxpayer. Revenue Rulings usually contain a short description of a fact situation, relevant law, and the IRS's conclusion regarding how the law applies to the facts. They are often issued when a recurring fact pattern comes to its attention, and the IRS decides public guidance is

[6] 467 U.S. 837 (1984).
[7] 562 U.S. 44 (2011).
[8] These tax-specific cases included National Muffler Dealers v. U.S., 440 U.S. 472 (1979), Rowan Co. v. United States, 452 U.S. 457 (1981), and United States v. Vogel Fertilizer Co., 455 U.S. 16 (1982).
[9] *Mayo*, 562 U.S. at 55 (quoting Dickinson v. Zurko, 527 U.S. 150, 154 (1999)).

necessary. Revenue Procedures, among other roles, provide guidance regarding the representations that taxpayers must make in requesting a Private Letter Ruling for a particular type of transaction. For example, you will read about Revenue Procedure 2001-28 in Chapter 16, which contains the guidelines that the IRS will use for purposes of issuing private letter rulings to taxpayers requesting assurance that a proposed sale/leaseback transaction will be respected for Federal income tax purposes. The IRS states in the Internal Revenue Manual that it will abide by outstanding revenue rulings with a taxpayer-favorable outcome, as the IRS always has the option of withdrawing the ruling if it subsequently determines that its analysis is incorrect.[10] Thus, you can be confident in advising your client of the favorable outcome reflected in a Revenue Ruling so long as the facts are identical (or not meaningfully different) and the ruling has not been withdrawn or declared obsolete. If, in contrast, a Revenue Ruling arrives at a conclusion that is contrary to the taxpayer's desired outcome, and the taxpayer pursues litigation, what level of judicial deference will be accorded to a Revenue Ruling or Revenue Procedure by a court?

No Supreme Court decision directly answers this question, but we can undertake an informed analysis. The Court held in *United States v. Mead Corporation*[11] that an agency interpretation that is not eligible for *Chevron* deference may nevertheless "claim respect according to its persuasiveness" under *Skidmore v. Swift & Co.*[12] "given the 'specialized experience and broader investigations and information' available to the agency … and given the value of uniformity in its administrative and judicial understandings of what a national law requires."[13] Whether the agency guidance is due heightened *Chevron* deference or only *Skidmore* respect turns on whether Congress has delegated authority to the agency to issue rules carrying "the force of law" and whether the guidance in question has been issued under such authority. The *Mead* Court made clear that using notice-and-comment procedures may not be necessary for guidance to be subject to *Chevron* deference and provided a multi-factor analysis to consider in making this determination. Nevertheless, while we have no definitive answer, many commentators believe that Revenue Rulings and Revenue Procedures, which are not issued with notice and comment in the Federal Register, do not carry the "force of law" and are entitled only to *Skidmore* deference, if that.[14] That is to say, if a court remains unpersuaded that the analysis contained in a cited Revenue Ruling is convincing on its own merits, it need not defer to the IRS guidance by mere fact of its publication. Going further, the Tax Court (discussed below) has stated that "revenue rulings are generally not afforded any more weight than that of a position advanced by the Commissioner on brief,"[15] though these pronouncements preceded *Mayo* and *Mead.*

Revenue Rulings and Revenue Procedures appear in the Internal Revenue Bulletin, which is issued weekly and which is semi-annually bound into the Cumulative Bulletin. For example, in Chapter 6, you will read Revenue Ruling 76-96, 1976-1 C.B. 23. The title of the ruling means that it was the 96th ruling issued in 1976, and the citation means that it can be found on page 23 of the first of the two semi-annual issues of the Cumulative Bulletin published in 1976. Because the title provides no indication of the ruling's subject matter, the best way to research rulings is through an

[10] Chief Counsel Publications Handbook, INTERNAL REVENUE MANUAL § 32.2.2.10 at http://www.irs.gov/irm/part32/irm_32-002-002.html#d0e850.
[11] 533 U.S. 218 (2001).
[12] 323 U.S. 134 (1944).
[13] *Mead Corp*, 533 U.S. at 234.
[14] *See, e.g.*, Marie Sapirie, *DOJ Won't Push* Chevron *Deference for Revenue Rulings*, 131 TAX NOTES 674 (2011).
[15] General Dynamics Corp. v. Comm'r, 108 T.C. 107 (1997) (citing Laglia v. Comm'r, 88 T.C. 894 (1987)).

online database.

**Private Letter Rulings (PLRs), Technical Advice Memoranda (TAMs), Notices, and other forms of Chief Counsel Advice (CCA).** A taxpayer contemplating a particular transaction may want advanced assurance from the IRS, before undertaking it, that the taxpayer's analysis of the proposed transaction's tax consequences is correct. So long as the matter is not on the IRS's annually issued no-rulings list (such as matters requiring fact-finding), the taxpayer (invariably through her tax lawyer) may draft and submit a Private Letter Ruling request, accompanied by a fee that varies based on the nature and complexity of the ruling. If the IRS agrees that the taxpayer's proposed tax analysis is correct, it will issue a Private Letter Ruling to that effect, which the taxpayer submits with her tax return in the year in which the transaction takes place. If preliminary conversations with IRS personnel indicate that a ruling would not be favorable, the taxpayer can withdraw the ruling request and weigh whether or not to proceed with the transaction as planned.

Significant IRS budget cuts made by Congress has forced the IRS to reduce the issuance of private letter rulings. Moreover, the cost and delay inherent in requesting a Private Letter Ruling from the IRS causes many taxpayers to decide instead to ask their tax advisor to issue an "opinion letter" to them. As its name implies, an opinion letter describes the tax advisor's informed opinion regarding the likely tax analysis that will govern the proposed transaction based on the statute, Treasury regulations, rulings, and case law. Opinion letters can be an important part of tax practice. Whether reliance on the opinion letter of a reputable tax advisor can permit the taxpayer to avoid tax penalties if the advice turns out to be wrong typically depends on whether the reliance was in "good faith" and "reasonable" under the circumstances.[16]

While taxpayers initiate PLRs in advance of a transaction, TAMs are typically initiated by IRS field personnel when auditing a taxpayer's return. If the field agent is unsure of the proper tax analysis of a transaction uncovered on audit, she may request guidance from the national IRS Office of Chief Counsel in Washington, D.C., regarding the proper analysis. The resulting answer is referred to as a TAM.

Both PLRs and TAMs are couched in the form of letters (to the taxpayer in the case of a PLR and usually to the field agent in the case of a TAM). While the IRS has long published Revenue Rulings and Revenue Procedures, it once did not publish PLRs and TAMs. Concerned that a vast body of private guidance was effectively available only to large firms with a sophisticated tax practice and routine contact with IRS personnel, the nonprofit tax publisher Tax Analysts sued the IRS under the Freedom of Information Act, requesting that the IRS be forced to publish PLRs and TAMs, and won.[17] Congress thereafter enacted § 6110, which since 1976 has required disclosure of certain types of "written determinations," including PLRs and TAMs, though identifying taxpayer information is redacted. Section 6110(k)(3) provides, however, that these items cannot be used or cited as precedent by other taxpayers. They are nevertheless quite helpful to the tax advisor, as they provide insight into how the IRS analyzes a particular transaction. At the least, they can help the advisor predict litigation risk.

[16] *See, e.g.*, U.S. v. Boyle, 469 U.S. 241 (1985). Tax advisors can also be subject to certain penalties for aiding and abetting an understatement of tax liability or promoting an abusive tax shelter. *See, e.g.*, §§ 6700, 6701. The standards under which tax lawyers and others can practice before the IRS are found in Circular 230, at www.irs.gov/pub/irs-utl/pcir230.pdf. *See also* www.irs.gov/Tax-Professionals/Circular-230-Tax-Professionals (an IRS web site for Circular 230 tax professionals containing relevant information).

[17] *See* Tax Analysts v. IRS, 505 F.2d 350 (D.C. Cir. 1974).

Both PLRs and TAMS are titled by a series of numbers and a date. For example, Chapter 8 cites PLR 201021048 (May 5, 2010), which is a Private Letter Ruling that was the 48th ruling (the last three numbers) issued during the 21st week (the middle numbers) of 2010 (the first four numbers). Because this numbering system provides no insight into the ruling's subject matter, the best way to research them is through an online database.

Notices are issued by the IRS when immediate guidance is needed. Chapter 6, for example, contains Notice 99-3, which was the third Notice issued in 1999.

In the early 1990s, the IRS significantly decreased the number of TAMs that it issued, replacing them with a new type of document called Field Service Advice (FSA) and claiming that FSAs were not required to be published. Once again, Tax Analysts sued and won.[18] Congress thereafter added § 6110(i) to the Code, specifically requiring publication of "Chief Counsel Advice," defined in very broad terms. Nevertheless, the IRS then argued that Chief Counsel Advice created in less than two hours and sent to field offices by email was not subject to disclosure (the two-hour rule). Once again, Tax Analysts sued in 2005, the District Court granted summary judgment, the D.C. Circuit affirmed, and the parties thereafter entered into a settlement in 2009 regarding the procedures under which the IRS will disclose such general legal advice, including email advice.[19]

Today, guidance from the Office of Chief Counsel can come in a number of forms, including Chief Counsel Advice (CCA), Notices, General Legal Advice Memorandum (GLAMS), and email advice. While some of these can often be researched through online databases and on the irs.gov website, email advice is usually found most easily through weekly updates published by Tax Analysts in Tax Notes Today (which also links to PLRs and other forms of Chief Counsel Advice).

Here is a good place to introduce Tax Analysts publications. Tax Notes is published in hard copy weekly and is likely available at your law library. It contains the weekly tax news on many fronts, as well as descriptions of new cases and short law-review-type articles on hot tax topics. It is a great resource for students looking to learn more about tax practice and what is going on in the tax world.

Tax Notes Today (TNT) is a daily dose of tax news that can be accessed on Lexis Advance. Click the pull-down menu at the top left next to "Lexis Advance Research" and click on "Lexis Advance Tax." At the bottom right of that page, click on "Tax Analysts Tax Notes Today" and then on "Get all documents for this source." It brings up the current date's Tax Notes Today (in reverse chronological order, so you'll eventually get to yesterday's Tax Notes Today, and so on). Click by several pages until you reach "Table of Contents" followed by "Summaries of Today's Important Tax Items." I suggest clicking on "Summaries" first, which summarizes the important news items. If any interest you, you can click further for the full story on the item. After working your way through the "Summaries" page, go back and click on the "Table of Contents" page, which will first list the tax headlines that you just read (without the accompanying summaries) but then will go on to list tax cases of the day, I.R.S. guidance, and links to third-party documents, such as reports drafted by the Congressional Budget Office, the Congressional Research Service, business and consumer groups, and think tanks (of various stripes) that focus on tax issues. You can click on anything that piques your interest. Practitioners often begin their day by perusing these two levels of TNT.

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[18] *See* Tax Analysts v. IRS, 117 F.3d 607 (D.C. Cir. 1997).
[19] *See* 2009 TNT 58-1, *available at* LEXIS, Tax Analysts, Tax Notes Today.

Finally, when a lower court issues a decision that is adverse to the government's position in the case, the Office of Chief Counsel will sometimes issue an "Action on Decision" (AOD) that announces the future litigation position that the IRS will take with regard to the issue. The AOD may announce, for example, that the IRS does not acquiesce in the outcome and will continue to litigate the issue. Or it may announce that it will acquiesce in the outcome and not pursue litigation in similar cases. If you find a judicial decision in favor of your client's position, you will want to research whether the Office of Chief Counsel has issued an AOD, which you can find at http://apps.irs.gov/app/picklist/list/actionsOnDecisions.html.

***Tax procedure overview***

Some of you will undoubtedly take the course on tax procedures, penalties, and crimes, but I want to provide a cursory overview of the basic civil tax procedural mechanisms that arise from the filing of a tax return to the initiation of litigation, if necessary.

For virtually all individual taxpayers, the taxable year (considered in Chapter 21) is the calendar year, and individual taxpayers are generally required to file an income tax return reporting their Taxable Incomes by April 15th of the year following the close of the calendar year and to pay any tax owed by the same date. Section 6065 requires the return to be signed under penalties of perjury. Most taxpayers may request an automatic six-month extension of time to file without having to provide any justification for the delay by timely filing Form 4868, but they must nevertheless pay the estimated tax due by the April 15th due date. If the later filed return shows that the tax actually due exceeded the estimated amount paid by no more than 10%, Treas. Reg. § 301.6651-1(c)(3)(i) provides that the IRS will not assert penalties, though the taxpayer will owe interest on the underpayment between the April 15th due date and the date on which the underpayment is paid.

The IRS engages in several types of audit review of taxpayer returns, including computer matching of amounts reported by payors and payees (of compensation, for example), correspondence examinations (by letter), office audits (at an IRS office), and field examinations (at a taxpayer's business, for example). If the examining agent accepts the return as filed, he will issue a "no change letter" to the taxpayer. In contrast, if the examining agent concludes that tax has been underpaid, he will draft a document often referred to as a "30-day letter" that contains the proposed tax adjustment. The 30-day nomenclature arises from the fact that the taxpayer has 30 days from the date of issuance to invoke the appeals process within the IRS, though the 30-day period is often extended. The taxpayer invokes the appeals process by filing a "protest" of the adjustment that describes her analysis of the facts and law, often drafted by a tax lawyer or other representative under a power of attorney executed on Form 2848. If the proposed adjustment is less than $25,000, however, the protest can take the form of a simple letter requesting appeals consideration.

During the appeals process, the taxpayer's representative will meet with the appeals officer assigned to the case for a conference, which the taxpayer may (or may not) attend, in an attempt to reach a settlement of the outstanding issues. The conferences are informal, with no transcript or rules of evidence. "Depending on the kind of case and the particular office, Appeals usually resolves 80% to 90% of the cases it takes, whether by full concession by the IRS, full concession by the taxpayer, or compromise."[20] A "closing agreement" to memorialize the settlement, which is generally binding on both parties, can be entered under § 7121. Arbitration or mediation is also

[20] DAVID RICHARDSON, JEROME BORISON & STEVE JOHNSON, CIVIL TAX PROCEDURE 126 (2nd ed. 2008).

a possibility.

If the taxpayer fails to request the appeals process within the required time (or the appeals process does not result in settlement), the IRS will issue a statutory notice of deficiency, often referred to as the "90-day letter." The 90-day nomenclature arises from the fact that the taxpayer has 90 days from the date of issuance to file a petition with the Tax Court under § 6213, which tolls the statute of limitations, to litigate the proposed adjustment without first paying the asserted tax owed. If the taxpayer does not file a Tax Court petition, the IRS can formally "assess" the tax at the expiration of the 90-day period.

The IRS's formal "assessment" of the tax owed under § 6203 (which is nothing more than a recording of the tax debt in the IRS's system and a mailing to the taxpayer's last known address) must occur within the applicable statute of limitations, which generally is three years from the *later* of the date the return is filed or its due date (absent tolling). If a taxpayer fails to file a return, therefore, the statute of limitations remains open indefinitely. There is no statute of limitations for fraud, and certain items have special statutes of limitations that differ from the general three-year rule. Formal assessment is required before collection can commence, including the possible use of property liens.

A few of the more important penalty provisions are discussed in Chapter 16.

***The judicial branch***

As noted above, the statutory rules governing Tax Court jurisdiction permit the taxpayer to litigate a proposed deficiency without first paying the asserted tax owed. The Tax Court is an Article I (rather than Article III) court located in Washington, D.C., consisting of 19 judges appointed by the President and confirmed by the Senate for 15-year terms. Retired judges whose terms have expired may serve as "senior judges" if recalled by the Chief Judge. In addition, the Tax Court employs a number of "special trial judges" that are the counterparts of magistrates in other Federal courts. Tax Court cases are heard by a single Tax Court judge, although the other judges have an opportunity to review a decision before it is published. In addition, if a case contains a novel issue or is one in which the court may reverse its own prior precedent, the Chief Judge may designate a case to be reviewed by the court conference, which consists of all 19 Tax Court judges, with a senior judge participating if it is his or her case that is before the conference. Such a decision is referred to as a "reviewed decision" and is similar to an *en banc* decision in other forums. A reviewed decision may have majority, concurring, and dissenting opinions. Although the court is based in Washington, D.C., the judges effectively "ride circuit" by hearing Tax Court cases in cities around the country throughout the year, which permits individuals to avoid the cost of traveling to Washington, D.C. IRS lawyers from the Office of Chief Counsel represent the government before the Tax Court.

Reviewed and "regular" opinions (as distinguished from memorandum and small-case decisions, described below) are formally reported in the United States Tax Court Reports. Long ago, the last name of the IRS Commissioner at the time appeared as the government party in Tax Court case names. For example, you will see many case names with "Helvering" as the government party, after Guy T. Helvering, who served as the Commissioner of Internal Revenue from 1933 to 1943 (and as a Congressman before and a Federal District Court judge after his service as Commissioner). Today, the government is represented simply by "Commissioner" in Tax Court decisions (*e.g.*, *O'Donnahbain v. Commissioner*, 134 T.C. 34 (2010), cited in Chapter 18).

Tax Court decisions involving the routine application of law to fact are published in "memorandum decisions," which are not formally reported in the United States Tax Court Reports. Nevertheless, some private publishers have long published memorandum decisions, and you can find them easily online (*e.g.*, *Berry v. Commissioner*, T.C. Memo. 2000-373, cited in Chapter 9). Similarly, "small case" decisions under § 7463, involving deficiencies of $50,000 or less that the taxpayer elects to litigate under simplified procedures at the cost of waiving appeal rights, are not formally published. The Tax Court's website, however, now posts *all* decisions (whether reviewed, regular, memorandum, or small case decisions) at www.ustaxcourt.gov.

Two other trial forums are available in addition to the Tax Court, which creates the ability to engage in some forum shopping: (1) the Federal District Court in which the taxpayer resides[21] and (2) the Court of Federal Claims, which is located in Washington, D.C. To gain access to either of these courts, the taxpayer permits the IRS to assess the deficiency by allowing 90 days to pass without filing a Tax Court petition, pays the asserted tax owed, and sues the Federal government for a refund of the claimed overpayment within the time frame required under the relevant statute of limitations. The taxpayer must pay the asserted tax owed because the subject matter jurisdiction of these courts is predicated on the claim that the government owes the taxpayer cash.

These two refund forums are also available in the case of overpayments outside of an audit, as well, such as when an employer or other taxpayer withholds (and sends to the IRS) too much estimated tax from a payment owed to the taxpayer. In that case, the taxpayer must first timely file a refund claim with the IRS, generally within the *later* of three years from the time the return is filed or two years from the time the tax was paid. If the IRS fails to pay the requested refund, the taxpayer can file a refund claim in either of these two forums. The government is usually represented by lawyers from the Department of Justice, Tax Division, in these two forums, and the government is usually indicated by "United States" in the case name (*e.g.*, *United States v. Gotcher*, 401 F.2d 118 (5th Circ. 1968), cited in Chapter 6).

**Choosing the forum.** Because Tax Court jurisdiction can be obtained without first paying the asserted tax deficiency, between 85% and 90% of tax litigation occurs there. A taxpayer litigating in either of the refund forums avoids interest accruals on any tax underpayment because the tax at issue has already been paid. Although interest continues to mount on the tax deficiency during the pendency of Tax Court litigation (should the taxpayer lose on the merits), the taxpayer can both prevent interest from accruing and maintain Tax Court jurisdiction if he pays the asserted deficiency *after* issuance of the 90-day letter.

Depending on the nature of the dispute, a taxpayer may wish to have issues of fact determined by a jury, available only in Federal district court, though jury trials are rare in civil tax cases.

Taxpayer cost can also factor into forum choice. A taxpayer living outside the Washington, D.C., area may be able to avoid travel costs by litigating in either the Tax Court (as it rides circuit) or his local Federal District Court. Unlike the Tax Court, the Court of Federal Claims usually hears cases only in Washington, D.C. In addition, the Tax Court requires informal discovery before formal discovery proceeds, which can reduce costs. The two refund forums do not have similar informal discovery proceedings. Finally, taxpayers can represent themselves *pro se* relatively easily in Tax Court, although this choice can often be an unwise one under the old adage that "he who represents himself has a fool for a client." Leandra Lederman and Warren B. Hrung conducted

[21] Bankruptcy courts can also hear tax disputes that arise in the course of bankruptcy adjudication.

an empirical study and found that *pro se* representation was detrimental in tried cases, though it did not affect the outcome in settled cases.[22]

Finally, each court's prior precedent—as well as the precedent of the court that would hear any appeal—should be an important factor in deciding where to litigate. The Tax Court's prior precedents include decisions of the Board of Tax Appeals (cited as B.T.A.), the predecessor to the Tax Court. Similarly, precedents for the Court of Federal Claims include decisions of its two predecessors: the Court of Claims and the Claims Court. Decisions of both the Tax Court and Federal District Court are appealed to the Circuit Court of Appeals in which the taxpayer resides. Decisions of the Court of Federal Claims are appealed to the Federal Circuit Court of Appeals.

Prior to 1970, the Tax Court believed that its role as a national court required it to be free to ignore Circuit Court of Appeals precedent with which it disagreed—even if that meant that a taxpayer appeal from an unfavorable Tax Court decision would likely result in an automatic reversal because the taxpayer lived in a circuit containing clear precedent that was contrary to the Tax Court's view of the issue. Because this stance imposed unnecessary costs on such taxpayers, the Tax Court announced a change of heart in *Golsen v. Commissioner*.[23] Today, the Tax Court will abide by precedent of the Circuit Court of Appeals in which the taxpayer resides under the so-called *Golsen* rule if the precedent is directly on point, even if the Tax Court disagrees with it. As you can imagine, whether a particular precedent is directly on point or is distinguishable in a relevant respect remains an issue, however.

Cases can be heard by the Supreme Court if it grants a *writ of certiorari* from the losing party at the Circuit Court of Appeals level. The Court is most likely to grant *cert.* in the case of a significant split among the various Circuit Courts of Appeals regarding the matter at issue—although the Court is generally known to dislike tax cases.

### *Excerpt from* Of Crud and Dogs: An Updated Collection of Quotations in Support of the Proposition That the Supreme Court Does Not Devote the Greatest Care and Attention to Our Exciting Area of the Law[24]

Erik M. Jensen

''This is a tax case. Deny.' That was [Justice William] Brennan's normal reaction to a [certiorari] request in a tax case.'[1]

'If one's in the doghouse with the Chief [Justice Burger], he gets the crud. He gets the tax cases. . . .' — Justice Harry Blackmun.[2]

A dog is ''a case that you wish the Chief Justice had assigned to some other Justice.' A deadly dull case, 'a tax case, for example.'' — Recently retired Justice Lewis F. Powell Jr.[3]

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[22] Leandra Lederman & Warren B. Hrung, *Do Attorneys Do Their Clients Justice? An Empirical Study of Lawyers' Effects on Tax Court Litigation Outcomes*, 41 WAKE FOREST L. REV. 1235 (2006), at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=899461.
[23] 54 T.C. 742 (1970).
[24] 58 TAX NOTES 1257 (1993). Reprinted with permission of the author.
[1] Bob Woodward & Scott Armstrong, THE BRETHREN 362 (1980).
[2] Quoted in Stuart Taylor, Jr., *Reading the Tea Leaves of a New Term*, N.Y. TIMES, Dec. 22, 1986, at B14.
[3] Quoted in Stuart Taylor, Jr., *Powell on His Approach: Doing Justice Case by Case*, N.Y. TIMES, July 12, 1987, at 1.

'Asked why he sings along with the chief justice at Mr. Rehnquist's annual Christmas carol party, [Justice David Souter] replies: 'I have to. Otherwise I get all the tax cases.''[4]

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Add to the list above Justice Ruth Bader Ginsburg's initial reply (in her law professor days before she joined the D.C. Court of Appeals and then the Supreme Court) to her husband, the late, great tax lawyer and tax law professor Marty Ginsburg, when he brought a Tax Court opinion for her to read one evening as they were working in their separate studies:

> I went next door, handed the advance sheets to my wife, and said, "Read this." Ruth replied with a warm and friendly snarl, "I don't read tax cases." I said, "Read this one," and returned to my room. No more than 5 minutes later—it was a short opinion—Ruth stepped into my room and, with the broadest smile you can imagine, said, "Let's take it." And we did.[25]

The 1970 case was *Moritz v. Commissioner*,[26] in which the Tax Court denied Mr. Moritz a deduction under (now repealed) § 214(a) of the Internal Revenue Code for expenses incurred in caring for his dependent invalid mother. The statute permitted the deduction to be taken only by a woman, a widower or divorced man, or a man whose wife was incapacitated or institutionalized. Mr. Mortiz was denied the deduction solely because he was a never-married man. The Ginsburgs agreed to represent Mr. Moritz *pro bono* in his appeal, and the Tenth Circuit Court of Appeals reversed on equal protection grounds. And there is more to the story!

> The government, amazingly, petitioned for certiorari on the asserted ground that the 10th Circuit's decision cast a cloud of unconstitutionality over literally hundreds of federal statutes that, like … § 214, contemplated differential treatment on the basis of sex. In those pre-personal computer days, there was no easy way for us to test the Government's assertion but the Solicitor General (Erwin Griswold, whom many of you will recall) took care of that by attaching to his petition a list—generated by the Department of Defense's mainframe computer—of those hundreds of suspect statutes. Cert. was denied in *Moritz*, and the computer list proved a gift beyond price. Over the balance of the decade, in Congress, [before] the Supreme Court, and many lower courts, Ruth successfully urged the unconstitutionality of those statutes.
>
> So Mr. Moritz's case mattered a lot. First, it fueled Ruth's early 1970s career shift from diligent academic to enormously skilled and successful appellate advocate—which in turn led to her next career on the higher side of the bench. Second, with Dean Griswold's help, *Moritz* furnished the litigation agenda Ruth actively pursued until she joined the D.C. Circuit in 1980.
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> All in all, great achievements from a tax case with an amount in controversy that totaled exactly $296.70.[27]

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[4] Paul M. Barrett, *David Souter Emerges as Reflective Moderate on the Supreme Court*, WALL ST. J., Feb. 2, 1993, at 1.
[25] Martin D. Ginsburg, *A Uniquely Distinguished Service*, 10 GREEN BAG 2D 173, 174-75 (2007).
[26] 469 F.2d 466 (10th Cir. 1972), reversing 55 T.C. 113 (1970).
[27] Ginsburg, *supra* note 26, at 175-76.

# Unit I:

# The Core Structures of Income and Consumption Taxation and Tax Policy

## Introduction to Chapters 1 through 4

Taxation is the means by which all governments, including our Federal government, raise revenue to pay for the costs of government, including the military, infrastructure, court system, Federal agencies, Medicare, Social Security, basic research that the private sector cannot accommodate, interest on loans used to smooth the peaks and valleys of the tax revenue stream when economic activity decelerates with recessions, *etc.* We can call the aggregate tax collected in any particular year *$X*. Regardless of whether you think *$X* is too high or too low, we must decide how the economic burden of *$X*—whatever the amount—should be allocated across the members of the population. Two attributes of a tax system that will affect the allocation of *$X* are (1) the tax base, *i.e.*, what is taxed and (2) the tax rate structure.

For example, suppose that Mary earns $75,000 in wages and no investment income. John earns $50,000 in wages but also receives $30,000 in interest paid on his substantial investment in corporate bonds. The burden of *$X* will be allocated very differently between Mary and John if we choose to tax, say, only investment income (such as John's interest), only wages, or both.

Similarly, suppose that Mary spends only $60,000 of her $75,000 in wages on personal consumption purchases for the year (such as food, clothing, rent, entertainment, *etc.*) and saves the remaining amount (after paying any tax that she owes) by depositing it in a bank savings account. Of the aggregate $80,000 that John earns in wages plus interest, he spends $40,000 on consumption purchases, depositing the remaining amount (after paying any tax that he owes) in a savings account. The burden of *$X* will be allocated very differently between Mary and John if we choose a tax base comprised only of amounts spent on personal consumption—and not amounts saved.

The tax rate structure also has an effect on how the burden of *$X* is apportioned across the members of the population. If our tax base comprises only wages, for example, notice how the allocation of the tax burden differs depending on whether we decide that a single tax rate should apply to each and every dollar earned (including the first dollar earned), a single tax rate should apply to wages exceeding a floor of tax-free wages, or progressively higher rates should apply to each chunk of wages earned (such as, say, 0% of the first $20,000 of wages, 10% of the next $30,000, 20% of wages between $40,000 and $100,000, 30% of wages between $100,000 and $500,00, and 40% of wages above $500,000).

Finally, the tax rate structure is necessarily affected by our prior choice of tax base. Generally speaking, the narrower the tax base, the higher rates must be to raise *$X*. The broader the tax base (the more items that are taxed), the lower rates can be to raise that same *$X*. Thus, decisions to accord preferential tax treatment to certain classes of activities or income affect not only those who benefit from these decisions but every remaining taxpayer who does not so benefit because their tax rates are higher than they would otherwise need to be to raise *$X*. In this way, decisions

regarding how to tax, say, multinational corporations affect not only the shareholders of multinational corporations (and their workers) but also the barista at the local coffee shop.

Our choice of tax base and tax rate structure will be affected by our shared (or contested) notions of (1) fairness in allocating *$X*, (2) the evidence (or beliefs, even in the absence of empirical data) of how different tax bases and rate structures affect economic activity (and thus aggregate societal wealth), and (3) administrative concerns. Our stated goal always is to raise *$X* in a way that is fair, administrable, and least damaging to economic growth. Or, as once stated more colorfully by Jean Baptiste Colbert, minister of finance to King Louis XIV of France, taxation is the art of "plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing."

Chapters 1 and 2 consider the two most viable possibilities under our current Constitution for a tax base broad enough to raise sufficient revenue for a modern industrialized state: income and consumption. Chapter 1 also introduces you to the essential structure of our Federal income tax, which often departs from a theoretically pure income tax, including mechanisms to prevent a certain amount of subsistence consumption from taxation. It also explores the difference between marginal and effective tax rates. With this information in hand, you will be in a better position to consider the history of how we got to where we are today, data regarding economic trends, as well as the ethical and economic theories affecting tax policy debates, all discussed in Chapter 3. Because the capitalization principle is the mechanism that primarily distinguishes an income tax from a consumption tax, Chapter 4 rounds out Unit 1 with a deeper look at current law regarding which outlays constitute a "capital expenditure."

# Chapter 1: The Essential Structure of the Income Tax

Part A. of this chapter introduces the core structure of an income tax under tax theory and how that theory is translated into positive law (or, in some cases, how positive law departs from theory). The idea is to demystify the Code, as many of the provisions that make up the backbone of the current Federal income tax is what you would expect to find there once you grasp the contours of that underlying theory.

Part B., in contrast, departs from core theory to explore three topics: (1) the mechanisms used in current law that permit a certain amount of subsistence consumption to escape taxation, (2) how several provisions categorize groups of deductions in a manner that devalues some of them (or, stated differently, how certain deductions are given precedence over others), and (3) the difference between marginal tax rates and effective tax rates.

## A. The theoretical core structure of a tax on "income" and how it is implemented in positive law

As you will read about more fully in Chapter 3, the modern Federal income tax was enacted in 1913 after ratification of the 16th amendment to the Constitution. What does that term "income" mean for tax purposes? In the early days of the income tax, before a tax-specific meaning of the term was explored and developed, the temptation was great to borrow meanings from other disciplines where the term "income" had been used for some time.

For example, suppose that Father died 200 years ago. In his will he directed that all of his land, which is rented to tenant farmers, be contributed to a trust. The trust document instructed the trustee (who managed the trust property) to distribute the "income" from the trust annually to his surviving wife for the rest of her life (a "life estate" to you property law buffs) with the "remainder" distributed to his son on his wife's death. Upon his wife's demise, the trust would distribute the land to the son, and the trust would be dissolved.

Under trust law at the time, the rent collected from the tenant farmers would be "income" that would be distributed to the wife annually. If, however, the trustee decided to sell a plot of land for $100 that had been purchased by Father before his death for, say, $75, the $25 profit from that sale would *not* be considered "income" that would be distributed to the wife. Rather, the cash (even if not reinvested in a different plot of land) would be considered to be part of the trust "corpus" that would eventually be distributed to the son under his remainder interest. Does that mean that the $25 profit should not constitute "income" for *tax* purposes, as well? Early on, some argued that it did. (And some continue to argue that such profit should not be taxed. Stay tuned.)

Similarly, financial accountants had long been used to constructing "income" statements for businesses so that those interested in the economic health of the business (such as potential investors and lenders) could have relevant information upon which to make informed financial decisions. Here, the $25 profit earned on the sale of land for $100 that had been purchased for $75 *would* show up on the "income" statement. But should financial accounting be determinative? Or might the rules of financial accounting deviate from the underlying values that inform how the aggregate tax burden *$X* ought to be apportioned among the members of the population?

Over time, theorists such as Henry Simons and Robert Haig (in the U.S.), George Schanz (in Germany), and others began to develop a tax-specific meaning for "income" that sometimes coincided with the meaning of the term in other disciplines and sometimes did not. They recognized that different disciplines may have different underlying purposes and values that inform the contours of the term "income" in a way that is uniquely suited to its particular purposes. By 1938, for example, Henry Simons, a public finance economist at the University of Chicago, described income for uniquely *tax* purposes in the following way.

> 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.[1]

While "the period in question" could theoretically be one's entire life, with no tax due until death, for administrative ease (and the regular collection of tax) the "period in question" is usually one year.

What does this language mean? Generally, the language after (2), above, implies that we should tax the *net increases in the taxpayer's wealth between the beginning and end of the year*. That is to say, the taxpayer's increases in wealth and reductions in wealth should be netted together, and the *net* increase (if any) should be taxed. Suppose, however, that the taxpayer's reduction in wealth arises from, say, spending $5,000 on a vacation trip. The taxpayer is certainly less wealthy after the trip than before because of the outlay, but should that wealth reduction be factored into his "net wealth increase" for the year? The language after (1) implies that *a reduction in wealth should not reduce the tax base if that wealth reduction reflects personal consumption spending because consumption spending is intended to remain within the tax base*. We can tax consumption spending (the vacation trip) only if we forbid that wealth decrease from entering into our determination under (2) regarding whether the taxpayer has enjoyed a net wealth increase or suffered a net wealth decrease for the year. Thus, more simply, the formula above could be restated essentially as:

> **Annual income equals wealth increases *less* wealth reductions but only if the wealth reduction does not represent personal consumption.**

In this way, wealth reductions spent on personal consumption (such as the vacation trip mentioned above) do *not* reduce the tax base (what is taxed). Because they do not reduce the tax base, they are taxed—albeit indirectly—by remaining *within* the tax base.

Because Schanz and Haig came to essentially the same conclusion, you will often hear this construction called the "Haig-Simons" or "Schanz-Haig-Simons" definition of "income" for purposes of income taxation. For shorthand, we can refer to it as SHS income.

Let's use a simple fact pattern to explore how a given item would be treated under the SHS economic conception of income and then proceed to the outcome under positive law found in the Internal Revenue Code. As mentioned above, the idea is to demystify the Code: a lot of what is in the Code—at least with the respect to its normative, core provisions (those that seek to properly measure "income" as a theoretical matter) as opposed to all the bells and whistles that then clutter it up—is what you would expect to find there, once you understand the underlying normative concepts that define an income tax. This exercise not only helps to rationalize the core structure of an income tax for you; the best tax lawyers are those whose knowledge of the underlying core

[1] HENRY SIMONS, PERSONAL INCOME TAXATION 50 (1938).

concepts helps them to advise a client on the likely outcome when positive law is ambiguous.

> **John and Mary are married and have two minor children, Oliver (age 10) and Sophie (age 7). Mary is the CEO of a mid-size corporation and receives an annual salary of $1 million. John is a dentist and the sole owner of an LLC that houses his dental practice. As described in the Introduction, a single-owner LLC is a disregarded entity for Federal income tax purposes, which means that its Gross Income and any allowable deductions will appear on John's and Mary's joint income tax return.[2]**
>
> **John's gross revenue collected from billing patients is $500,000 each year. This amount, however, is only his "gross" revenue. Unlike Mary, who is an employee, John incurs many costs in running his business. For example, he pays his receptionist and dental assistants a salary, he pays rent and utilities for his office space, and he purchases a new dental chair and X-ray machine this year.**
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> **John and Mary owned investment land that they rented to tenant farmers, which they purchased more than two years ago in May for $12,000 (Year 1). By December 31 of Year 1, the land had increased in value by $1,000 and was worth $13,000. By the end of Year 2, it had decreased in value to $10,000. In August of this year (Year 3), they sell it for $14,000 in cash. Before the sale of the land, they receive $1,000 in monthly rent from their tenant farmers. They also have a bank savings account, which generates $200 of interest this year.**
>
> **John's mother makes a substantial gift of $10,000 in cash to her son this year toward a down payment on the purchase of a new home for $1.5 million.**
>
> **John and Mary buy food and clothing, pay rent for a flat (before they buy their new house), pay utility costs with respect to both their rented flat and new home (after moving in), and take the kids to Disney World this year.**

Turning for a moment to positive law, look at § 1 of the Internal Revenue Code, which reveals that **the tax base—what is ultimately taxed—is called "Taxable Income."** Taxable Income is multiplied by the tax rates in § 1 to reach the tax due. (The tax rates you see in § 1, as well as the floors and ceilings for each bracket, do not reflect the changes in law since 1986 or the inflation adjustments mandated by § 1(f). We shall examine the current rate structure in Part B.) If Taxable Income incorporates perfectly the SHS concept of income, it should result in a tax base that consists of **wealth increases *less* wealth reductions but only if the wealth reduction is not spent on personal consumption.** What is Taxable Income under the Code?

For now, Taxable Income is "Gross Income" less allowable "deductions." Gross Income pertains to a *wealth increase*, whereas deductions pertain to certain *wealth reductions*.

Gross Income (wealth increases)
*Less* Deductions (certain wealth reductions)

Taxable Income (the tax base—what is ultimately taxed)

[2] If John had created a corporation instead of an LLC, the entity would not be ignored for Federal income tax purposes. The Federal income taxation of corporations, partnerships, and multi-owner LLCs and their owners are beyond the scope of this introductory textbook, which focuses on the income taxation of individuals.

***Introduction to § 61 "Gross Income"***

Gross Income under the Code is defined in § 61: "Gross Income means all income from whatever source derived, including (but not limited to)" fifteen listed items. Notice how open-ended it is (even circular, by referencing "income" in defining "Gross Income"). Notice also that the fifteen listed items do not exhaust the outer reaches of Gross Income because Congress included that crucial parenthetical: "(but not limited to)." In other words, Congress clearly contemplated that items of Gross Income exist in the world that are not specifically found in that list of fifteen items. In Chapter 6, we shall consider what items that are *not* listed in § 61 nevertheless constitute Gross Income under that vague *residual clause* at the beginning: Gross Income means income from whatever source derived.

Some of the listed items are obvious SHS wealth increases, such as § 61(a)(1) "compensation for services, including fees, commissions, fringe benefits, and similar items," § 61(a)(4) interest, and § 61(a)(5) rents. In each case, the recipient is wealthier after the receipt than before.

So let's return to Mary and John. Mary's $1 million in wages is clearly listed in § 61(a)(1) and thus is clearly includable in Gross Income, as is true for the interest generated by their savings account and the rent that they receive from their tenant farmers. The $500,000 that John receives from his patients for performing dental services is also described in § 61(a)(1) or § 61(a)(2) ("Gross Income derived from business"), as this amount constitutes fees for services that he performs for his patients in his sole proprietor business.

You might at first object that we should not *tax* John on the entire $500,000 under SHS principles because even a cursory consideration of the facts indicates that John incurs substantial costs in earning that "Gross" Income (unlike Mary, an employee). That is to say, it is obvious that he does not enjoy a wealth increase from his dental practice by the *entire* $500,000. While you would be correct, remember from our computation above that Gross Income under the Code is not the tax base (what will end up actually being taxed) but only the *first step* in reaching the tax base of "Taxable Income." John will be able to reduce his Gross Income by any allowable deductions (considered below) in reaching Taxable Income. John cannot take shortcuts, however, and reduce the $500,000 gross payments received from his patients to some lesser amount and include only the net profit in determining § 61 *Gross* Income in the first place. He must include every dollar of that $500,000 in his § 61 Gross Income. Only then can he consider allowable deductions in reaching Taxable Income.

What about the $10,000 that John's mother gives to him in order to help John and Mary purchase a home? Under SHS principles, John clearly enjoys a wealth increase on receipt of the $10,000 in cash and should include that $10,000 in the tax base. Notice, however, the introductory language to § 61(a): "[u]nless as otherwise provided in this subtitle." This language puts you on notice that what may otherwise constitute includable Gross Income (a wealth accession) might be rendered "excludable" under a specific statutory provision found elsewhere in the Code. One such provision is § 102(a), which provides John with statutory authority to *exclude* from Gross Income "gifts, bequests, devises, and inheritances." Why does positive law deviate from the core SHS concept of income here? Deviations from SHS income are not necessarily illegitimate, but they do make us pause and ask "why"? Stay tuned. We shall consider many such exclusions before the course is over, including an entire chapter devoted to the gift exclusion (Chapter 7). For now, I introduce you to § 102(a) chiefly to familiarize you with the *concept* of an "exclusion." **An "exclusion" pertains to a receipt or other wealth accession that nevertheless does not enter**

**into § 61 Gross Income.** The "whys" and "wherefores" will have to wait.

So we can amend our little formula from above.

Gross Income (wealth increases: **exclusion available?**)
*Less* Deductions (certain wealth reductions)

Taxable Income (the tax base—what is ultimately taxed)

Notice that "exclusion" is not the same thing as "deduction." Although both have the same economic effect of reducing the tax base (what is ultimately taxed), one (exclusions) pertain to wealth *increases*—an *inflow* idea—that never enter into Gross Income in the first place. The other (deductions) pertain to wealth *reductions*—an *outflow* idea—that reduce Gross Income in reaching Taxable Income (what is ultimately taxed). So let's turn to a few of John's and Mary's potential wealth reductions and consider whether they should be deductible from Gross Income in reaching Taxable Income.

***Deductions (part 1): nondeductible "capital expenditures" vs. potentially deductible "expenses"***

Which *outflows* or *wealth reductions* of John and Mary might be deductible in reducing § 61 Gross Income to reach Taxable Income? Our facts state that John and Mary pay salaries to his receptionist and dental assistant, pay rent and utilities for his office space, pay rent (before their home purchase) and utility costs for their personal residence, buy food and clothing, and take the kids to Disney World on vacation.

Recall our restatement of the SHS conception of "income" for tax purposes: annual income equals wealth increases *less* wealth reductions but only if the wealth reduction does not represent personal consumption. The language after "less" in the formulation above implies that an outlay must satisfy two, independent conditions before it should reduce the tax base via a deduction (if we are to honor SHS principles):

**To be deductible under SHS principles,**

**(1) the outlay or event must decrease wealth; *AND***

**(2) the wealth reduction must *not* represent personal consumption.**

Let's first consider John's and Mary's purchase of the investment land (which they rented to tenant farmers) for $12,000 in Year 1. Should that $12,000 cash outlay be deductible under SHS principles? To be deductible, the first requirement is that the outlay must decrease their wealth. Are John and Mary any less wealthy after taking $12,000 in cash (from, say, Mary's salary) and using it to purchase land *worth* $12,000? No, they are not any less wealthy. Rather, they have merely changed the form in which they are holding their wealth from dollar bills to land. Thus, their cash outlay to purchase the land should not generate a deduction (reducing their Gross Income in reaching Taxable Income).

In general, the nomenclature for an outlay that does not *reduce* wealth but rather merely *changes the form in which wealth is held* is called a "**capital expenditure**." In contrast, an "**expense**," in general, is an outlay that *immediately reduces wealth*. In other words, a capital expenditure is the opposite of an expense (and vice versa). Notice, by the way, that "expense" is thus a defined word of tax art. You must not make the mistake of using the word casually to mean any old outlay, even though the word "expense" is common and used outside of tax every day (whereas "capital

expenditure" rarely comes up in casual conversation).

***In order to deduct a wealth reduction under the Internal Revenue Code, you must find a Code section containing the magic words "there shall be allowed a deduction" and satisfy each and every requirement contained in that Code section. Even if you satisfy this Code section, you must then consider whether another, different Code section steps in to take away an "otherwise allowable" deduction.***

Is there a Code section that says "there shall be allowed a deduction for capital expenditures"? No, there is not. Indeed, **§ 263** ***expressly disallows*** **deduction of capital expenditures**. Why did Congress go to the bother of enacting a Code section expressly forbidding the deduction of capital expenditures if they would not be deductible in any event with silence? Before 1954, no Code section expressly forbade the deduction of capital expenditures, but that does not mean that capital expenditures were deductible; they were not deductible even before 1954 because no Code section authorized the deduction. But how do we know which outlays constitute "capital expenditures" (nondeductible) and which constitute "expenses" (potentially deductible)? The enactment of an express prohibition on deducting "capital expenditure" in § 263 provided a place for the Treasury Department to issue Treasury Regulations that help us to determine whether an outlay is—or is not—a capital expenditure (the topic of Chapter 4).

For example, take a sneak peek at Treas. Reg. § 1.263(a)-2(d)(1) and (2), Ex. (1). It states that "a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property … including … land and land improvements, buildings, machinery and equipment, and furniture and fixtures," and the example provides that the cost of purchasing new cash registers for use in a retail store is a nondeductible capital expenditure. The purchase of a new cash register merely changes the form in which the taxpayer is holding wealth rather than decreases his wealth.

Thus, Mary and John are not permitted to deduct the $12,000 outlay in purchasing the land in Year 1 because the outlay is categorized as a capital expenditure. Similarly, John cannot deduct the cost of the new dental chair and X-Ray machine that he purchases this year in connection with his dental practice, and they cannot deduct the purchase price of their new personal residence. None of these outlays reduce John's and Mary's wealth immediately but rather merely change the form in which they hold their wealth.

The same would have been true if they had decided to purchase shares of corporate stock (intangible property) instead of land, equipment, or a personal residence (tangible property). Look at Treas. Reg. § 1.263(a)-4(b)(1) and (c)(1)(i). Together, they provide that "a taxpayer must capitalize an amount paid to acquire an intangible," such as an ownership interest in a corporation, partnership, or limited liability company, among other items.

By being denied deductions for the land, dental equipment, and personal residence purchased in Year 1, John and Mary are indirectly taxed on these business, investment, and personal purchases of long-lived property in the year of purchase. ***A SHS income tax taxes additions to savings (such as stock purchases, land purchases, purchases of business equipment, purchases of personal residences, additions to a savings account, etc.) by denying deductions for these "capital expenditures" (mere changes in the form in which wealth is held as opposed to a reduction in wealth).***

***§ 61(a)(3) "gains derived from dealings in property" and the critical role of "basis"***

We have seen that John and Mary were not permitted to deduct the cost of their $12,000 outlay

when they purchased the land in May of Year 1 because the outlay did not reduce their wealth. The facts also tell us that the land increased in value to $13,000 by December 31 of Year 1. Does this $1,000 wealth increase result in a § 61 Gross Income inclusion for them at the end of Year 1?

If the Internal Revenue Code perfectly incorporated the SHS concept of income, the answer would be "yes." Mary and John are wealthier on December 31 of Year 1 than they were on January 1 by $1,000 because the value of the land that they purchased in May increased by that amount. Yet, the current Internal Revenue Code does *not* reach this wealth increase for tax purposes until a **realization event** occurs—most commonly a **sale for cash, an exchange of the property for other property, the destruction or theft of the property**, *i.e.*, an identifiable marketplace event of some sort. Similarly, potentially deductible decreases in property value are also not taken into account (such as the decrease in the value of the investment land in Year 2) until "realized." Why? As I mentioned above in connection with the gift exclusion, deviations from SHS principles are not necessarily illegitimate, but they do give us pause to ask "why"?

The answer cannot be mere lack of liquidity (cash) to pay tax. The cash to pay the tax could come from their savings or Mary's current salary. A taxpayer could perhaps even mortgage the land itself to obtain the cash with which to pay the tax on this increase in wealth. Do not make the mistake of thinking that "income" means "cash." (Notice that the SHS formulation does not mention cash but, rather, asks only whether the taxpayer's wealth has increased.) Indeed, if Mary is paid her $1 million salary one-half in cash and one-half in shares of corporate stock, the shares of stock usually must be valued and included in her Gross Income on receipt under § 61(a)(1), as the receipt constitutes compensation for services rendered. If wealth increases were rendered nontaxable by the mere expedient of not using cash, we would simply become a barter society, which would be very inefficient economically (reducing aggregate wealth). It would also be unfair in that only those with greater bargaining power, such as CEOs, would be in the position to demand nontaxable property in kind rather than cash, as it is far easier for most employers to simply pay cash compensation

The answer also cannot be that the wealth increase or decrease may be temporary in nature. A business may be profitable in Year 1 and operate at a loss in Year 2, but we do not delay taxation of the profit in Year 1 to see what will happen in Year 2. A loss in Year 2 may perhaps generate a refund of tax paid on Year 1's profit, but it does not allow Year 1's profit to go untaxed in the first place until the end of the taxpayer's life (to see if the taxpayer had an overall profit or loss for his lifetime). Rather, the general rule under ***the annual accounting principle*** is that we *take each year as it comes*, and the realization principle is a major and important deviation from the annual accounting principle. To be administrable, the tax system must artificially compartmentalize our lives into annual units. Indeed, compensation, interest, rents, *etc.*, are all taxed on an annual basis, whether paid in cash or in kind. Why should increases in property value be different?

The obvious answer is administrative concerns, as it would be an administrative nightmare for every taxpayer to value each and every piece of property at the beginning and end of each year in order to pay tax on the net increase in wealth (or perhaps to deduct the net reduction in wealth). This administrative concern is minimized, however, with respect to some kinds of property, such as publicly traded corporate stock, where all you would have to do is look up the trading price on December 31. For this reason, certain dealers in securities and investors in regulated futures contracts must "mark to market" their securities inventories or futures contracts each year, including the increase in value in Gross Income and deducting the loss in value (because these would be business or investment losses under § 165(c), more below) under §§ 475 or 1256. The

ordinary investor in corporate shares is free from § 475, however, and can ignore the changes in value of her securities until a realization event, such as a sale or exchange, just as Mary and John can ignore the changes in value of their land in Years 1, 2, and 3 before its sale.

The ability to defer the taxation of unrealized gain in property until a realization event provides a critically important financial benefit to those whose income is in the form of such gain. Even if no special, reduced tax rate applies to such gain when the property is eventually sold, the aggregate tax paid by the owner is less in real economic terms than it would be if the taxpayer's wealth increases were taxed each year as they accrued because of the **time value of money**.

Suppose, for example, that John's and Mary's $1,000 wealth increase in the value of the land by the end of Year 1 would have generated a 10% tax of $100 if the realization requirement were repealed (*i.e.*, if the land were taxed under a "mark to market" system each year). If they were required to pay the $100 tax at the end of Year 1, the current cost (as of Year 1) would have been the full $100. Now suppose, however, that they can defer paying that $100 tax (without paying interest to the government for the privilege of deferring the payment) until the end of Year 10 simply by delaying the sale until then. How much would the current cost be for John and Mary—measured at the end of Year 1—if they could earn, say, 3% (after-tax) interest on their wealth increase in the meantime? The "present value" (or current cost) of that future $100 obligation would be only $74.40, as this is the amount that they would have to set aside today for it to grow (after taxes) to $100 by the end of Year 10. We know this by looking at Table B, below, where the number at the intersection of Year 10 and 3% is .744.

**Table A: Compound Interest**

**Amount to Which $1 Now Will Grow by End of Specified Year at Compounded Interest**

| Year | 3% | 4% | 5% | 6% | 7% | 8% | 10% | 12% | 15% |
|---|---|---|---|---|---|---|---|---|---|
| 1 | 1.03 | 1.04 | 1.05 | 1.06 | 1.07 | 1.08 | 1.10 | 1.12 | 1.15 |
| 2 | 1.06 | 1.08 | 1.10 | 1.12 | 1.14 | 1.17 | 1.21 | 1.25 | 1.32 |
| 3 | 1.09 | 1.12 | 1.26 | 1.19 | 1.23 | 1.26 | 1.33 | 1.40 | 1.52 |
| 4 | 1.13 | 1.17 | 1.22 | 1.26 | 1.31 | 1.36 | 1.46 | 1.57 | 1.74 |
| 5 | 1.16 | 1.22 | 1.28 | 1.34 | 1.40 | 1.47 | 1.61 | 1.76 | 2.01 |
| 6 | 1.19 | 1.27 | 1.34 | 1.41 | 1.50 | 1.59 | 1.77 | 1.97 | 2.31 |
| 7 | 1.23 | 1.32 | 1.41 | 1.50 | 1.61 | 1.71 | 1.94 | 2.21 | 2.66 |
| 8 | 1.27 | 1.37 | 1.48 | 1.59 | 1.72 | 1.85 | 2.14 | 2.48 | 3.05 |
| 9 | 1.30 | 1.42 | 1.55 | 1.68 | 1.84 | 2.00 | 2.35 | 2.77 | 3.52 |
| 10 | 1.34 | 1.48 | 1.63 | 1.79 | 1.97 | 2.16 | 2.59 | 3.11 | 4.05 |
| 11 | 1.38 | 1.54 | 1.71 | 1.89 | 2.10 | 2.33 | 2.85 | 3.48 | 4.66 |
| 12 | 1.43 | 1.60 | 1.80 | 2.01 | 2.25 | 2.52 | 3.13 | 3.90 | 5.30 |
| 13 | 1.47 | 1.67 | 1.89 | 2.13 | 2.41 | 2.72 | 3.45 | 4.36 | 6.10 |
| 14 | 1.51 | 1.73 | 1.98 | 2.26 | 2.58 | 2.94 | 3.79 | 4.89 | 7.00 |
| 15 | 1.56 | 1.80 | 2.08 | 2.39 | 2.76 | 3.17 | 4.17 | 5.47 | 8.13 |
| 16 | 1.60 | 1.87 | 2.18 | 2.54 | 2.95 | 3.43 | 4.59 | 6.13 | 9.40 |
| 17 | 1.65 | 1.95 | 2.29 | 2.69 | 3.16 | 3.70 | 5.05 | 6.87 | 10.60 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 18 | 1.70 | 2.03 | 2.41 | 2.85 | 3.38 | 4.00 | 5.55 | 7.70 | 12.50 |
| 19 | 1.75 | 2.11 | 2.53 | 3.02 | 3.62 | 4.32 | 6.11 | 8.61 | 14.00 |
| 20 | 1.81 | 2.19 | 2.65 | 3.20 | 3.87 | 4.66 | 6.72 | 9.65 | 16.10 |
| 25 | 2.09 | 2.67 | 3.39 | 4.29 | 5.43 | 6.85 | 10.80 | 17.00 | 32.90 |
| 30 | 2.43 | 3.24 | 4.32 | 5.74 | 7.61 | 10.00 | 17.40 | 30.00 | 66.20 |
| 40 | 3.26 | 4.80 | 7.04 | 10.30 | 15.00 | 21.70 | 45.30 | 93.10 | 267.00 |
| 50 | 4.38 | 7.11 | 11.50 | 18.40 | 29.50 | 46.90 | 117.00 | 289.00 | 1080.00 |

**Table B: Present Value**

**What $1 at End of Specified Future Year Is Worth Today**

| Year | 3% | 4% | 5% | 6% | 7% | 8% | 10% | 12% | 15% |
|---|---|---|---|---|---|---|---|---|---|
| 1 | .971 | .962 | .952 | .943 | .935 | .926 | .909 | .893 | .870 |
| 2 | .943 | .925 | .907 | .890 | .873 | .857 | .826 | .797 | .756 |
| 3 | .915 | .890 | .864 | .839 | .816 | .794 | .751 | .711 | .658 |
| 4 | .889 | .855 | .823 | .792 | .763 | .735 | .683 | .636 | .572 |
| 5 | .863 | .823 | .784 | .747 | .713 | .681 | .620 | .567 | .497 |
| 6 | .838 | .790 | .746 | .705 | .666 | .630 | .564 | .507 | .432 |
| 7 | .813 | .760 | .711 | .665 | .623 | .583 | .513 | .452 | .376 |
| 8 | .789 | .731 | .677 | .627 | .582 | .540 | .466 | .404 | .326 |
| 9 | .766 | .703 | .645 | .591 | .544 | .500 | .424 | .360 | .284 |
| 10 | .744 | .676 | .614 | .558 | .508 | .463 | .385 | .322 | .247 |
| 11 | .722 | .650 | .585 | .526 | .475 | .429 | .350 | .287 | .215 |
| 12 | .701 | .625 | .557 | .497 | .444 | .397 | .318 | .257 | .187 |
| 13 | .681 | .601 | .530 | .468 | .415 | .368 | .289 | .229 | .162 |
| 14 | .661 | .577 | .505 | .422 | .388 | .340 | .263 | .204 | .141 |
| 15 | .642 | .555 | .481 | .417 | .362 | .315 | .239 | .183 | .122 |
| 16 | .623 | .534 | .458 | .393 | .339 | .292 | .217 | .163 | .107 |
| 17 | .605 | .513 | .436 | .371 | .317 | .270 | .197 | .146 | .093 |
| 18 | .587 | .494 | .416 | .350 | .296 | .250 | .179 | .130 | .0808 |
| 19 | .570 | .475 | .396 | .330 | .277 | .232 | .163 | .116 | .0703 |
| 20 | .554 | .456 | .377 | .311 | .258 | .215 | .148 | .104 | .0611 |
| 25 | .478 | .375 | .295 | .232 | .184 | .146 | .0923 | .0588 | .0304 |
| 30 | .412 | .308 | .231 | .174 | .131 | .0994 | .0573 | .0334 | .01551 |
| 40 | .307 | .208 | .142 | .0972 | .067 | .0460 | .0221 | .0107 | .00373 |
| 50 | .228 | .141 | .087 | .0543 | .034 | .0213 | .00852 | .00346 | .000922 |

Similarly, John and Mary would have liked to deduct the loss in value of their land in Year 2 when it occurred because of the time value of money, as deducting $1 today is worth more than deducting $1 in a future year. They are prohibited from doing so, however, under the realization requirement.

While you may never be asked to calculate the precise time-value-of-money benefit of being able to defer inclusion of a wealth increase (or being able to accelerate a deduction to an earlier

year), it is quite important for you to appreciate the time value of money as a general principle because it often is the silent, underlying stake at issue in tax planning. As you move through this course, you will begin to appreciate better that the real tax issue, while often phrased as "is this item includable" or "is this item deductible," is more often than not (when you peel back the layers of the onion) actually "*when* is this item includable" or "*when* is this item deductible"? All things being equal (and they are sometimes not, for reasons that we shall also examine in due course), taxpayers are often willing to go to quite a bit of tax planning to defer Gross Income or accelerate deductions—all because of the *time value of money*.

While John and Mary were able to ignore the changes in land value during their ownership period under the realization requirement, the sale in Year 3 is a realization event. Section 61(a)(3) requires that they include "gains derived from dealings in property" in Gross Income.

What does the word "gains" mean in § 61(a)(3)? The facts state that Mary and John sell the land for $14,000. Is $14,000 thus their "gain" that must be included in their Gross Income? After all, they now have $14,000 in cold, hard cash in hand after the sale. But you have already learned that "income" is not the same as "cash" (remember our CEO who was paid her salary partly in shares of stock). Indeed, John and Mary should not include the entire $14,000 in cash received if we want to conform to normative income tax principles because $12,000 of that cash was made part of the tax base in Year 1 (the purchase year) through deduction denial. Only $2,000 is new wealth that has never been included in their tax base before.

**Two fundamental precepts underlying a tax on "income" are:**

**(1) the same dollars should not be taxed to the same taxpayer more than once, and**

**(2) the same dollars should not provide a double tax benefit to the same taxpayer.**

How do we know that $12,000 of the $14,000 that they receive on the sale has already been taxed to John and Mary? Recall the earlier discussion that determined that they were *prohibited from deducting the $12,000 outlay when they purchased the land because it was a nondeductible capital expenditure*. Recall that the denial of a deduction in the year of purchase meant that the $12,000 was effectively taxed to them in that year by remaining within their tax base. If we had allowed them to deduct the $12,000 cost of the land in Year 1—contrary to current law—that $12,000 would have been removed from their tax base in Year 1, and the entire $14,000 received in Year 3 would then properly constitute amounts that have never been taxed to them before. Because Mary and John were already effectively taxed on that $12,000 in Year 1 through deduction denial, however, they cannot now be taxed on that same $12,000 a second time without violating fundamental precept (1), above.

The two fundamental precepts above differentiate an income tax from a wealth tax. For example, homeowners subject to state property taxes (a wealth tax) know that the "same dollars" are taxed to them again and again each year because a property tax is typically calculated by multiplying the property's aggregate fair market value each year by the tax rate. An income tax is more favorable to wealth creation than a wealth tax in that a $1 increase in wealth is taxed only once to the same taxpayer (in the year in which that $1 wealth increase is realized) rather than again and again, year after year.

So how does the Internal Revenue Code implement these precepts to ensure that only $2,000

of the $14,000 received on the sale is included in their Gross Income under § 61(a)(3)? While "gain" is another term (like "expense") that you might use casually in nontax contexts, the Internal Revenue Code defines it precisely as a tax term of art in § 1001(a), which also defines "loss" (another common word used in everyday life). Read § 1001(a) and (b) now. It defines realized "**gain**" as the **excess of "amount realized" over "adjusted basis"** and "loss" as the excess of adjusted basis over amount realized. More terms of art! **"Amount realized"** (A/R for short) is defined precisely in § 1001(b) as **"the sum of any money received plus the fair market value of the property (other than money) received"** on the property disposition. Because John and Mary sell their land for $14,000 in cash, the "amount realized" is $14,000. If John and Mary had instead received $9,000 in cash plus shares of corporate stock with a fair market value (FMV) of $5,000, their amount realized would have remained $14,000 (the sum of the $9,000 cash and the $5,000 FMV of the stock received in exchange for the land). If they had exchanged their land entirely for stock worth $14,000 (and no cash), their amount realized would, once again, have remained $14,000 (the sum of $0 cash and the $14,000 FMV of the stock received in exchange for the land).

What is John's and Mary's "adjusted basis" (A/B for short) in the land that they sold for $14,000? Section 1001(a) refers to § 1011, which provides that "basis" is determined under § 1012 or any other relevant basis section in the Internal Revenue Code, "adjusted as provided in § 1016." Section 1012, in turn, provides that the basis of property shall be "the cost of such property," unless another Code section governs the basis of the particular property at issue. Because John and Mary purchased the land, § 1012 does provide them with a $12,000 "cost basis" in the land.

What if the land had not been purchased but rather, say, inherited or obtained in a property settlement in a divorce action? These situations (and others) are where the cross-references in §§ 1011(a) and 1012(a) to (essentially) any other relevant basis rule found in the Internal Revenue Code come into play. We shall examine some of these other basis rules in due course. John's and Mary's basis is easy to determine, though. Because they did, in fact, purchase the land, we know that § 1012 (as opposed to some other Code section) governs their initial basis in the property at its $12,000 "cost."

Moreover, you will have to take my word for it for now that none of the adjustments listed in § 1016 (which we shall examine shortly) would have affected their initial $12,000 cost basis, which means that their "adjusted basis" at the time of the sale in Year 3 remains $12,000. Thus, John and Mary's "realized gain" is $2,000 ($14,000 A/R *less* $12,000 A/B). (Notice, by the way, that "amount realized" is *not* the same as "gain realized" or "realized gain." "Amount realized" is the precisely defined term found in § 1001(b) and is $14,000 on our facts. I do appreciate that these terms of art are very confusing at first, but you must get comfortable in using them or communication chaos results.)

**Notice that "basis" is the mechanism that allowed us to ensure that the same dollars were not taxed to the same taxpayer more than once.** ***Basis generally represents previously taxed dollars (or concurrently taxed dollars in the same year) that should not be taxed a second time to the same taxpayer.*** Thus, basis can always be recovered tax free, in the sense that John and Mary's $12,000 basis in the land is recovered tax free from the $14,000 obtained on the sale. Only $2,000 of that $14,000 (the amount realized in excess of basis) could not be protected from taxation as basis recovery. You will often hear of this rule as "tax-free return of basis" or "tax-free recovery of capital." While "tax free" implies special dispensation from taxation, in reality it refers to the fact that these dollars were *already once taxed* to John and Mary (when they purchased the land

and were denied a deduction for the outlay) and thus should not be taxed to them a second time.

What do I mean by the parenthetical above: "or concurrently taxed dollars in the same year"? The dollars may not literally have been "previously taxed" in the sense that the purchase (nondeductible capital expenditure) occurred in a prior year. The same result would occur if Mary and John had bought the land for $12,000 in January of Year 1 and sold it in December of Year 1 for $14,000. The purchase price in January would be a *nondeductible* capital expenditure (creating basis), which would be recovered tax-free on the December sale under § 1001. Their realized (includable) "gain" would again equal $2,000.

Let's return to Mary and consider again the variant in which she receives her $1 million salary one-half in $500,000 cash and one-half in shares of corporate stock worth $500,000. We have already determined that Mary must include the entire $1 million in Gross Income under § 61(a)(1), *i.e.*, not only the $500,000 in cash but also the shares received as compensation in kind with an FMV of $500,000. What is her § 1001 realized gain if she later sells the shares for, say, $700,000? Under § 1001(b), her amount realized (A/R) is the $700,000 sales proceeds. What is her adjusted basis (A/B) in the shares?

Now that you appreciate the critical role of basis as the means by which we can keep track of previously (or concurrently) taxed dollars, you know—even before looking at any authority—that Mary *must* have a basis in the shares equal to the $500,000 that she included in Gross Income on their receipt under § 61(a)(1), even though she did not purchase that stock herself for $500,000. If we were to conclude, instead, that she takes a $0 basis in the shares, her sale for $700,000 would produce a § 1001 realized gain of the entire $700,000 ($700,000 A/R *less* $0 A/B). Such a result would violate precept (1), above, by taxing the same dollars ($500,000) to the same taxpayer (Mary) more than once. Because Mary must include the $500,000 FMV of the shares in her Gross Income on their receipt as compensation under § 61(a)(1), she should be able to recover $500,000 of the $700,000 without tax.

As expected, Treas. Reg. § 1.61-(2)(d)(2) provides that Mary's "cost basis" in the property received as compensation for services rendered equals any amount that she paid for the shares ($0 on our facts) *plus* the amount that she included in Gross Income as compensation for services rendered under § 61(a)(1) ($500,000). Thus, her initial basis in the shares is $500,000, and her § 1001 realized gain on the later sale for $700,000 is $200,000 ($700,000 A/R *less* $500,000 A/B).

**Basis can generally be created in one of two ways: (1) the making of a nondeductible capital expenditure or (2) a Gross Income inclusion.**

An example of (1) is the purchase by John and Mary of their land for $12,000. Because the land purchase is a nondeductible capital expenditure, they take an immediate basis of $12,000 in that land to reflect the nondeduction of the $12,000, which means that the $12,000 remains in their tax base for the purchase year and is thus indirectly taxed to them in that year. John and Mary should not be taxed a second time on that same $12,000. Thus, when they sell the land for $14,000, they can recover their $12,000 basis tax-free under § 1001(a). Only the excess of the $14,000 A/R over their $12,000 A/B is § 1001 "gain" that is includable in Gross Income under § 61(a)(3).

An example of (2) is the receipt by Mary of corporate shares worth $500,000 as compensation for services rendered. Because Mary must include the $500,000 FMV of the shares in her Gross Income under § 61(a)(1) upon receipt, she takes an immediate "cost basis" of $500,000 in those shares to reflect the fact that she includes that $500,000 in Gross Income in the year of the share

receipt. She should not be taxed a second time on that same $500,000. Thus, if she sells the shares for $700,000, she can recover her $500,000 basis tax-free under § 1001(a). Only the excess of the $700,000 A/R over her $500,000 A/B would be § 1001 "gain" that would be includable in Gross Income under § 61(a)(3).

***Deductions (part 2): which "expenses" are deductible and why?***

You have learned a lot already! You have learned, for example, that "capital expenditures," as mere changes in the form in which wealth is held (rather than immediate wealth reductions), are not deductible under SHS income principles because they fail to satisfy the first requirement reviewed below (with a new, clarifying parenthesis).

> **To be deductible under SHS principles,**
>
> **(1) the outlay or event must decrease wealth (*e.g.*, the capitalization inquiry); *AND***
>
> **(2) the wealth reduction must *not* represent personal consumption.**

Thus, you now know that Mary and John cannot deduct the cost of the investment land, the business equipment (the new dental chair and X-Ray machine), or the personal residence that they purchased. Each of these purchases constitutes nondeductible "capital expenditures" rather than potentially deductible current "expenses." In order to keep track of the fact that John and Mary were indirectly taxed on these outlays (via deduction denial) at the time of purchase, they take a § 1012 cost basis in these properties, which can be recovered free of tax under § 1001 if and when they dispose of these properties.

Let's move on to consider outlays that *do* survive the step-1 capitalization inquiry, *i.e.*, to outlays that *do* represent a **current wealth decrease** and thus are properly categorized as "**expenses**" instead of "capital expenditures." In John's and Mary's fact pattern, these include the salaries that he pays to his receptionist and dental assistant, the rent and utility costs for his dental office space, the rent that John and Mary pay with respect to their apartment (before they moved into their new home), the utility costs for both the apartment and their new home, and the costs of the vacation trip to Disney World (among other everyday living costs). Because each of these outlays represent an immediate wealth decrease rather than a mere change in form in which wealth is held, they are properly categorized as "expenses" instead of "capital expenditures," thus surviving the step-1 inquiry noted above.

On to step 2! Recall our earlier point that even a current wealth decrease should not reduce the tax base under SHS normative principles if the wealth decrease represents the purchase of personal consumption in order to ensure that personal consumption costs remain in the tax base and are thus indirectly taxed. When we turn to positive law, we find that **§ 262** **confirms that "no deduction shall be allowed for personal, living, or family *expenses*"** (using that tax term of art). As with § 263 with respect to capital expenditures, § 262 is not necessary to deny deduction for personal expenses. Remember that, in order to take any deduction, you must always find a Code section expressly authorizing it with the magic words "there shall be allowed a deduction." Nevertheless, by enacting § 262, Congress provided a handy place for the Treasury Department to issue regulations that help us to determine whether a particular expense is, in fact, a "personal" one.

As with the introductory language to § 61, which reminds us that other Code sections might expressly authorize an "exclusion" of a Gross Income item that would otherwise be includable under § 61, the introductory language in § 262 reminds us that other Code sections might expressly

provide authority to *deduct* certain personal expenses that would otherwise be *nondeductible* under a normative SHS income tax. Examples include the deduction for charitable contributions made to certain tax-exempt entities (§ 170) and the deduction for interest paid on a loan incurred to purchase a personal residence (§ 163(h)(3)), each of which (and more) we shall examine in future chapters. The term used to describe **a provision that deviates from a pure, normative SHS income tax** is "**tax expenditure**," and we shall examine the concept of tax expenditures more closely in Chapter 3. Because none of John's and Mary's personal expenses are of this type, they cannot deduct any of their personal expenses.

The amounts that John pays as salaries to his receptionist and dental assistant, as well as the rent and utility costs for his office space are, however, current expenses that do not purchase personal consumption but rather help to generate business Gross Income. In other words, these costs satisfy both conditions for deduction under a normative SHS income tax.

Turning to positive law, we need to find a Code section containing the magic words "there shall be allowed a deduction" for these outlays, and we find it in **§ 162, which provides that "[t]here shall be allowed as a deduction all the ordinary and necessary expenses [as opposed to capital expenditures] paid or incurred during the taxable year in carrying on any trade or business…."** Unless some other Code section steps in to take away these otherwise allowable deductions (and there would be none in John's case), John can deduct the business expenses incurred in his dental practice from his $500,000 of Gross Income under § 61(a)(1) or (2) in arriving at § 1 Taxable Income (the tax base).

The deduction for business expenses does not reflect some sort of special solicitude or preference for business activity (as opposed to personal consumption). Rather, business expenses are normatively required to be deducted if we wish to ensure taxation of SHS income. **Recall fundamental precept (1) of an income tax: the same dollars should not be taxed to the same taxpayer more than once.** If we require John to include *every dollar* of his $500,000 gross revenue from his patients' payments in § 61 Gross Income *and* did not then allow him to deduct from this gross revenue the costs incurred to produce it, we would be doubly taxing John on the same dollars in a very real sense (equal to the undeducted costs), violating fundamental precept (1).

To see why this is true, return for a moment to John's and Mary's purchase and sale of their land. There, we denied John and Mary a deduction on their $12,000 outlay in purchasing the land, which meant that they were indirectly taxed on that $12,000 in the purchase year. This "nondeduction" created a $12,000 "basis" in the land to represent the previously taxed dollars reflected in the land. When they sold the land for $14,000, we did not require them to include the entire $14,000 gross sales proceeds in § 61 Gross Income. Rather, they were permitted to recover their $12,000 basis tax-free under § 1001 first so that only $2,000 was Gross Income within the meaning of § 61(a)(3) ("gains derived from dealings in property"). Thus, we ensured that fundamental precept (1) was honored by not taxing that $12,000 twice to John and Mary, which would have occurred if we *both* denied them a deduction of the $12,000 purchase price *and* required that they include the entire $14,000 gross sales proceeds in § 61 Gross Income.

Section 61(a)(3) is unusual in the sense that the Gross Income from the sale is already a *net* figure because of the simultaneous basis offset under § 1001. The basis is, in a sense, "deducted" before even arriving at § 61 Gross Income in the first place regarding the land sale. Congress could have reached the same end result by requiring John and Mary to include the entire "amount

realized" of $14,000 (the entire sales proceeds) in § 61 Gross Income and then creating a new "deduction" (not actually found in the Code) of $12,000 equal to their basis in the land in arriving at $2,000 of Taxable Income (the tax base). But because the undeducted purchase price of the land is so obviously a cost of the later profit on the sale of that very land, basis is created in the land directly and offset against the amount realized directly under § 1001 in arriving at § 61 Gross Income in the first place.

The salary that John pays to his employees, the rent that he pays for his office space, and the utility costs incurred for that space are clearly connected to creating the $500,000 of gross revenue, just as the $12,000 purchase price of the land was clearly connected to the $14,000 sale price of the land. Unlike with the land costs and sales revenue, however, we cannot say with any precision whether the receptionist's salary this week (or this month's rent or utility expense) should be tied to any particular patient's payment. We cannot, in other words, easily create "basis" in any particular business cost that could be used to offset (in § 1001 fashion) a portion of John's $500,000 in revenues in order to arrive at a § 61 *Gross* Income figure that is (like the land profit) already reduced to a *net profit* figure. In short, while the expenses are clearly income-producing costs of his business, the connection between any *particular* expense and any *particular* revenue receipt is not easy to determine, unlike the land purchase and later sale.

For this reason, Congress requires John to include every dollar of his $500,000 gross revenue in § 61 Gross Income (unreduced by any of the costs that he incurred to produce this revenue) but then *also* explicitly provides him with a current deduction from Gross Income under § 162 (in reaching Taxable Income) equal to all of the business expenses incurred in producing that gross revenue stream. When the smoke clears, he will be taxed only on his net profit, in order to ensure that we are not doubly taxing John on the same dollars, just as John and Mary were taxed only on their net profit from the land ownership.

What about "expenses" (current wealth decreases) incurred not in pursuit of business profit (generally, selling goods or services to others) or in pursuit of personal consumption (the trip to Disney World) but rather in pursuit of investment profit (managing your own savings)? For example, suppose that you rent a safety deposit box at a cost of $20 per month to safeguard a winning lottery ticket until you have the opportunity to claim your prize. There has always been a version of § 162 in the Code. In an early case construing it, *Higgins v. Commissioner*,[3] the Supreme Court concluded that managing one's own investments does not rise to the level of a "trade or business" within the meaning of the predecessor to § 162, no matter how large the investment portfolio. (Mr. Higgins was a very wealthy man who hired employees to manage his large holdings of U.S. investment properties for him while he lived abroad.) Under *Higgins*, the $20 safety deposit box fee could not be deducted under § 162—even though the lottery proceeds are clearly wealth accessions that are includable in Gross Income—because collecting lottery winnings does not comprise operating a "trade or business."

Requiring inclusion of the full "gross" proceeds of an investment while, at the same time, disallowing deduction of the expenses incurred to produce that investment Gross Income would twice tax the same dollars to the same taxpayer for the same reason that we would be doubly taxing John on the same dollars if we required John to include every dollar of the $500,000 received from his patients in Gross Income and, at the same time, denied him deduction of the expenses (such as his employee salaries, office rent, *etc.*) incurred to produce those receipts. Under SHS normative

[3] 312 U.S. 212 (1941).

principles, the only salient inquiry is whether the outlays contribute toward producing *includable Gross Income* of some sort (as opposed to purchasing personal consumption).

Congress responded to *Higgins* not by statutorily expanding § 162 to reach investment activity in addition to business activity but by enacting an entirely new Code section pertaining, essentially, to investment expenses. Section 212(1) and (2) allow the deduction of expenses incurred in an income-producing activity not rising to the level of a "trade or business."[4]

***Deductions (part 3): § 1001 "loss" (and more on normative income tax theory)***

Suppose that John and Mary had sold the land (purchased in Year 1 for $12,000) when it was worth only $10,000 in Year 2. You know now that John and Mary should *always* be permitted to recover their $12,000 basis tax-free (in order to honor fundamental precept (1)), so you know that the entire $10,000 received on the sale would constitute tax-free basis recovery and would not be included in § 61 Gross Income. But what about the $2,000 of *unrecovered basis*? They would have obtained a tax benefit from that basis if they had been able to sell the land for more (in the form of tax-free recovery of basis), but the land is now sold. Can they obtain any tax benefit for their *unrecovered* basis?

Notice that the amount of unrecovered basis on a property disposition satisfies the statutory definition of "**loss**" found in § 1001(a): **"loss shall be the excess of the adjusted basis … over the amount realized."** John and Mary would have realized a "loss" rather than a "gain" (both defined terms of tax art in § 1001(a)) if they had sold their property with a basis of $12,000 for an amount realized of only $10,000. Their realized "loss" would have been the $2,000 of unrecovered basis. In other words, by definition a "loss" *is* unrecovered basis.

We now have a clear (and realized) wealth decrease (basis that we now know will never be recovered), satisfying the first requirement in our SHS inquiry regarding deductions. This property is not personal consumption property, such as a personal residence or an automobile used for personal purposes, so the second requirement is satisfied as well. This loss *should* be deductible under SHS principles.

Under positive law, we need to find a Code section that contains the magic words "there shall be allowed a deduction" for a "loss." *See* § 165(a) and (c). Consistent with SHS principles, we see authorization to deduct business and investment losses in §§ 165(a) and (c)(1)-(2), but losses realized with respect to personal consumption property are generally disallowed under § 165(c)(3) (with minor exceptions in §§ 165(c)(3) and (h), which we shall peruse in Chapter 18).

We can now go a step further in defining what we really mean by a "wealth reduction" in the normative SHS income tax sense. To illustrate, suppose that Becky owns an art gallery and that she purchases a painting for $10,000 (its FMV) that increases in value several years later when the artist becomes popular. At this time, the painting is formally appraised at $50,000. Two of her regular customers consider purchasing it for its $50,000 appraised value. Before the sale, however, a thief burgles the store and, alas, makes off with the painting. While Becky thought that her store inventory insurance was up to date, it has in fact lapsed, and she is unable to obtain any insurance recovery for the loss.

If you ask the hypothetical "man on the street" the amount of Becky's "loss" on these facts, the likely response would be $50,000 because Becky clearly lost $50,000 of *economic* wealth. Before

[4] Section 212(3) was added much later and has a different flavor entirely. *See infra* Chapter 18.

the theft, she owned a sketch that was demonstrably worth $50,000, but after the theft she owned nothing. For *income tax* purposes, however, what is the amount of Becky's "loss" deduction under § 165? *See* § 165(b). Becky is limited to deducting her $10,000 *basis* in the painting rather than its $50,000 *economic value*. Why? What would be wrong (as a matter of income tax theory) with allowing Becky to deduct her full $50,000 economic loss (rather than a deduction limited to her $10,000 basis)?

Recall **fundamental precept (2): the same dollars should not provide a double tax benefit to the same taxpayer**. Because of the realization requirement, Becky did not include in her Gross Income the unrealized $40,000 appreciation in value of the painting. If Becky were both entitled to *exclude* this $40,000 (under the realization requirement) and *deduct* this same $40,000 (if §§ 1001 and 165(b) permitted her to deduct the full $50,000 FMV of the sketch), Becky would enjoy a double tax benefit for the same dollars, violating fundamental precept (2). This outcome is also another reminder that the word "loss," while used in everyday parlance, is a tax term of art under the Internal Revenue Code. A "loss" for Federal income tax purposes is *unrecovered basis*, which generally represents previously taxed dollars, not lost *value*.

Indeed**, if we are to honor SHS principles, *all* deductions under the Internal Revenue Code (not just "loss" deductions) must be supported by previously or concurrently taxed dollars (*i.e.*, after-tax dollars) in order to ensure that we are not providing a double tax benefit to the same taxpayer for the same dollars (both exclusion and deduction). "Basis" is the clearest example of previously or concurrently taxed dollars, but business and investment expenses, as well as depreciation (below), also should represent previously or concurrently taxed dollars because they pertain to producing what was (or will be) includable Gross Income.**

This outcome is explicit under §§ 1001 and 165(b) with respect to "loss" deductions (because a § 165 loss deduction is explicitly limited to unrecovered "basis"), but it is equally true with respect to any other deduction that is premised on normative income tax principles, *i.e.*, those deductions that are necessary to properly measure "income" in the SHS sense. Thus, § 162 business "expense" deductions and § 212 investment "expense" deductions are allowed *only* because they represent outlays stemming from *includable* Gross Income, usually in the same year.

Recall, for example, John's $500,000 of includable Gross Income from his dental practice and the § 162 business expense deductions that he was allowed for his employees' salaries, office rent, office utility costs, *etc.* Those deductions are justified only *because of* the Gross Income inclusion of the entire $500,000, from which he was able to pay these business expenses. In other words, they are "same dollars" (previously or concurrently taxed), justifying the § 162 deductions.

***Deductions (part 4): depreciation***

We have seen that John and Mary are not permitted to deduct the acquisition costs of their land or personal residence and that John is not permitted to deduct the acquisition cost of the new business equipment that he purchased this year (the dental chair and X-ray machine) because each of these outlays are properly categorized as capital expenditures, creating basis, rather than current expenses. We have also seen that basis can be recovered tax-free on later sale of the property, as when John and Mary sell their land, producing either a "gain" or "loss" under § 1001. But can this basis be recovered earlier—before sale or other disposition?

Read § 167(a). It allows a taxpayer to take a series of basis deductions, called "**depreciation**" deductions, during the life of the property, so long as the property is **(1) of a type subject to "wear**

**and tear" and (2) used in business or held for the production of income (*i.e.*, business or investment property)**. Notice that no depreciation deductions are allowed with respect to personal-use property, consistent with the SHS principle that property used to provide personal consumption (as opposed to producing Gross Income) should not reduce the tax base. The "wear and tear" requirement—explored in Chapter 14 in more detail—essentially means that the property at issue must waste away as a result of the business or investment activity in some predictable manner. In other words, the property must have an ascertainable useful life up front, when placed in service in the business or investment activity. Property with a potentially infinite life, such as land, collectibles, or corporate stock, is never depreciable because it does not predictably waste away from use. Buildings, no matter how solidly built, can be depreciable assets because they do eventually collapse, even with good care.

Thus, John and Mary cannot depreciate their investment land (because it fails to satisfy the "wear and tear" requirement) or their personal residence (because it is personal consumption property). John can, however, depreciate the business equipment (dental chair and X-ray machine) that he purchases this year for use in his business. The actual mechanics of how to schedule these basis deductions over time under §§ 167, 168, 197 and related provisions are addressed in Chapter 14. For now, it is enough to know that John will be able to accelerate the tax benefits of his basis in the business equipment. Why does John like this result? All together now: *because of the time value of money*. Deducting his basis beginning in the year of acquisition (instead of waiting until he either sells it or junks it and recovers his basis tax-free or takes a "loss" deduction under §§ 1001 and 165) has real economic value to John!

Some may think that allowing deduction of property basis prior to a sale, exchange, or destruction of the property (where the basis would offset amount realized, if any, under § 1001) is inconsistent with the realization principle. A fuller discussion of this issue must await Chapter 14, but the short version is that losses can legitimately be considered final and irretrievable (and thus "realized" in a nontrivial sense) even before disposition—*so long as the property wastes away over time in some predictable fashion and gets ever closer to the end of its useful life in producing Gross Income solely with the passage of time*. Thus, the "wear and tear" requirement is absolutely critical in determining which properties should properly be depreciable in the first place. Stay tuned!

***§ 1016 basis adjustments***

Suppose, for the purpose of illustration only, that John's new dental chair cost $10,000 (producing an initial cost basis under § 1012 of $10,000) and that he is permitted to depreciate this basis in a series of $1,000 deductions over the first 10 years of his ownership under the depreciation provisions. At the end of each of Years 1 and 2, John properly deducts $1,000 (for a total of $2,000) before selling the chair for $8,500 on January 1 of Year 3 because he wants to buy the new edition. The sale triggers § 1001, of course. Because he sold the chair for $8,500, the "amount realized" within the meaning of § 1001(b) is $8,500. What is John's "adjusted basis" in the chair at the time of sale, which will be used as an offset against the amount realized under § 1001(a) in determining his "gain" or "loss"?

What would be wrong with using his original $10,000 basis in calculating his § 1001 gain or loss? **Recall fundamental precept (2): the same dollars should not provide a double tax benefit to the same taxpayer.** If John is permitted to deduct $2,000 of his $10,000 basis in Years 1 and 2 under the depreciation provisions, he should not be permitted to use *that same basis a*

*second time* to reduce his § 1001 gain (or create or increase a § 1001 loss) in the year of sale. Thus, § 1016(a)(2) requires John to *reduce* his original $10,000 basis by the $2,000 deducted under the depreciation provisions, resulting in an "adjusted basis" of $8,000 at the time of sale. When he sells for $8,500, John realizes a $500 gain under § 1001 ($8,500 A/R *less* $8,000 A/B). As an aside, note that the depreciation deductions allowed during Years 1 and 2 exceeded the real loss in FMV during his ownership period, a common occurrence (as we shall see).

**Just as basis is the tool used to ensure that the same dollars are not taxed more than once to the same taxpayer, basis is the tool used to ensure that the same dollars do not provide a double tax benefit to the same taxpayer.**

While we are considering adjustments to basis under § 1016, let's consider another one. Suppose that Donald has long owned a hotel called Trumptown and that its current A/B is $400,000 (after reduction for depreciation deductions under § 1016(a)(2)). He decides to construct a major addition to the hotel, doubling its square footage, at a cost of $500,000. Can Donald immediately deduct this cost under § 162? While incurred in business (rather than for personal consumption), is the $500,000 outlay an "expense" (as required for immediate deduction under § 162) or a "capital expenditure" (nondeductible under § 263)? Compare Treas. Reg. § 1.162-4(a) with Treas. Reg. § 1.263(a)-1(a) and (d)(2). We shall spend all of Chapter 4 examining the capitalization rules in more detail, including the ever-difficult line between a "repair" (a current "expense") and an "improvement" (a nondeductible "capital expenditure"), but this is an easy case. The $500,000 expansion is an "improvement" rather than a mere "repair" and must be capitalized. How do we do that with respect to property that is already owned by the taxpayer?

*See* § 1016(a)(1). The language "properly chargeable to capital account" means "capital expenditure." This $500,000 capital expenditure incurred with respect to property already owned *increases* its basis from $400,000 to $900,000. Because this building is used in business and is subject to "wear and tear," this new basis will also be permitted to be depreciated going forward, as was his original basis. Again, stay tuned.

***A brief introduction to the concept of "capital" gains and losses***

If the § 1001 gain or loss on a sale, exchange, destruction, or other realization event with respect to property is includable in Gross Income (if a gain) or deductible under § 165 (if a loss), you must then consider whether the gain or loss is characterized as "ordinary" or "capital" in nature and why that characterization matters. We shall devote an entire chapter (Chapter 15) to examining the special rules that apply to capital gains and capital losses, but it is important for you to acquire an initial grasp of the two most fundamental consequences of these characterizations now because they will affect the discussion of topics throughout this course. The concept of "capital" gain and loss does not arise from the SHS conception of "income." They are *sui generis* to the income tax, for reasons that we shall explore in Chapter 15.

The first thing to note is that whether a § 1001 realized gain or loss is "capital" has nothing to do with whether the original purchase of the property qualified as a "capital expenditure," even though both (unfortunately for beginning tax students trying to keep all of this straight) use the term "capital." Virtually *all* purchases of long-lived property are capital expenditures, but that fact does not mean that the § 1001 gain or loss realized on a later sale or exchange of that property is "capital" gain or loss. You simply have to learn about these concepts in their own right. A "capital expenditure," you have learned, is simply an outlay that does not reduce wealth but rather merely changes the form in which wealth is held and is the opposite of an "expense." In contrast, **§ 1001**

**gain or loss is "capital" (rather than "ordinary") if the requirements found in § 1222 are satisfied.** Let's use a series of examples to illustrate the requirements in § 1222.

Suppose that Steve owns a retail shop that purchases jewelry on the wholesale market and then resells it to customers. Steve purchases a gold necklace at wholesale for $7,000 in Year 1 and sells it for $12,000 to a customer, Ellen, in Year 3, who wears it for personal adornment. After wearing the gold necklace for a few years, Ellen tires of it and sells it to Marty for $15,000 in Year 6 (because the price of gold has increased in the interim).

Steve cannot deduct the $7,000 cost of the necklace as a business "expense" under § 162 when he purchases it from the wholesaler because the $7,000 outlay fails to qualify as an "expense." Rather, the purchase is a nondeductible "capital expenditure" under § 263, and he takes a $7,000 cost basis in the necklace under § 1012. When he sells the necklace for $12,000 to Ellen, Steve realizes a $5,000 gain under § 1001 ($12,000 A/R *less* $7,000 A/B). Similarly, when Ellen purchases the necklace for $12,000, she cannot deduct the $12,000 cost of the necklace because it is a nondeductible capital expenditure, creating a $12,000 basis. When she sells it for $15,000 to Marty, Ellen realizes a $3,000 gain under § 1001 ($15,000 A/R *less* $12,000 A/B). Even though both Steve's and Ellen's purchases of the necklace are categorized as "capital expenditures," Steve's § 1001 gain of $5,000 is *not* characterized as "capital" gain, while Ellen's § 1001 gain of $3,000 *is* characterized as "capital" gain. Why? And what difference does it make?

A § 1001 gain or loss that is realized with respect to property is characterized as "capital" (instead of "ordinary") if the three requirements repeated in §§ 1222(1) through (4) are satisfied. If you peruse those subsections of § 1222, you will note three common features. **To be "capital":**

**(1) the § 1001 realized gain or loss must be includable (if a gain) or deductible (if a loss);**

**(2) the asset disposed of must satisfy the definition of "capital asset" found in § 1221; and**

**(3) the realized gain or loss must have arisen from a "sale or exchange" (as opposed to, for example, a theft or destruction).**

The first requirement alerts us to the possibility that some realized gains that would otherwise be immediately includable in Gross Income under § 61(a)(3) or realized losses that would otherwise be deductible under §§ 165(a) and (c) may, under some specific Code section, be excluded (if a gain) or disallowed as a deduction (if a loss). The tax term of art for such realized gains and losses that are not taken into account is that such gains and losses are "unrecognized." (A realized gain or loss that *is* "recognized" is one that *is* taken into account now.) We shall examine some "nonrecognition" provisions in later chapters. For current purposes, it makes sense to stop the analysis regarding whether a realized gain or loss is "capital" or "ordinary" if the gain or loss is not going to show up on the tax return in any event because of a nonrecognition provision. You will have to take my word for it (for now) that no nonrecognition provision would permit Steve's and Ellen's realized gain on their sales for cash to go unrecognized. Those gains will, indeed, appear on their tax returns in the sale year. Thus, the first requirement for both Steve's and Ellen's § 1001 gain to be characterized as "capital" gain is satisfied.

Similarly, the third requirement—that the gain be realized by way of "sale or exchange"—is also obviously satisfied for both Steve and Ellen on these facts because both sold the necklace for cash. If Steve had exchanged the necklace for, say, a new cash register for use in his business, the "sale or exchange" requirement would similarly have been satisfied.

The necklace is not, however, a "capital asset" as defined in § 1221 in Steve's hands, though it

*is* a "capital asset" in the hands of Ellen. Thus, the second requirement, above, is failed and the gain is characterized as "ordinary" instead of "capital" with respect to Steve's sale only. We shall examine § 1221 in greater detail in Chapter 15, but do read § 1221(a)(1) for now. Notice that the introductory phrase (before arriving at (1)) refers to all property in all the world—regardless of whether that property is held for business, investment, or personal purposes—*unless* the property is listed in one of the subsections of § 1221(a). Thus, if the necklace *is* described in one of the paragraphs in § 1221(a), it is *not* a capital asset, and the necklace in the hands of Steve is, in fact, described in the "inventory" or "dealer" exception found in § 1221(a)(1). Because Ellen, unlike Steve, does not hold the necklace as inventory, it *is* a "capital asset" in her hands. In short, you cannot simply conclude that gold necklaces are—or are not—capital assets. They are capital assets in the hands of some taxpayers (if they are *not* held as inventory to sell to customers, for example) and not capital assets in the hands of others. Jewelry held for personal purposes (as opposed to inventory) is just one example of a capital asset. Another is shares of corporate stock held as an investment (as opposed to be being held as inventory by a stock dealer).

So Steve's § 1001 gain is "ordinary," but Ellen's § 1001 gain is "capital." Why does that matter? Certain kinds of capital gain, called "net capital gain" (defined in § 1222(11)), is subject to a reduced tax rate under § 1(h), whereas ordinary gain is not. We shall tease apart the definition of "net capital gain" in Chapter 15, but it requires (as a first ingredient) that the capital asset have been held for more than one year before the sale or exchange, creating "long-term capital gain." So "net capital gain" (which requires at least some long-term capital gain) is preferably taxed compared not only to ordinary gain or short-term capital gain but all other kinds of ordinary income, including compensation, rent, interest, royalties, *etc.*[5] Net capital gain falling within Taxable Income of $400,000 ($450,000 for married couples filing jointly) or less is generally taxed at 15% (0% for taxpayers whose ordinary income is otherwise taxed at 15% or less). Net capital gain falling within Taxable Income exceeding the $400,000 (or $450,000) threshold is generally taxed at 20%. In contrast, the top tax rate on ordinary gain and ordinary income is 39.6%. **In short, certain capital gains are preferably taxed at a lower rate than ordinary gain (and ordinary income other than gain).** This rate differential is at the root of a good deal of tax planning, as we shall see.

What if Ellen had sold the jewelry, which she had purchased for $12,000, for only $5,000 (instead of $15,000) because the price of gold had fallen during her ownership period? Instead of realizing a gain under § 1001, she would have realized a § 1001 *loss* of $7,000 ($5,000 A/R *less* $12,000 A/B). Could Ellen deduct this loss under §§ 165(a) and (c)(3)? No. In Ellen's hands, the jewelry is personal consumption property, and personal consumption wealth reductions are intended to stay within the tax base under SHS principles. Because the loss will not appear on Ellen's tax return, the loss is not capital under the first requirement listed above (that the loss be deductible). Indeed, because the loss is not deductible, its character is irrelevant.

What if the property that Ellen purchased for $12,000 and then sells for $5,000 are shares of corporate stock in Gaggle, Inc., instead of jewelry worn for personal adornment? In that case, Ellen's loss is deductible under § 165(c)(2), and all three requirements found in § 1222 are satisfied. Thus, her deductible loss is a "capital" loss. Why does that matter?

Even though Ellen has authority to deduct the loss under § 165(c)(2)—the first step in the analysis—she must also take note of § 165(f), which refers her to § 1211 because her deductible

[5] Certain dividends received on corporate stock are also subject to the special reduced tax rate under § 1(h).

loss is capital. Read § 1211(b) now. Notice that § 1211 does not contain the magic words "there shall be allowed a deduction." Section 165 is the Code section that authorizes deduction of Ellen's loss. But even if you find a Code section that contains the magic words "there shall be allowed a deduction" and satisfy its terms, you must always then consider whether another, separate Code section steps in to take away the otherwise allowable deduction. Section 1211 is the first Code section among others that we shall examine that can step in to take away (or defer) an otherwise allowable deduction.

**With respect to capital losses that are otherwise deductible under the authority of § 165, § 1211(b) limits the amount of deductible capital losses (whether short-term or long-term) that can be taken in any year to the amount of realized and included capital gains (whether short-term or long-term) for that year plus up to $3,000 in additional capital loss. Under § 1212(b), any capital loss that is disallowed under § 1211(b) can be carried forward indefinitely to future years until it is either deducted under §§ 165 and 1211(b) or the taxpayer dies.**

For example, if Ellen also owns shares of stock in Realty, Inc., with an unrealized capital gain (which we can refer to as built-in gain) of $9,000, and she sells that Realty stock this year, realizing and including that $9,000 capital gain, she could then deduct her entire $7,000 realized and deductible capital loss on the sale of the Gaggle stock under §§ 165 and 1211(b). If however, she chooses not to sell the Realty stock with the $9,000 built-in gain, she can deduct only $3,000 of her otherwise deductible capital loss on the Gaggle stock sale this year. The remaining $4,000 would be carried forward. If, in the next year, Ellen realizes no capital gain, she could deduct another $3,000, carrying forward the last $1,000 to the next year, when it could finally be deducted.

The § 1211 capital loss limitation rule stems chiefly from the realization requirement (coupled with the special, reduced tax rate under § 1(h) for "net capital gain") and the "cherry picking" that could result without § 1211(b). Without § 1211(b), the taxpayer could choose to sell only properties with deductible, unrealized loss (built-in loss) and choose not to sell properties with built-in gain, thus making it appear as though the taxpayer lost wealth for the year under SHS notions of income when, she is, on net, actually wealthier (though the wealth increase is unrealized). Section 1211(b) essentially requires the taxpayer that wishes to deduct otherwise deductible (under § 165) capital losses to realize at least that much in capital gains in order to avoid deliberate mismeasurement of net wealth increases or decreases for the year. The ability to deduct an additional $3,000 in capital losses (in excess of realized capital gains) should be thought of as nothing more than a *de minimis* rule for small investors.

Note that only "capital" losses are subject to the limitation in § 1211(b), while ordinary losses that are deductible under § 165 are not so limited. For example, if Steve, our jewelry shop owner, sells the gold necklace to Ellen for less than he purchased it, his § 1001 loss is both deductible under § 165(c)(1) and ordinary (not capital) because the necklace is not a capital asset in his hands under the § 1221(a)(1) inventory exception. Thus, his loss deduction is allowable without limit, unconstrained by § 1211(b).

**In short, capital gains are treated favorably when compared to ordinary gains and ordinary income because capital gains may be taxed at a special, reduced tax rate. Capital losses are treated unfavorably when compared to ordinary losses because otherwise deductible capital losses are subject to deduction restrictions in § 1211(b) that do not apply to ordinary losses.**

## Problems

**1.** Rachel, a medical doctor, purchases a painting to hang on the wall of her living room (*i.e.*, for personal enjoyment) for $15,000 in February of Year 1 from an up-and-coming artist, Randy Borehall. At the end of Year 1, the painting is appraised at $17,000. At the end of Year 2, after a particularly nasty piece of publicity regarding Borehall's antics, the painting is appraised at $10,000. When Borehall dies in Year 3, Rachel is able to sell the painting in November for $20,000 in cash (you know what death can do to the value of an artist's work) to Jacob.

**a.** What does Rachel include in Gross Income (or deduct in reaching Taxable Income) in each of Years 1, 2, and 3 under current law?

**b.** What would Rachel include or deduct in each of Years 1, 2, and 3 under a pure SHS income tax, under which changes in wealth are taken into account annually, regardless of whether or not there has been a realization event (*i.e.*, under a mark-to-market system)? Recall the crucial role of "basis"—generally, a running record of previously or concurrently taxed dollars or, stated differently, dollars that have not yet been deducted. What would Rachel's basis in the painting be at the end Year 1, at the end of Year 2, and at the time of sale in Year 3? Remember also that she is using this painting for personal purposes, which will affect, in particular, your analysis of the loss in value in Year 2.

**c.** Is the result in **a.** or **b.** more favorable to Rachel and why?

**d.** In **a.**, what is the character of Rachel's § 1001 realized gain: capital or ordinary? Why does Rachel care?

**e.** Do your answers to **a.** and **d.** change if Rachel exchanges the painting for a boat owned by Jacob that is worth $20,000 (rather than selling the painting for $20,000 in cash)?

**2.** Rachel's mother gives her $5,000 in cash for her birthday in February of Year 1. What tax consequences to Rachel under SHS notions of income and under current law if she uses the cash to:

**a.** take a trip to Paris?

**b.** purchase shares of corporate stock worth $5,000, which she then sells for $7,000 in August of Year 2? Is this result consistent with the role that basis usually plays? Why or why not?

**3.** Tired of all of the clutter in her home, Rachel holds a garage sale where she sells a bunch of old furniture, clothes, dishes, toys, small appliances, *etc.*, which she had used in her home over the years. Nothing that she sold was valuable. When she counted the money in her till at the end of the day, she had $300 in cash. Does Rachel include this $300 in her Gross Income under current law? Why or why not?

**4.** Rachel pays her office nurse a salary of $50,000, pays rent for her medical office premises of $20,000, pays rent for her personal apartment of $15,000, pays $10,000 for food, and purchases a new patient examining table for $10,000. Describe Rachel's tax consequences under both SHS notions of income and current law for each of these outlays. (Do not worry about figuring out actual depreciation deductions, if any, to which she is entitled. Just note whether or not she would

be entitled to take any.)

**5.** What is Rachel's § 1001 gain or loss if, after several years of use in her business, Rachel decides to sell for $6,000 the examining table purchased in **4.**, above, after properly deducting $5,000 in depreciation deductions under §§ 167 and 168? (Skip, for now, the characterization of her § 1001 gain or loss as "ordinary" or "capital," as there are special characterization rules that govern the sale of property that has been the subject of depreciation deductions. As usual, stay tuned.)

**6.** Ryan, a lawyer, purchases shares of corporate stock for $20,000 in December of Year 1. At the end of Year 2, they are worth $17,000. He sells the shares in October of Year 3 for $13,000. Describe Ryan's tax consequences with respect to the purchase and ownership of the shares under both SHS notions of income and under current law.

**7.** Lindsey buys an office building for $100,000. After properly deducting $20,000 in depreciation, she has the building appraised, and it is demonstrably worth $110,000 because the surrounding neighborhood is quickly gentrifying. That is to say, Lindsey's office building has appreciated to a value above her original purchase price so that she now owns economic wealth of $110,000 with respect to the building. (As an aside, you will learn that the fact that Lindsey's property has increased in value does *not* mean her depreciation deductions were improper. Take my word for it that they were proper. Stay tuned.) Unfortunately, shortly after the appraisal, the building burns to the ground, and she learns that (because she failed to make payments) her insurance coverage has lapsed. What is the amount of Lindsey's § 165 "loss" deduction? She clearly lost $110,000 of real *economic value*, but can she deduct that amount? Why or why not? *See* § 165(b).

**8.** Doug purchases a boat in Year 1 for $200,000 for use in his business as a fisherman. In Year 2, Doug spends $30,000 to fix the boat up. Explain why Doug would like to categorize the $30,000 outlay as a mere "repair" (an "expense" under Treas. Reg. § 1.162-4) rather than an "improvement" (a "capital expenditure" under Treas. Reg. § 1.263(a)-1(d) and -3).

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Whew! There was a *lot* of information packed into Part A., which serves as the anchor for the rest of the course. In a sense, the rest of the book merely fills in additional detail to the big picture sketched here. For that reason, I recommend that you periodically reread this Part A. throughout the course when you feel yourself getting lost in the forest for the trees. Going back to first principles can provide that compass to get you back on track. Metaphor overload!!

## B. The tax rate structure, marginal vs. effective rates, and more

As noted earlier, the highest marginal tax rate on ordinary income is 39.6%, but a graduated rate structure begins at 10% and rises to 39.6% on each chunk of "Taxable Income." Recall from Part A. that Taxable Income is, generally speaking, § 61 Gross Income *less* any allowable deductions. The first chunk of Taxable Income is taxed at 10%, the next chunk at 15%, and so on at rates of 25%, 28%, 33%, 35%, and 39.6%.

Moreover, we have different rate schedules that apply in different household circumstances,

and the beginning and end of each rate threshold are indexed for inflation so that they rise each year, ensuring that mere inflation gain (rather than a real gain in purchasing power) does not cause income to creep up into the next higher tax bracket (formerly known as "bracket creep" before the inflation adjustments were adopted in 1986). The two most common rate schedules are reproduced below for 2017.[6]

**2017 Table for Unmarried Individuals**

| *If Taxable Income is:* | *The tax is:* |
|---|---|
| Not over $9,325 | 10% of Taxable Income |
| Over $9,325 but not over $37,950 | $932.50 plus 15% of excess over $9,325 |
| Over $37,950 but not over $91,900 | $5,226.25 plus 25% of excess over $37,950 |
| Over $91,900 but not over $191,650 | $18,713.75 plus 28% of excess over $91,900 |
| Over $191,650 but not over $416,700 | $46,643.75 plus 33% of excess over $191,650 |
| Over $416,700 but not over $418,400 | $120,910.25 plus 35% of excess over $416,700 |
| Over $418,400 | $121,505.25 plus 39.6% of excess over $418,400 |

**2017 Table for Married Couples Filing a Joint Return**

| *If Taxable Income is:* | *The tax is:* |
|---|---|
| Not over $18,650 | 10% of Taxable Income |
| Over $18,650 but not over $75,900 | $1,865 plus 15% of excess over $18,650 |
| Over $75,900 but not over $153,100 | $10,452.50 plus 25% of excess over $75,900 |
| Over $153,100 but not over $233,350 | $29,752.50 plus 28% of excess over $153,100 |
| Over $233,350 but not over $416,700 | $52,222.50 plus 33% of excess over $233,350 |
| Over $416,700 but not over $470,700 | $112,728 plus 35% of excess over $416,700 |
| Over $470,700 | $131,628 plus 39.6% of excess over $470,700 |

We must distinguish between the "marginal" rate and the "effective" (or average) rate. The **marginal rate** is **the rate at which the taxpayer's *last* (or marginal) dollar is taxed**. The **effective or average rate**, in contrast, is **the percentage of total economic income (or Adjusted Gross Income, described below) paid in tax**.

For example, if Paul is unmarried and has $40,000 of Taxable Income (Gross Income less allowable deductions), he is said to be "in" the 25% marginal tax bracket because his last dollars of Taxable Income would be taxed at 25%. But this phrasing does not mean that Paul pays 25% of his $40,000 of Taxable Income ($10,000) to the Federal Treasury. Rather, Paul would send only $5,738.75 to the Federal Treasury. Examine the third line of the table for unmarried individuals to see why this statement is true. That line provides that Paul's tax is $5,226.25 plus 25% of the excess of his $40,000 Taxable Income over $37,950, or 25% of $2,050 ($512.50). Nor does it mean that Paul's salary is $40,000. To have $40,000 of Taxable Income, his Gross Income and Adjusted Gross Income (or AGI, defined below) would have been much higher because of several deductions described below.

The marginal rate is important for at least two reasons. As described more fully in Chapter 3,

[6] Three additional rate schedules in § 1 that are not reproduced here apply to Heads of Household, Married Couples Filing Separate Returns, and Estates & Trusts. The last one is reproduced in Chapter 8.

economists care about marginal rates because it is at the margins where *behavior might change* in response to this rate, which can affect economic efficiency and thus economic growth (if behavior really does change significantly in response to the tax—a contested notion). The marginal rate is also important in connection with effective tax planning, as illustrated in Chapters 8 and 9 (examining income-shifting possibilities among family members).

In measuring the fairness of the distribution of the tax burden over the members of the population, however, the important parameter is the effective (or average) tax rate. While Paul's marginal rate is 25%, what is his effective rate? We know that we should put $5,738.75 in the numerator, but what should we put in the denominator? If we put Taxable Income in the denominator, Paul's effective tax rate is about 14.3% ($5,738.75/$40,000). But the most usual measure is AGI because it more nearly measures *economic* income, which is the ideal denominator. Using *real* economic income would require Paul to add to the denominator some items that increase Paul's wealth but are nevertheless excludable from Gross Income (such as gifts, which are excludable under § 102, or the increase in value of his assets that are ignored under the realization requirement) in determining his effective tax rate. If we used either AGI or real economic income (instead of Taxable Income), Paul's effective tax rate would be significantly lower than 14.3%. Let's see why. And let's start with a more detailed flow chart from Gross Income to tax due. (It is important to appreciate how items *affect* the bottom-line tax owed in order to engage in effective tax planning.)

## Computation of Tax

**Gross Income** - - - - - - - - - - - [§ 61, case law; statutory exclusion available?]

Minus **Deductions from Gross Income** - - - - - - - - - - - [deductions listed in § 62 but allowed by a Code section that says "there shall be allowed a deduction …."]

Equals **Adjusted Gross Income** (Individuals) - - - - - - [defined by § 62]

Minus **Personal Exemptions** - - - - - - [§§ 151 and 152, as reduced under § 151(d)(3) if applicable]

and either **Standard Deduction** - - - - - - - - - [§ 63]

or **Itemized Deductions** - - - - - - - - [deductions other than those listed in § 62, the Standard Deduction, and the Personal Exemption and Dependent Deductions, as limited by §§ 67 & 68 if applicable]

Equals **Taxable Income** - - - - - - - - - [defined by § 63]

Apply **Tax Rates or Tax Tables** - - - [§§ 1 and 3]

Yields **Tax Before Credits**

Minus **Tax Credits** - - - - - - - - - - - - - -[§§ 21-42, 53, and 6315]

Equals **Tax Due**

(Alternative Minimum Tax?) - - - - - - - -[§§ 55-59]

> **Let's consider Joan and Jim, a married couple with two minor children, Larry (age 10) and Laura (age 7). Joan is a teacher who earns $60,000 in 2017, and Jim is a construction worker who earns $50,000. In addition, they receive a $10,000 gift from Jim's wealthy grandmother. They do not yet own a home but rather rent an apartment. They contribute $2,000 to their church, a recognized charity, and they pay $3,000 in state and local income taxes.**

The first step in the chart listed above is to determine the § 61 Gross Income that Joan and Jim must include on their joint tax return.[7] They must include their $110,000 in aggregate salary under § 61(a)(1), but the $10,000 that they receive as a gift is excludable from their Gross Income under the authority of § 102, even though it represents *economic* income to them.

***§ 62 above-the-line deductions***

After determining their § 61 Gross Income, they are next permitted to take any **deductions *listed* in § 62 but *allowed* by some other Code section in reaching *Adjusted Gross Income* (AGI), typically referred to as Above-the-Line Deductions in tax jargon. Thus, AGI is Gross Income *less* the Above-the-Line Deductions.**

Note that § 62 does not provide the authority to take any deduction. You must find the authority to take the deduction in a Code section that contains the words "there shall be allowed a deduction" and satisfy its terms. Once satisfied that you have initial authority to take the deduction, you must then consider whether another Code section steps in to deny or reduce this otherwise allowable deduction. For example, you learned in Part A. that a loss on the sale of investment property (deductible under the authority of § 165(c)(2)) may nevertheless be limited by § 1211(b) if the deductible loss is a "capital" loss. Once you have survived this obstacle course and are convinced that you are, indeed, entitled to take the deduction, you must (as the last step in the analysis) determine *where* on the roadmap from Gross Income to Taxable Income the deduction is taken.

You can think of the Above-the-Line Deductions as the most preferred deductions because, unlike Itemized Deductions (considered below), they are not limited in any way. The first item on this preferred list of deductions is business deductions (such as ordinary and necessary business expenses under § 162 and depreciation deductions under §§ 167 and 168 of assets used in the business) so long as these business deductions are incurred by the self-employed rather than in one's capacity as an employee of another. *See* § 62(a)(1). A good example of these deductions would be the ones incurred by our dentist John in Part A. Recall that he paid his dental assistant and receptionist a salary, paid rent and utility costs for his office, and incurred depreciation deductions for his new dental chair and X-ray machine. These deductions would be taken above the line, directly from Gross Income in reaching AGI.

Losses incurred on the sale of property, such as capital losses, are listed in § 62(a)(3). All deductions attributable to property that produces rents or royalties are listed in § 62(a)(4), and alimony (studied in Chapter 9) is found in § 62(a)(10).

Notice that business deductions of *employees* are taken above the line *only* in certain limited circumstances. The most important of these is the first: business deductions incurred by employees that are *reimbursed* by their employers under what have come to be called "accountable plans," as

[7] We shall discuss the joint tax return as an income-splitting mechanism in Chapter 8.

defined in § 62(c). *See* §§ 62(a)(2)(A) and (c). If the reimbursement arrangement requires the employee both to substantiate the business expense and to return any excess reimbursement to the employer, the employee is permitted to deduct the business expense directly from Gross Income in arriving at AGI. But *the reimbursement itself, because coming from an employer, would be includable in the employee's Gross Income under § 61(a)(1) as compensation*. Because the inclusion in Gross Income under § 61(a)(1) would exactly offset the Above-the-Line business expense deduction under §§ 162 and 62(a)(1), Treas. Reg. § 1.62-2(c)(4) permits the employee to ignore *both* the inclusion *and* the offsetting deduction. This simplification measure has real economic benefits, as the reimbursement is also excludable for purposes of the payroll taxes mentioned in Chapter 3 (under which no deductions are allowed).

Because Joan and Jim have no deductions that are listed in § 62 (*i.e.*, no Above-the-Line Deductions), their AGI is also $110,000.

***Personal and dependent exemption deductions***

The next item listed on the flow chart, above, is the **Personal and Dependent Exemption Deductions** under §§ 151 and 152. Every taxpayer effectively has a zero bracket amount on the first dollars earned on the rationale that subsistence income should not be taxed on "ability to pay" grounds. (The ability to pay fairness norm is discussed in Chapter 3.) Congress effectuates this zero bracket through several means. The first is by allowing taxpayers to deduct under § 151 a flat amount called the "Personal Exemption." Additional deductions equal to the Personal Exemption amount can be deducted for each "Dependent," as defined in § 152. While § 151(d)(1) lists the Personal Exemption amount as $2,000, § 151(d)(4) requires that this amount be increased for inflation for each year since 1989. For 2017, the Personal and Dependent Exemption Deduction for each person is $4,050. Thus, Joan and Jim can deduct $16,200 ($4,050 x 4) under §§ 151 and 152 from their AGI.

Section 151(d)(3) phases out the Personal and Dependent Exemption Deductions for high-income taxpayers (often referred to as "PEP" for "**P**ersonal **E**xemption **P**hase-out") by reducing the aggregate amount by 2% for every $2,500 (or fraction thereof) that exceeds (for 2017) $261,500 of AGI for individuals ($313,800 for a married couple filing jointly). These phase-out thresholds are an odd number because they are indexed for inflation each year. Joan and Jim's AGI is too low to trigger the phase-out, but we can illustrate how it works by considering a married, childless couple with a $400,000 AGI. Before applying the phase-out rule, their aggregate Personal and Dependent Exemption Deductions would be $8,100 ($4,050 x 2) in 2017. Because the couple's $400,000 AGI exceeds $313,800 by $86,200, however, they would lose 70% of this amount because $86,200 divided by $2,500 is 34.48, and 35 reductions of 2% equals a 70% reduction. Thus, they would be permitted to deduct only $2,430 in the aggregate ($8,100 *less* $5,670).[8]

***Standard deduction versus itemized deductions***

Next, Joan and Jim would be entitled to deduct *either* the Standard Deduction under § 63(b)(1) *or* the aggregate of their so-called Itemized Deductions. **The Standard Deduction is a flat amount** available to individual taxpayers that is, like the Personal and Dependent Exemption Deduction, indexed for inflation each year. *See* § 63(c)(4). For 2017, the Standard Deduction for a married couple filing a joint tax return is $12,700 ($6,350 for single individuals). **Itemized**

[8] This result remains true only if the couple is not otherwise subject to the AMT, discussed shortly, as the Personal and Dependent Exemption Deductions are entirely disallowed under the AMT.

**Deductions consist of the universe of all deductions *except* (1) Above-the-Line Deductions (*i.e.*, those listed in § 62), (2) the Personal and Dependent Exemption Deductions, and (3) the Standard Deduction.**

The original impetus behind the 1944 enactment of the Standard Deduction was the desire for simplification during the period when the class tax was becoming a mass tax during WWII, as described in Chapter 3.[9] The new Standard Deduction allowed taxpayers who did not wish to keep track of the individual Itemized Deductions to which they would otherwise be entitled to simply take the Standard Deduction, instead. The Standard Deduction, in other words, is intended to represent an amount that the average taxpayer might otherwise incur in Itemized Deductions. Of course, in the real world, most taxpayers *will*, in fact, keep track of their Itemized Deductions and take whichever amount (the total of Itemized Deductions or the Standard Deduction) is larger. Thus, in a nontrivial way, the Standard Deduction represents an additional amount of tax-free subsistence spending available to all taxpayers (in addition to the Personal and Dependent Exemption Deduction) because every taxpayer is entitled to it simply for existing.

Itemized Deductions consist chiefly of the personal deductions that would not be allowed under a pure SHS income tax (*i.e.*, they are "tax expenditures"), as well as a limited category of business and investment expenses, discussed shortly. A large majority of individual taxpayers—approximately 70% of all individual filers—take the Standard Deduction instead of their aggregate of Itemized Deductions. Only about 12% of taxpayers earning less than $63,000 itemize. Higher income taxpayers, in contrast, virtually all itemize, with 90% of those earning more than $150,000 itemizing.[10]

The only possible Itemized Deductions on these facts would be the $2,000 in charitable contributions (§ 170(a)) and the $3,000 paid in state and local income taxes (§ 164(a)(3)). We know that these are Itemized Deductions because they are *not* listed in § 62. Because this total ($5,000) is less than Joan and Jim's $12,700 Standard Deduction, they will definitely take the Standard Deduction instead of itemizing. Notice, therefore, that **Itemized Deductions are entirely worthless to the extent that their aggregate does not exceed the Standard Deduction. Stated another way, Itemized Deductions have value only to the extent of their aggregate *excess* over the Standard Deduction. Thus, Itemized Deductions are less valuable than Above-the-Line Deductions—the preferred deductions—where each dollar does, in fact, offset Gross Income in reaching Taxable Income**. Joan and Jim's Taxable Income within the meaning of § 63 is:

| | | |
|---|---|---|
| | $110,000 | Gross Income (also their AGI) |
| *Less* | 16,200 | Personal and Dependent Exemption Deductions |
| *Less* | 12,700 | Standard Deduction |
| | $81,100 | Taxable Income |

Because Joan and Jim are not itemizing their deductions but rather taking the Standard Deduction, §§ 67 and 68 are irrelevant to them, but we need to talk about these provisions here. Let's talk about § 68 first.

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[9] *See* Joseph J. Thorndike, *The Love-Hate Relationship With the Standard Deduction*, 142 TAX NOTES 1394 (2014) (describing how charities lobbied against the enactment out of fear that the new Standard Deduction would reduce charitable giving, though a look back from 1960 showed that it did not).

[10] *See* David Wessel, *Campaign Paves the Way for Tax Reform*, WALL ST. J., Oct. 25, 2012, at A8, and at http://online.wsj.com/news/articles/SB10001424052970203937004578076650697167828.

***§ 68: the partial phase-out of itemized deductions***

Section 68 reduces the aggregate amount of otherwise allowable Itemized Deductions by 3% of the amount by which it exceeds the same threshold amounts described above with respect to the Personal and Dependent Exemption Deduction phase-out rule, *i.e.*, $261,500 for individuals in 2017 ($313,800 for married couples filing jointly). Unlike the Personal and Dependent Exemption Deduction, however, which can be fully phased out, Itemized Deductions cannot be reduced by more than 80% under § 68.[11] For example, a married couple with a $400,000 AGI and $50,000 in allowable Itemized Deductions would see their Itemized Deductions reduced by $2,586 (3% of the $86,200 excess of $400,000 over $313,800) to $47,339.

***§ 67: the 2% floor under "miscellaneous itemized deductions"***

Before applying § 68, however, § 67 may reduce some Itemized Deductions for those who (unlike Joan and Jim) itemize. Under § 67, the aggregate of "**Miscellaneous Itemized Deductions**," or MIDs, which are **a *subset* of all Itemized Deductions**, are deductible *only* to the extent that their aggregate exceeds 2% of AGI. If, for example, the aggregate of MIDs is $2,500 and the taxpayer's AGI is $100,000, the taxpayer could deduct only $500 of the total MIDs—not the entire $2,500. If the taxpayer's MIDs totaled only $1,500, none of the $1,500 would be deductible. You will often hear this rule referred to as the *2% floor* under MIDs or the § 67 haircut.

**MIDs are all Itemized Deductions *except* those listed in § 67(b)**, which is why MIDs are accurately described as a subset of the universe of all Itemized Deductions. Stated another way, the Itemized Deductions listed in § 67(b) are those that are *free* of the aggregate 2% floor and can be deducted in full by any taxpayer that elects to itemize instead of taking the Standard Deduction.

Notice that most of the personal (tax expenditure) deductions are found in the § 67(b) list and thus are free from the 2% floor, including the charitable contribution deduction under § 170, the deduction for qualified residence interest under § 163, and the deduction for state and local property and income taxes under § 164. Obviously missing from that list are §§ 162 (pertaining to business expenses) and 212 (pertaining to investment expenses). The § 162 business expense deductions of the self-employed are not Itemized Deductions in the first place but rather are Above-the-Line Deductions, as described above. *See* § 62(a)(1). Similarly some § 212 deductions are also taken above the line if they pertain to property that produces rents or royalties. *See* § 62(a)(4). But consider the § 162 *unreimbursed business expenses of an employee*. Because they are not reimbursed, they are not Above-the-Line Deductions listed in § 62(a)(2)(A) but rather are Itemized Deductions. Moreover, because § 67(b) does not list § 162 in any of its subsections, they are also MIDs. In addition, any § 212 deduction that does not pertain to the production of rents or royalties—and thus are not Above-the-Line Deductions under § 62(a)(4)—are both Itemized Deductions and, because also not listed in § 67(b), MIDs.

Most employees (unlike sole proprietors) will not incur significant deductible business expenses, but a few will. For example, suppose that Ellen is a lawyer working as in-house corporate counsel for Expo, Inc., that she pays $100 in annual American Bar Association dues (clearly an expense that would satisfy § 162), and that Expo, Inc., refuses to reimburse Ellen's business expense. When Ellen attempts to deduct this $100 on her own tax return, she will be hampered

[11] Certain Itemized Deductions are free from the § 68 limitation, such as medical expenses under § 213, personal casualty and theft losses under §§ 165(c)(3) and (h), investment interest under § 163(d), and wagering losses under § 165(d).

first by her ability to itemize (will she have enough Itemized Deductions to allow her to itemize, or will she take the Standard Deduction, instead?) and second by the 2% floor found in § 67. Even if she itemizes, the $100 expense, though technically deductible under § 162, would be nondeductible in fact if this is her only MID. In this manner, MIDs are the least favored deductions. (The most favored are the Above-the-Line Deductions, and the second most favored are Itemized Deductions that are free of the 2% floor because listed in § 67(b).)

Indeed, § 162 unreimbursed business expenses of employees and § 212 deductions (other than those pertaining to the production of rents or royalties that are deductible above the line under § 62(a)(4)) were the prime targets in the crosshairs of Congress when it first enacted § 67 in 1986 as a base-broadening measure to help pay for the dramatic reduction in the top marginal rate from 50% to 28% (described in Chapter 3). Here is a bit of legislative history:[12]

> The Congress concluded that the prior-law treatment of employee business expenses, investment expenses, and other miscellaneous itemized deductions fostered significant complexity, and that some of these expenses have characteristics of voluntary personal expenditures…. The use of the deduction floor also takes into account that some miscellaneous expenses are sufficiently personal in nature that they would be incurred apart from any business or investment activities of the taxpayer. For example, membership dues paid to professional associations may serve both business purposes and also have voluntary and personal aspects; similarly, subscriptions to publications may help taxpayers in conducting a profession and also may convey personal and recreational benefits. Taxpayers presumably would rent safe deposit boxes to hold personal belongings such as jewelry even if the cost, to the extent related to investment assets such as stock certificates, were not deductible.

***Alternative minimum tax***

Moreover, MIDs are entirely nondeductible—even to the extent that their aggregate exceeds 2% of AGI—under the "Alternative Minimum Tax" (AMT). Notice that, at the bottom of the earlier flow chart from Gross Income to tax due, you see a reference to the Alternative Minimum Tax. The AMT is a parallel tax system alongside what is referred to as the "regular" tax (to distinguish it from the AMT). The AMT was originally enacted in 1969 when the front pages of the national press reported that 155 wealthy taxpayers paid no income tax, even though they realized large amounts of *economic* income, because deductions, exclusions, timing rules, credits, *etc.*, combined to result in zero tax due. Every taxpayer must calculate the tax due under *both* the regular tax and the AMT and pay whichever is larger. The maximum tax rate under the AMT is currently 28% for individuals, which is lower than the maximum 39.6% tax rate under the regular tax, but *the AMT tax base is broader than the regular tax by denying some deductions, exclusions, etc., that are permitted under the regular tax*. For this reason, the AMT tax may be larger, even though the top AMT marginal tax rate is lower.

Among the most important deductions that are allowed for regular tax purposes but denied for AMT purposes are the §§ 152 and 152 Personal and Dependent Exemption Deductions (§ 56(b)(1)(E)), the § 164 deduction for certain state and local income and property taxes (§

[12] STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, JCS-10-87, May 4, 1987, at 78-79, at www.jct.gov/jcs-10-87.pdf.

56(b)(1)(A)(ii)), and *all* MIDs (instead of only MIDs below the 2% floor). § 56(b)(1)(A)(i). Thus, among the taxpayers most at risk for triggering AMT liability are those with many minor children, who live in high-tax states, and who are employees that have a lot of unreimbursed § 162 business expenses or large § 212 deductions that do not pertain to the production of rents or royalties. The preferential tax rate applicable to capital gains and dividends is maintained under the AMT, so realizing a lot of low-taxed capital gains and dividends will *not* trigger the AMT.

In the years between 2001 and 2013, the AMT became increasingly problematic for two reasons. The first is that the Standard Deduction that is used for AMT purposes was not indexed for inflation automatically each year (unlike the Standard Deduction used for purposes of the regular tax). Thus, even before 2001, the number of taxpayers snared by the AMT was beginning to increase steadily. The second is that the top AMT rate of 28% was not reduced in 2001 when the top rate for regular tax purposes was reduced from 39.6% to 35% (described in Chapter 3). Thus, a far larger number of taxpayers owed more tax under the AMT after 2001 than they did before 2001. (This problem was known in 2001 when the regular tax rate reductions were being debated, but nothing was done because doing nothing reduced the revenue cost of the legislation, with the AMT taking back some of what otherwise have been lost under the new "regular" rate structure—a move many charged was misleading.)

In response to this problem, Congress passed special legislation annually (often referred to as the "AMT patch") to increase the AMT Standard Deduction substantially in order to reduce the number of taxpayers caught up in the AMT. But this legislation, because it lost revenue against a baseline of "current law" that assumes no patch, was never easy (and often came in December, as the IRS was finalizing tax returns for use in the new year without the AMT patch). Sometimes, the revenue-losing AMT patch was matched with offsetting revenue increases elsewhere, but often the AMT patch simply increased the annual deficit (the excess of Federal spending over Federal revenue for the year). Why was not this problem taken care of permanently during these years, you sensibly ask? Because it was very expensive (in terms of scoring the lost revenue) to do that. The Tax Policy Center observed that "a one-year patch enacted for 2012 would reduce Federal tax revenue by about $85 billion, compared with a $1.1 trillion price tag for permanently indexing the AMT exemption for inflation, and a $1.4 trillion cost of full repeal over the 2012-2022 period."[13] Finally, the American Taxpayer Relief Act of 2012 permanently indexed the AMT Standard Deduction, avoiding the need for annual AMT patch legislation in the future.

Whew! We finally can summarize the status of business deductions:

```
      BUSINESS DEDUCTIONS:
      /                        \
Nonemployee:                    \
                                 \
Above the Line.                   \
 See § 62(a)(1).                 Employee
                               /         \
                              /           \
                             /             \
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[13] *Alternative Minimum Tax: What Has Been the Effect of Annual Patches?*, at www.taxpolicycenter.org/briefing-book/key-elements/amt/patches.cfm.

| | |
|---|---|
| and reimbursed under an "accountable plan" **or** unreimbursed and performing artist, state government official, <u>or primary/secondary teacher</u> | \ \ and not reimbursed (and not performing artist, state gov. <u>official or primary/secondary teacher)</u> |
| Above the line. *See* § 62(a)(2). *See also* Treas. Reg. § 1.62-2(c)(4): ignore both inclusion and deduction, if reimbursed | Itemized Deduction MID under regular tax Disallowed entirely under AMT |

We can also finally get back to Joan and Jim. Now that we have concluded that their Taxable Income is $81,100, we can compute their income tax due for 2017 (before considering any offsetting tax credits). Notice that their Taxable Income falls within the bracket described in line 3 of the 2017 Table for Married Couples Filing a Joint Return, reproduced earlier. That line provides that their tax due is $10,452.50 *plus* 25% of the excess of their $81,100 Taxable Income over $75,900 (.25 x $5,200), producing a tax of $11,752.50 ($10,452.50 *plus* $1,300).

Joan and Jim would next consider whether they are entitled to any **tax credits**. While a deduction reduces Gross Income in reaching Taxable Income (the tax base—what is taxed), a tax credit offsets the tax due. **While a $1 tax credit saves $1 in tax for taxpayers in every tax bracket, a $1 deduction saves an amount of tax that varies by the taxpayer's marginal tax rate that would have otherwise applied to the income absent the deduction.** Thus, a $1 deduction saves a taxpayer in the 39.6% bracket 39.6 cents (because, absent the deduction, the extra $1 of Taxable Income would have generated an additional 39.6 cents in tax), while the same $1 deduction saves a taxpayer in the 15% bracket only 15 cents (because, absent the deduction, the extra $1 of Taxable Income would have generated an additional 15 cents in tax.) In contrast, a $1 tax credit saves the taxpayer exactly $1 in tax, regardless of tax bracket. In other words, a tax credit has the same value to high and low bracket taxpayers alike, while a deduction is worth more to high-bracket taxpayers than to low-bracket taxpayers. For this reason, Congress will usually choose the tax credit mechanism when it intends particularly to target low-income taxpayers with a special tax benefit and a deduction when it intends particularly to target high-income taxpayers.

***Child tax credit and earned income tax credit***

Taxpayers with minor children effectively have a third mechanism (in addition to the Personal and Dependent Exemption Deduction and Standard Deduction) to augment the amount of subsistence income that will be free from income tax. The child tax credit in § 24 is equal to $1,000 for every child under age 17 that is eligible for the Dependent Exemption Deduction on the taxpayer's return. This $1,000 figure is not indexed for inflation. The child tax credit, aimed at low- and middle-income taxpayers, is phased out by $50 for every $1,000 of AGI for a married couple filing jointly that exceeds $110,000—another threshold that is not indexed for inflation. *See* §§ 24(b)(1) and (2). Because Joan and Jim's AGI does not exceed $110,000, their $2,000 child tax credit ($1,000 for each of their two children) is not reduced, and their $11,752.50 tax due (before credits) is reduced to $9,842.50. They are thankful that their AMT liability is less (take my word for it), so their $9,752.50 regular tax liability is truly what they owe in Federal income tax for the year.

Because Joan and Jim are employees, estimated Federal income taxes should have been withheld from each of their paychecks during the year by their employers, who must send the

withheld amounts to the Treasury or suffer severe penalties. (Self-employed individuals must submit estimated tax payments quarterly.) Under § 31, Joan and Jim will take a tax credit against their $9,752.50 tax owed for any amounts withheld by their employers. If, for example, their employers withheld a total of $9,600 in Federal income tax in 2017, they would credit $9,600 against their $9,752.50 income tax liability and remit the remaining $152.50 owed. If, in contrast, their employers withheld a total of, say, $12,000 from their paychecks in estimated Federal income taxes, their $12,000 tax credit would offset their entire tax liability, and they would receive a refund of $2,247.50 from the Treasury, equal to the excess tax withheld. In other words, the § 31 credit is a so-called refundable credit, which entitles the taxpayer to a payment from the Treasury to the extent that the tax credit exceeds the tax owed.

As an aside, many taxpayers love getting a tax refund from the Treasury each year and sometimes intentionally have their employer withhold from their paychecks more than their anticipated tax in order to ensure a large refund. In the 2015 tax season (pertaining to tax year 2014), nearly 73% of individual tax returns resulted in refunds averaging just over $3,120.[14] Because the Federal government does not pay interest on what is essentially a loan from the taxpayer to the government (equal to the amount of the tax overpayment), this behavior is not entirely rational, but cognitive psychologists are not surprised. The refund "feels" like free money, even though it simply represents the return of an interest-free loan. Chapter 3 will introduce you to several cognitive biases that affect tax policy analysis, but we can introduce the first here: **loss aversion**, under which people strongly prefer avoiding losses to acquiring gains. That is to say, the pain of having to make up a shortfall (if withholding falls short of the amount of tax actually owed) hurts more than the pleasure enjoyed on receiving what feels like a windfall (upon receiving a refund of one's own money). Thus, many taxpayers are willing to make an interest-free loan to the government in order to avoid having to pay what feels like "extra" tax owed at the time the return is filed—even though the amount of tax owed, of course, does not depend on the amount withheld. In Joan and Jim's case, they owe $9,752.50 this year in Federal income tax, regardless of whether they had $9,600 or $12,000 withheld from their paychecks. (If far too little tax is withheld, however, Joan and Jim can owe additional penalties.)

Another very important tax credit for the working poor that effectively augments the amount of subsistence living expenses protected from the income tax is the earned income tax credit (EITC) under § 32, which is a refundable tax credit (*i.e.*, if the EITC exceeds the Federal income tax owed, the excess is paid to the taxpayer). The EITC originated in 1975 as a means to effectively rebate the payroll taxes (Social Security Tax and Medicare Tax) on subsistence wages of low-income taxpayers—particularly those with children—because the payroll taxes have no zero bracket amount; the first dollar earned is taxed. Over time the amount of the credit increased so that it can exceed the amount of payroll taxes paid on subsistence wages as a work incentive. In other words the EITC is not a normative tax provision geared to measuring SHS income accurately but, rather, is an anti-poverty tax expenditure aimed at the working poor.[15] A cursory glance at § 32, however, reveals its complexity. It phases in, plateaus, and then phases out, depending on the number of children, income levels, and marital status. Joan and Jim would not be eligible for any EITC in light of their income level.

***Effective tax rate versus marginal tax rate***

[14] *See* www.irs.gov/uac/newsroom/tax-refunds-reach-almost-125-billion-mark-irs-gov-available-for-tax-help.
[15] *See, e.g.*, Kerry A. Ryan, *EITC as Income (In)stability*, 15 FLA. TAX REV. 583 (2014).

So let's finally get back to the question of Joan and Jim's "effective" (or average) Federal income tax rate. We saw earlier that their marginal rate is 25% because their last dollar falls in the 25% bracket. What is their effective tax rate? We know that the numerator is $11,752.50 (their tax liability), but what is the denominator? As noted earlier, Taxable Income is never used to measure effective tax rates because of all the base-narrowing measures (such as the Personal and Dependent Exemption Deductions, Standard Deduction, gift exclusion, personal deductions, *etc.*) that severely skew the measurement of wealth accessions for the year. If we use AGI (the most common measure), their effective tax rate is 10.7% ($11,752.50/$110,000). The most accurate measure would be *economic* income, which would also throw into the denominator the $10,000 gift that can be spent on personal consumption or saved (and thus would constitute SHS income in the absence of § 102). Using economic income in the denominator would produce an effective tax rate of 9.8% ($11,752.50/$120,000). Each (10.7% or 9.8%) is less than half their 25% marginal rate.

While economists are often concerned with marginal rates, effective tax rates are used in tax policy analysis regarding the fairness of the distribution of the tax burden. For example, some readers may have read in the popular press during the 2012 Presidential election season that President Obama's effective Federal income tax rate in 2010 was 26.3% while Governor Mitt Romney's effective Federal income tax rate in 2010 was nearly half that at 13.9%, even though the Romneys' Adjusted Gross Income was more than ten times higher than the Obamas' income. Both of those figures used AGI. The Obamas' AGI was $1,728,096, consisting mostly of his salary as President and substantial book royalties, both of which are taxed at ordinary income tax rates, and their tax payment was $453,770 ($453,770/$1,728,096 = 26.3%).[16] The Romneys' AGI was $21,646,507, consisting mostly of capital gains and dividends taxed at 15% (which would have been 20% if current law had applied, as described in Chapter 3), but the Governor did earn some ordinary income each year from speaking fees (about $350,000 in 2010) and other forms of investment income that were not subject to the 15% rate applicable to capital gains and dividends in that year, such as interest and book royalties. The Romneys' tax payment was $3,009,766 ($3,009,766/$21,646,507 = 13.9%).[17] Thus, the Romneys' tax payment was roughly four times larger than the Obamas' tax payment, but the Romneys' AGI was roughly ten times higher than the Obamas' AGI. **A tax with an effective tax rate that decreases as income rises is referred to as one that is "regressive relative to income."** (You will find more on the difference between regressive, proportionate, and progressive effective tax rates in Chapter 3.)

Most academic and policy measures of effective tax rates attempt to better approximate economic income by adding to the AGI denominator some SHS wealth accessions that are not includable in Gross Income for Federal income tax purposes. For example, the Congressional Budget Office (CBO) has measured effective Federal tax rates for income groups, considering *all* Federal taxes (not just the Federal income tax), since 1979. As of November 2014, they updated their data to include 2011, the latest year for which data is available (and projected through 2013).[18] The shaded areas in the chart below indicate periods of economic recession.

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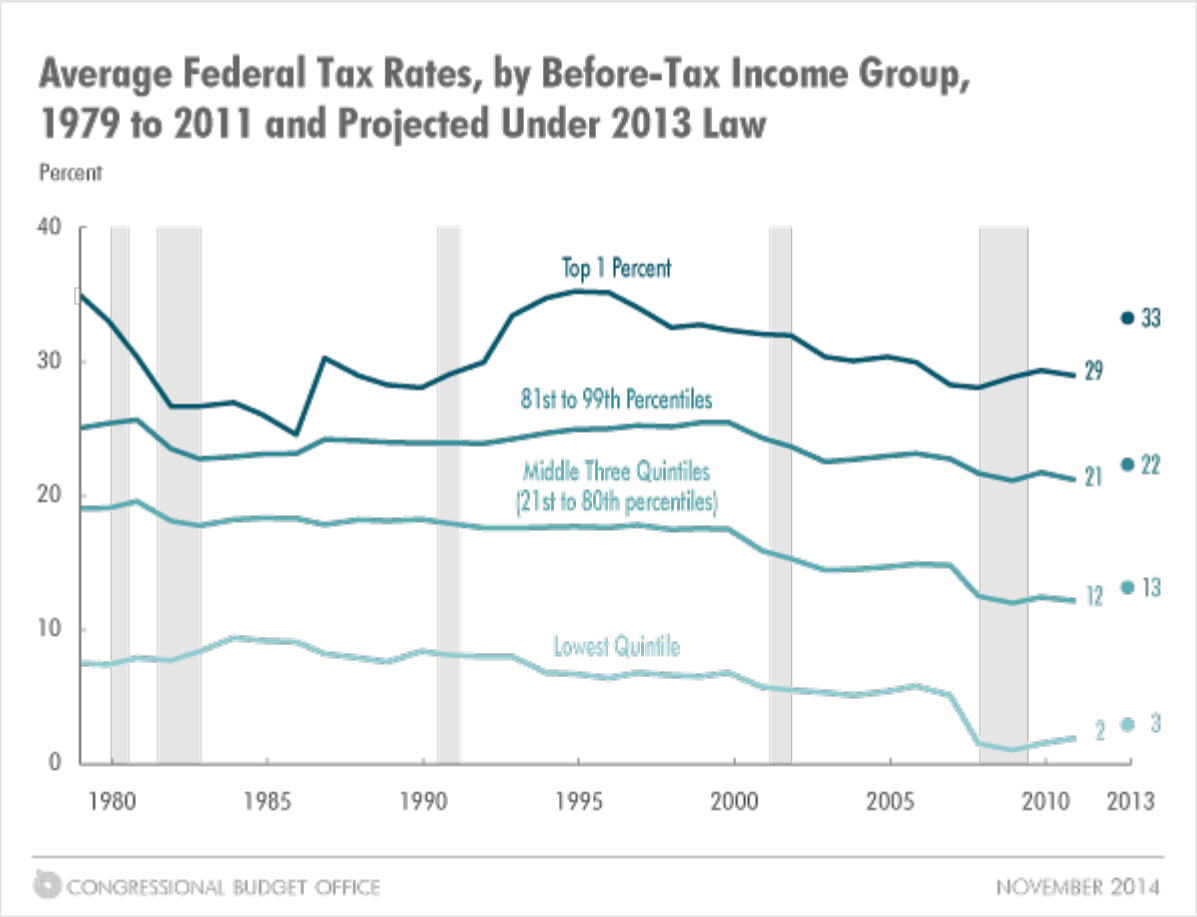
[16] www.scribd.com/doc/53364352/President-Mrs-Obama-s-2010-tax-returns. For tax year 2014, the Obamas paid $93,362 in Federal income tax on AGI of $477,383, for an effective Federal income tax rate of 19.6%. *See https://www.whitehouse.gov/blog/2015/04/10/president-obama-and-vice-president-biden-s-2014-tax-returns.* Their income consisted mostly of the President's $400,000 salary, with much lower book royalties than in prior tax years.

[17] http://thorndike.com/wp-content/uploads/2012/01/Romney1040-2010.pdf.

[18] www.cbo.gov/publication/49440.




CBO adds to the denominator cash transfer payments from the government to those at the lower end of the income scale, such as Social Security payments, Temporary Assistance to Needy Families payments, and veterans' programs payments. More controversially, CBO also adds the value of some benefits received in kind, such as school lunches and breakfasts, food stamps, housing assistance, energy assistance, and (notably) the benefits provided by Medicare, Medicaid, and the Children's Health Insurance Program. If taxpaying ability is not considered augmented by some of these in-kind items—such as the value of Medicare and Medicaid health care received in kind—the chart can be criticized for understating the effective tax rate at the lower end of the income scale (because of the too-high denominator).

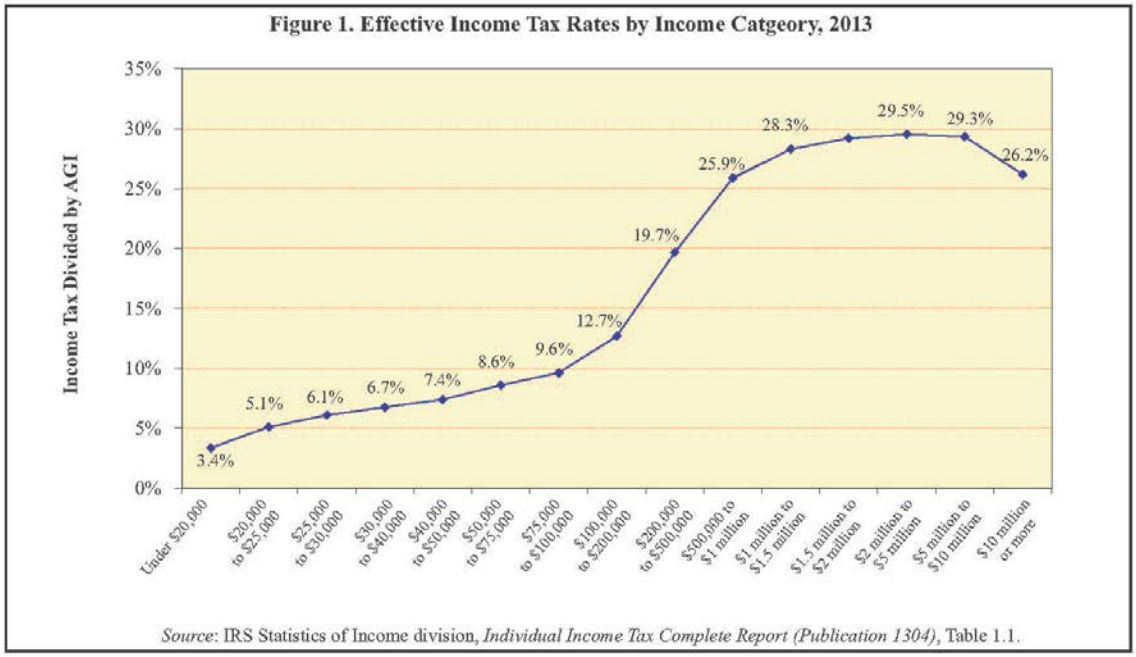
At the higher end of the income scale, the denominator is augmented by tax-exempt interest received on § 103 bonds (discussed in Chapter 2), which (unlike Medicare services received in kind) is cash that clearly represents ability to pay. Notably missing, however, is the built-in gain (*i.e.*, unrealized gain) in financial assets, which are heavily concentrated at the upper-end of the income scale, even though these unrealized gains would also be considered economic income under SHS principles. In addition, CBO assumes that 75% of the corporate tax is paid by the owners of capital and thus includes this amount in the numerator of upper-income households, but the undistributed income of corporations (on which that tax was paid) in excess of the tax paid itself is not included in the denominator—a really big distortion. (The remaining 25% of the corporate tax is deemed paid by workers and is thus included in the numerator of taxpayers at all

income levels.)[19] Thus, this chart can be criticized for overstating the effective tax rate for those at the top of the income scale, as built-in gain and undistributed corporate income are substantial (in the trillions of dollars).[20]

Indeed, a good deal of economic income is never taxed at the top end of the income scale because of the combination of the realization requirement, nonrecognition provisions (which allow certain realized gain, particularly with respect to financial assets and real estate, to go unrecognized under various Code provisions explored in Chapter 13 and upper-level tax courses), and the tax-free step up in basis at death under § 1014 (explored in Chapter 7).

Nevertheless, with these significant caveats in mind, the graph above shows that the effective Federal tax rate generally increases as income rises. **A tax with an effective tax rate that increases as income rises is referred to as one that is "progressive relative to income."** This data, however, does not break down the results within the top 1% itself, where we have seen (in connection with the 2010 effective Federal income tax rates for President Obama and Governor Romney) that effective rates can actually be lower for the very wealthy than for the merely wealthy.

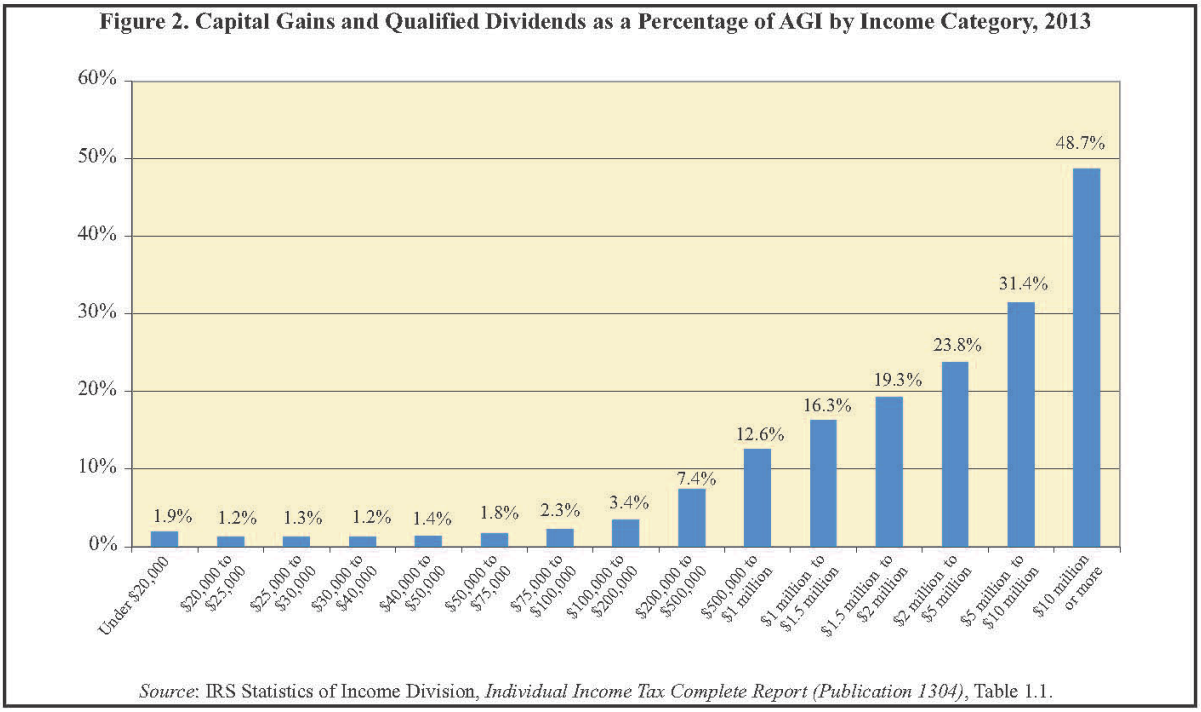
The graph below shows the effective Federal income tax rate across the entire income spectrum for 2013 (after the 2012 restoration of the top capital gains and qualified dividend tax rate to 20%, from 15%, for wealthy taxpayers), and it confirms that the effective tax rate for the very wealthy remains lower than for the merely wealthy.




The reason for this remains that net capital gain and qualified dividends (low-taxed income) remains heavily concentrated at the upper end of the income spectrum, as shown in the graph

[19] The issue of "tax incidence" is discussed in Chapter 3.
[20] *See* Patrick Driessen, *Corporate Tax Fate May Hinge on Modeling Omission*, 145 TAX NOTES 1043 (2014).

below.[21]




Additional data is provided in Chapter 3, where we shall delve into tax policy questions more deeply, but we are getting ahead of ourselves. The main reason for the discussion here was to explore the difference between marginal and effective tax rates. Before diving further into tax policy debates, we need to explore various forms of consumption taxation (Chapter 2). First, however, try your hand at applying the material that you learned in this section to the following problems.

## Problems

**1.** David and Daphne are married and have no children. David is a police sergeant who earns $65,000 this year, and Daphne is a registered nurse who earns $75,000. They earn no investment income this year, but they did receive a $10,000 gift from Daphne's mom. *See* § 102(a). David and Daphne file a joint return and take the Standard Deduction.

**a.** What is Daphne's and David's Adjusted Gross Income (AGI) and Taxable Income for this year?

**b.** What is Daphne's and David's marginal tax rate? Their effective tax rate (using AGI)?

**2.** Sheila and Shane are married and have two children: Erik, age 17, who is a junior in high

[21] Martin A. Sullivan, *U.S. Income Tax Still Not Progessive at the High End*, 152 TAX NOTES 903, 904 (2016). Reprinted with permission of Tax Analysts. *See also* James B. Stewart, *High Income, Low Taxes And Never A Bad Year*, at www.nytimes.com/2013/11/02/business/high-earnings-low-taxes-and-never-a-bad-year.html (focusing on the top 400 income tax returns in 2009 and discussing how the preferential rate applied to net capital gain and dividend is responsible for the very wealthy having a lower effective tax rate than the merely wealthy).

school, and Becky, age 10. Sheila does not work outside the home, and Shane is an electrical engineer who earns $130,000 working as an employee of Tectronics, Inc., this year. Together, they also receive $10,000 in interest on corporate bonds and $5,000 in interest on Ohio state bonds. In Chapter 2, you will learn that the interest on the Ohio state bonds is excludable from Gross Income under the authority of § 103. They contribute $5,000 to the Cleveland Orchestra, which is a deductible contribution under § 170. They pay $7,000 in real property taxes on their personal residence to their local Ohio county jurisdiction, and they pay $8,000 in Ohio state income taxes, both payments of which are deductible under § 164(a). They also pay $6,000 in interest on their home mortgage, which satisfies the definition of "qualified residence interest" within the meaning of § 163(h)(3) and is thus deductible (as explored more fully in Chapter 18). Finally, Shane pays professional dues and travels to several professional association meetings in the field of electrical engineering out of his own pocket in order to keep up to date on the latest information in his field, even though Tectronics, Inc., does not reimburse these costs to Shane. The total amount that is deductible by Shane under § 162 is $2,500. Sheila and Shane file a joint tax return.

**a.** What is Sheila and Shane's AGI for this year? Taxable Income?

**b.** Tectronics has already announced that there will be no employee raises for next year because of sluggish growth. Nevertheless, do you have any advice to Shane in negotiating next year's salary arrangement with Tectronics, Inc.?

**c**. Now for your first attempt at meaty statutory reading. Read §§ 24(a), (b)(1), (2), and (c)(1) very carefully. How much is Sheila's and Shane's child tax credit under § 24 for this year?

# Chapter 2: Consumption Taxation and Our Hybrid Income/Consumption Tax

In Chapter 1, you explored the core concepts informing the SHS concept of income, under which an individual's annual income generally equals her wealth increases *less* her wealth decreases but only if the wealth decreases do not represent personal consumption. Stated another way, an income tax base reaches *both* personal consumption spending *and* amounts added to savings (capital expenditures) by preventing both from being deducted—though you also learned that Congress frees subsistence consumption from taxation through various mechanisms (the Personal and Dependent Exemption Deduction, the Standard Deduction, the Child Tax Credit, and the Earned Income Tax Credit, to name a few). What if Congress decided to tax only the first part of the SHS equation, *i.e.*, only personal consumption spending (in excess of subsistence consumption), protecting additions to savings from taxation? This chapter describes several methods that would accomplish that goal.

We shall investigate consumption taxes for three reasons.

First, as you will read in more detail in the next chapter, the Federal government collected most of its revenue in the form of consumption taxes for more than 100 years before the 16th amendment was ratified and the modern income tax was enacted in 1913. Recent years have seen calls by some to return to our roots by repealing the income tax (and sometimes the payroll and other taxes, as well, which you will also read about in the next chapter) and replacing it with some form of pure consumption tax or adding a Federal consumption tax.[1] Thus, one goal of this chapter is to equip you with a basic understanding of how consumption taxes differ from income taxes and how the various forms of consumption taxation differ among themselves so that you can better digest these modern-day debates.

A second—and far more important—reason to study the various forms of consumption taxation, however, is that the current Internal Revenue Code is actually best understood as a hybrid income/consumption tax. Some provisions in the Code that are inconsistent with an SHS income tax are perfectly consistent with a consumption tax of one sort or another. A few of these provisions will be introduced in this chapter, and we shall identify additional examples as we progress.

Finally, a third reason to study this material is so that you can begin to appreciate the serious problem of **tax arbitrage** opportunities that arise **when the income tax rules pertaining to borrowed money** (briefly described in this chapter and explored in more detail in Unit IV) **are applied to a debt-financed investment otherwise accorded more favorable consumption tax treatment**. If this attempt is successful, the investor can achieve a tax result that is *better* than would occur under *either* a pure income or a pure consumption tax, which raises both fairness and economic efficiency concerns (both of which are explored in the next chapter, as well.)

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[1] For example, several of the Republican candidates for President in 2016 advocated adopting a VAT and reducing the tax collected under the income tax. *See* John Harwood, *Momentum Builds to Tax Consumption More, Income Less*, at www.nytimes.com/2015/11/24/upshot/momentum-builds-to-tax-consumption-more-income-less.html?_r=0.

# A. Consumption taxation forms and comparison to income taxation

How could a tax be structured to reach only consumption spending and not additions to savings? There are several approaches. At first, we shall ignore debt by assuming that the taxpayer uses no borrowed money. Then we shall add the additional wrinkle of debt in Part C.

### *A retail sales tax*

The easiest consumption tax to understand is a retail sales tax (RST), which is commonly imposed by state and local governments. Under this method of taxation, amounts spent to purchase consumption goods (and sometimes consumption services) are typically subject to a flat-rate tax with no exemption amount on the first dollars spent. For example, suppose that Mary goes to Specialty Toy Store and sees a child's carved wooden toy on the shelf priced at $100. Mary takes that toy to the store counter and purchases it to give to her child for his birthday. Suppose further that the state in which Mary resides imposes a 5% RST on retail sales of consumption goods. When Mary reaches the store counter, the clerk informs her that she must pay a total of $105, which she pays. The receipt that she obtains shows that she paid $100 for the toy and $5 in tax. The store transfers $5 of Mary's total $105 payment to the state as RST.

### *A value added tax*

A variation of an RST used by many other countries (in addition to their annual income taxes) is a value added tax (VAT). You can think of it, essentially, as an RST collected on the "value added" in each stage throughout the manufacturing and selling process, rather than all at once at the point of the final retail sale to the customer. One of the weaknesses of an RST is that the tax is collected *only* on the final retail sale to the consumer, so a seller must determine whether the buyer is a consumer that is going to use the item for personal consumption (taxable) or another business that is going to use it in the course of its own business (not taxable). Businesses can typically obtain a tax-exemption certificate or number to present at a retail establishment to show to the clerk to establish that a particular purchase is not to be taxed because it is not going to be used for personal consumption but, rather, is going to be used in business. States with high RSTs often have to deal with fraud in the form of phony tax-exemption certificates and numbers. A VAT avoids the necessity of making this determination and thus tends to be less prone to fraud. Moreover, in order for a business to get a benefit from any VAT paid by it to another, it must collect and remit the VAT on its own sales. In this way, it tends to be self-reinforcing in a way that RSTs are not. Because of enforcement difficulties with RSTs, public finance economists Joel Slemrod and Jon Bakija noted in 2003 that "only six countries have operated retail sales taxes at rates over 10 percent. Four of them, Iceland, Norway, South Africa, and Sweden, have since switched to a VAT, and a fifth, Slovenia, is about to."[2] The total collected in tax under a VAT should nevertheless be the same as under an RST. Here is an example.

> **Example:** Assume that the VAT rate is 5%. Toymaker purchases wood for $10 from Lumberman, who cut the wood from his own land. Lumberman must charge a $.50 VAT ($10 x .05) on the sale of wood to Toymaker, collecting $10.50 and remitting $.50 to the state. Toymaker carves a wooden toy from that wood, which he sells to Specialty Toy Shop for $50. Toymaker must charge a $2.50 VAT ($50

[2] JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM 214 (2nd ed. 2003).

x .05) on the sale of the toy to Specialty Toy Shop, collecting $52.50. Before Toymaker remits the VAT that he collected from Specialty Toy Shop to the state, however, Toymaker properly deducts the $.50 VAT that he, in turn, had paid to Lumberman. Thus, Toymaker remits only $2.00 to the state. Specialty Toy Shop sells the toy to Mary for $100 and must charge a $5.00 VAT ($100 x .05) on the sale to Mary, collecting $105. Before Specialty Toy Shop remits the VAT that it collected from Mary to the state, Specialty Toy Shop properly deducts the $2.50 VAT that it, in turn, had paid to Toymaker. Thus, Specialty Toy Shop remits only $2.50 to the state. In total, the state collects $5.00 ($.50 from Lumberman, $2.00 from Toymaker, and $2.50 from Specialty Toy Shop). As with RSTs, economists conclude that the "economic incidence" (described in Chapter 3) of VATS falls entirely on the end consumer, Mary.

One of the disadvantages of an RST or VAT is that they are *transactional* taxes (taxes imposed on a transaction-by-transaction basis) rather than *annual personal* taxes (annul taxes calculated on a person-by-person basis by reference to some personal characteristic, such as income, wealth, or consumption). Transactional taxes necessarily must use a single tax rate, which makes it difficult to build into the system any sort of 0% tax bracket on subsistence consumption. Indeed, the first dollar of consumption purchased by Poor is taxed at the same rate as the last dollar of luxury consumption purchased by Rich. Some states attempt to ameliorate this effect by exempting certain goods from taxation, such as food, but the effect is imperfect. Moreover, consumption services (as opposed to consumption goods) are often not taxed by many states, and consumption services are more often purchased by wealthier households than low-income households.

Some have proposed an RST on all consumption goods and services with an annual rebate (or "prebate" if it is sent monthly) to everyone in an amount equal to the RST that would be owed on poverty-level expenditures to ameliorate this effect. For example, some of you might have heard about the FairTax (one word), first championed by former Representative John Linder from Georgia (and others).[3] As introduced in Congress in 1999 and every congressional session since then, it would repeal the income tax, the payroll taxes (which fund Social Security and Medicare), and the gift and estate taxes and, instead, impose an RST on every consumer purchase of goods and services, with no exemptions.[4] All U.S. residents would receive monthly checks (the "prebate") equal to the FairTax that would be owed on poverty-level expenditures. All consumption purchases of new goods (used goods would be exempted), including the purchase of a newly constructed home, would be subject to the FairTax, as would all personal services, including the payment of tuition, the purchase of healthcare, legal, and financial services (such as interest on credit cards, home mortgages, and car loans), utilities, gasoline, auto repair services, the renting of an apartment and other real property, *etc.* Whether the payment of state income and property taxes would be subject to the FairTax (as representing the purchase of police and fire protection, public school education, *etc.*) is unclear.

The tax rate used in the FairTax bill is described as 23%, but that 23% rate is the "tax-inclusive rate," not the "tax-exclusive rate" that U.S. residents are most familiar with from their experience with state-level RSTs. The "tax-exclusive rate" is 30%. The difference between a "tax-inclusive

[3] *See* NEAL BOORTZ & JOHN LINDER, THE FAIRTAX BOOK: SAYING GOODBYE TO THE INCOME TAX AND THE IRS (2005). *See also* www.FairTax.org.

[4] To read a recent version of the Fair Tax of 2013 (H.R. 25), see www.govtrack.us/congress/bills/113/hr25/text. As with most RSTs, purchases of business and investment property and services would generally be exempt.

rate" and "tax-exclusive rate" is easiest to illustrate with our earlier example. Recall Mary's purchase of the $100 toy, above. We stipulated that the RST was 5% and that the she paid a total of $105 to the store clerk, who remitted $5 of that $105 to the state. That 5% rate is the "tax-exclusive rate." The "tax-inclusive rate" is 4.8%, equal to the $5 that she owed in tax divided by the *total $105 that she paid to the clerk, including the tax itself* (hence, the "tax inclusive" terminology). I described $5 RST that Mary paid in our example above at the "tax-exclusive rate" of 5% rather than the "tax-inclusive rate" of 4.8% because that is the way that most U.S. residents experience RSTs at the state and local levels.[5] In short, Mary would pay a $30 FairTax on the $100 toy that she purchased, notwithstanding the advertised 23% FairTax rate.

The FairTax drafters use the tax-inclusive rate in describing the RST because the U.S. income tax is, itself, described in tax-inclusive terms. Under § 275(a)(1), the Federal income tax paid is not deductible from the tax base for practical reasons, as Senator Henry Hollis noted when a deduction for Federal taxes was repealed in 1917. "It is a pure matter of expediency. If you so arrange the income tax this year that you allow those who pay it to take back a third of it next year [through a deduction next year], you have simply got to put on a bigger tax." Because Federal income tax is not deductible from the Federal income tax base, one's aggregate income for a year is spent in three ways: personal consumption, additions to savings, and tax.

Most economists believe that the 23% (tax-inclusive) or 30% (tax-exclusive) rate would not be sufficient to be revenue neutral for several reasons, including that it assumes perfect compliance and the enactment of no exemptions. In addition, the revenue calculations assume that the Federal government would pay FairTax to itself on its own purchases, such as defense purchases, but did not increase Federal outlays by the equivalent amount in determining revenue neutrality. Moreover, almost everyone agrees that those who earn $200,000 or more would pay a lower percentage of aggregate Federal tax revenue under the FairTax than they do now, while those earning between $15,000 or $24,000 per year (depending on the source) and $200,000 would see their aggregate share of the Federal tax burden increase.[6]

For these and other reasons, some have devised *annual* personal consumption taxes that, like annual income taxes, could incorporate a basic tax-free amount and graduated tax rates.

### *A cash-flow consumption tax*

The purchase of investment property (such as shares of corporate stock) by an investor or the purchase of business assets (such as a dental chair purchased by a dentist for use in his business) would not trigger an RST because those purchases do not represent personal consumption spending. How can we create the same end result as an RST using an annual tax return instead of imposing tax at the time of each consumer purchase?

We have seen that an SHS income tax reaches not only personal consumption spending (as do an RST or VAT) but *also* the amounts that are *saved*. **The mechanism by which we ensure that amounts saved are effectively taxed under an SHS income tax is through the denial of a deduction for capital expenditures.** Thus, if Hallie purchases *XYZ* stock for $5,000, she is denied a deduction for this addition to her savings under an income tax because the outlay is a nondeductible capital expenditure. She has merely changed the way in which she is holding her

[5] Those of you who visit Europe, in contrast, know that most VATs are not added at the counter as an extra amount owed at the time of purchase. Rather, the VAT is already included in the posted shelf price, which makes the tax less transparent.

[6] *See* www.factcheck.org/taxes/unspinning_the_fairtax.html.

wealth, which is an act of savings. Similarly, John's purchase of a dental chair for $10,000 to use in his dental practice is a nondeductible capital expenditure under an SHS income tax. Like Hallie, John has merely changed the way in which he is holding his wealth. How can we avoid taxing these additions to savings on an annual tax form so that only personal consumption spending is taxed? By allowing deductions for these outlays—even though they would be nondeductible under an income tax!

The annual tax base under a cash-flow consumption tax, which will reach the same end result as would an RST or VAT, starts with *all* cash receipts for the year, even receipts that would not constitute "income" under an income tax, such as basis recovery. Thus, if Paul sells stock for $10,000, the entire $10,000 initially enters his cash-flow consumption tax base, regardless of whether he originally purchased that stock for $5,000 or $12,000. The reason why that $10,000 initially enters his tax base is that he could potentially spend that $10,000 on personal consumption, and a cash-flow consumption tax seeks to reach consumption spending.

Next, all outlays *not* in pursuit of personal consumption would be deducted. Thus, Hallie's purchase of stock for $5,000 and John's purchase of his dental chair for $10,000 both would be immediately deducted in the purchase year under a cash-flow consumption tax because those outlays do not purchase personal consumption but rather represents an addition to savings. There is no concept of "basis" (generally representing undeducted, previously taxed dollars) in a cash-flow consumption tax on the purchase of business or investment assets because those outlays would be immediately deducted in the purchase year. Thus, we would generally need no mechanism to keep track of previously taxed dollars, as we do under an SHS income tax, for business and investment assets.[7]

Even the aggregate net deposits made to your checking account for the year (balance at the end of the year *less* balance at the beginning of the year) would create a deduction under a cash-flow consumption tax because the increased balance represents an addition to savings. Remember, we are replicating the end result of an RST, and depositing savings in a bank account would not generate an RST. Thus, the net increase in your savings and checking accounts would presumably be reported at the end of each year to the government to aid enforcement efforts in confirming the taxpayer's proper deduction for these increases to savings.

When the smoke clears, all that should be left in the tax base is the amount that is spent on personal consumption for the year, which is what would be taxed under an RST. Here is an example.

> **Example:** This year, John, a dentist, collects $500,000 from his patients, pays his dental assistant $30,000, pays his receptionist $20,000, purchases a new X-ray machine for $10,000, purchases a new dental chair for $5,000, purchases stock in *XYZ* Corp for $10,000, and sells stock in *ABC* Corp for $15,000, which John had purchased five years ago for $7,000.
>
> John must include on his cash-flow consumption tax return the $500,000 received from patients, as well as the entire $15,000 received on the sale of his *ABC* stock

[7] Some complications and gray areas would arise, particularly with respect to personal-use assets that have the potential to appreciate in value, unlike most personal-use assets. For example, the cost of a diamond engagement ring should not be deductible, as that outlay represents personal consumption. If it is sold for more than its original cost, however, only the amount exceeding the undeducted original purchase price should be included in the cash-flow consumption tax base because the purchase price was already taxed in the purchase year (via deduction denial).

(not merely what would be the $8,000 "gain" that he would include under an income tax). John would deduct the following non-consumption outlays: $50,000 paid to his dental assistant and receptionist (which would also be deductible in an income tax world as business "expenses"), the $15,000 that he spent in purchasing the new X-ray machine and dental chair (even though these would be *nondeductible* capital expenditures in an income tax world, subject only to depreciation deductions over time), and the $10,000 used to purchase the *XYZ* stock (even though this would be a *nondeductible* capital expenditure in an income tax world and would not generate depreciation deductions).

In sum, a cash-flow consumption tax is not concerned with keeping "savings"—capital expenditures—within the tax base. Rather, like an RST or VAT, it reaches only personal consumption spending. You can now better appreciate why the capitalization principle is the defining difference between an income tax and this form of consumption taxation.

***Exempting capital returns from tax: the wage tax and the E. Cary Brown yield-exemption phenomenon***

In Chapter 1, you learned that, under an SHS income tax, investment deductions are necessary *only because* capital returns are included in the tax base. If we were to require inclusion of capital returns but, at the same time, deny deduction of the costs incurred to produce that includable capital return, we would violate fundamental precept (1) that the same dollars should not be taxed to the same taxpayer more than once. On the flip side of the coin, **if capital returns are exempt from tax, we must deny all deductions in order to honor fundamental precept (2) that a taxpayer not enjoy a double tax benefit for the same dollars**. No deductions are necessary to reduce the gross return to a net profit if the gross return is not included in the tax base in the first place.

With respect to employees, who have few (if any) business deductions, what if Congress taxed only wages, exempting all capital returns from their investments from tax, such as capital gains, interest, dividends, rents, and royalties? No deductions would be allowed except for a Standard Deduction that would vary by family size because no deductions would be needed if investment income is tax-free. All wages exceeding the threshold would be taxed at a single rate. Business entities (and sole proprietors) could be subject to a cash-flow tax, similar to a cash-flow consumption tax, by requiring them to include all cash receipts but allowing immediate deduction of all business and investment outlays, including what would otherwise be nondeductible capital expenditures under an income tax.

With some variation, this is essentially the tax base under the so-called flat tax advocated initially by Robert E. Hall and Alvin Rabushka and by others since then.[8] It was also part of

[8] *See* ROBERT E. HALL & ALVIN RABUSHKA, THE FLAT TAX (2d ed. 1995). Steve Forbes, a 1996 candidate for President, championed the flat tax as the centerpiece of his campaign, which first brought the tax to popular attention. Hall and Rabushka actually recommended a VAT at the business level, rather than a business cash-flow tax. Under a traditional VAT, wages paid by businesses are not deducted from the tax base. Hall and Rabushka argued that some progressivity could be introduced into a VAT by nevertheless allowing businesses to deduct wages paid from their VAT base and requiring individuals to include such wages on an individual return, normally not required in a VAT system. The wages would then be taxed at the same single VAT rate to the extent that they exceeded a Standard Deduction that would vary by family size. In this way, some progressivity could be introduced into the VAT (to the extent of the wages not taxed because of the Standard Deduction). The "flat" in "flat tax" comes from the single tax rate that would apply to labor income (only) in excess of the Standard Deduction, but by far the more extraordinary feature of the so-called flat tax is not the single tax rate but the radical change in tax base, exempting capital returns.

Congressman Paul Ryan's tax-reform plan that he introduced as part of the 2012 Budget, which was approved by the House of Representatives but not by the Senate.[9] Such a wage tax can be viewed as one form of consumption taxation because, as shown by E. Cary Brown,[10] an influential economist in the 1950s, the end result of **taxing only labor income and exempting the "yield" or investment return on capital (*e.g.*, capital gains, interest, rent, and royalties) from tax can produce the same end result as under a cash-flow consumption tax, *i.e.*, the same end result as deducting the original investment but including 100% of the returns, both the original investment and the capital return**. This equivalence will hold, however, only if (1) tax rates do not change over time and (2) the investments that are taxed under a cash-flow consumption tax, on the one hand, or a wage tax, on the other, produce only the expected market return (the "normal" return) and not an extraordinary (or "supranormal") return, unforeseen by the market (and thus not affecting the original purchase price of the investment).

Not only can the result be identical under a cash-flow consumption tax and a wage tax; the tax owed under an income tax on the same facts will be higher, and the additional amount of tax owed will precisely equal the tax expressly not owed on the capital return under the wage tax and implicitly not owed on the same return under the cash-flow consumption tax. Let's compare the results of all three kinds of taxes under a common fact pattern to see why these statements are true.

> **Assume that the tax rate under the cash-flow consumption tax, the wage tax, or the income tax is a flat 20%. George earns $100,000 in wages. He invests in shares of corporate stock using whatever is left after paying any tax on his wages that he cannot avoid under the tax system, but notice that whether the wages will actually be taxed will depend (under the cash-flow consumption tax) on what George does with the $100,000, and our facts state that George will invest whatever he can in the shares. After one year, the stock has appreciated by 5%, and George sells the shares and spends the entire amount (both the original purchase price of the stock and the gain on sale) on personal consumption.**

## Income Tax

Here is a nice review of the rules that you learned in Chapter 1, Part A. The $100,000 in wages is includable in Gross Income under § 61(a)(1), and George has no deductions. Thus, his Taxable Income is also $100,000, generating a $20,000 tax. The remaining $80,000 used to purchase the stock is a nondeductible capital expenditure, creating a basis of $80,000. The sale of the stock after it appreciates by 5% results in a sale price of $84,000 ($80,000 x .05= $4,000), and George has, for the moment, $84,000 of cash in hand. However, George's § 1001 gain is $4,000 ($84,000 A/R *less* $80,000 A/B), which is also subject to the 20% tax, generating an additional $800 tax ($4,000 x .20). Thus, after paying this additional tax, **George has $83,200 after-tax cash** left ($84,000 sales proceeds *less* $800 tax owed on the gain), which he spends on personal consumption.

***Notice that, for an investment to be taxed under income tax principles, both (1) the investment must be made with undeducted (after-tax) dollars (George was prohibited from deducting the $80,000 capital expenditure in purchasing the stock) and (2) the capital return (whether gain,***

[9] THE ROADMAP PLAN, http://roadmap.republicans.budget.house.gov/plan/#Federaltaxreform.

[10] *See* E. Cary Brown, *Business Income Taxation and Investment Incentives*, in INCOME EMPLOYMENT & PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSEN 300 (1948).

***interest, rents, royalties, etc.) must be included in the tax base (the $4,000 investment return in the form of § 1001 gain was included).***

## Cash-Flow Consumption Tax

The $100,000 in wages is initially included in his cash-flow consumption tax base as potential consumption. Because George wishes to invest as much as he can in the stock, he can ensure that his wages effectively will not be taxed at this time by investing the entire $100,000 and thereby generating a $100,000 offsetting deduction against his wages equal to the $100,000 non-consumption outlay. Thus, George owes no tax yet ($100,000 wages *less* $100,000 stock purchase = zero cash-flow consumption tax base). After the stock has appreciated by 5%, George sells it for $105,000 ($100,000 x .05 = $5,000), and George has, for the moment, $105,000 of cash in hand. However, George must include the *entire* $105,000 in his cash-flow consumption tax base as potential consumption. Because he purchases no other investments (but rather will spend whatever is left on personal consumption), George has no offsetting deductions, generating a $21,000 tax ($105,000 x .20). Thus, **George has $84,000 after-tax cash** left ($800 more than he had under an income tax), which he spends on personal consumption

George's investment return was nominally included in the tax base under a cash-flow consumption tax (*i.e.*, George had to include the *entire* $105,000, including the 5% return of $5,000, in his tax base). Note, however, that this return was earned on deducted (pre-tax) dollars (George was permitted to deduct his $100,000 stock purchase when he made the initial investment), and the outcome was more favorable than under an income tax.

## Wage Tax

The $100,000 in wages is taxed, generating a $20,000 tax. The remaining $80,000 is invested in the stock, and George cannot take any deductions. After the stock appreciates in value by 5%, George sells it for $84,000 and owes no tax on the $4,000 profit, as it is a capital return, not wages. Thus, **George has $84,000 after-tax cash** left (the same amount as under the cash-flow consumption tax), which he spends on personal consumption.

Although George's investment return is earned on after-tax dollars (as under an income tax), the investment return is expressly excludable from the tax base, and the outcome is more favorable than under an income tax.

Thus, when the smoke clears, George has $84,000 in after-tax cash left to spend on personal consumption under *either* the cash-flow consumption tax *or* the wage tax. Notice also that the $800 difference between this amount and the $83,200 that he has left in after-tax cash under the income tax is precisely equal to the tax owed under the income tax on the capital return that was expressly exempted under the wage tax and implicitly free of tax under the cash-flow consumption tax. "Wait," you say. "The 5% capital return was not exempt from tax under the cash-flow consumption tax because George had to include the *entire $105,000 sales proceeds of the stock sale* on his cash-flow consumption tax return and pay a 20% tax on it, and that $105,000 includes the 5% appreciation in value of the stock." Ahhhhhh, I reply, although that capital return was nominally included on George's cash-flow consumption tax return, was it effectively taxed when you look more deeply? Although you are correct that George had to include that capital return, *that return was earned on untaxed (or pre-tax) dollars*. He enjoys the same end result as under a wage tax that denies deduction of the initial investment (as under an income tax) but *explicitly excludes the*

*capital return from the tax base.*

***Under the E. Cary Brown yield-exemption phenomenon, deducting the cost of an investment in the purchase year and including 100% of the sale proceeds (both the original investment and the capital return) in the tax base (as under a cash-flow consumption tax) results in the same outcome as not deducting the cost of the investment but expressly exempting the capital return from the tax base (as under a wage tax) under certain conditions. Both results are better than under an income tax. To be taxed under income tax principles (1) the investment must be made with undeducted (after-tax) dollars and (2) the capital return must be included in the tax base. If either (1) or (2) is lacking, the investment is being treated to more favorable consumption tax treatment, not income tax treatment.***

The equivalence between a cash-flow consumption tax and a wage tax does not hold if the investment unexpectedly produces an outsize return that was unanticipated by the market. The reason for this is that the **tax comes at the back end under a cash-flow consumption tax (when the investment is sold and spent on consumption) but at the front end under a wage tax (when the investment is made with undeducted, after-tax dollars)**. If an investment earns unanticipated market returns (which were not reflected in a higher purchase price when the investment was acquired because they were not anticipated), the unanticipated return (often called supranormal returns) would effectively be captured and taxed when spent on consumption under a cash-flow consumption tax but would escape taxation under a wage tax.

To understand this point, we need to take a detour and discuss one way in which "the market" comes up with the "fair market value" (FMV) of an asset. One common way to describe how the market arrives at the FMV of any asset is to say that FMV is the market's best guess at the present, discounted value of the future stream of payments expected to be generated by that asset. Thus, for example, the FMV of a plot of land that is rented to tenant farmers may be calculated by discounting to present value the future stream of rental payments expected to be paid by the tenant farmers to the land's owner, added to the present value of the sale price eventually expected to be obtained on the land's sale. Let's say that this discounted present value is $10,000, so Brenda is able to purchase the land for $10,000 from its current owner. What happens if oil is discovered and the land suddenly (and unexpectedly) is worth $100,000—much more than the market originally anticipated that it would be worth when Brenda purchased it? When Brenda sells it for $100,000 and spends the entire amount on personal consumption, the increased consumption that she can purchase with her unanticipated return would effectively be taxed under a cash-flow consumption tax but would escape taxation under a wage tax. If the market had known about that oil when Brenda purchased it, she would have had to pay much more than $10,000 for the land, but that was not the case.

> **Example: Assume that George is subject to a cash-flow consumption tax but that Brenda is subject to a wage tax, both using a 20% flat tax rate. They each earn $100,000 in wages and invest whatever is left after paying any tax on the wages that cannot be avoided under the tax system. Both George and Brenda *expect* to earn a 5% return on their investments, as that rate reflects the average market return. George does, in fact, earn a 5% return, but Brenda's investment unexpectedly hits it big and her return is 20%. George and Brenda sell their investments and spend the entire amount (both the original purchase price of the investment and the gain on sale) on personal consumption.**

George's outcome is precisely the same as described above under the cash-flow consumption tax, as the facts are the same. **George pays $21,000 in tax and enjoys $84,000 of personal consumption from his original $100,000 in wages.** Because Brenda is taxed under a wage tax instead of a tax-flow consumption tax, the $100,000 in wages is taxed at the front end, generating a $20,000 tax, and the remaining $80,000 of after-tax dollars are invested. She anticipates only a 5% return (for a total future sale price of $84,000), but the she enjoys an unexpectedly large 20% return, and she is able to sell it for $96,000, instead ($80,000 x .20 = $16,000). If that 20% return had been anticipated by the market, she would undoubtedly have had to pay much more than $80,000 to purchase the investment, but the market failed to anticipate such a large return. When Brenda sells the investment for $96,000, she owes no tax on the unexpectedly large $16,000 profit, as the profit is a capital return, not wages. Thus, **Brenda pays $20,000 in tax (less than George) and enjoys $96,000 of personal consumption (more than George) from her original $100,000 in wages. She owes no additional tax on her extra consumption.**

For this reason (and as more fully explored in the next chapter), a cash-flow consumption tax is considered to allocate the tax burden (on consumption) more fairly than does a wage tax that exempts capital returns because only the former ensures that two taxpayers enjoying the same amount of consumption will pay the same tax.

## B. Consumption tax provisions in the Internal Revenue Code

Although we generally refer to the Internal Revenue Code as imposing an "income tax," numerous consumption tax provisions are embedded within it. Any Code section that allows the exclusion of a capital return from the tax base is a consumption tax provision consistent with the wage tax model, and any Code section that allows the premature deduction of a capital expenditure (or otherwise allows an investment to be made with pre-tax dollars) is a consumption tax provision consistent with the cash-flow consumption tax model. In either case, the returns from capital are either explicitly (wage tax model) or implicitly (cash-flow consumption tax model to the extent of the normal return) free from tax. Here are just a few of them.

**Certain retirement savings**. Traditional Individual Retirement Accounts (IRAs) under § 219 of the Code, qualified pension plans (under §§ 401-417), and § 401(k) plans (named after § 401(k) of the Code) provide cash-flow consumption tax treatment for retirement savings. Contrary to an SHS income tax but consistent with a cash-flow consumption tax, contributions to these accounts are immediately deductible (even though they are capital expenditures) if made directly by a taxpayer. If a portion of compensation earned is contributed to these accounts by an employer, the contributed compensation is not includable in the employee's Gross Income under § 61(a)(1) but rather is excludable from Gross Income. Thus, these IRA, qualified pension plan, and § 401(k) accounts are funded with *pre-tax dollars* (instead of after-tax dollars). Moreover, the investment return earned in these accounts is not currently taxed as it accrues, so the taxpayer has no "basis" in the account because no dollars in the account have yet been taxed. Withdrawals from these accounts are therefore fully includable at the back end, as under a cash-flow consumption tax.

Instead of cash-flow consumption tax treatment, so-called Roth IRAs under § 408A provide wage tax treatment. Contributions to the account are *not* deductible (or excludable, if paid by an employer on an employee's behalf), unlike with a traditional IRA, qualified pension plan, or § 401(k) plan, so these investments are made with after-tax dollars, as under an SHS income tax. The entire investment return, however, is excludable from Gross Income when withdrawn from

investment, as under the wage tax variety of consumption taxation (and unlike under an SHS income tax).

**Accelerated depreciation**. Depreciation deductions under §§ 167 and 168 are allowed at a rate that is faster than would occur under so-called economic depreciation. The early deduction of basis provides subtle but important cash-flow consumption tax treatment. Even though the profit earned by the business is nominally includable in the tax base, it is effectively free from tax between the time that the investment is deducted and the time that it *would* have been deducted under economic depreciation principles because the profit is earned on pre-tax dollars to the extent of the premature deductions. We shall study §§ 167 and 168 in Chapter 14.

**Section 179 expensing**. Certain purchases of business equipment are immediately deductible by small businesses under § 179, also explored in Chapter 14, as though they were "expenses" rather than "capital expenditures." The early deduction of basis provides subtle but important cash-flow consumption tax treatment. Even though the profit earned by the business is nominally includable in the tax base, it is effectively free from tax between the time that the investment is deducted and the time that it *would* have been deducted under economic depreciation principles because the profit is earned on pre-tax dollars.

**Exclusion of personal residence gain**. Section 121 of the Code is a consumption tax provision of the wage tax variety. Under its authority, taxpayers can generally exclude up to $250,000 of realized § 1001 gain ($500,000 in the case of a married couple filing jointly) on the sale of a principal residence. We shall study § 121 in Chapter 18.

**Exclusion of state and local government bond interest**. Section 103 is a consumption tax provision of the wage tax variety, as it expressly authorizes exclusion of one kind of capital return: the interest received on bonds issued by state and local governments. More on § 103 in Part D.

**The realization requirement**. The realization requirement, permitting deferral of tax on economic wealth increases until the property is disposed of, is a subtle cash-flow consumption tax feature, as it allows further investment gains (and dividends in the case of stock, rent in the case of tangible property, royalties in the case of intellectual property) to be earned on pre-tax dollars instead of after-tax dollars, as would occur under a mark-to-market system (explored in Chapter 1). Only a market-to-market system avoids this consumption tax component of current law.

**Deferred gain under nonrecognition rules**. Several provisions allow even § 1001 realized gain on the sale or exchange of property to be deferred to the future (to go "unrecognized" in tax jargon) so long as the proceeds are reinvested in certain kinds of replacement property. These provisions are consistent with a cash-flow consumption tax, which effectively defers taxation even when investments are sold or exchanged so long as the proceeds are reinvested (rather than consumed). Two such provisions that we shall study in Chapter 13 are §§ 1033 and 1031. Those who go on to study corporate and partnership taxation will study many more.

**Forgiveness of unrealized gain at death**. The complete forgiveness of built-in gain at the time of the taxpayer's death under § 1014, considered in Chapter 7, is a consumption tax provision of the wage tax variety, excluding what would otherwise be an includable capital return.

**Reduced tax rate on net capital gain**. The reduced tax rate applied to "net capital gain," if realized during life, is a subtle wage-tax-like feature of current law. Though the rate is usually not 0%, as it would be under a pure wage tax, the § 1(h) rate (usually 15% or 20%) is lower on this particular form of capital return than it is on an equivalent amount of wages (or other forms of

capital return, such as interest or royalties). Coupled with the cash-flow consumption tax advantage of the realization requirement itself, net capital gain is really super special under current law!

## C. The additional wrinkle of debt

The income tax treatment of the borrowing and lending of money is very different from the treatment of debt under the various forms of consumption taxation. While Chapters 10 through 12 are devoted to examining the income tax treatment of debt more closely, we need to take a sneak preview of the broad outline of how borrowed money is treated under an income tax here. For this purpose, we need focus only on the borrower's tax consequences.

Suppose that Lori borrows $10,000 from National Bank in Year 1 for use in her business at 5% annual interest, with the principal to be repaid in Year 10. National Bank transfers $10,000 to Lori in Year 1. Each year of the 10-year loan period, Lori pays $500 to National Bank as interest, which you can think of as rent paid to use the money owned by National Bank (just as tenants pay rent to use an apartment owned by a landlord). In Year 10, Lori transfers $10,000 to National Bank. What are Lori's tax consequences (the borrower) under an SHS income tax?

Lori's $10,000 cash receipt in Year 1 raises a Gross Income issue. Must she include the $10,000 in cash as a wealth accession? Under current law, her future obligation to repay the $10,000 results in the conclusion that Lori has not, in fact, enjoyed a current wealth accession in Year 1, which means that she does not include the $10,000 in Gross Income under § 61. One way to think about this issue (though not the only way) is to construct a balance sheet for Lori and list her assets on the left side and her liabilities on the right. When she receives the $10,000 loan, she would increase her assets by the $10,000 in cash that she receives (which superficially looks like a wealth accession), but she would also simultaneously increase her liability side by that same $10,000. Thus her "net worth" or "wealth" (the value of her assets *less* her outstanding indebtedness) does not increase by reason of the cash receipt.

When she repays the $10,000 of borrowed principal in Year 10, can she deduct that cash payment? While Lori transfers cash (which can superficially look like a wealth reduction), she also eliminates this same $10,000 liability from her balance sheet. Thus, her net worth or wealth (assets *less* liabilities) again remains unchanged. Lori is not less wealthy for having repaid this $10,000 obligation, so she is entitled to no deduction.

Lori's interest payments, however, stand on an entirely different footing. The $500 interest that she pays each year is properly categorized as an "expense," as the payment represents an immediate wealth decrease (the opposite of a capital expenditure). Moreover, because we have stipulated that she uses this borrowed principal in her business, it is a business expense. While § 162 generally authorizes the deduction of business expenses, this particular expense (interest) has its own special Code section—§ 163—but § 163(a) would authorize Lori's deduction, and no other subsection of § 163 (or any other Code section) would take away Lori's otherwise allowable interest deduction. Thus, she is entitled to deduct her interest expense.

***The receipt and repayment of borrowed principal has no tax consequences under an SHS income tax for the borrower, but the borrower's payment of interest is generally deductible if incurred in business or investment activities but nondeductible (with exceptions) if incurred in personal consumption activities.***

How is borrowed money treated under an RST? Assume that you reside in a state that imposes

a 5% RST on consumer purchases, that you go to a car dealer and purchase an automobile for $10,000 (which you will use for personal purposes), and that you finance this $10,000 purchase price entirely with borrowed money (whether from the dealer or a bank). Whether you purchase the car entirely from past savings or borrowed money makes no difference to your RST liability; you will owe $500 in RST upon the purchase of the personal-use car. Thus, borrowed money that is used to purchase personal consumption *is* implicitly taxed under an RST.

Let's next consider the tax treatment of borrowing under a wage tax. Recall that a wage tax base consists *only* of wages (capital returns are expressly excluded) and that *no deductions are permitted*. Thus, **borrowed principal is not included in the wage tax base (because not wages), but interest is not deductible—*even if the borrowed money is used in an investment activity***. In short, we need to allow investment deductions (such as interest on a loan used to purchase investment property) *only if* investment returns are includable in the tax base, and investment returns are not included in the tax base under a wage tax.

Finally, what about borrowed money under a cash-flow consumption tax? Recall that *all* cash receipts are includable in the tax base of a cash-flow consumption tax because those cash receipts represent potential consumption, and this rule applies to the borrowed principal of a loan, as well. Recall, as well, that all non-consumption outlays can be deducted under a cash-flow consumption tax. Principal and interest repayments do not purchase personal consumption and thus are deductible under a cash-flow consumption tax, regardless of how the borrowed money is used. Thus, on your $10,000 car purchase using borrowed money, you would have to *include the $10,000 of borrowed money* in your cash-flow consumption tax base in the purchase year. Moreover, because you use the car for personal purposes (rather than business or investment purposes), you do not obtain an offsetting deduction for the car purchase. In addition, however, you would be able to *deduct the principal and interest payments* as you made them under a cash-flow consumption tax, as those outlays do not purchase additional personal consumption.

Recall that, under certain circumstances, the tax outcomes (unrelated to debt) under a cash-flow consumption tax and wage tax are equivalent. The same is true with respect to the treatment of debt: including borrowed principal and deducting both principal repayments and interest (under a cash-flow consumption tax) will reach the same end result as *not* including the borrowed principal and *not* deducting either the principal repayments *or interest* (as under a wage tax). Thus, because the inclusion of all borrowed principal in the cash-flow consumption tax base and the subsequent deduction of both principal and interest from that tax base is cumbersome, the wage tax approach to debt could be used instead: no inclusion of borrowed principal and no deduction of either principal repayments (as under an income tax) *and no interest deduction—even if the interest is incurred in investment activity (unlike under an income tax).*

Adopting that last simplification, we can summarize these rules in the following way:

- Borrowed principal is excluded by the borrower, whether under an SHS income tax, a wage tax, or a cash-flow consumption tax;
- Principal repayments are nondeductible by the borrower, whether under an income tax, a wage tax, or a cash-flow consumption tax; and
- Interest is *never* deductible under a wage tax or cash-flow consumption tax but is deductible under an income tax if incurred in income-producing activities (business or investment).

## D. Tax arbitrage: the income tax treatment of debt coupled with consumption tax treatment of the debt-financed investment

With respect to George's investment described in Part A., above, we saw that his tax outcome was more favorable under either a cash-flow consumption tax or wage tax than under an SHS income tax. In other words, consumption tax treatment of an investment is more lucrative for George than the income tax treatment of that same investment. **George can obtain even *better* than consumption tax treatment, however, if he can succeed in applying the income tax rules pertaining to debt (deductible interest) to an investment otherwise accorded more favorable consumption tax treatment (either the investment is made with pre-tax dollars or the investment return is excludable)**. The common jargon used to describe this phenomenon is "**tax arbitrage**" because he is arbitraging the rules of one tax system (the income tax rules for debt) against the rules of another tax system (the consumption tax treatment of the investment, itself). The bottom-line consequence is that George, if successful, can achieve tax nirvana: **a double tax benefit for the same dollars to the same taxpayer**. Such a result is inconsistent with *both* an SHS income tax and a consumption tax and thus raises both fairness and economic efficiency concerns.

To consider an example of the cash-flow consumption tax variety, suppose, that George borrows $10,000 to purchase a widget-making machine in his small business. Under income tax principles, this purchase is a nondeductible capital expenditure. As mentioned in Part B. (and as you will explore more fully in Chapter 14), however, small businesses are permitted to treat this machine purchase as an immediately deductible business "expense," as under a cash-flow consumption tax! Take a sneak preview of § 179(a). Thus, George gets to (1) exclude the $10,000 borrowed cash, (2) deduct that $10,000 capital expenditure immediately (cash-flow consumption tax treatment), and (3) deduct the interest on the debt as business interest under § 163(a) (which would not be permitted under a cash-flow consumption tax)!

Even big businesses that cannot take advantage of § 179 are permitted to depreciate assets much faster under §§ 167 and 168 than would be permitted under pure economic depreciation (more subtle "semi" consumption tax treatment), and a large majority of these assets are purchased with debt, the interest on which is *fully* deductible. The result is better than would occur under either a pure SHS income tax or a pure cash-flow consumption tax: *better* than consumption tax treatment.

Indeed, these tax arbitrage opportunities can cause taxpayers to use debt to purchase property when they otherwise would have used past tax savings—simply in order to obtain *better* than consumption tax treatment—violating the neutrality economic norm that you will read about in the next chapter and causing the economy to be leveraged to an extent that otherwise would not occur in absence of these tax arbitrage opportunities.

For a timely example, please read: http://www.nytimes.com/2016/09/02/business/economy/if-trump-gets-his-way-real-estate-will-get-even-more-tax-breaks.html?_r=1

To consider an example of tax arbitrage with a consumption tax provision of the wage tax variety, consider § 103, which permits an exclusion from Gross Income of one kind of capital return: the interest received on bonds issued by state and local governments. What if a § 103 bond is purchased with borrowed cash? Suppose, for example, that Profiteer is in the 39.6% tax bracket and borrows from National Bank at 5% interest to purchase $100,000 of tax-exempt § 103 bonds yielding 4% interest. At first, it does not seem to make economic sense for Profiteer to borrow at 5% interest to purchase an investment yielding only a 4% return. Who in their right mind would

do this? Well, what if the interest expense is deductible (under the income tax rule that business and investment interest expense is generally deductible) but the capital return is excludable?

| | |
|---|---|
| Tax-exempt interest received | $4,000 |
| *Less* after-tax interest cost: $5,000 paid reduced by tax saved via the interest deduction ($1,980) | - 3,020 |
| "Profit" | $980 |

Notice that this "profit" does not come from some daring act of entrepreneurship that adds wealth to the economy (increases GDP). Rather, it is a "profit" merely in the form of a payment from the U.S. Treasury funded by other taxpayers (*i.e.*, you and me), which raises both fairness and economic efficiency concerns. That is to say, this $980 "profit" represents a mere *shift* in wealth rather than the creation of new wealth. The fancy word for this kind of activity is "rent-seeking," a term that you will read in the next chapter. Keep this example in mind when you come to it.

But even if the arbitrage is not so substantial as to create an actual "profit," this better than consumption tax treatment reduces positive tax owed in a way that is inconsistent with either a pure income tax or pure consumption tax (and which represents rent-seeking). Congress has attempted to disallow this tax arbitrage. Read § 265(a)(2). But § 265(a)(2) is notoriously difficult to enforce. Moreover, debt-financed investments that otherwise are provided more favorable wage tax treatment *other* than excludable § 103 interest can provide similar tax arbitrage opportunities, and § 265(a)(2) would not step in to deny them. For example, many investments that produce low-taxed capital gain (which have a wage-tax flavor because of the reduced tax rate, even though it's not a 0% tax rate) are purchased with debt producing fully deductible interest.[11] So stay tuned, as we shall be conscious of these tax arbitrage problems that arise as we move through the course.

***Introduction to the concept of "capture"***

Introducing you to §103 here has an additional purpose unrelated to exploring the tax arbitrage possibilities posed by § 103. Section 103 is an ideal provision to introduce you to the concept of "capture," which will affect the tax policy analysis of many provisions that we shall study. **When Congress enacts a special deduction or exclusion aimed at Taxpayer *A* on the face of the statute, Person or Entity *B* might be able to step in and effectively "capture" that tax benefit through the *price mechanism*, sometimes unbeknownst to *A*.** In future chapters, we shall consider the capture phenomenon in connection with the exclusions and deductions pertaining to home ownership, the exclusion for employer-provided health care, and other provisions. In these scenarios, the average taxpayer may not appreciate that the economic benefit of the exclusion or deduction that appears to be aimed at him on the face of the statute may, in fact, be captured by other actors in the marketplace.

The language in § 103 appears to provide the tax benefit (exclusion of the interest) to *the bondholder*. But who may effectively captures that tax benefit? The answer is (or at least should be—more below) the bond issuer, which is the state or local government, through being able to borrow at lower interest rates than would otherwise be the case if the interest payments were included in Gross Income by the bondholders under § 61(a)(4). The § 103 exclusion (unlike the provisions mentioned above) is one in which the capture phenomenon is above board; everybody

[11] Similar to § 265(a)(2), Congress has attempted to prevent this type of arbitrage under § 163(d), which you will study in Chapter 16 (Tax Shelters), but as with § 265(a)(2), enforcement has proven difficult.

knows about it and expects it, which is why it makes an ideal provision to illustrate the capture phenomenon. Indeed, the idea is that the market *should* react to this preference in order to allow state and local governments to borrow at a lower interest cost

For example, assume that market conditions require corporations to offer 5% annual interest on a $100,000 corporate bond. Because the $5,000 annual interest is includable in Gross Income under § 61(a)(4), a bondholder in the 39.6% tax bracket pays $1,980 in tax ($5,000 x .396) and has $3,020 in *after-tax cash* left each year. Thus, a state or local government could offer an interest rate of only 3.02% of *excludable* interest on a $100,000 § 103 bond to attract a bond buyer in the 39.6% bracket because the bond buyer would be in the same *after-tax* position with either the corporate bond or the § 103 bond ($3,020 in annual after-tax cash). In short, a 39.6% bracket taxpayer would be tax-indifferent between buying a corporate bond paying 5% includable interest or a § 103 bond paying 3.02% excludable interest.

As it turns out, however, §103 is an inefficient, wasteful way to deliver this subsidy to state and local governments because tax-exempt bonds must offer a rate higher than implied by the highest tax bracket in order to attract enough buyers from lower brackets to buy all of the bonds that state and local governments want to sell. The reason for this is not only that state and local governments want to sell a lot of bonds but also that the market for them is significantly narrowed by the high number of tax-exempt purchasers who do not benefit from the exclusion and thus have no desire to buy the lower-interest-paying bond. For example, among the biggest investors in stocks and bonds in the U.S. are tax-exempt qualified pension plans, § 401(k) plans, *etc.*, as well as foreign individuals and corporations, who generally do not pay tax on *any* interest or capital gain earned in the U.S., even on corporate stocks and bonds that produce includable gain and interest for you and me. Thus, such buyers are more interested in purchasing the higher return investment (the corporate bond paying 5% interest rather than the tax-exempt bond paying 3.02% interest) because they will not owe U.S. income tax on the higher return in any event.

Thus, if corporate bonds are paying 5% (includable) interest, and there are an insufficient number of bonder buyers in the highest 39.6% bracket to offer only 3.02% interest on the tax-exempt bond, our tax-exempt bond issuer must offer 3.25% interest to attract buyers in the 35% bracket, or 3.35% to attract 33% bracket taxpayers, or 3.6% to attract buyers 28% bracket taxpayers, and so on. When the smoke clears, **the Federal government loses more revenue from the § 103 exclusion than ends up in the hands of state and local governments. Moreover, this revenue shortfall inures entirely to taxpayers in the higher brackets, who obtain interest at a rate that is higher than necessary for them to be tax-indifferent between the taxable corporate bond and the tax-exempt § 103 bond.** Here is an example.

> **Example:** Assume a simplified tax world in which there are only two tax brackets: 40% and 20%. The prevailing market interest rate paid on taxable corporate bonds is 10%. The Grovers Corners Public School District wishes to issue $10 million of school construction bonds. Without § 103, the School District would have to offer 10% interest to compete with corporate bonds (an interest cost of $1 million each year), but with § 103 in place, the School District can offer only 6% interest (entailing an interest cost of $600,000 each year) to attract buyers in the 40% tax bracket. Unfortunately, there are an insufficient number of buyers in the 40% tax bracket willing to purchase the Grovers Corners bonds, so the School District must offer an interest rate of 8% on all of the bonds to attract buyers in the 20% tax bracket, as well, because there is no feasible way to segment the bond offering

between 40% bracket purchasers and 20% bracket purchasers.

The subsidy indirectly received by the School District under § 103 is $200,000 each year ($1 million interest that the School District would have had to pay on bonds paying 10% includable interest *less* $800,000 interest actually paid on the tax-exempt bonds paying 8% interest). Assume that half of the bonds ($5 million) are purchased by 40% bracket taxpayers and half ($5 million) are purchased by 20% bracket taxpayers. The tax revenue lost by the Federal Treasury under § 103 with respect to the 20% bracket taxpayers equals $100,000 ($500,000 of interest that would have been paid on bonds paying includable 10% interest multiplied by the buyers' 20% tax bracket) and with respect to the 40% bracket taxpayers equals $200,000 ($500,000 multiplied by 40%). Thus, the Federal government loses a total of $300,000 in tax revenue under § 103 in order to provide a subsidy to the state or local government of only $200,000—*and that $100,000 ends up entirely in the hands of the 40% bracket buyers* (through receiving 8% tax-free interest instead of the tax-indifferent rate of 6%). The 40% bracket buyers end up with $100,000 more cash in hand *after taxes are taken into account* than they would have had in hand with corporate bonds paying 10% includable interest.

A more efficient and less wasteful system would be to repeal § 103, effectively requiring the state or local government to issue bonds paying 10% includable interest on our facts, and then to have the Federal Treasury send a check for $200,000 to the state or local bond issuer. Such a system would avoid the $100,000 waste and would also avoid the windfall to high-bracket taxpayers.[12]

The American Reinvestment and Recovery Act of 2009 allowed, for the first time, just such an arrangement, albeit on a temporary basis. Under temporary § 54AA, state and local governments were provided, in effect, the option to issue bonds for certain specified purposes (called "Build America Bonds") before the end of 2010 paying includable interest (rather than tax-exempt interest), coupled with a subsidy check from the Federal Treasury to the state or local issuer keyed to the top 35% tax rate then in effect. They were a hit. Through early spring of 2010, $90 billion of Build America Bonds were sold in 1,066 bond issues in 48 states.[13]

Finally, while the cash borrowed with § 103 bonds can be used by state and local governments for such classic public goods as roads, bridges, universities, firehouses, and police stations, a sizable amount (with caps keyed to the population in each state) can effectively be borrowed by *private* businesses with the assistance of state and local governments—called "private activity bonds"—even though most private businesses must issue bonds that pay includable interest, raising serious questions regarding the justification for the tax subsidy.[14]

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[12] The § 103 exclusion for interest on state and local bonds used to be thought of as constitutionally mandated, but the 1988 decision in *South Carolina v. Baker*, 486 U.S. 1062 (1988), rejected that notion.

[13] *See Build America Bonds Will Save $12.3 Billion, Analysis Say*, N.Y. TIMES, Apr. 2, 2010, at B9.

[14] *See, e.g.*, Mary Williams Walsh & Louise Story, *A Stealth Tax Subsidy for Business Faces New Scrutiny*, at www.nytimes.com/2013/03/05/business/qualified-private-activity-bonds-come-under-new-scrutiny.html?_r=0.

# Chapter 3: Ethical Debates, <u>Economic Theories, and Real-World Impacts</u>

Chapters 1 and 2 explored the contours of two common types of "tax base" (what is taxed): income and consumption. Part A. of this chapter will relate information regarding the adoption and development of the income tax over time and its impact on the Federal budget and living standards. Part B. will explore the norms, theories, and politics of taxation, which will draw on some of the information conveyed in Part A. regarding economic trends over time. While the material in Chapters 1 and 2 was chiefly descriptive, some of the material in this chapter comes with a lot of baggage in the political arena. Thus, I want to say a word first about how we sometimes approach material of this type.

We all have unique ways of looking at the world and making sense of it. We all begin our decision-making processes and evaluations with certain models in our heads of how the world works and should work, which have been ingrained by culture, education, family, religion, events, and perhaps even our genes. These models shape how we perceive the world. Thus, two different people looking at precisely the same situation can have very different perceptions about what the most consequential facts are. Indeed, cognitive psychologists have identified the so-called confirmation bias as one of the most potent cognitive biases that we all share.

Although he is a cognitive psychologist and not an economist, Daniel Kahnman won the 2002 Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel (commonly referred to as the Nobel Prize in Economics) in recognition of the contributions that he and the late Amos Tversky made in helping us to better understand how thought patterns and behavior differ in predictable ways from the "rational man" assumptions that economists often typically build into their economic models. Their work (and the work of others) led to the burgeoning field of "behavioral economics," which seeks to study these behaviors in a systematic way.

Behavioral economists and cognitive psychologists have identified numerous "cognitive biases" that we, as humans, all share. The **confirmation bias** mentioned above is **the tendency to search for or interpret information in a way that confirms one's preconceptions**. "**Disconfirmation bias**," as one would expect, is the opposite: **the tendency for people to dismiss or avoid information which contradicts their prior beliefs**.

The technology revolution, with the introduction first of cable television and then the internet, has created niches that make it ever easier to indulge in (or exploit) the confirmation bias. In the dark ages of my childhood, with only three nationally broadcast news stations that a high number of homes tuned to each evening, the three national news programs had to steer a path that appealed broadly and thus could not cater in an obvious way to the extreme left or right of the political spectrum. In addition, prior to 1987 the Federal Communications Commission (FCC) required, under the so-called fairness doctrine, that radio and television broadcasters using the public air waves must present multiple viewpoints on contentious public debates. The FCC members appointed by President Ronald Reagan abolished the fairness doctrine in 1987. These events have combined to allow us to subdivide ourselves into information niches in which we hear only echoes of our prior beliefs, reinforcing them even further, turbo-charging the confirmation bias. Thus, those who self-identify as, say, strong libertarians or New Deal progressives can tune in chiefly to those information sources that reinforce these preconceptions, with these sources subsequently

moving ever more to one extreme or the other.

Another cognitive bias is the "**bias blind spot**," or **the tendency to see oneself as less biased than other people, or to be able to identify more cognitive biases in others than in oneself**. Particularly in my role as a teacher, I always try to remain sensitive to this bias in myself.

The tendency to indulge the confirmation bias has reached even the Supreme Court. Please click and read the following article:

www.nytimes.com/2013/10/12/business/media/when-our-news-is-gerrymandered-too.html?_r=0.

As the article above illustrates, one feature that you will see in this chapter (as well as in future chapters) is a link to short articles that succinctly illustrate or summarize (in an interesting way, I hope) a policy issue that I discuss or empirical data that are important in considering the policy issue.[1] These inclusions are unusual in that they are not traditional, academic articles. I hope that these materials provide compelling context that adds richness to your understanding of how we got to where we are today, where the tension points are situated that may lead to change, and how one might think about these issues in an ordered way. Some of these short pieces will have a definite viewpoint, but none will (I hope) be perceived as ones that seek *only* to conform to my own confirmation bias.

Other cognitive biases that can have an impact on taxation include the **endowment effect** (or divestiture aversion), which is **the tendency to ascribe more value to items or a position merely because we own them**. Studies show that people who are given, say, a coffee mug demand more in cash to give up the mug than they would be willing to pay to purchase the item. This effect contributes to the cognitive bias known as **loss aversion**, under which **people strongly prefer avoiding losses to acquiring gains**. These biases can result in behavior that is inconsistent with the "rational man" assumptions made by some economists in modeling predictions of anticipated behavior changes in connection with a proposed change in law, including tax law.

Several other cognitive biases combine to make us sometimes make judgments based on a personally known anecdote or widely reported example in the press of one case or incident, while downplaying larger pools of evidence or data that contradict the individual anecdote. These include the **base rate neglect** or **base rate fallacy**, or **the tendency to base judgments on specifics, ignoring general statistical information**; the **availability heuristic**, or **estimating what is more likely by what is more available in memory, which is biased toward vivid, unusual, or emotionally charged examples**; and the **anchoring effect**, or **the tendency to rely too heavily, or "anchor," on a past reference or on one trait or piece of information when making decisions (also called "insufficient adjustment")**. As an example of this cognitive bias in the tax policy setting, the popular press widely reported that the French actor Gerard Depardieu obtained a Russian passport after the French President Francois Hollande recommended temporarily raising

[1] These links are to articles from the New York Times (only) because the New York Times Company graciously allows such links without payment of copyright reprint permission. *See* www.nytimes.com/content/help/rights/linking/linking.html. As I did in the Preface, I want again to publicly thank the New York Times Company for this policy. I wanted to include links to articles from other publications but could not do so without paying reprint permission fees, which were (unfortunately) cost prohibitive. Nevertheless, I sometimes *cite* to articles from other sources in footnotes. As a reader, you are, of course, free to enter the web address in your own browser should you wish to read the article. <Grin.> I also want to publicly thank those authors and sources who provided reprint permission without charge with respect to excerpts that you will read from time to time in the body of the textbook.

(for two years) the top marginal income tax rate from 41% to 75% on income exceeding €1 million. (France also imposes a wealth tax and a VAT.) This vivid example of fleeing a country (or a state in the U.S.) in response to an increase in the top tax rate can cause a reader to believe that this response is a common one, a belief that can affect the analysis of the policy issue, but broader empirical data is not consistent with this assumption.[2]

As an aside, those looking for good empirical data can often find it by looking at material published by the Congressional Budget Office, the Tax Policy Center (a joint undertaking between the Urban Institute and the Brookings Institution), the Census Bureau, the IRS Statistics of Income Division, and the Joint Committee on Taxation, a committee nominally made up of the members of the House Ways & Means Committee and the Senate Finance Committee, but whose work is done by its professional staff consisting of economists and lawyers charged with, among other duties, scoring tax bills and doing studies mandated by Congress. Information pertaining to the experience of other nations can often be found in data compiled by the Organization for Economic Cooperation and Development (OECD).

## A. The development of the income tax and how taxes affect the Federal budget and living standards

Under the Articles of Confederation that preceded the Constitution, the Federal government had no power to tax individuals, states, or business entities directly. Rather, the Federal government could only send a "requisition" to each state to collect a stated amount to turn over to the Federal government, and the states were left to decide for themselves how to fulfill the requisition. As you might expect, states often failed to comply, and the very survival of the new country was threatened, as the Federal government needed revenue to retire the Revolutionary War debt, maintain the military and courts, *etc*. Thus, a primary reason for calling a Constitutional Convention to replace the Articles of Confederation was the need to provide the Federal government with the power to tax citizens and residents directly, without going through the states. "For a generation that had fought a war with England about taxation, however, it was equally important that any taxing power be constrained."[3] Thus, both a "uniformity" and "apportionment" requirement were included with respect to the Federal taxing power.

Under Article 1, § 8, clause 1, of the Constitution, Congress is granted power to "lay and collect Taxes, Duties, Imposts, and Excises" on individuals, entities, transactions, *etc.*, without going through the states, but these levies must "be uniform throughout the United States." This "uniformity" requirement prevents express discrimination among the states. Thus, for example, if Congress enacted an excise tax tomorrow on the extraction of each barrel of oil from the ground, it could not impose that tax at a rate of, say, 10% for oil found in Texas but 20% for oil found in Alaska without violating the uniformity clause. The fact that oil is distributed unevenly among the states, however, which means that entities and individuals in Texas and Alaska would pay much more of this hypothetical oil excise tax than would residents in Tennessee or Vermont, would not violate the uniformity clause.

Article 1, § 9, clause 4, requires that all "direct" taxes, including any "capitation" tax (or per-

[2] *See, e.g.*, James B. Stewart, *The Myth of the Rich Who Flee from Taxes*, at www.nytimes.com/2013/02/16/business/high-taxes-are-not-a-prime-reason-for-relocation-studies-say.html.
[3] ERIK M. JENSEN, THE TAXING POWER: A REFERENCE GUIDE TO THE UNITED STATES CONSTITUTION 17 (2005).

person head tax), be apportioned among the states according to population. Taxes that are not "direct" taxes are not subject to the apportionment requirement. Though the Constitution does not use the term, taxes that do not qualify as direct have come to be known as "indirect" taxes. The distinction between a direct and indirect tax is somewhat cloudy (more below), but taxes imposed on individuals for merely existing (a capitation tax) or merely owning property (such as real estate) have been held to be direct taxes, while taxes imposed only on a transaction, such as the hypothetical oil excise tax described above or a retail sales tax imposed on the purchase of consumer items, have been held to be indirect.[4]

Direct taxes were thought to have greater potential for abuse in that they were imposed merely for existing or owning real estate and thus could not easily be escaped by citizens and residents. Excise and sales taxes, in contrast, were relatively noncontroversial forms of taxation because they could be avoided simply by choosing not to extract the oil (in the hypothetical example provided above) or choosing not to purchase the consumer item. As Alexander Hamilton wrote in Federalist 21:

> It is a signal advantage of taxes on articles of consumption that they contain in their own nature a security against excess. They prescribe their own limit; which cannot be exceeded without defeating the end proposed, that is, an extension of the revenue. When applied to this object, the saying is as just as it is witty, that, "in political arithmetic, two and two do not always make four." If duties are too high, they lessen the consumption; the collection is eluded; and the product to the treasury is not so great as when they are confined within proper and moderate bounds. This forms a complete barrier against any material oppression of the citizens by taxes of this class, and is itself a natural limitation of the power of imposing them.

To illustrate how the apportionment requirement might work, assume that Congress decided that it would levy an annual tax on the value of real property owned by individuals that would, in the aggregate, collect *$X* each year, just as many states and local governments impose real estate property taxes. Under the apportionment clause, the portion of *$X* that would be collected from individuals in each state must mirror the state's percentage of the total U.S. population. Thus, because 12.17% of the U.S. population lives in California, 12.17% of *$X* must be collected from California residents. Similarly, because .2% of the U.S. population lives in Vermont, .2% of *$X* must be collected from residents of Vermont. Satisfaction of the apportionment rule would require that different tax rates would necessarily have to be imposed in each state (which would then be multiplied by the value of the real estate in that state) in order to ensure that the proper amount of *$X* was collected from that state. As this simple example illustrates, the apportionment requirement "makes direct taxes more difficult to implement than they otherwise would be."[5]

As is obvious with some thought, no tax other than a capitation or head tax (*e.g.*, each resident

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[4] In the decision upholding the constitutionality of the Affordable Care Act, the Supreme Court held that the "shared responsibility payment" imposed on those who fail to purchase health insurance while not being exempt under the statute from the requirement to purchase was a tax but not a direct tax because it was "triggered by specific circumstances—earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several states." National Federation of Independent Business v. Sebelius, 132 S. Ct. 2566, 2597 (2012). *See generally* Erik M. Jensen, *Post-NFIB: Does the Taxing Clause Give Congress Unlimited Power?*, 136 TAX NOTES 1309 (2012) (answering "no").

[5] JENSEN, *supra* note 3, at 24.

must pay a $10 tax to the Federal government) could simultaneously satisfy *both* the uniformity and apportionment requirements. Thus, these clauses have been interpreted together to mean that indirect taxes must satisfy the uniformity requirement while direct taxes must satisfy the more onerous apportionment requirement.

The ugly issue of slavery also had an impact on the shape of the taxing power created in the Constitution. The number of Representatives awarded to each state in the House of Representatives in Congress is based on population, as determined by the census required to be taken every ten years under Article 1, § 2. The slave-holding states wanted slaves to count in full for purposes of representation in the House, which would give the southern states more congressional power. But counting them in full would harm the southern states when it came to apportioning direct taxes because the higher the population, the higher the aggregate Federal direct tax that could be apportioned to southern states. The famous (or infamous) three-fifths compromise counted slaves as three-fifths of a person for purposes of *both* representation in the House and direct taxation (overturned by the 14th amendment).

In 1794, at the urging of Alexander Hamilton, Congress enacted a tax on carriages "kept by or for any person, for his or her own use, or to be let out to hire, or for the conveying of passengers." The tax was geographically uniform but was not apportioned among the states according to population. Thus, if the carriage tax was an indirect tax, it was constitutional. If it was a direct tax, however, it was unconstitutional because unapportioned. In *Hylton v. United States*, [6] the Supreme Court concluded that the carriage tax was not a direct tax and suggested that only capitation and real estate taxes were direct taxes.

Until the Civil War, the Federal government raised nearly all of its revenue through various forms of consumption tax, such as excise taxes and tariffs on the use or purchase of goods. With the significantly increased revenue needed to fund the Civil War effort, Congress (controlled by Republicans) first considered raising revenue primarily through an apportioned land tax. Instead, Congress enacted a combination of several new taxes, including both the first income and inheritance taxes in 1861, controversial though they were.[7] The Supreme Court upheld the constitutionality of the income tax against a charge that it was an unapportioned direct tax in *Springer v. United States*,[8] concluding that "direct taxes, within the meaning of the Constitution, are only capitation taxes, as expressed in that instrument, and taxes on real estate…."[9] Congress allowed the tax to expire in 1872.

> [T]he Civil War tax expired because by the early 1870s there no longer was an urgent need for revenue; tariffs were bringing in enough to keep the country going. But good economic times did not last, and demands on government increased. The period between the 1872 expiration of the Civil War tax and the enactment of the 1894 income tax saw several panics and depressions, including one in 1893 (which gave a sense of immediacy to the 1894 debates). That period nevertheless also saw an astonishing accumulation of wealth by some very visible Americans. The contrast between wealth and suffering was one of the reasons several radical political parties, including the People's (Populist) party, were created in the late

[6] 3 U.S. (3 Dall.) 171 (1796). For more on the *Hylton* saga, see JENSEN, *supra* note 3, at 38-44.
[7] For an interesting description of the debates surrounding the Civil War enactment of the first income and inheritance taxes, see Sheldon D. Pollack, *The First National Income Tax 1861-1872*, 67 TAX LAW. 331 (2014).
[8] 102 U.S. 586 (1881).
[9] *Id.* at 602.

nineteenth century.[10]

The income tax enacted in 1894 was held to be unconstitutional as an unapportioned direct tax in *Pollack v. Farmers' Loan & Trust Co.*[11] Thereafter, Democrats and Republicans adopted a Joint Resolution containing the 16th amendment to the Constitution in 1909, and the amendment was ratified by the necessary three-fourths of the states (under Article V) in 1913. The 16th amendment provides: "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." This amendment did not repeal the direct tax clause. Rather, it merely excuses the income tax from the apportionment requirement that otherwise applies to direct taxes. Thus, for example, Congress could not enact an annual real estate property tax (or other form of wealth tax) today without satisfying the apportionment requirement, as it is a direct tax that is not an income tax protected from the apportionment requirement under the 16th amendment. The modern income tax was enacted the same year, in 1913.

The debates that occurred both before the enactment of the 1894 income tax and the introduction of the 16th amendment in 1909 were very similar in flavor. Both focused on shifting more the of the tax burden from the lower classes to the wealthy. Both also showed a surprisingly sophisticated understanding of the difference between an income tax and a consumption tax.

### *Excerpt from* The Taxing Power: A Reference Guide to the United States Constitution[12]

Erik M. Jensen

Commentators generally see the late nineteenth-, early twentieth-century proponents of an income tax as trying to reorient the tax system. As historian Gerald Eggert put it in describing the background of the 1894 income tax:

> Congressional debates made it clear … that the tax was, in part, a response to the widespread demand to equalize the tax burdens borne by the various classes. The tariff, which was the Federal government's chief source of revenue, lay most heavily on the poorer classes—ran the argument—while the proposed income tax would be paid by the wealthier classes.

Edward Whitney (Assistant Attorney General at the time of *Pollack*) explained the 1894 tax the same way: "The [Democratic] party controlling the House of Representatives, accepting the theory that the prevailing taxes on consumption bore especially hard on the smaller incomes, undertook to make up the deficit with a compensatory duty upon the larger ones."

… Consumption taxes like tariffs were thought to be shifted to purchasers, and, if that was right, a poor man bore the same tax burden in buying a bag of sugar as did a rich man. The tax burden, that is, had nothing to do with respective abilities to pay the taxes, and that was not fair.

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[10] JENSEN, *supra* note 3, at 38.

[11] 157 U.S. 429 (1895). An income tax imposed on corporations was upheld, however, as an excise tax (an indirect tax) on the privilege of doing business in the corporate form. Flint v. Stone Tracy Co., 220 U.S. 107 (1911).

[12] JENSEN, *supra* note 3, at 52-55 and 62-64 (footnotes omitted). Reprinted with permission. *See also* Sheldon D. Pollack, *Origins of the Modern Income Tax, 1894-1913*, 66 TAX LAW. 295 (2013) (recounting the political battles and strategies surrounding the adoption of an income tax in the late 19th and early 20th centuries).

The difference between an income tax and a consumption tax—one is consistent with ability to pay, one is not—was stressed throughout the congressional debates. The bill began in the House of Representatives, where Democratic Representatives Benton McMillan of Tennessee, chairman of the Ways and Means Subcommittee on Internal Revenue and a longtime proponent of income taxation, and the already legendary William Jennings Bryan of Nebraska recommended a two-percent tax on incomes of $4,000 or more…. McMillan explained the income tax legislation this way:

> I ask of any reasonable person whether it is unjust to expect that a small per cent of this enormous revenue shall be placed upon the accumulated wealth of the country instead of placing all upon the consumption of the people…. And yet when it is proposed to shift this burden from those who cannot bear it to those who can; to divide it between consumption and wealth; to shift it from the laborer who has nothing but his power to toil and sweat, to the man who has a fortune made or inherited, we hear a hue and cry raised by some individuals that it is unjust and inquisitorial in nature.

… High and low income people who, McMillan posited, spend about the same on necessities "pay the same taxes to the Government, because taxes are to be paid upon what they consume!"

… And, said McMillan, the relative burdens on the poor had been growing: "The taxes having continually increased upon consumption, and no corresponding increase having been placed upon accumulation, we see such colossal fortunes amassed as were never concentrated in any other age or in any other country in the world."

… [T]here were other reasons why tax obligations should be connected with ability to pay. For one thing, income tax supporters believed the rich had disproportionately benefited from national policies. The rich were rich *because of* what government had done. Moreover, the wealthy received more from government—the value of protecting property, for example, goes up with the value of property protected, or so it was argued—and income tax proponents argued that the wealthy should have to pay for the extra services.

… To conform to ability-to-pay standards, tax law had to relieve burdens on consumption. That was the constant theme advanced by income tax supporters. The House Ways and Means Committee report on the 1894 legislation made the point like this: "The wealth of this country amounts to more than $65,000,000,000, and the question arises whether it is not just and fair that a portion of this money should be raised by a tax on the earnings of wealth instead of imposing it all, or nearly all, on consumption."

Because of the push for fairness, the disputes inevitably had a class-versus-class flavor. With a proposed rate of only two percent, the charges of socialism seem a bit much today: "vicious, socialistic and un-American" and "the most socialistic measure which was ever enacted in this country," noted a couple of typical authors. But there *was* a class aspect to the legislation. The tax affected only about one percent of the population, the legislative attack on the wealthiest of the wealthy was no accident, and once the principle of an income tax had been accepted, there was no guarantee that rates would stay low. Lawyer James C. Carter, representing a bank nominally defending the tax before the Supreme Court, conceded it was "class legislation in th[e] sense [of distinguishing between rich and poor]. That was its very object and purpose."

… Income tax opponents did not limit themselves to questioning the populist origins of the tax;

they also marshaled an arsenal of substantive arguments against the tax, and in favor of a consumption tax system. The income tax historically belonged to the states, they argued, and it ought to be used by the national government only in emergencies, if at all. It was socialistic, nothing but class legislation, and it was sectional in purpose—aimed at the East, where the wealthy were concentrated. Moreover, it was a pernicious tax that would encourage Americans to lie about their economic situations and, if the tax was going to be enforced, require that government agents pry into the private affairs of citizens. "Inquisitorial" was an often used adjective.

President Cleveland stayed on the sidelines during the debates…. He … allowed the 1894 income tax legislation to become law without his signature….

[After the *Pollack* decision invalidating the 1894 income tax, a renewed movement for an income tax] began to hit its stride near the end of the first decade of the twentieth century. Democratic Representative Cordell Hull of Tennessee introduced income tax legislation in 1907, and the Democratic Party called for an income tax amendment in its 1908 platform:

> [W]e favor an income tax as part of our revenue stream, and we urge the submission of a constitutional amendment specifically authorizing congress to levy and collect a tax upon individual and corporate incomes, to the end that wealth may bear its proportionate share of the burdens of the Federal government.

Support for an income tax had been building among Republicans as well. In 1906 President Theodore Roosevelt stated that a "graduated income tax of the proper type would be a desirable feature of Federal taxation …." Roosevelt's successor, William Howard Taft, also appeared to accept … the desirability, at least in emergencies, of an income tax. In accepting the Republican nomination in 1908, Taft stated: "I believe that an income tax, when the protective system of customs and the internal revenue tax shall not furnish enough for governmental needs, can and should be devised …." Furthermore, "insurgent Republicans" had come to Congress willing to join with Democrats and any remaining Populists to push for an income tax….

In short, by taxing more than what was spent on consumption and, as a result, reaching the wealthy in a way that tariffs did not, the income tax was considered fundamentally different from taxes on consumption. In Professor Michael Graetz's words, "When this nation adopted the Sixteenth Amendment, achieving fairness in the distribution of the tax burden was the essential reason for taxing income and for taxing it at progressive rates."

On the merits …, income tax debates in 1909 mirrored those of 1894…. As was true in 1894, much of the discussion in 1909 was about how an income tax would further the ability-to-pay principle in a way that consumption taxes did not. Senator Bailey explained his amendment to the tariff bill: "I believe [the income tax] is the only tax ever yet devised by the statesmen of the world that rises and falls with a man's ability to pay it."

When Cummins introduced his bill, Senator Augustus Octavius Bacon of Georgia pressed him to justify it. Would Cummins favor the income tax if enough revenue could be raised by tariffs? Bacon wanted to know "whether it was rested upon the importance of shifting the burdens of taxation from the great masses of consumers, so far as we may be able to do it, to rest it in part, at least, upon the shoulders of those who have the wealth of the country." Cummins finally answered: "[I]f I could change the situation I would so rearrange and readjust these schedules as to decrease the revenue derived from the custom-houses and place it where it should belong—upon those fortunate people who enjoy large incomes." Said Bacon: "Now the Senator has stated exactly the

thing I wanted him to state."

Ability to pay dominated discussions of income tax proponents in 1909: Income taxes are consistent with that principle, consumption taxes are not. What follows is a representative sample of statements made on the floors of Congress; there are many more examples.

Senator Bailey (Texas): "Under any circumstances an income tax is more equitable than a tax on consumption. It is more just as between the different classes, and it better conforms to that sound canon of taxation which enjoins upon us to lay all taxes on those who can bear them…."

Senator William Borah (Idaho): An income tax was needed to supplement the tariffs "in order that we may arrive as nearly as we can, as human ingenuity can make it, at a tax which is levied upon a man's ability to pay and in accordance with what he derives as a measure of benefit from his Government." He added, "We believe that every tax system based upon consumption should be supplemented by a system which taxes property and the wealth of the country …."

Senator Cummins (Iowa): "[A]n income tax, levied upon those who ought to bear the burdens of government, … will meet even that principle more perfectly than to levy duties upon things that the people must use, and impose the weight of government only by the rule of consumption."

Representative Ollie M. James (Kentucky): "[N]o tax was ever more unjust … than a tax upon consumption …. A tax upon what some people eat and what they wear would deny them the necessities of life, while others, rolling in opulence …, would not feel such a tax."

Representative Robert Lee Henry (Texas): "Equality in taxation should be the north star to light our pathway and direct our feet in the enactment of such statutes. No tax more equitably distributes the burdens of government than an income tax."

Representative Adam M. Byrd (Mississippi): A tariff falls "upon consumption and not upon wealth, upon what one eats and wears and not upon his property; it means that the citizen who can scarcely provide food and raiment for his wife and children contributes as much or more to the support of Government as does the multimillionaire."

Representative William Sulzer (New York): "At the present time nearly all taxes … are levied on consumption—on what the people need to eat and to wear and to live; on the necessities of life; and the consequence is that the poor man … pays practically as much to support the Government as the rich man …."

Representative David A. DeArmond (Mississippi), a veteran of the 1894 battles: "There is no good reason why taxation should not be according to ability to pay—according to wealth, according to income. Your tariff tax is a tax upon necessity, a tax in proportion to the amount you buy, a tax in proportion to what you must have, not a tax in proportion to what you possess."

Representative Courtney W. Hamlin (Missouri): "The tariff tax is levied entirely upon consumption. The laboring man must expend his income for food, fuel, clothing, and tools of industry, and these taxes are heavier upon the necessities." He added that Democrats had always argued for shifting the burden of government "at least partially … from the backs of the poor to those who can bear it; to divide these burdens between wealth and consumption; to divide them between the man who has nothing but his labor and the man who has incomes many times greater."

Representative William R. Smith (Texas): "No one can contend that our system of indirect taxation [has no] objectionable features, because … its burdens are measured by what the citizen's needs require him to purchase for consumption and not by the amount of his wealth, nor by his

ability to pay."

Overall the tone of the debates was more civil than in 1894. There were fewer Populists around, and, given the reduced opposition to an income tax, less reason to debate with "agrarian ferocity." But except for differences in tone, passages could be moved from 1894 to 1909 and back again without changing the nature of the debate in either year.

Opponents also made the same points that had been made in 1894. An income tax, it was said, was socialistic and inquisitorial. It ought to be available, if at all, only in emergencies….

But the opposition went nowhere. [In July of 1909, a] joint resolution containing the Amendment passed unanimously in the Senate (77-0) and in the House a week later, after about four hours' debate, by a vote of 318 to 14. The level of opposition was greater than the vote suggest, because of absences and abstentions, but the votes were nevertheless overwhelmingly favorable.

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It took fewer than four years to gain the necessary ratification of three-fourths of the states. The 16th amendment became part of the Constitution when the final state (Delaware) ratified it on February 3, 1913. The first income tax enacted under the new amendment was passed by the House (281 to 139) in May and by the Senate (44 to 37) in September and was signed by President Wilson on October 3, 1913.

Consistent with the goals indicated in the debates, the new income tax was expressly aimed at reaching chiefly the capital income of the wealthy, as opposed to the labor income of the working man. Only between 1 and 2% of households containing married couples, divorced and widowed men and women, and single men and women aged 20 or older owed income tax.[13] The act achieved this by taxing "Taxable Income" (Gross Income *less* deductions) only above $3,000 for individuals and $4,000 for married couples—a very high threshold in 1913 when the average annual income was $800[14]—at rates that graduated from 1% to 7%. Taxable Income from $0 to $20,000 ($486,000 in 2016 dollars) was taxed at 1%; between $20,000 and $50,000 at 2%; between $50,000 and $75,000 at 3%; between $75,000 and $100,000 at 4%; between $100,000 and $250,000 at 5%; between $250,000 and $500,000 at 6%; and over $500,000 ($12.1 million in 2016 dollars) at 7%.

With the increased revenue needs of WWI, the top marginal rate increased by 1918 to 77% on Taxable Income exceeding $1,000,000 ($15.9 million in 2016 dollars). After the war, rates dropped in 1921, 1924, 1926, and 1928, with a top rate of 24% in 1928 on Taxable Income exceeding $200,000 ($2.8 million in 2016 dollars).

Thus, it is clear that the intent of the enactors of the income tax to reach mainly the wealthy made it a "class tax" for the first several decades of its life. The transition of the income tax from a "class tax" to a "mass tax" occurred with the extraordinary revenue needs of WWII, and the income tax has remained a "mass tax" ever since, with more than half of households owing income tax. In addition, Congress enacted the provisions requiring tax withholding at source for wage income in 1943. The highpoint in marginal rates was 1944 and 1945, with the top rate at 94% for Taxable Income exceeding $200,000 (nearly $2.7 million in 2016 dollars).

With the post-WWII cold war, the highest marginal rate stayed high—at 91% on Taxable

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[13] Thomas Piketty & Emmanuel Saez, *Income Inequality in the United States 1913-2000*, Table A0 at 65, http://elsa.berkeley.edu/~saez/piketty-saezOUP04US.pdf.

[14] www.irs.gov/app/understandingTaxes/student/whys_thm06_les01.jsp#taxTrivia.

Income exceeding $200,000—until the Kennedy administration, when the top rate was reduced to 70%. A special rule, however, provided that "earned income" (labor income) would be taxed at no more than 50%.

During the Reagan administration, the top marginal rate was first reduced to 50% for all income (not merely labor income) in 1981. The large deficits that ensued resulted in major tax increases in 1982 and 1984 through base broadening; the top marginal rate did not increase. By 1986, the top net capital gain tax rate was 20%, and the top marginal tax rate on ordinary income remained at 50%. The Tax Reform Act of 1986 reduced the top marginal tax rate on ordinary income to 28%, *but it* ***increased*** *the maximum net capital gain tax rate to 28% (from 20%) so that all income in each bracket was taxed at the same rate*. Because capital gains are so heavily concentrated in the highest income households (as illustrated in Part B. of Chapter 1), the distribution of the overall tax burden among the members of the population was not radically changed under the '86 Act, even with the top rate on ordinary income being nearly cut in half, though it did shift the tax burden down the income scale a bit.

With increased deficits, however, the top marginal tax rate on ordinary income increased from 28% to 31% in the George H.W. Bush administration, but the top 28% capital gains tax rate was not changed, thus reintroducing a small tax differential between the top tax rate applying to ordinary income and gains and capital gains. Two additional rates were introduced in the Clinton administration of 36% and 39.6%, with the latter applying to Taxable Income exceeding $250,000, but the capital gains rate was reduced from 28% to 20%, resulting once again in a significant differential between the top tax rate applying to ordinary income and capital gains.

During the George W. Bush administration, the top tax rate on ordinary income was reduced from 39.6% to 35% in 2001, and the top tax rate imposed on net capital gain was reduced from 20% to 15% and extended to most dividends (which had previously been taxed at the ordinary income tax rate) in 2003. The 2001 and 2003 rate reductions were expressly made temporary and were scheduled to expire at the end of 2010. The rate reductions were extended temporarily, however, in the Obama administration through the end of 2012. On January 2, 2013, Congress passed the American Taxpayer Relief Act of 2012, which generally extended the rates in effect under the 2001 and 2003 acts for most taxpayers permanently, except that the act restored the highest marginal rate on ordinary income and gain to 39.6% and restored the 20% rate for net capital gain falling within Taxable Income exceeding $400,000 ($450,000 for married couples filing jointly). The top marginal rate on net capital gain falling below those thresholds remains generally at 15% (0% for those whose top marginal rate is 10% or 15%), though the bulk of net capital gain is realized by high-income households.

While only about 56% of households typically pay Federal income tax, nearly all pay so-called payroll taxes on their labor income, and two-thirds of households pay more in payroll taxes than income taxes.[15] The Social Security Tax was enacted in 1935, and the Medicare Tax was enacted in 1966. Under the Social Security Tax, the employee must pay a 6.2% tax on wages up to $127,200 in 2017 (up from $118,500 in 2016), and the employer must pay a 6.2% tax on the same base (summing to 12.4%). The tax funds payments to current retirees under our pay-as-you-go Social Security system, as well as certain other payments to non-retirees. The Social Security Tax wage base increases each year by an amount equal to the increase in *average* wages (not median

[15] *See, e.g.*, Andrew Mitrusi & James Poterba, *The Distribution of Payroll and Income Tax Burdens, 1979-1999*, 53 NAT'L TAX J. 765 (2000).

wages). Because average wages have increased faster than the median wages (because of disproportionate wage gains at the top—described below), the payroll tax burden on workers earning just above the Social Security wage base (*e.g.*, $130,000) has increased faster than have their wages.[16] Indeed, the $8,700 increase in the wage base in 2017 is the largest one-year increase since 1983. Under the Medicare Tax, the employee pays 1.45% on all wages, without limit, and the employer pays the same 1.45% (summing to 2.9%), with the funds used for the Medicare program.

Thus, taken together, the aggregate payroll tax is 15.3% on wages up to $127,200 in 2017, with one-half of the tax paid by the employer and one-half by the employee. Wages above that amount are generally subject (with an exception noted below) to a tax of 2.9% (the Medicare Tax portion), again with one-half paid by the employer and one-half paid by the employee.

We need to take a detour for a moment here to discuss the "economic incidence" of a tax. The person nominally charged with handing over a tax may not be the person who bears the burden of the tax economically because the nominal payor may be able to effectively shift the economic burden of the tax to others in the marketplace through the price mechanism. For example, a widget seller who must pay a newly imposed 10% tax on each widget sale may be able to shift the economic pain of that tax entirely to the widget buyer through increasing the price by 10%. Or perhaps the widget seller keeps widget prices the same but shifts the burden of the tax to her employees by lowering their salaries (over time, through smaller raises) by the equivalent amount. Or perhaps the widget seller passes on the incidence of the tax to her suppliers by bargaining for a reduced price for widget input components.

Economists generally agree that the economic burden of the individual income tax falls on the actual payor but that the incidence of the employer portion of the payroll taxes falls entirely on the employee (though nominally paid by the employer) through wages that are depressed by an equivalent amount, *i.e.* that the entire tax is economically borne by the employee. The self-employed pay the 15.3% aggregate payroll tax (and 2.9% tax on self-employment income above the social security tax wage base) directly.

In short, someone earning $1 million (including the employer-paid payroll taxes) effectively pays the same $15,773 of Social Security tax as one who earns $127,200 (12.4% of the first $127,200 earned by each) in 2017. The $1 million earner, however, will pay more in Medicare Tax than the $127,200 earner.

Someone earning $1 million in dividends, interest, rents, and capital gains (and no wage income) paid neither Social Security Tax nor Medicare Tax in 2012. Beginning in 2013 under the Patient Protection and Affordable Care Act (colloquially referred to as Obamacare by, apparently, both supporters and opponents of the law), an additional 0.9% Medicare Tax is owed on wages exceeding $200,000 for individuals and $250,000 for married couples so that their Medicare tax totals 3.8% instead of 2.9% on labor income exceeding those thresholds. More significant was the extension of the 3.8% Medicare Tax to investment income for the first time (instead of being levied only on labor income) for those with Taxable Income exceeding those same thresholds.

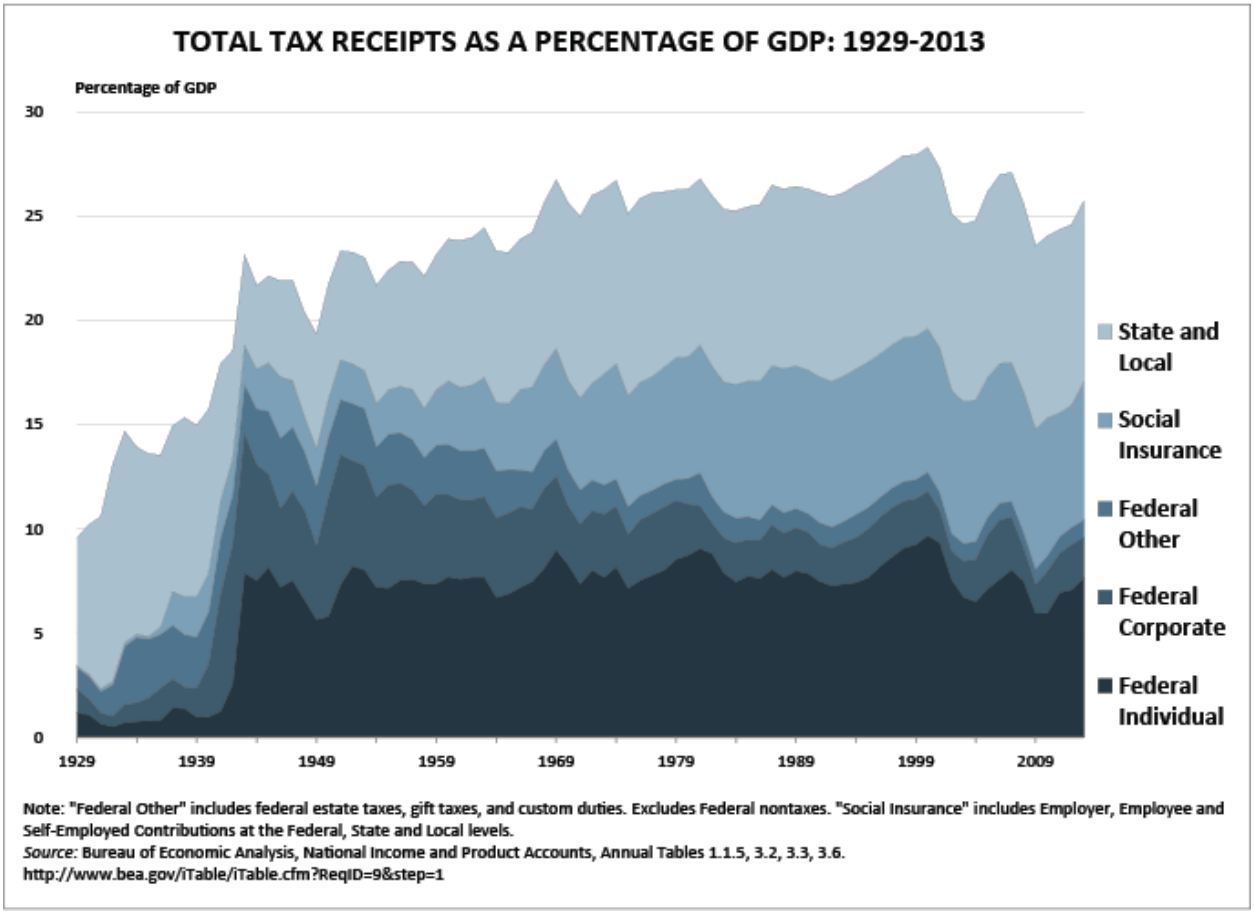
The Social Security Tax base has always been limited to labor income on the theory that most (though not all) Social Security payments constitute wage replacements so wages should fund

[16] *See, e.g.*, Deborah A. Geier, *The Payroll Tax Liabilities of Low- and Middle-Income Taxpayers*, 106 TAX NOTES 711 (2005).

them. Medicare, on the other hand, has never had any formal relationship to past income (whether labor or investment income), but the payroll tax system was easy to "piggyback" on in 1966 when the Medicare Tax was first enacted.

Thus, labor income is often taxed twice to the same person at the Federal level—once under the Federal income tax and once under the payroll taxes. Capital income (interest, dividends, royalties, rents, and capital gains) are generally taxed only once (under the income tax), though some investment income in households with Taxable Income exceeding $200,000 is now taxed under both the Federal income tax and the Medicare Tax.

As you can see from the chart below,[17] the aggregate amount collected under the individual Federal income tax has remained virtually constant as a percentage of gross domestic product (GDP—which you can think of as roughly "national income") ever since the income tax was transformed from a class tax to a mass tax with WWII, but the amount collected in the payroll taxes (on labor income only) has substantially increased over that time period.




The bottom tranche is the amount collected in individual Federal income tax. The tranche that is second from the top represents the amount of national income collected in payroll taxes. While it started out as a relatively small portion of Federal revenue, it has notably increased over time so that today it collects almost as much as the individual income tax.

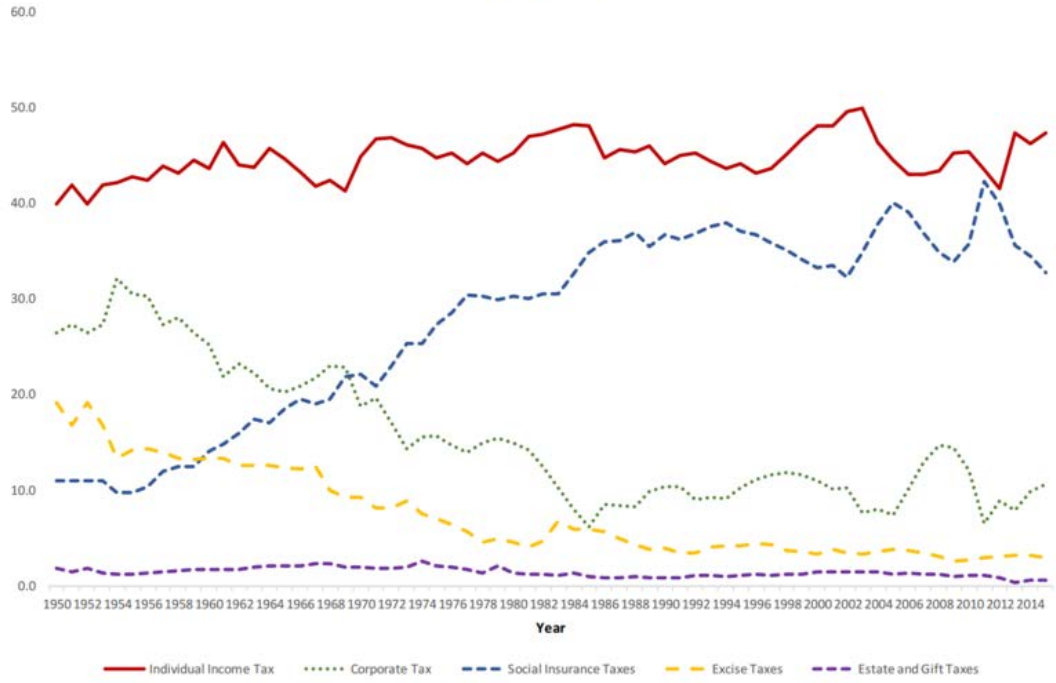
[17] www.taxpolicycenter.org/taxfacts/displayafact.cfm?Docid=14. Reprinted with permission.

The second tranche from the bottom is the amount of national income collected via the corporate tax. Though corporations nominally pay the income taxes owed on their income, corporations are artificial entities, not real people, and only real people can bear the economic incidence of a tax. Precisely who bears the economic incidence of the corporate tax has, unlike the payroll taxes, been subject to some debate. It could be shareholders, whose dividends are smaller than they otherwise would be absent the corporate tax. It could be all owners of capital (even owners who do not own shares of corporate stock) as economy-wide capital returns reach equilibrium regardless of whether the return is earned inside or outside a corporation. Or it could be the corporation's employees, whose salaries are smaller than they otherwise would be. Nevertheless, while there are some dissents, the broad consensus of economic opinion is that the corporate tax is borne mostly by all owners of capital (investments), whether corporate stock, partnership interests, real estate, *etc*., with some born by labor. For example, the Congressional Budget Office (CBO) assumes that the incidence of the corporate tax falls 75% on capital and 25% on labor. Notice how the portion of GDP collected in corporate tax has steadily decreased since WWII.

Indeed, the combined payroll and corporate tax tranches, viewed together, has increased only slightly, but there has been a dramatic shift of the tax burden from capital (the corporate tax) to labor (the payroll taxes). And recall that the amount of labor income that is reached under the payroll taxes is capped (for 2017) at $127,200 per wage earner, so no taxes represented in this tranche comes from wages above the relevant cap for the years at issue.

These points are even more apparent when you switch the inquiry from *the percentage of GDP* that is collected from each kind of Federal tax to *the percentage of total Federal tax revenue* that is collected from each kind of Federal tax, displayed in the chart below.[18]

**Figure A−1.−Federal Receipts by Source as Share of Total Receipts, 1950-2015**



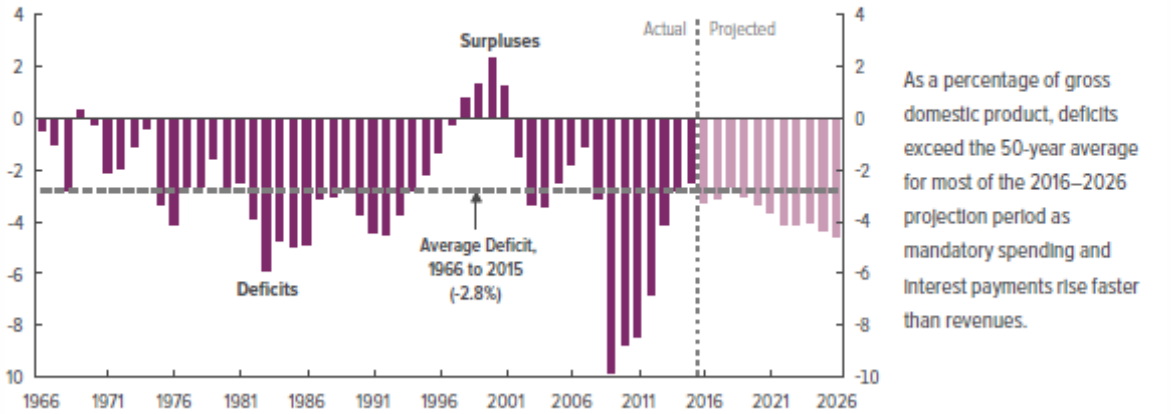

[18] JOINT COMMITTEE ON TAXATION, OVERVIEW OF THE FEDERAL TAX SYSTEM AS IN EFFECT FOR 2016, JCX-43-16 (May 10, 2016), at www.jct.gov/publications.html?func=showdown&id=4912.

Of course, focusing only on who pays what sorts of Federal tax over time provides an incomplete fiscal picture. If tax collections are less than spending, the government must borrow (by selling Treasury securities) to make up the shortfall. While such borrowing is expected (and even beneficial) during times of recession, significant deficit spending during periods of economic expansion suggests that tax collections relative to spending are out of equilibrium. The first figure below shows annual deficits (or surpluses) for every year since 1966, with projections through 2026.[19]

Figure 1-1.

**Total Deficits and Surpluses**

Percentage of Gross Domestic Product



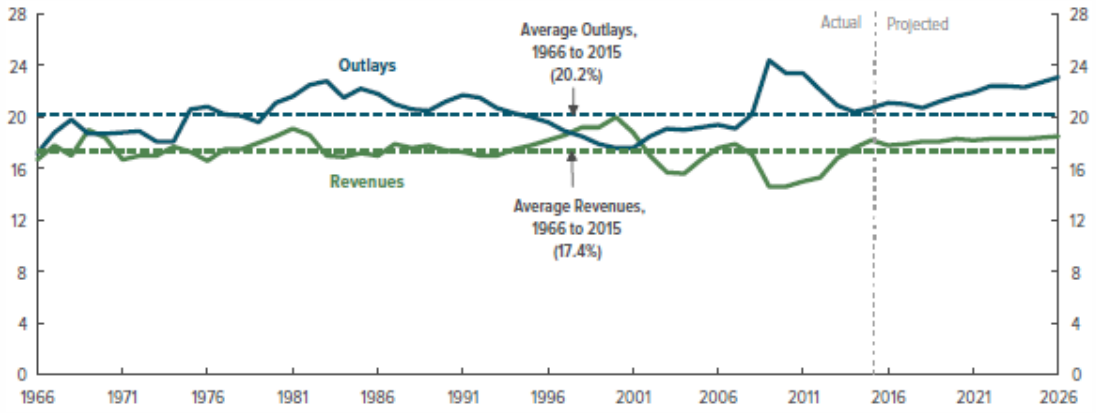

Source: Congressional Budget Office.

The chart below shows the relationship of revenues to outlays since 1966: average outlays represent about 20% of GDP, while average revenues average about 17.4% (with a high of 20.6% in 2000—the last year of budget surplus).[20]

Figure 1-2.

**Total Revenues and Outlays**

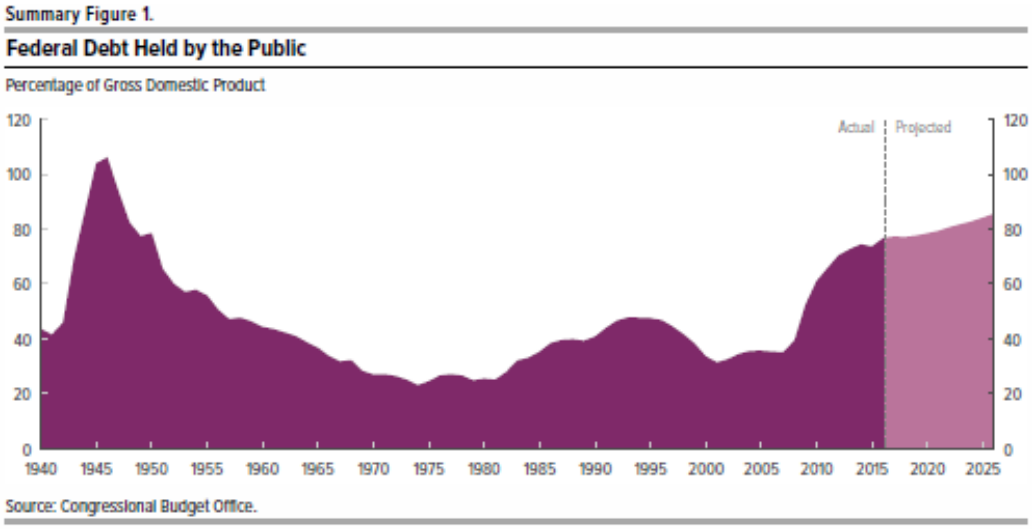
Percentage of Gross Domestic Product



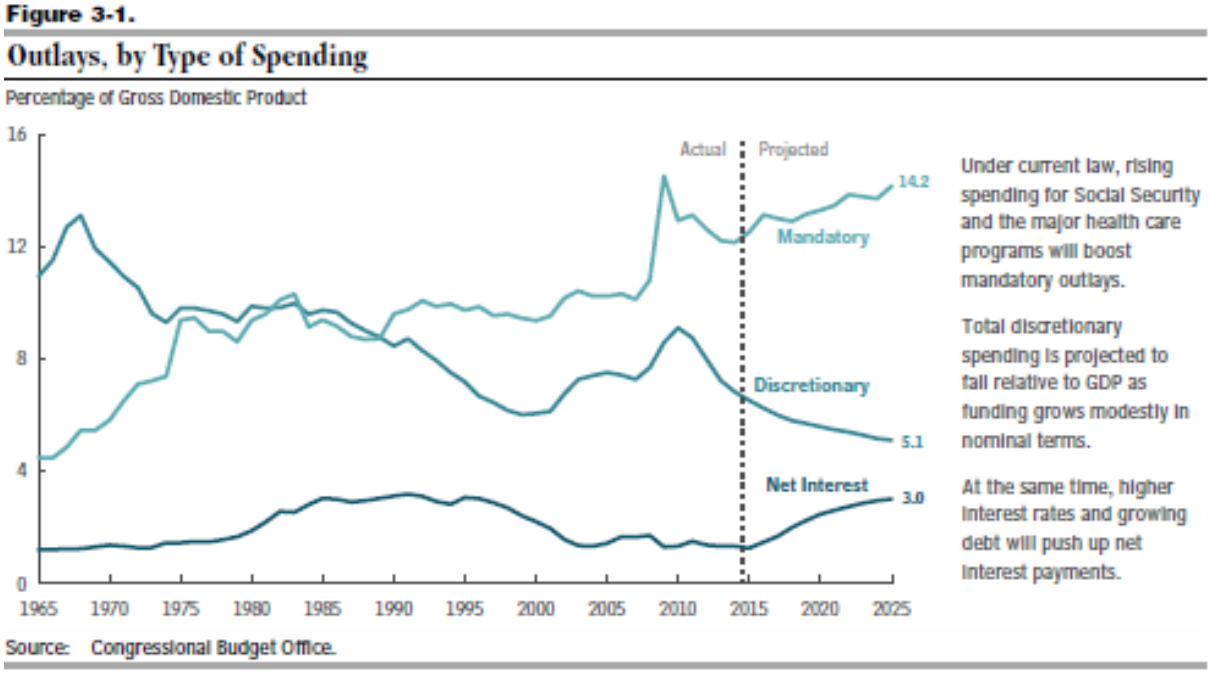

Source: Congressional Budget Office.

[19] CONGRESSIONAL BUDGET OFFICE, *An Update to the Budget and Economic Outlook 2016 to 2016*, at https://www.cbo.gov/publication/51908 [hereinafter CBO 2016 REPORT] 10.
[20] *Id.* at 11.

This relationship results in the following picture of outstanding and projected Federal debt (if revenue is not increased or spending decreased).[21]




About two-thirds of Federal spending is done automatically under mandatory programs (most notably, Social Security, Medicare, and Medicaid) without annual votes by Congress, as illustrated below, which shows outlays by category since 1965 (projected through 2025).[22]

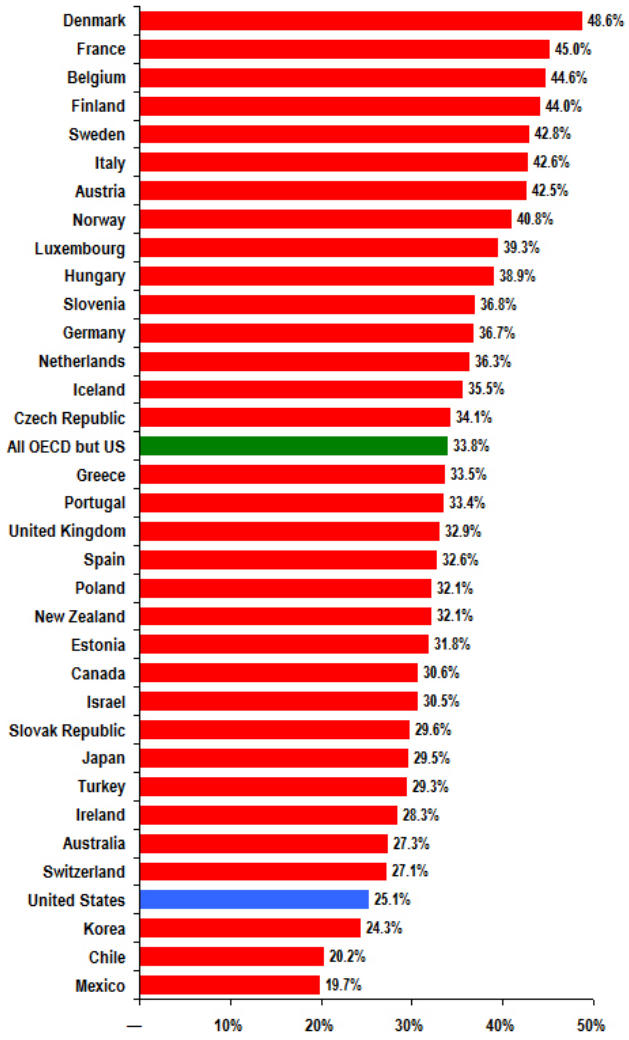



Because of the rhetoric often heard from some politicians and commentators in the popular press, many in the U.S. might think that the aggregate Federal, state, and local tax burden in the

[21] CBO 2016 REPORT, *supra* note 19, at 4.
[22] THE CONGRESSIONAL BUDGET OFFICE, *The Budget and Economic Outlook: 2015 to 2025*, at www.cbo.gov/publication/49892 at 22.

United States is high by international standards, but the opposite is true. While the U.S. spends more on defense than most of the rest of the industrialized world put together, Americans are among the most lightly taxed citizens of all industrialized nations. Among the members of the OECD (essentially, all of the major countries of the industrialized world), the U.S. collected—in Federal, state, and local taxes *combined*—a smaller percentage in GDP than every other country except Korea, Chile, and Mexico in 2013, the latest year for which complete data is available, as shown in the chart below.[23]

**OECD Countries' 2013 Taxes as % of GDP**



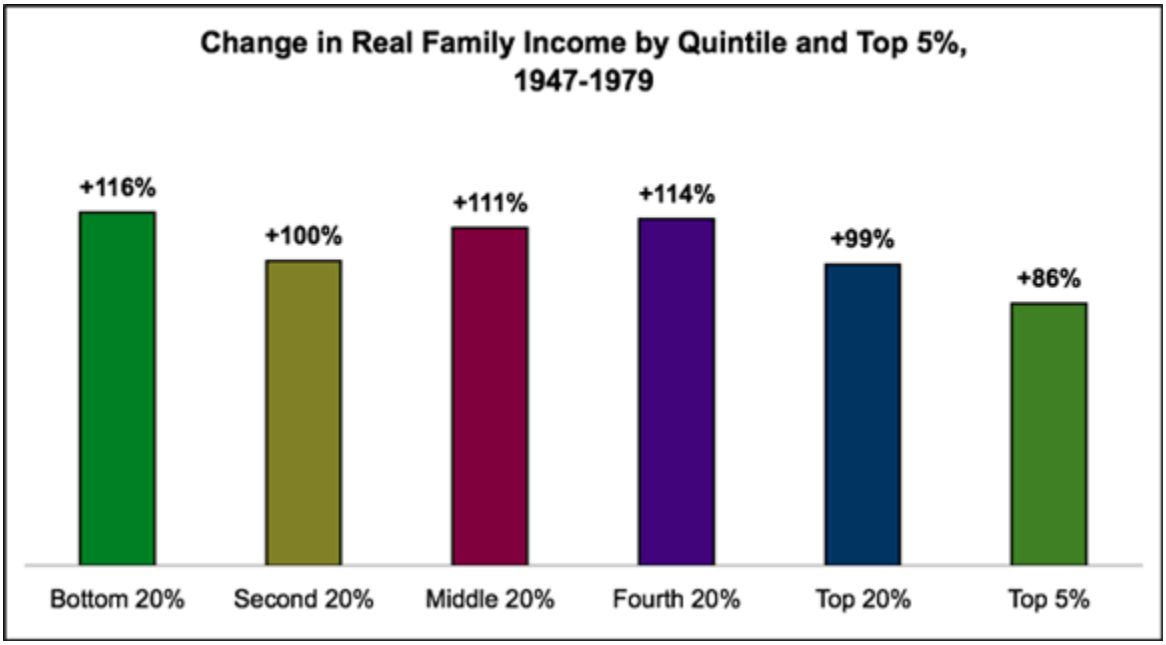

**Notes:**
Annual totals for non-U.S. OECD are weighted by GDP.
2013 is the most recent year for which OECD has data.
2012 data is used for Greece, Poland, Australia and the Netherlands above due to lack of more recent data.
**Source:** OECD data, http://stats.oecd.org/; U.S. Data from Treasury and U.S. Census. 2015.

[23] CITIZENS FOR TAX JUSTICE, *The U.S. is One of the Least Taxed Developed Countries*, at http://ctj.org/ctjreports/2015/04/the_us_is_one_of_the_least_taxed_developed_countries.php#.VSkd2OHGqW4. Reprinted with permission.

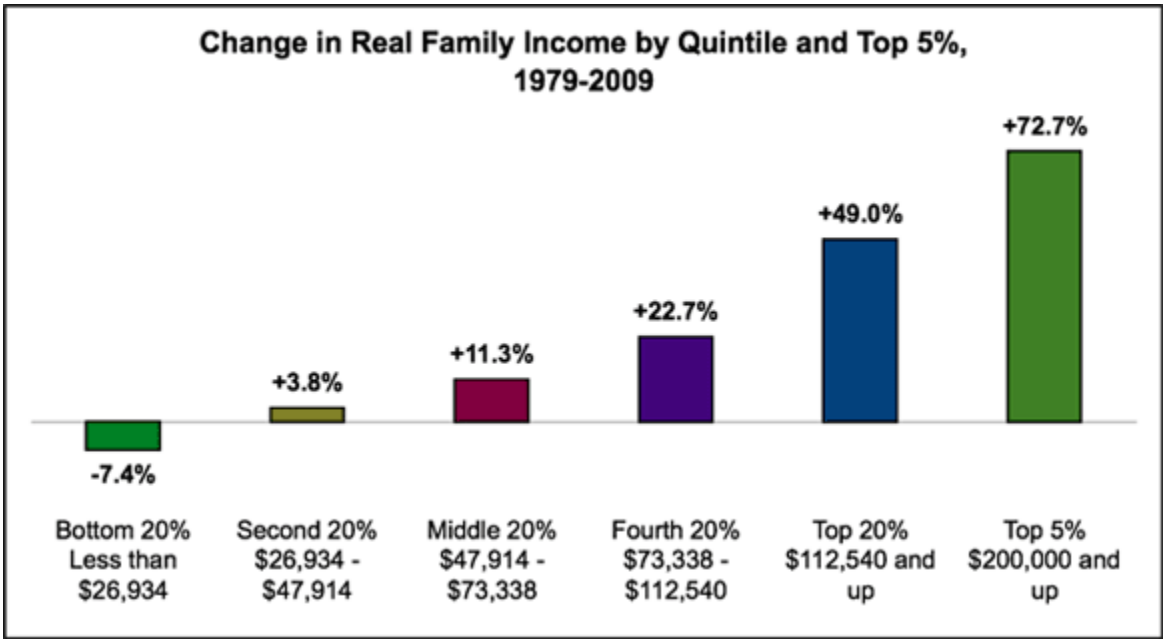
In thinking about how to apportion the pain of balancing the budget (whether through spending cuts, tax increases, or a combination of the two), information concerning growth and income trends over the past 60 years may provide additional helpful context.

Economic growth—*i.e.*, increases in national income in the aggregate—comes chiefly from increases in what economists call "productivity"—the measure of goods and services produced for each hour of work. The post WWII period until about 1974 was the golden age of economic growth rates. Some years saw growth rates between 5 and 10% (even higher in the early 1950s).[24] But the period since 1974 has shown lower average growth rates, with most years below 3%.

How is the increase in GDP created by increases in productivity shared among the members of the population? Compare the two charts below.[25]




[24] www.tradingeconomics.com/united-states/gdp-growth.
[25] http://inequality.org/income-inequality. Charts licensed under a Creative Commons 3.0 license.




These bar graphs show the periods between 1947 and 1979 (top) and between 1979 and 2009 (bottom), illustrating both the aggregate gains from growth and how such gains were shared by the members of the population during these two periods. Notice that the bars collectively on the top chart are notably higher than on the bottom. That is to say, economic growth rates were much more robust before the mid-1970s than they have been since then. Moreover, the *sharing* of the gains from growth has become increasingly lopsided. Before 1979, the increased income from increasing productivity was shared by both labor and capital; some went to workers in the form of higher wages, and some went to the owners of capital. Indeed, notice that the top 5% on the top chart took a slightly *smaller* share of the gains from growth then did those in lower quintiles.

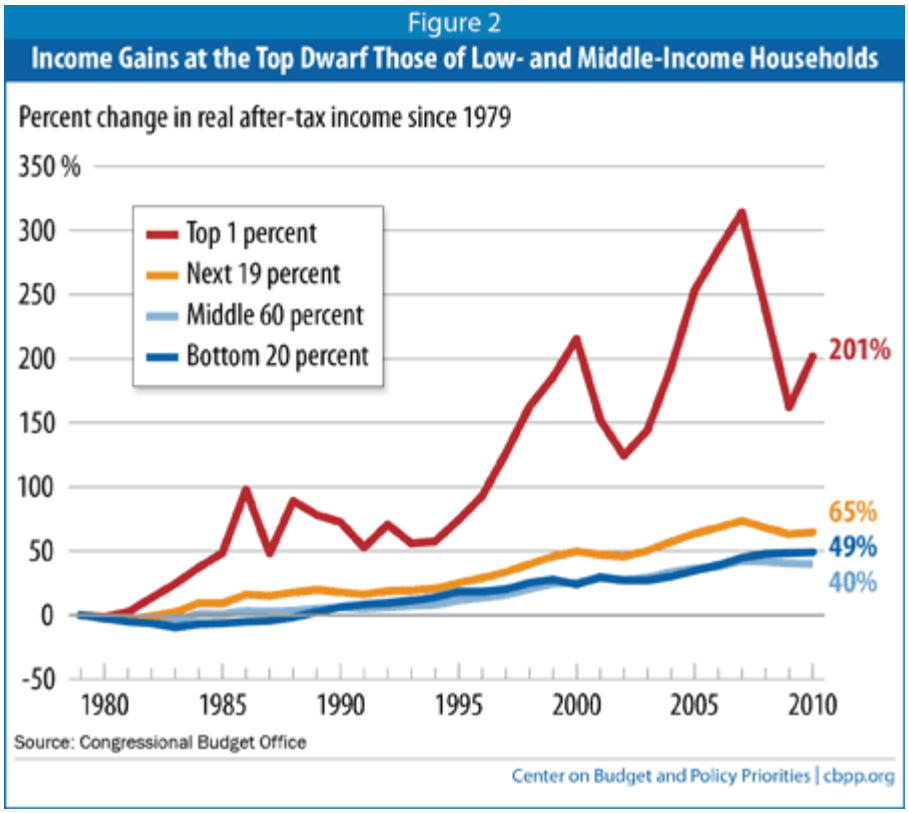
But over the last several decades the increased national income from economic growth and prosperity has gone substantially to the owners of capital, which is heavily concentrated at the top—particularly the top 1%—with diminishing percentages of the gains from growth going to workers (wage income). Thus, comparing the top 1% to the middle 20% (the middle of the income spectrum), we see opposing trends before and since the late 1970s.

Please click and read the following article:

www.nytimes.com/2014/04/05/business/economy/corporate-profits-grow-ever-larger-as-slice-of-economy-as-wages-slide.html/

The chart below[26] illustrates this phenomenon in a different way.

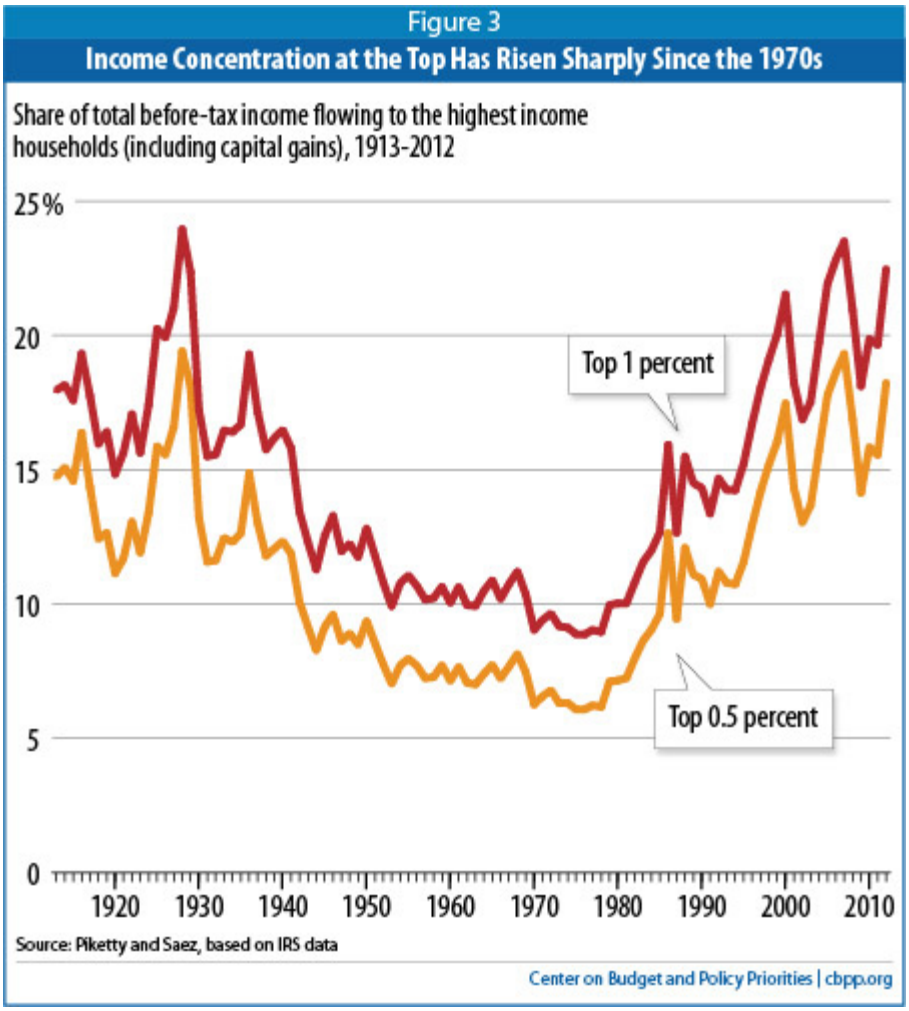
[26] Chad Stone, Danilo Trisi, Arloc Sherman, and William Chen, *A Guide to Statistics on Historical Trends in Income Inequality*, at www.cbpp.org/cms/?fa=view&id=3629. Reprinted with permission.




In other words, this chart shows how the top 1% is truly in a class by itself. Those in the 90th to 99th percentiles have much more in common with median earners than with the top 1%.

The chart below[27] (which uses before-tax rather than after-tax income) shows the share of income of both the top 1% and the even more elite group of the top .5% since 1929. These trend lines show that the post-1980 period mirrors a gradual return to the income share enjoyed by the top 1% just before the 1929 market crash and ensuing Great Depression.

[27] *Id.*




And these trends continue. In September 2015, the Labor Department released data indicating that productivity was rising at an annual rate of 3.3 %, while a report issued the same day by the Economic Policy Institute showed that "even as labor productivity has improved steadily since 2000, the benefits from improved efficiency have nearly all gone to companies, shareholders and top executives, rather than rank-and-file employees."[28] A December 2015 Pew Report shows that the middle class is no longer in the majority, with increases in both low-income and wealthy households, and that "the nation's aggregate household income has substantially shifted from middle-income to upper-income households, driven by the growing size of the upper-income tier and more rapid gains in income at the top."[29]

> Fully 49% of U.S. aggregate income went to upper-income households in 2014, up from 29% in 1970. The share accruing to middle-income households was 43% in 2014, down substantially from 62% in 1970. And middle-income Americans have fallen further behind financially in the new century. In 2014, the median

[28] Nelson D. Schwartz, *Low-Income Workers See Biggest Drop in Paychecks*, at www.nytimes.com/2015/09/03/business/low-income-workers-see-biggest-drop-in-paychecks.html?_r=0.
[29] PEW RESEARCH CENTER, *The American Middle Class is Losing Ground* (Dec. 9, 2015) at www.pewsocialtrends.org/2015/12/09/the-american-middle-class-is-losing-ground/ [hereinafter *Pew Report*].

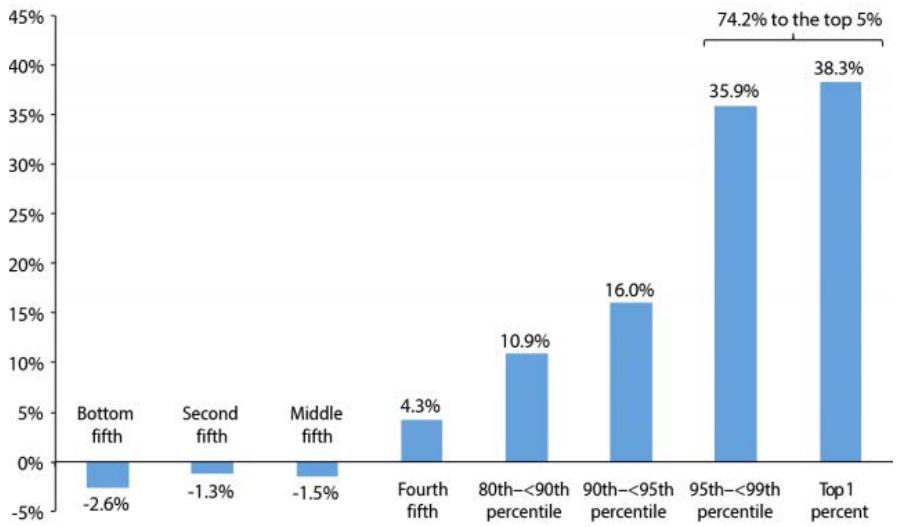
income of these households was 4% less than in 2000.[30]

Median household income rose significantly in 2015 but is still 1.6% lower than in 2007 (adjusted for inflation) and 2.4% lower than the peak reached in the late 1990s boom.[31]

The data above focuses particularly on income trends, but wealth (assets *less* debts) is even more concentrated than income. For example, ignoring the value of owner-occupied residences, in 2007 the top 1% owned 42% of the nation's financial wealth (the fair market value of assets other than one's home *less* debt), while the bottom 80% owned only 7%. Looking only at stocks, bonds, and mutual funds, the top 1% owned 50.9%, whereas the bottom 50% owned only 0.5%. Debt, however, is fairly evenly distributed; the bottom 90% of households owes 73% of the debt, with the top 1% owing only 5% of the debt.[32]

That snapshot picture of 2007 downplays the growth in wealth inequality over the last three decades. Wealth inequality grew substantially between 1983 and 2010, as shown in the chart below, which displays the *growth* in wealth among quintiles between these two points in time.[33]

**Share of total household wealth growth accruing to various wealth groups, 1983–2010**




The Great Recession had an even greater impact on wealth inequality than on income inequality because housing is the primary investment asset of the middle class. "The crash in the housing market that preceded the Great Recession was more severe and of longer duration than the turmoil in the stock market. Thus, the portfolios of upper-income families performed better than the portfolios of middle-income families from 2007 to 2013. When all is said and done, upper-income families, which had three times as much wealth as middle-income families in 1983, had seven times as much in 2013."[34]

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[30] *Id*.
[31] Neil Irwin, *The Economic Expansion is Helping the Middle Class, Finally*, at www.nytimes.com/2016/09/14/upshot/the-economic-expansion-is-helping-the-middle-class-finally.html.
[32] http://thinkprogress.org/economy/2011/10/03/334156/top-five-wealthiest-one-percent/.
[33] http://stateofworkingamerica.org/chart/swa-wealth-figure-6b-share-total-household/. Licensed under a Creative Commons license.
[34] *Pew Report*, *supra* note 29.

Research in 2016 confirmed that the "main driver of wealth in recent years has been investment income at the top. That is a switch from the 1980s and 1990s, when gains in income were primarily generated by working."[35]

> That divergence can slow innovation and further entrench inequities, said Heather Boushey, an economist at the Washington Center for Equitable Growth. When labor income provides the primary route to riches, it creates incentives for people to improve their education and work harder…. But if getting ahead requires already having a stockpile of cash or inheriting a windfall from your parents, then it is much harder to work your way up.
>
> "If you're closing off entryways, then you are basically shutting off avenues to competitiveness, innovation, and growth," Ms. Boushey said, "even if you don't care about fairness."[36]

Why has the increased income from productivity gains gone increasingly to owners of capital rather than to labor? Most studies theorize that this trend—which is significantly more pronounced in America than in other countries—is mainly attributable to three factors: cheaper labor abroad (trade), the increased use of automation (technology), and trends that weaken labor's bargaining strength (changes in labor law and privatization). Please click and read the following article:

www.nytimes.com/2013/01/13/sunday-review/americas-productivity-climbs-but-wages-stagnate.html?_r=0.

Others argue that an additional important factor is public policy, including tax policy. For example, Thomas Piketty argues in an influential 2014 book[37] that the theory championed by Samuel Kuznet in the 1950s and 1960s that mature capitalist economies do not inevitably evolve toward economic inequality has been undermined by massive data sets that only recently have become possible to compile. His data shows that, as economies mature, the return to capital outstrips the overall rate of economic growth, meaning that lesser and lesser amounts of the gains from growth accrue to labor (workers). This trend leads to greater and greater wealth concentration unless the political system intervenes with countervailing measures, such as wealth taxation.

When these trends first began in the late 1970s, many middle-class families were able nevertheless to maintain living standards by having spouses (usually the wife) enter the workforce for the first time. The significant increase in dual-earner households in this era, in other words, masked these trends at first. For example, only about 45% of women aged 25 to 54 were in the workforce in 1964, whereas that figure rose to about 77% by 1998.[38] When second-earner spouses saturated the workforce as the 20th century came to a close, many middle-class families then turned to debt to maintain living standards. In particular, the deductibility of interest on second mortgages or home equity lines of credit (studied in Chapter 18) turned many homes into ATMs, the proceeds

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[35] Patricia Cohen, *A Bigger Economic Pie, But a Smaller Slice for Half of the U.S.*, at http://www.nytimes.com/2016/12/06/business/economy/a-bigger-economic-pie-but-a-smaller-slice-for-half-of-the-us.html.

[36] *Id.*

[37] THOMAS PIKETTY, CAPITAL IN THE TWENTY-FIRST CENTURY (2014). *See also* Steven Erlanger, *Taking on Adam Smith (and Karl Marx)*, at www.nytimes.com/2014/04/20/business/international/taking-on-adam-smith-and-karl-marx.html; Jennifer Schuessler, *Economist Receives Rock Star Treatment*, at www.nytimes.com/2014/04/19/books/thomas-piketty-tours-us-for-his-new-book.html?_r=0;

[38] Len Burman, *Rising Economic Inequality and Tax Policy*, slide 5, at www.taxpolicycenter.org/press/upload/inequality%20and%20taxes.Burman.5-07.swf.

of which supported consumption spending. Perhaps most significantly, student loans increased substantially. The amount of outstanding student loan debt exceeded the amount of outstanding credit card debt for the first time in 2010.[39] The amount of student loans taken out in 2010 exceeded $100 billion for the first time, and the total amount of outstanding student loan debt exceeded $1 trillion for the first time in 2012.[40] This debt load on the younger generation, coupled with stagnant middle-class incomes, can dampen demand for goods and services and thus dampen economic growth for years to come. (More on "supply" and "demand" in Part B., below.)

With the bursting of the real estate bubble in 2007 to 2008, the combination of stagnant middle-class incomes and the lack of ready alternatives to maintain spending have turned increased attention to these long-term trends in increasing income and wealth inequality.

As noted earlier, a wealth tax is not likely at the Federal level under the apportionment clause. But could the income tax rate structure be fashioned so that effective Federal income tax rates were progressive relative to wealth (instead of income)? Such a rate structure would return the income tax to a "class tax," as it was in the first several decades of its life, with only the wealthy paying it. Would that be consistent with notions of fairness? How might it affect economic growth? Indeed, should we instead return to the pre-income tax days and tax only consumption, such as with a national retail sales tax? Whether we stick with income or move to a consumption tax base, what about the rate structure? Should it be progressive or flat? Should subsistence consumption be freed from tax, whether under an income tax or consumption tax? These questions lead us to a consideration of ethical norms and economic theories in more detail.

## B. Fairness norms, economic theories, and politics

One chief takeaway from this part is that no single tax base and tax rate structure can be seen as indisputably the "best" in raising *$X* (whatever that amount). In the end, which is the one that you might consider the "best" will inevitably be a function of your values and worldview. Moreover, after reading this material, you might well each come to different conclusions based on which bit of evidence or argument below speaks most loudly to you. (Remember the confirmation bias?) Nevertheless, I hope that this material can, at the least, help you to think about these issues (and arguments that you will hear by one side or another in the popular press) in a more refined, formal way. While the material is necessarily cursory in its depth, there is nevertheless a lot here. I hope that you agree that this material adds richness to your study. We shall bring these norms to bear as we progress through the course, particularly as we examine various provisions that depart from SHS income tax principles.

The three major ingredients of tax policy discussions are fairness norms, economic norms, and administrability. These can be brought to bear regarding both the tax base—what is taxed—and the tax rate structure, though they are interdependent to a degree in the sense that the narrower the tax base (the less that is taxed), the higher rates must be to raise *$X* (the aggregate revenue sought to be raised under the tax). Thus, decisions to accord preferential tax treatment to certain classes of activities or income affect not only those who benefit from these decisions but every remaining

[39] Mary Pilon, *Student-Loan Debt Surpasses Credit Cards*, at http://blogs.wsj.com/economics/2010/08/09/student-loan-debt-surpasses-credit-cards/.
[40] Dennis Cauchon, *Student Loans Outstanding Will Exceed $1 Trillion This Year*, at www.usatoday.com/money/perfi/college/story/2011-10-19/student-loan-debt/50818676/1.

taxpayer who does not so benefit because their tax rates are higher than they would otherwise need to be to raise *$X*.

Let's first think about the issue of *tax base*—what should be taxed. As you read in Part A., the Federal government raised nearly all of its revenue through various forms of consumption taxation for more than a century before the 16th amendment was adopted and the modern Federal income tax was enacted in 1913. As you also read, the movement to adopt an income tax was based mostly on notions of fairness, as an income tax was thought to shift at least some of the tax burden from the lower and middle classes to the wealthy. Consistent with its origins, the income tax at first reached less than one percent of the population. Thus, it was purely a "class tax" that was imposed primarily on the capital income of the wealthy before it shifted with WWII to a "mass tax" that has been paid by more than half of U.S. households ever since. Over the last twenty years or so, there has been vociferous calls, however, to move back to our roots by repealing the income tax in favor of some sort of pure consumption taxation again, whether a retail sales tax, a VAT, a cash-flow consumption tax, or the so-called flat tax that would tax only wage income (not capital income) at the individual level, as described in Chapter 2.

Most recently, some commentators have begun to argue that we should *add* a broad-based consumption tax to the income tax at the Federal level (common in many other countries) in order to raise additional revenue that can then be used to reduce projected future deficits arising from current spending commitments and/or to increase direct spending programs aimed particularly at the lower and middle classes and at public goods that benefit even those not the direct recipient of the spending (such as education and basic research). The goal would be to view the tax and spending systems together to achieve *fiscal* progressivity as an integrated whole (even though the new consumption tax would be regressive relative to income if viewed alone) by expanding the social safety net and opportunity programs.[41] Of course, whether the new revenue obtained under any add-on Federal consumption tax would be spent on social safety net programs could not be guaranteed. The current Congress cannot bind future Congresses from changing how Federal revenue is spent.

Which fairness norms and economic norms may be relevant in thinking about these proposals?

***Fairness norms in general***

One of the most commonly discussed fairness norms in beginning tax textbooks is horizontal equity. **Horizontal equity** is easy to state: **like-situated taxpayers should be taxed alike**. Who could argue with that? But how do we measure "likeness"?

> **Jane has $10 million in wealth (the fair market value of her assets *less* outstanding indebtedness). This year, she realizes $1 million in income (both labor and capital income), and the FMV of her assets increases by $3 million. She spends only $50,000 on personal consumption, adding $950,000 to her savings.**

[41] *See, e.g.*, Eric M. Zolt, *Inequality in America: Challenges for Tax and Spending Policies*, 66 TAX LAW REV. 1101 (2013); Reuven S. Avi-Yonah, *The Parallel March of the Ginis: How Does Taxation Relate to Inequality and What Can Be Done About It?*, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2392971; Edward Kleinbard, *Progressive Tax or Progressive Fiscal System?*, at http://taxprof.typepad.com/taxprof_blog/2014/04/kleinbard-delivers-.html (lecture based on WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY (Oxford University Press 2014)).

**Patti has a negative net worth (more outstanding indebtedness than assets). This year, she wins a $1 million prize. She spends $200,000 on personal consumption, using the remainder to reduce debt and add to savings.**

**George has no savings but also no debt. This year, he realizes $50,000 in income and spends all $50,000 on personal consumption, saving nothing.**

Are Jane and George alike (and thus should be taxed alike) because each spends $50,000 on personal consumption? If we impose a 20% retail sales tax on consumption and repeal the income tax, both Jane and George will pay $10,000 in tax (.20 x $50,000 consumption expenditures), but Jane's effective tax rate *relative to realized income* would be .01% ($10,000/$1,000,000), while George's would be 20% ($10,000/$50,000). **Flat-rate consumption taxes, such as retail sales taxes, are regressive relative to income**. But should that matter? If they are considered the "same" because they spend the same amount on consumption, perhaps consumption (not income) should be put in the denominator, with the result that they both have an effective tax rate—*relative to consumption*—of 20%.

Or are Jane and Patti alike because each has realized $1 million in income? Are they not alike because Jane's assets have also increased in FMV by $3 million in unrealized gain, which means that Jane's increase in *wealth* is higher than Patti's? Are none of them alike because Jane has wealth while Patti is underwater and George is in equipoise? Horizontal equity, while it sure sounds nice, does not help very much in determining which kind of tax base is most "fair," so we must turn to other notions of tax fairness.

The ultimate question can be phrased as follows: *what is the fairest way to allocate the costs of maintaining a regulated capitalist economy, where the market's laws of supply and demand create wealth, among the members of the population?*

**Possibility 1: Allocate the costs equally among all members of the population.**

**Possibility 2: Allocate the costs according to wealth.**

**Possibility 3: Allocate the costs according to "ability to pay."**

**Possibility 4: Allocate the costs according to "utility" or "standard of living."**

**Possibility 5: Allocate the costs according to the benefits received from government.**

Possibility 1 postulates an equal-amount head tax imposed on each member of the population. Projected Federal spending for Fiscal Year 2016 is about $3.9 trillion,[42] and the U.S. population consists of approximately 316 million people.[43] Thus, a flat head tax would result in a tax owed by every man, woman, and child of approximately $12,340, regardless of income or wealth ($3.9 trillion/316 million people). Because an equal, per person head tax would have to be very low (much lower than $12,340) to be able to be paid by children and the poor, such a distribution is not realistic to support a modern industrialized state with a large military. We need to move on.

Possibility 2 postulates an annual tax on wealth (the fair market value of assets *less* outstanding indebtedness). You learned in Part A. that wealth inequality has grown substantially over the last 30 years—and is even more pronounced than income inequality. Unlike an income tax, a wealth tax taxes the same dollars to the same taxpayer more than once. Many European countries impose

[42] *See* www.cbo.gov/topics/budget.
[43] *See* http://quickfacts.census.gov/qfd/states/00000.html.

annual wealth taxes, but in the U.S. an annual wealth tax would constitute a direct tax and thus would need to be apportioned among the states according to population under Article 1, § 9, clause 4, of the Constitution, described in Part A. Because apportionment would be administratively infeasible, a wealth tax is not likely to be adopted in the U.S.—absent a constitutional amendment removing the direct tax clause or removing the apportionment requirement from a wealth tax (similar to the approach taken in the 16th amendment).[44]

Nevertheless, if apportioning the tax burden according to relative wealth is appealing, one could conceivably create a tax rate structure on either income or consumption with the goal of replicating the distribution of the tax burden that *would* occur with an annual flat-rate wealth tax. Such an approach would, however, likely require exemption for much of the income scale with then very steeply progressive rates where wealth is concentrated. It would also result in little or no taxation of young adults (while they are building wealth after a period of negative net worth while they are indebted students) and much heavier taxation of the older generation. Even if thought desirable, such a result is not likely as a political matter.

Possibility 3—that the costs of government should be allocated according to ability to pay—is traditionally perceived as being the primary fairness norm underlying the income tax. Recall the debates that preceded the 1894 income tax and the congressional adoption of the 16th amendment in 1909 described in Part A. That is to say, the most common argument in favor of income taxation is that it better measures one's ability to contribute to the national fisc than does consumption taxation because *both* amounts spent on consumption *and* amounts saved (an income tax base) represent ability to pay.

Possibility 4—that the costs of government should be allocated according to "utility"—requires that we explore this term a bit. "Utility" is a fancy term introduced by the economist Daniel Bernoulli and can be thought of, in this context, roughly as well-being or enjoyment in life. The utility norm is generally thought to support consumption taxation over income taxation because one's utility or well-being can be measured by how much one consumes—*i.e.*, by one's standard of living—not by how much one both consumes and saves. Of course, not everyone agrees that having savings (wealth) provides no utility, but for purposes of discussion, we can assume that the utility or standard-of-living norm would support consumption taxation over income taxation.

Possibility 5 postulates allocating the costs of government by reference to the benefits received from government. The most easily understood benefit taxes are highway tolls, driver license fees, gasoline taxes (the proceeds of which support highway maintenance), the entrance fee to enter national parks, and the like. The Social Security Tax and Medicare Tax might be thought of as benefit taxes, as their payment allows one to enjoy Social Security payments and medical care later in life, though even those who do not pay Medicare Tax (because they either earn no income or earn only capital income, such as interest, dividends, and capital gains not exceeding $200,000 or $250,000 for a married couple filing jointly) are eligible to enroll in the Medicare program upon reaching age 65, so the fit is less perfect. On the other hand, perhaps that is not the only way to think about the benefit norm.

Although the ability-to-pay norm is thought to be the primary fairness norm underlying an income tax, perhaps there is room for the benefit norm to be thought of as extra support for income taxation over consumption taxation. Recall that some proponents of income taxation in the early

[44] *But see* John T. Plecnik, *The New Flat Tax: A Modest Proposal for a Constitutionally Apportioned Wealth Tax*, 41 HASTINGS CONST. L.Q. 483 (2014).

20th century cited not only the ability-to-pay norm but also the benefit norm in the sense that those with more private property (more wealth) benefited proportionately more from government protection of that property ownership (through law and through regulation) than did those without much property. Anarchy is inimical to private property, while rule-of-law values and regulation of such matters as contract, copyright, banking, *etc.*—government actions all—protect private wealth.

> The person earning $500,000 per year is able to do so *only because* he or she lives in a regulated capitalist system and can exploit the market to sell products or services. That $500,000 is not earned by the individual in a vacuum; it is—perhaps in very large part—made possible by our system of laws (where contracts will be enforced), our education system, a functioning court system, functioning transportation and technology systems, a military complex, *etc.*, *etc.*, *etc.* As Bill Gates's dad said in support of the estate tax: "It is a very legitimate claim of society on an accumulation of wealth which would not have occurred without an orderly market, free education and incredible dollars spent on research."[45]

***Fairness and the wage tax***

Is a tax on labor income only fair? One fairness argument sometimes heard in support of taxing labor income only and excluding capital returns from tax (capital gains, dividends, interest, rents, and royalties) is that taxing capital returns under an income tax taxes the same dollars to the same taxpayer more than once, which is unfair. "Wait," you say. "We learned in Chapter 1 that a fundamental precept of an income tax is that the same dollars should *not* be taxed to the same taxpayer more than once. That value is why basis keeps track of those dollars, to ensure that they are not taxed again to the same party. Only the returns *in excess* of basis are taxed to ensure compliance with that fundamental precept."

But the wage tax proponents who make this argument look at the issue of "same dollars" differently than the way in which we have viewed "same dollars" (as basis). Recall our discussion in Chapter 2 (in connection with the wage tax) regarding a common way to describe how "the market" arrives at the "fair market value" of any asset: fair market value is the market's best guess at the present, discounted value of the future stream of payments expected to be generated by that asset. Thus, for example, the fair market value of a share of stock may be calculated by discounting to present value (1) the future stream of dividend payments expected to be paid by the corporation and (2) the future sales proceeds expected to be received on later sale (including the appreciation in the share's FMV). Let's say that this discounted present value is $10,000. When Ryan purchases that stock for $10,000 and is denied a deduction for the $10,000 purchase price (as he would under both an income tax and a wage tax), neither the dividends received nor the eventual sale gain realized should be taxed to Ryan (as they would under an income tax) because—the argument goes—he was already implicitly taxed on those dollars when he was denied a deduction on the initial $10,000 purchase price (equal to the market's best guess regarding the discounted present value of those *future* receipts).

This argument is reflected in Congressman Paul Ryan's 2013 Budget, which was passed by the House of Representatives in 2012 but not by the Senate. In the description of this provision in his

[45] Deborah A. Geier, *Incremental Versus Fundamental Tax Reform and the Top One Percent*, 56 SMU LAW REV. 99, 119.

tax-reform plan, Congressman Ryan writes:

> *Elimination of Double Taxation of Savings*. The current system essentially taxes savings twice: individuals pay tax on their earnings and, if they choose to invest those after-tax funds, they pay another tax on the return from their savings (*i.e.*, interest, capital gains, or dividends). This proposal eliminates the second layer of taxation. Not only is this fair to individual taxpayers, it also is good for the economy. Greater savings leads to more investment and higher rates of productivity. Higher productivity ultimately drives increased living standards. The plan also eliminates the estate tax, another form of double taxation that is particularly harmful to small businesses.[46]

Those who disagree with this argument note that this pricing mechanism merely *describes a way of arriving at market value* and that the present value of those future payments is not actually the *same thing* as the future payments themselves, as taxpaying capacity *over time* is what should be relevant. For example, Nicholas Kaldor, a mid-20th century British economist, rejected the "double tax" argument when he wrote:[47]

> Some people would take strong objection to this statement on the ground that the market value of property is merely the discounted value of its expected future yield; wealth viewed as a stock and as a flow are merely two different aspects of the same thing, and not two different things; to regard the discounted value of the flow of wealth as something additional to the flow of wealth itself is counting the same thing twice over. All this may well be true from some points of view, *but from the point of view of the measurement of taxable capacity—which is the only purpose in question here—it is not correct to say that the one is just a reflection of the other.*

Indeed, many who argue for a pure consumption tax base (as opposed to an income tax base) think that a tax on labor income only is the *least* fair form of consumption taxation because it fails to reach the extraordinary (or supranormal) return that exceeds the discounted present value of what the market expected when the investment was purchased, as was also described in Chapter 2 with respect to Brenda. There, we saw that, under the E. Cary Brown yield-exemption phenomenon, denying deduction of the original investment but excluding returns (under a wage tax) will provide the same outcome as a cash-flow consumption tax (deducting the investment in the year of purchase but including 100% of the return, including basis recovery) *only if the investment assets produce precisely the normal market return originally expected when the market set the asset price*. If the investment produces a *higher* return than originally expected, that excess return is effectively taxed under a retail sales tax, VAT, or cash-flow consumption tax (when the extra, unforeseen return is spent on consumption) but is free from tax forever—even when spent on consumption—under a wage tax that reaches only labor income.

For this reason, the Roth IRA (listed as an example of the wage tax version of consumption taxation in Chapter 2) can be criticized as being less fair than the traditional IRA, traditional § 401(k) plan, or qualified pension plan. When unexpected, outsized returns are obtained, more revenue is lost to the Treasury with the Roth IRA than with the traditional IRA and its equivalents

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[46] THE ROADMAP PLAN, http://roadmap.republicans.budget.house.gov/plan/#Federaltaxreform. In his 2014 proposed budget (announced in 2013), Congressman Ryan mentioned "the prevalence of double taxation of capital and investment" but otherwise did not elaborate. *See* http://budget.house.gov/uploadedfiles/fy14budget.pdf, at 23.

[47] NICHOLAS KALDOR, AN EXPENDITURE TAX 31-32 (3d ed. 1955) (emphasis added).

(which means that tax rates on taxable wages must be higher than they otherwise would have to be to raise *$X*). Moreover, the more favored treatment of the taxpayer whose Roth IRA obtains that unexpected return is arbitrary when compared to those whose identical investment is taxed under the rules of the traditional IRA and its equivalents, thus violating horizontal equity. To appreciate this, review Brenda's and George's investments in Chapter 2. Both earned $100,000 in wages, both purchased investments expected to earn 5%, but George was taxed under a cash-flow consumption tax while Brenda was taxed under a wage tax. If their investments had both earned the expected 5% return, they both would have enjoyed the same $84,000 of after-tax consumption. Brenda's investment, however, unexpectedly earned a 20% return, so she was able to enjoy $96,000 of after-tax consumption without paying any additional tax on that extra consumption. If George's investment had also unexpectedly earned a 20% return, the extra return would have been taxed under his cash-flow consumption tax when spent on consumption.

***Fairness and other forms of consumption taxation***

With respect to consumption taxes in general, you read in Part A. how the movements in the late 19th and early 20th centuries championing the move from consumption taxation to income taxation was premised primarily on concerns about fairness and wealth concentration. Because consumption taxes are regressive relative to income, fairness arguments in support of them are difficult to mount. Nevertheless, some supporters of consumption taxation argue in moral terms that consumption taxes are fair because they punish spenders, who take from society through their spending (a notion attributed to the philosopher Thomas Hobbes), and reward savers, who are virtuous. Hobbes wrote: "For what reason is there, that he which laboureth much, and sparing the fruits of his labour, consumeth little, should be more charged, than he that living idlely getteth little, and spendeth all he gets: seeing the one hath no more protection from the Commonwealth than the other?"[48]

Using such thinking, Professor Edward McCaffery, for example, argues that we should replace the individual and corporate income, as well as the wealth transfer taxes (described in Chapter 7), with a progressive-rate, cash-flow consumption tax.[49] Consistent with Hobbes, he argues that it is not unfair to impose the same tax burden on Jane, who earns $1 million and spends $50,000 on consumption (saving $950,000), and George, who earns $50,000 and spends $50,000 on consumption (saving nothing), because Jane is noble and George is selfish. Jane "isn't getting away with something [if we tax only her consumption spending]. She is simply living a noble, prudent lifestyle and helping everyone else out in the process …"[50] while non-savers "are only about themselves, who look to spend every last penny on their narrowly selfish desires."[51] While Jane would benefit from the failure to tax her savings and from the repeal of the estate tax, her "good fortune will inure to the benefit of all. When the wealthy save, they help society."[52]

Exempting income from tax unless and until spent is inconsistent with the expanded version of the benefit norm described above because it allows the taxpayer taking advantage of our regulated capital system in amassing great wealth to avoid contributing meaningfully to the costs of maintaining that system to the extent they avoid consumption spending. More important, the

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[48] Gilbert E. Metcalf, *Consumption Taxation*, at www.taxpolicycenter.org/taxtopics/encyclopedia/Consumption-Taxation.cfm.
[49] EDWARD J. MCCAFFERY, FAIR NOT FLAT 75 (2002).
[50] *Id*. at 105.
[51] *Id*. at 75.
[52] *Id*. at 110.

argument that consumption spending takes from society and thus is to be discouraged is odd in the sense that the voluntary market purchase of consumption (representing about 70% of economy activity) makes both the seller and the buyer better off under traditional economic thought.

> Buyers and sellers engage in market exchanges because they benefit from the trade. As a general rule both sides are better off after the exchange than they were before the exchange. Buyers are better off because they have a net gain in consumer surplus [the difference between the price actually paid by the consumer and the higher price that the consumer was willing to pay]. Sellers are better off because they have a net gain in producer surplus [the difference between the price actually received by the seller and the lower price that the seller was willing to accept]. Voluntary market exchanges are undertaken because they are beneficial to both sides of the transaction. If buyers and sellers did not gain from the trade, then they would not voluntarily undertake the trade.[53]

Thus, when I buy apples from the orchard owner, both of us are thought to benefit. When I decline to buy the apples, both of us are thought to suffer. The gains from trade are what make an economy grow. Overconsumption of nonrenewable resources (think fossil fuels) can do damage (as discussed below), but consumption tax advocates who decry consumption as "taking" from society are not focused on the consumption of limited resources but rather *all* consumption.

While consumption tax advocates sometimes attempt to frame their support in terms of fairness, the argument that saved wealth benefits society at large (mentioned in the quotation by Professor McCaffery) is really, at bottom, an economic argument. Here is the argument: the economy would benefit if all savings were freed from tax under a consumption tax because (1) there is an insufficient supply of affordable capital for businesses to start and grow, (2) people would substitute savings behavior for spending behavior if we taxed only consumption, (3) this increase in savings would increase the pool of capital available to businesses, thus lowering the cost of capital for businesses (by lowering interest rates), (4) businesses would deploy the newly affordable capital supply to start and expand businesses that they could not before because of the lack of affordable capital, (5) the increased supply of goods and services made possible by these events would increase economic growth, (6) the gains from growth would be shared by both labor and owners of capital, and thus (7) everyone in society would be made better off. This is what Congressman Ryan meant when he said (in the quotation a few pages earlier): "Not only is this [taxing only wages and not capital returns] fair to individual taxpayers, it also is good for the economy. Greater savings leads to more investment and higher rates of productivity. Higher productivity ultimately drives increased living standards."

Each of these assumptions, of course, raises empirical questions and addressing them requires that we move on to consider the economic theories and debates that influence tax policy choices.

### *Welfare economics*

Economists concern themselves with economic efficiency, but different groups of economists can sometimes approach this concept stressing different aspects of it. The traditional adherents of **welfare economics** define economic efficiency by reference to "utility" or well-being (with roots in utilitarianism), under which **government interference in the marketplace is considered efficient if it would make at least one person better off and no one worse off (called "Pareto"**

[53] www.amosweb.com/cgi-bin/awb_nav.pl?s=wpd&c=dsp&k=gains+from+trade.

**efficiency)**. Measuring whether people are better or worse off, however, is done by reference to their utility rather than to nominal dollars taken or received. Moreover, even if Pareto efficiency is not present (because the move will make at least some people worse off, measured by utility), welfare economists may still support the move if the ***utility gains of the winners outweigh the utility losses of the losers*** under a cost-benefit analysis—referred to as Kaldor-Hicks efficiency, after the economists who described it. Notice, therefore, that traditional welfare economics implicitly incorporates a concern for both economic efficiency (a well-functioning economy) and equity.

Because utility theory has had the greatest impact in the tax realm on views regarding whether the tax rate structure should be proportionate, regressive, or progressive relative to income, let's revisit that issue more deeply here. In each example below, assume that Poor earns $15,000 of income each year and that Rich earns $500,000.

**A tax rate structure that is *proportional relative to income* is one in which everyone's *effective tax rate* (tax paid/aggregate income) is the same.** For example, assume that all income is taxed at 15%, with no Standard Deduction, Personal and Dependent Exemption Deduction, or other non-normative deductions, *i.e.*, deductions not necessary to measuring "income" properly. In other words, the first dollar earned is taxed at the same rate as the last dollar earned. While Poor would pay $2,250 in tax and Rich would pay $75,000, each would have an effective rate of 15% ($2,250/$15,000 for Poor and $75,000/$500,000 for Rich).

**A tax rate structure that is *regressive relative to income* is one in which the effective tax rate declines as income rises.** For example, assume that the first $100,000 of income is taxed at 15% but that all income in excess of $100,000 is free from tax. Poor would again owe $2,250 and again have an effective tax rate of 15% ($2,250/$15,000), while Rich would owe $15,000 and have an effective tax rate of 3% ($15,000/$500,000). Rich paid more in tax ($15,000) than did Poor ($2,250), but his effective tax rate (the percentage of his income paid in tax) was less. (This roughly describes the payroll taxes. As described earlier, in 2016, the first $118,500 of labor income is taxed at a combined employer/employee Social Security and Medicare Tax rate of 15.3%, while labor income in excess of that figure is taxed at 2.9.

**A tax rate structure that is *progressive relative to income* is one in which the effective tax rate rises as income rises.** A progressive rate structure is argued by some to be more fair under **vertical equity** (a companion to the notion of horizontal equity described earlier), under which **differently situated taxpayers should be taxed differently**. For example, assume that the first $10,000 if income is free from tax but that all income in excess of $10,000 is taxed at 15%. Poor would owe $750 in tax and would have an effective tax rate of 5% ($750/$15,000), while Rich would owe $73,500 and would have an effective tax rate of 14.7%. Thus, notice that a rate structure consisting of only two rates ($0 on a threshold amount of income and 15% on all income exceeding that threshold) is progressive, though it is much less progressive than under a graduated rate structure, in which marginal rates increase as income increases, as under current law. Recall, however, the material in Chapter 1, Part A., where we saw that effective tax rates for the superrich are lower than for the merely rich because of the preferential rate applied to net capital gain and dividends, which are heavily concentrated at the top of the income and wealth spectrum.

If one concludes that the tax burden should be progressive relative to income, another issue that affects the debate is how progressivity should be *framed*. Is the right inquiry one that asks how much of the aggregate tax burden is paid by each income group, *e.g.*, how much of the aggregate

tax collected is paid by, say, the top one-tenth of 1% of income earners (or perhaps wealth holders)? Or is the right inquiry one that asks how much of *pre-tax* income is paid in tax by each income group, which takes into account trends in pre-tax income and changes in tax rates at the top?

You can see how framing issues affect the debate in the following excerpt from a Congressional Research Service report: "[T]he top 0.1% of taxpayers paid 9.4% of all income taxes in 1996 and 11.8% in 2006 but their share of income paid in taxes decreased from 33% in 1996 to 25% in 2006."[54] An observer focusing on the first half of that sentence might say that the progressivity of the income tax *increased* for the top one-tenth of 1% of taxpayers between 1996 and 2004 because that portion of the population paid a larger portion of aggregate tax in 2004 than in 1996. Another observer focusing on the second half of that sentence might say that the progressivity of the tax burden *decreased* during that same period because the effective tax rate for the very wealthy decreased between 1996 and 2004. (The second half of the statement also explains in part why wealth inequality is growing even faster than income inequality.)

A graduated, progressive rate structure, under which both marginal and effective rates rise as income rises, is sometimes defended by welfare economists by reference to **the declining marginal utility of money**. The idea is that the last dollar earned by Warren Buffett, who is very wealthy, is worth less to him than the last dollar earned by the Little Match Girl, who may die without it because it represents subsistence income. That is to say, the "utility" or satisfaction that each additional dollar brings decreases as you obtain more and more dollars, which justifies allocating the tax burden so as to take progressively more of them as their utility decreases. In this way the utility gains of the winners (the *value* that the $1 represents to the Little Match Girl) outweigh the utility costs of the losers (the *value* of Warren Buffett's last dollars earned).

A different justification for a progressive rate structure was crafted by Canada's Royal Tax Commission in 1966.[55] It advocated that the tax rate structure should be *proportional* (*i.e.*, a single, flat rate) relative to *discretionary* income (instead of all income), which it defined as the portion of total income not necessary to maintain the household. The Commission made immediately clear that "[m]aintenance is not synonymous [sic] with bare, physical subsistence. Rather, it denotes the provision of services necessary to maintain the appropriate standard of living of the family or unattached individual relative to others." In other words, as income increases, it is reasonable to assume that a larger dollar amount will be needed to maintain it, unlike a flat-amount Standard Deduction that applies to all households (regardless of income). Nevertheless, the Commission assumed that, as income rises, a larger and larger percentage of total income is discretionary income that is not necessary to maintain the household.

One way to achieve this result would be "to establish an ascending schedule of proportions of income that would represent discretionary [income], and then subject these to a proportional [*i.e.*, flat-rate] tax." The Commission conceded that "the fraction of a tax unit's income available for discretionary use is not an objective phenomenon" but rather would result from the political process.

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[54] Thomas L. Hungerford, CONGRESSIONAL RESEARCH SERVICE, TAXES AND THE ECONOMY: AN ECONOMIC ANALYSIS OF THE TOP TAX RATES SINCE 1945 (UPDATED) (2012), at www.fas.org/sgp/crs/misc/R42729.pdf.

[55] 3 REPORT OF THE ROYAL COMMISSION ON TAXATION 1–24 (1966). All quotations in the text are taken from this report. *See also* Deborah A. Geier, *The Taxation of Income Available for Discretionary Use*, 25 VA. TAX REV. 765 (2006) (using this report as a point of departure in considering tax reform).

| | | Discretionary Income | | Tax on Discretionary Income at an Assumed Rate of 50 per cent | | | |
|---|---|---|---|---|---|---|---|
| Income Bracket ($) | Assumed Fraction of Income in Bracket Available for Discretionary Use | From Bottom to Top of Bracket $ | Cumulative Total to Top of Bracket $ | From Bottom to Top of Bracket $ | Cumulative Total to Top of Bracket $ | Marginal Rate of Tax on Income in Bracket a/ % | Average Rate of Tax on Income at Top of Bracket b/ % |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
| 0 - 195 | 0.0 | 0 | 0 | 0 | 0 | 0 | 0.0 |
| 195 - 390 | 0.1 | 20 | 20 | 10 | 10 | 5 | 2.5 |
| 390 - 781 | 0.2 | 78 | 98 | 39 | 49 | 10 | 6.3 |
| 781 - 1,562 | 0.3 | 234 | 332 | 117 | 166 | 15 | 10.6 |
| 1,562 - 3,125 | 0.4 | 626 | 958 | 313 | 479 | 20 | 15.3 |
| 3,125 - 6,250 | 0.5 | 1,526 | 2,520 | 781 | 1,260 | 25 | 20.2 |
| 6,250 - 12,500 | 0.6 | 3,750 | 6,270 | 1,875 | 3,135 | 30 | 25.1 |
| 12,500 - 25,000 | 0.7 | 8,750 | 15,020 | 4,375 | 7,510 | 35 | 30.0 |
| 25,000 - 50,000 | 0.8 | 20,000 | 35,020 | 10,000 | 17,510 | 40 | 35.0 |
| 50,000 - 100,000 | 0.9 | 45,000 | 80,020 | 22,500 | 40,010 | 45 | 40.0 |
| 100,000 - 200,000 | 1.0 | 100,000 | 180,020 | 50,000 | 90,010 | 50 | 45.0 |

The Commission then concluded that "a more familiar method to achieve the same result would be to apply to a base that measures [total income, rather than only discretionary income] a schedule of progressive rates of tax." That is to say, the same tax can be computed by multiplying the marginal rates in the penultimate column above by the *aggregate* income (not limited to "discretionary" income) in each of the brackets in the first column.

Voila! We have a progressive rate tax on total income.

### *Chicago-school-style economics*

A group of economists at the University of Chicago in the 1970s and 1980s focused more single-mindedly on economic efficiency and its impact on aggregate economic growth, with little or no concern for utility or equity (*i.e.*, the distribution of the fruits of that economic growth). The work of this group is sometimes referred to as the "Chicago school"[56] or sometimes "neoclassical economics" and is most closely associated with a vigorous form of **free market economics**, under which **economic efficiency is defined as the unrestricted flow of dollars and talent to their**

[56] *See, e.g.*, Paul Krugman, *The M.I.T. Gang*, at www.nytimes.com/2015/07/24/opinion/paul-krugman-the-mit-gang.html. This short article compares "the ascendancy for laissez-faire economic ideas and the Chicago school, which promoted them" in the 1970s and 1980s with more recent influential economists trained at the Massachusetts Institute of Technology, such as former Federal Reserve Chair Ben Bernanke, where "Keynes never went away." The M.I.T. view, he asserts, "was overwhelmingly vindicated after crisis struck in 2008. Chicago school types warned incessantly that responding to the crisis by printing money and running deficits would lead to 70s-type stagflation, with soaring inflation and interest rates. But M.I.T. types predicted, correctly, that inflation and interest rates would stay low in a depressed economy, and that attempts to slash deficits too soon would deepen the slump."

**highest and best uses, thus maximizing aggregate societal wealth, through vigorous bargaining among the buyers and sellers of goods and services, each with full information, on price—without constraint or government interference.** Unlike more traditional welfare economics analysis, under which government action in the marketplace may not only be defensible but desirable, Chicago school economists argue that government interference in the price mechanism is (in the absence of a market failure) anathema, as such interference presumptively reduces aggregate societal wealth by directing goods and services to lesser efficient uses (reducing aggregate societal wealth). In short, to the neoclassical economist, free and unfettered market behavior is the guiding star, without regard to its effects on the distribution of wealth and income.

Except for one form noted below, taxation obviously interferes in the marketplace by affecting the cost of a good or service, so the name of the game with respect to taxes for the Chicago school is usually that **taxes should be structured so as to distort marketplace behavior as little as possible**, commonly referred to as ***the neutrality norm***. Market participants should not be artificially encouraged (through the tax structure) to, say, engage in behavior *A* over behavior *B* or to purchase good *C* over service *D*. Notice, therefore, that special tax preferences encouraging one marketplace behavior over another is discouraged under this school of thought.

The only perfectly efficient tax for such economists is an equal-amount head tax, such as one that requires each and every man, woman, and child to pay $12,340 to the Federal government in tax each year (as described in Part A.). Such a tax is perfectly efficient because it is imposed merely for existing. Except for the possibility of suicide, no change in behavior can result in avoidance of the tax, which means that the market (the price mechanism) will not be distorted by the tax.

Because an equal-amount head tax is not realistic, what is the next best alternative? The neutrality norm suggests a very broad tax base with few special exclusions or non-normative deductions (deductions having nothing to do with properly measuring SHS income) because the broader the tax base, the lower marginal rates can be and still raise *$X*. The lower the rates, the less likely the tax will be to interfere with economic decision-making and thus the less likely the tax will be to distort market prices. High marginal rates are anathema under this view because it is *at the margins* that behavior can (at least theoretically) be influenced. Here is an example using work effort.

**For example, if that last (marginal) dollar of labor income will be taxed at a high rate, perhaps the worker will choose not to earn it and substitute untaxed leisure for work—the *substitution effect*—decreasing economic efficiency and aggregate societal wealth. Of course, it is also true that increasing tax rates can cause people to work harder (not less) in order to meet a fixed target of after-tax discretionary income to save or spend. This offsetting effect is called the *income effect*.**

Moreover, work effort may not be very responsive at all—one way or the other—to marginal rates in the real world. The question is an empirical one. How sensitive is work effort to the marginal rate at which that labor income would be taxed? In economics jargon, what is the **elasticity of work effor**t? Chicago school economists generally prefer that we tax "inelastic" goods or services (rather than "elastic" goods or services) because taxing inelastic goods is less likely to result in behavior change. **An inelastic good or service is one for which supply or demand is unaffected by a price change, including a price change due to taxation**. If work effort is not very sensitive to marginal tax rates, *i.e.*, is relatively inelastic, then an increase in the marginal rate will not markedly change behavior and thus will not markedly reduce aggregate

societal wealth.

Most of us are employees. Very few employees are in a position to decide whether or not to work an extra hour for extra pay—to trade an hour of (untaxed) leisure for an additional hour of (taxed) labor. As described in Part A., the post-WWII era of very high marginal rates at the top saw robust economic growth rates. Economic growth rates have been much lower in the modern era of relatively low tax rates, though (as any good empiricist will tell you) correlation is not causation. At the least, empirical evidence is weak regarding a strong disincentive effect of taxes on work effort.[57]

A related issue to elasticity is tax salience. **Tax salience refers to the visibility of the tax (or a tax preference).** The more invisible the tax (or a tax preference), the less likely it may affect behavior and, thus, the less likely it may interfere with the allocation of resources across the economy. While low-salience taxes may be more efficient, they may also present transparency and distributional concerns. If the salience of a tax is low, the tax's burden can be more easily imposed in a regressive manner on the unsuspecting. For example, most employees probably do not appreciate that the incidence of the employer-paid portion of Social Security and Medicare Taxes likely falls on them through wages that are depressed by an equivalent amount, as discussed earlier.

A critical distinction that often is obfuscated by political partisans misusing economic principles is the difference between "pro-market" and "pro-business." Chicago school economists are not "pro-business" in the sense that they support tax provisions that funnel benefits to business activity. Indeed, many such provisions are anathema to such economists because they interfere with the market's allocation of resources. Thus, beware the politician arguing that a tax preference benefiting business activity needs to be enacted or maintained in order to help the economy grow. The partisan is misusing economic theory to sound neutral while actually advocating market distortion.

Even Chicago school economists do not object to interfering in market price, however, to ameliorate **market failures** because market failures are presumptively inefficient, including the distortions imposed by monopoly power, negative externalities, and rent-seeking behavior. In addition, economists may not object to a special tax incentive to encourage behavior resulting in positive externalities, if structured well.

***Negative and positive externalities and Pigovian taxes***

**Negative externalities are harms imposed on others that are not captured in market price**. The most common current example is environmental damage. For example, mining companies or oil companies can sometimes damage the environment but impose the costs of that damage on others. A carbon tax imposed on oil and mining companies, effectively increasing the price of their product to consumers, can decrease demand for the item (by encouraging, under the substitution effect, the purchase of alternative fuels by consumers) or can create revenue used to ameliorate the damage. The higher price effectively forces the companies to "internalize" the environmental damage costs. Sometimes these penalty taxes imposed to combat negative externalities are called Pigovian taxes (or sometimes Pigouvian taxes) after the British economist Arthur Pigou, who showed how imposing a tax on pollution could actually increase economy efficiency.

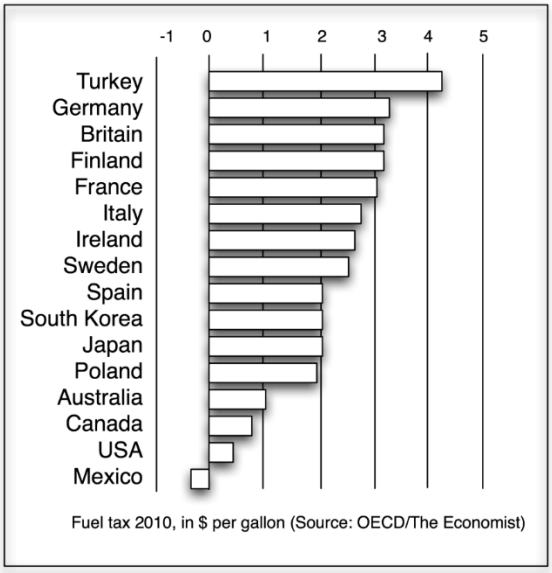
Swapping a portion of our income tax or payroll taxes with some form of carbon tax (whether

[57] *See, e.g.*, Christina D. Romer, *That Wishful Thinking About Tax Rates*, at http://www.nytimes.com/2012/03/18/business/marginal-tax-rates-and-wishful-thinking-economic-view.html?_r=0.

imposed on carbon emitters or carbon consumers) in a revenue-neutral manner is a hotly debated Pigovian tax topic. Please click and read the following article:

www.nytimes.com/2012/07/05/opinion/a-carbon-tax-sensible-for-all.html.

As shown in the chart below,[58] drivers in Turkey, Germany, Britain, Finland, and France pay more than $3.00 in tax per gallon of gasoline. Drivers in the United States, in contrast, pay approximately $.40 cents in tax per gallon. Mexico is the only country to subsidize gasoline usage.




Of course, a flat-rate carbon tax imposed on the first dollar of carbon consumption (like other flat-rate consumption taxes) is regressive relative to income, which is why some consider them to be less fair than income taxes. How regressive a carbon tax would be depends on which taxes would be reduced in a revenue-neutral adoption of the tax. If the revenue raised through the new carbon tax were used to reduce payroll taxes, for example, the distributional impact would be quite different than if the revenue raised were used to reduce, say, corporate taxes or the estate tax.[59]

Other common Pigovian taxes are those imposed on cigarettes and alcohol. More recently, some have proposed imposing Pigovian taxes on sugared soft drinks in an effort to combat obesity an diabetes.[60] But regulation is a common alternative to Pigovian taxes in combatting negative externalities, and former New York City Mayor Michael Bloomberg famously proposed such a regulation, which would have proscribed the sale of soft drinks larger than sixteen ounces by restaurants, sports arenas, movie theaters, and street carts. The proposal relied on several cognitive

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[58] Peter Uetz, June 2, 2012, at http://commons.wikimedia.org/wiki/File:Fuel_tax_in_OECD_countries,_2010..png. Attribution-Share Alike 3.0 Unported license.

[59] *See, e.g.*, Donald Marron & Eric Toder, THE TAX POLICY CENTER, *Carbon Taxes and Corporate Tax Reform*, at www.taxpolicycenter.org/UploadedPDF/412744-Carbon-Taxes-and-Corporate-Tax-Reform.pdf; Donald Marron, Eric Toder & Lydia Austin, *Taxing Carbon and Recyling the Revenue: Who Wins and Loses?*, 149 TAX NOTES 1085 (2015).

[60] *See* Margaret Sanger-Katz, *Yes, Soda Taxes Seem to Cut Soda Drinking*, www.nytimes.com/2015/10/13/upshot/yes-soda-taxes-seem-to-cut-soda-drinking.html?_r=0. *See generally* Victor Fleischer, *Curb Your Enthusiasm for Pigovian Taxes*, 68 VAND. L. REV. 1673 (2015) (describing the conditions under which Pigovian are, and are not, well-suited to the negative externality at issue).

biases.

> Bloomberg's proposal makes clever use of what economists call "default bias." If you offer a choice in which one option is seen as a default, most people go for that default option. People who are automatically enrolled in a retirement plan, for instance, are more likely to stay with their original plan than those who choose plans for themselves. In countries where people have to choose to be an organ donor, most people aren't donors; in countries where people have to actively say they don't want to be an organ donor, most are donors. The soda ban makes sixteen ounces or less the default option for soda drinkers; if they want more, they'll have to make an extra effort.
>
> …
>
> [R]esearch shows that what people "want" has a lot to do with how choices are framed. In one well-known study, researchers put a bowl of M&M's on the concierge desk of an apartment building, with a scoop attached and a sign below that said "Eat Your Fill." On alternating days, the experimenters changed the size of the scoop—from a tablespoon to a quarter-cup scoop, which was four times as big. If people really ate just "what they want," the amount they ate should have remained roughly the same. But scoop size turned out to matter a lot: people consumed much more when the scoop was big. This suggests that most of us don't have a fixed idea of how much we want; instead, we look to outside cues—like the size of a package or cup—to instruct us.
>
> …
>
> [T]he mere existence of the supersize can change your idea of how much you want to drink. In a classic experiment by Itamar Simonson and Amos Tversky, people asked to choose between a cheap camera and a pricier one with more features were divided more or less equally between the two options. But when a third option—a fancy, very expensive camera—was added to the mix most people went for the mid-range camera. The very expensive camera made the middle one seem less extravagant. In the same way, the fact that a large soda is now forty ounces makes a twenty-ounce soda feel sensible. Bloomberg's ban is designed to flip this effect on its head ….
>
> Many economists would say that, if we want to discourage soda consumption, taxing it—the way we do alcohol and tobacco—would be more efficient than a ban. Some European countries do have such taxes, but the idea has been a political non-starter in New York.[61]

As the excerpt notes, regulation tends to be less efficient than Pigovian taxes in reducing some types of negative externalities. Returning to the carbon tax example, for instance, reducing gasoline consumption through regulating mileage standards in new cars is not nearly as effective in reducing gasoline consumption as a carbon tax would be.

The weakness with the fuel economy rules is that they don't affect people's

[61] James Surowiecki, *Downsizing Supersize*, THE NEW YORKER, the Financial Page, August 13 & 20, 2012, at 36, and at www.newyorker.com/talk/financial/2012/08/13/120813ta_talk_surowiecki. *See also* Jonathan Masur & Eric Posner, *Toward a Pigovian State*, 164 U. PA. LAW REV. 93 (2015) (arguing that government regulators should choose Pigovian taxes over regulation in combatting many negative externalities).

> behavior the way higher gas prices do. They apply only to new vehicles—not the ones on the road now—so it takes quite a long time to alter our overall gas use. And they carry perverse incentives: because new vehicles go farther on a gallon of gas, they give us a reason to drive more, leading to more congestion, pollution, and gas consumption….
>
> According to economists crunching the numbers, this makes mileage standards somewhere between 2.4 and 13 times more expensive than a gasoline tax as a tool to reduce our use of fuel….
>
> In Britain, where gas and diesel are taxed at $3.95 a gallon, the American automaker Ford sells a compact Fiesta model that will go nearly 86 miles on a gallon. In the United States, where gas taxes average 49 cents, Ford's Fiestas will carry you only 33 miles on a gallon of gas.[62]

While economists almost universally prefer a carbon tax over fuel economy regulation, surveys show that the public is largely unimpressed by what most economics think, as illustrated in polling described by THE ECONOMIST magazine. "Whereas 93% of economists reckoned a carbon tax is a less costly way to cut emissions than car fuel-mileage standards, only 23% of the public agreed. Such divergence may help to explain the lack of traction for the policy in Washington, D.C."[63]

**Positive externalities are benefits enjoyed by others that are not captured in market price**. If a business cannot capture the full benefit (in market price) from certain activities that create positive spillover effects for society at large, the business may underinvest in that activity, to the detriment of society. A classic example is research and development.

> An exception to the level-playing-field rule arises when industries generate positive externalities. Businesses that conduct significant amounts of research and development generate positive spillover benefits for the economy for which they are not fully compensated. Therefore, there is an economic justification for a tax subsidy directed to research-intensive industries.[64]

But the incentive must be well targeted to activities that produce significant positive externalities for society at large and structured to avoid "windfall benefits" (more below) to be efficient.[65]

### *Rent-seeking behavior*

Another important market failure relevant to tax policy, in addition to the problem of negative externalities, is "rent-seeking" behavior—a phenomenon that we shall revisit from time to time (particularly in connection with tax shelters). The term "economic rents" here has a special meaning to economists that has nothing to do with the common meaning of that word to those students who pay money to a landlord to live in an apartment. You can think of **rent-seeking**

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[62] Eduardo Porter, *Taxes Show One Way To Save Fuel*, at www.nytimes.com/2012/09/12/business/fuel-efficiency-standards-have-costs-of-their-own.html.

[63] *Free Exchange: If Economists Agree on Something, the Public Will Almost Certainly Think Differently*, THE ECONOMIST, Jan. 12, 2013, at 66, and at www.economist.com/news/finance-and-economics/21569378-if-economists-agree-something-public-will-almost-certainly-think.

[64] Martin A. Sullivan, *The Simple Economics of Like-Kind Exchanges*, 148 TAX NOTES 491, 493 (2015).

[65] *See id.* (criticizing the tax preference for like kind exchanges, discussed in Chapter 13). *See also* Martin A. Sullivan, *Benefits of Boustany-Neal Patent Box Vary Widely*, 148 TAX NOTES 707 (2015) (criticizing a proposed tax subsidy to certain income obtained from intellectual property and related activities).

**behavior** as **manipulation of the social or economic environment to enrich oneself *without creating new wealth*** or, in the pithy words of the The Economist magazine, **"[c]utting yourself a bigger slice of the cake rather than making the cake bigger**."[66] The "profit" enjoyed by the rentier is not *real* profit; rather, it represents mere wealth-shifting from one to another *without* profit to the economy as a whole. A common example of illegal rent-seeking behavior is blackmail, but much rent-seeking behavior is legal, if inefficient. A recent example from the popular press is the increase in price charged by Turing Pharmaceuticals for a decades-old drug that Turing merely acquired, raising the price overnight from $13.50 to $750 per pill.[67] Economists Lucian Bebchuk, Jesse Fried, and David Walker have provocatively argued that the very dramatic increases seen in U.S. executive compensation packages over the last several decades (with the average CEO pay rising from 20 times the average worker's pay in 1965 to 278 times as much today)[68] are a result of rent-seeking behavior, with the cross-fertilization on corporate boards of these executives blessing each others' escalating pay packages at the expense of workers and shareholders.[69] If that is true, a special penalty tax on executive compensation exceeding a stipulated threshold (such as § 162(m), discussed in Chapter 20) could be defended even by champions of a vigorous free market.

Economic rents in the tax context can be described as wealth accessions enjoyed by a person that would not have occurred in a perfectly competitive and transparent economy but rather arise by gaming the system, as in Profiteer's rent-seeking behavior described in Chapter 2. The after-tax profit that Profiteer could command by purchasing § 103 bonds paying 4% interest with borrowed money charging 5% interest (absent effective application of § 265(a)(2)) represents not some daring entrepreneurial activity that created new wealth but, rather, a simple transfer from the Federal Treasury, funded with tax dollars paid by you and me, to Profiteer. Profiteer is a "rentier."

### *Supply-side economics*

**Supply-side economics** is simply one way to describe the most strident form of Chicago-school style economics. It heavily influenced tax policy debates in the Reagan administration and remains controversial today. Detractors of supply-side economics dismiss it as "trickle-down economics." The opposite of supply-side economics is a **demand-side** policy prescription in the face of lackluster growth that often is referred to as **Keynesian stimulus** after the early 20th century economist John Maynard Keynes.

Economic growth is generally dependent on both the available **supply** of goods and services for sale in the marketplace and the **demand** for those goods and services from customers able and willing to buy them. Economic growth can be dampened from either the supply side (*e.g.*, a lack of physical, human, or financial capital to create the goods or services that buyers want) or the demand side (*e.g.*, the lack of money in the hands of the consuming public with which to buy the proffered goods and services). If lack of capital (supply) is the problem, one response can be to reduce the tax rates on capital returns or at the top of the income spectrum so that more money is in the hands of the suppliers of goods and services to meet the previously unmet demand, which

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[66] www.economist.com/economics-a-to-z/r.

[67] *See, e.g.*, Julie Creswell & Andrew Pollack, *The Bad Boy of Pharmaceuticals Hits Back*, at www.nytimes.com/2015/12/06/business/martin-shkreli-the-bad-boy-of-pharmaceuticals-hits-back.html?_r=0.

[68] James Surowiecki, *Open Season*, THE NEW YORKER, Oct. 21, 2013, at 31, and at www.newyorker.com/talk/financial/2013/10/21/131021ta_talk_surowiecki.

[69] Lucian Bebchuk, Jesse Fried, and David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

will, in turn, increase the number of jobs and the (taxable) wages of workers sufficiently to partly offset the revenue loss from the supply-side tax cuts.

If lack of demand is the problem because consumers' buying power is depressed (through, say, increased unemployment or stagnant wages), one response can be to reduce taxes at the lower end of the income scale so that broad swaths of consumers have more after-tax income left to purchase goods and services. This increased demand will, in turn, increase the number of jobs and the (taxable) wages of workers sufficiently to partly offset the revenue loss from the demand-side tax cut. (An example of a demand-side move purely in the private sector was when Henry Ford more than doubled the wages of his workers on the factory floor so that they could purchase the cars that they were manufacturing. Ford's revenue loss—from more than doubling his workers' wages—was partly offset by the increased profits he realized by being able to sell more automobiles.)

Whether a supply-side stimulus or a demand-side (Keynesian) stimulus is successful is, of course, a matter of empirical inquiry, but empirical inquiry is muddied by the inability to isolate easily any one factor in measuring the effect on economic growth of these tax changes. Nevertheless, it is worth noting that top rates are now so low by historical standards that any supply-side effect from further reduction is, even if present, likely diminished. The reductions in the top rate from 91% to 70% (Kennedy administration) and from 70% to 28% (Reagan administration) were dramatic. Further dramatic reductions are unlikely.

Moreover, recall the material in Part A. regarding how economic growth rates were much higher from the post-WWII era to the mid-1970s (when the top marginal rate was much higher than today) and have been notably lower since then (with much lower top marginal rates), even though the amount collected in aggregate income tax as a percentage of GDP has remained remarkably constant at the individual level and has been reduced substantially at the corporate level throughout this period. The robust growth rates in the post WWII era, however, may have had more to do with the devastated state of Europe (particularly Britain, Germany, and France) and Japan after the war and the quiescence of China and India, which were not major economic powers, resulting in the U.S. being a major net exporting nation during this period (whereas today the U.S. is a net importing nation). Moreover, the more evenly distributed gains from growth in the three decades after WWII demonstrated in Part A.—with the bottom 80% of the income spectrum actually garnering a bit more of the gains from growth than those at the top—may have had more to do with the much larger presence and strength of private-sector labor unions and such government spending programs as the GI bill (which allowed many to be the first in their families to attend college) than the tax rate structure. In short, these are empirical questions that are difficult to untangle and easy assumptions (often made by partisans with a particular point of view to forward) should be met with skepticism. The tax code may have much less power to affect these matters than is often assumed without sufficient evidence.

In addition, many economists assumed in the past that the growing wealth and income inequality seen in recent decades was merely a function (and unavoidable cost) of a vigorous, growing economy. Today, however, many are abandoning that assumption, with more recent evidence showing that significant wealth and income inequality actually contributes meaningfully to sluggish economic growth rates in the first place because of the demand-side drag when the middle class has less discretionary income to spend.[70]

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[70] *See, e.g.*, Annie Lowry, *Income Inequality May Take Toll on Growth*, at www.nytimes.com/2012/10/17/business/economy/income-inequality-may-take-toll-on-growth.html?pagewanted=all

A more subtle aspect of supply-side argumentation (separate from advocating a reduction in the top marginal rates on all income) is that it supports the switch in tax base from income to consumption, as suggested earlier. To review, the argument is this. Suppliers of goods and services need more cheap capital to invest, to create these goods and services. By cheap capital I mean, for example, the ability to raise corporate capital by selling corporate bonds at a low interest rate. What brings interest rates down? The argument is that if we just *save* more and thereby increase the *pool of available capital* interest rates will necessarily go down under the laws of supply and demand because interest rates go down when there is a lot of capital (savings) chasing productive investments. If capital is scarce, in contrast, savers can demand higher interest rates, and businesses have a harder time raising capital at a cost-effective price.

So the argument is that we can increase the pool (and thus lower the cost) of available capital that can be productively invested by businesses if we tax only consumption and not savings.[71] The gains from this ensuing increase in economic growth would then be shared by both labor (wages) and capital, increasing living standards for all. Again, this view is reflected in the quotation from Congressman Ryan's tax-reform plan quoted earlier in this chapter.

Is it a convincing argument? The argument assumes many things. The argument first assumes that there is a dearth of savings available to U.S. business so that interest rates are high, making it difficult for businesses to form and expand. But that assumption appears to be not just untrue but glaringly, obviously untrue. Interest rates are at historic lows, with lots of talk of a "global savings glut" looking for places to invest (even while Americans' savings rates decreased over the last several decades of stagnant wage growth).[72] Indeed, the global savings glut has been blamed in part for our repeated stock and asset bubbles since the late 1990s. "[T]hese aren't just a series of unrelated accidents. Instead, what we're seeing is what happens when too much money is chasing too few investment opportunities…. [W]hat's important now is that policy makers take seriously the possibility, I'd say the probability, that excess savings … is the new normal."[73] And corporations are sitting on literally trillions of undistributed profits—a huge pool of untapped capital. But, for the sake of argument, let's assume that we need to increase the savings rates of Americans to increase available capital for businesses to start and expand.

The argument that a consumption tax would meaningfully increase the savings rates of Americans relies on the "substitution effect" described earlier, except now it refers not to substituting untaxed leisure for (taxable) work effort but rather substituting savings behavior (which would be free of tax under a consumption tax until spent on consumption) for spending behavior (immediately taxed). In other words, if we tax all savings at a zero rate—the argument

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(summarizing studies); Annie Lowrey, *Obama Adopts Catchphrase to Describe Proposed Recipe for Economic Revival*, at www.nytimes.com/2013/07/23/us/politics/president-adopts-catchphrase-to-describe-proposed-recipe-for-economic-revival.html?_r=0.

[71] Another way of framing the same issue is that, by taxing capital income, an income tax encourages current consumption over future consumption (and thus is non-neutral), whereas a consumption tax treats current and future consumption the same. For empirical doubts about this assumption, see Chris William Sanchirico, *Do Capital Income Taxes Hinder Growth?*, at https://publicpolicy.wharton.upenn.edu/issue-brief/v1n2.php.

[72] *E.g.*, Daniel Gross, *Savings Glut*, at www.slate.com/articles/business/moneybox/2005/06/savings_glut.html. Sheila C. Bair, the former Chair of the Federal Deposit Insurance Corporation, wrote in 2013: "A report last year by Bain and Co. projected that by 2020 there will be $900 trillion in financial assets around the globe, chasing investments in a real economy worth only $90 trillion in gross domestic product." Sheila C. Bair, *Grand Old Party*, at www.nytimes.com/2013/02/27/opinion/republicans-must-bridge-the-income-gap.html?_r+0.

[73] Paul Krugman, *A Moveable Glut*, at www.nytimes.com/2015/08/24/opinion/a-moveable-glut.html.

goes—the average consumer will increase his savings rate (the percentage of income saved), interest rates will fall as the pool of capital enlarges, and this increased pool of cheap capital can be exploited by business to generate more goods and services to sell to the public to meet unmet demand. Is that true?

Recall that offsetting the substitution effect is the "income effect," which (in this context) means that the taxpayers with fixed goals or "targets" for savings can *decrease* the percentage of income that they save (*i.e.*, decrease their savings rate) and still meet their target. To illustrate, assume that Bill has the target of saving $100,000 by the time that Junior reaches college or $1 million by the time that he retires and that Bill has determined that he must save 20% of his pre-tax income each year if savings are taxed under an income tax. If, however, the income tax is replaced by a consumption tax so that savings are not taxed, Bill may be able to save *less* than 20% of his income each year *and still reach his targets*.

As with the effect of income taxes on work effort, empirical evidence has been unable to determine precisely which effect predominates with respect to savings behavior, but the evidence tends to show that the vast majority of middle-class taxpayers are largely target savers (sometimes called "lifecycle savers"), while the wealthy tend to save at far higher rates for reasons unrelated to anticipated future consumption costs (or even planned future bequests).[74] Thus, for the vast majority of Americans, the income effect may predominate. If that is true, substituting a consumption tax for the income tax can have the counterintuitive effect of *decreasing* the percentage of pre-tax income that most Americans save. Indeed, savings rates began to decrease notably just after the introduction and widespread adoption of the IRA and § 401(k) account in the late 1970s and early 1980s, which are accorded consumption tax treatment, although (once again) correlation is not causation. For example, this decrease in savings rates occurred just about at the same time that income inequality began to accelerate and middle-class wages began to stagnate. Was the decrease in discretionary income remaining after meeting consumption needs behind the trend toward decreased savings rates? Again, these effects are difficult to disentangle.

Finally, it is worth noting that the major savings of most middle-class taxpayers are already taxed under consumption tax principles: (1) tax-preferred retirement accounts (such as qualified pension plans, IRAs and § 401(k) plans), (2) the built-in gain in personal residences (which is mostly or entirely tax-free under § 121, considered in Chapter 18), and (3) the inside build-up of life-insurance policies, which are tax-free to the insured while living and tax-free to the recipient (under § 101) when the proceeds are paid by reason of the death of the insured (considered in Chapter 7). Thus, a fair description of the current Internal Revenue Code is that it already operates mostly as a consumption tax for middle-class households (above a tax-free amount representing subsistence consumption) but as an income tax for wealthier households, whose savings exceed the limits that can be protected from taxation under our hybrid income-consumption tax. The most significant deviations from SHS income taxation for the wealthy are (1) not taxing property appreciation until realized (and completely forgiving tax at death, as described in Chapter 7) and (2) effectively not fully taxing capital gains (by taxing realized gains at a reduced tax rate). Thus, a move to pure consumption taxation would surely move the tax burden down the income scale.

***The limits of economic theory***

While neoclassical economists view a vigorous free market with both parties bargaining on

[74] *See, e.g.*, Christopher D. Carroll, *Why Do the Rich Save So Much?*, in DOES ATLAS SHRUG?: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH (Joel B. Slemrod ed. 2000) at 465.

price at arm's length and with full information as maximizing societal wealth as a whole, they cannot argue that the resulting *distribution* of wealth or income is "fair" or that it allocates wealth and income according to "just desserts" (*i.e.*, that those who garner disproportionate wealth or income "deserve" that share). As retired law Professor Alan Gunn once memorably put it:

> As a fan of a market economy, I am amazed at the number of people who think that prices (including wages) are supposed to measure what people "deserve." Prices are determined by supply and demand, period (absent government intervention, to be sure). Markets do what they do—mainly, putting information to use—very well. But one of the things they don't do is give people what they deserve. Complaining about this makes about as much sense as complaining that the laws of physics are unfair.[75]

Two public finance economists put it this way:

> [E]conomists have often proclaimed at congressional hearings and in the press that one tax system is superior to another. To make such a judgment, the economist is implicitly introducing his or her own values into the choice, values that Congress or the majority of Americans may not share. For this reason, in principle any panel of economists offering their opinions on the best tax system should be followed by a panel of philosophers or ethicists who offer their views on the ethics …. In practice, of course, we do not convene such a panel every time an adjustment in the pattern of tax liabilities is considered, and we rely on the political system to make these kinds of choices.[76]

Within the proper realm of economic evidence, we must take care regarding the limits of economic models premised on assumed behavior that may not reflect real-world behavior.

### What Legal Scholars Need to Know About Economic Research on Taxation: The Evidence Thoroughly Debunks the Conventional Wisdom[77]

Neil H. Buchanan

> *Reviewing* Peter Diamond & Emmanuel Saez, *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*, 25 JOURNAL OF ECONOMIC PERSPECTIVES 165 (Fall 2011).

Too often, policy research relies more on the misleadingly elegant results of economic theory than on actual evidence. Tax policy discussions, as I will describe below, are especially prone to being infected by this evidence-free approach to analysis. Fortunately, two of the best public finance economists in the world, Peter Diamond and Emmanuel Saez, have recently provided a much-needed antidote: *The Case for a Progressive Tax: From Basic Research to Policy Recommendations*. To understand just how important their article is, it is necessary to appreciate the deep roots of the problem that their article addresses.

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[75] Alan Gunn, e-mail submission to Taxprof, a closed, Internet discussion group for tax law professors at AALS-accredited law schools, April 24, 2002 (copy on file with author).

[76] JOEL SLEMROD & JON BAKIJA, TAXING OURSELVES: A CITIZEN'S GUIDE TO THE GREAT DEBATE OVER TAX REFORM (2d ed. 2000) 53.

[77] http://tax.jotwell.com/what-legal-scholars-need-to-know-about-economic-research-on-taxation-the-evidence-thoroughly-debunks-the-conventional-wisdom. Reprinted with permission.

As an economics graduate student, and later as a young economics professor, I often felt a deep sense of unease about the disconnect between economic theory and the empirical research that was relevant to evaluating that theory. Overwhelmingly, we learned in classes (and from theoretical scholarship) a series of "known results" that followed from the manipulation of economic models—results that, however nicely derived from the assumptions of those models, either were not backed up by any empirical research, or the magnitude of which turned out to be quite trivial.

For example, in macroeconomic theory courses (both those that were required of all first-year graduate students, and those that were only required of those of us who planned to specialize in macroeconomics), we learned that nearly all macroeconomic models included a deceptively simple assumption: Increases in the real interest rate ($r$) cause decreases in real business investment ($I$), and decreases in $r$ lead to increases in $I$. If $I$ is desirable, therefore, $r$ should not rise.

This was, moreover, presented to us as not merely an assumption that "makes the math work," but as an intuitively obvious matter as well. The real interest rate is a "price," that is, it is the cost of borrowing money to finance business investment, and every good economist simply *knows* that an increase in the price of anything leads to a decrease in its demand. In a revealing attempt to invoke the imprimatur of the hard sciences, this was confidently referred to as an application of "the law of demand."

But *how big* is the response of $I$ to $r$? Can it be entirely unresponsive? Can it, like some well-known "paradoxes," respond positively to changes in r, rather than negatively? When I began to look at the empirical research, I found not just that the evidence of a negative relationship between $I$ and $r$ was weak, but that decades of research had failed to turn up credible evidence of any relationship at all between the two variables (even ignoring questions regarding the direction of causality). Almost as a hobby, I found myself collecting quotations from top-tier macroeconomists, all of them confessing in various ways, "We keep looking for that elusive negative relationship between $r$ and $I$, but we can't find it." Even so, if you ask almost any economist today, "What is the relationship between $r$ and $I$?" he will almost surely say, with great confidence, "They're inversely related."

After I became a legal scholar, I focused on tax law and policy. This, too, is an area in which the "law of demand" is supposed to give us definitive answers to important questions. Taxes alter the prices that people face, and therefore, economic theory should supposedly be essential in telling us how to think about tax issues.

What makes the landscape of legal scholarship different, of course, is that most legal scholars have not been trained in economic theory. Perhaps understandably, therefore, they tend to defer to the views of economists on many issues. If an economist confidently states that "Economic theory tells us _____," the temptation for many legal scholars is to say, "Well, I don't know the economics, so I am in no position to say otherwise."

This deference to economists, of course, is hardly limited to legal scholars. Journalists, including business journalists, tend to regurgitate a standard set of statements about the world that are, in fact, nothing more than unexamined conclusory statements that the journalists have heard from orthodox economists. As one of many examples, the top economics writer for *The New York Times* confidently claimed a few years ago that "higher tax rates discourage work and investment, two crucial ingredients for economic growth. But higher taxes on consumption don't have nearly the same effect as taxes on incomes or companies. If anything, consumption taxes encourage savings, which lifts investment." How did he know any of this? The author did not even feel the

need to justify his assertions. Apparently, he felt that he was saying nothing more controversial than claiming that the sun rises in the East.

Such assertions of cause and effect are part of what many public finance economists are happy to tell us are "known results" from economic theory. After hearing these claims by economists, legal scholars who study taxation have, at least by my observation, generally (and quite erroneously) concluded that those results must be backed up by evidence and are uncontroversial among people who "know the economics." Those claims are, many people seem to believe, simply the Economic Truth. Other statements of supposed truth include the "double distortion" argument and the claim that inefficiency rises as the square of the tax rate, which are used to support the ideas, respectively, that we should not tax capital income, and that increases in marginal tax rates are increasingly harmful to the economy.

Similarly, it is often taken as received truth that subsidizing poorer people's wages creates a disastrous work disincentive. If a person believes that statement to be true, he can then insist that he does not *want* to ignore the plight of the poor, but that "economic theory tells us" that indulging our soft hearts by helping the poor would be pure folly.

The problem is that none of those cause-and-effect relationships is established by economic evidence—and, for most of them, the evidence leads to precisely the opposite conclusions. Just as I had found that the supposed relationship between interest rates and investment was not what was so often assumed, the empirical research on all of these tax-related questions does not support the received wisdom, either. By my reading, in fact, the evidence for those assertions is so weak that continuing to believe in them is little more than an act of faith—or superstition.

What I had not done, and what I had not seen from any other scholar, was to summarize the state of knowledge—both theoretical and empirical—about taxes and their effects on important social outcomes, to show that there is no "there there" to back up these oft-heard claims. Luckily, Diamond and Saez decided to do that difficult and important work. In the Fall 2011 issue of the *Journal of Economic Perspectives*, they summarized the best available research and, based on that evidence, made three specific recommendations:

> (1) "Very high earnings should be subject to rising marginal rates and higher rates than current U.S. policy for top earners,"
>
> (2) "Tax (and transfer) policy toward low earners should include subsidization of earnings and should phase out the subsidization at a relatively high rate," and
>
> (3) "Capital income should be taxed."

These recommendations are not the personal opinions of the authors. They are the conclusions that can be drawn from the existing body of economic research. In short, three of the key assumptions that too many public finance economists have successfully exported into legal tax policy research, and that legal scholars had no particular reason (or standing) to question, are unsupported by the evidence.

What makes the Diamond and Saez paper especially helpful is that it was published in an economics journal that requires authors to minimize the use of mathematical exposition, which makes the results comprehensible to non-economists. (For those who care about credentials, it also helps that Diamond recently won the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, commonly—though inaccurately—known as the Nobel Prize in Economics.) The exposition, while still tough sledding in places, allows interested readers to follow the logic and

evidence that the authors present.

Notably, Diamond and Saez do not merely say that the evidence is lacking to support the conventional superstitions about taxes, but that the evidence supports the *opposite* conclusions: that marginal tax rates on high incomes should be increased, that lower incomes should be subsidized, and that capital income should be taxed. Diamond and Saez are not writing on a blank slate. They are debunking received wisdom, exposing shibboleths that legal scholars need to un-learn if scholarship in taxation is to move forward, fulfilling its promise to guide policymakers toward wise decisions. For legal scholars with interests in tax policy, this is the essential article to read.

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***Tax expenditures***

The concept of "tax expenditures," first coined by then-Assistant Secretary for Tax Policy Stanley Surrey in the 1960s, is a critical one in tax policy debates, and it is one that deeply implicates both strands of tax policy analysis that we have been considering—fairness and efficiency—thus providing an apt topic to end this chapter.

**A "tax expenditure" deviates from core, normative concepts underlying the tax base in a way that implements nontax social or economic policy by providing either an incentive (to change behavior) or a subsidy (a transfer to a worthy recipient), or both, through the tax system that is the functional equivalent of a direct-spending program. Tax expenditures can be in the form of special deductions, exclusions, credits, or tax rates.**

Assume, for example, that Congress adopts a pure SHS income tax, with no non-normative departures (except for the realization requirement). Under a pure SHS income tax (or a consumption tax, for that matter), no deductions are allowed for personal consumption costs. Now assume that Congress decides that it wants to, say, defray the costs of childcare for working parents. Whether or not that decision is wise as a social policy matter, Congress has a choice regarding how to implement this decision, once made. It can leave the "pure" income tax alone (under which childcare costs would be nondeductible), collect the revenue under that tax, and use some of that revenue on a direct-spending program that sends checks to working parents (or a childcare agency) at a cost of, say, $100 billion each year. Alternatively, it could enact a "tax expenditure," creating a childcare deduction (or credit) that reduces the revenue collected in the first place by $100 billion each year—but only if the amount that would otherwise be included in the tax base is spent by the taxpayer on a qualified childcare program. *Both* options can be seen as government spending, but one is done via a direct-spending program while the other is done indirectly through a tax provision that deviates from a normative SHS income tax.

A direct-spending program may work better than the tax expenditure in achieving the desired behavior because of the impact, once again, of behavioral responses to the two types of programs. For example, a tax subsidy for child-care costs may increase employment of mothers less than would a direct spending childcare program. Please click and read the following article:

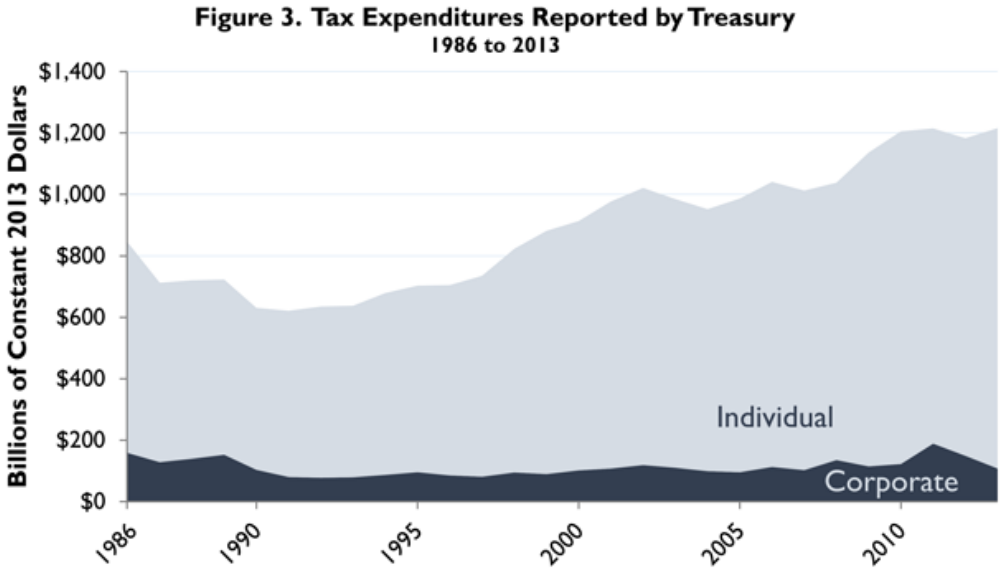
www.nytimes.com/2014/12/18/upshot/nordic-nations-show-that-big-safety-net-can-allow-for-leap-in-employment-rate-.html?_r=0&abt=0002&abg=0

Tax expenditures are non-neutral on their face; they can cause changes in behavior. Examples include buying a larger home than you otherwise might (instead of, say, investing in the stock

market) because of all the tax preferences for personal residences or providing compensation to employees in the form of health care instead of cash because of the exclusion for employer-provided health care.

Moreover, with some tax expenditures at least, it is problematic if they do *not* result in changed behavior because, in that case, the tax expenditure results in nothing more than an economically inefficient **windfall loss—tax revenue that Congress need not have given up because taxpayers would have engaged in the behavior even without the tax expenditure.** Rewarding behavior that would have been engaged in without the tax benefit loses revenue that must be made up with tax *rates* that are higher than they otherwise would have to be on, say, wages to raise *$X*. In other words, these base-narrowing provisions are not costless.

Tax expenditures have exploded in recent decades, as shown in the chart below.[78]




The revenue that goes uncollected each year because of tax expenditures (approximately $1 trillion) is only slightly less than the annual revenue collected under the individual income tax. Moreover, if all tax expenditures were repealed, the budget would be balanced (though virtually no one supports repealing them all).

Here are a few of the more notable income tax expenditures under the income tax aimed at individuals and their anticipated revenue costs for 2015 and from 2015-2019 (in billions).[79]

| | 2015 | 2015-2019 |
|---|---|---|
| Employer-provided and individual retirement savings incentives | $149.4 | $937.1 |
| Exclusion of employer-provided health care | 145.5 | 769.8 |

[78] William McBride, *A Brief History of Tax Expenditures*, at http://taxfoundation.org/article/brief-history-tax-expenditures. Reprinted with permission.

[79] JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURE FOR FISCAL YEARS 2015-2019, JCX-141-15 (Dec. 7, 2015), at www.jct.gov/publications.html?func=startdown&id=4855. These revenue estimates do not incorporate the revenue loss under the payroll taxes (Social Security and Medicare) pertaining to the exclusions for employer-provided health care and retirement savings.

| | | |
|---|---|---|
| Deductions for nonbusiness state income (or sales) and property taxes | 133.2 | 762.1 |
| Reduced rate on net capital gain and qualified dividends | 131.7 | 689.6 |
| Deduction of mortgage interest on owner-occupied residences | 71.0 | 419.8 |
| Earned income tax credit | 72.7 | 371.4 |
| Step-up in basis at death | 32.4 | 171.3 |
| Capital gains exclusion for sales of primary residences | 24.1 | 149.9 |

In addition, we shall in due course examine a few tax expenditures aimed at business activity, such as accelerated depreciation and the ability of small businesses to deduct certain capital expenditures immediately under § 179 as though they were current "expenses."

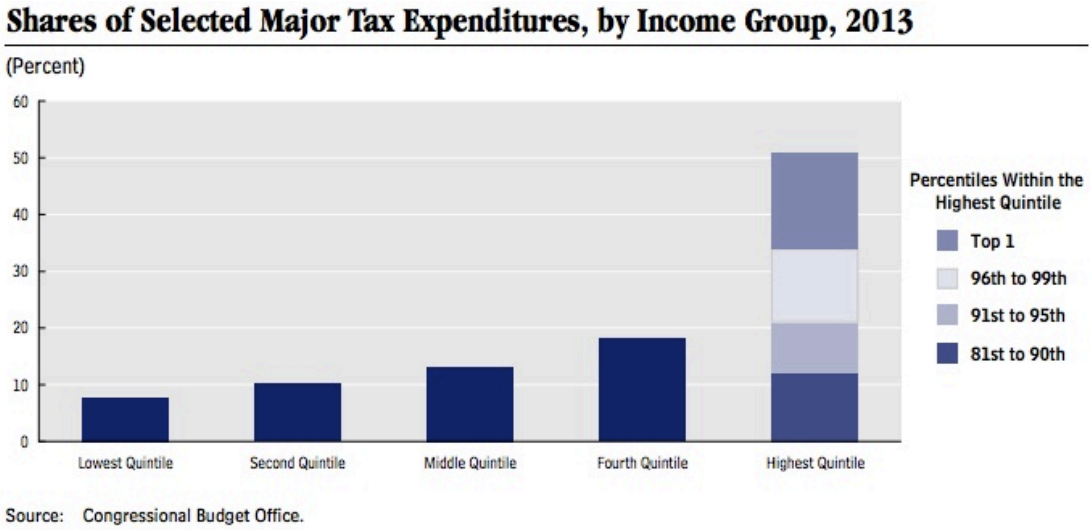
Tax expenditures have proliferated in part because some conservatives on the right see them as simply reducing tax revenues and thus reducing the size of government, while some liberals on the left see them as the only available political means to enact social spending. Because of this confluence, they are much easier to enact than direct spending programs and, once enacted, are very difficult to reduce, not only because of entrenched interests that spring up to defend them but also because of our shared cognitive biases. As mentioned earlier, under the **loss aversion cognitive bias**, we hate losing $1 more than we enjoy gaining $1. For example, phasing out the deduction for qualified residence interest paid with respect to personal residences is a tougher sell in a world with it than would failing to adopt it in a pretend world that does not already contain it. Also, under the **status quo cognitive bias**, we like things to stay relatively the same, or, stated differently, we are resistant to change. But they can have perverse effects in that some are upside-down benefits that disproportionately provide more benefits to those at upper-income levels than to those at the lower end of the income scale, which often is inconsistent with what might have been enacted under a direct-spending program equivalent.

For example, a taxpayer in the 39.6% tax bracket saves 39.6% cents in tax for every $1 of employer-provided health care excluded under § 106 (examined in Chapter 18), a taxpayer working for the same employer at a lower salary saves 25 cents for that *same $1* of employer-provided healthcare if the excluded dollar would otherwise fall in the 25% bracket, and someone whose employer does not provide health care does not benefit at all from this tax expenditure. If you were to think about how Congress might have crafted a direct-spending program equivalent aimed at subsidizing health care costs, you might understandably doubt that it would have chosen to subsidize highly paid employees more generously than lower-paid employees and would have chosen no subsidy at all for the employee whose employer fails to provide health care benefits. But this exactly describes the effect of the § 106 exclusion. Indeed, Jacob Hacker, a political scientist at Yale University, argues that the amount of social spending in the United States is *not* significantly lower than in the so-called welfare states in Europe but that the U.S. does far more of its social spending via tax expenditures, with these resulting upside-down effects.[80]

The extent of these upside-down effects can be seen in the chart below,[81] which shows that 17% of the benefits are absorbed by the top 1%, more than 50% by the top 20%, and only 8% by the lowest 20%.

[80] *See generally* JACOB HACKER, THE DIVIDED WELFARE STATE: THE BATTLE OVER PUBLIC AND PRIVATE SOCIAL BENEFITS IN THE UNITED STATES (2002).

[81] CONGRESSIONAL BUDGET OFFICE, *The Distribution of Major Tax Expenditures in the Individual Income Tax System*, at www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.




While direct spending programs and tax expenditures can be seen as economic equivalents, the beneficiaries of indirect spending (tax expenditures) often do not perceive themselves as benefiting from government programs, which clearly skews political debate. Please click and read the following article:

www.nytimes.com/2015/10/08/opinion/we-all-get-free-stuff-from-the-government.html?_r=0

Those interested in reading more about tax expenditures at this point can take a sneak preview of Chapter 17, Part A., and the introduction to Chapter 18.

# Chapter 4: The Contours of "Capital Expenditure" v. "Expense" (or Current Depreciation)

In Chapter 1, you learned that business and investment outlays that qualify as current "expenses" can be immediately deducted under §§ 162 and 212, respectively. In contrast, outlays that are categorized as "capital expenditures" are nondeductible (regardless of whether incurred in business, investment, or personal consumption activity) but create basis that can reduce the tax base in the future (via depreciation or amortization deductions if the asset so qualifies or via reduced gain or increased loss under § 1001 on a realization event). The common way to describe why the distinction between an expense and a capital expenditure is important is because of the time value of money; a dollar deducted today is worth more than a dollar that reduces the tax base in a future year. The more specific or nuanced reason why this distinction is important is that the capitalization principle is the defining difference between an SHS income tax and a consumption tax, as you learned in Chapter 2. If Chris purchases shares of corporate stock for $10,000, he cannot deduct that outlay under an SHS income tax because it is a capital expenditure. The basis thereby created will reduce his tax base only in the future. In contrast, he would be able to deduct immediately that addition to his savings in the purchase year under a cash-flow consumption tax, and we have seen that consumption tax treatment is more favorable for Chris. Indeed, under the E. Cary Brown yield-exemption phenomenon, the asset's return, while nominally included in his tax base in the future when withdrawn from investment, is effectively free from tax (to the extent not exceeding the expected normal return) because earned on pre-tax dollars. Stated differently, if Chris is permitted to deduct his $10,000 cost immediately, the tax consequences can be the same as if he were *not* permitted to deduct that $10,000 immediately (as under an income tax) but were permitted to exclude the investment's return from tax (unlike under an income tax) between the time that he (prematurely) deducted the outlay and the time that he should have been permitted deduction.

For these reasons, the issue of which outlays should properly be categorized as capital expenditures is much more important than one of mere timing, as you sometimes read in court opinions. Characterizing an outlay as a current "expense" that should properly be characterized as a "capital expenditure" can provide inadvertent consumption tax treatment through the back door.

Congress has shown that it knows well how to enact consumption tax provisions when it wants to do so. Chapter 2 contained a list of some of those provisions. These provisions are conscious deviations from the SHS income tax norm, which otherwise provides the default position regarding the core structure of the Internal Revenue Code. Because Congress knows how to deviate from SHS principles when it wants to do so, one can argue that administrators of the statute and courts should be careful to protect income tax values by applying a strong capitalization principle (in ambiguous circumstances) to avoid providing consumption tax treatment inadvertently through the manipulation of doctrine, without the blessing of Congress.

The issue becomes even more important if borrowed money is used to make the outlay at issue. You learned in Chapter 2 that business and investment interest (generally deductible under an income tax) should be nondeductible under a cash-flow consumption tax that permits borrowed principal to be excluded. In other words, the tax arbitrage possibilities of combining the income tax rules pertaining to debt (an interest deduction) with respect to an investment that is otherwise

accorded consumption tax treatment (where interest would not be deductible) would provide a tax outcome that is more favorable than would occur under *either* a pure SHS income tax or cash-flow consumption tax. Because the stakes are so high, the issue of which outlays must be capitalized has been highly litigious, particularly during the time surrounding the *INDOPCO* decision, below.

This chapter will begin in Part A. by considering outlays pertaining to the acquisition or creation of an intangible asset (typically referred to merely as an "intangible"). The Supreme Court's 1992 *INDOPCO* decision made tax headlines and caused Treasury to open a new regulations project to revamp completely the capital expenditure regulations in an effort to bring more certainty to this area. Treasury divided the project into two phases, with the first devoted to intangibles (at issue in *INDOPCO* itself) and the second devoted to tangible assets. The intangibles regulations were finalized in December 2003. The regulations pertaining to tangible assets, considered in Part B., took much longer. The final regulations were made effective as of January 1, 2014.

Part C. will then consider the related issue pertaining to which indirect costs (such as labor expenses, state taxes other than income taxes, production-period interest, and depreciation) *incurred in the process creating an asset* must be capitalized into the basis of that newly created asset rather than immediately deducted. The Supreme Court's 1974 decision in *Idaho Power* led Congress to enact § 263A in 1986, which codified more precise rules to implement the idea illustrated in *Idaho Power*.

## A. Outlays pertaining to intangibles

For a pre-*INDOPCO* case involving the purchase of an intangible, consider *Commissioner v. Boylston Market Association*,[1] in which the taxpayer purchased and paid for, in Year 1, insurance coverage for his business that would last for three years. The taxpayer sought to deduct the entire payment in Year 1 as a business expense under § 162, but the court agreed with the government that the purchase of insurance coverage that lasted three years was a nondeductible capital expenditure, not a current expense, because the coverage lasted substantially beyond the end of Year 1. Rather than a current wealth decrease, the payment represented merely a change in the form in which wealth was held when the company purchased an intangible (insurance coverage) that lasted well beyond the year of payment. Whether the basis created on the making of that nondeductible capital expenditure is amortizable over the three-year period of insurance coverage under the depreciation provisions is a separate question from the issue of whether the outlay is, in the first instance, a capital expenditure or expense. We shall study the depreciation provisions in Chapter 14. Right now, we are interested solely in exploring the threshold capitalization question.

*INDOPCO* involved the proper treatment of the costs incurred by National Starch (renamed INDOPCO after the transaction) in the course of the acquisition of its stock by another corporation, Unilever. While such facts (a corporate acquisition) appear to be far afield of the typical facts found in a course devoted to the taxation of the individual, the way in which the court analyzed the capital expenditure issue goes far beyond the fact pattern before it. You need not understand the underlying structure (or tax consequences) of the acquisition transaction, itself, to appreciate the discrete issue analyzed here: whether the legal and investment banking fees incurred by National Starch/Indopco (the target corporation) in connection with the acquisition of its stock by Unilever should be categorized as a current business "expense" (deductible under § 162) or as a

[1] 131 F.2d 966 (1st Cir. 1942).

nondeductible "capital expenditure" (creating basis).[2]

## INDOPCO, INC. v. COMMISSIONER

503 U.S. 79 (1992)

JUSTICE BLACKMUN delivered the opinion of the Court.

Petitioner INDOPCO, Inc., formerly named National Starch and Chemical Corp., manufactures adhesives, starches, and specialty chemical products. In October 1977, representatives of Unilever U.S., Inc. 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. 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 IRS that the transaction would be tax-free for those National Starch shareholders who exchanged their stock for preferred stock [of a Unilever subsidiary], the transaction was consummated in August 1978 [and National Starch continued to exist as a corporate subsidiary of Unilever.]

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.

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

[2] For those who do go on to the tax course considering mergers and acquisitions, however, you will read an important Revenue Ruling pertaining to the underlying tax structure of the transaction in this case. *See* Rev. Rul. 84-71, 1984-1 C.B. 106 (consistent with the private letter ruling obtained by the tax lawyers in this deal). The tax lawyers made this deal work. Tax lawyers rock!

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 … a separate and distinct additional asset," see *Comm'r* 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.

The Court also has examined the interrelationship between the Code's business expense and capital expenditure provisions. 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." *See also Comm'r* 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 *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354 (1971), 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. 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 or capital expenditures. 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, "serve to create or enhance for Lincoln what is essentially a separate and distinct additional asset." "[A]s an inevitable consequence," we concluded, "the payment is capital in nature and not an expense, let alone an ordinary expense."

*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. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that 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.

Nor does our statement in *Lincoln Savings* 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. 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 U.S. v. Mississippi Chemical Corp.*, 405 U.S. 298 (1972) (expense that "is of value in more than one taxable year" is a capital expenditure); *Central Texas Savings & Loan Assn. v. U.S.*, 731 F.2d 1181 (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.

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 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, 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." Morgan Stanley's report to the National Starch board 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 U.S."

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 3,500 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.

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. Comm'r*, 326 F.2d 712, 715 (CA8 1964).

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Though not relevant to the resolution of this case (because the outlays were held to be capital expenditures rather than expenses), note the language in the opinion that describes the several, separate § 162 elements that must be satisfied (in addition to being an "expense") before an outlay can be deducted under § 162. What does "ordinary" mean, according to the Court? Necessary? We shall explore this issue in more detail in Chapter 22.

***Post-INDOPCO developments***

The "substantial future benefits test" enunciated in *INDOPCO* makes sense as a theoretical matter. After all, your appreciation of the difference between an income tax and consumption tax shows that the major feature distinguishing between a current "expense" and a nondeductible "capital expenditure" should be whether *the outlay contributes chiefly to creating <u>only</u> this year's Gross Income (expense) or contributes meaningfully to creating income in future years (capital*

*expenditure).* If the outlay contributes meaningfully to *future* income, the investment should be made with after-tax dollars in order to ensure effective taxation of that future income. If an investment producing future income is made with pre-tax dollars, in contrast, the return (though nominally included on the tax return) can be seen as effectively free from tax between the time the investment producing that return was prematurely deducted and the time it would have been deducted under a pure SHS income tax, as you learned in Chapter 2.

While understandable as a theoretical matter, the "future benefits" test announced in *INDOPCO* was immediately controversial. Many outlays that had been routinely treated as expenses by the government before *INDOPCO*, such as the cost of a routine commercial TV spot advertising a product, could conceivably be reconsidered under this opinion. Thus, the IRS first calmed the waters by issuing several Revenue Rulings to reassure the tax community. For example, Rev. Rul. 92-80[3] concluded that ordinary business advertising expenses generally remain deductible after *INDOPCO*, even if they create goodwill lasting beyond the current year, and Rev. Rul. 96-62[4] concluded that employee training costs remain generally deductible immediately as expenses, notwithstanding the future benefits obtained from training the employee in new skills.

At the same time, however, the government began litigating cases under the future benefits test. For example, *Wells Fargo & Co. v. Commissioner*,[5] like *INDOPCO*, involved an acquisition of a Target corporation by another corporation. The government maintained that Target employee salary costs must be capitalized to the extent that the employees' time was spent working on the acquisition. The 8th Circuit Court of Appeals disagreed, however, distinguishing *INDOPCO* by noting that the relevant Target employees had been hired to work in the Target's general business operations before the acquisition became a possibility, that their compensation was not increased as a result of their work on the acquisition, and that they would have been paid their established salaries even if the acquisition had not occurred.

Finally, Treasury announced and then issued new Treasury Regulations that provide greater clarity regarding when an outlay pertaining to acquiring or creating an intangible must be capitalized, which are found primarily in Treas. Reg. § 1.263(a)-4 and -5. The drafters stated that they used the "substantial future benefits" test to inform the new regulations but that the government would no longer cite the "substantial future benefits test"—alone—as justification for capitalization without prior notice published in the Federal Register.[6]

***Outline of the regulations pertaining to intangibles***

The Treasury Regulations pertaining to intangibles are now found at Treas. Reg. § 1.263(a)-4, and those regulations at -4(b)(1), (c), and (d) confirm that taxpayers must capitalize amounts paid to acquire an intangible from another or to create an intangible, including ownership interests in business entities, a financial instrument (such as a bond, futures contracts, foreign currency contract), a lease, a patent, a copyright, a trademark, goodwill, a customer list, software, and more. Thus, a $250,000 loan made by National Bank to client *A* is a nondeductible capital expenditure for National Bank because it creates a debt instrument (an intangible),[7] and the purchase of a patent from the inventor is similarly a nondeductible capital expenditure. Such amounts include

[3] 1992-2 C.B. 57.
[4] 1996-2 C.B. 9.
[5] 224 F.3d 874 (8th Cir. 2000).
[6] *See* Treas. Reg. §§ 1.263(a)-4(b)(1)(iv) and -(4)(b)(2).
[7] *See* Treas. Reg. §§ 1.263(a)-4(d)(2)(i)(B) and (d)(2)(vi), Ex. (1).

transaction costs incurred to investigate or facilitate the transaction, as well, unless the aggregate of such costs is *de minimis*, defined as not exceeding $5,000.[8] In addition, costs incurred to defend or perfect title to an intangible already owned must be capitalized.[9] Subject to the 12-month exception (more below), prepaid expenses must be capitalized.[10] Drawing directly from *Boylston Market*, *supra*, for example, Treas. Reg. § 1.263(a)-4(d)(3)(ii), Ex. (1), provides that a taxpayer who pays $10,000 to obtain three years of insurance protection must capitalize the cost. Similarly, amounts paid to obtain membership or privileges in an organization or to obtain rights from a governmental organization or state must be capitalized, including the cost of hospital privileges paid by a physician and of bar admission paid by a lawyer, subject to the 12-month rule.[11]

The 12-month rule is a significant change in law. Before the promulgation of this regulation, an outlay made in December of Year 1 to purchase a 12-month intangible benefit (such as insurance coverage) would have to be capitalized, as the bulk of the benefit was realized *after* the close of the taxpayer year in which the benefit was purchased. Under Treas. Reg. § 1.263(a)-4(f)(1), in contrast, "a taxpayer is not required to capitalize under this section amounts paid to create … 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) [t]he end of the taxable year following the taxable year in which the payment is made." For an example, see Treas. Reg. § 1.263(a)-4(f)(8), Ex. (1) & (2). To prevent gamesmanship, Treas. Reg. § 1.263(a)-4(f)(5) provides that "the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal."

Treas. Reg. § 1.263(a)-5 generally provides that the costs incurred to rearrange the capital structure of a corporation, such as the costs incurred in the acquisition of National Starch by Unilever in *INDOPCO*, must be capitalized.

## Problems

**1.** Mary, who uses the calendar year as her taxable year, owns a coffee shop. She purchases insurance coverage that protects against damage to the building, as well as personal liability coverage in case a customer sues. Instead of paying for coverage monthly, Mary pays the entire contract amount on September 1 of Year 1. Can May deduct her payment as an "expense" under § 162 in the year of payment, or must she capitalize the cost under § 263, instead?

**a.** On September 1 of Year 1, she pays $12,000 for 24-month coverage, effective on that date and extending to August 31 of Year 3? *See* Treas. Reg. § 1.263(a)-4(f)(1).

**b.** On September 1 of Year 1, she pays $6,000 for 12-month coverage, effective on that date and extending to August 31 of Year 2?

**c.** On September 1 of Year 1, she pays $6,000 for 12-month coverage, effective February 1 of Year 2 and extending to January 31 of Year 3?

**d.** Same as **b.**, except that the contract has a renewal clause that entitles Mary to renew the contract for a second 12-month period at the same price? *See* Treas. Reg. § 1.263(a)-4(f)(5).

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[8] Treas. Reg. § 1.263(a)-4(e).
[9] Treas. Reg. § 1.263(a)-4(d)(9).
[10] Treas. Reg. § 1.263(a)-4(d)(3).
[11] *See* Treas. Reg. §§ 1.263(a)-4(d)(4) and (5).

**2.** Sally, an inventor, owns an exclusive patent on a new technology. Saul sues Sally (say that three times fast), alleging that he is the true owner of the patent. To settle the lawsuit, Sally pays $10,000 to Saul in exchange for Saul's release of all future claims against Sally regarding the patent. Can Sally deduct the payment as an "expense" under § 162 in the year of payment, or must she capitalize the cost under § 263, instead? *See* Treas. Reg. § 1.263(a)-4(d)(9).

**3.** On November 1 of Year 1, Matthew enters into negotiations with Martin to lease commercial property from Martin for 25 years. Matthew pays Susan, one of his outside legal counsel, $4,000 on November 15 of Year 1 to assist in the negotiations of the lease terms with Martin. Matthew and Martin come to an agreement in January of Year 2, and Matthew pays Larry, a second outside legal counsel, $2,000 to draft the lease agreement. Can Matthew deduct the $4,000 paid to Susan in Year 1 and the $2,000 paid to Larry in Year 2 as expenses under § 162, or must he capitalize the costs to his lease agreement under § 263, instead? *See* Treas. Reg. § 1.263(a)-4(e). Would the result be the same if Susan and Larry were full-time, in-house counsel (*i.e.*, employees) in Matthew's business?

## B. Outlays pertaining to tangible assets

The Treasury Regulations pertaining to tangible property are chiefly found at Treas. Reg. § 1.263(a)-2. Subject to two mutually exclusive exceptions—a *de minimis* rule and a rule pertaining to "materials and supplies"—the costs to acquire, produce, or improve tangible assets, such as land, buildings, and business equipment, must be capitalized.[12] On the flip side of the coin, amounts incurred to *sell* property must also be capitalized, and capitalization occurs by reducing the "amount realized" under § 1001 in determining gain or loss. Selling costs incurred by "dealers" selling inventory, however, can be deducted immediately as ordinary and necessary business expenses under § 162.[13] Just as in the case of intangibles, costs incurred to defend or perfect title to real or personal[14] tangible property must also be capitalized.[15]

As with intangibles, costs incurred to facilitate or investigate the acquisition of tangible business or investment property must generally be capitalized (creating basis) rather than deducted as current expenses, even if the property is not purchased.[16] If the business or investment property is not purchased after the investigation, the basis created by the capitalized cost can be deducted as a "loss" under § 165 (recall from Chapter 1, Part A., that the definition of a "loss" in the tax sense is *unrecovered basis*). Because not "sale or exchange" occurs, this loss deduction would be ordinary, unhampered by § 1211(b).

In the case of *real property only*, however, costs incurred in the course of deciding *whether* to purchase real property and *which* real property parcel to purchase need not be capitalized (commonly referred to in the tax community as the "whether and which" rule for real property), unless the item is on the list of "inherently facilitative costs," which must always be capitalized.[17]

[12] Treas. Reg. § 1.263(a)-2(d)(1).
[13] Treas. Reg. § 1.263(a)-1(e).
[14] The use of the word "personal" here does not refer to personal-*use* property but rather non-real estate in the property law sense.
[15] Treas. Reg. § 1.263(a)-2(e).
[16] Treas. Reg. § 1.263(a)-2(f)(3).
[17] Treas. Reg. § 1.263(a)-2(f)(2)(iii).

The list of "inherently facilitative costs" is found at Treas. Reg. § 1.263(a)-2(f)(2)(ii) and includes, for example, appraisal costs, the cost of negotiating the acquisition terms or obtaining tax advice in connection with the acquisition, sales and transfer taxes, title registration costs, and brokers' commissions.

***Two mutually exclusive de minimis elections***

Recall that the intangible regulations had a simple $5,000 *de minimis* rule. For tangible property, the *de minimis* rules are more complex. Treas. Reg. § 1.263(a)-1(f) contains alternative elective *de minimis* rules, depending on whether or not the taxpayer has an "applicable financial statement" within the meaning of Treas. Reg. § 1.263(a)-1(f)(4). First, taxpayers that have an applicable financial statement can elect to treat amounts paid to acquire, produce, or improve tangible property as current expenses (rather than capital expenditures) if:

- the taxpayer has written accounting procedures in place at the beginning of the tax year in question that treats outlays (i) costing less than a stipulated amount or (ii) having an economic useful life of 12 months or less as current expenses for nontax purposes;
- the taxpayer treats the outlay in question as an expense on its applicable financial statement consistent with its written procedures; and
- the amount paid does not exceed $5,000 per invoice or (as substantiated by the invoice) per item (or some other amount announced in the Federal Register in the future).

An "applicable financial statement" is defined as (i) a financial statement required to be submitted to the Securities and Exchange Commission (SEC); (ii) a certified audited financial statement that is accompanied by a report of an independent CPA and that is used for reports to shareholders or partners, for credit purposes, or for any other nontax purpose; or (iii) a financial statement (other than a tax return) that is required to be submitted to a state or Federal government or agency other than the SEC. Notice that such statements must be used for nontax, public purposes to qualify under this *de minimis* rule, chiefly to provide public information to owners, lenders, and regulators regarding the health of the business. The outlay allowed to be treated as a current expense for *tax* purposes under this *de minimis* rule must also be treated as a current expense *on the financial statement*, thus reducing financial statement current-year "profits." The inherent tension in requiring the business to publicly show a reduced profit for financial reporting purposes to owners and lenders (because of the current expense deduction on the financial statement) is thought to provide a built-in safeguard against misuse of the *de minimis* rule for tax purposes.

Small businesses are unlikely to satisfy the requirements of an "applicable financial statement" within the meaning of the regulation, so the first set of proposed regulations contained no *de minimis* rule for such taxpayers. After receiving criticism for this omission, Treasury added an additional *de minimis* rule to the final regulations for those taxpayers who do not have an applicable financial statement. Such taxpayers can elect to treat amounts paid to purchase, produce, or improve tangible property as a current expense—not to exceed $2,500 per item (or invoice)[18]—if they have in place at the beginning of the taxable year accounting procedures treating costs less than a specified dollar amount (or having a useful life of 12 months or less) as current expenses for nontax purposes and record the items on their nontax books and records as expenses.

[18] The final regulations contained a $500 cap, but this amount was increased in November 2015 to $2,500 in Notice 2015-82, 2015-50 I.R.B. 1, for taxable years beginning in 2016.

To make either *de minimis* election, the taxpayer must attach a statement that he is making the election to a timely filed tax return.[19] In no case can either of the *de minimis* rules described above apply to the acquisition of land or inventory.

***The § 162 deduction for "materials and supplies"***

Finally, only taxpayers who do *not* elect to use the *de minimus* safe harbors described above can use the companion § 162 regulation pertaining to "materials and supplies," the cost of which can be treated as an expense rather than a capital expenditure. Treas. Reg. § 1.162-3(c) identifies as "materials and supplies" items such as "fuel, lubricants, water, and similar items that are reasonably expected to be consumed in 12 months or less" or property costing $200 or less (increased from $100 in the proposed regulations). Think oil used to lubricate lawnmowers in a landscaping business, spare parts for the lawn mowers (such as spark plugs), and pencils, paper, and toner cartridges used in the landscaper's business office. Taxpayers making either of the *de minimis* safe harbor elections described above must account for such costs under those safe harbors, instead of the "materials and supplies" rule in Treas. Reg. § 1.162-3(c).[20]

Property that is expensed (either under the *de minimis* rule or "materials and supplies" rule) has a zero basis, which means that if the property is sold, the taxpayer will certainly realize a gain. This gain must be treated as ordinary gain, even if the asset otherwise qualifies as a capital asset or § 1231 property (considered in Chapter 15).[21]

## Problems

**1.** Ringo, who does not have an "applicable financial statement," decides that he wants to relocate his music business to a larger building. He pays $5,000 to a real estate broker to find a suitable building for his purposes. After she locates a suitable building, Ringo hires a contractor to perform an inspection for termites and other potential problems, paying $3,000. After a good report, Ringo purchases the building for $1,000,000. Can he deduct any of these payments as "expenses" under § 162, or must he capitalize the costs under § 263, instead?

**2.** Paul does not have an "applicable financial statement" but does have in place before the beginning of the taxable year an accounting procedure to treat capital expenditures of $2,500 or less pertaining to tangible property as current expenses. Paul owns a retail store in City *A*. He wishes to explore the feasibility of expanding by opening a new store in city *B*. In October of Year 1, he pays $10,000 to a real estate development firm to study the retail environment in city *B* and to perform market surveys, evaluate zoning requirements, and provide preliminary recommendations on site selection. In December of Year 1, Paul hires an appraiser and pays to her $2,000 to appraise a property for possible purchase. In March of Year 2, Paul decides not to acquire the property. Must he capitalize these costs? What if the appraiser charges $3,000?

**3.** George, a landscaper, does not have an "applicable financial statement" and (unlike Paul) does not have in place before the beginning of the taxable year an accounting procedure to treat capital expenditures of $2,500 or less pertaining to tangible property as current expenses. He pays $90 for a new handsaw, which should last for 24 months, for use in his landscaping business. He

[19] *See* Treas. Reg. § 1.263(a)-1(f)(5).
[20] *See* Treas. Reg. §§ 1.263(a)-1(f)(1)(ii) and (iii).
[21] *See* Treas. Reg. §§ 1.263-1(f)(3)(ii) and (iii).

also pays $250 for a new edge trimmer, which typically lasts only 9 months for George. Must he capitalize these costs? (Ignore the possible applicability of other Code sections, such as § 179. Consider only the initial capitalization question.)

**4.** John sells Blackacre, A/B of $600,000, for $900,000. In so doing, he incurs legal fees of $1,000, as well as a sales commission to a broker of $9,000. Must he capitalize these costs? How does one do that in connection with a sale of property? What if John is a real estate dealer?

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***The difficult distinction between repair (expense) and improvement (capital expenditure)***

The capitalization issue that has produced the most litigation over the years with respect to tangible property has been whether an outlay constitutes a mere "repair" (an expense under Treas. Reg. § 1.162-4(a)), on the one hand, or an "improvement" (a capital expenditure), on the other. For example, in *American Bemberg Corp. v. Commissioner*,[22] the taxpayer built a factory in 1925 through 1928 near a river. Twelve years later (in 1940), portions of the floor caved in, creating holes as deep as 42 feet. The taxpayer engaged a well-known engineering firm to recommend a remedy, but additional cave-ins occurred in 1941. The taxpayer hired a second firm with expertise in "subsoil engineering," and it recommended "an elaborate program of drilling and grouting and making some replacements," which the taxpayer had to do or "abandon its plant." The taxpayer expended nearly $1 million (about $14.6 million in 2015 dollars) to complete the required work, which fixed the problems.

The taxpayer immediately deducted the cost as a mere repair "expense," but the government argued that the outlay constituted an improvement or betterment of the factory building and, thus, a nondeductible capital expenditure.

The Tax Court majority, in a reviewed decision, examined "the purpose, the physical nature, and the effect of the work" in distinguishing between a repair and an improvement.

> In connection with the purpose of the work, [the outlays were] intended [to] avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to continue in operation not on any better scale, but on the same scale and as efficiently as it had operated before. The purpose was not to rebuild or replace the plant, but to keep it as it was and where it was.
>
> In connection with the physical nature of the work, the drilling and grouting was not a work of construction nor the creating of anything new. While the amount of grout introduced was large, it by no means represented a large percentage of the tremendous cube of earth standing between the plant floor and the bedrock which lay at an average depth of over 50 feet below the plant floor. The work could not successfully have been of smaller scope.
>
> In connection with the effect of the work, the accomplishment of what was done forestalled imminent disaster and gave petitioner some assurance that major cave-ins would not occur in the future. The original geological defect has not been cured;

[22] 10 T.C. 361 (1948), *aff'd*, 177 F.2d 200 (6th Cir. 1949) (per curiam).

> rather its immediate consequences have been dealt with.

Thus, the majority held in favor of the taxpayer. The dissent, in contrast, argued:

> These large expenditures created a substantial underground structure, a part of the plant, which did not exist, had no previous counterparts, and was not a part of the petitioner's capital previously. Its life and benefits would last for considerably more than one year. The expenditures were capital in their nature and should be recovered ratably over its useful life.

In light of the underlying tax values at stake described at the beginning of this chapter, which is the better approach? Many contradictory court decisions on similar facts contributed to the need for Treasury to amend the regulations pertaining to this troublesome distinction. Today, the new regulations, found at Treas. Reg. § 1.263(a)-3, provide a detailed roadmap to the analysis that effectively supersedes this large body of contradictory case law.

***Improvement: betterment, restoration, or adapting the property to a new use***

Treas. Reg. § 1.263(a)-3(d) now provides that outlays must be treated as capital expenditures if they "improve" the unit of property, and property is considered "improved" if the costs (1) result in a *betterment* to the unit of property, (2) *restore* the unit of property, or (3) *adapt* the unit of property to a new or different use (unless the requirements for the alternative *de minimis* exceptions are satisfied).

*Betterment* results if the outlay (i) ameliorates a "material condition or defect" existing prior to the taxpayer's acquisition of the unit of property or one that arose during its production (whether or not the taxpayer was aware of the defect), (ii) results in a "material addition," *e.g.*, physical enlargement, expansion, or extension, or (iii) results in a "material increase in productivity, efficiency, strength, quality, or output" of the unit of property.[23] Outlays incurred to correct "normal wear and tear" do not result in betterment.[24]

An amount is paid to *restore* property if, for example, it repairs damage or replaces a component that was deducted as a loss under § 165 (such as in the case of a casualty loss deduction that reduces basis), returns the property to its "ordinarily efficient operating condition if the property has deteriorated to a state of disrepair and is no longer functional for its intended use," results in rebuilding the unit of property to "like new" condition, or replaces "a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property."[25] A "major component" is one that "performs a discrete and critical function in the operation of the unit of property," and a "substantial structural part" is one that "comprises a large portion of the physical structure of the unit of property."[26]

An amount is used to *adapt the property to a new or different use* if "the adaptation is not consistent with the taxpayer's ordinary use of the unit of property at the time originally placed in service by the taxpayer."[27]

In contrast, outlays constitute a mere repair (expense)—rather than in improvement (capital

[23] *See* Treas. Reg. § 1.263(a)-3(j)(1).
[24] *See* Treas. Reg. § 1.263(a)-3(j)(2)(iv).
[25] Treas. Reg. § 1.263(a)-3(k)(1).
[26] Treas. Reg. § 1.263(a)-3(k)(6).
[27] Treas. Reg. § 1.263(a)-3(*l*)(1).

expenditure)—if they are "necessitated by normal wear and tear or damage to the unit pf property that occurred during the taxpayer's use of the unit and of property" and "correct the effects of normal wear and tear to the unit of property that occurred during the taxpayer's use of the unit of property."[28]

***Determining the "unit of property"***

The threshold task in making the "improvement" determination, however, is to establish the "unit of property" that should be the focus of the inquiry. With respect to real property, each building, its structural components, and significant systems is considered to be a single unit of property, but the improvement standard is then applied *separately* to (i) the building structure and its structural components (*e.g.*, roof, walls, and floor), and (ii) each of the buildings systems, such as HVAC (heating, ventilation, and air conditioning), plumbing systems, electrical systems, all escalators, all elevators, fire protection and alarm systems, security systems, gas distribution systems, and any other structural components identified in published guidance.[29] In an example of the latter, the regulations posit a retail building owned by *B* with two elevator banks in different parts of the building, with three elevators in each bank (a total of six elevators in the building), and concludes "if an amount paid by *B* for work on the elevators is an improvement (for example, a betterment) to the elevator system, *B* must treat this amount as an improvement to the building."[30]

In the case of property other than buildings, the regulations adopt a "functional interdependent test" to determine the unit of property.[31] "Components of property are functionally interdependent if the placing in service of one component by the taxpayer is dependent on the placing in service of the other component by the taxpayer."[32] In an example, the regulations conclude that a computer and printer put into service in a law office constitute two separate units of property (rather than a single unit of property) because "the computer and the printer are not components that are functionally interdependent (that is, the placing in service of the computer is not dependent on the placing in service of the printer)."[33]

***Routine maintenance safe harbor***

One of the most important innovations of the new regulations is the creation of a new "safe harbor" for routine maintenance with respect to both buildings and other tangible property.[34] With respect to buildings, routine maintenance consists of the "recurring activities that a taxpayer expects to perform as a result of the taxpayer's use … to keep the building structure or each building system in its ordinarily efficient operating condition," including "the inspection, cleaning, and testing of the building structure or each building system, and the replacement of damaged or worn parts with comparable and commercially available replacement parts."[35] Whether the activities qualify as "routine" depends on "the recurring nature of the activity, industry practice, manufacturers' recommendations, and the taxpayer's experience with similar or identical

[28] Treas. Reg. § 1.263(a)-3(j)(iv)(A)-(B).
[29] *See* Treas. Reg. §§ 1.263(a)-3(e)(1) and (2).
[30] Treas. Reg. § 1.263(a)-3(e)(6), Ex. (2).
[31] Special unit-of-property rules apply to plant property, network assets, and leased property, which are not described here.
[32] Treas. Reg. § 1.263(a)-3(e)(3).
[33] Treas. Reg. § 1.263(a)-3(e)(6), Ex. (9).
[34] *See* Treas. Reg. § 1.263(a)-3(i). A "safe harbor" is a provision of a statute or a regulation that specifies that certain well-defined conduct will be *deemed* either to come within or not to violate a given rule.
[35] Treas. Reg. § 1.263(a)-3(i)(1)(*i*).

property."[36] At a minimum, however, the taxpayer must reasonably expect to perform the activities at least once every 10 years.[37]

The rules are similar for property other than buildings, except that the taxpayer must reasonably expect to perform the maintenance activities more than once during the property's "class life" (essentially, the useful life over which the taxpayer may depreciate the property under the provisions studied in Chapter 14). For an example, see Treas. Reg. § 1.263(a)-3(i)(6), Ex. (1) (pertaining to engine maintenance for airplanes). Routine maintenance costs do not qualify for the safe harbor if they are done at the same time as a betterment, however.[38]

***Small business safe harbor election for building improvements***

Finally, for small taxpayers, the final regulations added a safe harbor election for building property held by taxpayers with annual average gross receipts (over three years) of $10 million or less. They can elect to avoid capitalizing a building improvement (without regard to the unit-of-property analysis described above) if the total amount paid during the tax year for repairs, maintenance, improvements, and similar activities performed on the eligible building does not exceed the lesser of $10,000 or 2% of the unadjusted basis of the building.[39] Eligible building property must have an unadjusted basis of $1 million or less.[40] This election is independent of the *de minimis* safe harbor election described earlier, and a separate election must be made with respect to each building by attaching the election to a timely filed return.[41]

## Problems

**1.** In Year 1, Danielle purchases a store on a parcel of land that includes underground gasoline storage tanks. Though she was not aware of the fact when she purchased the land, Danielle learns in Year 2 that the tanks have leaked, contaminating the soil, and she incurs $10,000 to remediate the spillage. Must she capitalize the costs, or can she deduct them immediately as business expenses under § 162?

**2.** David has long owned a meat processing plant. Federal meat inspectors find oil seeping through the concrete walls of the plant, creating a fire hazard, and order David to correct the problem or they will close the plant down. David spends $10,000 to add a concrete lining to the walls and floors, which corrects the problem. Must he capitalize the cost?

**3.** Mark owns an office building whose roof needs new shingles. Mark spends $10,000 in replacing the old wooden shingles with asphalt shingles of comparable quality. Must he capitalize? What if he replaces the shingles with a lightweight composite material of improved quality that extends the useful life of the roof? What if the roof inspection reveals that a major portion of the sheathing and rafters has rotted and the entire roof, including the decking, insulation, membrane and shingles, needs to be replaced?

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[36] *Id.*
[37] *Id.*
[38] *See* Treas. Reg. § 1.263(a)-3(i)(6), Ex. (10).
[39] *See* Treas. Reg. § 1.263(a)-3(h)1).
[40] *See* Treas. Reg. § 1.263(a)-3(h)(4).
[41] *See* Treas. Reg. § 1.263(a)-3(h)(6).

**4.** Rhonda owns a tugboat, and the tugboat manufacturer recommends inspection and cleaning of the engine every three years, with replacement of worn parts, as necessary. In Year 3, Rhonda spends $6,000 for scheduled maintenance, which includes cleaning, inspecting, reconditioning, and the replacement of minor parts. Must she capitalize the cost? In Year 6, when the next scheduled maintenance occurs, Rhonda decides to upgrade the engines to increase their horsepower and propulsion, thus allowing her to pull heavier loads. The amount that she pays ($15,000) includes the replacement of some parts with upgraded components to achieve the increased power that she desires but also the usual cleaning, inspecting, reconditioning, and the replacement of minor parts, which benefit the upgrades. Must she capitalize?

## C. Indirect costs of producing inventory (and other property)

There is no question that the utility in *Idaho Power*, below, is constructing property, the costs of which must be capitalized into basis. But which costs should be counted?

**COMMISSIONER v. IDAHO POWER CO.**

418 U.S. 1 (1974)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities [power lines and related facilities]. During 1962 and 1963, taxpayer owned a wide variety of automotive transportation equipment, including cars, trucks, power-operated equipment, and trailers. The 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. For Federal income tax purposes, the taxpayer claimed as a deduction all the year's depreciation on the transportation equipment, using a life of 10 years.

The Commissioner disallowed the deduction for the construction-related depreciation. He added the amount of the depreciation so disallowed to the taxpayer's adjusted basis in its capital facilities.

The issue comes down to a question of timing, that is, whether the construction-related depreciation is to be amortized over the shorter life of the equipment or, instead, over the longer life of the facilities constructed. 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 [an] 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 [an] asset is a true cost, since the asset is being depleted. When the asset is used to further the taxpayer's day-to-day business 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 is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing asset.

Established tax principles require the capitalization of the cost of acquiring an asset. This principle has obvious application to the acquisition of an asset by purchase, but it has been applied,

as well, to the costs incurred in a taxpayer's construction of capital facilities.

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 [an] asset, they must be capitalized and are then entitled to be amortized over the life of the asset so acquired. Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of 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 asset constructed.

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 must be capitalized by the taxpayer having the 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 obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost charged to it by the contractor.

Finally, the priority-ordering directive of § 161—or, for that matter, § 261 of the Code—requires that the capitalization provision of § 263(a) take precedence, on the facts here, over § 167(a). The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere, none of which is applicable here, an expenditure incurred in acquiring assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

[Dissenting opinion of JUSTICE DOUGLAS omitted.]

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When Baker Bob owns a delivery truck and uses it to deliver baked goods to restaurants around town, Bob would currently deduct the depreciation allowable on the truck under §§ 167 and 168, as that depreciation is a cost of producing this year's Gross Income (only). In contrast, when Developer Diana owns a backhoe that she uses in constructing *other property*—a building for her own use or for sale to others, the depreciation otherwise allowable on the backhoe during the construction period must be added to the basis of the constructed building, instead of being currently deductible. If the building is going to be used by Developer Diana in her own business, the building's basis (which includes the construction-period depreciation on the backhoe) would be depreciated over the much longer life of the building. If Developer Diana is, instead, going to sell the building, the basis (which includes the construction-period depreciation on the backhoe) would be offset against the § 1001(b) "amount realized" on sale.

***§ 263A codification***

Congress enacted § 263A in 1986, which provides greater clarity regarding which indirect costs of the type illustrated in *Idaho Power* must be capitalized. These rules trump any rules found in the Treasury regulations under § 263. While they contain quite a bit of detail, some of the more

important rules are described below.

Section 263A generally applies to real or personal property produced by the taxpayer or acquired for resale, except that it does not apply to personal property acquired for resale by taxpayers whose average annual gross receipts for the prior three years did not exceed $10 million.[42] Section 263A(a) requires that the "direct costs" and an allocable share of "indirect costs" be capitalized into the property produced or acquired, but exceptions apply to the production of animals and plants by farmers,[43] as well as to any "qualified creative expense" incurred by professional writers, photographers, and artists.[44]

While interest is usually considered to be a current "expense," production-period interest is an indirect cost that must generally be capitalized into the produced property rather than deducted currently under § 163.[45] Other indirect costs that must be capitalized generally include labor costs, storage costs, depreciation, rent, state sales and property taxes, insurance, utilities, repairs and maintenance, engineering and design costs, licensing fees, and more.[46] Indirect costs specifically excepted from capitalization include selling and distribution costs, research and experimental costs, and amounts permitted to be deducted under § 179.[47] The Treasury regulations under § 1.263A are lengthy and detailed, but this short description gives you a flavor. (Chocolate.)

[42] § 263A(b)(2)(B).
[43] § 263A(d).
[44] § 263A(h).
[45] *See* § 263A(f).
[46] *See* Treas. Reg. § 1.263A-1(e)(3)(ii).
[47] Treas. Reg. § 1.263A-1(e)(3)(iii).

# Unit II:

# Two Types of Gross Income:
# Compensation and Residual Gross Income

## Introduction to Chapters 5 and 6

In Chapter 1, you learned that § 61(a) of the Code lists several items of Gross Income, including, among other items, interest, rent, dividends, and "gains derived from dealings in property." In connection with that last item, you learned that "gain" was a precise term of tax art, defined in § 1001(a) as the excess of § 1001(b) "amount realized" over the property's "adjusted basis." You will further explore the concept of § 1001 realized and recognized "gain" in Chapter 13. This unit explores more closely two other types of § 61 gross income: § 61(a)(1) compensation for services rendered and so-called residual gross income.

Chapter 5 will consider the scope of the compensation inclusion under § 61(a)(1). As you will learn, *all* compensation for services rendered must be included in gross income under § 61(a)(1) unless an *express* statutory exclusion applies. Though there were a few common law doctrines that developed in the early days of the income tax, which allowed some forms of compensation paid in kind to escape taxation (such as the convenience-of-the-employer doctrine that was eventually codified in § 119 in 1954), Congress made its intent absolutely clear in 1984 when it enacted § 132 that no common law exclusions remain. To exclude compensation from gross income, the payee must satisfy an express statutory exclusion.

The most important compensation exclusions today are (1) the exclusion for employer-provided health care in §§ 105 and 106 (among the most expensive tax expenditures in the Code) and (2) the exclusion for contributions to certain retirement accounts, which are accorded consumption-tax treatment, such as IRAs, qualified pension plans, and § 401(k) plans. The former will be discussed in Chapter 18, and the details of the latter are beyond the basic income taxation course, though they will be mentioned again in connection with the cash method of accounting in Chapter 22. With our limited time, Chapter 5 will consider two statutory exclusions provisions, §§ 119 and 132, as well as the rules in § 83 that apply to property paid in kind as compensation that is subject to a substantial risk of forfeiture. The interested student who wishes to learn about other compensation exclusions can explore the exclusions for the rental value of parsonages (§ 107), certain combat zone compensation of members of the Armed Forces (§ 112), so-called Cafeteria Plans (§ 125), dependent-care assistance programs (§ 129), adoption assistance programs (§ 137), employer-provided life insurance (§ 79), and more. (Alas, there are only so many classroom hours in the basic tax course!)

Chapter 6 will then explore the contours of that terribly vague language found in what we can call the "residual clause" in § 61: "Gross Income means all income from whatever source derived." We know that this language must contain positive content, *i.e.*, that items of includable Gross Income must be described by that language, because the parenthetical in § 61—"(including but not limited to)"—states that the fifteen listed items do not exhaust the universe of Gross Income items. The very vagueness of that language, however, means that both the administrators of the statute

and the courts appear to have more leeway to conclude that a receipt does—or does not—constitute Gross Income. How should they decide which items should be included in Gross Income under the residual clause? Which analytical tools should they use? Are these judgments merely arbitrary? Can the underlying tools of tax policy that you learned in Chapter 3 and the core concepts underlying SHS income that you learned in Chapter 1 inform the adjudicator, whether that adjudicator is the IRS issuing guidance or a court confronting that vague language in a tax dispute?

# Chapter 5: § 61(a)(1) Compensation

As just described in the introduction to this unit, this chapter will consider the general contours of the compensation inclusion under § 61(a)(1), two statutory exclusions pertaining to compensation (§§ 119 and 132), as well as the rules in § 83 that apply to property paid in kind as compensation that is subject to a substantial risk of forfeiture. The most important compensation exclusion (for employer-provided health care) will be examined in Chapter 18 (pertaining to the personal consumption tax expenditures), an introductory consideration of compensation paid to tax-preferred retirement accounts will be considered in Chapter 22 (in connection with the cash method of accounting), and certain education fringe benefits will be addressed in Chapter 17 (addressing the acquisition of human capital).

A payment made by an employer to an employee (or made by a services recipient to an independent contractor services provider) is expressly listed as Gross Income in the very first listed item in § 61(a)(1). Notice how broad the language found there is: "compensation for services, including fees, commissions, fringe benefits, and similar items." The name attached to the payment is irrelevant to the taxation of that payment. And the payment need not necessarily ever touch the employee's or independent contractor's hands, as illustrated in the relatively early Supreme Court case below.

**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 $548,132.27, 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.

Pursuant to these resolutions, the 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 paid for 1918: $681,169.88; taxes paid for 1919: $351,179.20.

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes paid by the company for Mr. Wood were additional income to him for the years 1919 and 1920.

[W]e 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 a gain 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 [current § 61(a)(1)]. 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. This is evidenced by the terms of the resolution passed August 3, 1916, more than one year prior to the year in which the taxes were imposed. 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 employer 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. 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."

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Note the Court's rejection of exclusion by Mr. Wood as a "gift." In 1986, Congress amended § 102 by adding subsection (c), which expressly denies exclusion of payments made by an employer to an employee as a gift. Section 102(c)(2), however, helpfully reminds us that other statutory exclusions may apply, including exclusion as a *de minimis* fringe under § 132(e) (considered below) or as an employee achievement award under § 74(c).

Although the case does not use the words, you can think of *Old Colony Trust* as one of the first cases to apply the very important "substance over form" doctrine in tax. **Under the substance over form doctrine, a transaction is taxed according to its underlying economic substance if its form does not fairly reflect that underlying substance.** In form, cash went directly from the company to the IRS, not to Mr. Wood as compensation. In *substance*, however, the cash implicitly went first to Mr. Wood (includable compensation) and then from Mr. Wood to the IRS and to his state's treasury. Or this could case could illustrate another common law doctrine: the step transaction doctrine. In form, one step occurs (the payment of money by the corporation to the IRS), but in substance two steps occur: the payment of cash to Mr. Wood (step 1), followed the

payment of that cash by Mr. Wood to the IRS and his state's treasury (step 2). The portion deemed paid by him to the IRS would be nondeductible under § 275(1), but the portion deemed paid by Mr. Wood to his state's treasury would likely be deductible under § 164(a)(3) today, though it would be an Itemized Deduction, as described in Chapter 1, Part B.

Mr. Wood's includable salary thus had to be "grossed up" by the amount of the taxes paid on his behalf directly to Federal and state authorities by Mr. Wood's company. Whether any additional tax owed under *Old Colony Trust* on the gross-up, itself, would be paid by the company is, of course, a matter of the employment contract between the executive and the company. Some contracts may provide that only the first level of income tax owed would be paid by the company (which would be the largest chunk) and that any additional tax owed (under *Old Colony Trust* principles) by reason of the payment is the executive's responsibility. Other employment contracts may provide for a *full* gross-up, meaning that any additional tax owed by reason of the first tax payment would also be paid by the company, and the additional tax owed on that second payment would also be paid by the company, and so on, until the additional compensation reaches zero. Executive compensation experts have the algebraic formula in hand that allows them to compute what a full gross-up would end up costing the company.

Even in the case of a full gross-up, this practice does not affect the total tax collected by Treasury. For example, assume a combined Federal and state flat income tax rate of 45% on $1 million of compensation for the sake of simplicity. Whether the corporation contracts with Executive Ed to pay $1.82 million with no gross-up or $1 million with a full Federal and state gross-up, Ed will have approximately $1 million in hand after taxes are paid, and the Federal and state Treasuries will collect roughly $820,000 in aggregate tax. Let's see why that statement is true.

A payment of $1.82 million with no gross-up would cause Ed to pay $819,000 to the Treasury directly ($1.82 million x .45), leaving him with slightly more than $1 million cash in hand. In contrast, if Ed's employment contract requires a salary of $1 million *net* of Federal and state income tax, the company will pay $450,000 tax ($1 million x .45) in the first round. That $450,000 payment made on Ed's behalf constitutes additional income to Ed under *Old Colony Trust* principles, resulting in a second tax of $202,500 ($450,000 x .45), resulting in additional tax owed of $91,125 ($202,500 x .45), and so on until a total of slightly more than $819,000 is paid by the company on Ed's behalf.

While the total tax paid is not affected, tax gross-ups raise transparency concerns for shareholders regarding the total compensation paid by a company to its executives. As a 2005 Wall Street Journal article observed, "[d]etails of the little-known payments, called 'tax gross-ups,' are often buried in impenetrable footnotes or obscure filings."[1] If shareholders read that the executive's compensation package amounts to $1 million, they may infer that the executive would owe Federal and state income tax on that $1 million, leaving less in the executive's hands after taxes are taken into account. They may not appreciate that the executive's before-tax salary is actually $1.82 million. Thus, in 2009 the Wall Street Journal reported that some companies were beginning to scale back on tax gross-ups as more light has been shed on them by advocacy groups.[2]

The issue illustrated in *Old Colony Trust* goes far beyond tax gross-ups, however. What if Sue

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[1] *See* Mark Maremont, *Latest Twist in Corporate Pay: Tax-Free Income for Executives*, at http://online.wsj.com/news/articles/SB113521937434129170.

[2] Cari Tuna, *Firms End Key Benefit for Executives*, at http://online.wsj.com/news/articles/SB123999269099029747.

is the CEO of Realty, Inc., and Realty pays CEO Sue's gym membership for her at a cost of $1,000 each year? Under *Old Colony Trust*, she must include that $1,000 in her Gross Income under § 61(a)(1), even if the payment goes directly from Realty to the gym. Moreover, because gym membership is a personal expense, she cannot deduct the payment that she is deemed to have made. § 262(a).

Mr. Wood's tax payment in *Old Colony Trust* and CEO Sue's gym membership were both paid in cash, but compensation need not be paid in cash to be cognizable for tax purposes. Compensation paid in the form of property received in kind or in the form of services received in kind is also includable (absent application of §§ 119 or 132, below).

For example, assume that Realty, Inc., sells to CEO Sue Blackacre, which is demonstrably worth $100,000, for only $10,000. CEO Sue must include the $90,000 worth of Blackacre that she received in kind (for free) in her Gross Income as compensation.[3] What should be CEO Sue's basis in Blackacre under SHS principles? Recall from Chapter 1 the two most common ways for basis to be created: (1) through the making of a nondeductible capital expenditure and (2) through an income inclusion with respect to property. Sue creates $10,000 of basis when she pays $10,000 for Blackacre, a nondeductible capital expenditure under § 263. She also creates $90,000 of basis when she includes $90,000 in her Gross Income under § 61(a)(1) on receipt of the property as compensation.[4] Thus, the sum of $10,000 (paid by Sue) and $90,000 (included by Sue) results in a $100,000 Blackacre basis, its full fair market value. Recall that basis is generally a running record of previous taxed dollars to ensure that we do not tax the same taxpayer twice on the same dollars. When Sue is denied a deduction for her $10,000 capital expenditure, that amount remains in her tax base and is implicitly taxed. When Sue includes $90,000 of compensation in her Gross Income, the $90,000 is explicitly taxed. Thus, Sue needs a $100,000 Blackacre basis to ensure that she is not taxed on any part of that $100,000 a second time when she sells Blackacre in the future.

Ditto with respect to services (as opposed to property) received in kind, as illustrated in the revenue ruling below.

**REVENUE RULING 79-24**

1979-1 C.B. 60

Certain members of barter clubs must include in income the fair market value of services received in exchange for services rendered. Likewise, the owner of an apartment building who receives a work of art created by a professional artist in return for the rent-free use of an apartment must include in income the fair market value of the work of art, and the artist must include the fair rental value of the apartment.

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 professional or trades

[3] *See* Treas. Reg. § 1.61-2(d)(1). In the very next chapter, you will learn that a bargain purchase between strangers does *not* result in realized gross income at the time of purchase for the buyer, as the benefit of the bargain does not represent a *substitute* for a clearly includable item, such as compensation, in that case. Stay tuned.
[4] *See* Treas. Reg. § 1.61-2(d)(2).

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 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.

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The Associated Press reported that the NBC broadcasting network once gave matching silver Boxster sports cars (worth $40,000 at the time) to Eric McCormack, Debra Messing, Sean Hayes, and Megan Mullaly, the four stars of the "Will & Grace" television show. "It was a nice way for us to say thank you for a great first season," said Dave Bartus, an NBC vice president. "We walked out into the parking lot and said, 'There's one for each of you.' They seemed truly shocked."[5] Of course, the TV stars had to include in their Gross Incomes the fair market value (FMV) of the cars under § 61(a)(1).

Here is another example:

> Phil Lubin, chief executive of Evernote, turned to his wife last year and asked if she had suggestions for how the software company might improve the lives of its employees and their families. His wife, who also works at Evernote, didn't miss a beat: housecleaning.
>
> Today, Evernote's 250 employees—every full-time worker, from receptionist to top executive—have their homes cleaned twice a month, free.
>
> It is the latest innovation from Silicon Valley: the employee perk is moving from the office to the home…. Stanford School of Medicine is piloting a project to provide doctors with housecleaning and in-home dinner delivery. Genentech offers

[5] ASSOCIATED PRESS, *"Will & Grace" Stars Get Porsches*, at www.apnewsarchive.com/1999/-Will-Grace-Stars-Get-Porsches/id-f4d340339fe0455e7a8313f73f664701. Eric McCormack then auctioned off the Porsche, with the proceeds benefiting Project Angel Food, a charity that delivers meals to those with debilitating illnesses. *See* Jessica Gold Haralson, *Erik McCormack auctioning Will & Grace Porsche*, at www.people.com/people/article/0,,20223342,00.html.

take-home dinners ….[6]

As with the TV stars, the Evernote employees must include in their Gross Incomes the FMV of these services.

Why would employers go to the bother of paying compensation in the form of property or services in kind—rather than cash—if employees (or independent contractors) must include the fair market value (FMV) of the property or services in Gross Income (absent application of an exclusion provision, such as §§ 119 and 132)? After all, paying cash is clearly easier for employers. A cash economy is also much more efficient than a barter economy. Moreover, perhaps the employee does not really want that particular property or service and would have preferred the cash, instead, so that she could buy something that she really wants.

Richard Thaler is one of the leading economists in the behavioral economics movement introduced in Chapter 3, which explores behavior that appears irrational on its surface. Please click and read the following article:

www.nytimes.com/1999/06/30/opinion/the-gasoline-powered-raise.html. (Come this holiday season, do not say that I never taught you anything practical.)

Thus, do not assume that an employer would never bother to arrange paying compensation in kind if it were going to be includable in any event, as would cash. Nevertheless, some compensation paid in kind (either with property or with services) is excludable under either § 119 or § 132, addressed in Parts A. and B., respectively.

## A. Section 119

Section 119 had its start in the common law under the "convenience of the employer" doctrine, created by some courts and affirmed by the IRS in the early days of the income tax. A straightforward example was the food and bed afforded to an army major at Fort Monroe in Virginia in *Jones v. United States*.[7] Should the value of the food and bunk provided in kind to the major be includable in Gross Income as compensation under § 61(a)(1)? The *Jones* court said "no" in 1925 because the food and lodgings were provided for the convenience of the employer (the U.S. Army) in order for the employee to perform his duties properly, not to provide remuneration to the employee.[8] As early as 1919, the IRS agreed that a seaman away on the high seas need not include the value of meals and lodgings provided by his employer on the ship (or boat).[9] Treasury memorialized this position in a 1920 regulation.[10] The doctrine was codified in 1954 when Congress enacted § 119, but it did not take long for taxpayers far afield of army majors and fishermen to argue that meals and lodgings should be excluded under § 119.[11]

Note each, separate requirement listed in § 119 that must be satisfied in order for the meals or

[6] Matt Richtel, *Housecleaning, Then Dinner? Silicon Valley Perks Come Home*, at www.nytimes.com/2012/10/20/us/in-silicon-valley-perks-now-begin-at-home.html?pagewanted=all.
[7] 60 Ct. Cl. 552 (1925).
[8] *See also* Benaglia v. Comm'r, 36 B.T.A. 838 (1937); Diamond v. Sturr, 221 F.2d 264 (2d Cir. 1955); Comm'r v. Doak, 234 F.2d 704 (4th Cir. 1956); Papineau v. Comm'r, 16 T.C. 130 (1951); Ellis v. Comm'r, 6 T.C. 138 (1946).
[9] O.D. 265, 1 C.B. 71 (1919).
[10] T.D. 2992, 2 C.B. 76 (1920).
[11] Today, the exclusion of military housing is afforded under § 134. A "minister of the gospel" can exclude the value of housing provided in kind under § 107(1) and can exclude a cash housing allowance under § 107(2).

lodgings to qualify for exclusion. Does lunch money (cash) constitute "meals"? What are "the business premises of the employer" of state troopers? The entire state? Private restaurants along the public highways? If the requirements of § 119 are not satisfied, did the common law, convenience-of-the-employer doctrine survive the 1954 enactment of § 119 so that amounts failing to satisfy the new statutory provision might nevertheless be excludable?

## COMMISSIONER v. KOWALSKI

434 U.S. 77 (1977)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

Respondent is a police trooper employed by the State of New Jersey. During 1970 he received a base salary of $8,740, and an additional $1,698 designated as an allowance for meals. Under the meal 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. 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.

In the absence of a specific exemption, respondent's meal-allowance payments are income within the meaning of [§ 61(a)(1)].

Respondent contends, however, that § 119 can be construed to [exclude] the meal-allowance payments. By its terms, § 119 covers meals furnished by the employer and not cash reimbursements for meals. The Senate Report is very clear: "Section 119 applies only to meals or lodging furnished in kind." *See also* Reg. § 1.119-1(c)(2). Accordingly, respondent's meal allowance payments are not subject to exclusion under § 119.

Alternatively, respondent argues 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" are not income. In 1920 a convenience-of-the-employer section was added to the regulations, which as modified stated:

> When living quarters such as camps are furnished to employees for the convenience of the employer, the value need not be added to the cash compensation of the employee, but where a person receives as compensation for services rendered a salary and in addition thereto living quarters, the value to such person of the quarters furnished constitutes income subject to tax.

O.D. 514, 2 C.B. 90 (1920), extended the convenience-of-the-employer doctrine to cash payments for "supper money." ….

Even if we assume that respondent's meal-allowance payments could have been excluded from income pursuant to the doctrine we have just sketched, we must nonetheless inquire whether such an implied exclusion survives the 1954 recodification. Two provisions of the 1954 Code are relevant to this inquiry: § 119 and § 120, now repealed.

In enacting § 119, Congress was determined to "end the confusion as to the tax status of meals and lodging furnished an employee by his employer." The House proposed to exclude meals from income "if they [were] furnished at the place of employment and the employee [was] required to accept them as a condition of his employment." The House view [entailed] 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. The Senate Report states:

> 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.

In a technical appendix, the Senate Report further elaborated that:

> 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.

After conference, the House acquiesced in the Senate's version of § 119.

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 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 non-compensatory cash payments is without merit.

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. In any case, Congress has already considered respondent's equity argument and has rejected it in the repeal of § 120 of the 1954 Code. That provision as enacted allowed state troopers like respondent to exclude from income up to $5 of subsistence allowance per day. Section 120 was repealed after only four years, however, because it was "inequitable, since there are many other individual taxpayers whose duties also require them to incur subsistence expenditures regardless of the tax effect." H.R. Rep. No. 775.

MR. JUSTICE BLACKMUN, with whom THE CHIEF JUSTICE joins, dissenting.

I have no particular quarrel with the conclusion that the payments received by the New Jersey troopers constituted income to them under § 61. I disagree with the Court's conclusion that the payments are not excludable under § 119. The Court draws an in-cash or in-kind distinction. This has no appeal or persuasion for me because the statute does not speak specifically in such terms. It does no more than refer to "meals furnished on the business premises of the employer," and from those words the Court draws the in-kind consequence. I am not so sure. In any event, for me the business premises of the State of New Jersey are wherever the trooper is on duty in that State.

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What does "convenience of the employer" mean? Treas. Reg. § 1.119-1(a)(2) provides that the meals and lodgings must be provided by the employer for a "substantial *noncompensatory* business reason" (emphasis added), as opposed to a "means of providing additional compensation." The "mere declaration" by the employer that the meals or lodgings are provided for a noncompensatory business reason is not sufficient; rather, all the facts and circumstances must be examined in making this determination. Note the several examples provided in the regulations that will

constitute a substantial noncompensatory business reason, such as having the employees available for emergency call during meals. Also note that providing meals merely to boost employee morale is *not* a substantial noncompensatory business reason.

If a hospital provides meals in kind to all employees for free at the hospital cafeteria, and it can be shown that the doctors and nurses that are employed by the hospital are not infrequently called back to their wards during meals, can the ward janitors, who are not often called back to the ward for emergencies, exclude their free meals? Could you imagine the reaction if the low-paid employees were told that their free meals must be valued and included in their Gross Incomes but that the better-paid doctors and nurses need not include the value of their free meals in their Gross Incomes? Likely to counteract such perceptions of unfairness, Congress enacted § 119(b)(4) in 1998.

Note that the statute imposes an additional requirement for the value of lodgings provided in kind to be excludable under § 119 (not required for meals): that "the employee is required to accept such lodging … as a condition of employment." What does that additional requirement mean? Does it mean only that the employer stipulate in the employment contract that the employee must accept the lodgings provided on the business premises? What employer would refuse to add such a provision in the contract at the request of the employee once the employer agreed to provide such free lodgings in any event? *See* Treas. Reg. § 1.119-1(b). As described in the regulation, can you think of any fact pattern where the convenience of the employer requirement would be satisfied but the condition of employment requirement would not be (or vice versa)?

What does the "business premises of the employer" mean? *See* Treas. Reg. § 1.119-1(c)(1).

## LINDEMAN v. COMMISSIONER

60 T.C. 609 (1973)

JUDGE FEATHERSTON: [Jack B. Lindeman was the general manager of the Beach Club Hotel in Fort Lauderdale, Florida. For many years, he and his family were provided a free four-room suite in the hotel in which to live, but his employer decided that the suite could be more profitably rented to guests. Thus, his employer purchased a house across a 50-foot-wide street from the hotel and allowed Mr. Lindeman to live there rent-free. The government sought to include the fair rental value of the home in Mr. Lindeman's Gross Income under § 61(a)(1).]

As a general rule, all remuneration for services is Gross Income, and an employee's remuneration includes the value of lodging or living quarters furnished by his employer. *See* Treas. Reg. sec. 1.61-2(d)(1). However, section 119 excludes from an employee's Gross Income the value of lodging furnished to him by his employer if three conditions are met: (1) The lodging is furnished for the convenience of the employer; (2) the employee is required to accept the lodging as a condition of his employment; and (3) the lodging is "on the business premises" of the employer. The sole issue in the instant case is whether the house in which petitioner and his family lived during 1968 and 1969 was "on the business premises" of Beach Club Hotel.

These deceptively simple words—"on the business premises" of the employer—have been the subject of extended judicial opinions with varying results. *See, e.g.*, *Comm'r v. Anderson*, 371 F.2d 59 (C.A. 6, 1966), reversing 42 T.C. 410 (1964), and *Gordon S. Dole*, 43 T.C. 697 (1965), affirmed per curiam 351 F.2d 308 (C.A. 1, 1965). We examine anew the legislative history of section 119 insofar as it bears on the issue presented for decision.

The requirement of section 119 that, to be excludable from Gross Income, lodging must be furnished and accepted "on the business premises" of the employer was first adopted as part of the 1954 Code. As passed by the House of Representatives, the section used the term "place of employment" rather than "business premises." H. Rept. No. 1337, to accompany H.R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., pp. 18, A39 (1954). The Senate changed the term to "business premises," but the accompanying report explained that "Under both bills meals and lodging are to be excluded from the employee's income if they are furnished at the place of employment and the employee is required to meet certain other conditions." S. Rept. No. 1622, to accompany H. R. 8300 (Pub. L. No. 591), 83d Cong., 2d Sess., pp. 19, 190-191 (1954).

The Senate version was adopted with the following explanation in Conf. Rept. No. 2543, 83d Cong., 2d Sess., p. 27 (1954):

> The term "business premises of the employer" is intended, in general, to have the same effect as the term "place of employment" in the House bill. For example, lodging furnished in the home to a domestic servant would be considered lodging furnished on the business premises of the employer. Similarly, meals furnished to a cowhand while herding his employer's cattle on leased lands, or on national forest lands used under a permit, would also be regarded as furnished on the business premises of the employer. * * *

As in the case of other exclusions from Gross Income, this one is subject to abuse, and the statutory language must be construed with this thought in mind. Accordingly, the term "on" in relation to the employer's business premises does not mean "in the vicinity of" or "nearby" or "close to" or "contiguous to" or similar language, but is to be read literally. *Comm'r v. Anderson*, *supra* at 67. If the lodging is furnished at a location some distance from the place where the employee works, the lodging is not furnished on his employer's business premises.

In determining what are the employer's "business premises," Congress quite obviously intended a commonsense approach. Read literally, the statutory language ordinarily would not permit any exclusion for lodging furnished a domestic servant, since a servant's lodging is rarely furnished on "the business premises of his employer"; yet the committee report, quoted above, shows a clear intention to allow the exclusion where the servant's lodging is furnished in the employer's home. Similarly, the section, as a condition to the exclusion, does not require that the meals or lodging be furnished at any particular location on the employer's property; thus, the same committee report clearly states that meals provided for a cowhand are excludable even though they are furnished on leased lands or on lands used under a permit.

These illustrations in the committee report, moreover, demonstrate that section 119 does not embody a requirement that the meals or lodging be furnished in the principal structure on the employer's business premises. Thus, the committee report makes it explicitly clear that a cowhand's meals and lodging need not be furnished at the ranch headquarters. And surely the right of a domestic servant to the section 119 exclusion cannot be made to turn on whether his lodging is furnished in the family residence or in servants' quarters located elsewhere on the estate. Indeed, in *Boykin v. Commissioner*, 260 F.2d 249 (C.A. 8, 1958), affirming in part and reversing in part 29 T.C. 813 (1958), the Commissioner at least implicitly conceded that a physician's living quarters, located on the grounds of a Veterans Administration Hospital, were on his employer's business premises even though he performed none of his employment services in his living quarters. Similarly, the Commissioner has ruled that meals furnished at branch offices of an

employer, as well as at a central dining facility, meet the requirements of the section. Rev. Rul. 71-411, 1971-2 C.B. 103.

The issue as to the extent or the boundaries of the business premises in each case is a factual issue, and in resolving that question consideration must be given to the employee's duties as well as the nature of the employer's business. The section 119 exclusion applies where the lodging is furnished at a place where the employee performs a significant portion of his duties or on the premises where the employer conducts a significant portion of his business. *Comm'r v. Anderson*, 371 F.2d at 67. Or, in the words of this Court in *Gordon S. Dole*, 43 T.C. at 707, "the phrase should be construed to mean either (1) living quarters that constitute an integral part of the business property or (2) premises on which the company carries on some of its business activities."

We think petitioner has shown that the house which his employer furnished him during 1968 and 1969 was part and parcel of the "business premises" of Beach Club Hotel. In reaching this conclusion, we think it apparent that the business premises of the hotel are not limited to 3100 North Ocean Boulevard, where the hotel building is located, but include both parking lots and the house furnished to petitioner.

There is a large parking lot on the property where the hotel building is located, but it is by no means adequate to meet the needs of the hotel guests. The parking lot situated across Oakland Park Boulevard is used by hotel guests and employees and is essential to the operation of the hotel business. Even though these lots are across a street from the hotel building, they are obviously as much a part of the "business premises" of the hotel as the parking area located on the lot at 3100 North Ocean Boulevard.

Similarly, we think the house in which petitioner resides is part of the business premises of the hotel. These lots were acquired to alleviate a chronic shortage of parking spaces in connection with the operation of the hotel and to provide the hotel general manager with living quarters that were more economical to the hotel.

Moreover, the nature of the Beach Club Hotel business is such as to require the general manager to live where he is immediately accessible at all hours, and the house meets this need. It is stipulated that:

> In 1963, after a cost study, Beach Hotel Corporation determined it should be more profitable to purchase or rent accommodations [sic] for * * * [petitioner] and his family as close to the hotel as possible and have the suite of four rooms he was occupying available to be rented.

Thereupon, [the house was acquired by the Beach Club Hotel] to provide housing for petitioner and his family. This was a business decision based on business considerations, and there is no suggestion in the record that it was prompted by any other factors or that it involves an abuse of the section 119 exclusion.

The house is so situated and so used that it is part of the hotel plant. While petitioner's office is located in the business area of the hotel building (as it was while he occupied the suite of rooms as his residence), he is subject to call 24 hours a day, and he is as readily accessible for the frequent calls by direct telephone as he was in the suite located in the hotel building. He often returns to the hotel building several times in an evening. People dealing with him through the direct telephone line have no way of knowing whether he is in the hotel building or his home. Moreover, from the house he can observe the entire south half of the building and can "tell if there is a disturbance of

any kind, see if lights are on or off, if the night lights don't come on early enough," and the like.

While petitioner does most of his management work in his office in the hotel building, he also has an office in the house. In this latter office in his home, he receives calls from the hotel personnel or guests on the direct telephone line from the hotel while he is not on regular duty. He also uses this office when he is working on new brochures or rate structures and when he is planning a program for future hotel activities, such as "cook-outs, games, picnics on the beach, cocktail parties, and this sort of thing." In addition, he occasionally entertains a guest of the hotel.[5]

In our view, these facts demonstrate that the lodging furnished petitioner is, within the meaning of section 119, "on the business premises of his employer" or, within the meaning of the accompanying committee reports, "at the place of employment." The house in which he lives is an indispensable and inseparable part of the hotel plant, and it is within the perimeter of the hotel property. Since it is part of the premises where petitioner performs the duties required in his job and where his employer carries on its business, we hold that petitioner is entitled to the section 119 exclusion.

*Commissioner v. Anderson*, 371 F.2d 59 (C.A. 6, 1966), on which respondent relies, is factually distinguishable. In that case, the housing furnished the employee was "two short blocks" from the facility being managed by the taxpayer (p. 61), and the Court of Appeals did not conclude, as we do here, that the living quarters of the employee-taxpayer were an integral part of the business property. Accordingly, the Court of Appeals held that the requirements of the statute were not met. In the instant case, the premises of the business managed by petitioner include the house in which his lodging was furnished.

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The *Lindeman* case noted the servant and cow hand examples in the regulations, which were drawn from the legislative history. (Are they particularly helpful examples in the 21st century?) Do the chosen examples imply that the employer must have some sort of ownership interest in the premises, such as a lease or a fee interest? If that is the case, the private restaurants along the public highways in New Jersey could not have been the "business premises of the employer" in the *Kowalski* case, notwithstanding Justice Blackmun's dissenting opinion to the contrary. Moreover, even if the servant is considered to be on the business premises of the employer, does she satisfy the "convenience of the employer" requirement?

One of the common law cases pre-dating codification in § 119 of the convenience of the employer doctrine was *Benaglia v. Commissioner*,[12] which one tax professor[13] described thusly:

> In *Benaglia*, a hotel manager was permitted to exclude the value of a posh hotel suite and equally extravagant meals on the ground that his presence was necessary to attend to the "numerous, varied, and unpredictable" demands of the filthy rich patronizing the establishment—*i.e.*, for the convenience of the employer. 36 B.T.A.

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[5] Seeking a decision on the broader ground that the house was located "at the place of employment," petitioner deemphasizes the duties which he performs in this home office. However, under the meaning of the term "on the business premises," discussed above, we think his work at his home office as well as its proximity to the hotel building are factors to be taken into account.

[12] 36 B.T.A. 838 (1937).

[13] Erik M. Jensen, *Food for Thought and Thoughts About Food: Can Meals and Lodging Provided to Domestic Servants be for the Convenience of the Employer?*, 65 IND. L.J. 639 (1990).

> at 840. Any benefit to the manager was "merely an incident of the performance of his duty." *Id.* The favorable tax treatment, some commentators have noted, "apparently runs with the land." The manager of the same hotel, forty years after *Benaglia*, continued the tax-free receipt of meals and lodging, "although he admitted to an enterprising tax professor that he had never handled a nighttime emergency." Byrnes & McIntyre, *Famous Events in Tax History*, 1 TAX NOTES INT'L 260 (1989).

Is Mr. Benaglia's exclusion—very different from the soldiers and sailors at sea with which the common law doctrine originated—consistent with the standard of living fairness norm discussed in Chapter 3? These sorts of observations bring us to the tax policy issues underlying excludable compensation received in the form of consumption provided in kind. Under the *Old Colony Trust* two-step, the employee would be treated as receiving *cash* compensation (includable in Gross Income under § 61(a)(1)), which she then uses to purchase the meals or lodgings (nondeductible personal expenses under § 262 in reaching Taxable Income). If an employer provides meals or lodgings to an employee that satisfies each of the requirements of § 119, however, the employee can exclude from Gross Income the FMV of the meals or rental value of the lodgings, notwithstanding *Old Colony Trust*. What factors justify departure from the *Old Colony Trust* two-step? What tax policy tools does Congress draw on in crafting the lines between includable and excludable compensation paid in the form of consumption provided in kind? And can these tax policy tools help to inform how the requirements provided in the exclusion provisions ought to be interpreted by judges and the administrators of the statute in the case of ambiguity?

One possible tax policy tool is horizontal equity, but the usual problems with that standard (discussed in Chapter 3) are also implicated here. Sam is provided $100 in cash salary and purchases his own $10 meal, which is a nondeductible personal expense under § 262. Thus, his Taxable Income is $100, including the amount expended on the meal that he ate. Sally is provided $90 in cash salary and is provided a free $10 meal by her employer that is excludable under § 119. Thus, her Taxable Income is $90. At the end of the day, both Sam and Sally have $90 of cash in hand and have eaten a meal, but Sam's Taxable Income is $10 higher than Sally's. Does this situation violate the horizontal equity norm that similarly situated taxpayers should be taxed alike? But *are* they similarly situated? Why or why not? Does your reasoning have any impact on how broadly or narrowly § 119 ought to be construed (and § 132, in a moment)?

How about this line of reasoning? In *Old Colony Trust*, it was easy to see why the employer's payment of Mr. Wood's Federal income tax should be construed as though (1) Mr. Wood received additional cash compensation (a clearly includable wealth accession), which (2) he then sent to the IRS as Federal income tax (a nondeductible payment under § 275(1)). It was easy to see because Mr. Wood's payment of Federal income tax was mandatory, so we can be comfortable in assuming that had he, in fact, received additional cash compensation (equal to the tax payment) he would have used that cash in the very manner in which his employer used it—to pay his Federal income tax. In enacting § 119 (or in construing whether one or more of the requirements imposed by § 119 is satisfied), is it helpful for Congress, a court, or the IRS to consider how likely it is that the employee would have bought precisely the same meal or rented precisely the same premises if she had been provided cash compensation instead? After all, if we can determine that the employee would have bought precisely the same consumption, we can be comfortable in assuming that having it provided in kind is the equivalent of (1) receiving additional cash compensation (clearly includable), which was then (2) used to purchase the nondeductible personal consumption. Of

course, such an inquiry (how likely is it that the taxpayer would have chosen to purchase precisely the same meal or rent precisely the same premises?) would not be administrable as a statutory test in the real world, which is why Congress must come up with *proxy tests* (such as convenience of the employer) to get at the same underlying question indirectly. If there is a strong noncompensatory business reason why the employer provided the meals or lodgings (relevant to the ability of the employee to perform his or her job duties), perhaps we can be less sure that the employee would have used an equivalent amount of cash compensation to purchase the same meals or lodgings and thus should be wary of applying the *Old Colony Trust* two-step.

Notice that this sort of analysis is premised on the ability to pay fairness norm rather than the standard of living fairness norm. The more certain we are that the meals and lodgings are of the same sort that the taxpayer would have purchased, the more reasonable it is to deem an intermediate cash receipt à la *Old Colony Trust*, which clearly represents ability to pay. Along the same lines, the *Kowalski* Court rejected broadly interpreting the word "meals" to include *cash* (used to buy meals chosen by the employee). Finally, the same reasoning underlies the refusal to allow cash (or a cash equivalent) to be excluded as a *de minimis* fringe under § 132(e) (with one narrow exception for "supper money"), as you will learn in Part B., below.

Taking the analysis one step further, does not the receipt of free meals and free lodgings in kind—even if they are different from the type of meals or lodgings that the employee would otherwise have purchased—nevertheless free the taxpayer from having to spend *some amount* on meals and lodging? After all, we all have to eat and to find shelter. In Chapter 20, we shall consider the *deductibility of cash spent on meals* as a business expense (rather than the *inclusion of free meals received in kind* as compensation). For example, when John travels to another city for a business meeting, he will incur meal costs on the road, which are generally deductible under § 162(a)(2). In 1986, however, Congress enacted § 274(n)(1), which generally reduces John's § 162 business expense deduction for meals to 50% of the cost. The idea is that, even though business reasons support deduction of a portion of his meal costs while traveling on business, the meal nevertheless also provides nourishment because John must eat in any event. Thus, 50% of the cost is allocated to nourishment (nondeductible personal consumption) and 50% is allocated to the business purpose underlying the meal (deductible). So here is the question: even if business reasons justify some exclusion for meals and lodgings provided in kind for the convenience of the employer, should Congress have similarly amended § 119 in 1986 to limit the exclusion of the meals or lodgings to 50% of the value received (with the remaining 50% included) on the theory that the employee would have had to buy food and shelter (nondeductible personal consumption) in any event?

## B. Section 132

In the late 1970s, Treasury decided to issue additional regulations under § 61(a)(1) to clarify what other kinds of in-kind compensation (other than meals and lodgings provided for the convenience of the employer under § 119) could be excluded from Gross Income, notwithstanding § 61(a)(1), because complaints had arisen that different employers were given varying IRS advice regarding the same sorts of items. Congress responded by imposing a moratorium in 1978 on new Treasury regulations pertaining to this issue, providing Congress some time to enact new statutory provisions. Finally, in 1984, Congress enacted § 132 and added the language regarding "fringe benefits" to § 61(a)(1), thus making it clear that no common law exclusions exist with respect to

compensation. Absent explicit statutory authority to exclude, *all* compensation—whether paid in cash or in kind—must be included in Gross Income under § 61(a)(1).

### *Excerpt from* General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984[14]

#### *Reasons for Change*

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the Congress struck a balance between two competing objectives. First, the Congress was 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 generally have been treated by employers, employees, and the Internal Revenue Service as not giving rise to taxable income.

[W]here an employer has only one line of business, the fact that the selection of goods and services offered in that line of business may be limited in scope makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees …. By contrast, allowing tax-free discounts for all lines of business of a conglomerated organization, where the employee might have unlimited choices among many products and services which individuals normally consume or use on a regular basis, would be indistinguishable in economic effect from allowing tax-free compensation in the form of cash or gift certificates. Also, the noncompensatory element involved in providing discounts on the particular products or services that the employee sells to the public may be marginal or absent where an employer offers discounts across all lines of business.

…

The second objective of the new statutory rules is to set forth clear boundaries for the provision of tax-free benefits…. Congress was concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly. This erosion of the income tax base results because the preferential tax treatment of fringe benefits serves as a strong motivation to employers to substitute more and more types of benefits for cash compensation. A similar 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 addressed in the Social Security Amendments of 1983. In addition, continuation of the dramatic growth in noncash forms of compensation—at a rate exceeding the growth in cash compensation—could further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash.

Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, because not all employers can or will provide comparable compensation packages…. [A]n unlimited exclusion for noncash benefits discriminates among employers. For example, if tax-free discounts were allowed across all lines of business of an employer, a large employer with many types of businesses (*e.g.*, department store, hotel, airline, *etc.*) would be given a favorable edge by the tax system in competing for

[14] STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 840-42 (Dec. 31, 1984).

employees as compared with a small firm having one line of business (*e.g.*, a specialty clothing store)….

Accordingly, the Congress determined that specific rules of exclusion should be set forth in the Code, with limitations on the availability, applicability, and scope of these statutory exclusions. These general limitations include a nondiscrimination rule, the line of business limitation, and the limitation on exclusions to benefits provided to the employee and the employee's spouse and dependent children….

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the Act from income and employment taxes. Under the Act, 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 Congress believed 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….

These amendments made clear that any fringe benefit that does not qualify for exclusion under a specific Code provision is includable in the recipient's Gross Income, and in wages for withholding and other employment tax purposes, at the excess of the fair market value of the benefit over any amount paid by the recipient for the benefit.

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Note the concern repeatedly stated in the legislative history excerpt about possible damage to the tax base if consumption provided in kind (as compensation) were broadly excludable. A broad exclusion would encourage the *substitution* of in-kind compensation (excludable) for cash compensation (includable). Such a substitution would be inefficient, causing a tax-motivated change in behavior, as it is easier for most employers to pay compensation in cash rather than in kind. Moreover, always remember that tax-base-narrowing provisions are never costless; the resulting reduction in tax base would require tax *rates* to be higher than they would otherwise need to be to raise *$X*, raising additional efficiency concerns.

The original version of § 132 enacted in 1984 contained only the provisions now listed in § 132(a)(1) through (4), pertaining to the no additional cost service, the qualified employee discount, the working condition fringe, and the *de minimis* fringe, as well as the exclusion for qualified tuition reductions for employees of educational institutions, added to the Code in § 117(d) (considered in Chapter 17). Subsequent acts have since expanded § 132 to address the qualified transportation fringe, the qualified moving expense reimbursement, the qualified retirement planning service, and the qualified military base realignment and closure fringe.

Compensation excludable for Federal income tax purposes under § 132 is also not taxed as "wages" under the payroll taxes (Social Security and Medicare).

The employer is typically the party that seeks to determine whether an item is includable or excludable because, if the item is includable, the employer must (1) withhold and send to Treasury the estimated income tax, as well as payroll taxes, owed by the employee from remaining cash wages, (2) pay its employer share of the payroll taxes on these amounts, and (3) include those amounts in the year-end Form W-2 that is sent to the employee. The IRS may choose to conserve

resources by pursuing fringe benefit issues primarily with employers.

For example, in *American Airlines, Inc. v. United States*,[15] American Airlines gave to every employee a $50 American Express "Be My Guest" voucher that could be used like cash at any establishment that accepted American Express credit cards as a gesture of appreciation for the employees' extra work effort during a labor dispute at a competing airline that substantially increased American's passenger load. American Airlines decided on the voucher in lieu of a firm-wide banquet. The face amount of the vouchers totaled $4,250,000, and more than 97% were redeemed. American did not include the vouchers in the employees' Gross Incomes for income and payroll tax purposes and did not pay the employer share of payroll taxes on the amount, arguing that the vouchers could be excluded as a *de minimis* fringe within the meaning of § 132(e)(1). While a firm-wide banquet would have been excludable as a *de minimis* fringe under Treas. Reg. § 1.132-6(e)(1), which provides exclusion authority for "occasional cocktail parties, *group meals*, or picnics for employees and their guests" (emphasis added), the vouchers were held not to be excludable because they constituted "cash equivalent fringe benefits" within the meaning of Treas. Reg. § 1.132-6(c). Notice that the IRS pursued this issue with the employer, not the numerous employees.

## Problems

These problems provide an opportunity for close parsing of the statute and regulations. While I sometimes cite helpful Treasury regulations, *always* start with the statutory language at issue in each problem before turning to the cited regulations. In particular, before embarking on the problems, carefully read § 132(a), (b), (c), (d), (e), (f), (j)(1), and (h)(2)(A), (h)(3).

Section 132(h)(3) was added in 1985. Why would Congress specify that use by parents qualify as use by employees only in the case of airline transportation? The Chairman of the House Ways and Means Committee, where all tax legislation originates, was Dan Rostenkowski, who sponsored the 1985 legislation. I understand that his two daughters worked for an airline that provided free air travel on a space-available basis for parents of employees (in addition to spouses and dependents). As my nieces and nephews commonly observe, "just sayin."

**1.** Holly works as a flight attendant on Hilarity Airlines, owned by Conglomerate, Inc., which also owns Hooyacht Hotels. Conglomerate allows all of its employees, as well as their spouses and children, to fly for free (Hilarity Airlines) or stay for free (Hooyacht Hotels) on their vacations on a space-available basis. Holly and her husband Hal use this perk to fly at no cost to Hawaii (FMV $600 each for a total FMV of $1,200), where they stay for free in a room at the Hooyacht Hotel in Honolulu for 5 nights (FMV $2,000 for all 5 nights). On the flight to Hawaii, they ate free meals and drank beverages. At the Hooyacht Hotel, the maid serviced their room each day, cleaning their room while there were on the beach. Which fringe benefit exclusion might apply to the facts? What are the separate and independent requirements that must be satisfied for the exclusion provision to apply? After isolating possible statutory issues, see Treas. Reg. §§ 1.132-2(a)(5)(ii) and -4(a)(1)(i) for help in resolving them.

**2.** Same as **1.** except that Holly is an Executive Vice President of Hilarity Airlines rather than a flight attendant, and only executives are allowed to fly for free on Hilarity Airlines or stay for

[15] 204 F.3d 1103 (Fed. Cir. 2000).

free in Hooyacht Hotels on a space-available basis. All employees other than executives get a 50% discount for flying or staying in the hotel on a space-available basis. Thus, on the same flight that Holly and her husband took, non-executives would have had to pay $300 each for the flight seats (worth $600 each). *See* Treas. Reg. § 1.132-8(a)(2).

**3.** Same as **1.** (where Holly was a flight attendant), except that, in addition to being able to fly for free on Hilarity Airlines on a space-available basis, Holly is provided annually one voucher that allows her to make advanced reservations for confirmed seats for herself, her spouse, and her children. She uses this voucher to purchase two seats (for herself and her husband Hal) to fly to Paris (FMV $1,500 each for a total FMV of $3,000) for free. *See* Treas. Reg. § 1.132-2(a)(2); -3(e).

**4.** Jack works as a salesperson at Jock Shoes, where he sells the latest designer athletic shoes. All employees are permitted to buy shoes for personal use (not for friends) at a 40% discount. Jack purchases for $60 shoes that are sold to customers for $100. During the year, Jock Shoes has $1 million in total sales and $700,000 in cost of goods sold.

**5.** Sam works for Gold Unlimited, which buys and sells gold. All employees are permitted to buy gold at a 10% discount from the price at which gold is selling on that day. Sam purchases a quantity of gold for $900 on a day that gold is selling for $1,000 for the quantity that he purchased. During the year, Gold Unlimited has $1 billion in total sales and $900 million in cost of goods sold. In addition to § 132(c)(4), read Treas. Reg. § 1.132-3(a)(2)(ii).

**6.** Sally is in-house corporate counsel (instead of a flight attendant) for Conglomerate, Inc., the owner of Hilarity Airlines and Hooyacht Hotels, described above. In addition to the perks noted above, Conglomerate agrees to pay 100% of the cost of professional association dues for all employees. Conglomerate pays Sally's $275 American Bar Association dues for the year. In addition, Sally and her husband take advantage of the space-available policy noted above for flights and rooms to fly at no cost to Hawaii (FMV $600 each for a total FMV of $1,200), where they stay for free in a room at the Hooyacht Hotel in Honolulu for 5 nights (FMV $2,000 for all 5 nights). Sally does corporate work for both the Hilarity and Hooyacht lines of business. *See* Treas. Reg. § 1.132-4(a)(1)(iii), (iv).

**7.** Conglomerate, Inc., supports the local theater complex that hosts touring Broadway shows. Conglomerate provides to Jacob, an executive, one set of free theater tickets (FMV $250) to attend a touring company performance of a hot Broadway show for himself and his spouse. Only executives are provided such tickets. What if, instead, Conglomerate provides Jacob with $250 in cash to use in purchasing the tickets, rather than provides the tickets in kind? *See* Treas. Reg. § 1.132-6(e)(1) and -6(c).

**8.** Conglomerate, Inc., reimburses Jacob for the cost of his dinner approximately four nights each month when he works late at the office. Conglomerate does not reimburse dinner costs for non-executives who must work late. *See* Treas. Reg. § 1.132-6(d)(2).

**9.** Conglomerate, Inc., has a cafeteria in its headquarters building that is open to all employees. The cafeteria charges low prices (substantially less than the FMV of the meals) in order to just

break even in running the cafeteria. Must the employees include the difference between the FMV of the meals and the price paid for them? Assume that § 119 is not satisfied on the facts. *See* § 132(e)(2). What if the facility is an Executive Dining Room open only to Executives?

**10.** Conglomerate, Inc., reimburses Jacob for his parking costs in a garage close to the office building at a cost of $150 each month. Only executives' parking costs are reimbursed.

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Suppose that you rack up frequent flier miles on business trips reimbursed by your employer and that you subsequently use those frequent flier miles to take a personal trip. That personal trip was, in substance, paid for by your employer because the miles used to take the trip were compiled on travel paid for by your employer. Nevertheless, the IRS has announced that it will not seek to tax the use of such frequent flier miles unless the employee is able to convert them to cash,[16] as occurred in *Charley v. Commissioner*.[17]

## C. Section 83

Recall Mary from Chapter 1, Part A., who was a CEO of a mid-size corporation receiving $1 million in annual compensation. We considered then the case in which she received her compensation in the form of $500,000 in cash and shares of corporate stock with a FMV of $500,000. We confirmed then that Mary must include the full $1 million of compensation in her Gross Income under § 61(a)(1), including not only the cash but also the $500,000 FMV of the corporate shares, under Treas. Reg. § 1.61-2(d)(1), and that she would take a $500,000 cost basis in those shares (equal to the amount that she included in Gross Income with respect to their receipt) under Treas. Reg. § 1.61-2(d)(2).

Let's change the facts a bit. Suppose that a condition is attached to Mary's retention of those shares to the effect that, if Mary were to quit or be fired for cause before the end of Year 5, she would have to forfeit those shares back to her corporate employer. You will sometimes hear such shares referred to as "restricted stock" or "nonvested stock." Should Mary still include the $500,000 FMV of those shares on receipt in Year 1? If she includes their value in Year 1, can she reduce that value (to something less than $500,000) to take account of the forfeiture risk, *i.e.*, the potential that she might have to return the shares? Or should she wait to include the FMV of those shares until the risk of forfeiture lapses at the end of Year 5 and include their FMV at that time, which may be more or less than $500,000?

Congress enacted § 83 in 1969 to answer these questions. Under § 83(a), Mary would defer inclusion of the FMV of her stock until the forfeiture risk lapses in Year 5 and the property vests in Mary outright. Thus, she would include nothing in Year 1 on the receipt of the restricted stock. If it were worth, say, $600,000 in Year 5 when the forfeiture risk lapses, she would include $600,000 of compensation Gross Income under § 61(a)(1) at that time (as ordinary income) and take a $600,000 cost basis at that time, reflecting the income inclusion. Any additional increase in value (or loss in value) would produce capital gain or loss, as the case may be, when realized because the stock is a capital asset in Mary's hands within the meaning of § 1221. Under Treas. Reg. § 1.83-1(a), Mary's corporate employer is considered to be the owner of the shares until the

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[16] *See* Announcement 2002-18, 2002-1 C.B. 621.
[17] 91 F.3d 72 (9th Cir. 1996).

forfeiture risk lapses. Therefore, if any dividend is payable on the stock during the period before vesting, Mary would have no legal right to the dividend. Nevertheless, many corporations pay an equal amount "in lieu of" the dividends to folks like Mary, who must include these amounts as (ordinary) compensation income.

Under § 83(b), however, Mary can make an election (within 30 days of receipt) to include the FMV of the restricted property in the year of receipt (thus creating a basis equal to that Gross Income inclusion). The FMV is determined without regard to the forfeiture risk inherent in the stock. What factors should Mary consider in deciding whether to make a § 83(b) election?

As you learned in Chapter 1, the deferral of an income inclusion benefits Mary because of (all together now) *the time value of money*. All things being equal, Mary would like to defer an income inclusion as long as possible. But sometimes all things are not equal. For example, what if Mary believes that the top tax rate may increase beyond 39.6% before the stock vests in Year 5? She would have to weigh two factors—possibly higher tax rates in the future and the time value of deferral—against each other in determining whether deferral would be beneficial. That is to say, even though she would lose the time value of money by giving up deferral and including the $500,000 now, that real economic loss may be more than made up for by having that inclusion taxed at 39.6% if she believes that future tax rates will be significantly higher.

Moreover, even if tax rates remain absolutely unchanged between Year 1 and Year 5, Mary may still wish to include the $500,000 FMV in Year 1 because the property received (stock) is a capital asset. While the top tax rate applicable to ordinary income (such as compensation) is 39.6%, recall from Chapter 1 that the top tax rate applicable to "net capital gain" (which requires at least some long-term capital gain, as explored more fully in Chapter 15) is generally 15% for those with Taxable Income of less than $400,000 ($450,000 for married couples filing jointly) or less and 20% for those with Taxable Income exceeding those thresholds. Suppose that Mary expects that stock to be worth $600,000 in Year 5 when the forfeiture risk lapses. If she defers inclusion until Year 5, she will include $600,000 of high-taxed ordinary income at that time. If, in contrast, she makes a § 83(b) election in Year 1 and includes the $500,000 FMV of the stock in that year, she will take a $500,000 cost basis. When the forfeiture risk lapses in Year 5 and she sells for its then-value of $600,000, she would realize $100,000 of low-taxed capital gain ($600,000 A/R *less* $500,000 A/B). Which would be better? Once again, she would have to weigh the pain of losing the time-value-of-money benefit against the reduction in tax rate that could potentially apply to the $100,000 expected future appreciation.

Suppose that Mary expects the stock (FMV of $500,000 on receipt in Year 1) to *lose* value to, say, $200,000, before the forfeiture restriction lapses in Year 5. In that case, she clearly would not want to make the § 83(b) election to include $500,000 of high-taxed income now, creating a $500,000 basis, only to realize a $300,000 capital loss later ($200,000 A/R *less* $500,000 A/B). Not only would Mary lose the time value of money but, under the § 1211(b) capital loss limitation rule to which you were introduced in Chapter 1, the capital loss may be difficult to deduct in Year 5 if Mary does not realize substantial capital gain in that year (though she could carry forward any undeducted capital loss under § 1212(b)). If, instead, she included nothing in Year 1, she would include only the stock's $200,000 Year-5 FMV when the forfeiture risk lapses (and would realize no loss). In this way, she enjoys both the time value of money and avoids the capital loss deduction restrictions in § 1211(b).

How good is Mary's crystal ball …?

Read the last sentence in § 83(b)(1). A downside of making the § 83(b) election (which, recall, creates basis equal to the amount included) is that, should the forfeiture occur, Mary would be denied deduction of her otherwise allowable $500,000 loss deduction (equal to her basis) under §§ 165(b) and (c)(2). Thus, if Mary does *not* make a § 83(b) election and quits in Year 3, she would avoid any income inclusion. If Mary *does* make a § 83(b) election and quits in Year 3, she would include the $500,000 FMV in Year 1 on receipt (creating a $500,000 basis in the stock); when she quits in Year 3 and must forfeit her stock to her employer, she could not deduct her $500,000 basis. Why should Mary be denied a loss deduction equal to the basis of this lost investment? The legislative history is silent with respect to this question. As a normative matter, it's incorrect to deny her the loss deduction for investment property.

The employer's § 162 deduction for compensation paid is taken in the same year and in the same amount as the employee's compensation inclusion.[18] Thus, both the timing and amount of the employer's deduction will depend on whether the employee makes a § 83(b) election.

While stock happens to be the most common property that triggers application of § 83, notice that § 83 is not limited to stock. For example, recall CEO Sue from earlier in this chapter, who purchased Blackacre for $10,000 from her employer when the property was worth $100,000. If the retention of Blackacre is conditioned on CEO Sue not quitting or being fired for cause before the end of Year 5, she would not (contrary to our earlier analysis) include the $90,000 received for free in her Gross Income in Year 1, unless she chooses to do so by making a § 83(b) election.

Finally, what if Mary receives not stock but an option to buy stock? For example, Conglomerate gives CEO Sue an option to buy Conglomerate stock for $100 per share at a time when the stock is trading at $100 per share. That property right, even if not subject to a substantial risk of forfeiture, would have a $0 value at the time of receipt, as it provides her no benefit that any other buyer of the stock enjoys. So let's change the facts and say that the option gives CEO Sue the option to buy Conglomerate stock for $90 per share at a time when the stock is trading at $100 per share. That property right surely has value to CEO Sue, but must she include something at the time she receives this "in the money" option if it is not subject to a substantial risk of forfeiture?

Luckily for CEO Sue, Treas. Reg. § 1.83-7(b)(1) provides that an option like Sue's must be included on receipt as compensation only if it has a "readily ascertainable" FMV at that time, which will generally be the case only if the option is "actively traded on an established market."[19] While some stock options are traded over established markets, the kind received by CEO Sue rarely are. Thus, CEO Sue would include nothing in Gross Income as compensation on the receipt of this in-the-money option. If she exercises that option, however, for $90 per share when the FMV of the stock received is $100 per share, she would include the $10 received for free as ordinary compensation income under §§ 61(a)(1) and 83(a). Her basis for each share would then equal the $90 that she paid (a nondeductible capital expenditure that creates basis) *plus* the $10 that she included as compensation income under §§ 61(a)(1) and 83(a) for a $100 total basis. If the stock continues to increase in value, and CEO Sue is able to sell it for, say $120, her $20 realized gain ($120 A/R *less* $100 A/B) would be capital gain. Thus, the longer she waits to exercise that option, the more high-taxed compensation income that she will realize if that stock continues to increase in value between the time of the option receipt and its exercise. Sometimes the option grant may

[18] *See* § 83(h).

[19] Options that are not actively traded on an established market are considered to have a "readily ascertainable" FMV only if certain conditions described in Treas. Reg. § 1.83-7(b)(2) are met, and they rarely are.

stipulate that the exercise date can be no sooner than a particular date in the future in order to encourage the executive to do everything in his or her power to increase the corporation's future share price.[20] Of course, if CEO Sue expects the stock's FMV to fall below her $90 per share option price, she would likely choose not to exercise her option, and she would thus realize no tax consequences.

## Problems

What are the tax consequences for Employee Erin in each of the following?

**1.** In Year 1, Erin receives shares of corporate stock from her employer-corporation with a FMV of $200 for no consideration (*i.e.*, she pays nothing for the stock shares). No restrictions attach to Erin's receipt and continued ownership of those shares. The stock has a FMV of $300 at the end of Year 3, but she does not sell until Year 5, when she sells for $500.

**2.** Same as **1.**, except that the stock certificates are stamped with a legend that states that, should Erin quit or be fired for cause before the end of Year 3, she must forfeit the stock back to her employer-corporation. Erin does not make the § 83(b) election. The stock has a FMV of $300 at the end of Year 3, but she does not sell until Year 5, when she sells for $500.

**3.** Same as **2.**, except that Erin decides to make the § 83(b) election. The stock has a FMV of $300 at the end of Year 3, but she does not sell until Year 5, when she sells for $500. What if, instead, the shares lose value and she is able to sell for only $100 in Year 5?

**4.** Same as **3.**, except that Erin is fired for cause in Year 2 before the stock vests, and she must forfeit the stock at that time.

**5.** Based on the results in 2 through 4, above, what questions would you ask Erin in helping her to decide whether or not to make a § 83(b) election?

[20] Special rules apply to so-called incentive stock options (ISOs) in § 421 that differ from the rules prescribed here. ISOs are uncommon.

# Chapter 6: § 61 Residual Gross Income

Section 61(a) provides that "Gross Income means *all income from whatever source derived*, including (but not limited to) the following items …." (Emphasis added.) Because of that parenthetical, we know that items of Gross Income exist in the world that are not found among the 15 listed items, but what are they? How should that vague residual clause be interpreted by both courts and the administrators of the statute? That issue is what this chapter is all about.

In the early days of the income tax, interpreters often turned to the meaning of the term "income" in other disciplines and contexts for help. Thus, for example, readers of 19th century English novels (confession: Jane Austen fan here) often read that Lord Wembley has "30,000 pounds a year" in income on which to live. This "income" would come typically from land, such as rent from the tenants on his estate. Under the social conventions of the time, Lord Wembley would never dream of invading his "capital"—the land—to spend on personal consumption, invading his "capital" to live. Rather, it was understood that Lord Wembley would live only on the income produced by his capital so that the capital, itself, could be passed intact to his first-born son. If a plot of land proved to be inconveniently situated and he sold it, he would not view the cash sales proceeds (or any profit from the sale) as available for consumption. Rather, he would use the sales proceeds to purchase other land or other capital, which would, in turn, produce "income" that he could legitimately consume under the social conventions of the time.

Notice that rent and interest tend to be paid *periodically*, *i.e.*, from time to time or with regularity, such as monthly or quarterly. Similarly, returns on human capital in the form of wages are also paid *periodically*. Thus, some early interpreters concluded that "income" meant only the *periodic* payments from invested capital (such as interest, dividends, rents, and royalties) and the *periodic* return to human capital in the form of wages. Under this view, one-time, lump-sum payments were not considered "income" but rather "capital" receipts that, when invested, would produce future "income." Thus, the "gain" realized on the sale of land was not considered "income" under the early English income tax but rather the entire proceeds (including any gain) were considered a tax-free "capital" receipt. If profit from one-time sales of land were considered "income" and thus taxed, the wealth of the landed gentry might diminish over time when that wealth needed to remain intact to be handed down to the first-born son.

Similarly, let's return to an earlier example, under which Father died in the 19th century and, under his will, instructed that the title to all of his land and other investment property be transferred to a trust, with "income" from the trust to be paid to surviving Wife for the rest of her life. Upon her death, his will instructed that the trust should be dissolved, with the trust "capital" or "corpus" distributed to the first-born son. If the trustee of that trust sells land or another investment asset held in the trust at a profit during Wife's life, that profit (what we would call § 1001 "gain" today) would *not* be distributed to Wife as "income" but rather would be considered a "capital" receipt that belongs to the trust corpus and which would, when invested again by the trustee, produce future "income" to be distributed to Wife. Because the profit was not a *periodic* return but rather a lump sum, it was not considered to be "income" (available to spend on consumption) but rather a capital receipt that would eventually be distributed to the first-born son on Wife's death.

This all sounds quite odd to our 21st-century ears. Today, we do not view one-time, lump-sum receipts as out of bounds for spending on personal consumption under any social convention

(lottery winnings anyone?). And the term "capital" receipt would, to our ears, mean only a tax-free return of *basis*—not the entire "amount realized." Gain realized on the sale of an asset (the excess of amount realized over basis) is similarly available to spend on personal consumption under 21st-century mores. In the early 20th century, however, when the modern income tax was first enacted, debate swirled regarding whether "income" under the residual clause was limited to the *periodic* receipts from invested financial or human capital so that "gain" or profit on the sale of an investment (capital gain) would *not* be considered "income," just as under the English income tax.[1]

In the 1920 Supreme Court decision in *Eisner v. Macomber*,[2] the Court said—when interpreting the meaning of that vague residual clause—that "income may be defined as the gain derived from capital, from labor, or from both combined, provided it to be understood to include profit gained through a sale or conversion of capital assets." If that last clause had not been added, we still might have been unsure after *Macomber* whether § 1001 "gain" realized on the sale of an asset could legitimately be considered "income" for tax purposes.[3]

But when you think about that *Eisner v. Macomber* definition of income for more than a moment, you realize that some receipts would still escape the "income" label if the receipt could not be traced back to a capital investment or to labor. What about lottery winnings, prizes, punitive damages, and other windfalls? They are not compensation for services rendered (a return to labor), and they are not a return on invested capital (§ 1001 "gain" on the sale of an asset, interest, dividends, rents, or royalties). Does that mean that they are not "income" within the meaning of the residual clause?

It seems odd that the facts in the following case had to be litigated all the way up to the Supreme Court, as the outcome seems so intuitive today. But you can see why the issue arose when you appreciate the background described above.

## COMMISSIONER V. GLENSHAW GLASS

348 U.S. 426, *reh'g denied*, 349 U.S. 925 (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 two cases were consolidated for argument before the Court of Appeals for the Third Circuit and were heard en banc. 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 § 22(a) of the Internal Revenue Code of 1939 [the predecessor to current § 61(a)]. In a single opinion, the Court of Appeals affirmed the Tax Court's separate rulings in favor of the taxpayers. 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 Internal Revenue's ensuing petition for certiorari.

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[1] Capital gains have been regularly taxed under the English income tax only since 1965.
[2] 252 U.S. 189 (1920).
[3] In case we were not sure of this result, the Court confirmed in the following year that even "occasional" capital gains on the disposition of property constitute "income." *See* Merchants' Loan & Trust Co. v. Smietanka, 255 U.S. 509 (1921).

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

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 and treble damages for injury to its business by reason of Hartford's violation of the Federal antitrust laws. 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, 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. As previously noted, the Tax Court and the Court of Appeals upheld the taxpayer.

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. After a holding that a violation had occurred, the case was remanded to the trial court for a determination of damages. It was found that Goldman had suffered a loss of profits equal to $25,000 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 balance constituted punitive damages and as such was not taxable. The Tax Court agreed, and the Court of Appeals, hearing this with the Glenshaw case, affirmed.

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 § 22(a) [predecessor to current § 61(a)]?

The sweeping scope of the controverted statute is readily apparent:

> SEC. 22. GROSS INCOME.
>
> (a) GENERAL DEFINITION.—'Gross Income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service . . . of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; 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….

This Court has frequently stated that this language was used by Congress to exert in this field "the full measure of its taxing power." *Helvering v. Clifford*, 309 U.S. 331, 334; *Helvering v. Midland Mutual Life Ins. Co.*, 300 U.S. 216, 223; *Douglas v. Willcuts*, 296 U.S. 1, 9; *Irwin v. Gavit*, 268 U.S. 161, 166. 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. *Comm'r v. Jacobson*, 336 U.S. 28, 49; *Helvering v. Stockholms Enskilda Bank*, 293 U.S. 84, 87-

91. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements on the rented property was taxed in *Helvering v. Bruun*, 309 U.S. 461. Cf. *Robertson v. U.S.*, 343 U.S. 711; *Rutkin v. U.S.*, 343 U.S. 130; *U.S. v. Kirby Lumber Co.*, 284 U.S. 1. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of § 22(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 to say now that it adds nothing to the meaning of "Gross Income."

Nor can we accept respondents' contention that a narrower reading of § 22(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." The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed "only the form, not the essence," of his capital investment. It was held that the taxpayer had "received nothing out of the company's assets for his separate use and benefit." The distribution, therefore, was held not a taxable event. 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. *Helvering v. Bruun*, *supra*, at 468-469; *U.S. v. Kirby Lumber Co.*, *supra*, at 3.

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 that 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.

It is urged that re-enactment of § 22(a) without change since the Board of Tax Appeals held punitive damages nontaxable in *Highland Farms Corp.*, 42 B.T.A. 1314, indicates congressional satisfaction with that holding. Re-enactment—particularly without the slightest affirmative indication that Congress ever had the Highland Farms decision before it—is an unreliable indicium at best. *Helvering v. Wilshire Oil Co.*, 308 U.S. 90, 100-101; *Koshland v. Helvering*, 298 U.S. 441, 447. Moreover, the Commissioner promptly published his nonacquiescence in this portion of the *Highland Farms* holding and has, before and since, consistently maintained the position that these receipts are taxable. It therefore cannot be said with certitude that Congress intended to carve an exception out of § 22(a)'s pervasive coverage. Nor does the 1954 Code's legislative history, with its reiteration of the proposition that statutory Gross Income is "all-inclusive," give support to respondents' position. The definition of Gross Income has been simplified, but no effect upon its present broad scope was intended. Certainly punitive damages cannot reasonably be classified as gifts, *cf. Comm'r v. Jacobson*, 336 U.S. 28, 47-52, nor do they come under any other exemption provision in the Code. We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not Gross Income. *See Helvering v. Midland Mutual Life Ins. Co.*, *supra*, at 223.

Reversed.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE HARLAN took no part in the consideration or decision of this case.

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The language from § 22 quoted in the case is from the 1939 Internal Revenue Code. In 1954, Congress did a thorough rewrite of the Code—a "recodification"—including changing most Code section numbers. Thus, § 22 of the 1939 Code became § 61(a) in the 1954 Code. Although *Glenshaw Glass* was decided in 1955, the tax years at issue predated the 1954 recodification, which is why the Court cited § 22 rather than § 61. Although the language in old § 22 looks slightly different from that in current § 61 (with the residual clause appearing at the end of old § 22 instead of at the beginning, as in current § 61), the two versions are not materially different. Thus, the *Glenshaw Glass* Court's interpretation of the scope of the residual clause in old § 22 applies equally to the residual clause in current § 61.[4]

Which statutory interpretation tools did the *Glenshaw Glass* Court use in deciding that punitive damages fell within the residual clause? Did it look to common understandings of the term "income" in 1913 under the notion that the meaning of that term as it was understood by the original enactors of the statute should govern what that term means in 1955? Or did the Court effectively permit the meaning of the term "income" to evolve over time? And what was the structure of the argument pertaining to the *Highland Farms* case? Sometimes you will hear this argument referred to as the "legislative reenactment doctrine." Did you find it convincing?

Finally, the statutory interpretation canon referred to as *ejusdem generis* (Latin for "of the same kind") directs that, when a statute contains a list of persons or items with common characteristics and then appends a general catch-all clause (such as the residual clause in old § 22 or current § 61), the scope of the catch-all clause should be limited to items with the same common characteristics of the specifically listed items. For example, if a statute provides that a motor vehicle tax should apply to "automobiles, trucks, motorcycles, *and other motor-powered vehicles*," the word "vehicles" should not be interpreted to include airplanes because the other items on the list all pertain to ground transportation vehicles.

What common characteristics are shared by the specifically enumerated items in old § 22 quoted in the opinion? Notice that all of the listed items could be traced back to labor or capital. If the Court wanted, therefore, it could have chosen to invoke *ejusdem generis* to re-affirm *Eisner v. Macomber's* approach to the residual clause, which would mean that receipts not traced back to labor or capital (such as windfalls and punitive damages) would not constitute Gross Income within the meaning of the residual clause. But the Court did not do that. Indeed, the Court gave new meaning to the residual clause by replacing the *Macomber* language—which looked *backward* by asking whether today's receipt could be traced back to labor or capital—with language that asks only whether the taxpayer has been *enriched* by the receipt: "undeniable *accessions to wealth*, clearly realized, over which the taxpayer[] ha[s] complete dominion." Thus, whether the receipt can be traced back to labor or capital is irrelevant; we ask only whether the taxpayer is wealthier by reason of the receipt or event.

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[4] The Tax Reform Act of 1986 also resulted in a recodification of the Internal Revenue Code, but most of the Code section numbers remained unchanged. The current Internal Revenue Code comprises Title 26 of the U.S. Code and is properly referred to as the "The Internal Revenue Code of 1986, as amended," with that last phrase inserted to account for the virtually annual changes made to the Code by Congress.

Where did the Supreme Court find this new perspective? There is no direct evidence that the Supremes ever read the works of Henry Simons, Robert Haig, or Georg Schanz, but their work in attempting to articulate a *tax-specific* meaning of the term "income" had by 1955 become widely discussed—at least in the academic world. Henry Simons's book (quoted in Chapter 1), which built on the prior work of Georg Schanz and Robert Haig, was published in 1938. Moreover, the Government's Brief in *Glenshaw Glass* explicitly referred to the concept.[5] At the least, dated Victorian notions about not spending lump-sum, non-periodic windfalls on consumption had gone by the wayside by then. When you recall my simplified restatement of the SHS notion of income from Chapter 1—*wealth increases* less wealth decreases that are not spent on personal consumption—you can appreciate how *Glenshaw Glass* can be seen as effectively incorporating SHS notions into the modern interpretation of the residual clause. For that reason, you can think of *Glenshaw Glass* as an example of what some refer to as "dynamic statutory interpretation," under which the meaning of unamended statutory language can change over time, including the meaning of the term "income" in the § 61 residual clause.[6]

Section A. examines the scope of "wealth accession" within the meaning of *Glenshaw Glass*. Section B. explores when a clear wealth accession is deemed to be "realized." The third *Glenshaw Glass* factor (referring to "complete dominion") will be important in considering attempts to shift income among taxpayers, considered in Chapter 8.

## A. What is an "accession to wealth" within the meaning of *Glenshaw Glass?*

We move from the simple (cash) to the more ambiguous (consumption received in kind).

***Cash receipts that are not basis recovery***

Once the Court decided that the proper question to ask in *Glenshaw Glass* was whether the taxpayer had enjoyed a wealth accession by reason of the event, the case before it became an easy one because a punitive damage award—a cash receipt that clearly does not represent basis recovery—is new wealth that has never been taxed before to this taxpayer. Glenshaw Glass clearly enjoyed an increase in its wealth upon receipt of the punitive damages.

But do all cash receipts that are not basis recovery (or borrowed money or amounts that are excludable under specific statutory authority, such as the § 102 gift exclusion) constitute § 61 Gross Income under the residual clause?

**REVENUE RULING 76-131**

1976-1 C.B. 16

Advice has been requested whether benefit payments received by individuals under the Alaska Longevity Bonus Act, Alaska Statutes, Title 47, Chapter 45, sections 10 to 170, effective January 1, 1973, are includible in the Gross Income of the recipients pursuant to section 61 of the Internal Revenue Code of 1954.

The Alaska Longevity Bonus Act grants a bonus of $100 per month to persons 65 years of age

[5] *See* Alice G. Abreu & Richard K. Greenstein, *Defining Income*, 11 FLA. TAX REV. 295, 306 (2011).
[6] *See, e.g.*, William N. Eskridge, Jr., *Dynamic Statutory Interpretation*, 135 U. PA. L. REV. 1479 (1987).

and over who have maintained a continuous domicile in the territory or State of Alaska for 25 years. Such bonus will be paid only as long as an eligible person retains a domicile in Alaska.

The purpose of the statute as stated therein is to provide an incentive to continue uninterrupted residence in the state and under no circumstances is to be considered a form, type or manner of public relief. It is also stated that the bonuses are not predicated on need.

Section 61 of the Code provides, in part, that Gross Income means all income from whatever source derived unless otherwise excluded by law.

The Internal Revenue Service has consistently held that payments made under legislatively provided social benefit programs for promotion of the general welfare are not includible in a recipient's Gross Income. See for example, Rev. Rul. 63-136, 1963-2 C.B. 19, concerning payments under the Manpower Development and Training Act; Rev. Rul. 68-38, 1968-1 C.B. 446, involving payments under Title II-A of the Economic Opportunity Act of 1964; and Rev. Rul. 72-340, 1972-2 C.B. 31, concerning stipends paid by a city to unemployed or underemployed probationers.

The Alaska Longevity Bonus is distinguished from welfare program payments in that the benefits are payable to any Alaskan meeting the age and residency requirements regardless of financial status, health, educational background, or employment status.

Accordingly, in the instant case, benefit payments received by individuals under the Alaska Longevity Bonus Act are includible in the Gross Income of the recipients pursuant to section 61 of the Code.

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In the 1990s, Congress replaced the Aid to Families with Dependent Children (AFDC) program (often referred to as "welfare") with the Temporary Assistance for Needy Families (TANF) program. AFDC payments were excludable from Gross Income under the so-called general welfare doctrine, and the IRS was asked whether TANF payments were similarly excludable from Gross Income because TANF requires that specified percentages of individual recipients engage in work activities and imposes penalties on the states for noncompliance with that requirement. "Work activities" was broadly defined, however, to include a range of activities, such as engaging in job search and job readiness assistance programs, community service programs, certain education programs, and the like. In Notice 99-3,[7] the IRS ruled as follows:

> Payments by a governmental unit to an individual under a legislatively provided social benefit program for the promotion of the general welfare that are not basically for services rendered are not includible in the individual's Gross Income and are not wages for employment tax purposes, even if the individual is required to perform certain activities to remain eligible for the payments. *See* Rev. Rul. 71-425, 1971-2 C.B. 76; Rev. Rul. 75-246, 1975-1 C.B. 24. If, however, taking into account all the facts and circumstances, payments by a governmental unit are basically compensation for services rendered, even though some training is provided, then the payments are includible in the individual's Gross Income and are generally wages for employment tax purposes. Rev. Rul. 75-246, 1975-1 C.B. 24.

[7] 1999-1 C.B. 271.

> Due to the flexibility TANF affords states to determine basic eligibility rules and benefit amounts, a TANF payment may be made both for the promotion of the general welfare and as compensation for services. In these cases, it is extremely difficult to characterize the basic purpose of the payments. It is also not practically feasible to determine the relative proportion of the payment each purpose represents.
>
> In many of these cases, TANF payments are received in lieu of (and generally in amounts no greater than) payments the individual formerly received or would have received under AFDC based upon the individual's personal and family subsistence requirements. In these cases, the primary measure of the amount received is the personal or family need of the individual recipient rather than the value of any services performed.
>
> In cases where the following three conditions are satisfied, TANF payments will be treated as made for the promotion of the general welfare and therefore will not be includible in an individual's Gross Income and will not be wages for employment tax purposes:
>
> (1) The only payments received by the individual with respect to the work activity are received directly from the state or local welfare agency (for this purpose, an entity with which a state or local welfare agency contracts to administer the state TANF program on behalf of the state will be treated as the state or local welfare agency);
>
> (2) The determination of the individual's eligibility to receive any payment is based on need and the only payments received by the individual with respect to the work activity are funded entirely under a TANF program (including any payments with respect to qualified state expenditures …, and
>
> (3) The size of the individual's payment is determined by the applicable welfare law…

Neither the ruling nor the notice provide much analysis regarding the source of the so-called general welfare doctrine. Can you construct one? Is Congress's apparent intent to protect bare subsistence income from taxation via the mechanisms studied in Chapter 1, Part B. (such as the Standard Deduction and the Personal and Dependent Exemption Deductions) relevant? How about the "ability to pay" fairness norm that was most discussed when the income tax was first adopted, as described in Chapter 3? Unemployment compensation payments are includable in Gross Income under § 85, as they are considered *substitutes* for what would have been includable compensation income under § 61(a)(1) had the taxpayer not lost her job.

What about Social Security payments? Unlike the TANF payments described above, Social Security payments are not need-based and thus are not excludable under the general welfare doctrine because they are payable regardless of financial status. Unlike the payments under the Alaska Longevity Bonus, however, the recipient likely made earlier payments (in the form of Social Security Tax payments) which, from one perspective, could be seen as investment in an asset (creating basis) that generates this stream of payments. Let's think about the issue from the theoretical perspective first and then look at positive law.

The payment of Social Security tax under the payroll tax system (described in Chapter 3) during

one's working life is not deductible under the income tax. As a theoretical matter, therefore, the nondeduction for income tax purposes during one's working life could conceivably be thought to create "basis" in the future payment stream, which could offset those payments on receipt—*if you conceive of the system as similar to a personal retirement account*. That conceptualization is controversial, however, because the Social Security system is not truly an individualized pension system but, rather, a *current* tax-and-transfer system. That is to say, current Social Security tax payments fund payments to *current retirees* (as well as certain disability and other payments); they are not set aside for the payee and invested on the payee's account for a future stream of payments. Thus, they are more commonly considered to be "expenses" (which do not create basis).[8]

If, however, we indulge in the notion that the payment of Social Security Tax and the receipt of Social Security payments in retirement are related, the resulting creation of basis with the tax payments would mean that Social Security payments would be includable in Gross Income only to the extent exceeding that basis. For ease, we could allocate 100% of each payment received to tax-free basis recovery until basis is exhausted and then include 100% of each payment thereafter. Or, once the payment stream began, we could allocate basis over the estimated remainder of the taxpayer's life (using actuarial tables) so that a portion of each payment is tax-free basis recovery and a portion of each payment is includable, similar to the rules found in § 72 that apply to payments received under certain annuity contracts (explored in Chapter 10). Because of the time value of money, the former system would be of greater benefit to the Social Security recipient.

Under positive law, however, neither approach is taken. Prior to 1983, Social Security payments were entirely excludable from Gross Income, perhaps on the simplifying assumption that the receipts never exceeded our hypothetical basis. In 1983, however, Congress enacted § 86, which now requires inclusion of a portion of Social Security payments received by those with Adjusted Gross Income (AGI) exceeding certain thresholds. Today, anywhere between 0% and 85% of Social Security payments can be includable under § 86, depending on AGI, filing status, and the amount of Social Security payments received.

In 1983, research showed that most recipients of Social Security payments received substantially more in lifetime benefits than they paid in taxes over their working lives. That is no longer true for the most recent class of retirees if you view Social Security payments alone. If you add in Medicare taxes paid and benefits received, however, it remains true.[9] Virtually everyone today receives in kind many times more health care than they pay in Medicare Tax. For example, a two-earner married couple pays, on average, approximately $120,000 in aggregate Medicare Tax but receives Medicare services valued at $427,000.[10] This observation takes us to the next question: whether the value of Medicare benefits (and other consumption benefits) received in kind ought to be included in § 61 Gross Income under the residual clause.

### *Consumption received in kind*

You learned in Chapter 1 that the taxation of personal consumption is accomplished primarily through *deduction denial*. That is to say, personal consumption spending, although a wealth

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[8] *See generally*, Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income Tax and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002).

[9] C. Eugene Steuerle &Stephanie Rennane, *Social Security Taxes and Benefits Over a Lifetime*, at www.urban.org/UploadedPDF/social-security-medicare-benefits-over-lifetime.pdf.

[10] *See* Bruce Bartlett, *Taxing Medicare Benefits*, at http://economix.blogs.nytimes.com/2013/09/17/taxing-medicare-benefits/?_r=0 (using data from the Urban Institute).

reduction, is not deductible. Personal expenses are nondeductible under § 262(a), and the basis created on the purchase of personal-use property cannot be depreciated under §§ 167 and 168 or be deducted as a loss when the property is sold for less than basis. *See* § 165(c)(3). In this manner, purchased personal consumption remains in the tax base via deduction denial, resulting in taxation.

Should consumption received in kind for free from another—rather than purchased by the taxpayer—be valued and included in § 61 Gross Income? When I say "consumption received in kind," I generally mean the value of consumption services and consumer goods received in kind, such as food, entertainment, gym memberships, health care, lodging, and the like. Some receipts—even if considered Gross Income within the meaning of § 61—might nevertheless be excludable under a specific Code section (such as § 102 pertaining to gifts or the fringe benefit exclusions for certain forms of compensation received in kind considered in the last chapter). Thus, we are considering here only receipts that—if they *do* constitute § 61 Gross Income—would fail to qualify for exclusion under another Code section.

In *Glenshaw Glass* terms, the question is whether free consumption increases the taxpayer's *wealth*. Free consumption certainly is unlike the cash punitive damages received by the Glenshaw Glass Company, easily a wealth accession. After all, free consumption is illiquid; you cannot send the free entertainment or health care to the IRS in payment of a tax. But we have seen in Chapter 5 that lack of liquidity does not prevent in-kind consumption from being treated like a wealth accession if it is received as compensation for services rendered. In that case, the consumption must be valued and included in Gross Income (absent application of an explicit statutory exclusion, such as §§ 119 or 132).

But in the compensation context, you quite incisively reply, the in-kind consumption clearly *replaces* what would otherwise clearly constitute a wealth increase—cash compensation. Most compensation is, in fact, paid in cash. In situations where in-kind consumption can be considered a *substitute* for something that would clearly constitute a wealth accession, we must be vigilant to include that in-kind consumption in Gross Income to prevent undermining the tax base. Indeed, the excerpt from the Joint Committee on Taxation reprinted in Chapter 5 expressed this very concern when it described the enactment of § 132:

> Congress was concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly. This erosion of the income tax base results because the preferential tax treatment of fringe benefits serves as a strong motivation to employers *to* ***substitute*** *more and more types of benefits for cash compensation.*[11]

Because of this concern, the receipt of free consumption by an employee that is not described in §§ 119, 132, or another exclusion provision is reconstructed *in substance* as though (1) the employee received cash (clearly a wealth accession), which (2) the employee then used to purchase personal consumption (nondeductible under § 262) under *Old Colony Trust*.

Thus, one clear instance in which the receipt of consumption in kind is considered to rise to the level of a wealth accession (and thus includable in § 61 Gross Income, absent a specific statutory

[11] STAFF OF THE JOINT COMM. ON TAX'N, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84, 840-42 (Dec. 31, 1984). (Emphasis added.)

exclusion) is when *the receipt is otherwise expressly listed as an item of Gross Income in § 61 or elsewhere, outside the residual clause: e.g., compensation under § 61(a)(1), dividend under § 61(a)(7), rent under § 61(a)(5), or a prize under § 74(a).* In each of those instances, the consumption received in kind is clearly a *substitute* for cash, the most common forms of compensation, dividends, rent, and prizes. Of course, the taxpayer wishing to avoid inclusion can always decline the receipt and avoid the Gross Income inclusion. But if the receipt is accepted rather than declined, Congress made its intent clear that these types of receipts are includable in Gross Income by expressly listing them in the enumerated list of clearly includable Gross Income items, without regard to whether the compensation, dividend, rent, or prize is paid in cash or in kind.

In the piece below, the goody bags provided to presenters were, in essence, either a prize or compensation for services rendered. (You will read in the next chapter why exclusion as a "gift" was not possible under the Federal income tax definition of that term.)

### Oscar Freebies Balloon to $80K (Don't Tell IRS)[12]

Robert W. Wood

No matter who you are, it is somehow fun to receive free stuff. Perhaps it is less fun for the truly wealthy, but it's still fun, especially if the items are downright cool and are dropped in your lap. It should be no surprise that companies flock to the celebrity appeal of the Oscars.

Who wouldn't want to have Tom Hanks wearing your polo shirt, Sandra Bullock wearing your watch, or Cate Blanchett snacking on your protein bar? The allure is too great not to try. All sorts of products benefit from celebs giving them a try. So with a kind of effusive zeal, companies throw expensive goodies at the nominees, and this year, the volume and value for the most elite offerings has risen to over $80,000.

That's about double the 2013 take, so the economy must be improving. Gift bags include such essentials as:

- $16,000 hair restoration procedure;
- $15,000 walking tour around Japan;
- $9,000 trip to Las Vegas;
- $6,850 train trip in the Canadian Rockies;
- $5,000 toward art from Gizara;
- $5,000 toward laser hair removal and cosmetic surgery from Ideal Image;
- $4,895 home water filtration system;
- $3,300 resort stay at the Imanta's Ocean Casa suite in Mexico;
- $2,700 "O-Shot" procedure to stimulate a woman's sex drive;
- $2,560 home spa system from Steamist;
- $2,000 five-night stay at the Koloa Landing Resort in Hawaii;
- $1,572 pet supplies from Epic Pet Health;
- $850 for 10 personal training sessions with Huntley Drive Fitness;
- $500 lifetime membership to a meditation gym;

[12] www.forbes.com/sites/robertwood/2014/03/01/oscar-freebies-balloon-to-80k-dont-tell-irs/. Reprinted with permission of the author.

- $290 Swiss-made watch from Slow Watch;
- $280 portable camera from Narrative Clip;
- $280 package of organic maple syrup from Rouge Maple;
- $120 pink and camo pepper guns from Mace;
- $39 in weight-loss products from Hydroxycut;
- $35 six-pack of herbal tea lollipops from Dosha Pops;
- $23 worth of reusable dry-cleaning bags from Green Garmento; and
- $6 device keeps hair from clogging in the shower from DrainWig.

Sure, winning is better. Oscars don't have a cash prize like Olympic medals. But still, taking home an Academy Award means a recipient will make ***a lot*** more money in the future. But a gift bag worth $80,000 is hardly inconsequential, not like a Thanksgiving turkey from your employer.

That means somebody has to pay tax on it. That makes the ***biggest*** winner of them all the IRS. In case the attendees "forget," they will receive an IRS Form 1099 reporting the value of what they took home. Form 1099 is that irksome piece of paper that tells the IRS you were paid….

For years, the entertainment industry and the IRS locked horns repeatedly over taxes…. But eventually, the brouhaha was settled …. Now, IRS guidelines are clear. If you get a gift bag, you generally have taxable income equal to its fair market value. Can't you argue this was a "gift" and you aren't being paid? Nope, you lose. You must report it on your tax return.

What about gift certificates or vouchers for trips or personal services? If you redeem the certificates or vouchers, you must include the fair market value of the trip or service on your tax return.

If these are gifts, why are they income? They're ***not gifts*** for tax purposes. The organizations and merchants don't give them solely out of affection or respect.

Can you take a charitable contribution deduction if you "regift" a gift bag? Yes, if you donate the gift bag to a qualified charity. But the fair market value of the gifts must still be reported on your tax return.

Are there third-party reporting requirements for gift bags? Yes. Organizations and vendors distributing gift bags may have to issue Form 1099-MISC, Miscellaneous Income.

What if you make a selection in a free shopping room for participating in the show? The value of your selection is income and you must report it.

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This brings us to the obvious next step in the analysis. Suppose the consumption received in kind is *not* compensation for services rendered, a dividend, rent, a prize, or some other type of explicitly listed Gross Income item. In that case, the only provision that could result in inclusion in § 61 Gross Income is the residual clause, as interpreted by *Glenshaw Glass*: *a wealth accession*. When should consumption received in kind for free that is not compensation, a dividend, *etc.*, be considered a *wealth* receipt? To the average taxpayer, "wealth" connotes property or cash.

Suppose that you are a jazz fan, and you are walking down the street when you come across a jazz saxophonist who opens his case and begins to play with the hope that passersby will throw some cash into his case. You *love* jazz. Indeed, you went last night to a nightclub to hear a jazz performer, paying $25 for the entrance ticket to hear him. You could not deduct that $25 ticket

price because it was a nondeductible personal expense. Must you value this free concert and include that value in § 61 Gross Income, as though you received cash (a clear wealth accession) followed by a nondeductible personal expense?

Of course not! But *why* not? In Chapter 1, we saw that Henry Simons described income 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."[13] One could argue that Simons's reference to "rights *exercised* in consumption" implies that the taxation of consumption under an income tax should primarily be accomplished via *deduction denial*, not through a Gross Income inclusion if received in kind. That is to say, a taxpayer who freely chooses to exercise his right to spend prior wealth receipt on consumption in the marketplace should be denied a deduction for that consumption under the ability to pay fairness norm described in Chapter 3, which defines the tax base according to the resources under the control of the taxpayer that are available for contribution to the fisc. Thus, the Code denies *deductions* (wealth reductions) for personal expenses, depreciation, and losses.

Under this deduction-denial route to taxing personal consumption, one can argue that we should tax personal consumption received in kind under *Glenshaw Glass's* "wealth accession" interpretation of the residual clause only when we are fairly confident that, under the particular facts and circumstances, the in-kind consumption is the equivalent of (1) the receipt of cash (clearly a wealth accession) followed by (2) a free-spending choice on consumption (nondeductible). In other words, if we are not confident that the taxpayer might have purchased the consumption at issue with his own resources, perhaps it is not reasonable to interpose a deemed cash step (followed by nondeduction of the personal consumption outlay), *i.e.*, to equate the in-kind consumption receipt with a *wealth* receipt representing ability to pay.

Notice that this is the same sort of reasoning that we explored in the last chapter in trying to construct an analytical framework regarding where the lines are drawn in §§ 119 and 132 in the compensation context. We suggested there, for example, that the convenience of the employer test for meals and lodgings provided to an employee (*i.e.*, substantial noncompensatory business reasons) could be seen as a more administrable proxy test for determining whether we can be fairly confident that the taxpayer would have freely purchased the same consumption on his own.

If consumption is received in kind outside of a market transaction, such as the free jazz concert enjoyed on the street by a passerby, we cannot be so sure that the consumption receipt is the equivalent of a cash receipt followed by a free-spending choice to purchase the personal consumption. Similarly, the lack of a marketplace transaction means that the value of self-provided services does not produce Gross Income, even though economists sometimes count this value as income. Thus, when you grow your own vegetables to consume, you do not include the value of the consumed vegetables in Gross Income.[14] Nor do you include the imputed rental income generated by owner-occupied housing (considered further in Chapter 18), even though economists (and some other countries) count it as income.

With this background, let's return to the receipt of medical care received under the Medicare program. Unlike the free jazz concert, the receipt of health care under the Medicare program is an identifiable marketplace transaction, with the government paying for the services rendered to you. Nevertheless, the government has never argued that the value of this in-kind consumption is

[13] HENRY SIMONS, PERSONAL INCOME TAXATION 50 (1938).
[14] *See* Morris v. Comm'r, 9 B.T.A. 1273 (1928).

includable in § 61 Gross Income under the residual clause, even though the value of medical care received under the Medicare and Medicaid programs is included by the CBO as economic income in the denominator when describing effective Federal tax rates, as described in Chapter 3 (thus reducing effective tax rates). As noted above, the value of medical care received by a retiree under the Medicare system far exceeds the typical taxpayer's payment of Medicare Tax over one's working life. Thus, even if one did consider the payment of Medicare Tax as creating "basis" that could be recovered tax-free when medical care is provided later in life, this fiction could not explain full exclusion of the value received.

Is the receipt of the free medical care by the retiree the equivalent of (1) the receipt of cash that was then used (2) to purchase medical care? How confident are we that the retiree would have chosen to purchase the same medical care if it had not been provided for free? Should the answer to this question turn on the taxpayer's financial status? After all, even certain *cash* payments received under government programs is not considered includable residual Gross Income if the payment satisfies the "general welfare" doctrine, described above—typically government payments made on account of financial need. Similarly, § 86 requires wealthier retirees to include a portion of Social Security payments received, as described above. Should this mean that Congress ought to amend the statute to require wealthier retirees to include a portion of Medicare benefits received, as well?

On the other hand, in the private medical insurance market, the payment of premiums entitle the payor to specified benefits regardless of whether the value of medical care eventually received under the contract exceeds the aggregate of premiums paid, and the excess value received does not create includable § 61 Gross Income under the residual clause for Federal income tax purposes. Does this analogy explain why the value of medical care received under the Medicare and Medicaid programs is similarly not valued and included in Gross Income for Federal income tax purposes (without regard to the financial status of the recipient or whether it exceeds or is less than Medicare tax paid over one's working life)? Can you argue that what is purchased under an insurance contract is not the actual future medical care received but rather *risk shifting*—the shifting of financial risk to the insurance pool at large if the cost of your medical care proves to be extraordinary in amount—so that whatever recoveries are received under the insurance contract were fully purchased in that sense? Or do these examples merely represent the purchase of services (at arm's length between strangers) at a bargain price? *Cf.* Part B., below. Frankly, there are no easy answers to these questions, but the value of Medicare services received is not includable in Gross Income.

Next hypothetical: You hire a lawyer to pursue a litigation matter on your behalf. The lawyer takes you and your spouse out to dinner to discuss the matter and pays the cost of all three meals (the one for herself, as well as the ones for you and your spouse). We shall consider the possibility of the lawyer's deduction for her outlay in Chapter 20. Here we are concerned only with whether you and your spouse must include in your § 61 Gross Incomes the value of the free meals that you enjoyed. The meals clearly do not constitute compensation, a dividend, *etc.* If the value of the free meals is to be included, therefore, it could be included *only* under the residual clause, as interpreted by *Glenshaw Glass*. Is the receipt of the free meals in this context the equivalent of a cash receipt (a clear wealth accession) followed by a free-spending choice to purchase nondeductible personal consumption? What proxy tests are used in the following cases to arrive at the answer in a more administratively feasible way?

In the following case, Mr. Gotcher was an employee of a Volkswagen car dealership who had

been identified as a good candidate to co-invest in the dealership as a principal. The 12-day, expense-paid trip described in the case was paid for mostly by Volkswagen Germany and Volkswagen of America, though a small portion was paid by his employer. Nevertheless, even the small portion paid by his employer was not analyzed as compensation because the purpose of the trip was to entice Mr. Gotcher to invest in the dealership, itself. Thus, the § 61(a)(1) compensation inclusion is not discussed by the court. Rather, the FMV of this free trip could only be included under the residual clause (or possibly as a § 74 prize). For that reason, *Gotcher* cannot be cited as authority for § 61(a)(1) compensation to be excluded from Gross Income; the case deals only with the scope of the residual clause.

## UNITED STATES v. GOTCHER

401 F.2d 118 (5th Cir. 1968)

Before JOHN R. BROWN, CHIEF JUDGE, and BELL AND THORNBERRY, CIRCUIT JUDGES.

THORNBERRY, CIRCUIT JUDGE: In 1960, Mr. and Mrs. Gotcher took a twelve-day expense-paid trip to Germany to tour the Volkswagen facilities there. The trip cost $1,372.30 [paid mostly by Volkswagen of Germany and Volkswagen of America]. Upon returning, Mr. Gotcher bought a twenty-five percent interest in Economy Motors, the Sherman, Texas Volkswagen 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 $1,372.30 in their 1960 income. The Commissioner determined that the taxpayers had realized income to the extent of the $1,372.30 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 …. 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 ….

Section 61 of the Internal Revenue Code of 1954 defines Gross Income as income from whatever source derived and specifically includes fifteen items within this definition. 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 section 61 unless it is conferred as compensation for services rendered. This conception of Gross Income is too restrictive since it is well-settled that section 61 should be broadly interpreted and that many items, including noncompensatory gains, constitute Gross Income.

In determining whether the expense-paid trip was income within section 61, we must look to the tests that have been developed under this section. The concept of economic gain to the taxpayer is the key to section 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 two cases, *Rudolph v. U.S.*, 5th Cir. 1961, 291 F.2d 841, and *Patterson v. Thomas*, 5th Cir. 1961, 289 F.2d 108, this Court has examined expense-paid trips and held that the value of these trips constituted income. Both of these cases involved conventions for insurance salesmen, and in both it was evident that the trip was awarded as compensation for past services. The instant case differs from *Rudolph* and *Patterson* in that there 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

….

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. The VW story was related by Mr. Horton, who is Manager of Special Events for VW of America. His testimony was uncontradicted and unimpeached. He stated that 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. 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. It was hoped that this would be accomplished by following the international architectural plans that VW had for its dealerships. It was also hoped that the dealer would adopt VW's international plan for the sales and services department. Mr. Horton testified that 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. *See* Patterson v. Thomas, *supra*. 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. *See Peoples Life Ins. Co. v. U.S.*, U.S. Ct. Cl. 1967, 179 Ct. Cl. 318, 373 F.2d 924, 930. Indeed, the district court found that even this touring of the countryside had an indirect relation to 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 before these items were excluded by the 1954 Code, the Treasury and the courts recognized that they should be excluded from Gross Income. 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. *See Disney v. U.S.*, C.D. Calif. 1967, 267 F. Supp. 1; *Comm'r v. Riss*, 1967, 1967 T.C. Memo 258, 26 T.C.M. 1334.

In the recent case of *Allen J. McDonnell*, 26 T.C.M. 115, Tax Ct. Mem. 1967-18, 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 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 the dealers 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 goodbusiness 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. *Comm'r v. Glenshaw Glass Co., supra.* Clearly, the lack of control works in 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. Comm'r*, 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. 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. Thus, the rule is that the economic benefit will be taxable to the recipient only when the payment of expenses serves no legitimate corporate purpose. *See Comm'r v. Riss*, 8th Cir. 1967, 374 F.2d 161. 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. *See United Aniline Co.*, 1962, 21 T.C.M. 327.

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 the 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. He had been selling cars since 1949. 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 section 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 a 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. *See Disney v. U.S.*, *supra*. 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 section 162. *Acacia Mutual Life Ins. Co. v. U.S.*, D. Md. 1967, 272 F. Supp. 188, 201. Also, it must be shown that the wife made the trip only to assist her husband in his business. A single trip by a wife with her husband to Europe has been specifically rejected as not being the exceptional type of case justifying a deduction. *Warwick v. U.S.*, E.D. Va. 1964, 236 F. Supp. 761; *See also Silverman v. Comm'r*, 8th Cir. 1958, 253 F.2d 849.

JOHN R. BROWN, CHIEF JUDGE (concurring): I concur in the result and in the opinion. Attributing income to the little wife who was neither an employee, a prospective employee, nor a dealer, for the value of a 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.

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Is the Gross Income issue irrelevant to Mr. Gotcher because—if the court *had* decided that the free trip constituted residual Gross Income to Mr. Gotcher—he would then have been permitted to deduct the same amount under § 162 as a business expense in any event, resulting in no bottom-line tax consequences? No. Recall from Chapter 4 that investigative costs incurred in purchasing an intangible (like a dealer franchise) are generally categorized as nondeductible "capital expenditures" instead of current "expenses." The same would be true if Mr. Gotcher had not been offered the free trip by VW Germany but rather had simply decided on his own initiative to fly to Germany (at his own expense) to see for himself whether investing in the dealership would be a wise decision. His costs would not be deductible under § 162. The nondeductibility of the costs is why the initial Gross Income issue was pivotal.

## Problem

High-Tech Corp pays the cost of air fare, hotel, taxis, meals, and incidental expenses for Joseph and Michael to fly from Cleveland, Ohio, to Palo Alto, California, so that Joseph can interview for a position as a software engineer with High-Tech. The total cost of the expense-paid trip is $3,000 ($1,500 for each). Michael, Joseph's spouse, is a lawyer, and he uses the time in Palo Alto to explore the local legal market and the potential for obtaining a lawyer position. Must Joseph, Michael, or both include the value of the expense-paid trip in their Gross Incomes? Would it make any difference if Michael were a stay-at-home spouse with three young children?

## HAVERLY v. UNITED STATES

513 F.2d 224 (7th Cir. 1975)

Before HASTINGS, SENIOR JUDGE, and SWYGERT AND CUMMINGS, CIRCUIT JUDGES.

HASTINGS, SENIOR JUDGE: This case presents for resolution a single question of law which is of first impression: whether the value of unsolicited sample textbooks sent by publishers to a principal of a public elementary school, which he subsequently donated to the school's library and for which he claimed a charitable deduction, constitutes Gross Income to the principal within the meaning of Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. § 61.

During the years 1967 and 1968 Charles N. Haverly was the principal of the Alice L. Barnard Elementary School in Chicago, Illinois. In each of these years publishers sent to the taxpayer unsolicited sample copies of textbooks which had a total fair market value at the time of receipt of $400. The samples were given to taxpayer for his personal retention or for whatever disposition he wished to make. The samples were provided, in the hope of receiving favorable consideration, to give taxpayer an opportunity to examine the books and determine whether they were suitable for the instructional unit for which he was responsible….

In 1968 taxpayer donated the books to the Alice L. Barnard Elementary School Library. The parties agreed that the donation entitled the taxpayer to a charitable deduction under 26 U.S.C. § 170, in the amount of $400, the value of the books at the time of the contribution. The parties further stipulated that the textbooks received from the publishers did not constitute gifts within the meaning of 26 U.S.C. § 102 since their transfer to the taxpayer did not proceed from a detached and disinterested generosity nor out of affection, respect, admiration, charity or like impulses.

Taxpayer's report of his 1968 income did not include the value of the textbooks received, but it did include a charitable deduction for the value of the books donated to the school library. The Internal Revenue Service assessed a deficiency against the taxpayer representing income taxes on the value of the textbooks received. Taxpayer paid the amount of the deficiency, filed a claim for refund, and subsequently instituted this action to recover that amount.

Upon agreement of the parties, the case was submitted to the district court on the uncontested facts and briefs for decision without trial. The district court issued a memorandum opinion which held that receipt of the samples did not constitute income. *Haverly v. U.S.*, N.D. Ill., 374 F. Supp. 1041 (1974). The court subsequently ordered, in accordance with its decision, that plaintiffs recover from the United States the sum of $120.40 plus interest. The United States appeals from that judgment. We reverse.

Section 61(a) of Title 26 of the United States Code provides: "Except as otherwise provided in this subtitle, Gross Income means all income from whatever source derived, including (but not limited to) the following items:" The section thereafter enumerates fifteen items none of which, the government concedes, encompass the receipt of sample textbooks. The taxpayer concedes that receipt of the books does not fall within any of the specific exclusions from Gross Income set out in Sections 101 through 124 of Title 26. The only question remaining is whether the value of the textbooks received is included within "all income from whatever source derived."

The Supreme Court has frequently reiterated that it was the intention of Congress "to use the full measure of its taxing power" and "to tax all gains except those specifically exempted." *James v. U.S.*, 366 U.S. 213, 218-219, 6 L. Ed. 2d 246, 81 S. Ct. 1052 (1961). The Supreme Court has also held that the language of Section 61(a) encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 219; *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 99 L. Ed. 483, 75 S. Ct. 473 (1955).

There are no reported cases which have applied these definitions of income to the question of the receipt of unsolicited samples. The parties have cited to the court a number of cases applying income definitions to other fact situations. We have considered these cases, but we find them of no particular assistance in resolving the question before us. In view of the comprehensive conception of income embodied in the statutory language and the Supreme Court's interpretation of that language, we conclude that when the intent to exercise complete dominion over unsolicited samples is demonstrated by donating those samples to a charitable institution and taking a tax deduction therefor, the value of the samples received constitutes Gross Income.

The receipt of textbooks is unquestionably an "accession to wealth." Taxpayer recognized the value of the books when he donated them and took a $400 deduction therefor. Possession of the books increased the taxpayer's wealth. Taxpayer's receipt and possession of the books indicate that the income was "clearly realized." Taxpayer admitted that the books were given to him for his personal retention or whatever disposition he saw fit to make of them. Although the receipt of unsolicited samples may sometimes raise the question of whether the taxpayer manifested an intent to accept the property or exercised "complete dominion" over it, there is no question that this element is satisfied by the unequivocal act of taking a charitable deduction for donation of the property.

The district court recognized that the act of claiming a charitable deduction does manifest an intent to accept the property as one's own. It nevertheless declined to label receipt of the property as income because it considered such an act indistinguishable from other acts unrelated to the tax laws which also evidence an intent to accept property as one's own, such as a school principal donating his sample texts to the library without claiming a deduction. We need not resolve the question of the tax consequences of this and other hypothetical cases discussed by the district court and suggested by the taxpayer. To decide the case before us we need only hold, as we do, that when a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the taxpayer's Gross Income.

This conclusion is consistent with Revenue Ruling 70-498, 1970-2 C.B. 6, in which the Internal Revenue Service held that a newspaper's book reviewer must include in his Gross Income the value of unsolicited books received from publishers which are donated to a charitable organization and for which a charitable deduction is taken. This ruling was issued to supersede an earlier ruling, Rev. Rul. 70-330, 1970-1 C.B. 14, that mere retention of unsolicited books was sufficient to cause

them to be Gross Income.

The Internal Revenue Service has apparently made an administrative decision to be concerned with the taxation of unsolicited samples only when failure to tax those samples would provide taxpayers with double tax benefits. It is not for the courts to quarrel with an agency's rational allocation of its administrative resources.

In light of the foregoing, the judgment appealed from is reversed and the case is remanded to the district court with directions to enter judgment for the United States.

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**Problem**

You receive in the mail a free sample of a new brand of coffee from Coffee A Go-Go. As a coffee lover, you immediately use the new sample to brew and enjoy a pot of coffee. Must you include the value of the free sample in Gross Income?

## B. When is a wealth accession "clearly realized" within the meaning of *Glenshaw Glass?*

Even if a wealth accession is obvious, as in the case of valuable property received for free, *Glenshaw Glass* also requires the wealth accession to be "clearly realized" before it is included in § 61 Gross Income under the residual clause. In this manner, the Supreme Court blessed the realization requirement as a general matter, although Congress has deviated from it in §§ 475 and 1256, pertaining to mark-to-market taxation for certain securities and futures contracts. Thus, Barbara's purchase of Blackacre in March of Year 1 for $100 is a nondeductible capital expenditure because Barbara has merely changed the form in which she is holding her wealth (rather than lost wealth, an expense), and she takes a $100 cost basis under § 1012 in the property. If Blackacre increases in value to, say, $150 by the end of Year 1, Barbara has experienced a $50 wealth increase, satisfying the first requirement under *Glenshaw Glass*. Nevertheless, that wealth increase is ignored until a realization event occurs, such as a sale, exchange, destruction, theft, *etc.*, under the second requirement.

***The bargain purchase rule***

What if, instead, Barbara is able to purchase property at a price that is *less* than FMV, which means that Barbara is wealthier *immediately at the time of purchase* (equal to the amount received for no consideration) rather than only later, as the purchased property appreciates in value above its original purchase price? Is that clear wealth increase "realized" at the time of purchase—a marketplace event—or may she ignore the immediate wealth increase until a later realization event, just as she can ignore the post-purchase increases in value until a realization event?

The answer depends on the surrounding facts. Recall, for example, CEO Sue from Chapter 5, who is an employee of Realty, Inc., and who purchases Blackacre from Realty for $10,000 when its FMV is $100,000. We saw that, under § 61(a)(1), CEO Sue must include in her Gross Income the $90,000 Blackacre value that she receives in kind as compensation *immediately upon the purchase* and takes, therefore, a $100,000 cost basis ($10,000 nondeductible capital expenditure

*plus* $90,000 income inclusion) under Treas. Reg. § 1.61-2(d)(1) and (2).[15] We also saw, however, that if Blackacre's continued ownership is subject to a substantial risk of forfeiture, § 83 allows CEO Sue to avoid including the bargain purchase element until the forfeiture risk lapses. Section 83 treatment matters because of both (1) the time value of money and (2) the characterization (ordinary versus capital) of the wealth accession.

Neither Congress nor the IRS has sought to tax the bargain purchase between unrelated parties in the marketplace solely under the residual clause, where the benefit of the bargain is not a *substitute* for otherwise includable compensation, a dividend, rent, a prize, or some other specifically listed type of includable Gross Income.

## Problem

Charles, a surgeon, is a knowledgeable art lover, and he browses the flea markets and garage sales in the hope of finding an undiscovered treasure. At one garage sale in May of Year 1, Charles sees a small painting that he believes may well be the work of the 15th-century French artist Jean Fouquet, who is credited with inventing the portrait miniature. Many of his early works were believed to have been lost in the French Revolution, but a few have since been found in unexpected places. Charles bargains down the price from the $150 marked price to $100. After the purchase, he enlists the help of the world's foremost expert of Jean Fouquet's work, who confirms in December of Year 1 that the work is authentic and has a likely market value of $1 million. Charles properly insures the work and hangs it on his wall to enjoy. In Year 4, however, Charles decides that he would rather have the cash and sells the painting through an art auction house for $3 million. Describe his tax consequences with respect to the purchase in Year 1 and the sale in Year 4.

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### *Commercial rebates*

What about the receipt of a cash rebate from the manufacturer of a product? Notice that the rebate comes from a third party (the manufacturer) rather than the seller, so the transaction is clearly not a bargain purchase between a buyer and a seller.

**REVENUE RULING 76-96**

1976-1 C.B. 23

Advice has been requested whether, under the circumstances described below, the rebates received by qualifying retail customers are includible in their Gross Incomes under section 61 of the Internal Revenue Code of 1954….

*M*, a manufacturer of automobiles, instituted a program whereby it pays *40x* dollar rebates to all qualifying retail customers who purchase or lease a new automobile. *M* also pays *5x* dollar rebates to all qualifying retail customers who purchase a new automobile and trade in a specified type of vehicle. For purposes of the rebate program, a qualifying retail customer is one who independently negotiates, at arm's length, with one of *M's* dealers to arrive at a purchase or lease price for an automobile. The automobile must be a type specified by *M* and the purchase or lease

[15] Recall that real estate is not "qualified property" within the meaning of § 132(c)(4), so Sue could not exclude any part of the discount as a qualified employee discount, even if the other requirements for a qualified employee discount are satisfied.

must be made within a prescribed period. The rebates are made subsequent to the delivery of the automobile.

Section 61 of the Code provides that Gross Income means all income from whatever source derived, unless specifically excluded by law.

Section 1012 of the Code provides that the basis of property shall be the cost of such property with exceptions not pertinent here.

Section 1016 of the Code provides, in pertinent part, that proper adjustment in respect of the property shall in all cases be made for expenditures, receipts, losses, or other items, properly chargeable to capital account….

In the case of a purchase, at the time qualifying retail customers conclude negotiations with *M's* dealer, section 1012 of the Code establishes a basis for the automobiles. Assuming there are no trade-in automobiles involved, the actual purchase price of the new automobiles will be their basis. The rebate represents a reduction in the purchase price of the automobile. Thus, when the qualifying retail customers each receive the *40x* dollar rebate, section 1016 requires a downward adjustment to the basis of the automobiles.

Accordingly, the *40x* dollar rebates paid by *M* to qualifying retail customers who purchase … a new automobile are not includible in the qualifying retail customers' Gross Incomes.

Also, the qualifying retail customers who purchase a new automobile and trade in a specified type of vehicle and receive the *5x* dollar trade-in rebates are not in receipt of Gross Income. However, under section 1016 of the Code, a downward adjustment to the basis of a new purchased automobile is required.

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When you receive a cash payment that is contingent on the ownership of underlying property, the cash receipt must be categorized as either:

(1) a cashing in of the underlying property interest, itself, or
(2) Gross Income with respect to the property, such as interest (on a loan), rent (on leased property), a royalty (on a copyright or patent), or a dividend (on stock).

If a cash receipt is categorized as falling within category (1), the receipt is tax-free to the extent of basis in the underlying property, with basis reduced, dollar for dollar, under § 1016. Once basis is exhausted, any further cash receipt will produce gain because there is no more basis to take from the underlying property to attach to the cash. Thus, we must create an income inclusion to create basis to attach to the excess cash. In other words, the cash receipt is tax-free in category (1) cases *only because* it can take basis from the underlying property to attach to the cash.

If, in contrast, the receipt is categorized as falling within category (2), the receipt does *not* reduce basis but instead is fully includable in Gross Income under § 61(a)(4), (5), (6), or (7), respectively. The basis of the underlying property remains unchanged because the income inclusion, itself, immediately creates basis to attach to the cash, so we need not take basis from the underlying property to attach to the cash.[16]

[16] Of course, one exception to this analysis is interest received on § 103 bonds, as described in Chapter 2. Though the interest is excluded from Gross Income, basis in the underlying bond is not taken to attach to the cash interest payment.

The property owner is not usually free to simply elect to treat the payment as falling either in category (1) as tax-free basis recovery or category (2) as income with respect to the property. The surrounding objective facts will be used to determine the nature of the cash payment. Thus, if Landlord purchases Blackacre for $100,000 and enters into a lease with a tenant farmer that stipulates a yearly rent of $5,000, Landlord, upon receiving the first payment of $5,000, cannot simply elect to treat the payment as tax-free basis recovery, reducing his basis in the land from $100,000 to $95,000 and excluding the $5,000 payment from his tax return. Rather, their lease agreement indicates that the payment is for the use of the land and will be treated as rent, includable under § 61(a)(5), with Blackacre basis remaining unchanged at $100,000.

In Rev. Rul. 76-96, above, the receipt of cash from the manufacturer (contingent on the purchase of a car) was treated as tax-free basis recovery (category (1)) rather than the receipt of Gross Income (category (2)) with respect to the car. If it had been treated as a category (2) receipt, it would have been includable under the residual clause, as interpreted by *Glenshaw Glass*, because cash would clearly constitute a wealth accession if it is not basis recovery. Because it was, instead, treated as basis recovery, the receipt is excludable, but the car's initial cost basis must be reduced by the tax-free receipt.

Those of you who go on to study the taxation of corporations, pass-through entities (such as partnerships, multi-owner LLCs, and so-called Subchapter S corporations), and their owners under Subchapters C, S, and K will see a fuller (more complex) elaboration of these simple rules, but the rebate context is a simple example.

## Problem

James purchases a fancy DSLR camera from his local camera store for $1,000. The camera store retains the full $1,000, but his purchase entitles James to a $100 rebate from the camera's manufacturer. James submits the required documentation, and he receives a $100 cash payment from the manufacturer. How does James treat the receipt?

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### *Lessee improvements that are not "rent"*

The case below predated *Glenshaw Glass* but nevertheless remains relevant for its discussion of realization. There was no doubt that the landlord became immediately wealthier when he regained possession of his previously leased land with a valuable building on it that was constructed by the tenant. Did the building constitute in-kind "rent" within the meaning of § 61(a)(5)? Read Treas. Reg. § 1.61-8(c). If not, was that wealth accession *realized* when the landlord regained possession within the meaning of *Glenshaw Glass's* interpretation of the residual clause? Why or why not? Is the landlord like Charles, our bargain purchaser? What are the tax stakes for the landlord?

**HELVERING v. BRUUN**

309 U.S. 461 (1940)

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The bond's basis remains intact *and* the interest is excludable: the best of both worlds! Remember, however, that § 103 is a tax expenditure provision that intentionally deviates from SHS normative analysis for nontax policy reasons.

MR. JUSTICE ROBERTS delivered the opinion of the Court.

The controversy had its origin in the petitioner's assertion that the respondent realized taxable gain from the forfeiture of a leasehold, the tenant having erected a new building upon the premises. The court below held that no income had been realized. Inconsistency of the decisions on the subject led us to grant certiorari.

The cause was submitted upon a stipulation of facts. From this it appears that on 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.

The parties stipulated "that as 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 that 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. The ruling was incorporated in two succeeding editions of the Treasury Regulations. In 1919 the Circuit Court of Appeals for the Ninth Circuit held in *Miller v. Gearin*, 258 F. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.

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.

In 1935 the Circuit Court of Appeals for the Second Circuit decided in *Hewitt Realty Co. v. Comm'r*, 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 (p. 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.

In 1938 this court decided *M. E. Blatt Co. v. U.S.*, 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….

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

We might rest our decision upon the narrow issue presented by the terms of the stipulation. It does not appear what kind of a building was erected by the tenant or whether the building was readily removable from the land. It is not stated whether the difference in the value between the building removed and that erected in its place accurately reflects an increase in the value of land and building considered as a single estate in land. On the facts stipulated, without more, we should not be warranted in holding that the presumption of the correctness of the Commissioner's determination has been overborne.

The respondent insists, however, that the stipulation was intended to assert that the sum of $51,434.25 was the measure of the resulting enhancement in value of the real estate at the date of the cancellation of the lease. The petitioner seems not to contest this view. Even upon this assumption we think that gain in the amount named was realized by the respondent in the year of repossession.

The respondent cannot successfully contend that the definition of Gross Income in § 22 (a) of the Revenue Act of 1932 is not broad enough to embrace the gain in question…. [The respondent]

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. 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.

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The real estate lobby responded immediately by petitioning Congress to reverse the result in *Bruun* for future landlords. Congress responded by enacting §§ 109 and 1019. Section 109 may have been understandable in the 1930s in view of the extreme financial dislocations caused by the Great Depression, with many lessees defaulting and landlords regaining possession at a time when they may not have had the liquidity to pay the resulting tax liability under *Bruun* because banks were not lending (*i.e.*, Mr. Bruun might not have been able to mortgage his property to obtain the cash with which to pay tax on his clear wealth accession). Is § 109 still defensible today in light of your better understanding of the difference between income taxation and consumption taxation (explored in Chapter 2)? Consider the following.

Plots *X* and *Y* are identical plots of land situated near each other. In Year 1, Maria purchases Plot *X* and Mario purchases Plot *Y*, with each paying $100,000.

Maria does not want the bother of building a commercial building on the land herself, so she immediately rents the land to Ronald Tramp, a real estate developer for a lease term of 30 years. Under their lease, Tramp will pay to Maria rent of $1,000 per year for the raw land (its fair rental value as undeveloped land), increased only by the rate of inflation under the consumer price index each year. Tramp then shoulders the costs of building the commercial rental building on the land. After the construction period, Tramp will be able to rent the commercial building to others and keep the resulting rental payments for the duration of the 30-year lease term, at the end of which Maria will be entitled to obtain the land back with the building. She then will be in a position to continue to rent the commercial building to others.

In Year 3, however, shortly after the building is constructed, Ronald Tramp becomes insolvent and defaults on the lease, and Maria regains possession of the land with the newly constructed building worth $1 million, which she properly excludes from her Gross Income under § 109. She immediately rents it to tenants at an aggregate rent of $200,000 per year, the market rate for similar buildings in the location.

In contrast, after his purchase Mario builds a commercial building very similar to Maria's at a cost of $1 million to him. When the construction is completed in Year 3, he immediately rents it to tenants. He, too, can charge no more than the market rent of $200,000 per year for the area.

Both Maria and Mario must include the $200,000 rent that each receives in Gross Income

beginning in Year 3 under § 61(a)(5). But are they really treated similarly for tax purposes? Recall from Chapter 2 the two requirements that must be present for an investment to be taxed under income tax principles: (1) the investment must be made with after-tax dollars and (2) the investment's return must be included in the tax base. Are both requirements satisfied for both Maria and Mario? Which investment is being taxed under income tax principles, which investment is being taxed under cash-flow consumption tax principles, and why? Does § 109 violate horizontal equity?

***Treasure trove***

Treasure trove is includable in residual Gross Income in the year found or, if ownership is disputed, in the year reduced to undisputed possession.[17] Thus, when Mr. and Mrs. Cesarini purchased an old piano at auction for $15 in 1957 and found nearly $4,500 hidden inside it when they cleaned the piano in 1964, the treasure trove was includable in Gross Income in the year found (1964).[18] Similarly, if Lindsey is beachcombing in Hawaii and finds a diamond ring or a gold bullion brick washed ashore from some old shipwreck, she must also include the item's FMV in her residual Gross Income in the year reduced to her undisputed possession.

Should valuable home run baseballs that set important Major League baseball records be included in Gross Income under the § 61 residual clause in the year snagged by a fan? Is the wealth accession realized when caught under *Bruun* or realized only on later sale? Is the wealth accession excludable in the year caught under the bargain purchase rule, *i.e.*, does the cost of purchasing the ticket also necessarily include any caught baseballs so that the wealth accession is not realized until the ball is later sold? Does or should public perceptions regarding implementation of the residual clause affect the analysis?

This issue was hotly debated as Mark McGwire and Sammy Sosa competed in 1998 to break the previous record of 61 home runs hit in a single season (by Roger Maris in 1961) and again when Barry Bonds broke McGwire's record by hitting 73 home runs in 2001. Once again, what are the tax stakes here?

## ***Excerpt from* DEFINING INCOME**[19]

Alice G. Abreu & Richard K. Greenstein

The breadth of the *Glenshaw Glass* definition appears to be nearly co-extensive with the Haig–Simons definition of income, which is widely accepted as providing the theoretical foundation for the income tax. Accordingly, many tax professionals interpret the language in section 61 and *Glenshaw Glass* solely in light of the economic principles reflected in the Haig–Simons definition. The analytical structure for determining what is income appears clear and is generally treated as immutable. The analysis begins with the broad mandate of section 61 and *Glenshaw Glass*. As long as there is a realized accession in the economic sense within the taxpayer's dominion, *Glenshaw Glass* would seem to provide that there is income unless, pursuant to the very first words of section 61, there is an exclusion in the statute. From the time they are introduced to the tax law, students are taught this analytical structure, and by the time they become practitioners and then

[17] *See* Treas. Reg. § 1.61-14.
[18] Cesarini v. U.S., 428 F.2d 812 (6th Cir. 1970).
[19] 11 FLA. TAX REV. 295 (2011) (footnotes omitted).

judges or scholars, it is second nature.

The apparent breadth of the *Glenshaw Glass* formulation seems to give the Internal Revenue Service (IRS) wide authority to tax accessions to wealth. Nevertheless, the IRS has sometimes taken the position that a particular accession is income, only to be rebuffed by a trial or appellate court and then abandon its position. Other times the IRS has chosen not to take the position that a particular accession is income at all…. For example, … courts have held that … an expense-paid trip to Germany to inspect VW facilities provided to a [potential] VW dealer to induce him to make an … investment in the dealership [was not] income, and the IRS acknowledges that cash welfare payments are not income either. Sometimes, as in the case of "swag bags" given to nominees and presenters at the Academy Awards, the IRS has taken a position consistent with the apparent breadth of *Glenshaw Glass*, but other times, as in the case of less valuable free samples received by ordinary people, child support, government transfer payments, government-funded benefits (such as public education and medical care), or even record-breaking baseballs caught by baseball fans, it has not.

While such instances reflect the IRS's and the courts' reluctance to attempt to implement the full apparent breadth of the *Glenshaw Glass* definition of income, neither the courts, nor tax scholars, nor the IRS have articulated a comprehensive theory that explains all of these specific outcomes. Perhaps in reaching these conclusions the courts and the IRS are being lawless, deliberately ignoring the apparent mandate of *Glenshaw Glass*. Or maybe they simply do not understand the breadth of the *Glenshaw Glass* definition and are therefore incompetently failing to effectuate it.

We believe that neither lawlessness nor incompetence explains the apparent inconsistency between the breadth of the *Glenshaw Glass* definition and the narrower interpretation adopted by the courts and the IRS. We subscribe, rather, to a third explanation: that the rulings of the courts and the IRS reflect a widespread uncertainty and disagreement about what counts as the kind of "accession to wealth" that should be taxed—that is, widespread uncertainty and disagreement about what the language in the Internal Revenue Code and *Glenshaw Glass* means.

Our thesis is that what explains the inconsistency and the uncertainty and disagreement is that economics—at least Haig–Simons economics—is not everything. Although the *Glenshaw Glass* definition of income is largely consistent with the Haig-Simons definition, and thus with economics, it fails to take into account other values that count for the people who are subject to the tax and must buy into it, at least to some degree, for the tax to be administrable.

The IRS, the agency charged with administering the tax law, sometimes understands this. While the IRS rarely acknowledges these noneconomic values explicitly—perhaps for fear of unmooring tax from economics and being left rudderless on a turbulent sea—it does give itself some slack, taking into account competing, noneconomic values, and finding no income when *Glenshaw Glass* could be read to suggest otherwise. And in those instances when the IRS misunderstands the competing values, courts or Congress provide the slack, rebuffing the IRS without explicitly recognizing the departure from strict economic values and thereby retaining an anchor to prevent excessive drift….

Even individuals who agree on the essential need for taxation will differ on what ought to be subject to tax, and those differences are not only deep but are often unexplored. Tax may be different from other areas of the law in at least two ways. First, self-interest can affect tax values in ways that are less evident in other areas of law. *Ex ante*, an individual might not know what

kind of contract or tort rules she might favor because she would not know whether she would be likely to be a breaching promisor or a disappointed promisee, or the driver of the vehicle or the pedestrian who was hit. In tax, however, self-interest will almost always move an individual toward a conclusion of no income. Sides are more easily taken, even in the abstract.

Second, putting self-interest to one side, while socialization produces in most individuals a shared morality and sense of right and wrong, socialization does not typically produce in individuals a sense of what ought, or ought not, be taxed. Those who teach tax know that until students take the introductory income tax course, few have given much thought to the subject. They may know that there is an obligation to pay tax, as do most people, but like most people, they expect the tax law to consist of a set of mechanical rules unmoored from values. Students expect that the subject will be artificial, unlike, for example, constitutional law, which they know will involve the clash of deeply felt values.

That perceived artificiality complicates the clash of values. People who have not thought much about the values of equity and efficiency in taxation but care about baseball may well think that a caught record-breaking baseball ought to bring nothing but joy to its catcher. There is almost certainly a greater national consensus about baseball than about what ought to be taxed and it is likely that most baseball fans would agree with former IRS Commissioner Rossotti that the lucky fan who catches the record-breaking ball deserves "a round of applause, not a tax bill."

Commissioner Rossotti's account of his reaction to the caught baseball tax controversy … is worth detailing because it illustrates perfectly the clash of values we have identified. Commissioner Rossotti was the first Commissioner in a very long time who was not a tax professional. He had founded and run a large information technology corporation and was brought in to head the IRS at a time when the agency was in great turmoil and the approach of Y2K raised the specter of the possible collapse of its computer systems. That he was not a lawyer, much less a tax lawyer, is important because it means he brought to the position of Commissioner the reactions and sensibilities of a member of the public, not of someone whose professional training began at the knee of section 61 and *Glenshaw Glass.* In his reflections on his time as Commissioner he recounted the events that began the baseball tax controversy: a New York Times reporter asked "a hypothetical question about gift tax due from a fan who might catch [Mark McGwire's] record-breaking baseball and give it back to McGwire." When an IRS spokesperson answered the question by saying that tax would be due, a firestorm of controversy erupted. As Rossotti explains:

> More than innocent-spouse cases, more than small-business owners losing their businesses, more than ITS modernization failures, the prospect of the IRS taxing this hypothetical good-hearted fan unleashed the fury of the American people, not to mention their representatives in Congress. This was what people thought of when they talked about a faceless bureaucracy.

The firestorm of controversy erupted because even if most people had not thought much about what ought to be taxed, it seemed obvious to them that a ball caught at a park should not be. In the words of White House spokesman Mike McCurry, taxing the baseball was "about the dumbest thing I've ever heard in my life."

It is telling that tax professionals, those who had been inculcated with the structure that begins with section 61 and proceeds to *Glenshaw Glass*, were unanimous in their view that catching the baseball and keeping it produces income. Commissioner Rossotti was fortunate in not having to answer that question. The IRS Chief Counsel was able to respond to the catch-and-return

hypothetical by analogy to disclaimers and thus conclude that there would be no tax. A subsequent IRS Chief Counsel, himself a baseball fan, had no such easy out. When asked the income question directly, he covered his head with his hands and declined to respond.

Commissioner Rossotti is justifiably proud of his handling of the situation, reporting that

> the press grudgingly gave us credit for not being so pinheaded after all. I was told one of the television commentators read my quote "Sometimes pieces of the tax code can be as hard to understand as the infield fly rule. All I know is that the fan who gives back the home run ball deserves a round of applause, not a big tax bill" to the national audience at the beginning of the game in which McGwire hit his sixty-second homer. By the skin of our teeth, we had turned a potential public relations disaster into something that made it seem as if real people worked at the IRS, even people who knew what the infield fly rule was.

Commissioner Rossotti's account of the IRS response to the controversy captures the importance of the IRS's role in resolving clashes of values in defining income. It is significant that, in Commissioner Rossotti's words, "real people work at the IRS."

…

Practicing tax lawyers may not consciously experience the full force of the clash because their duty to represent their client's interest will usually cause them to want to find no income and they will attribute any IRS desire to find income to rapaciousness born of the duty to collect revenue. Law trains us to think in adversarial terms. But tax lawyers who work for the IRS, particularly those in its Office of Chief Counsel, have a more difficult task. Those tax lawyers would probably agree that equity and efficiency point toward taxing the value of the baseball (because it is an accession to wealth clearly realized within the taxpayer's dominion if she keeps it), and the Chief Counsel who covered his head with his hands and pleaded not to be asked the question probably reflects that. But as lawyers working for the IRS they understand the difficulty of administering such a conclusion, not only because of the difficulty of valuation but also because it necessarily implies taxing all caught baseballs, including those of relatively little value. Such a result, while equitable and efficient, is unadministrable, not only because people would rebel but also because it would be impossible for the IRS to enforce it. Administrability encompasses noneconomic values, which affect the IRS's ability to enforce the law, as well. Equity, efficiency, and administrability thus clash in this case as they do in those involving free samples, because the free sample of shampoo mailed to an individual's house is logically indistinguishable from the one included in the Oscar swag bag. A rule based on administrability could be an invitation to circumvention and would lack the flexibility to address similar but unforeseen iterations of the same issue by weighing noneconomic values that affect public perception and enforceability. In the case of income, a standard is therefore most apt.

But if we cannot rely on a shared consensus regarding tax values to render the *Glenshaw Glass* standard apt, what is the substitute? The answer is *ad hoc* intervention by the IRS. The IRS has specified on a case-by-case basis what counts as an accession to wealth for purposes of income taxation, and it has generally done so in a manner that respects the values of equity and efficiency, along with the equally important value of administrability. The *Glenshaw Glass* standard will produce the right result in those cases where the values align, so salary will be income because treating it as such promotes both equity and efficiency and is highly administrable. But in cases where the values point in different directions, such as the case of the client who is taken to lunch

by her lawyer, the IRS can weigh equity and efficiency, both of which would point to income, but allow administrability to outweigh them, leaving itself open to argue income when it senses abuse, either because the value of the lunch is excessive or because it suspects some non-business motivation on the part of the lawyer. Moreover, with a standard the IRS can take into account noneconomic values that are not central to tax law but emerge as important in specific situations—like reverence for the game of baseball.

The use of a standard, as exists in the administered definition of income, respects equity and efficiency. At the same time, the standard allows for the crucial value of administrability by giving the agency charged with administering the tax law, the IRS, the ability to weigh the relative values, including noneconomic values, and make decisions that reflect current circumstances. The very cloudiness of the definition thus becomes its strength….

What we propose, that the definition of income be acknowledged to be a standard that should be interpreted in light of the values—including noneconomic values—that animate the field of income taxation, may sound heretical or even incoherent to the contemporary scholarly ear, but it is not revolutionary when viewed in historical context. It has a long and distinguished pedigree that dates to the period shortly before the Court's decision in *Glenshaw Glass* and that was contained in scholarship that was cited by the Government to the Court in that case.

Professors Surrey and Warren understood that even the *Macomber* formulation was "a generalization rather than a definition" that failed to answer questions such as whether the "act of picking up found money [was] 'labor'" which would be captured by the *Macomber* formulation of income as "gain derived from capital, from labor, or from both combined." They acknowledged that the Haig-Simons definition was too broad to be administrable and concluded instead that

> the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces. Each force and judicial reaction in turn reflects an underlying judgment as to what types of receipts should be subject to a tax imposed on "income."
>
> …
>
> In the income tax, as in other complex legislation, the need is for a standard which will project our present aims into the future and serve as the vehicle for solving the unforeseen cases as they arise. The legislative function is not denied or thwarted when other branches of the Government are relied upon by Congress to perform substantial tasks in the application of statutes. Administration and judicial interpretation are necessary parts of the overall process of legislation. The income tax is no exception.

We couldn't agree more.

Because the Surrey and Warren article was cited in the Government's brief in *Glenshaw Glass* and because its discussion of the definition of income implicated precisely the issue facing the Court—expansion of the *Macomber* definition—and was prominent, having been placed at the very beginning of the piece, we believe that it is likely that the Court considered it, and took it to heart in the formulation it adopted in that case. We think that history has proven Professors Surrey and Warren … right. While a definition of income that is acknowledged to be a standard does not fit the desire for technical precision that seems to be the hallmark of so much tax legislation, it is

not for that reason inapt. Acknowledging that the *Glenshaw Glass* formulation is not a rule but a standard will not land the tax system in a quagmire but will instead … allow a deliberate examination of whether a particular item ought to be included in the tax base.

In law, as in baseball, there are rules and there are standards. The infield fly rule is a rule, but the strike zone is a standard. In law, apparently crystalline rules can turn into muddy standards as they are applied to situations in which competing values clash. The *Glenshaw Glass* definition of income may seem to provide a rule, but it is actually a standard, and the IRS is its umpire. Unlike the umpire, the IRS generally does not have the last word. However, the IRS does call the balls and strikes within the zone. In doing so it weighs numbers of factors and tries to reach the right result: a tax system that is equitable, efficient, and administrable. By exploring the IRS's role in defining income and by dissecting the factors that make it so difficult to articulate a clear, precise, and accurate definition of the income that is taxed, we have tried to illuminate the penumbral area where income becomes no-income. In that area, economics are important, but noneconomic values also count. Economics is not everything.

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For the record, and contrary to the article's claim that "[t]here was unanimity of opinion on the part of tax professionals, for whom it was clear that the baseball was income when caught …," I did not think that the home run baseball was income when caught.[20] In my view, while the baseball was a clear wealth accession, the issue was one of realization, and I believed that the fan was closer to the lucky buyer who was able to engage in a bargain purchase with a stranger than the landlord in *Bruun*. He expected only to be able to watch a good game of baseball when he bought his ticket and attended the game, but he was able to walk away with a baseball, the FMV of which was unclear (though substantial).[21] Having a zero basis in the ball, the fan would realize a § 1001 gain on later sale that would equal the entire amount realized. If he waits more than a year, therefore, the gain would contribute to low-taxed net capital gain. If the ball were income on receipt, instead, the included value would be higher-taxed ordinary income. In other words, the stakes were the same as those at issue for our bargain purchaser and for Mr. Bruun. But what do I know?

Nevertheless, this article excerpt suggests that the very opaqueness of the language in the residual clause that might drive law students nuts—"Gross Income means all income from whatever source derived"—may actually be a good thing because, as a standard rather than a rule, it effectively allows both the administrator of the statute and courts to use external norms to decide whether the matter at issue meets *Glenshaw Glass's* requirement that the event results in a realized wealth accession—or not. For example, if we can be fairly sure after examining the surrounding facts that the noncash receipt (which is not compensation, a dividend, or a prize) is not the equivalent of a cash receipt followed by a free-spending choice to purchase personal consumption, we can be comfortable in concluding that the receipt of in-kind consumption is not a wealth accession under the residual clause, as in *Gotcher* or the case of the clients who are treated to a meal by their lawyer as they discuss their case with her. If, on the other hand, we are convinced that the accepted (rather than declined) receipt is a *substitute* for cash or that the taxpayer would

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[20] *See also* Lawrence A. Zelenak & Martin J. McMahon, Jr., *Taxing Baseballs and Other Found Property*, 84 TAX NOTES 1299 (1999).

[21] I do not think that a baseball hit by a player into the stands can be properly categorized as a "prize," which would be includable immediately under § 74. In contrast, if fans are informed that their purchase of a ticket entitles them to be entered into a drawing for a new car worth $20,000 during the seventh-inning stretch, the lucky fan whose ticket is drawn clearly must include the $20,000 FMV of the car on receipt under § 74. Context is everything!

likely have purchased the same consumption in any event, we can be much more comfortable in concluding that the receipt constitutes a realized wealth accession representing ability to pay, as in the case of our Oscar presenters. And even the anticipated reaction of the public at large (as in the case of the home run baseball) could conceivably be a legitimate consideration in applying these norms by a tax administration concerned with public perceptions about the legitimacy of the tax system overall.

If the fan who catches the record-breaking home run baseball is not required to include the value of the baseball immediately in the year of receipt, when will that value be taxed under the income tax if the fan dies before selling the ball? Great segue to Unit III!

# Unit III:

# The Possibilities for Income Shifting

## Introduction to Chapters 7 through 9

This unit consists of three chapters that explore the possibilities for shifting income from one to another or splitting income between two (or more) taxpayers. Because of the progressive rate structure in § 1, the total tax paid can sometimes be lowered if income is shifted to another in a lower marginal rate bracket or if income is split between two taxpayers, with the ensuing ability to use the lower rate brackets twice.

Chapter 7 starts with an examination of both *inter vivos* gifts during life and death-time bequests because the § 1015 basis rule for *inter vivos* gifts, in particular, carries with it the possibility to shift built-in gain from one taxpayer to another.

Chapter 8 then considers other income-shifting possibilities within the intact family, including consideration of the assignment-of-income doctrine under the common law and related statutory provisions.

Finally, Chapter 9 considers the income-shifting possibilities in divorce.

# Chapter 7: Gifts and Bequests

Recall from Chapter 1 that a fundamental precept of an income tax is that the same dollars should not be taxed to the same taxpayer more than once and that we use "basis" as the tool to keep track of previously taxed dollars to implement this precept.

Do not be lulled into thinking that the same dollars cannot be taxed to the same taxpayer more than once *under two separate tax systems*, however. It happens routinely. For example, the same dollar of labor income is commonly taxed twice to the same taxpayer at the Federal level: once under the payroll taxes (the Social Security and Medicare Taxes described in Chapter 3) and once under the income tax.

Moreover, even if we limit our focus to the Federal income tax itself, the same dollar is commonly taxed *to more than one taxpayer* as it is transferred from taxpayer to taxpayer in the economy. For example, Doris earns wages from her job as a store clerk, and she includes those wages in her Gross Income under § 61(a)(1). Doris then pays some of her after-tax dollars to her window washer, David, for washing the windows of her home. They are after-tax dollars because, as a personal expense, Doris cannot deduct the outlay, which means that the amount that she pays to David effectively remains in her tax base and is taxed to her. David cannot claim that his receipt should be free of Federal income tax in his hands because those dollars were already taxed once (to Doris) under the Federal income tax. Thus, the same dollars are includable in Gross Income by both Doris and David and are taxed twice under the income tax as they move from Doris to David.

What if Doris simply makes a gift of those dollars to David during life or leaves a bequest to David at her death?

***Possible taxation approaches to the transfer and receipt of gifts and bequests***

When we think about gratuitous transfers, whether an *inter vivos* gift (during life) or a death-time bequest, we have two taxpayers to consider—the donor and the donee—and we have two possible tax systems to consider at the Federal level: the Federal income tax and the Federal wealth transfer taxes, consisting of an integrated system composed of the estate tax, the gift tax, and the generation-skipping transfer tax, each of which is legally imposed on the donor. Unlike wealth taxes, which tax the fair market value of assets again and again, year after year, the wealth *transfer* taxes are excise taxes imposed on the donor only on the act of transfer, whether during life or at death. The wealth transfer taxes are the subject of a separate tax course and are not examined here in any detail except to the extent that their mere existence may help us to think about how gratuitous transfers should be treated under the income tax.

Should the income tax treatment of *inter vivos* gifts and death-time bequests be integrated with the wealth transfer taxes so that the same dollars are not taxed under both Federal tax systems? If the answer to that is "yes," should the payroll taxes (Social Security Tax and Medicare Tax) on wages be integrated with the income tax on wages so that the same dollars are not taxed under both Federal tax systems, as well?[1] If the answer to the latter is "no" because the income tax and payroll taxes serve different purposes, should the answer to the former also be "no" for the same reason? Should the income and wealth transfer tax systems ensure that a dollar is taxed *at least*

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[1] *See, e.g.*, Deborah A. Geier, *Integrating the Tax Burdens of the Federal Income and Payroll Taxes on Labor Income*, 22 VA. TAX REV. 1 (2002).

*once* between the two systems rather than escaping tax entirely under both, as is not uncommon today (particularly because of the combination of the realization requirement, the high estate tax exemption, and § 1014, described below)?

Under the Federal income tax—viewed alone and without regard to any possible treatment under the estate tax—should amounts transferred as *inter vivos* gifts or bequests be effectively taxed to both the donor and the donee, just as both David, the window washer, and Doris were effectively taxed on the same dollars under the income tax? The making of a gift is clearly a personal expense of the donor, so it would generally be nondeductible (unless contributed to a charity, considered in Chapter 18). Thus, the issue boils down to whether it ought to be included in the donee's Gross Income when received. And what if property (instead of cash) is transferred, and the property has unrealized built-in gain at the time of transfer? Should the gift or bequest qualify as a realization event under § 1001? At what basis should the donee take the property?

To help us to think about these questions, consider the story appearing in the *Los Angeles Times* in 2010, which reported that Christie's New York sold Pablo Picasso's 1932 portrait of his mistress entitled "Nude, Green Leaves and Bust" for $106.5 million. Bidders came from all over the world, including Asia, the U.S., Europe, and Russia, although the winning bidder (by telephone) was not identified. The article relates the following:

> The painting came from the estate of Frances Brody, the Los Angeles arts patron who died last year [2009] at age 93. Her husband Sidney, a real estate developer, died in 1983. The estate consigned this Picasso to Christie's along with some 80 other artworks. The most valuable pieces, including sculptures by Alberto Giacometti, went up for auction Tuesday night; the remainder are slated for Wednesday morning…. The Brodys originally bought "Nude, Green Leaves and Bust" in January 1951 from Paul Rosenberg's New York gallery for $19,800 (about $166,000 in today's dollars).[2]

When an individual dies, a new taxpayer automatically springs into existence called an "estate," which in essence takes the place of the decedent. The estate owes income tax on any income realized by it during its existence, using the rate schedule found in § 1(e) (reprinted in Chapter 8). For example, when the estate receives an interest payment on a corporate bond that the decedent owned before death, the estate must include that interest payment in its Gross Income under § 61(a)(4), just as the decedent would have included the interest if she had not yet died. At some point in time, the estate will distribute all of its (after-tax) cash and other assets to the estate beneficiaries as described in the decedent's will or (absent a will) as described in the state's intestacy statutes and cease to exist. Thus, the cash collected by the Brody estate on the sale

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[2] Jori Finkel, *Picasso Sets Record Sales Price*, http://articles.latimes.com/2010/may/05/entertainment/la-et-brody-picasso-20100505. At the time, this sale represented the highest price ever obtained for an artwork. That record was first broken in 2013, when Francis Bacon's three-paneled painting "Three Studies of Lucian Freud" sold for $142.4 million. *See* Carol Vogel, *At $142.4 Million, Triptych is the Most Expensive Artwork Ever Sold at an Auction*, at www.nytimes.com/2013/11/13/arts/design/bacons-study-of-freud-sells-for-more-than-142-million.html. In turn, that record was again broken in 2015 when Picasso's "Les Femmes d'Alger" was sold for $179.4 million. *See* Doreen Carvajal, *Impressionist and Modern Art Lifts Christie's First Half*, at www.nytimes.com/2015/07/21/business/international/impressionist-and-modern-art-lifts-christies-first-half.html?_r=0.

Trivia tidbit: After Frances Brody's death, the talk show host Ellen DeGeneres bought the house from the estate for $40 million before it officially was listed for sale. *See* Steven Kurutz, *The Unsettling Thing About Ellen*, at www.nytimes.com/2014/04/24/garden/the-unsettling-thing-about-ellen.html?hpw&rref=garden.

described above, as well as any other cash and property owned by the estate, less any income tax (and estate tax, if any) owed, would be distributed to Mrs. Brody's beneficiaries.

What are the possible ways that the events described above could be taxed, considering both the income tax and the estate tax? There are various possibilities that we could construct, from the least-taxed combination to the most-taxed combination.

Least taxed possibility: The automatic transfer of the painting by the decedent to this new taxpayer (the estate) is not a realization event under § 1001 for income tax purposes. Nevertheless, the estate steps up the basis of the painting from the $19,800 cost basis that it had in the hands of Frances to its fair market value (FMV) at her death, which is determined by the sale, itself, to be $106,500,000. Thus, while the sale by the estate of the painting is a realization event under § 1001 for income tax purposes, the sale produces no gain because the A/R and A/B are the same—$106,500,000—meaning that no income tax is owed by the estate on the sale. No wealth transfer tax is imposed on Frances's estate when that $106,500,000 and other property owned by the estate are transferred to her daughter. Her daughter does not include the cash from the sale or the FMV of other property received in her Gross Income for Federal income tax purposes. Notice that, under this approach, we have laundered out the $106,480,200 built-in gain in the painting, which is never taxed to anyone.

Most taxed possibility: The transfer of the painting from Frances to her estate on her death is a realization event under § 1001 so that the $106,480,200 built-in gain is taxed on her final individual income tax return, payable by the estate. In addition, the after-tax cash from the sale, plus the FMV of any other property held by the estate, is taxed to her estate under the estate tax (to the extent that it exceeds any applicable exemption amount) before transfer to her daughter. Her daughter includes the cash (after the estate's payment of income and estate taxes) plus the FMV of any other property that she receives from the estate in her Gross Income for income tax purposes on receipt because they constitute a realized wealth increase for her.

And, of course, we could construct various degrees between those two extremes. We could, for example, provide that the transfer to the estate is a realization event for income tax purposes but that no wealth transfer tax applies. We could provide that the receipt by her daughter is includable for income tax purposes as an accession to her wealth—with or without an estate tax. Or we could provide that the bequest is not a realization event but that the full $106,500,000 FMV is taxed to her estate under a wealth transfer tax. Her daughter could exclude the painting on receipt under the income tax.

And so on.

Before turning to positive law, your thoughts? Remember your tax policy tools from Chapter 3. How may these decisions about how to tax these events affect taxpayer behavior under the neutrality norm? Any fairness concerns? And remember that *$X* (the aggregate amount collected in tax each year) stays about the same as a percentage of GDP so that the narrower the tax base, the higher the marginal rates need to be to raise *$X*, and the broader the base, the lower the rates need to be to raise *$X*. In other words, whether and when we tax the painting's built-in gain, whether we tax the transfer of wealth, and whether we require gifts and bequests received by the donee to be included in Gross Income for income tax purposes affects not only the parties directly involved but the rest of the taxpaying public, whose tax rates are inevitably affected by these decisions. In short, they are not costless decisions.

***A brief description of positive law***

What follows first is a brief description of the wealth transfer taxes imposed on the donor on the making of a gift or bequest.

The original estate tax was enacted in 1916 (three years after the enactment of the income tax) and was intended to "reallocate the costs of underwriting a modern state across the geographical regions and socioeconomic classes."[3] In other words, it was intended primarily to raise revenue from those best able to pay. But an important secondary reason was to combat the ill effects of rapidly advancing wealth concentration at the time, including political influence peddling that can harm democratic values, the consolidation of monopoly power in business, *etc.* As described by the Joint Committee on Taxation, the new estate tax was viewed as "preventing undue concentrations of wealth and complementing the income tax to fulfill the goal of the progressive tax system."[4] This view was common in early 20th century political and economic thought. For example, in a 1910 speech former (Republican) President Theodore Roosevelt said:

> The absence of effective State, and, especially, national restraint upon unfair money-getting has tended to create a small class of enormously wealthy and economically powerful men, whose chief object is to hold and increase their power…. The really big fortune, the swollen fortune, by the mere fact of its size acquires qualities which differentiate it in kind as well as in degree from what is possessed by men of relatively small means. Therefore, I believe in a graduated income tax on big fortunes, and in another tax which is far more easily collected and far more effective—a graduated inheritance tax on big fortunes, properly safeguarded against evasion, and increasing rapidly in amount with the size of the estate.[5]

Similarly, in a 1919 speech as president of the American Economic Association, noted economist Irving Fisher noted the trend toward increasing income and wealth inequality. He warned against the effects of "an undemocratic distribution of wealth" and spoke favorably of heavily taxing estates to limit inherited wealth, saying:

> I believe that it is very bad public policy for the living to allow the dead so large and unregulated an influence over us. Even in the eye of the law there is no natural right, as is ordinarily falsely assumed, to will property…. Justice McKenna of the United States Supreme Court says: "The right to take property by devise or descent is the creature of the law and not a natural right—a privilege, and therefore the authority which confers it may impose conditions on it."… Numerous limitations of the right to will property already exist in each of our states—some under common law, others under statute law. There are, in particular, restrictions against tying up property (except in charitable bequests) in perpetutity. These restrictions have, undoubtedly, restrained the accumulation of swollen fortunes. There is no reason why we cannot continue to add to such limitations so far as seems wise.[6]

To combat avoidance of the estate tax through lifetime gifts, a gift tax was enacted in 1924,

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[3] AJAY MEHOTRA, MAKING THE MODERN AMERICAN FISCAL STATE 27 (2014).
[4] JOINT COMMITTEE ON TAXATION, DESCRIPTION OF GIFT AND ESTATE TAX MATTERS, JCS-30-83, June 27, 1983, at 15.
[5] http://teachingamericanhistory.org/library/document/new-nationalism-speech/.
[6] http://www.jstor.org/stable/1813978?seq=8.

repealed in 1926, and reintroduced in 1932. The generation-skipping transfer tax was enacted in 1976, and the estate, gift, and generation-skipping transfer taxes were effectively integrated into a single, unified system at that time.

In 2000, the estate tax exemption amount (the cumulative amount that could be transferred during life and at death without tax) was $675,000, effectively $1.35 million for a married couple, and marginal tax rates ranged from 18% at the low end to 55% on very large estates. As part of the tax reductions that occurred in 2001 in the George W. Bush administration, which were (as you recall from Chapter 3) scheduled to sunset at the end of 2010, the estate tax exemption amount was gradually increased each year until it reached $3.5 million ($7 million for a married couple) in 2009, and the top marginal tax rate was gradually reduced each year until it reached 45% in 2009. (Because Mrs. Brody died in 2009, her estate would have been taxed using these figures.) For tax year 2010, the estate tax was fully repealed for that year only (because of the sunset), which, as you can imagine, created all sorts of late-night jokes about pushing grandma off the train in 2010. At least four billionaires died in 2010, thus avoiding estate tax, including George Steinbrenner, the irascible owner of the New York Yankees.[7]

For 2011—when the estate tax otherwise would have reverted to 2000 levels—Congress acted to increase the exemption amount to $5 million ($10 million for a married couple), to reduce the top tax rate to 35%, and to index the exemption amount for inflation. Because of the inflation adjustment, the exemption amount was $5.12 million ($10.24 million for a married couple) for 2012. Absent further Congressional action, the estate tax exemption amount was scheduled to be reduced to $1 million ($2 million for a married couple), with a top tax rate of 55%, in 2013.

The American Taxpayer Relief Act of 2012, however, made permanent the $5 million 2010 initial exemption ($10 million for a married couple) prior to inflation adjustments and reduced the top tax rate from 55% to 40%, which the Joint Committee on Taxation estimated would collect $369 billion less revenue over the decade ending in 2023 than if Congress had retained the 2001 law. The 2017 inflation-adjusted exemption amount is $5.49 million ($10.98 million for a married couple). Recall the difference (discussed in Chapter 3) between the *marginal* rate and *effective* or *average* tax rate. That 40% rate is the marginal rate imposed on the last estate tax base dollar. As under the income tax, average or effective tax rates are much lower.

> The estate tax remains one of the most progressive parts of the tax code. In 2013, more than 99.8 percent of estates will owe no tax. Among the 3,780 estates that will pay the tax, the 810 largest—those with gross assets exceeding $20 million—will account for nearly three-fourths of the total estate tax revenue…. About one-fifth of the burden will fall on estates valued between $10 million and $20 million, while just 7 percent will come from estates worth less than $10 million.
>
> Because of its exemption, the estate tax claims a bigger percentage of larger estates. Taxable estates with gross assets less than $10 million will pay an average tax rate 7.7 percent, while estates with gross assets of between $10 million and $20 million will pay 15.8 percent on average. Estates valued at more than $20 million will pay an average rate of 18.8 percent.[8]

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[7] The other four were Janet Morse Cargill of the family that founded Cargill, Inc., the Texas pipeline magnate Daniel Duncan, and the California real estate mogul Walter Shorenstein. "By rough calculation, their deaths in 2010 have cost the government some $6.5 billion." www.elderlawanswers.com/Resources/Article.asp?ID=8454.

[8] Benjamin Harris, *Estate Taxes After ATRA*, 138 TAX NOTES 1005 (2013).

Under the integrated estate and gift tax system, each individual donor can transfer $14,000 (as of 2017) to each donee during life without incurring gift tax on the transfer and without eating into the cumulative estate tax exemption amount. For example, a married couple with two children can transfer $56,000 each year (with each spouse giving $14,000 to each of their two children) without incurring gift tax or using any of their estate tax exemption amount, which means that they can transfer at least $560,000 over ten years to their children without tax and without reducing their estate tax exemption amount. I say "at least" because the $14,000 figure is also adjusted for inflation over time and will likely be increased in the coming years, allowing more than $560,000 to be transferred without tax. In 2005, for example, the gift tax annual exclusion was $11,000, and in 2012 it was $13,000. Moreover, education and health costs paid directly to the provider on behalf of another do not count toward the $14,000 annual gift tax exclusion. Thus, a good deal of wealth can be transferred during life and at death without transfer tax, even with the estate and gift tax in place.

As for the income tax, **in the U.S., the making of a gift, whether during life or at death, is not a § 1001 realization event for the donor.** Thus, the built-in gain in property owned at death (the difference between the property's FMV and its A/B) is not taxed under the income tax to the decedent (on her final tax return) in the United States.

With respect to the donee's receipt, read § 102(a). **Both *inter vivos* gifts and bequests are fully excluded from the Gross Income of the donee for income tax purposes, with no cap on the amount that can be excluded.** In contrast, the 1894 income tax (which was ruled unconstitutional under the apportionment clause, as you read in Chapter 3, and thus never went into effect) included in the tax base "money and the value of all personal property acquired by gift or inheritance" (leaving out real property).[9] While the entire 1894 income tax was controversial, this provision was subject to particular scrutiny, as described by tax historian Joseph Thorndike. The provision did have its supporters, including Senator George Vest, who opined that "when the child or widow receives from the father or husband an estate, there is no reason, if the income of the child or of the widow is increased to that extent, that the new estate should not bear an equal and just portion of the common taxation of the Government."[10] But Senator David Hill's criticized the provision as follows:

> What a man receives by gift, that which he does not earn, is not an income within a proper sense of the term. That which my father leaves me by inheritance or by will is not an income within the proper, strict definition of the term. It is an inheritance. It is a gift which in my judgment ought not to be taxed by the General Government. At least there could be no sound reasons advanced why such a tax ought to be placed in the bill.[11]

The New York Times editorial page similarly criticized this provision:

> The theory of an income tax is that it requires the citizen to pay annually to the Government a certain percentage of the profits of his business or occupation or the increment of his capital. An inheritance is in no sense a part of such annual income, and a tax upon it is a confiscation of a certain portion of the principle outright.[12]

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[9] *See* Joseph J. Thorndike, *When Estates Were (Almost) Taxed as Income*, 147 TAX NOTES 483 (2015).
[10] *Id*. at 484.
[11] *Id*.
[12] *Id*.

By the time that the income tax was enacted again in 1913 (after ratification of the 16th amendment), all gifts and bequest were excluded by the recipient under the predecessor to § 102(a). Why the change of heart between 1894 and 1913? There is no 1913 legislative history underlying the gift exclusion. The 1913 income tax exclusion could not have been premised on the notion that the gift or bequest would be taxed to the donor under the estate tax and should not therefore be included by the donee under the income tax, as there was no estate tax in 1913. Moreover, even with an estate tax now in place, the gift exclusion cannot be premised on the notion that the estate tax and the income tax treatment of gifts are integrated to avoid double taxation (albeit under two separate tax systems) between the two taxpayers because the gift exclusion under the income tax was not repealed when the estate tax was repealed for 2010. The cash bequests of George Steinbrenner and the other billionaires who died in 2010 were taxed under neither the estate tax (to the donor) nor the income tax (to the donee).

Recall the discussion from Chapter 6 regarding Victorian notions distinguishing between (1) lump sum, nonperiodic "capital receipts" and (2) periodic "income" receipts. The 1913 exclusion likely had its roots in such notions, *i.e.*, that the lump sum gift or bequest was not, itself, income but would produce future income when invested. The last two quotations above hinted at this, and the 1914 income tax treatise written by economist E.R.A. Seligman (published just a year after the 1913 income tax was enacted with the gift exclusion in place) stated this notion explicitly when describing the defunct 1894 income tax: "If anything is irregular and unperiodic, it is an inheritance. The income from the inheritance is indeed regular, but the [1894] law taxed not only the income from the inheritance but the inheritance itself." His clear implication was that inclusion of gifts or bequests as "income" was clearly wrong under theoretical notions of what that term meant at the time.

By 1938, however, Henry Simons was elucidating the meaning of "income" for uniquely *tax* purposes (as opposed to its meaning for financial or trust accounting purposes, where the "periodic" gloss was strong), and he recognized gifts and bequests as clear wealth accessions for the donee. Moreover, as we saw in Chapter 3 the income tax is usually defended on ability to pay grounds. Receiving a large gift or bequest increases one's ability to pay just as much as receiving a large salary (or prize) does. On horizontal equity grounds, do we want to treat people who work hard for a living (and whose wages are includable under the income tax) worse than we do those who are lucky enough to live off of transferred wealth from gramps? Simons said:

> The income tax is not a tax upon income but a *tax upon persons according to their respective incomes;* and, subject to the requirement of adherence to simple, general rules, the objective of policy must be fairness among persons, not fairness among kinds of receipts (whatever that might be construed to mean)….
>
> Considerations of equity surely afford little ground for excluding (or including) particular receipts according to the intentions of the second parties…. Thus, as regards donees, current income-tax practices as to gifts find no sanction in considerations of fairness; and they do involve a distinction between gifts and compensation which introduces serious administrative difficulties and which, moreover, invites the dressing-up of real exchanges in the guise of one-sided transfers.[13]

[13] HENRY C. SIMONS, PERSONAL INCOME TAXATION at 128, 134-35 (1938).

So why does the unlimited gift exclusion in § 102(a) remain in the 21st century? Congress could, for example, cap the exclusion to a "reasonable" amount (either annually or for the donee's lifetime) to ensure that ordinary birthday and holiday gifts remain excludable but that substantial gifts and bequests in excess of the cap are includable.

Perhaps Congress believes that a mere transfer, without rendering services (such as in the case of David, the window washer, and Doris), should result in only one level of taxation between the two taxpayers under the income tax. Because the donor is denied deduction of personal expenses under § 262 and is thus implicitly taxed on the transfer, the only way to ensure only a single layer of income tax between the donor and donee is to permit the donee to exclude gifts and bequests, notwithstanding horizontal equity concerns between donees and workers like David. Convincing?

## A. The basis of property received in kind as a gift or bequest (and related rules)

If an *inter vivos* gift or death-time bequest is received in kind rather than in cash, at what basis does the donee take the property? Carefully read both §§ 1014(a) and 1015(a) before considering the following problems. Pay particular attention to the language in § 1015(a) after the words "except that" in considering Problem 3. In addition, note §§ 1223(1) and (9) regarding the deemed holding period of property obtained by *inter vivos* gift or death-time bequest.

**Problems**

**1.** Jonathan purchased land many years ago for $100,000, which is rented to tenant farmers who pay Jonathan an annual rent of $5,000. Today, the land is worth $400,000. Jonathan has just learned that he is terminally ill and does not have much longer to live. Do you advise Jonathan to:

**a.** sell the land now to a buyer for $400,000 and provide a bequest in his will for the cash proceeds to be transferred to his good friend Jill;

**b.** give the land to Jill now and let her sell it; or

**c.** provide a bequest in his will for the land to go to Jill after his death?

**2.** Same as **1.**, except that the land, which Jonathan purchased for $100,000, is now worth only $75,000. Should Jonathan:

**a.** sell the land now to a buyer for $75,000 and provide a bequest in his will for the cash proceeds to be transferred to his good friend Jill;

**b.** give the land to Jill now and let her sell it; or

**c.** provide a bequest in his will for the land to go to Jill after his death?

**3.** Notwithstanding your advice, Jonathan gave the land described in **2.** to Jill before he died. Rather than sell immediately, Jill held the land for several years. What is her § 1001 realized gain or loss in each case if she eventually sells for:

**a.** $60,000;

**b.** $110,000; or

**c.** $80,000? *See* Treas. Reg. § 1.1015-1(a)(2).

**4.** During the years of Jill's ownership of the land in **3.** before sale, must she include the rent that she receives from the tenant farmers, or can she exclude the rent under § 102(a) on the theory that the rent is all a part of Jonathan's gift of the land? *See* § 102(b)(1).

**5.** Cindy recently died, and her will contains bequests for both Carl and Candy. Cindy's will directs that land that she owns should be transferred to Carl. The land was purchased by Cindy years ago for $80,000, and it has a FMV of $120,000 on Cindy's death. Her will also directs, however, that the rent paid by the tenant farmers working the land should be paid to Candy (rather than Carl) until the current lease term ends in two years. When Candy receives the first lease payment of $2,000, she asks you whether she can exclude the receipt under § 102(a), as she received this rent as a bequest under Cindy's will. While § 102(b)(1) does not apply on these facts, see § 102(b)(2).

**6.** Hal and Helen are the proud parents of Hallie, who is a 24-year-old medical student whom they continue to support through her studies in medical school. Hallie works part-time as a lab technician in a hospital, but she does not earn much above minimum wage. Hal and Helen pay Hallie's medical school tuition directly, but they also plan to sell shares of corporate stock that they bought for $2,000 when Hallie was a child in order to contribute toward Hallie's living expenses this year. The stock is now worth $16,000. Do you have any advice for Hal and Helen?

**7.** Jacob bought land many years ago for $7,000, and it was appraised at $20,000 just before he sold it to his cousin Caleb for $10,000. In other words, Jacob sold the land at a deep discount to his cousin! What are Jacob's tax consequences? At what basis does Caleb take the land? The theoretically correct answer is that Jacob sold 50% of the land (worth $10,000) for $10,000 and made a gift of the remaining 50% (worth $10,000), which means that 50% of the basis ($3,500) would be allocated to the sale transaction and 50% to the gift transaction. Under that approach, Jacob would recognize a $6,500 gain under § 1001 ($10,000 A/R *less* $3,500 allocated basis) with respect to the 50% interest that he sold. Caleb would take a $10,000 cost basis (under § 1012) in 50% of the property and a $3,500 carryover basis (under § 1015(a)) in 50% of the property for a total basis of $13,500. But that is not the approach taken by the regulations in the case of a "part gift/part sale" transaction. What are the results to both Jacob and Caleb under current law? *See* Treas. Reg. §§ 1.1001-1(e) and 1.1015-4. How would your answers change if Jacob's basis in the land had been $12,000 instead of $7,000?

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***Historical development of the basis rules***

While the original 1913 revenue act provided authority to exclude gifts and bequests, it provided no special basis rule for such receipts received in kind rather than in cash. The only basis rule in the Code at that time was the predecessor to current § 1012, providing that the basis of property was equal to its "cost." When the Treasury was asked what the "cost" basis of property received by gift or bequest would be, it responded with "FMV"—probably on the analogy that when property is purchased at arm's length the cost basis typically equals FMV. Recall that in 1913, a tax-specific meaning of "income" was yet to evolve, and the concept of "basis" was not yet fully understood in its modern role of keeping track of previously taxed dollars.

It did not take propertied families long to figure out that they could launder out any unrealized gain by making intra-familial gifts before a sale to an unrelated third party for cash at no further gain. For example, Papa bought land in 1913 for $100 and took a "cost" basis of $100 in the land. By 1917, the land had increased in value to $120, so Papa gave it as a gift to Daughter, who took a "cost" basis of $120 in the land, even though the gift was not a realization event for Papa and even though she was permitted to exclude the value of the land from her Gross Income under the predecessor to § 102. In 1920, the land had further increased in value to $130, so Daughter gave the land to Sibling, who excluded the $130 value from his Gross Income and who took a $130 "cost" basis in the land before selling it to Stranger for its $130 FMV, generating no § 1001 gain ($130 A/R *less* $130 A/B).

Congress finally responded to this scenario by enacting the predecessor to § 1015 in 1921, but the taxpayer in *Taft v. Bowers*[14] soon claimed that the new carryover (or transferred) basis rule was unconstitutional. The taxpayer's brief depended on the antiquated "capital receipt" notion described above and in the last chapter, as recounted in this excerpt.

> The taxpayer's counsel made the argument that the receipt of the gift was a ''capital'' receipt that must, under the Constitution, take an FMV basis to prevent any part of the value from creating gain (and thus income) when converted to cash:
>
> > Until the Revenue Act of 1921 became effective, the Department [of the Treasury] laid down the rule that gain on the sale of property acquired by gift could be computed only by taking into [account as basis] the value of the gift when it was acquired. This was an express recognition by the Treasury Department that a gift is a capital transaction … and that the donee can have ''gain'' only to the extent that the proceeds in his hands exceed the *value of his capital* at the time of acquisition.
>
> And later:
>
> > The corpus of the gift is capital in the hands of the donee at the time of its receipt. But the mere conversion of such capital into money does not constitute income…. An amount sufficient to restore the *capital value* that existed at the commencement of the taxing period must be withdrawn from the gross proceeds in order to determine whether there has been a gain or loss, and the amount of the gain, if any.
>
> But the Court upheld the constitutionality of the new basis rule [in *Taft v. Bowers*], even though it was inconsistent with early notions of income and capital that were borrowed from business and trust accounting. The term ''capital'' was permitted to evolve as a *tax* concept that protected tax values. The new rule meant that ''capital'' was synonymous with ''basis,'' a tax-free return of capital meant only a tax-free return of basis, and basis meant previously taxed dollars. Thus, the Sixteenth Amendment does not require that basis must equal FMV that can be recovered tax-free just because in 1913 it was commonly thought so. Rather, Congress is empowered to change the basis rule to ensure that it reflects only previously taxed

[14] 278 U.S. 470 (1929).

dollars; the Sixteenth Amendment is no bar. [15]

***Is § 1014 justified? If not, which alternative would be better?***

Notably, Congress limited the predecessor to § 1015 to *inter vivos* gifts, leaving intact the FMV basis rule for property received at death, currently memorialized in § 1014. Why? The old "capital receipts" notion continued to hold powerful sway at this time, as evidenced by the treatment of damage awards to compensate for the loss of human capital, considered in Chapter 17. Perhaps Congress thought that change was forced in the *inter vivos* gift context because of the abuse that had come to light but that enacting § 1015 was sufficient to take care of that immediate problem. Unlike the *inter vivos* gifts described above among Papa, Daughter, and Sibling, a transfer at death happens only once in a lifetime so that the built-in gain can be laundered out only once in a lifetime. Is that a satisfying reason to keep § 1014 alive today, however, with our better understanding of the role of basis?

As shown in the chart in Chapter 3, 1014 is expected to lose more than $170 billion in revenue between 2015 and 2019, alone. As always, this revenue loss must be made up with higher tax rates on everyone else. Section 1014 benefits mainly those owning property who enjoyed significant wealth accessions during life that were not taxed at the time of the wealth accessions *only* because of the realization requirement. Section 1014 is the first significant provision that we have encountered that violates the fundamental rule that basis generally represents dollars that have been previously taxed under the income tax (if not to the donee, at least to the donor).

When the estate tax was fully repealed for one year in 2010, Congress replaced § 1014 with new § 1022 for the year, which provided a carryover (or transferred) basis similar to § 1015, *except* that the basis of up to $1.3 million worth of property selected by the executor would be stepped up to FMV (plus another $3 million worth of property if it went to a surviving spouse). Ironically, under this new rule many heirs of decedents dying in 2010 with smaller estates were very unhappy with this state of affairs.

For example, consider Jim, a single individual with an estate containing only one piece of unencumbered property, Blackacre, which Jim had bought for $700,000 years ago and which was valued at $3 million on his death. Under Jim's will, Blackacre was left to his niece Becky. If Jim died on December 31, 2009, his estate would *not* be subject to the estate tax then in effect because his $3 million estate did not exceed the $3.5 million estate tax exemption amount in 2009. Moreover, Becky would be able to take the property distributed in kind from her uncle's estate with a basis stepped up to its 2009 FMV of $3 million under § 1014, with the previous built-in gain laundered out. How did those results change if Jim died just one day later, on January 1, 2010? Jim's estate would not be subject to estate tax because it was repealed for 2010, but Becky would have to take a basis in Blackacre equal to her uncle's $700,000 basis, increased by no more than $1.3 million to $2 million, preserving a $1 million built-in gain for future reckoning.

By the middle of 2010, when heirs of small estates began to appreciate the effect of estate tax repeal coupled with the new § 1022 carryover basis rule, they complained to their representatives in Congress, who reacted in late 2010 by enacting a law that essentially allowed heirs of decedents dying in 2010 and their estates to jointly elect to be taxed under either 2009 law or 2010 law. The heirs of large estates, such as the four billionaires who died, likely opted to avoid the estate tax and take a carryover basis (increased, as permitted, under § 1022) for property distributed in kind

[15] Deborah A. Geier, *Murphy and the Evolution of "Basis,"* 113 TAX NOTES 576, 581 (2006) (footnotes omitted).

(planning for that preserved gain to be wiped out under § 1014 when they died), while the heirs of smaller estates likely opted to elect treatment under 2009 law. What a mess!

The realization requirement, itself, is often criticized by economists for violating the neutrality norm by encouraging taxpayers to hold on to property (in order to delay the resulting tax on sale) that could be more efficiently used by another. You will hear this phenomenon referred to as the "lock-in effect," discussed more deeply in Chapter 15 (pertaining to capital gains and losses). Section 1014 turbo-charges the lock-in effect because owners will not merely defer the tax on built-in gain but eliminate it entirely—if and only if they hold on to the property until death. A mark-to-market system (considered in Chapter 1) would eliminate the lock-in effect because gains would be taxed as they accrue each year. While a mark-to-market system might be impractical for all but publicly traded securities because of the difficulty of valuing property each year, why not make death a realization event, as such a rule would require valuation only once? Indeed, § 1014 already requires valuation of property at death so that the donee can take that FMV basis!

Canada has made death a realization event for income tax purposes and has repealed its estate tax. So if Frances Brody and her daughter, described in the article excerpt earlier, had lived in Canada, the built-in gain in the Picasso painting would have been taxed to Frances (unlike here in the U.S.), no wealth transfer tax would have applied, and her daughter would, as in the U.S., be permitted to exclude the cash or property received in kind from her mother's estate under Canada's income tax. Because the built-in gain in any property owned by Frances at her death would be taxed under the income tax on her final return, her daughter would appropriately take a stepped-up, FMV basis of any property received in kind under the income tax. Such a system makes the behavioral decision to sell to a third party (who might be able to put the property to better use) or give to an heir less tax sensitive, as the transfer is going to be a realization event either way, which means that economists prefer it as more behaviorally neutral than the U.S. system. Because a gratuitous transfer is *not* a realization event under § 1001 in the U.S., whereas a sale is, behavior is skewed, reducing economic efficiency.

A different way to integrate the two systems would be to keep the transfer a nonrealization event for the donor (no § 1001 gain on Mrs. Brody's final income tax return), repeal the estate tax, but amend § 102(a) to require her daughter to include substantial gifts and bequests in excess of a "reasonable" exemption amount ($25,000? $100,000? Annul or a cumulative lifetime exclusion?). As Henry Simons said, the income tax is not a tax on income, *per se*, but a tax on *persons*, as measured by their income (wealth accessions) under the ability to pay fairness norm.

## B. What is a "gift" within the meaning of § 102(a)?

The lack of clear understanding regarding the modern rationale underlying the gift exclusion for income tax purposes makes it difficult for courts to give meaning and scope to the word "gift." Indeed, the sheer number of separate opinions in *Duberstein*, below, illustrates this fact. If we better understood the purpose of the gift exclusion today, we would have better tools in place to interpret the term. The touchstone definition is found in *Duberstein*. What was the government's approach in defining the term, found in footnote 6? In looking at the words in § 102(a) carefully—"gift, bequest, devise, or inheritance"—can you construct a statutory interpretation argument justifying the government's interpretation? Under the statutory interpretation canon *noscitur a sociis* (Latin for "it is known from its associates"), the meaning of one word in a list of similar

words should be informed by the common features among the words.[16] How did that approach differ from the Court's? Which do you think is the better approach in this particular context? Why? Would Stanton's case be litigated today? Review § 102(c), added in 1986.

## 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." They pose the frequently recurrent question whether a specific transfer to a taxpayer in fact amounted to a "gift" to him within the meaning of the statute. The importance to decision of the facts of the cases requires that we state them in some detail.

No. 376, *Comm'r v. Duberstein*. The taxpayer, Duberstein, 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, and in proceedings

[16] This canon is slightly different from *ejusdem generis*, discussed in Chapter 6 in connection with the scope of the residual clause in § 61. *Ejusdem generis* can be invoked when a list of items is followed by a generic catch-all clause. *Ejusdem generis* instructs that the scope of items within the catch-all clause should be limited to those with the same common characteristics of the specifically listed items. For example, if a statute provides that a motor vehicle tax should apply to "automobiles, trucks, motorcycles, *and other motor-powered vehicles*," the word "vehicles" in the catch-all clause should not be interpreted to include airplanes because the other items on the list all pertain to ground transportation vehicles. While *ejusdem generis* pertains to the meaning of a vague catch-all clause at the end of a list of items, *noscitur a sociis* pertains to the meaning of one word nestled among others in a list. Rather pedantic, I know. *See, e.g.*, Babbitt v. Sweet Home Chapter of Communities for a Great Oregon, 515 U.S. 687, 720-21 1995) (Scalia, J., dissenting).

to review the deficiency the 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 payer to be remuneration for services rendered to it by Duberstein." The Court of Appeals for the Sixth Circuit reversed.

No. 546, *Stanton v. U.S.*. 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 installments of Two Thousand Dollars at the end of each and every month commencing with the month of December, 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: "We 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 into 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's 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, giving him an opportunity to resign rather than be discharged. At another special meeting two days later it was revealed that Watkins had not resigned; the previous resolution terminating his services was then viewed as effective; and the 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 such embarrassment or question at any time as to his willingness to resign if the Board desired, he was tendering his resignation. It was tabled, though not without dissent. The next week, on November 5, at another special meeting, Stanton again tendered his resignation which this time was accepted.

The "gratuity" was duly paid. So was a smaller one to Stanton's (and the Operating Company's) secretary, under a similar resolution, upon her resignation at the same time. The two corporations shared the expense of the payments.

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," 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 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. 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.... 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.[6] 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 voluntary 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. 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. Comm'r*, 302 U.S. 34, 41, it is not a gift. And, conversely, "where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." *Robertson v. U.S.*, 343 U.S. 711, 714. 7 A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity, " *Comm'r v. LoBue*, 351 U.S. 243, 246; "out of affection, respect, admiration, charity or like impulses." *Robertson v. U.S.*, *supra*, at 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. Comm'r*, 302 U.S.

[6] The government's proposed test is stated: "Gifts should be defined as transfers of property made for personal as distinguished from business reasons."

34, 43. "What controls is the intention with which payment, however voluntary, has been made." *Id.*, at 45 (dissenting opinion).

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.

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

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…. 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 fact-finding 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 data 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; *Comm'r v. Heininger*, 320 U.S. 467, 475; *U.S. v. Yellow Cab Co.*, 338 U.S. 338, 341; *Bogardus v. Comm'r, supra*, at 45 (dissenting opinion).

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 fact-finders 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 matter.

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. 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). "A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *U.S. v. U.S. Gypsum Co.*, 333 U.S. 364, 395. The rule itself applies also to factual inferences from undisputed basic facts, id., at 394, as will on many occasions be presented in this area. *Cf. Graver Tank & Mfg. Co. v. Linde Air Products Co.*, 339 U.S. 605, 609-610. And Congress has in the most explicit terms attached the identical weight to the findings of the Tax Court. I. R. C., § 7482 (a).

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 fact-finding 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." 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.

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.

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, agreeing with *Bogardus* that whether a particular transfer is or is not a "gift" may involve "a mixed question of law and fact," 302 U.S., at 39, 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 under the test which the Court fashioned nearly a quarter of a century ago in *Bogardus v. Comm'r*, 302 U.S. 34.

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*. The District Court found that the $20,000 transferred to Mr. Stanton by his former employer at the end of ten years' service was a gift and therefore exempt from taxation under I. R. C. of 1939, § 22 (b)(3) (now I. R. C. of 1954, § 102 (a)). I think the finding was not clearly erroneous and that the Court of Appeals was therefore wrong in reversing the District Court's judgment. While conflicting inferences might have been drawn, there was evidence to show that Mr. Stanton's long services had been satisfactory, that he was well liked personally and had given splendid service, that the employer was under no obligation at all to pay any added compensation, but made the $20,000 payment because prompted by a genuine desire to make him a "gift," to award him a "gratuity." *Cf. Comm'r v. LoBue*, 351 U.S. 243, 246-247. The District Court's finding was that the added payment "constituted a gift to the taxpayer, and therefore need not have been reported by him as income . . . ." The trial court might have used more words, or discussed the facts set out above in more detail, but I doubt if this would have made its crucial, adequately supported finding any clearer. For this reason I would reinstate the District Court's judgment for petitioner.

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

As the Court's opinion indicates, we brought these two cases here partly because of a claimed difference in the approaches between two Courts of Appeals but primarily on the Government's urging that, in the interest of the better administration of the income tax laws, clarification was

desirable for determining when a transfer of property constitutes a "gift" and is not to be included in income for purposes of ascertaining the "Gross Income" under the Internal Revenue Code. As soon as this problem emerged after the imposition of the first income tax authorized by the Sixteenth Amendment, it became evident that its inherent difficulties and subtleties would not easily yield to the formulation of a general rule or test sufficiently definite to confine within narrow limits the area of judgment in applying it. While at its core the tax conception of a gift no doubt reflected the non-legal, non-technical notion of a benefaction unentangled with any aspect of worldly requital, the diverse blends of personal and pecuniary relationships in our industrial society inevitably presented niceties for adjudication which could not be put to rest by any kind of general formulation.

Despite acute arguments at the bar and a most thorough re-examination of the problem on a full canvass of our prior decisions and an attempted fresh analysis of the nature of the problem, the Court has rejected the invitation of the Government to fashion anything like a litmus paper test for determining what is excludable as a "gift" from Gross Income. Nor has the Court attempted a clarification of the particular aspects of the problem presented by these two cases, namely, payment by an employer to an employee upon the termination of the employment relation and non-obligatory payment for services rendered in the course of a business relationship. 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.

Thus, regarding the two frequently recurring situations involved in these cases—things of value given to employees by their employers upon the termination of employment and payments entangled in a business relation and occasioned by the performance of some service—the strong implication is that the payment is of a business nature. The problem in these two cases is entirely different from the problem in a case where a payment is made from one member of a family to another, where the implications are directly otherwise. No single general formulation appropriately deals with both types of cases, although both involve the question whether the payment was a "gift." 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 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 Court has made only one authoritative addition to the previous course of our decisions. Recognizing *Bogardus v. Commissioner*, 302 U.S. 34, as "the leading case here" and finding essential accord between the Court's opinion and the dissent in that case, the Court has drawn from the dissent in *Bogardus* for infusion into what will now be a controlling qualification, recognition that it is "for the triers of the facts to seek among competing aims or motives the ones that dominated conduct." 302 U.S. 34, 45 (dissenting opinion). All this being so in view of the Court, it seems to me desirable not to try to improve what has "already been spelled out" in the opinions of this Court but to leave to the lower courts the application of old phrases rather than to float new ones and thereby inevitably produce a new volume of exegesis on the new phrases.

Especially do I believe this when fact-finding tribunals are directed by the Court to rely upon their "experience with the mainsprings of human conduct" and on their "informed experience with human affairs" in appraising the totality of the facts of each case. Varying conceptions regarding the "mainsprings of human conduct" are derived from a variety of experiences or assumptions about the nature of man, and "experience with human affairs," is not only diverse but also often drastically conflicting. 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. 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. By applying what has already been spelled out in the opinions of this Court, 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*. I would do so on the basis of the opinion of Judge Hand and more particularly because the very terms of the resolution by which the $20,000 was awarded to Stanton indicated that it was not a "gratuity" in the sense of sheer benevolence but in the nature of a generous lagniappe, something extra thrown in for services received though not legally nor morally required to be given…. 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." The force of this document, in light of all the factors to which Judge Hand adverted in his opinion, was not in the least diminished by testimony at the trial. Thus the taxpayer has totally failed to sustain the burden I would place upon him to establish that the payment to him was wholly attributable to generosity unrelated to his performance of his secular business functions as an officer of the corporation of the Trinity Church of New York and the Trinity Operating Co. Since the record totally fails to establish taxpayer's claim, I see no need of specific findings by the trial judge.

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***Consequences of the Duberstein Court's approach to "gift"***

As noted earlier, the donor cannot deduct the value of a gift made to a friend or relative because it is a personal expense under § 262. Thus, although the donee excludes the gift, the amount is taxed once between the donor/donee pair—through deduction denial for the donor. While the Court deferred to the trial court in *Duberstein* and concluded that Mr. Duberstein was not, in fact, entitled to exclude the Cadillac, it did so only because of the trial court's evaluation of the motive of the donor established at trial. The Court knew, but appeared to be untroubled by the fact, that Mr. Berman deducted the FMV of the Cadillac as a business expense under § 162, creating the possibility that business income earned by Mr. Berman would go untaxed to *anyone* if the Cadillac is also excluded by Mr. Duberstein.

The government's proposed rule would have avoided this possibility, as it would have prevented exclusion by the putative donee in the business context, thus ensuring that—even with a business expense deduction by the donor—the amount would be taxed once between the two.

Congress reacted to *Duberstein* not by preventing exclusion by the recipient but by attempting to prevent deduction by the donor as a business expense by enacting § 274(b), which you should read now. Section 274 is a Code section that does not authorize the taking of a deduction (it does

not contain the magic words "there shall be allowed as a deduction") but rather steps in to take away an otherwise allowable deduction under some other Code section, such as § 162. Section 274(b) would be unnecessary if the *Duberstein* Court had accepted the government's alternative interpretation of "gift" within the meaning of § 102.

Note that § 274(b) disallows a § 162 business expense deduction in excess of $25 for the transferor *only* if the item is excludable by the transferee *under § 102(a).*[17] In the *Duberstein* scenario, for example, § 274(b) is designed to try to ensure that Berman would effectively be taxed on the value of the Cadillac by denying a deduction in excess of $25 if the transfer were truly a "gift" that is excludable by Duberstein under § 102 (unlike the outcome in the case, itself). But this outcome is not assured. There is no joinder in tax. A donor like Berman might litigate before the Tax Court and convince the Tax Court that the transfer was made to compensate for past services or as an incentive for future economic benefits obtained from the recipient. At the same time, a recipient like Duberstein might litigate before a District Court or the Court of Federal Claims and convince the trier of fact that the donor's intent was rooted in detached and disinterested generosity. The likelihood of the government getting whipsawed is certainly reduced after enactment of § 274(b), but it is not impossible. It has happened.[18]

Are business donors likely to admit that they are making the transfer as a gift, limiting themselves to a $25 deduction under § 274(b)? Will not the Bermans of the world argue that the transfer is *not* a gift so that they can take a full § 162 deduction, unreduced by § 274(b)? How does this affect the ability of the donee to argue that the receipt is excludable under § 102? Recall that the *donor's intention* controls under *Duberstein*. If the donor refuses to acknowledge that the transfer was a gift by limiting himself to a $25 deduction under §§ 162 and 274(b), can the donee persuasively argue that the donor's intention was to make a gift?

On the other hand, how does the donee, or the trier of fact in the donee's case, know whether the donor took a full deduction? Personal tax return information is private and cannot be accessed except in the taxpayer's own litigation. And what if the donor is a tax-exempt entity, which does not take tax deductions because it is exempt from paying income tax? Recall the facts in *Stanton*, in which a church, which is a tax-exempt entity, made the payment.

Finally, notice that, in order for the § 274(b) deduction restriction to apply, the amount must have been excluded by the recipient "*under section 102*, which is not excludable from his gross income under any other provision of this chapter." (Emphasis added.)

## Problem

After turning age 65, Robert retired from his long-time job, and his employer presented him with a gold watch at a retirement dinner. The watch cost the employer $200. While $200 might not seem *de minimis* within the meaning of § 132(e), the 1984 legislative history accompanying the enactment of § 132 gave as an example of an excludable *de minimis* fringe the gold watch

[17]As an aside, the section is incoherently drafted because §§ 274(b)(1)(A) and (B) carves out from the term "gift" items that could not qualify as gifts in any event under the *Duberstein* test. Samples and promotional items are transferred for commercial reasons, not out of detached and disinterested generosity, affection, respect, admiration, charity or like impulses.

[18] Compare Estate of Carter v. Comm'r, 453 F.2d 61 (2d Cir. 1971) (allowing § 102(a) exclusion by the donee in a year prior to enactment of § 274(b)) with Bank of Palm Beach & Trust Co. v. U.S., 476 F.2d 1343 (Ct. Cl. 1973) (allowing a full business expense deduction for the donor on the same transfer).

presented to an employee at his retirement, so Robert excludes the $200 value from his Gross Income. How much can Robert's employer deduct under § 162?

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***A Duberstein example and introduction of "small tax case" jurisdiction in the Tax Court***

The case below is a summary opinion in a "small tax case" under § 7463, pertaining to the Tax Court's jurisdiction and procedures. A taxpayer with a deficiency at issue of $50,000 or less can elect to have his or her case heard under more informal rules of procedure than otherwise apply in the Tax Court. The cost of making this election is that the taxpayer surrenders all appeal rights should she lose.[19] Many taxpayers using these simplified proceedings represent themselves *pro se*, though not always. The taxpayer in the case below was represented by counsel.

**JUE-YA YANG v. COMMISSIONER**

T.C. Summary Opinion 2008-156

GERBER, JUDGE: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case. Respondent determined a $9,423 deficiency in Federal income tax and a $1,183 accuracy-related penalty under section 6662(a) for petitioner's 2005 tax year. The deficiency determination was based on unreported income adjustments of $40,000 and $10,500. Petitioner conceded that the $40,000 amount was income, but she contends that the $10,500 amount was a gift and not taxable as income. The sole issue for our consideration is whether the $10,500 petitioner received during 2005 was a gift or income.

Petitioner, Jue-Ya Yang, resided in California at the time her petition was filed. Petitioner met Howard Shih through a mutual friend and they began dating. Mr. Shih earned his living as an artist and calligrapher. Eventually, petitioner's relationship with Mr. Shih became more intimate. She moved into his home, and they cohabited. Petitioner did some housekeeping and cooking, but she did not work for Mr. Shih under any form of written or oral contract for services. Petitioner did not have any skill or experience in connection with Mr. Shih's artistic endeavors.

During 2005 Mr. Shih gave petitioner checks totaling $10,500 to use for herself. Mr. Shih reported to respondent by means of a Form 1099-MISC, Miscellaneous Income, that the $10,500 he paid to petitioner constituted wage income and, ostensibly, he deducted the payments for purposes of computing his income for 2005. Relying on Mr. Shih's filing of Form 1099-MISC, respondent determined that petitioner had received income of $10,500.

The conclusion that a transfer amounts to a "gift" is one that must be reached on consideration of all the factors and one that is left to the trier of facts. *Comm'r v. Duberstein*, 363 U.S. 278, 287-289 (1960). In *Duberstein*, the Supreme Court set forth the following principles that underlie the dichotomy between a gift and income:

> 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

[19] *See* § 7463(b).

> 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. 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, 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." A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity,"; "out of affection, respect, admiration, charity or like impulses." And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." * * *

Mr. Shih was romantically involved with Ms. Yang, and she moved into his home. There were discussions of a formal engagement, and their relationship was intimate. Mr. Shih testified at the trial and his testimony concerning his romantic relationship with Ms. Yang was evasive. Mr. Shih was called by respondent and testified on direct examination that Ms. Yang had performed services in his business in exchange for the payments made to her during 2005. On cross-examination, however, after admitting that his relationship with Ms. Yang was more than a professional one, Mr. Shih could not recall taking her out on dates or any intimacy in their relationship, even though their relationship existed only a few years ago.

It is obvious that Mr. Shih and Ms. Yang have conflicting interests in the outcome of this controversy and that their positions are diametrically opposed. Mr. Shih structured the payments to Ms. Yang so that they appeared to be wages. He issued a Form W-2, Wage and Tax Statement, and used the notation "salary" or "wages" on some of the checks used for payment. Ms. Yang, however, was forthright in her testimony and answered all questions whether or not they favored her position. On the other hand Mr. Shih professed to remember only those things that supported his position that the payments were income to Ms. Yang. We find his testimony to be evasive and untrue.

The facts show that Mr. Shih made payments totaling $10,500 to Ms. Yang with "detached and disinterested generosity" out of his affection for her at the time of payment. We accordingly hold that the $10,500 in payments made during 2005 was a gift and not reportable as income.

Ms. Yang conceded $40,000 in unreported income for 2005, and respondent has carried his burden of production to establish that section 6662(a) applies with respect to that adjustment. Petitioner offered no evidence of reasonable cause with respect to her failure to report the $40,000 in income. Accordingly, we hold that petitioner is liable for an accuracy-related penalty under section 6662(a) with respect to the $40,000 adjustment. Because we have decided that the $10,500 was a gift and not taxable, we need not address the accuracy-related penalty on that adjustment.

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The *Yang* case also shows that an information return is not determinative of actual tax consequences. Information returns are merely enforcement tools to alert the IRS of a possible understatement.

***The possible limits of the Duberstein "intent" approach***

Matthew is a veteran who lost a leg in Iraq. Wearing his uniform and telling his story in subway stations in New York City, Matthew has learned that he can collect about $40,000 each year by panhandling, and he has found that he enjoys this activity more than he would a 9 to 5 job. Even

if the motive of each and every person who gives him cash is "detached and disinterested generosity," should Matthew's collected cash be excludable from Gross Income?

What about tips received by waiters in restaurants and so-called tokes received by casino dealers in the *Olk* case, below? These amounts do not come from the employer but rather from customers patronizing the establishment. Does *Duberstein* control the analysis of the receipt? Or is *Duberstein* distinguishable? In what way? Should the motive or intent of the donor control when receipts are not one-time events, as in *Duberstein*, but rather an expected part of the recipient's overall remuneration in making a living? If you were the appellate judge writing the opinion below, could you have written it in a manner that reaches the same end result without struggling to fit the facts within the confines of *Duberstein*? Is that struggle a bit artificial on these facts?

## OLK v. UNITED STATES

536 F.2d 876 (9th Cir. 1976)

GOODWIN and SNEED, CIRCUIT JUDGES, and VAN PELT, DISTRICT JUDGE.

SNEED, CIRCUIT JUDGE: This is a suit to obtain a refund of Federal income taxes. The issue is whether monies, called "tokes" in the relevant trade, received by the taxpayer, a craps dealer employed by Las Vegas casinos, constitute taxable income or gifts within the meaning of section 102(a), INT. REV. CODE of 1954. The taxpayer insists "tokes" are non-taxable gifts. If he is right, he is entitled to the refund for which this suit was brought. The trial court in a trial without a jury held that "tokes" were gifts. The Government appealed and we reverse and hold that "tokes" are taxable income.

There is no dispute about the basic facts, which explain the setting in which "tokes" are paid and received. The district court's finding with respect to such facts which we accept are, in part, as follows:

> In 1971 plaintiff was employed as a craps dealer in two Las Vegas gambling casinos, the Horseshoe Club and the Sahara Hotel. The basic services performed by plaintiff and other dealers were described at trial. There are four persons involved in the operation of the game, a boxman and three dealers. One of the three dealers, the stickman, calls the roll of the dice and then collects them for the next shooter. The other two dealers collect losing bets and pay off winning bets under the supervision of the boxman. The boxman is the casino employee charged with direct supervision of the dealers and the play at one particular table. He in turn is supervised by the pit boss who is responsible for several tables. The dealers also make change, advise the boxman when a player would like a drink, and answer basic questions about the game for the players.
>
> Dealers are forbidden to fraternize or engage in unnecessary conversation with the casino patrons and must remain in separate areas while on their breaks. Dealers must treat all patrons equally, and any attempt to provide special service to a patron is grounds for termination.
>
> At times, players will give money to the dealers or place bets for them. The witnesses testified that most casinos do not allow boxmen to receive money from patrons because of their supervisory positions, although some do permit this. The

> pit bosses are not permitted to receive anything from patrons because they are in a position in which they can insure that a patron receives some special service or treatment.
>
> The money or tokes are combined by the four dealers and split equally at the end of each shift so that a dealer will get his share of the tokes received even while he is taking his break. Uncontradicted testimony indicated that a dealer would be terminated if he kept a toke rather than placed it in the common fund.
>
> Casino management either required the dealers to pool and divide tokes or encouraged them to do so. Although the practice is tolerated by management, it is not encouraged since tokes represent money that players are not wagering and thus cannot be won by the casino. Plaintiff received about $10 per day as his share of tokes at the Horseshoe Club and an average of $20 per day in tokes at the Sahara. (footnotes omitted).

Additional findings of fact by the district court are that the taxpayer worked as a stickman and dealer and at all times was under the supervision of the boxman who in turn was supervised by the pit boss. Also the district court found that patrons sometimes give money to dealers, other players, or mere spectators at the game but that between 90-95% of the patrons give nothing to a dealer. No obligation on the part of the patron exists to give to a dealer and "dealers perform no service for patrons which a patron would normally find compensable." Another finding is that there exists "no direct relation between services performed for management by a dealer and benefit or detriment to the patron."

There then follows two final "findings of fact" which taken together constitute the heart of the controversy before us. These are as follows:

> 17. The tokes are given to dealers as a result of impulsive generosity or superstition on the part of players, and not as a form of compensation for services.
>
> 18. Tokes are the result of detached and disinterested generosity on the part of a small number of patrons.

These two findings, together with the others set out above, bear the unmistakable imprint of *Commissioner v. Duberstein*, 363 U.S. 278 (1959) ….

The position of the taxpayer is simple. The above findings conform to the meaning of gifts as used in section 102 of the Code. *Duberstein* further teaches, the taxpayer asserts, that whether a receipt qualified as a non-taxable gift is "basically one of fact," *id.* 363 U.S. at 290, and appellate review of such findings is restricted to determining whether they are clearly erroneous. Because none of the recited findings are clearly erroneous, concludes the taxpayer, the judgment of the trial court must be affirmed.

We could not escape this logic were we prepared to accept as a "finding of fact" the trial court's finding number 18. We reject the trial court's characterization. The conclusion that tokes "are the result of detached and disinterested generosity" on the part of those patrons who engage in the practice of toking is a conclusion of law, not a finding of fact. Finding number 17, on the other hand, which establishes that tokes are given as the result of impulsive generosity or superstition on the part of the players is a finding of fact to which we are bound unless it is "clearly erroneous" which it is not.

The distinction is between a finding of the dominant reason that explains the player's action in making the transfer and the determination that such dominant reason requires treatment of the receipt as a gift. Finding number 17 is addressed to the former while number 18 the latter. A finding regarding the basic facts, *i.e.*, the circumstances and setting within which tokes are paid, and the dominant reason for such payments are findings of fact, our review of which is restricted by the clearly erroneous standard. Whether the dominant reason justifies exclusion from Gross Income under section 102 as interpreted by *Duberstein* is a matter of law. Finding number 18 is a determination that the dominant reason for the player's action, as found in number 17, justifies exclusion. This constitutes an application of the statute to the facts. Whether the application is proper is, of course, a question of law.

Our view is supported by Judge Sobeloff's opinion in *Poyner v. Commissioner*, 301 F.2d 287 (4th Cir. 1962). He drew a line between the basic facts, the actual happenings, and a finding of the "dominant reason" for the payments on the one hand and the determination whether the "dominant reason" justified exclusion from Gross Income on the other. The latter requires an application of the law to the facts and with respect to it the appellate court may make an independent judgment. *Id.* at 290.

This is a sensible approach. Otherwise an appellate court's inescapable duty of appellate review in this type of case would be all but foreclosed by a finding, such as in number 18, in which the resolution of the ultimate legal issue was disguised as a finding of fact. The error in insisting that findings numbers 17 and 18 are both findings of fact with respect to the "dominant reason" is revealed when the language of finding number 18 is compared with *Duberstein*'s statement, "A gift in the statutory sense, on the other hand, proceeds from a 'detached and disinterested generosity,' *Comm'r v. LoBue*, 351 U.S. 243, 246; 'out of affection, respect, admiration, charity or like impulses.'" 363 U.S. at 285. Their similarity is not coincidental and demonstrates that finding number 18 is but an application of the statutory definition of a gift to all previous findings of fact including finding number 17. Number 18 merely characterizes all previous findings in a manner that makes classification of the receipt as a gift inevitable. "Detached and disinterested generosity" are, by reason of *Duberstein*, the operative words of the statutory definition of a gift. To apply them to facts, including a finding with respect to "dominant motive," is to apply the statute to such facts. It is a conclusion of law.

Freed of the restraint of the "clearly erroneous" standard, we are convinced that finding number 18 and all derivative conclusions of law are wrong. "Impulsive generosity or superstition on the part of the players" we accept as the dominant motive. In the context of gambling in casinos open to the public such a motive is quite understandable. However, our understanding also requires us to acknowledge that payments so motivated are not acts of "detached or disinterested generosity." Quite the opposite is true. Tribute to the gods of fortune which it is hoped will be returned bounteously soon can only be described as an "involved and intensely interested" act.

Moreover, in applying the statute to the findings of fact, we are not permitted to ignore those findings which strongly suggest that tokes in the hands of the ultimate recipients are viewed as a receipt indistinguishable, except for erroneously anticipated tax differences, from wages. The regularity of the flow, the equal division of the receipts, and the daily amount received indicate that a dealer acting reasonably would come to regard such receipts as a form of compensation for his services. The manner in which a dealer may regard tokes is, of course, not the touchstone for determining whether the receipt is excludable from Gross Income. It is, however, a reasonable and relevant inference well-grounded in the findings of fact.

Our view of the law is consistent with the trend of authorities in the area of commercial gratuities as well as with the only decision squarely in point, *Lawrence E. Bevers*, 26 T.C. 1218 (1956), and this Circuit's view of tips as revealed in *Roberts v. Commissioner*, 176 F.2d 221 (9th Cir. 1949). Generalizations are treacherous but not without utility. One such is that receipts by taxpayers engaged in rendering services contributed by those with whom the taxpayers have some personal or functional contact in the course of the performance of the services are taxable income when in conformity with the practices of the area and easily valued. Tokes, like tips, meet these conditions. That is enough.

The taxpayer is not entitled to the refund he seeks. REVERSED.

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***The relationship between § 61 and exclusion provisions***

The introductory language to § 61—"[e]xcept as otherwise provided by this subtitle"—reminds us of the relationship between § 61 and statutory provisions that authorize an "exclusion" from Gross Income. Taxpayers need not search for an "exclusion" provision, such as § 102, if the receipt does not rise to the level of § 61 Gross Income in the first place. Only if an item would otherwise constitute Gross Income would the taxpayer scour the Code in search of statutory authority to "exclude" the receipt.

Recall Mr. Gotcher from Chapter 6, who received in-kind consumption that was not compensation (specifically includable under § 61(a)(1)), a dividend (§ 61(a)(7)), rent (§ 61(a)(5)), a prize (§ 74), or any other receipt that Congress specifically mandated must be included in Gross Income without regard to the form taken (whether in cash or in kind). Thus, whether the in-kind consumption had to be valued and included in his Gross Income turned solely on whether it rose to the level of Gross Income under the residual clause in § 61—"Gross Income means all income from whatever source derived"—as construed in *Glenshaw Glass*. The *Gotcher* court concluded that Mr. Gotcher's trip did not constitute residual income under this vague clause because the trip primarily benefited VW Germany, who was hoping to convince Mr. Gotcher to invest in a VW dealership. In other words, VW Germany's spending was in pursuit of its own business objectives. Notice, therefore, that the very reasoning that permitted Mr. Gotcher to avoid a Gross Income inclusion under § 61 would have *prevented* him from excluding the receipt as a "gift" under § 102 had the receipt otherwise constituted Gross Income. VW Germany clearly did not provide the trip to Mr. Gotcher out of detached and disinterested generosity. Rather, VW Germany provided the trip because it anticipated (or at least hoped for) an economic benefit by convincing Mr. Gotcher to invest in a VW dealership.

Similarly, recall the Oscar and Emmy goody bags provided to presenters, also described in Chapter 6. As noted in the article, if the receipts rose to the level of Gross Income in the first place, exclusion surely would not be available under § 102, as the businesses providing those goodies to the presenters did so because of the anticipated advertising effect that they would enjoy when the stars paraded around wearing the jewelry and other items provided. If the provider is transferring the property and services for its own business reasons to the presenters, however, would not that mean that the receipts fail to rise to the level of Gross Income in the first place under the residual clause? Perhaps these outcomes are explained by concluding that what the stars received were simple "prizes" (specifically includable under § 74) or constituted "compensation" (specifically includable under § 61(a)(1)) so that the residual clause and *Gotcher* are irrelevant.

What are we to make of the fact that § 102 provides exclusion authorization only for the receipt of "property" (which would encompass cash) but makes no mention of *services*, such as a free trip? For example, if your friend pays for your birthday trip to Bruges, Belgium, out of detached and disinterested generosity, do you lose the § 102 exclusion because the object of the gift was not "property"? Clearly no. Under the *Old Colony Trust* two-step, the free trip is, in substance, analyzed as the deemed receipt of cash (clearly property that could be excluded under § 102) followed by the donee's purchase of the trip.

***Final thoughts***

Finally, recall from Chapter 1 that one difference between a pure wealth tax and a pure SHS income tax is that the former taxes a dollar of wealth to the same taxpayer again and again while the latter taxes a dollar of wealth to the same taxpayer only once—in the year realized. You have learned in this chapter that the § 102 exclusion of gifts and bequests by the recipient coupled with the step up in basis at death under § 1014 deviate *radically* from SHS principles, with the result that much wealth (property appreciation) escapes taxation entirely, contributing to wealth inequality over time. Please click and read the following article:

http://www.nytimes.com/2013/02/10/business/yourtaxes/a-wealth-tax-would-look-beyond-income.html?_r=1

Under the direct tax clause of Article 1, § 9, clause 4, which you read about in Chapter 3, an annual wealth tax would be required to be apportioned among the states according to population. Because such an apportionment would be unworkable, an annual wealth tax without apportionment would require a constitutional amendment, making it unlikely (if not impossible).[20] The estate and gift taxes, which are not imposed annually but rather only on the act of transferring wealth, are indirect excise taxes (on the act of transfer) that escape the apportionment requirement. As noted earlier, however, the combination of the realization requirement, § 1014, and the high estate and gift tax exemption amount means that a good deal of wealth is never taxed to either the donor or donee under either the income tax or wealth transfer taxes.

## C. Life insurance proceeds received on death of the insured

Section 101(a)(1) generally excludes the proceeds of life insurance received by reason of the death of the insured, even though the receipt is clearly a wealth accession for the recipient. Just as a donor cannot deduct a gift because it is a personal expense under § 262, the person who pays life insurance premiums generally cannot deduct this personal expense, though businesses who take out a life insurance policy with respect to a key employee (such as the CEO) can usually deduct the cost as a business expense under § 162. Indeed, the tax-free nature of the proceeds on death has caused a dramatic expansion of this practice in the corporate context over the last several decades, with some businesses taking out life insurance policies on most or all of their employees—not just key employees—sometimes referred to as "janitors" or "peasants" insurance. Prior to a change in law in 2006, many of these employees were unaware that their employer had purchased life insurance policies on their lives, and the company may collect many decades later when the insured is no longer even employed by the company. Please click and read the following

[20] *But see* John T. Plecnik, *The New Flat Tax: A Modest Proposal for a Constitutionally Apportioned Wealth Tax*, 41 HASTINGS CONST. L.Q. 483 (2014) (describing a possible way to implement a wealth tax that could satisfy the apportionment requirement).

article:

http://dealbook.nytimes.com/2014/06/22/an-employee-dies-and-the-company-collects-the-insurance/?_php=true&_type=blogs&_r=0

***Is the § 101(a)(1) exclusion justified?***

The rationale underlying the § 101(a)(1) exclusion is just as cloudy as that underlying § 102(a) but was likely premised on the same dated "capital receipts" analysis discussed earlier. That is to say, the lump sum, nonperiodic receipt was not considered an "income" receipt but rather a "capital" receipt that, once invested, would produce future "income" under old-fashioned, Victorian-era analysis. Perhaps it survives today by analogy to a "bequest" made through the vehicle of an insurance company. Does the bequest-like nature ring true, however, in the case of janitors insurance?

***Sales of life insurance policies to investors***

Does the bequest-like nature ring true if an owner of a life insurance policy on his or her own life sells it to Ian Investor—or a company formed by Ian Investor "at the forefront of a controversial but rapidly growing industry," as described below?

> In an arrangement known as a "life settlement," [the settlement company] pays the holder a lump sum for the policy now, takes over paying the premiums for as long as the insured person lives, then collects the benefits—generally worth far more—when the person dies. [The company] keeps some of the policies in its own portfolio. It sells others to institutional investors. From an investor's standpoint, as a general rule, the sooner these people die, the better.
>
> …
>
> The life-insurance market was once even more freewheeling. In 18th-century England, people took out policies on prominent figures in ill health. The practice was eventually deemed gambling. It led to laws like those in U.S. states today, which generally require that the person who takes out a policy have an established relationship at the time with the insured. Once purchased, however, the policy is considered property of the policyholder, who is free within certain limits to use it at will. That includes selling to someone else the rights to collect the benefits.
>
> …
>
> Now banks including Goldman Sachs Group Inc., Credit Suisse Group, and Bear Stearns Cos. want to expand the industry further. In April [2006], these banks helped form the Institutional Life Markets Association to lobby against efforts to restrict the business. Some Wall Street firms are also seeking to buy policies more directly, trying to cut out parties such as Coventry [a life settlement firm]. This year, Cantor Fitzgerald LP set up an Internet-based exchange for those who want to sell or buy policy rights.
>
> …
>
> In conferences in recent years, investment banks and ratings agencies have discussed bundling life-insurance policies into securities they can sell to pensions

or hedge funds, much as mortgages have been packaged for years. [21]

When the policy purchaser receives the death benefits, can the purchaser exclude the entire proceeds? *See* § 101(a)(2).

## Problems

**1.** Bea owns a life insurance policy on which she paid premiums for many years. Upon her death at age 89, her daughter Beulah collects $500,000. How much must Beulah include in Gross Income?

**2.** At age 74, Bea needs money and sells her life insurance policy to Investor for $100,000, who continues to pay premiums totaling $50,000 before Bea dies at age 89 and Investor collects $500,000 (instead of Beulah). How much must Investor include in Gross Income?

[21] Liam Pleven & Rachel Emma Silverman, *An Insurance Man Builds a Lively Business in Death*, at http://online.wsj.com/news/articles/SB119604142916903531.

# Chapter 8: Income Shifting in the Happy Family

In Chapter 7, you learned that the making of a cash gift or bequest—funded from, say, wages earned by the donor—does not succeed in shifting income tax liability from the donor to the donee. The amount transferred by the donor is a nondeductible personal expense under § 262(a), and the receipt by the donee is excludable from Gross Income under § 102(a). Thus, the wages earned to fund the cash gift are effectively taxed to the donor at the donor's tax rates (rather than to the donee at the donee's tax rates).

On the other hand, built-in gain (*i.e.*, unrealized § 1001 gain) in property *will* be shifted to another if the property is transferred by *inter vivos* gift because (1) the gift, itself, is not a realization event for the donor and (2) § 1015 generally provides for a carryover basis in the hands of the donee. Thus, built-in gain will effectively be shifted to the donee and taxed at the donee's (possibly lower) marginal rate when realized (unless, of course, the donee retains the property until death, at which time the built-in gain will be laundered out under § 1014).[1]

This ability for propertied families to engage in income shifting more readily than families whose chief source of income is from labor is a theme carried forward in this chapter, which considers additional possibilities for income shifting or splitting in the happy family, as well as reactions by both Congress and the courts to such attempts.

Two reasons explain why income shifting or splitting can reduce the aggregate tax paid. First, the income may be taxed at a lower rate if successfully shifted to a family member for whom the income will be marginal (last) dollars in a rate bracket that is lower than the transferor's marginal rate bracket. Second, the ability to split income between two (or more) taxpayers for tax purposes may mean that the lower brackets can effectively be used twice rather than only once, as would occur if the entire amount must be included by only one taxpayer. Part A. considers income splitting via the joint return, and Part B. considers other income-shifting possibilities.

## A. Income splitting via the joint return

The place to start is *Lucas v. Earl*.

**LUCAS v. EARL**

281 U.S. 111 (1930)

MR. 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.

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[1] We also saw, however, that the § 1015 basis rule for *inter vivos* gifts prevents built-in loss from being effectively shifted to a donee in a higher marginal rate bracket.

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 State of 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, 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.

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At the time of *Lucas v. Earl*, there was only one Federal income tax rate schedule that was used by all taxpayers, including married individuals, who filed separate tax returns. If the attempted assignment of income from Mr. Earl to Mrs. Earl of one-half of his wages had been successful for income tax purposes, why would the aggregate tax paid between them have been lower than if, as held, the attempted assignment of income had no effect for tax purposes?

While I sometimes edit opinions to make them shorter for student digestion, I did not edit Justice Holmes's opinion at all. Can you figure out why, precisely, Mr. Earl's assignment of income to his wife—while assumed to be valid under state contract law—did not shift the Federal income tax burden on that assigned income to his wife? Could Guy Earl and his wife have executed the contract with the intent of reducing their aggregate Federal income liability? When was this contract signed? Recall from Chapter 3 that the 16th amendment was ratified in 1913 and that the first income tax was enacted in the same year.

*Lucas v. Earl* and *Poe v. Seaborn*, though decided in the very same term of Court, came to very different outcomes. Why?

## POE v. SEABORN

282 U.S. 101 (1930)

MR.JUSTICE ROGERTS 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. 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 on 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 Sections 210(a) and 211(a) of the Revenue Act of 1926 [the predecessor to current § 1] 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. 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, 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 (*Fielding v. Ketler*, 86 Wash. 194). 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 (*Fidelity & Deposit Co. v. Clark*, 144 Wash. 520). She may prevent his making substantial gifts out of community property without her

consent (*Parker v. Parker*, 121 Wash. 24). The community property is not liable for the husband's torts not committed in carrying on the business of the community (*Schramm v. Steele*, 97 Wash. 309). The books are full of expressions such as "the personal property is just as much hers as his" (*Marston v. Rue*, 92 Wash. 129); "her property right in it [an automobile] is as great as his" (92 Wash. 133); "the title of one spouse … was a legal title as well as that of the other" (*Mabie v. Whittaker*, 10 Wash. 656, 663).

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. A description of the community system of Washington and of the rights of the spouses, and of the powers of the husband as manager, will be found in *Warburton v. White*, 176 U.S. 484.

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 Sections 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 Sections 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 (*Warburton v. White*, 176 U.S. 494) that "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."

In that case, it was held that such agency of the husband was neither a contract nor a property right vested in him, and that it was competent to the legislature which created the relation to alter it, to confer the agency on the wife alone, or to confer a joint agency on both spouses, if it saw fit—all without infringing any property right of the husband.

The reasons for conferring such sweeping powers of management on the husband are not far to seek. Public policy demands that in all ordinary circumstances, litigation between wife and husband during the life of the community should be discouraged. Lawsuits between them would tend to subvert the marital relation. The same policy dictates that third parties who deal with the husband respecting community property shall be assured that the wife shall not be permitted to nullify his transactions. The powers of partners, or of trustees of a spendthrift trust, furnish apt analogies.

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 principal, decided the instant question in favor of the Government. He relies on *United States v. Robbins*, 269 U.S. 315, and *Lucas v. Earl*, 281 U.S. 111.

In the Robbins case, we found that the law of California, as construed by her own courts, gave the wife a mere expectancy and that the property rights of the husband during the life of the community were so complete that he was in fact the owner. Moreover, we there pointed out that this accorded with the executive construction of the Act as to California.

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 services" 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 it 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 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 income, and its judgment is

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*Poe v. Seaborn* is often criticized because the wife had almost no legal rights under the community property law in Washington at the time except in the case of gross mismanagement by the husband. Nevertheless, the decision remains good law for two propositions: (1) income earned by an agent (the husband in this case) is properly allocable to the principal (the marital community) and (2) state community property law governs the determination of the extent to which income is considered to be community property for Federal income tax purposes, rather than the separate property of one of the spouses.

Recall that the Earls lived in California, which is also (like Washington) a community property state. Under *Poe v. Seaborn*, therefore, should not the Earls have been permitted to split Guy Earl's

labor earnings on their individual income tax returns? Note the *Poe v. Seaborn* Court's description of the *Robbins* case, which described California's community property law at that time as creating no more than a mere "expectancy" in the wife. Under proposition (2), above, we can now explain more fully why the *Lucas v. Earl* Court prohibited income splitting even though the Earls lived in a community property state: Mr. Earl's salary income was considered to be his separate property under California community property law at the time. So why did the Earls enter into their 1901 contract? They did so as an estate planning device in an attempt to permit the property to pass at death outside probate.[2]

Another example of labor income that is properly allocable to the principal and not included in the Gross Incomes of its agents is a fee earned for legal services provided by a supervising lawyer and students working in a law school clinic. The IRS ruled in Revenue Ruling 74-581[3] that a university's law school attorney-faculty members and students are not required to include in their Gross Incomes amounts earned with respect to their court-appointed representation of indigent defendants while participating in the university's clinical program. Under the clinic program, the University had the legal right to these fees, not the faculty members or students. (Moreover, because the university is a tax-exempt organization, the fees would not likely be taxed to the principal on these facts, either.) In contrast, a nun working in a clinic as a nurse-midwife must include her wages in Gross Income, even though she signs her paychecks over to her religious order under her vow of poverty.[4] Both the Tax Court and 7th Circuit rejected her contention that her work was performed as an agent of her religious order because the order had no day-to-day control over her work and because her failure to insist on direct payment to her order undermined her argument that she was working as an agent of the order. She accepted the paychecks as an individual and then signed them over to the order.[5]

Notice that the income in *Poe v. Seaborn* consisted not only of labor income, as in *Earl*, but also of property income. Thus, *Poe v. Seaborn* also announced a third proposition: *property income is taxed to the owner of the property* (here, the marital community). The Court further developed this idea in subsequent cases, discussed in Part B.

Perhaps the real reason why the same court that decided *Lucas v. Earl* was comfortable with the income splitting of the services income in *Poe v. Seaborn* is the pragmatic one that the income splitting in the former resulted from arrangements made by the taxpayers—which *looks* manipulative even though the particular arrangement in that case was not done for income tax purposes—whereas the income splitting in the latter arose from a state law that had nothing to do with taxes, regardless of whether the taxpayers wanted to split their income, *etc*.

Buttressing this inference is the Court's 1944 decision in *Commissioner v. Harmon*.[6] Recall from Chapter 3 that the income tax went from being a "class tax" paid mainly by the top 1% of

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[2] My thanks go to Professor Patricia Cain for this information and insight.
[3] 1974-2 C.B. 25.
[4] Schuster v. Comm'r, 800 F.2d 672 (7th Cir. 1986).
[5] Because the nun had to include her wages in Gross Income, she would be entitled to deduct the amount contributed to her order under § 170, pertaining to charitable contributions. As you will learn when we study § 170 in Chapter 18, however, no more than 50% (30% in some cases) of AGI can be offset by charitable contributions. Thus, her failure to avoid inclusion under an agency theory meant that approximately one-half of her wages were subject to income taxation, notwithstanding her contribution. If she had succeeded in her agency argument, none of the wages would have been taxed because religious orders are also tax-exempt entities.
[6] 323 U.S. 44.

income earners to a "mass tax" paid by a majority of households with the skyrocketing revenue needs of WWII. With many more households subject to the income tax, some common law states (so called because they do not adopt the statutory community property legal regime) tried to garner their residents the same income-splitting benefits enjoyed by married couples in community property states by enacting an optional or elective community property regime. When Oklahoma did so, the *Harmon* Court rejected the subsequent income splitting under the optional new law. Here is an excerpt from that decision.

> On July 29, 1939, Oklahoma adopted a community property law operative only if and when husband and wife elect to avail of its provisions. In conformity to the requirements of the statute, the respondent and his wife filed, October 26, 1939, a written election to have the law apply to them. From November 1 to December 31, 1939, they received income consisting of his salary, dividends from his stocks, dividends from her stocks, interest on obligations due him, distribution of profits of a partnership of which he was a member, and oil royalties due to each of them. The Act constitutes all of these receipts community income. The taxpayer and his wife filed separate income tax returns for 1939 in which each reported one half of the November and December income.
>
> Under *Lucas v. Earl* an assignment of income to be earned or to accrue in the future, even though authorized by state law and irrevocable in character, is ineffective to render the income immune from taxation as that of the assignor. On the other hand, in those states which, by inheritance of Spanish law, have always had a legal community property system, which vests in each spouse one half of the community income as it accrues, each is entitled to return one half of the income as the basis of Federal income tax. Communities are of two sorts,—consensual and legal. A consensual community arises out of contract. It does not significantly differ in origin or nature from such a status as was in question in *Lucas v. Earl*, where by contract future income of the spouses was to vest in them as joint tenants. In *Poe v. Seaborn*, *supra*, the court was not dealing with a consensual community but one made an incident of marriage by the inveterate policy of the State.
>
> In Oklahoma, prior to the passage of the community property law, the rules of the common law … represented the settled policy of the State concerning the relation of husband and wife. A husband's income from earnings was his own; that from his securities was his own. The same was true of the wife's income. Prior to 1939, Oklahoma had no policy with respect to the artificial being known as a community. Nor can we say that, since that year, the State has any new policy, for it has not adopted, as an incident of marriage, any legal community property system. The most that can be said is that the present policy of Oklahoma is to permit spouses, by contract, to alter the status which they would otherwise have under the prevailing property system in the State.
>
> Such legislative permission cannot alter the true nature of what is done when husband and wife, after marriage, alter certain of the incidents of that relation by mutual contract. Married persons in many noncommunity states might, by agreement, make a similar alteration in their prospective rights to the fruits of each other's labors or investments, as was done in *Lucas v. Earl*. This would seem to be possible in every State where husband and wife are permitted freely to contract with

each other respecting property thereafter acquired by either.

Thereafter, equal-income, one-earner married couples were treated very differently for Federal income tax purposes, depending on whether they lived in a community property state or a common law state. As already noted, before 1948, there was only one tax rate schedule applicable to all filers, whether married or single. To illustrate, let's assume (for the sake of simplicity) that this rate schedule contained only two tax rates: 10% on income up to and including $40,000 and 20% on income exceeding $40,000. Greg earned a $60,000 salary and was married to Greta, who did not work outside the home. Because Greg and Greta lived in Washington State, the community property state at issue in *Poe v. Seaborn*, each filed a tax return including $30,000, or one-half of Greg's aggregate $60,000 salary. Because they each were able to use the lower 10% rate bracket, they each owed $3,000 in tax, for an aggregate tax liability between the two of them of $6,000. George and Jenna, in contrast, lived in a common law state. As with Greg and Greta, George earned a $60,000 salary and Jenna did not work outside the home. George was required to include his entire $60,000 salary on his own return, and Jenna included nothing on hers. Thus, George owed $8,000 in tax: $4,000 on the first $40,000 (10% of $40,000) and $4,000 on the remaining $20,000 (20% of $20,000). In short, George and Jenna owed $2,000 more in Federal income tax than did Greg and Greta, even though both husbands earned the same $60,000 salary (and neither wife earned income outside the home).

The resulting perceptions of unfairness led Congress to enact a second tax rate schedule in 1948 applicable to married couples filing jointly that effectively provided couples in common law states the same income-splitting benefits enjoyed by married couples in community property states. The new 1948 joint return schedule was designed so that married couples would pay twice the tax of a single taxpayer earning one-half of the couple's aggregate taxable income. Thus, under the new rate schedule for married couples filing jointly, George and Jenna would owe the same $6,000 tax owed by Greg and Greta, equal to twice the $3,000 tax that a single taxpayer would owe on $30,000 of taxable income (one-half of the couple's aggregate $60,000 income).

While the new rate schedule equalized the treatment among married couples with the same aggregate income, regardless of whether they lived in a community property state or common law state, it introduced a new "singles penalty" for individuals earning the same income as the one-earner spouse. Thus, while George and Jenna would owe only $6,000 in tax on George's $60,000 salary under the new rate schedule for married couples filing jointly, Jim would owe $8,000 in tax on the same $60,000 salary (under the old rate schedule, now limited to unmarried individuals). Put another way, George and Jenna enjoyed a "marriage bonus" that Jim was denied. The Jims of the world were unhappy.

Enter 1969. "As a result of this basic rate structure, by 1969, an individual with the same income as a married couple could have had a tax liability as much as 40 percent higher than that of the married couple. To address this perceived inequity, which was labeled a 'singles penalty' by some commentators, a special rate schedule was introduced for single taxpayers (leaving the old schedule solely for married individuals filing separate returns). The bracket breakpoints and standard deduction amounts for single taxpayers were set at about 60 percent of those for married couples filing joint returns."[7] Whereas there was only one tax rate schedule applicable to all taxpayers in 1947, after 1969 there were four: (1) unmarried individuals (enacted in 1969), (2)

[7] JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO PROPOSALS TO REDUCE THE MARRIAGE TAX PENALTY, JCS-1-98 (Jan. 27, 1998), at www.jct.gov/publications.html?func=fileinfo&id=2935.

married couples filing a joint return (enacted in 1948), (3) married filing separate returns (the pre-1948 schedule) and (4) head of household.[8] Today, the tax schedule for married couples filing separately contains rate bracket thresholds and ceilings that are precisely one-half those found in the rate schedule for married couples filing jointly.[9]

As no good deed goes unpunished, the new favorable 1969 rate schedule for unmarried individuals created a new "marriage penalty" for two-earner couples in which the two spouses earned nearly equivalent incomes. That is to say, a married couple in which each of the husband and wife earned $30,000 owed more in tax under the 1969 rate schedule for a married couple filing jointly (or under the schedule for married couples filing separately) than would Jim, a single individual earning $60,000.

While two-earner married couples with equivalent incomes were rather rare in the 1960s, they became increasingly common by the early 1980s. In 1981, therefore, Congress enacted a new deduction for two-earner married couples equal to 10% of the lesser of (1) the lower-earning spouse's income or (2) $3,000. Stated differently, the maximum deduction for two-earner couples was $3,000. When rates were dramatically flattened in the Tax Reform Act of 1986 (with the top marginal rate reduced from 50% to 28%, as described in Chapter 3), the two-earner deduction was repealed, as the rate-flattening reduced the marriage penalty for two-earner couples substantially, if not entirely, for most couples.

By 1997, however, marriage bonuses and penalties were the talk of the town again, with the top marginal tax rate at 39.6%. Most commentary focused on the marriage penalty for two-earner couples with substantially equivalent earnings, but more married couples actually enjoyed a marriage bonus than suffered a marriage penalty, and more revenue was lost under the marriage bonus than was paid under the marriage penalty. As a CBO study documented:

> Measured as a percentage of income, marriage penalties and bonuses are largest for low-income families and least for high-income families.
>
> … An estimated 42 percent of couples incurred marriage penalties in 1996, 51 percent received bonuses, and 6 percent paid taxes unaffected by their marital status.
>
> … One-earner couples received seven-eighths of the total of bonuses in 1996 but represented less than one-half of all couples.[10]

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[8] Congress added this additional rate schedule in 1951, which provided to unmarried individuals who had one or more dependents (often divorced women) approximately one-half of the benefit enjoyed by married couples via the joint return. This rate schedule was sometimes referred to as providing a "divorce bonus." *See, e.g.*, JOINT COMMMITTEE ON TAXATION, THE INCOME TAX TREATMENT OF MARRIED COUPLES AND SINGLE PERSONS: A REPORT, JCS-17-80 (April 2, 1980), at www.jct.gov/publications.html?func=startdown&id=3888. With the 1969 adoption of the more favorable rate schedule for individuals, the Head of Household rate schedule was adjusted to provide approximately 75% of the benefit of income-splitting via the joint return. *See id.*

[9] Why would anyone file under the married filing separately schedule, as opposed to filing a joint return? A disadvantage of filing a joint return is that each spouse is jointly and severally liable for any resulting tax deficiency, while those who file separately are not responsible for a tax deficiency on their spouse's return. *See* § 6013(d)(3). Under certain circumstances that are not easy to satisfy, the "innocent spouse" on a joint return can appeal for relief from joint and several liability. *See* § 6015; Rev. Proc. 2013-34, 2013-2 C.B. 397 (describing updated innocent spouse guidelines).

[10] CONGRESSIONAL BUDGET OFFICE, FOR BETTER OR FOR WORSE: MARRIAGE AND THE FEDERAL INCOME TAX (June 1997) at xiv to xv. In addition to the rate schedules, the § 32 Earned Income Tax Credit and the Standard Deduction

Across all married couples in 1996, $28.8 billion was projected to be paid in marriage penalties, while $32.9 billion was projected to be saved in marriage bonuses, for a net revenue loss to the Treasury of slightly more than $4 billion compared to a system in which all taxpayers filed as individuals, regardless of marital status.[11]

The amendments enacted in 2001 (made permanent in 2012) significantly reduced the marriage penalty for two-earner, middle class couples with substantially equivalent incomes (and thereby increased the marriage bonus for one-earner couples) by increasing the Standard Deduction for a married couple filing jointly to an amount precisely twice that for individuals (it had been previously been slightly less than double) and ensuring that the 10% and 15% brackets were precisely twice as wide as those for individual filers. (They had been previously been less than twice as wide.) The point at which the 25% and higher brackets phase out for joint returns is not twice that of individuals, however. Thus, a marriage penalty can still apply at higher levels of aggregate income for a dual-earner couple with substantially equivalent incomes.

While many countries now use individual filing for income tax purposes to avoid these difficulties, mandatory individual filing regardless of marital status with a statutory override for *Poe v. Seaborn* (to prevent income splitting for Federal income tax purposes in community property states) is highly unlikely in the U.S. For one thing, the IRS opposes the move because eliminating the joint return today would significantly increase the aggregate number of returns that it must process each year.

***Registered domestic partnerships (RDPs) and civil unions***

In *United States v. Windsor*,[12] the Supreme Court struck down the Defense of Marriage Act, under which same-sex couples who legally married in those states that recognized such marriages were nevertheless treated as unmarried individuals for purposes of Federal law, including Federal tax law. The 2015 Supreme Court decision in *Obergefell v. Hodges*[13] held that the Due Process and Equal Protection clauses of the 14th amendment provide to all same-sex couples the fundamental right to marry. Thus, the Federal income tax treatment of same-sex married couples is the same as for opposite-sex married couples today.

Several states, however, also recognize civil unions or registered domestic partnerships (RDPs), both between opposite-sex and same-sex couples.[14] In Revenue Ruling 2013-17,[15] the IRS announced: "For Federal tax purposes, the terms 'spouse,' 'husband and wife,' 'husband,' and 'wife' do not include individuals (whether of the opposite sex or same sex) who have entered into a registered domestic partnership, civil union, or other formal relationship recognized under state law that is not denominated as a marriage …, and the term 'marriage' does not include such formal relationships." In other words, members of a civil union or RDP must file as individuals for Federal income tax purposes. This treatment differs from state law except Colorado, which simply tracks whatever Federal law says on this issue. For example, members of an RDP or civil union in California file a joint income tax return for state income tax purposes but must file separate returns

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suffered from notable marriage penalties before the 2001 amendments described in the text. The Earned Income Tax Credit, in particular, continues to suffer from marriage penalties.

[11] *Id*. at xv.

[12] 133 S. Ct. 2675 (2013).

[13] 135 S. Ct. 2584 (2015).

[14] For an updated list of the status of RDPs and civil unions in each state, consult www.nclrights.org/wp-content/uploads/2013/07/Relationship_Recognition.pdf.

[15] 2013-2 C.B. 201.

under the Federal income tax.

Several states that recognize civil unions or RDPs are also community property states (including California, Nevada, and Washington). How does *Poe v. Seaborn* apply to RDPs, whether the partners are of the same or opposite sex?

**CHIEF COUNSEL ADVICE 201021050**[16]

May 5, 2010

On February 24, 2006, the Office of Associate Chief Counsel (Income Tax & Accounting) issued Chief Counsel Advice (CCA) 200608038 concluding that an individual who is a registered domestic partner in California must report all of his or her income earned from the performance of personal services. In light of a change to California law, effective in 2007, you asked us whether California registered domestic partners should each report half of the community income on their Federal returns….

FACTS

In 2005, California law significantly expanded the rights and obligations of persons entering into a California domestic partnership for state property law purposes, but not for state income tax purposes. Specifically, the California Domestic Partner Rights and Responsibilities Act of 2003 (the California Act), effective on January 1, 2005, provided that "Registered domestic partners shall have the same rights, protections, and benefits, and shall be subject to the same responsibilities, obligations, and duties under law ... as are granted to and imposed upon spouses." However, the California Act provided that "earned income may not be treated as community property for state income tax purposes."

On September 29, 2006, California enacted Senate Bill 1827. Senate Bill 1827 repealed the language of the California Act providing that earned income was not to be treated as community property for state income tax purposes. Thus, effective January 1, 2007, the earned income of a registered domestic partner must be treated as community property for state income tax purposes …. As a result of the legislation, California, as of January 1, 2007, treats the earned income of registered domestic partners as community property for both property law purposes and state income tax purposes.

LAW AND ANALYSIS

Section 61(a)(1) of the Internal Revenue Code provides that Gross Income means all income from whatever source derived including compensation for services such as fees, commissions, fringe benefits, and similar items.

Federal tax law generally respects state property law characterizations and definitions. *U.S. v. Mitchell*, 403 U.S. 190 (1971), *Burnet v. Harmel*, 287 U.S. 103, 1932-2 C.B. 210 (1932). In *Poe v. Seaborn*, 282 U.S. 101, 1930-2 C.B. 202 (1930), the Supreme Court held that for Federal income tax purposes a wife owned an undivided one-half interest in the income earned by her husband in Washington, a community property state, and was liable for Federal income tax on that one-half interest. Accordingly, the Court concluded that husband and wife must each report one-half of the community income on his or her separate return regardless of which spouse earned the income.

[16] www.irs.gov/pub/irs-wd/1021050.pdf. *See also* PLR 201021048 (May 5, 2010).

*United States v. Malcolm*, 282 U.S. 792 (1931), applied the rule of *Poe v. Seaborn* to California's community property law.

California community property law developed in the context of marriage and originally applied only to the property rights and obligations of spouses. The law operated to give each spouse an equal interest in each community asset, regardless of which spouse is the holder of record. *d'Elia v. d'Elia*, 58 Cal. App. 4th 415, 68 Cal. Rptr. 2d 324 (1997).

By 2007, California had extended full community property treatment to registered domestic partners. Applying the principle that Federal law respects state law property characterizations, the Federal tax treatment of community property should apply to California registered domestic partners. Consequently, for tax years beginning after December 31, 2006, a California registered domestic partner must report one-half of the community income, whether received in the form of compensation for personal services or income from property, on his or her Federal income tax return.

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In summary, assignment of labor income by contract is generally not possible under *Lucas v. Earl*. The joint return does permit income splitting between spouses, however, which effectively provides to married couples living in common law states the income-splitting benefits enjoyed by married couples living in community property states. Members of an RDP or civil union are not considered married for Federal income tax purposes and must file separate returns. Such couples living in community property states that recognize community property rights for members of an RDP or civil union must nevertheless split their income on those separate returns (to the extent considered community property under state law), just as did the married couple in *Poe v. Seaborn*.

Whew!

## B. Income-shifting possibilities outside the joint return

The following problems should help you to think about the income-shifting possibilities outside of the joint return. Some of these possibilities were suggested in the material in Part A. or prior chapters, but most are suggested by the remaining material in this Part B. I include the problems here (rather than at the end of Part B.) in the hope that reading them in advance and keeping them in mind may help you to parse the remaining material more carefully as you move through it. Don't forget to return to the problems after you have finished the reading!

### Problems

Ellen is a dentist whose marginal rate as defined in Part B. of Chapter 1 (the rate at which her last, or marginal, dollar is taxed) is 28%, while her daughter Emma's marginal rate is only 15%. Which, if any, of the following strategies will successfully shift income tax liability from Ellen's 28% bracket to Emma's 15% bracket?

**1.** Ellen transfers $5,000 in cash, funded by her dental practice, to Emma as a gift.

**2.** Ellen pays Emma $5,000 for cleaning the reception area and the office restroom in Ellen's dentist's office on two Friday evenings in September. *See* Treas. Reg. § 1.162-7.

**3.** Ellen enters into a contract, which is enforceable under state law, that entitles Emma to 20% of Ellen's income arising from her dental practice from the moment that Ellen earns it.

**4.** Ellen's grandmother died recently, and Ellen learned that she received a life interest in a trust created under her grandmother's will. The trust will be funded with stocks and bonds owned by her grandmother before her death. The will directs the trustee to distribute the annual income from the trust to Ellen every December 15th for the rest of her life. At Ellen's death, the trust will be dissolved, and the stocks and bonds held by the trust will be distributed to Ellen's nephew, Erik. Review § 102(b)(2) from Chapter 7. Ellen immediately sends a document to the trustee informing him that she is assigning 50% of her life interest in the trust for the rest of her life to Emma. On December 15th of this year, each of Emma and Ellen receives $5,000 from the trustee.

**5.** Same as **4.**, except that, instead of assigning 50% of her life estate for the rest of her life, Ellen assigns 50% of her life estate to Emma for this year only. On December 15th of this year, each of Emma and Ellen receives $5,000 from the trustee.

**6.** Ellen owns a patent on a dental instrument that she invented which provides her with an annual royalty of $5,000. Ellen assigns her right to receive this year's royalty payment to Emma. Emma receives this year's $5,000 royalty payment.

**7.** Ellen transfers ownership of the patent, itself, to Emma. Emma receives this year's $5,000 royalty payment. Does it matter whether Emma is 14 years old or 26 years old?

**8.** Ellen creates a trust, transferring ownership of the patent to it. Under the trust terms (1) income from the trust will be distributed annually to Emma for the duration of the trust and (2) Ellen retains the right to dissolve the trust at any time, with the patent distributed to herself, *i.e.*, the trust is revocable. Emma receives this year's $5,000 royalty payment. Assume that Emma is 26 years old. *See* § 676(a).

**9.** Same as **8.**, except that (1) the trust is irrevocable and (2) Ellen retains the right to designate who will receive the distribution of trust income each year until Ellen's death, at which time the trust will dissolve and the patent will be distributed to Emma. For this year, Ellen designates Emma as the beneficiary that will receive the trust income distribution, so Emma receives this year's $5,000 royalty payment. *See* § 674(a).

**10.** Same as **8.**, except that the trust is irrevocable for its duration but will dissolve after 20 years, at which time the patent will return to Ellen's ownership. As the sole income beneficiary, Emma receives this year's $5,000 royalty payment. Assume that the value of Ellen's reversionary interest when the trust is created is 4%. *See* § 673(a).

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In Chapter 7, you learned that "estates" are taxpayers that spring into being automatically when an individual dies and that estates must file an income tax return with respect to any income earned by the estate during its "life." Similarly, trusts can be taxpayers, too. The current income tax rules pertaining to trusts as entities are found in Subchapter J of the Code and are studied in the Wealth

Transfer Tax course in more detail, as trusts are common vehicles used to transfer wealth from one generation to the next. Nevertheless, we must get a taste of trust income taxation here in order to consider the income-shifting possibilities that trusts may (or may not) provide.

First, let's identify some nomenclature, as well as the potential taxpayers pertaining to a trust. The taxpayer who forms a trust and funds it with cash or property is called the trust "grantor." The trust is administered by the "trustee" according to the terms of the trust document and trust law. The trust document will name the trust "beneficiaries" and describe their distribution rights. Some trust beneficiaries may legally assign (to the extent permitted under the trust document and trust law) all or a portion of their distribution rights to a third party. At some point in time, the trust will end, and the trust's "corpus" (the cash and property owned by the trust at that time) will be distributed to the "remainder." The remainder who obtains his trust interest as an *inter vivos* gift or by bequest can exclude his or her receipt under § 102(a) when the trust is dissolved. *But who will include in Gross Income the trust's annual income?* The answer is never the trustee, as the trustee is a mere agent of the trust, itself. (Remember *Poe v. Seaborn* in this regard.)

One possibility is the grantor of the trust if the trust's existence is ignored for Federal income tax purposes (as though it were never created in the first place and the grantor continued to own the trust property directly) under rules that will be explored in a few pages. Such trusts have come to be called "grantor trusts."

But first let's explore the rules pertaining to a trust that is recognized as an entity separate from its grantor for tax purposes (a nongrantor trust). **Under the statute, nongrantor trust income is generally taxed only once: *either* to the trust's beneficiaries (to the extent distributed to them) *or* to the trust itself (to the extent retained by the trust rather than distributed to beneficiaries).** *See* § 61(a)(15).

Even though trust income is listed as an item of Gross Income, § 61's introductory clause ("except as otherwise provided in this subtitle") reminds us that explicitly listed items can nevertheless be excluded if a statutory exclusion applies. Thus, even though compensation for services rendered is listed as an item of Gross Income in § 61(a)(1), you learned in Chapter 5 that compensation can be excluded under §§ 119 and 132 if their requirements are satisfied. Can a trust distribution be excluded by a beneficiary under § 102(a), notwithstanding § 61(a)(15), if the trust interest was received as a gift or bequest from the grantor? No. As you learned in Chapter 7, § 102(b)(2) applies to negate the § 102(a) exclusion in the case of a gift or bequest of *income only*. But what if the beneficiary assigns his or her income distribution right to a third party before the distribution? Can the trust beneficiary thereby shift the income to the third-party's tax return?

In the case below, Mr. Blair's father created a trust under his will which was not a grantor trust. Mr. Blair was a beneficiary with a life estate in the trust's income. Under the rules described above, therefore, Mr. Blair must include trust income distributions in his Gross Income. He nevertheless escaped taxation of a portion of the trust's income that he assigned (before the distribution occurred) to his children. Precisely why was Mr. Blair's assignment of income successful for purposes of income taxation?

## 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 $6000 for the remainder of that calendar year, and to $9000 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 $9000 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.

The question first arose with respect to the tax year 1923 and the Commissioner of Internal Revenue ruled that the income was taxable to the petitioner. The Board of Tax Appeals held the contrary. The Circuit Court of Appeals reversed the Board, holding that under the law of Illinois the trust was a spendthrift trust and the assignments were invalid. We denied certiorari.

[Subsequent litigation then settled that the trust was not a spendthrift trust under state law and that Mr. Blair's assignments were thus valid under trust law.] The Circuit Court of Appeals … 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.

In the face of this ruling of the state court it is not open to the Government to argue that the trust "was, under the Illinois law, a spendthrift trust." The point of the argument is that, the trust being of that character, the state law barred the voluntary alienation by the beneficiary of his interest. The state court held precisely the contrary. The ruling also determines the validity of the assignment by the beneficiary of parts of his interest. That question was necessarily presented and expressly decided.

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 skillfully devised to prevent the same 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. Comm'r*, 279 U.S. 716. 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.

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*.

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." 83 F.2d, p. 662. 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. 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. 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." *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.

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Instead of assigning specified interests in his life estate to his children *for the rest of his life*, would Mr. Blair's assignment have been successful for income tax purposes if he had assigned the right to receive the income for only, say, the next year?

## HARRISON v. SCHAFFNER

312 U.S. 579 (1941)

MR. JUSTICE STONE delivered the opinion of the Court.

In December, 1929, respondent, the life beneficiary of a testamentary trust, "assigned" to certain of her children specified amounts in dollars from the income of the trust for the year following the assignment. She made a like assignment to her children and a son-in-law in November, 1930. The question for decision is whether, under the applicable 1928 Revenue Act, 45 Stat. 791, the assigned income, which was paid by the trustees to the several assignees, is taxable as such to the assignor or to the assignees.

The Commissioner ruled that the income was that of the life beneficiary and assessed a deficiency against her for the calendar years 1930 and 1931, which she paid. In the present suit to recover the tax paid as illegally exacted the district court below gave judgment for the taxpayer, which the Court of Appeals affirmed. We granted certiorari to resolve an alleged conflict in principle of the decision below with those in *Lucas v. Earl*, 281 U.S. 111; *Burnet v. Leininger*, 285 U.S. 136, and *Helvering v. Clifford*, 309 U.S. 331.

Since granting certiorari we have held, following the reasoning of *Lucas v. Earl*, *supra*, that one who is entitled to receive, at a future date, interest or compensation for services and who makes a gift of it by an anticipatory assignment, realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty. *Helvering v. Horst*, 311 U.S. 112; *Helvering v. Eubank*, 311 U.S. 122. Decision in these cases was rested on the principle that the power to dispose of income is the equivalent of ownership of it and that the exercise of the power to procure its payment to another, whether to pay a debt or to make a gift, is within the reach of the statute taxing income "derived from any source whatever." In the light of our opinions in these cases the narrow question presented by this record is whether it makes any difference in the application of the taxing statute that the gift is accomplished by the anticipatory assignment of trust income rather than of interest, dividends, rents and the like which are payable to the donor.

Respondent, recognizing that the practical consequences of a gift by assignment, in advance, of a year's income from the trust, are, so far as the use and enjoyment of the income are concerned, no different from those of the gift by assignment of interest or wages, rests his case on technical

distinctions affecting the conveyancing of equitable interests. It is said that since by the assignment of trust income the assignee acquires an equitable right to an accounting by the trustee which, for many purposes, is treated by courts of equity as a present equitable estate in the trust property, it follows that each assignee in the present case is a donee of an interest in the trust property for the term of a year and is thus the recipient of income from his own property which is taxable to him rather than to the donor. *See Blair v. Comm'r*, 300 U.S. 5.

We lay to one side the argument which the Government could have made that the assignments were no more than an attempt to charge the specified payments upon the whole income which could pass no present interest in the trust property. *See* Scott on Trusts, §§ 10.1, 10.6, 29, 30. For we think that the operation of the statutes taxing income is not dependent upon such "attenuated subtleties," but rather on the import and reasonable construction of the taxing act. *Lucas v. Earl*, *supra*, 114.

Section 22(a) of the 1928 Revenue Act provides, "'Gross Income' includes gains, profits, and income derived from . . . interest, rent, dividends, securities or the transactions of any business carried on for gain or profit, or gains or profits, and income derived from any source whatever." By §§ 161(a) and 162(b) the tax is laid upon the income "of any kind of property held in trust," and income of a trust for the taxable year which is to be distributed to the beneficiaries is to be taxed to them …. In construing these and like provisions in other revenue acts we have uniformly held that they are not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid. *See Corliss v. Bowers*, 281 U.S. 376; *Lucas v. Earl*, *supra*; *Helvering v. Horst*, *supra*; *Helvering v. Eubank*, *supra*; *Helvering v. Clifford*, *supra*. It was for that reason that in each of those cases it was held that one vested with the right to receive income did not escape the tax by any kind of anticipatory arrangement, however skillfully devised, by which he procures payment of it to another, since, by the exercise of his power to command the income, he enjoys the benefit of the income on which the tax is laid.

Those decisions are controlling here. Taxation is a practical matter and those practical considerations which support the treatment of the disposition of one's income by way of gift as a realization of the income to the donor are the same whether the income be from a trust or from shares of stock or bonds which he owns. It is true, as respondent argues, that where the beneficiary of a trust had assigned a share of the income to another for life without retaining any form of control over the interest assigned, this Court construed the assignment as a transfer *in praesenti* to the donee, of a life interest in the corpus of the trust property, and held in consequence that the income thereafter paid to the donee was taxable to him and not the donor. *Blair v. Comm'r*, *supra*. But we think it quite another matter to say that the beneficiary of a trust who makes a single gift of a sum of money payable out of the income of the trust does not realize income when the gift is effectuated by payment, or that he escapes the tax by attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income, where that is its obvious purpose and effect. We think that the gift by a beneficiary of a trust of some part of the income derived from the trust property for the period of a day, a month or a year involves no such substantial disposition of the trust property as to camouflage the reality that he is enjoying the benefit of the income from the trust of which he continues to be the beneficiary, quite as much as he enjoys the benefits of interest or wages which he gives away as in the *Horst* and *Eubank* cases. Even though the gift of income be in form accomplished by the temporary disposition of the donor's property which produces the income, the donor retaining every other substantial interest

in it, we have not allowed the form to obscure the reality. Income which the donor gives away through the medium of a short term trust created for the benefit of the donee is nevertheless income taxable to the donor. *Helvering v. Clifford*, *supra*; *Hormel v. Helvering*, ante, p. 552. We perceive no difference, so far as the construction and application of the Revenue Act is concerned, between a gift of income in a specified amount by the creation of a trust for a year, see *Hormel v. Helvering*, *supra*, and the assignment by the beneficiary of a trust already created of a like amount from its income for a year.

Nor are we troubled by the logical difficulties of drawing the line between a gift of an equitable interest in property for life effected by a gift for life of a share of the income of the trust and the gift of the income or a part of it for the period of a year as in this case. "Drawing the line" is a recurrent difficulty in those fields of the law where differences in degree produce ultimate differences in kind. *See Irwin v. Gavit*, 268 U.S. 161, 168. It is enough that we find in the present case that the taxpayer, in point of substance, has parted with no substantial interest in property other than the specified payments of income which, like other gifts of income, are taxable to the donor. Unless in the meantime the difficulty be resolved by statute or treasury regulation, we leave it to future judicial decisions to determine precisely where the line shall be drawn between gifts of income-producing property and gifts of income from property of which the donor remains the owner, for all substantial and practical purposes. *Cf. Helvering v. Clifford*, *supra*.

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In *Helvering v. Horst*,[17] cited by the *Harrison v. Schaffner* Court, a father owned a corporate bearer bond with interest coupons attached. Interest coupons represent the right to receive the associated interest payment. When the coupon is presented for payment, the corporate borrower must pay the interest to the coupon holder. The father gave an interest coupon to his son, who presented the coupon later in the year to the corporate borrower and received the interest payment. The father did not include the interest in his Gross Income, arguing under *Blair* that he divested himself completely of the underlying property (the interest coupon) on which the interest was paid when he gave the coupon to his son. The Court disagreed. Here is an excerpt.

> 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.
>
> This was emphasized in *Blair v. Commissioner*, 300 U.S. 5, on which respondent relies, where the distinction was taken between a gift of income derived from an obligation to pay compensation and a gift of income-producing property. In the

[17] 311 U.S. 112 (1940).

> circumstances of that case, the right to income from the trust property was thought to be so identified with the equitable ownership of the property, from which alone the beneficiary derived his right to receive the income and his power to command disposition of it, that a gift of the income by the beneficiary became effective only as a gift of his ownership of the property producing it. Since the gift was deemed to be a gift of the property, the income from it was held to be the income of the owner of the property, who was the donee, not the donor—a refinement which was unnecessary if respondent's contention here is right, but one clearly inapplicable to gifts of interest or wages. Unlike income thus derived from an obligation to pay interest or compensation, the income of the trust was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away. *Blair v. Comm'r*, *supra*, 12, 13 and cases cited. We have held without deviation that where the donor retains control of the trust property the income is taxable to him although paid to the donee. *Corliss v. Bowers*, *supra*. *Cf. Helvering v. Clifford*, *supra*....
>
> 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*, 115.

In both *Schaffner* and *Horst*, the attempted assignments of income failed for tax purposes, with the result that the income had to be included by the assignors, not the assignees. In each case, however, the assignee did receive the cash in actual fact—from the trustee in *Schaffner* and from the corporate borrower in *Horst*. How do we account (for income tax purposes) for the cash receipt in the hands of the assignees in an unsuccessful assignment of income? The *Schaffner* Court remarked that "one who is entitled to receive, at a future date, interest or compensation for services and who makes a gift of it by an anticipatory assignment, realizes taxable income quite as much as if he had collected the income and paid it over to the object of his bounty." While in form the cash goes directly from third parties to the assignees, in unsuccessful assignments of income the cash is deemed to have been received by the assignor first in substance (and included by him) and then transferred to the assignee as a gift (excluded under § 102(a)). In short, we apply the *Old Colony Trust* two-step (*supra* Chapter 5), where cash paid directly from the corporation to the IRS was deemed to have been received, in substance, first by Mr. Wood (and included by him as compensation) and then transferred by Mr. Wood to the IRS. While the gift deemed received from the assignor is excludable to the extent permitted under § 102 for income tax purposes, a gift tax under the unified gift, estate, and generation-skipping transfer taxes (briefly described in Chapter 7) could possibly be triggered in an unsuccessful assignment of income if the transfer is very large.

***The § 1(g) kiddie tax***

Suppose that, contrary to the facts of the case, Mr. Horst had given his son not just a single interest coupon but also the underlying bond, with all of the coupons. Under *Blair*, *Schaffner*, and *Horst*, taken together, it is clear that a complete ownership transfer of the underlying property that

produces the income succeeds in shifting that income to the assignee for tax purposes. It became quite common, therefore, for savvy investors to transfer ownership of the family's investment portfolio to Junior. After all, Junior is only two years old and will not run off to Reno with the loot. Because the assignment was successful, the investment income earned on that portfolio would be included on Junior's tax return and taxed at his (presumably much lower) tax rates.

Enter 1986. As part of the Tax Reform Act of 1986, Congress enacted § 1(g), commonly referred to as the "kiddie tax." Under that section, "unearned income" of a child (essentially all income except compensation for services rendered by the child) that exceeds certain thresholds, while included in Gross Income by Junior on Junior's tax return, is taxed at mummy and daddy's highest marginal tax rate, as though the income were marginal dollars received by them. In other words, even though the assignment of income is successful, the assignment ends up doing mummy and daddy little good from an income tax perspective. I say "little" good because, to the extent that the child's unearned income does not exceed the thresholds described in § 1(g)(4)(A)(ii) (as indexed for inflation), the kiddie tax will not apply. Thus, there remains a little room for shifting relatively small amounts. While the threshold can vary (depending on whether the child has significant itemized deductions of his own), the threshold is generally $2,100 for 2017.

When first enacted, the kiddie tax applied to children younger than 14, but this threshold has been increased over the years. Today, § 1(g) generally applies to those younger than 18, but it can apply to dependents younger than age 24 (generally, those young adults for whom parents are providing more than 50% of their support), if he or she is not filing a joint return with a spouse.

To avoid having to go to the bother of filing a tax return for Junior, mummy and daddy can elect under § 1(g)(7) to include the portion of Junior's unearned income exceeding the threshold amount on their own tax return, as that income is going to be taxed at their tax rates anyway. The details of § 1(g) can be somewhat complex, including the determination of the threshold below which unearned income will not trigger operation of the section in a given year, but my purpose here is mainly that you appreciate both Congress's reaction to successful assignments of property income to children and the general idea regarding how § 1(g) operates.

***The grantor trust rules***

Notice that neither taxpayer in the *Blair* and *Schaffner* cases was the "grantor" of the trusts—the person who created the trust, transferred cash or property to it, and designated the trust beneficiaries. Rather, the taxpayers were the lucky *beneficiaries* (holding life interests) of trusts created and funded by others. In other words, the taxation of *the grantor* was not at issue in those cases; the only issue was whether the trust's designated beneficiary successfully assigned trust income (which the beneficiary must otherwise include in Gross Income under Subchapter J and § 61(a)(15)) to a third party.

Some taxpayers realized early on, however, that creating a trust and transferring one's own investment property to it could achieve tax savings by effectively using the lower rate brackets more than once, while keeping the income all in the family. From the discussion in Part A., recall that prior to 1948 there was only a single tax rate schedule applicable to all taxpayers and that the married spouses living in the community property state at issue in *Poe v. Seaborn* were permitted to split the husband's salary (as well as the couple's investment income) on two tax returns (one for each spouse), which effectively allowed them to use the lower rate brackets *twice*, lowering their aggregate tax from what it would have been if the husband had included his wages entirely on a single tax return. Absent rules preventing the technique, the same approach could be used to

split income between two (or more) income tax returns using trusts.

Assume, for example, that Susan is a high-income taxpayer whose marginal dollars fall in the highest tax bracket. Susan makes large gifts to family members each year, but such gifts do not shift income from her high-bracket tax return to low-bracket family members. (Recall the combination of § 262(a) for Susan and § 102(a) for her recipients.) How can she effectively move some of those "last dollars" to one or more other tax returns, removing them from her high tax bracket to the lower rate brackets of a second (and third, and fourth, *etc.*) taxpayer?

Susan creates a trust and transfers her investment portfolio to it. That is to say, unlike Messrs. Blair and Schaffner, Susan is the trust's grantor. If the existence of the trust is respected for tax purposes, the investment income earned by the trust would be taxed to the trust itself if undistributed, effectively using the lower rate brackets a second time. Alternatively, Susan could name family members as trust beneficiaries—the very family members to whom she used to make large gifts every year anyway—and direct that the trust distribute trust income in specified percentages to each of these (low bracket) beneficiaries each year. In that case, the income would be included by the beneficiaries rather than by the trust. Voila! The lower rate brackets are used multiple times, reducing the aggregate tax liability of the family substantially. Does it work?

## HELVERING v. CLIFFORD

309 U.S. 331 (1940)

MR. JUSTICE DOUGLAS delivered the opinion of the Court.

In 1934 respondent declared himself trustee of certain securities which he owned. All net income from the trust was to be held for the "exclusive benefit" of respondent's wife. The trust was for a term of five years, except that it would terminate earlier on the death of either respondent or his wife. On termination of the trust the entire corpus was to go to respondent, while all "accrued or undistributed net income" and "any proceeds from the investment of such net income" was to be treated as property owned absolutely by the wife. During the continuance of the trust respondent was to pay over to his wife the whole or such part of the net income as he in his "absolute discretion" might determine. And during that period he had full power (a) to exercise all voting powers incident to the trusteed shares of stock; (b) to "sell, exchange, mortgage, or pledge" any of the securities under the declaration of trust "whether as part of the corpus or principal thereof or as investments or proceeds and any income therefrom, upon such terms and for such consideration" as respondent in his "absolute discretion may deem fitting"; (c) to invest "any cash or money in the trust estate or any income therefrom" by loans, secured or unsecured, by deposits in banks, or by purchase of securities or other personal property "without restriction" because of their "speculative character" or "rate of return" or any "laws pertaining to the investment of trust funds"; (d) to collect all income; (e) to compromise, etc., any claims held by him as trustee; (f) to hold any property in the trust estate in the names of "other persons or in my own name as an individual" except as otherwise provided. Extraordinary cash dividends, stock dividends, proceeds from the sale of unexercised subscription rights, or any enhancement, realized or not, in the value of the securities were to be treated as principal, not income. An exculpatory clause purported to protect him from all losses except those occasioned by his "own wilful and deliberate" breach of duties as trustee. And finally it was provided that neither the principal nor any future or accrued income should be liable for the debts of the wife; and that the wife could not transfer, encumber, or anticipate any interest in the trust or any income therefrom prior to actual payment thereof to her.

It was stipulated that while the "tax effects" of this trust were considered by respondent they were not the "sole consideration" involved in his decision to set it up, as by this and other gifts he intended to give "security and economic independence" to his wife and children. It was also stipulated that respondent's wife had substantial income of her own from other sources; that there was no restriction on her use of the trust income, all of which income was placed in her personal checking account, intermingled with her other funds, and expended by her on herself, her children and relatives; that the trust was not designed to relieve respondent from liability for family or household expenses and that after execution of the trust he paid large sums from his personal funds for such purposes….

During the year 1934 all income from the trust was distributed to the wife who included it in her individual return for that year. The Commissioner, however, determined a deficiency in respondent's return for that year on the theory that income from the trust was taxable to him. The Board of Tax Appeals sustained that redetermination. The Circuit Court of Appeals reversed. We granted certiorari because of the importance to the revenue of the use of such short term trusts in the reduction of surtaxes.

Sec. 22(a) of the Revenue Act of 1934 [the predecessor to § 61] includes among "Gross Income" all "gains, profits, and income derived … from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; 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." The broad sweep of this language indicates the purpose of Congress to use the full measure of its taxing power within those definable categories. Hence our construction of the statute should be consonant with that purpose. Technical considerations, niceties of the law of trusts or conveyances, or the legal paraphernalia which inventive genius may construct as a refuge from surtaxes should not obscure the basic issue. That issue is whether the grantor after the trust has been established may still be treated, under this statutory scheme, as the owner of the corpus. In absence of more precise standards or guides supplied by statute or appropriate regulations, the answer to that question must depend on an analysis of the terms of the trust and all the circumstances attendant on its creation and operation. And where the grantor is the trustee and the beneficiaries are members of his family group, special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as § 22(a) is concerned.

In this case we cannot conclude as a matter of law that respondent ceased to be the owner of the corpus after the trust was created. Rather, the short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by respondent all lead irresistibly to the conclusion that respondent continued to be the owner for purposes of § 22(a).

So far as his dominion and control were concerned it seems clear that the trust did not effect any substantial change. In substance his control over the corpus was in all essential respects the same after the trust was created, as before. The wide powers which he retained included for all practical purposes most of the control which he as an individual would have. There were, we may assume, exceptions, such as his disability to make a gift of the corpus to others during the term of the trust and to make loans to himself. But this dilution in his control would seem to be insignificant and immaterial, since control over investment remained. If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary

reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property. That might not be true if only strictly legal rights were considered. But when the benefits flowing to him indirectly through the wife are added to the legal rights he retained, the aggregate may be said to be a fair equivalent of what he previously had. To exclude from the aggregate those indirect benefits would be to deprive § 22(a) of considerable vitality and to treat as immaterial what may be highly relevant considerations in the creation of such family trusts. For where the head of the household has income in excess of normal needs, it may well make but little difference to him (except income-tax-wise) where portions of that income are routed—so long as it stays in the family group. In those circumstances the all-important factor might be retention by him of control over the principal. With that control in his hands he would keep direct command over all that he needed to remain in substantially the same financial situation as before. Our point here is that no one fact is normally decisive but that all considerations and circumstances of the kind we have mentioned are relevant to the question of ownership and are appropriate foundations for findings on that issue. Thus, where, as in this case, the benefits directly or indirectly retained blend so imperceptibly with the normal concepts of full ownership, we cannot say that the triers of fact committed reversible error when they found that the husband was the owner of the corpus for the purposes of § 22(a). To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which may have little or no significance in such household arrangements.

The bundle of rights which he retained was so substantial that respondent cannot be heard to complain that he is the "victim of despotic power when for the purpose of taxation he is treated as owner altogether." *See DuPont v. Comm'r*, 289 U.S. 685, 689.

The judgment of the Circuit Court of Appeals is reversed and that of the Board of Tax Appeals is affirmed.

MR. JUSTICE ROBERTS, dissenting: I think the judgment should be affirmed. The decision of the court disregards the fundamental principle that legislation is not the function of the judiciary but of Congress.

In every revenue act from that of 1916 to the one now in force a distinction has been made between income of individuals and income from property held in trust. It has been the practice to define income of individuals, and, in separate sections, under the heading "Estates and Trusts," to provide that the tax imposed upon individuals shall apply to the income of estates or of any kind of property held in trust. A trust is a separate taxable entity. The trust here in question is a true trust….

If judges were members of the legislature they might well vote to amend the act so as to tax such income in order to frustrate avoidance of tax but, as judges, they exercise a very different function…. Courts ought not to stop loopholes in an act at the behest of the Government, nor relieve from what they deem a harsh provision plainly stated, at the behest of the taxpayer. Relief in either case should be sought in another quarter.

No such dictum as that Congress has in the income tax law attempted to exercise its power to the fullest extent will justify the extension of a plain provision to an object of taxation not embraced within it. If the contrary were true, the courts might supply whatever they considered a deficiency in the sweep of a taxing act. I cannot construe the court's opinion as attempting less….

If some short term trusts are to be treated as nonexistent for income tax purposes, it is for Congress to specify them.

MR. JUSTICE MCREYNOLDS joins in this opinion.

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**A trust that is transparent for tax purposes—*i.e.*, is ignored for tax purposes, as though it did not exist—is called a "grantor trust." The income earned by a grantor trust is included in the Gross Income of the grantor, who created and funded the trust with cash or property**—Mr. Clifford in the above case. You can think of a grantor trust as being treated the same (for Federal income tax purposes) as a one-owner Limited Liability Company (LLC), which you learned in the Introduction is an entity that is similarly ignored for tax purposes. That is to say, the sole owner of the LLC includes and deducts the amounts attributable to the LLC on her own individual tax return as though she did not create the LLC but rather operated the business directly as a sole proprietor. This is precisely how a grantor trust is treated for Federal income tax purposes.

Even though Mr. Clifford lost his case, others followed in his wake and were more careful to draft trust instruments that deprived themselves of a bit more power and that created trusts that lasted for more than the five years in *Clifford*. Shortly after *Clifford* was decided, the Treasury Department issued regulations that more precisely described the characteristics of a grantor trust, and these regulations were codified in 1954 (addressing the issue highlighted in Justice Roberts's dissent), modified significantly in 1969, and modified significantly again in 1986. Prior to 1986, a trust's life had to exceed 10 years to avoid grantor trust status. Such trusts came to be known as *Clifford* trusts because they were specifically designed to avoid grantor trust status under *Clifford*. "*Clifford* trusts, *i.e.*, trusts with a reversionary interest that would not take effect in fewer than 10 years, were widely used to shift income tax consequences of trusts from the grantor to the trust or a beneficiary from the 1940s through 1986."[18]

In the Tax Reform Act of 1986, Congress substantially revised the grantor trust rules, now found in §§ 671 to 677 of the Code.[19] Notice how detailed they are. To get a flavor, take a look, for example, at §§ 673(a), 674(a) and 676(a). Instead of a simple 10-year rule, how is the reversionary interest necessary to avoid grantor trust status measured today? Because § 673 provides no methodology in valuing reversionary interests, the IRS utilizes the methods used to value reversionary interests under § 2037 for estate tax purposes.[20]

While you may at first assume that all trust creators seek to avoid having their trusts be

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[18] Lisa Whitcomb & Scott A. Bowman, *What's Yours Is Mine and What's Mine Is Mine: Grantor Trust Sections 673 and 676*, at 2, available at www.americanbar.org/content/dam/aba/events/taxation/taxiq-11mid-022.authcheckdam.pdf.

[19] Notice that §§ 671 in 677 apply only to determine whether the trust is a grantor trust (ignored for tax purposes) or a nongrantor trust (not ignored for tax purposes). For example, they do not control the different issue regarding whether an assignment by a nongrantor trust beneficiary to a third party, as in *Blair* and *Harrison v. Schaffner*, will be respected (or not) for tax purposes under the common law assignment of income doctrine developed by such cases, even though the issue of "control" informs both issues.

[20] *See, e.g.*, Rev. Rul. 76-178, 1976-1 C.B. 273.

categorized as a grantor trust for income tax purposes, that assumption is false. Those of you who go on to the Wealth Transfer Tax course will learn that taxpayers commonly transfer property to trusts that purposefully trigger one of the rules found in §§ 671 to 677 to ensure that the trust will be a grantor trust (ignored for tax purposes) in order to achieve gift or estate tax benefits. Such trusts are often referred to as "intentionally defective grantor trusts."

***Income splitting using a nongrantor trust***

Let's suppose that Susan does not wish her trust to be treated as a grantor trust and that she has obtained good tax advice to ensure that the trust that she creates will be respected for tax purposes as a separate entity, rather than ignored as a grantor trust under §§ 671 to 677. Because of a second change enacted in 1986, Susan would want to ensure that 100% of the trust's ordinary income and capital gains (or close to it) are actually distributed every year (and thus taxed to the designated beneficiaries) rather than retained and accumulated by the trust (and taxed to it). The reason for this advice is that Congress drastically compressed the tax rate schedule for trusts and estates in § 1(e) in 1986. Compare the 2016 schedule below for estates and trusts[21] to the 2016 schedules for unmarried individuals and married couples filing jointly reprinted in Chapter 1, Part B.

**2017 Table for Trusts & Estates**

| *If Taxable Income is:* | *The tax is:* |
|---|---|
| Not over $2,550 | 15% of taxable income |
| Over $2,550 but not over $6,000 | $382.50 plus 25% of excess over $2,550 |
| Over $6,000 but not over $9,150 | $1,245 plus 28% of excess over $6,000 |
| Over $9,150 but not over $12,500 | $2,127 plus 33% of excess over $9,150 |
| Over $12,500 | $3,232.50 plus 39.6% of excess over $12,500 |

In addition, undistributed net capital gain in excess of $12,500 is taxed at the 20% net capital gain rate in 2017 (rather than the 15% rate that applies to individual taxpayers with AGI of less than approximately $400,000).

In effect, Susan can shift investment income earned by her nongrantor trust to the tax returns of her low-bracket family members by ensuring distribution of 100% of the trust's income and net capital gain each year, thus lowering the aggregate tax burden on that income.[22] If Susan's nongrantor trust does not distribute its income every year (and therefore is analogous to her own pocketbook or bank account), the trust's marginal income tax rate will quickly reach the same 39.6% rate (and 20% rate for net capital gain) that would have applied to that income had she never created the trust in the first place and had included the investment income on her own return.

***Final thoughts***

The material in this part can be seen as an elaboration of the last part of the *Glenshaw Glass* definition of residual Gross Income: accessions to wealth, clearly realized, *over which the taxpayer has complete dominion*. The cumulative effect of what we have considered here is that *control*, rather than enjoyment, is at the root of the analysis regarding attempted assignments of income from both property and services. Retention of control over the thing that produces the income (your

[21] Rev. Proc. 2013-15, 2013-1 C.B. 441.

[22] But what if the beneficiaries are her 12-year-old niece and 7-year-old nephew, whose parents are in the 39.6% marginal tax bracket, as well? Do not forget about the kiddie tax.

own body and mind in the case of services and the underlying property in the case of property) brings taxation with it. In other words, retention of control connotes tax ownership. That analysis explains why there is so much more flexibility regarding the ability to assign property income compared to services income. You cannot give up control and ownership over your own body and mind as the source of income. As phrased by the *Horst* Court, "[T]he 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."[23] (Emphasis added.) In other words, the worker controls whether the services income will be earned because he can turn the spigot on or off by choosing to work or not. You *can*, in contrast, give up control over property that produces income.

While this reasoning may be intellectually tidy, note that this gives propertied people—the wealthy—a much greater ability to shift their (capital) income than the larger majority whose main source of income is from labor (compensation for services rendered).

[23] *Horst*, 311 U.S. at 118.

# Chapter 9: Income Shifting in the Fractured Family

In Chapter 8, you studied the constraints imposed on income shifting in the happy family under both the assignment-of-income doctrine and statutory provisions. This chapter considers the planning possibilities regarding income shifting in divorce, whether between same-sex or opposite sex spouses.[1]

Because divorce, unlike transfers in the intact family, is a one-time event that is not typically undertaken to achieve income shifting for Federal income tax purposes, Congress has explicitly provided more leeway for income shifting in this context. Thus, the wise tax advisor will carefully consider the *after-tax* consequences of the various transfer possibilities when negotiating and drafting the divorce or separation instrument.

## A. Cash payments

The background rule regarding the tax consequences for both the payor and payee of a cash "support" payment—whether in divorce, as in the case below, or in the intact family—is found in *Gould v. Gould*.

**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 three thousand dollars ($3,000.00) every month for her support and maintenance [Ed. Note: approximately $77,000 per month in 2015 dollars]. 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.

Pertinent portions of the act follow:

… "B. 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 from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the

[1] Same-sex married couples are treated the same as opposite-sex married couples for Federal income tax purposes after both Windsor v. Commissioner, 133 S. Ct. 2675 (2013), and Obergefell v. Hodges, 133 S. Ct. 2584 (2015), as briefly described in the last chapter.

income from but not the value of property acquired by gift, bequest, devise, or descent….”

In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are construed most strongly against the Government, and in favor of the citizen. *U.S. v. Wigglesworth*, 2 Story, 369; *Am. Net & Twine Co. v. Worthington*, 141 U.S. 468, 474; *Benziger v. U.S.*, 192 U.S. 38, 55.

As appears from the above quotations, the … income upon which … an annual tax shall be assessed, levied, collected and paid is defined in division B. The use of the word itself in the definition of “income” causes some obscurity, but we are unable to assert that alimony paid to a divorced wife under a decree of court falls fairly within any of the terms employed.

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 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.*

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Once again, this opinion was not heavily edited. Precisely why was the alimony received by Mrs. Gould not “income” within the meaning of the residual clause? If we engage in a thought experiment and consider how *Gould* might have been decided if it had arisen after *Glenshaw Glass* (rather than before), might it have satisfied the *Glenshaw Glass* construction of the residual clause, *i.e.*, was Mrs. Gould’s cash receipt an accession to wealth, clearly realized, over which she had complete dominion? If we similarly analyze Mr. Gould’s payment through the normative lens of measuring “income” accurately, the payment would be nondeductible by him as a personal expense under § 262.

But perhaps that is not the appropriate way to conceive of this analysis. Recall that the tax treatment of gifts explored in Chapter 7 generally ensured that the amount transferred as a gift was taxed only once between the donor and donee, not twice (though you also learned that there is a lot of leakage, particularly under § 1014, which allows wealth accessions to go untaxed to either party under the income tax). Mrs. Gould’s receipt was clearly not excludable as a “gift” because the payment by Mr. Gould was made out of legal compulsion, not “detached and disinterested generosity,” in the words of *Duberstein*. Nevertheless, the Court stressed the fact that Mr. Gould was denied a deduction for his payment when it said: “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 thought was written as a single sentence, with a

semi-colon connecting the two independent clauses. This form implies a causal link, *i.e.*, that Mrs. Gould need not include the receipt *precisely because* Mr. Gould could not deduct the payment. In other words, the Court implied that the amount should not be taxed to both. Because the Court has no power to create nonstatutory deductions, it exercised its power to define the contours of residual income (where we saw in Chapter 6 that the very vagueness of the language permits consideration of external norms) in a way that ensured that the amount was not taxed twice by holding that the recipient need not include the payments in Gross Income. The Court would presumably have come to the same conclusion with respect to child support, if any had been at issue.

Today, *Gould* stands for the proposition that, except to the extent overturned by statute under §§ 71 and 215, explored below, explicit or implicit cash support payments made within the intact or broken family have no income tax consequences for either the payor or the payee. For example, the implicit cash payments from the working spouse to a nonworking spouse in a one-earner household residing in a common law state result in neither deduction for the working spouse nor inclusion by the nonworking spouse under *Gould* if they should file separate returns, regardless of any possible "gift" analysis. Like explicit gifts, however, the amounts are taxed only once within the payor/payee pair.

Viewed this way, the question in the broken family context is not "is it income?" but rather "*whose* income is it?" The income could be taxed to the recipient by requiring the recipient to include it and allowing the payor to deduct it. Conversely, it could be taxed to the payor by allowing the recipient to exclude it and disallowing a deduction for the payor. The government becomes a mere stakeholder in the matter. In other words, inclusion by the payee and deduction by the payor (or, alternatively, exclusion by the payee and nondeduction by the payor) should not be viewed as independent ends in themselves in trying to measure "income" properly for each party as a normative matter but, rather, as merely instrumental means to implement our decision regarding *whose marginal rates* should apply.

With today's comparatively low rates, the answer may not be obvious. In 1942, however, a practical problem arose with the *Gould* resolution to this question. Recall from Chapter 3 that the top individual marginal income tax rate rose to 94% during WWII to fund the war effort (on incomes exceeding $200,000, or nearly $3 million in today's dollars). With the significant increase in rates, Congress voiced concern that a payor of alimony would have little left on which to live once he (and it was always a "he" in this era) paid his alimony and then tax on his Taxable Income—*including* the alimony payment. Thus, Congress reversed the *Gould* rule by statute in 1942, requiring the recipient to include alimony and creating a new deduction for the alimony payor. But Congress drew the line at payments "fixed" for child support in the divorce instrument, which remained tax-neutral payments. In this way, the statute explicitly blessed income shifting from the payor's (presumably higher) tax bracket to the recipient's (presumably lower) tax bracket with respect to alimony but not child support.

The legislative history is silent regarding why child support was carved out of the new income-shifting rules, but we can guess at the rationale. In this more traditional era—when it was, indeed, only husbands who paid alimony and child support—it might have been thought that shifting the tax obligation with respect to alimony would be sufficient to alleviate the immediate and practical problem of a husband being unable to satisfy both his alimony and income tax liability if alimony were not deductible. A man's financial obligation to his children—including the obligation to pay the income tax on amounts spent to support them—might have been considered to be stronger than that to his ex-wife.

In addition to carving out child support in 1942, Congress attempted to ensure that cash property settlements did not qualify for the new income-shifting regime by requiring that, to be eligible for the inclusion/deduction scheme, payments must be "periodic" and must discharge a legal obligation imposed on the payor because of the marital relationship. These last two requirements were thought to ensure that the payments had the flavor of continuing "support" paid out of future-earned income of the payor, as opposed to the splitting up of past (saved) income of the marital unit (a property settlement). But these requirements were difficult to administer, and Congress simplified the law in 1984 by enacting the current versions of §§ 71 and 215. Nevertheless, the requirements now found in § 71(b) that must be satisfied in order for the payment to be includable by the payee and deductible by the payor under § 215 continue to ensure that the payments have a support-like flavor. We can call such payments "tax alimony." What are those requirements?

- Under the language in § 71(b) preceding subparagraph (1), the payment must be in *cash* to qualify as tax alimony. Thus, the receipt of property in kind cannot qualify.
- Under § 71(b)(1)(A), the cash payment must be received "by (or on behalf of)" the recipient spouse under the terms of a "divorce or separation instrument," as defined in § 71(b)(2).
- Under § 71(b)(1)(B), the payment must *not* be designated by the parties in the divorce or separation instrument as one that is excludable by the payee and nondeductible by the payor. Notice that, in this way, the parties are empowered to *opt out* of the inclusion/deduction scheme for payments that otherwise satisfy § 71(b) if they so wish.
- Under § 71(b)(1)(C), the parties must not be living in the same household at the time of payment. The concern here was avoidance of the income-shifting constraints imposed on the intact family (studied in the last chapter) by a couple choosing to divorce but then continuing on as though nothing happened, simply in order to take advantage of the income-shifting rules in §§ 71 and 215.
- Under § 71(b)(1)(D)—a requirement that generates the most litigation—there must be no liability to make the payment (or a substitute payment) if the payee spouse should die before payment is received. A payment liability that survives the payee spouse's death, allowing the decedent's estate to collect, looks much more like a property settlement to which the spouse was entitled than an amount intended to purchase food, housing, clothing, *etc.*, for the payee spouse. To be blunt, a dead spouse obviously does not need continuing support payments. It looks like a property settlement dressed up to look like support.
- Under § 71(c)(1), the payment must not be one that is "fixed" as child support in the divorce or separation instrument—another heavily litigated requirement.

Any payment that does not satisfy *each and every one* of these requirements is a tax-neutral payment under *Gould*, neither includable by the payee nor deductible by the payor. Any payment that satisfies these requirements is includable by the payee under §§ 61(a)(8) and 71(a) and deductible by the payor under § 215,[2] regardless of what the payment may be called for state law purposes. Thus, a cash property settlement in substance can fit within the inclusion/deduction scheme so long as the payments satisfy the form requirements listed above.

Notice that there is no requirement that the payment satisfy any state law definition of

[2] The § 215 alimony deduction is not an Itemized Deduction but rather an Above-the-Line Deduction under § 62(a)(10). Thus, a payor taking the Standard Deduction is not deprived of the alimony deduction.

"alimony." Indeed, many state laws have abandoned such terms in favor of "equitable distribution," "equitable apportionment," and similar language. Moreover, just because a payment *does* satisfy the definition of "alimony" for *state law purposes* does not mean that it automatically qualifies for the inclusion/deduction scheme under §§ 71 and 215, even though it is clear from a reading of the litigated cases that a significant number of divorcing couples (and even their counsel) *think* that this is true. For example, *Pettet v. U.S.*[3] recites:

> Don … testified that he was unfamiliar with the Federal tax law requirements of 26 U.S.C. § 71(b)(1). His attorney, Mr. Davis, testified that he too was unfamiliar with the requirements of this tax provision including the termination at death requirement. Don's accountant, Mr. Thomas May, testified that during the negotiation of the Agreement he advised Rosa and Don of the tax consequences of paying and receiving alimony, *i.e.*, that it was includable as income for Rosa and deductible for Don. But he testified that he was unfamiliar with the termination at death requirement of 26 U.S.C. § 71(b)(1) and advised the parties on the tax consequences of alimony according to Don's characterization of the payments as "alimony."
>
> The court finds that use of the term alimony … is insufficient to prove the parties' intentions that the payments terminate at Rosa's death. That Don intended the payments to be "alimony" or even intended them to be deductible from his income does not demonstrate that *both* he and Rosa intended the mortgage portion of the … payments to terminate upon her death.

Congress imposed uniform requirements for the inclusion/deduction scheme in 1984—ignoring state definitions (if any) of "alimony," "property settlements," and "child support"—because of the belief that divorcing couples should be treated the same for Federal income tax purposes on making similar payments, no matter where they happened to live. This laudable goal is cold comfort, however, for those couples who have their economic bargains (arrived at after taking the assumed tax consequences into account) upset after the fact when they discover that they have tripped over a rule of which they were unaware, particularly the stop-at-death rule.

In the 1984 statute, the divorce or separation instrument had to expressly state that the payments would stop at death to qualify as tax alimony. Congress deleted this language (though not the requirement) just two years later, in 1986, so that payments that would stop at death by operation of state law would satisfy the stop-at-death requirement, even if the divorce or separation instrument was silent on the matter. Thus, if the parties (or a state judge) fail to stipulate in the divorce agreement whether the liability to make a described cash payment would survive the recipient spouse's death—a not uncommon occurrence—the Federal judge in the ensuing tax litigation must explore the underlying state law in an attempt to glean whether state law *would have* required the payment at issue to be made after the death of the payee's spouse. These are entirely hypothetical inquiries because both spouses remain living and are simply trying to determine whether the payment is a tax-neutral one or includable by the payee and deductible by the payor! Is this a sound way to figure out whose marginal rates should apply to the cash payment?

A common example in the litigated cases is the payment by one spouse of the other spouse's attorney fees in the divorce. A family court judge will order the payment (or the spouses will agree

[3] 97-2 U.S.T.C. ¶ 50,948 (E.D.N.C. 1997).

in their divorce agreement that one spouse should pay the other spouse's attorney fees), but the order or agreement is typically silent regarding whether the payor spouse's obligation to make the payment would be voided if the payee spouse should happen to die between the time the order is entered or the agreement is executed and the payment is made. The judge adjudicating the resulting tax controversy must immerse himself in the intricacies of often ambiguous state law regarding whether the payor spouse's obligation would survive the death of the payee spouse (or whether the payee spouse's estate would have to pay the attorney fees at issue, instead).

For example, in *Smith v. Commissioner*,[4] the Georgia Superior Court ordered Lawrence Smith to pay $25,000 in attorneys' fees and costs incurred by Connie Page Smith in connection with their divorce. The order was (not surprisingly) silent regarding whether Mr. Smith's obligation would disappear should Ms. Smith die before she received the payment. Mr. Smith deducted the payment, but the Tax Court, after an examination of state law, concluded that Georgia law would not have absolved Mr. Smith of the payment obligation if Ms. Smith had died during that interim. The Tax Court stated:

> While it seems somewhat peculiar to discuss payment of fees made to a former spouse's attorneys for services in terms of alimony or separate maintenance payments, section 71(b) does not differentiate as to the reasons for the payment….
>
> Petitioner contends … that the focus of section 71(b)(1)(D) is whether "the payment was for a period which could not end after [the spouse's] death," rather than whether the liability could survive the death of the spouse. We do not agree…. It may be that under Georgia law, which controls here, the liability for support or alimony payments would be extinguished by the payee's death, but the liability here was for attorneys' fees. Petitioner points us to no authority, and we have discovered none, that such a debt would be extinguished by the wife's death.[5]

The Tax Court came to a similar conclusion in *Ribera v. Commissioner*,[6] *Zinsmeister v. Commissioner*,[7] and *Berry v. Commissioner*[8] but only after exploring ambiguous state law regarding whether the payment obligation would have survived the death of the payee spouse.

Coming to precisely the opposite conclusion is *Burkes v. Commissioner*,[9] in which the divorce decree required Mr. Burkes to pay $60,000 to his ex-wife's attorneys for their work in connection with the divorce. The provision stated: "[Mr. Burkes] shall pay to … [Mrs. Burkes] the sum of $60,000.00 as additional alimony toward attorney fees, for which sum judgment is rendered and execution may issue."[10] Once again, the document was silent regarding whether the obligation to pay would disappear if Ms. Burkes died in the short period between the entering of the divorce decree and the payment to the attorneys. Looking to Ohio law, the Tax Court concluded that the term "alimony" can comprise both support payments and property settlements. Alimony constituting support payments stop by reason of the death of the payee under Ohio law; alimony constituting property settlement payments does not. Therefore, the Tax Court had to determine

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[4] T.C. Memo. 1998-166.
[5] *Id*.
[6] T.C. Memo. 1997-38.
[7] T.C. Memo. 2000-364.
[8] T.C. Memo. 2000-373.
[9] T.C. Memo. 1998-61.
[10] *Id*.

whether the term "alimony" was used here in its "support" sense or in its "property settlement" sense under Ohio law, and it concluded that the payment constituted support, the obligation for which would end on the payee's death. Therefore, the payment of the attorneys' fees constituted deductible alimony for Mr. Burkes, unlike in *Smith*, *Ribera*, *Zinsmeister*, and *Berry*.

Other examples include an order for one spouse to pay the other spouse's health insurance premiums and even car repair expenses.[11] Whether the payment qualifies as tax alimony will depend on the Federal judge's parsing of state law regarding whether the obligation to make the payment would have survived the payee spouse's purely hypothetical death. Quite odd!

Going further, how do we determine if an amount is "fixed" in the divorce or separation instrument as child support within the meaning of § 71(c) and thus is excludable by the recipient and nondeductible by the payor? What if no amount is expressly "fixed" as child support but the payor's "alimony" obligation is explicitly reduced in a designated year that happens to coincide with a child reaching, say, age 21? *See* § 71(c)(2).

Alternatively, suppose that a state family court judge orders a stream of unallocated "family support payments" that implicitly encompasses both spousal and child support elements. Every state has published child support guidelines that provide how much child support should generally be ordered for various family sizes of varying incomes. Can the recipient of an unallocated "family support" payment argue that the entire payment is "fixed" as child support within the meaning of § 71(c)(1)—and is thus excludable—if it does not exceed the amount prescribed in the state child support guidelines? Does *no* part of the payment qualify as child support? Notice that § 71(c)(1) provides that the "*the terms of the divorce or separation instrument*" must "fix" the amount that constitutes child support. Courts have read this language literally.

In *Simpson v. Commissioner*,[12] for example, a Pennsylvania family court issued an order requiring Mr. Simpson to pay a monthly unallocated family support payment of $718 to Ms. Simpson for the support of herself and their minor children. Ms. Simpson argued that the entire payment constituted child support because the Pennsylvania child support guidelines would require a monthly payment of $789, which exceeded the unallocated family support payment. The Tax Court, however, concluded that such inferences are not permissible in determining whether any amount is "fixed" as child support *in the divorce or separation instrument* for Federal income tax purposes.

> The language of section 71(c)(1) is clear that for payments to be child support, the written divorce instrument by its terms must fix a sum which is payable as child support. It is inappropriate, in light of this clear statutory language, to look beyond the written instrument to examine what effects, if any, are made by operation of State law.
>
> If Congress had intended for us to look beyond the written instrument, it would have amended section 71(c)(1) to so reflect…. We conclude, therefore, that because the court order does not specifically fix a portion of the $718 monthly payment as child support, the entire amount of such payments received by petitioner in 1994

[11] *See, e.g.*, Barrett v. U.S., 74 F.3d 661 (5th Cir. 1996) (medical insurance policy); Preston v. Comm'r, 209 F.3d 1281 (11th Cir. 2000) (car repair expenses).
[12] T.C. Memo. 1999-251.

and 1995 is alimony and includable in income.[13]

Ditto in *Lawton v. Commissioner*,[14] where the Tax Court confirmed that "[e]ven assuming, for the sake of argument, that a simple reference to the [state child support guidelines] grid would produce an accurate figure for what portion of the amounts she received was for child support, petitioner has not satisfied the requirements of section 71(c)(1). The amount of child support must be fixed by the terms of the instrument."

Finally, the presence of § 71(f) adds to the notion that the § 71(b) payments that are includable by the recipient and deductible by the payor should have the flavor of "support" rather than "property settlement," even though those words are never used in § 71(b). The idea behind § 71(f) is that divorcing spouses attempting to disguise a tax-neutral cash property settlement as includable/deductible tax alimony would frontload the payments because of the stop-at-death requirement. If the cash payments otherwise satisfying the requirements of § 71(b) are excessively front-loaded, the statute essentially presumes that a portion of the front-loaded payments are actually disguised property settlements masquerading as includable/deductible support payments. The statute does not, however, deny inclusion by the payee and deduction by the payor of the payments in the year made. Rather, the statute creates a phantom offsetting *deduction by the payee* and *inclusion by the payor* in Year 3 to, in effect, counteract the economic effects of the prior- and current-year inclusions by the payee and deductions by the payor of the payments actually made.

To be specific, § 71(f)(1) creates a *deduction for the payee* and *Gross Income inclusion for the payor* in the third post-separation year of any "excess alimony payments." Thus, while the payee includes the payments actually received in Years 1, 2, and 3 under § 71(a), the payee's Year-3 deduction under § 71(f)(1)(B) will economically reverse a portion of the current- and prior-year inclusions. Similarly, while the payor deducts the payments actually made in Years 1, 2, and 3 under § 215, the payor's Year-3 Gross Income inclusion under § 71(f)(1)(A) will economically reverse a portion of the current- and prior-year deductions.

For example, assume that Sam and Sheila, who have no children, divorce in Year 1 and maintain separate households thereafter. Under the terms of their divorce agreement, Sam must pay Sheila $100,000 in Year 1, $60,000 in Year 2, and $30,000 in each year thereafter until Sheila either dies or remarries. The agreement does not, under § 71(b)(1)(B), designate any of the payments as excludable by Sheila and nondeductible by Sam. Because these payments satisfy each of the requirements found in § 71(b), Sheila must include in her Gross Income $100,000 in Year 1, $60,000 in Year 2, and $30,000 in Year 3 and every year thereafter. Similarly, Sam deducts $100,000 in Year 1, $60,000 in Year 2, and $30,000 in Year 3 and every year thereafter under § 215(a). In addition to Sheila's $30,000 Year-3 inclusion, however, she also is entitled to *deduct* the $62,500 "excess alimony payment" in Year 3. Similarly, in addition to Sam's $30,000 Year-3 deduction, he must *include* in Gross Income the $62,500 "excess alimony payment" in his Year-3 Gross Income.

How did we arrive at $62,500 as the "excess alimony payment"? Under § 71(f)(2), the "excess alimony payment" is the sum of "the excess payments for the 1st post-separation year" and "the excess payments for the 2nd post-separation year." Because we need the number computed for the 2nd post-separation year in order to compute the number for the 1st post-separation year, we start

[13] *Id*.

[14] T.C. Memo. 1999-243; *see also* Gonzales v. Comm'r, T.C. Memo. 1999-332; Ambrose v. Comm'r, T.C. Memo. 1996-128; Heller v. Comm'r, 103 F.3d 138 (9th Cir. 1996).

with § 71(f)(4). Carefully read the formula provided there. After filling in the numbers in our agreement in the appropriate slots, the excess payment for the 2nd post-separation year is $15,000: (A) $60,000 *less* (B) [$30,000 *plus* $15,000]. Now we have the information that we need to apply § 71(f)(3). The excess payment for the 1st post-separation year is equal to $47,500: (A) $100,000 *less* (B) $52,500. To arrive at the $52,500 described in (B), we must start with the average of (I) $60,000 *less* $15,000 (or $45,000) and (II) $30,000. To arrive at the average of two figures, you must add them together and divide by two. Thus, the average of $45,000 and $30,000 is $75,000/2, or $37,500. We must then add $15,000 to this figure under § 71(f)(3)(B)(ii) to reach $52,500. Subtracting this $52,500 from the $100,000 described in § 71(f)(3)(A) leaves $47,500. The "excess alimony payments" within the meaning of § 71(f)(2) is, therefore, $62,500 ($15,000 under § 71(f)(4) *plus* $47,500 under § 71(f)(3)), which is the amount that Sheila (the payee) *deducts* in Year 3 under § 71(f)(1)(B) and that Sam (the payor) *includes* in Year 3 under § 71(f)(1)(A). In that same Year 3, Sheila will include (and Sam will deduct) the $30,000 payment actually made.

Whew!

Is this all worth it? Putting § 71(c) and (f) aside, notice that the parties are expressly permitted to *opt out* of the § 71 inclusion/§ 215 deduction scheme simply by designating the payments under § 71(b)(1)(B) as not includable by the payee and not deductible by the payor, but they are not provided the similar freedom to simply *opt in* to the inclusion/deduction scheme. If they want the cash payment to be includable by the payee and deductible by the payor, they must navigate the minefield of § 71(b), including the stop-at-death requirement in § 71(b)(1)(D), the § 71(c) restriction, and the § 71(f) front-loading rules. Satisfying these formal requirements is crucial.

### *Excerpt from* Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce[15]

Deborah A. Geier

Since we are not dealing, under this pragmatic paradigm, with something as theoretically fundamental as the question of "what is income" but rather dealing only with a pragmatic decision regarding which of two parties should be taxed on what is concededly income to *someone*, the main concerns should be what side effects—good and bad—would result from our decision regarding whom to tax.

Since all cash payments incident to divorce will be taxed to one or the other spouse, the Federal government is a mere stakeholder regarding the issue of whether a cash payment is includable/deductible or excludable/nondeductible. Only the rate-bracket differential between the parties (if any) can result in a revenue loss, and this loss is self-limiting, as the greater the amount paid to the lower-bracket payee in the includable/deductible system, the higher the tax bracket that will apply to it, until further income-shifting would not produce a revenue loss. Moreover, in the context of a payor in a significantly higher tax bracket than the payee in the includable/deductible system—which is the very context that would appear to result in the most lost revenue—any revenue loss is more illusory than real because of the loss of the marriage bonus [Ed. Note:

[15] Deborah A. Geier, *Simplifying and Rationalizing the Federal Income Tax Law Applicable to Transfers in Divorce*, 55 TAX LAW. 363, 431-39 (2002); *earlier version at* JOINT COMMITTEE ON TAXATION, STUDY OF THE OVERALL STATE OF THE FEDERAL TAX SYSTEM AND RECOMMENDATIONS FOR SIMPLIFICATION, JCS-3-01, VOLUME III (ACADEMIC PAPERS), April, 2001, at 19.

described in Chapter 8 in the context of a high-income spouse with a low-income or no-income spouse] which occurs on the divorce.

Since little revenue is at stake, the parties should be given full power to decide who, between them, should be taxed on all cash transfers incident to divorce. Well-advised taxpayers already have a great deal of power to decide who is taxed, but the power can be implemented only by choosing the correct transactional form for the payment stream. Transactional elections … are not appropriate in the world of divorce, a common transaction not engaged in for tax reasons, often by people not well informed of the effective elections available to them by choosing the correct form. Rather than hiding the effective elections, the elections should be made explicit, with simple default rules for those taxpayers who fail to address the issue in their divorce instrument.

An explicit election is preferable to trying to further distinguish, for Federal tax purposes, among alimony, child support, and property settlements. Without exception, the difficulties described … in the litigated cases stem from trying to properly characterize the cash payment as "alimony," "child support," or "property settlement" for Federal income tax purposes …. But as illustrated by the litigated cases, these payments are nearly impossible to distinguish on any consistent basis.

As indicated by the child support guideline controversy …, child support can still fairly easily be cast as alimony if the right form is used. Cash property settlements are also not easy to identify. The underlying assumption of current law is that cash property settlements can, in fact, be differentiated from support payments on a consistent basis and that the "stop-at-death" rule, coupled with the recapture rule in the case of front-loaded payments, serves to adequately police that line. Both contentions are dubious, at best, and reflect outdated notions that family law is increasingly abandoning. With respect to the recapture rule, for example, property settlements may be paid over several years in level payments. Only the constraints of the tax law require the parties to maintain contact for at least three years in order that the status of their "alimony" arrangement be respected as such….

Moreover, the "stop-at-death" rule serves only to require judges to delve, once again, into state law to try to determine whether any part of an unallocated payment stream *might* stop automatically if the payee should die, an actuarially unlikely event that the parties never addressed in their agreements…. And it results in many payments that are clearly not property settlements—such as the payment of attorney fees, medical expenses, and auto repair expenses—to be so characterized….

For all of these reasons, the statute should not attempt to identify those payments eligible for the inclusion/deduction system by reference to whether or not they fall into a particular category. Moreover, Congress should also reject treating all cash payments either under a rigid exclusion/nondeduction system or rigid inclusion/deduction system in the name of simplification. A mandatory exclusion/nondeduction system for all cash payments is not wise for the following reasons.

First, mandatory exclusion/nondeduction for all cash payments would likely increase the aggregate tax burden on divorcing couples, since the couple in different tax brackets (where substantial cash payments are more likely) would lose their marriage bonus at the same time that more of the couple's income would be taxed at the payor's higher marginal rate bracket under the schedule for single filers. Divorce is usually accompanied by financial hardship (and triples the chances of bankruptcy). Therefore, Congress should avoid adopting what would amount to a

mandatory divorce tax "penalty" in many cases.

Second, a mandatory exclusion/nondeduction rule would also introduce a disparity between less wealthy couples, where support payments must come from future wages of the payor, and wealthy couples, who could still engage in significant income-shifting by transferring income-producing assets to the payee to fund support…. It would also be inconsistent with the income-shifting allowed under I.R.C. § 1041, … so there would be a new and dramatic difference between the two areas, whereas both now contemplate income shifting.

Third, a rigid exclusion/nondeduction rule would decrease flexibility in settling other matters in the divorce, with the likelihood of increasing the number of cases that go to full contest in state court.

Fourth (and perhaps most important), when the payor is in a higher tax bracket, a mandatory exclusion/nondeduction system would erase the current-law bias that encourages the payor to make larger payments than he or she would otherwise make and that leaves the payee with more after-tax cash than he or she would otherwise have under an exclusion/nondeduction system.

For example, assume that John and Mary, who have one minor child, age 12, are divorcing. The child will live primarily with Mary, with generous visitation to John. Without taking into consideration the following cash transfers, John, if single, would be in the 36% bracket, and Mary would be in the 15% bracket. Mary demands $1,000 per month in child support for ten years. John does not object to the figure but suggests that they call the payment a "family support payment," with no amount specifically designated as "child support." They agree that if Mary should die before their child is emancipated (an actuarially unlikely event), John will gain full custody.

The intent is to structure the payments as includable/deductible "tax alimony." Economically, it doesn't matter whether the payment is called "child support" or "family support" or "alimony." "Alimony" sounds mercenary and "child support" sounds benevolent, but otherwise there is no difference; the recipient is typically under no duty to account for how the funds are used.

Mary would reject that offer, since her $1,000 per month would be worth less to her if she must pay tax on it. John then offers $1,200 per month. After Mary's 15% tax ($180), she has $1,020, which is more than she would have under a rigid exclusion/nondeduction system under which John would agree to pay no more than $1,000 per month. John is willing to do this only because his net outlay is reduced from $1,000 to $768 ($1,200 *less* $432 tax savings) because of the deduction. John and Mary effectively save $180 net[248] and share the spoils. (Mary should claim more of the spoils than $20.)

As indicated by the above example, which uses current law, this kind of flexibility is *already* incorporated into the statute, so long as the parties agree that the payments would end on the payee's death and are not excessively front-loaded. Why not make the flexibility explicit? Failing to do so simply rewards the well-advised over the ill-advised. The election is one dependent on knowledgeably structuring the transaction in a certain manner (increasing attorneys' fees and penalizing the ill-informed) rather than one that can be simply made explicit in the divorce agreement.

[248] This figure represents the $360 that John would have paid on that $1,000 per month if they designated it as "not alimony" less the $180 that Mary will pay on that $1,200 per month if they make sure the definition of alimony in I.R.C. § 71 is satisfied.

Moreover, since Mary is in a lower tax bracket than John, it would be defensible to assume (since assumptions are unavoidable) that she is in greater need of the funds than John and that structuring the tax system so that she could end up with more after-tax cash is good policy, particularly since payees after divorce do tend to have a lower standard of living than payors….

That John must be given a deduction to encourage him to provide Mary with more after-tax cash bothers some commentators who just don't like to see the Johns of the world reduce their taxes in this manner. But such a view reverts to a different paradigm—asking whether John, viewed independently, should be able to deduct an amount that is not made in pursuance of income—rather than the more pragmatic paradigm of deciding simply who should be taxed on these payments by looking to the side effects of the various possible decisions. I admit that I like the fact that Mary ends up with more after-tax cash here under the inclusion/deduction system, and the bald fact is that John would not be willing to provide her with more after-tax cash if he weren't better off as well, *i.e.*, if it weren't for the tax savings that he enjoys through the deduction under his higher rate bracket. In short, this side effect is one that tends toward encouraging the higher-income spouse to provide more after-tax income to the lower-income spouse, which might be a good side effect for society in general, at a cost to the fisc that is self-limiting.

Finally, John's deduction would encourage him to satisfy his $1,200 per month payment obligation, rather than renege on his $1,000 per month obligation that he would otherwise agree to under an exclusion/nondeduction system, an all-too-common occurrence in the real world….

Why don't I simply advocate that *all* cash payments fall within the inclusion/deduction system, with no ability on the part of the parties to agree to exclusion/nondeduction? I think that such a system would be less optimum than one preserving the effective flexibility of current law (for the well-advised). First, for parties who will not be in different tax brackets after divorce—which may be the case more often with lower- and middle-income taxpayers who are both in the 15% bracket or both in the 28% bracket—it would be defensible to allow them to decide who should be taxed on these payments simply because no revenue is at stake. The greater flexibility to designate tax responsibility for cash payments can grease the wheels of negotiation with respect to many other matters on the table, such as who gets the car. Parties who *are* in different tax brackets should, if well-advised, not wish to opt out of the inclusion/deduction system in most cases, since *both* can usually be better off (after taxes) under that system, as illustrated in the John/Mary negotiations….

The flexibility allowed to the parties to decide to whom cash payments should be taxed is not the cause of confusion under current law. Rather, as illustrated by the cases discussed above, the confusion under current law arises because the flexibility provided to the parties is dependent on them knowing and understanding the various transactional forms and requirements available to them. It is not necessary to eliminate the flexibility available to the parties under current law in the name of simplification; rather, it is necessary only to allow the parties to exercise their flexibility explicitly, rather than indirectly, by allowing them to designate for themselves the extent to which some or all cash payments incident to divorce should be includable/deductible or excludable/nondeductible.

In such a system, the only remaining issue is which default rule should govern in case of silence or a failure to reach agreement. The default rule should ideally provide the outcome that the parties might have agreed to if they had thought about it, *i.e.*, it should not be counterintuitive or surprising. I believe that the payee likely would not be surprised to find out that cash that he or she receives and controls and spends is includable. But if the payor pays a child's tuition or summer

camp fees directly to a third party, with no control by or direct consumption by the payee, the payee might likely be surprised to find that such a payment is includable (absent a designation otherwise). Thus, I recommend that the default rule should be inclusion/deduction unless the payment is made to a third party on behalf of a child. Such payments should be relatively easy to distinguish. This default rule would step in, however, only in cases in which the parties fail to stipulate how their cash payments should be treated for tax purposes. For example, if the parties so choose, they could agree that payments to a third party on a behalf of a child are includable/deductible payments.

At bottom, the appropriate reform analogy is the 1984 reform to the dependency exemption pertaining to the minor children of divorced spouses. [P]rior to 1984, the spouses often had to engage in protracted litigation to determine who provided the greater amount of support for the children in order to determine who was entitled to the dependency exemptions. While such an approach was surely theoretically defensible, it was impractical when applied to the real world, and it resulted in an overabundance of costly litigation for both the divorced parties and the government, while little, if any, Federal revenue was at stake. The 1984 reform simply assigned a default rule that the custodial parent gets the exemption, in the absence of an agreement by the parties that the non-custodial parent should get it.[16] In that way, the parties could negotiate between themselves who would get the dependency exemption. This resolution might not be theoretically pure, but it was an absolutely defensible simplification that should provide the ready touchstone for simplification of the tax consequences of cash transfers in divorce.

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The Tax Court agrees that a "family support" payment (or an unallocated payment for the support of both the ex-spouse and children) does not trigger § 71(c)(1) because no amount is "fixed" specifically as child support in the agreement.[17]

As described in the excerpt, the divorcing parties (and their counsel) should consider the *after-tax cost* of the payments to the payor (the pre-tax payment *less* tax saved) and *the after-tax benefit* of the receipts to the payee (the pre-tax payment *less* tax owed) when negotiating a cash payment stream. This analysis is where your appreciation of the marginal rate concept, explored in Part B. of Chapter 1, becomes valuable. If the parties work together, those in different tax brackets can often *both* be better off with includable/deductible payments than with excludable/nondeductible payments. Nevertheless, the ability to memorialize their agreement in a way that will produce the expected tax outcomes is hampered by the forms required in § 71(b) and (c).

The recommendations described above were made in the context of a study ordered by Congress and undertaken by the Joint Committee on Taxation concerning tax simplification. The recommendations have not (yet?) found their way into the statute. Thus, great care must be taken to avoid the traps for the unwary embedded in §§ 71 and 215, and the parties should draft their

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[16] *See* §§ 152(e)(1) and (2).

[17] *See, e.g.*, Crabtree v. Comm'r, T.C. Memo. 2015-163. The parties, who had two minor children, drafted their divorce instrument themselves, which the court entered as an order. It contained 13 paragraphs, one of which required the ex-husband to pay $5,232 monthly to his ex-wife as unallocated alimony/child support "for a continued 8 year period with the provision as long as Mrs. Girard should not remarry or cohabitate." The Tax Court agreed that no amount was fixed for child support, but they neglected to satisfy the stop-at-death requirement! Thus, the payments were nevertheless tax neutral payments (not includable by the payee and not deductible by the payor).

divorce or separation instruments with precision.[18]

The excerpt stresses the parties' ability to *opt out* of the inclusion/deduction scheme under § 71(b)(1)(B) in their divorce agreement as one means available to them to decide for themselves the after-tax consequences of cash payments otherwise satisfying the § 71(b) definition of tax alimony. Can the parties be *forced* to opt out under the order of a state judge? Would that be a wise interpretation of the statutory language in view of the concerns expressed in the excerpt?

## TUCKER v. COMMISSIONER

T.C. Summary Opinion 2013-94

DEAN, SPECIAL TRIAL JUDGE: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

Respondent determined a deficiency of $10,425 in petitioner's 2010 Federal income tax and disallowed, in part, a claimed deduction for payments made on behalf of Darlene Wilmoth-Tucker (Ms. Wilmoth). The remaining issue for decision is whether the payments petitioner made in 2010 on behalf of Ms.Wilmoth are properly deductible as alimony payments under section 215.

Background

Petitioner and Ms. Wilmoth were married on May 25, 1985. The parties separated in 2004, and Ms. Wilmoth later initiated divorce proceedings. In April 2009 the court (trial court) exercising jurisdiction over petitioner's divorce proceedings issued a memorandum (memorandum) identifying and distributing the marital estate and awarding support. With respect to child and spousal support, the trial court ordered petitioner to pay Ms. Wilmoth $2,414 per month. The trial court further ordered petitioner "to provide for Mrs. Tucker's health insurance in the amount of $1,400 per month."

In August 2009 the trial court issued the final divorce decree (final decree) and affirmed, ratified and incorporated by reference its own memorandum, ordering that

> [U]pon entry of the Final Decree of divorce, * * * [husband] shall pay to * * * [wife] the sum of $1,400 per month in addition to spousal support to assist * * * [wife] in paying health insurance premiums. <u>This is not in the nature of spousal support and shall not be taxable to * * * [wife] nor deductible to * * * [husband] for income tax purposes.</u>

[Emphasis added].

Petitioner appealed the trial court's order in the final decree, in pertinent part, because of the language characterizing the health insurance premium payments as not in the nature of spousal support. Petitioner alleged that the trial court lacked the authority to order him to make health insurance premium payments that were "not in the nature of spousal support" and that the trial court failed to properly characterize the payments as either a distribution of property or in the

[18] Wealthy divorcing parties may use a so-called alimony trust to arrange payments. The ins and outs of alimony trusts are beyond the scope of this introductory textbook, but those interested in reading more should see Katrina Vitale, *Revisiting the Tax Consequences of the Alimony Trust*, 152 TAX NOTES 1461 (2016).

nature of spousal support. Upon appeal, the Court of Appeals of Virginia (appeals court) determined that "the trial court did not err upon inclusion of the phrase 'not in the nature of spousal support'" in the final decree. The appeals court explained in an analogous case that although health insurance premium payments may be labeled as spousal support for bankruptcy purposes (and may be "labeled" as such in a separation agreement or divorce decree), a court may also simultaneously characterize these payments as "not in the nature of spousal support" for income tax purposes only. *Stacy v. Stacy*, 669 S.E.2d 348 (Va. Ct. App. 2007).

The appeals court went on to explain the rationale for the simultaneous yet contradictory characterization for a payment. A Virginia State court may designate a payment as "in the nature of spousal support" to prevent, for example, a discharge of such an obligation in bankruptcy proceedings. However, the court may also designate the same payment as "not in the nature of spousal support" for income tax purposes, thereby limiting the payor spouse's ability to claim a deduction for the payment. The appeals court concluded that it would not decide whether the language in the final decree was sufficient to avoid potential tax consequences but that it seemed apparent that the language was included for that purpose. The appeals court then found that the health insurance premium payments were in the nature of spousal support and upheld the trial court's characterization of the payments as nondeductible by the husband and not includible in income by the wife.

The appeals court affirmed the trial court's order in the final decree regarding the health insurance premium payments and reversed and remanded on other issues. The trial court on remand issued a final order affirming its language in the final decree, stating that "the order for health insurance payments to the plaintiff from the defendant in the sum of $1,400.00 per month as set forth on page 4 of the final decree is affirmed and said order shall continue in full force and effect." The trial court's final order retained the original language in the final decree which specified that the health insurance premium payments were "not in the nature of spousal support and shall not be taxable to *** [wife] nor deductible to *** [husband] for income tax purposes."

For the 2010 tax year petitioner paid $16,632 in health insurance premiums on behalf of Ms. Tucker.[3] On his 2010 Federal income tax return petitioner claimed a deduction for "alimony paid" on behalf of Ms. Tucker for her health insurance premiums. In a notice of deficiency dated July 2, 2012, respondent disallowed petitioner's claimed deduction for the health insurance premium payments.

The parties agree that petitioner and Ms. Wilmoth lived in separate households at all relevant times and that the obligation to make payments to Ms. Wilmoth will automatically terminate upon her death. In addition, petitioner's obligation to make health insurance premium payments on behalf of Ms. Wilmoth is provided for in a divorce or separation instrument. Respondent contends that because the final decree specifies that the health insurance premium payments are "not in the nature of spousal support," such payments are nondeductible by petitioner and not includible in income for Ms. Wilmoth.

Discussion

[3] Respondent notes that the $16,632 disallowed in the notice of deficiency is not representative of the 12 monthly health insurance premium payments of $1,400 petitioner made because 12 multiplied by $1,400 equals $16,800. Respondent disallowed $16,632 because it was the difference between what was allowed ($29,968) as an alimony deduction and the total amount petitioner claimed on his 2010 Federal income tax return ($45,600).

Section 215(a) allows a deduction for alimony paid during the payor's taxable year. Section 215(b) defines alimony or separate maintenance as any "payment (as defined in section 71(b)) which is includible in the gross income of the recipient under section 71." Section 71(b) provides a four-step inquiry for determining whether a cash payment is alimony…. Payments are deductible as alimony only if all four requirements of section 71(b)(1) are met.

Section 71 was originally enacted to provide a uniform definition of alimony so that alimony payments could be distinguished from property settlements, which receive different tax treatment. H.R. Rept. No. 98-432 (Part 2), at 1495 (1984), 1984 U.S.C.C.A.N. 697, 1137; *see also Kean v. Comm'r*, 407 F.3d 186, 189 (3d Cir. 2005), aff'g T.C. Memo. 1995-183. Congress specifically intended to eliminate the subjective inquiries into intent and the nature of payments that had plagued the courts in favor of a simpler, more objective test. *Hoover v. Comm'r*, 102 F.3d 842, 845 (6th Cir. 1996), aff'g T.C. Memo. 1995-183.

The parties are in agreement that petitioner's payments were made pursuant to a divorce or separation instrument, that petitioner and his former wife were not members of the same household during the year at issue, and that the obligation to make the payments will not survive the death of the payee spouse. The parties disagree, however, as to whether the divorce or separation instrument designates the payments as not includible in gross income for the payee and not allowable as a deduction for the payor.

Petitioner acknowledges that caselaw does not allow a deduction for payments made to a former spouse if the instrument ordering such payments specifies that the payments are nondeductible by the payor spouse. Petitioner contends that even though the final decree characterizes the payments as nondeductible by the payor spouse, the spouses themselves must first intend such a designation. Petitioner cites section 1.71-1T(b), Q&A-8, Temporary Income Tax Regs., 49 Fed. Reg. 34455 (Aug. 31, 1984), in support of his proposition that the spouses must intend such a designation.

Section 1.71-1T(b), Q&A-8, Temporary Income Tax Regs., *supra*, provides that "spouses may designate that payments otherwise qualifying as alimony or separate maintenance payments shall be nondeductible by the payor and excludible from gross income by the payee by so providing in a divorce or separation instrument." Petitioner emphasizes that the phrase "spouses may designate" (emphasis added) demonstrates that the trial court lacked the authority to include such language without the consent of the parties. Petitioner further alleges that despite the "income tax" language in the final decree, the trial court had not contemplated an income tax designation for these payments. Accordingly, petitioner urges this Court to look beyond the four corners of the final decree to determine whether the parties intended to include language characterizing the health insurance premium payments as nondeductible by the payor and not includible in income by the payee.

Petitioner's argument that the regulations constrain a trial court's ability to characterize such a payment as nondeductible and excludible from income is without merit. Section 1.71-1T(b), Q&A-8, Temporary Income Tax Regs., *supra*, provides that the parties to a separation may agree that payments in the form of alimony are nondeductible by the payor and not includible in income by the payee. The regulations allow for parties to agree but do not provide spouses with complete authority to define such payments in a State court matter. Furthermore, the regulations do not contemplate or regulate the ability of a State trial court, in its discretion, to designate a payment as alimony, as child support, or as an equitable division of property under State law. The appeals court recognized that the trial court had broad discretion in characterizing the payments made

pursuant to the separation instrument, and the trial court used its discretion in characterizing the payments as nondeductible by petitioner and not includible in income by Ms. Wilmoth. On remand, the trial court specifically affirmed, in full force and effect, its characterization in the final decree regarding the health insurance premium payments. Finally, section 71(b) provides a uniform definition of alimony, and this Court will not revert to the inquiry that courts wrestled with before the enactment of section 71(b) by looking to the intent of the parties in determining whether health insurance premium payments are in the nature of spousal support.

As discussed above, section 71 requires, as one of the conditions to qualify as alimony, that the divorce instrument not designate a payment as not includible in gross income and not allowable as a deduction under section 215. The final decree is conclusive in characterizing the health insurance premium payments as nondeductible by the payor spouse and not includible in income by the payee spouse, thus excluding the payments from the definition of alimony pursuant to section 71(b)(1)(B). The health insurance premium payments are not alimony under section 71(b) and are, therefore, not deductible by petitioner.

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A state judge clearly has the power to "fix" a payment as "child support" in the divorce instrument, thus triggering § 71(c) and rendering a payment excludable/nondeductible. Does the statute indicate an intent to empower state judges to go further and simply declare that payments otherwise satisfying § 71(b) are (or are not) includable/deductible for Federal income tax purposes? Notice that the taxpayer lost his ability to appeal this decision to a U.S. Circuit Court of Appeals by electing to litigate under § 7463. The appellate court referred to in the decision was a state appeals court having jurisdiction over the state family law matters but having no authority to decide Federal income tax controversies.

## Problems

**1.** Tom and Katie, who have one minor child, are divorcing, and Katie will have primary custody of their daughter. Tom will be in the 39.6% tax bracket when he files as an individual. Aside from the tax consequences of any cash payments that they negotiate as part of their divorce settlement, Katie expects to have Taxable Income (Gross Income *less* deductions) of about $90,000, which will place any additional marginal dollars that she includes in the 28% tax bracket. Katie has not requested alimony, but she has demanded $50,000 each year as child support until their minor daughter reaches age 18, dies, or marries, whichever occurs first. Student A represents Tom. Student B represents Katie. You must meet, negotiate the terms of the cash payments to be incorporated into the divorce agreement, and report back to the class the final result of your negotiations and how you both arrived at those terms.

**2.** Janice and Kathleen divorce, and their divorce agreement requires that Janice pay the rent for Kathleen's apartment directly to her landlord for five years or until her earlier death or remarriage. Do the rental payments satisfy the definition of tax alimony? *See* Treas. Reg. § 1.71-1T(b), Q&A 6.

**3.** Arnold and Maria, who have two minor children, are divorcing. Maria will have primary custody of their two children, one of whom will turn 18 in 2018 and the other of whom will turn 18 in 2020. Arnold and Maria's divorce instrument provides for an annual cash payment equal to

$1 million for 10 years or until Maria's earlier death or remarriage. In 2018, however, the $1 million payment will be reduced to $750,000, and in 2020, the payment will be further reduced to $500,000. Maria received the first $1 million this year. Must she include the entire $1 million? *See* § 71(c)(2).

**4.** Kelsey and Camille, who have one minor child, are divorcing. Camille will have primary custody of their child. Their divorce agreement provides that Kelsey will pay $400,000 in alimony annually for five years or until Camille's earlier death or remarriage and $600,000 in child support annually until their child reaches age 18, dies, or marries, whichever occurs first. Kelsey pays only $500,000 of the required $1 million aggregate payment this year. How much can Kelsey deduct? *See* § 71(c)(3).

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Under a "qualified domestic relations order" (QDRO) within the meaning of § 414(p), divorcing couples can negotiate the sharing of one spouse's retirement savings housed in certain eligible qualified defined benefit or qualified defined contribution plans (such as under a §§ 401(k) or 457). Prior to creation of the QDRO in 1984, it was possible to split pension assets in a divorce, but the court order was directed at the spouse with the pension, rather than at the pension plan itself. For example, John might have been ordered by the court to pay one-half of his monthly pension payments to Mary when he begins to receive them—perhaps twenty years in the future. If John died before retirement, Mary received nothing. Under § 414(p), in contrast, the pension plan administrator is the subject of the order, and Mary receives vested rights. In other words, the administrator is ordered to treat Mary just as if she were a plan participant. While the primary purpose of the QDRO was to recognize these pension assignments and to protect Mary's interest in the plan, even if John should predecease Mary, the provisions also ensure that Mary, as the "alternate payee" under a QDRO, includes the payments in Gross Income when ultimately paid under the plan, not John. In other words, a QDRO enables just the kind of income-shifting contemplated by §§ 71 and 215.

While QDROs cannot apply to individual retirement accounts (IRAs) § 408(d)(6) provides similar treatment for IRA transfers in divorce.

## B. Transfers of property in kind

You have already learned that a transfer of property in kind cannot qualify for the inclusion/deduction scheme in §§ 71 and 215 because of the requirement in § 71(b) that such transfers be made in cash. A second question arises, however, with respect to transfers of property in kind, illustrated by the facts in *Davis v. Commissioner*.[19] In that case, Mr. Davis transferred shares of DuPont stock to his ex-wife as part of their divorce agreement. He had earlier purchased the shares for $75,000, and they were worth $82,250 when he transferred them to Mrs. Davis. In exchange, Mrs. Davis released Mr. Davis from all state law claims, including dower rights and any rights that she may have had under the laws of testacy and intestacy. Mr. Davis did not include the $7,250 built-in gain in his Gross Income in the year of transfer.

While you learned in Chapter 7 that the making of a gift is not a realization event under § 1001,

[19] 370 U.S. 65 (1962).

you also know that transfers in divorce cannot satisfy the *Duberstein* test because the transfer is made under legal compulsion rather than detached and disinterested generosity. Moreover, the transfer of property in settlement of a debt *is* a realization event.[20] Thus, if Mary borrows $4,000 from John and repays her debt to him by transferring property with a value of $4,000 and basis of $3,000, Mary realizes and recognizes a § 1001 gain of $1,000.

The *Davis* Court applied this unexceptional marketplace rule, assumed that the value of the release of the marital rights equaled the value of the stock, concluded that Mr. Davis realized a § 1001 gain of $7,250 on the transfer, and concluded that Mrs. Davis took a cost basis of $82,250 in the property under § 1012. The Court noted in a footnote the "administrative practice" of not taxing Mrs. Davis on the release of marital rights, which presumably have a zero basis.[21]

Had Mrs. Davis possessed some sort of ownership interest in the stock at the time of the divorce, as in a community property state, the outcome would likely have been different, as a division of jointly owned property was not usually considered to be a realization event. The Court acknowledged, but apparently was not overly troubled by, the disparities that its decision would create between residents of community property states and residents of common law states.

The post-*Davis* era was one of confusion and uncertainty and certainly one full of traps for the unwary. The government conceded that approximately equal divisions of community property[22] or property in states where the law is "similar to community property law"[23] were not realization events and that the transferee took a carryover basis in the property. Similarly, the IRS ruled that approximately equal divisions of property owned as joint tenants or as tenants in common were nontaxable divisions of property, even though ownership was not partitioned but, rather, some assets went in their entirety to one spouse and some went in their entirety to the other.[24] Not all transfers in community property states were tax-free events, however. An exchange of separate (nonmarital) property for community property or an unequal division of community property resulted in taxation,[25] as did unequal divisions of jointly owned property in common law states.[26]

This reliance on state law enabled states to enact anti-*Davis* legislation, exemplified by Oregon's statute: "Subsequent to the filing of a petition for annulment or dissolution of marriage or separation, the rights of the parties in the marital assets shall be considered a species of co-ownership and a transfer of marital assets … shall be considered a partition of jointly owned property."[27] The "equitable distribution statutes" of other states were sometimes interpreted to vest a property interest in the transferee in the case of a "special equity" determination. These eleventh-hour vestings of property rights during the course of divorces in common law states most often

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[20] Int'l Freighting Corp. v. Comm'r, 135 F.2d 310 (2d Cir. 1943) (transfer of appreciated property to employee as payment for services rendered is a realization event for transferor).
[21] 370 U.S. at 73, n.7. *See also* Rev. Rul. 67-221, 1967-2 C.B. 63.
[22] Rev. Rul. 76-83, 1976-1 C.B. 213.
[23] Rev. Rul. 74-347, 1974-2 C.B. 26.
[24] Rev. Rul. 81-292, 1981-2 C.B. 158.
[25] *See, e.g.*, Siewart v. Comm'r, 72 T.C. 326 (1979) (receipt by W of noncommunity cash and a personal note of H for transfer of her one-half interest in community property constituted a sale, not a division of community property); Carrieres v. Comm'r, 64 T.C. 959 (1975), *aff'd*, 552 F.2d 1350 (9th Cir. 1977) (*per curiam*) (taxable sale to W to the extent H used his separate property to pay for W's community property interest in stock but no taxable sale with respect to the portion of such stock exchanged for H's interest in other community property).
[26] Rev. Rul. 74-347, 1974-2 C.B. 26.
[27] ORS 107.105(1)(f) (discussed in Laird v. U.S., 16 Cl. Ct. 441 (1989)).

were upheld by the courts as effectively eviscerating *Davis*.[28]

This state of affairs resulted in much confusion and costly litigation, many traps for the unwary, and a variety of results for similarly situated taxpayers, depending on state law. It also resulted in a fair amount of whipsaw for the Federal Treasury, with the transferor spouse claiming a tax-free division of property and the transferee claiming a stepped-up basis under *Davis* on later disposition. In 1984, Congress finally enacted § 1041, which you should read now.

Section 1041(a) is the first "nonrecognition" provision that we have encountered. Had § 1041(a) been in effect in *Davis*, Mr. Davis would not have "recognized" his $7,250 "realized" § 1001 gain, which means that he would not include the § 1001 gain in his Gross Income under § 61(a)(3). Notice, however, that the built-in gain would not have disappeared from the tax system; rather, it would have been preserved for future reckoning in the hands of Mrs. Davis. Under § 1041(b)(1), Mrs. Davis would have excluded the stock received from Mr. Davis as though it were a "gift," and she would have taken a carryover basis in the property under § 1041(b)(2), *i.e.*, the same basis that Mr. Davis had in the stock. Thus, the built-in gain would have been both *deferred* and *shifted* from Mr. Davis's return to Mrs. Davis's return, to be realized and recognized by her when she sold the DuPont stock to a third party. (Of course, if she had held the stock until her death, the preserved built-in gain would then have been wiped out under § 1014.)

Notice that § 1041 is not limited to transfers incident to divorce but also applies to transfers during marriage—whether a true "gift" made out of detached and disinterested generosity or a sale for valuable consideration. Thus, for example, assume that Patti, a lawyer, sells a painting to a stranger for $500 that she had purchased years earlier for $100. Patti's § 1001 realized gain of $400 ($500 A/R *less* $100 A/B) would be recognized (included in her Gross Income under § 61(a)(3)) and would likely contribute to her low-taxed "net capital gain." If, on the other hand, Patti sells the same painting to her husband John, an art dealer, for $500, her $400 realized gain under § 1001 would go unrecognized under § 1041(a), and John would take Patti's $100 basis under § 1041(b)(2). Thus, when he sells the painting to a customer for $500, his $400 realized and recognized gain is ordinary because the painting is an inventory item in his hands. *See* § 1221(a)(1). In short, Patti cannot launder out the low-taxed gain by selling to her husband for valuable consideration, who would then realize no high-taxed ordinary income when he sold to his customer. Rather, he takes the same basis that he would take in the painting if Patti had simply given the painting to him as a gift (§ 1015) instead of selling the painting to him for $500 (§ 1012).

Even in the case of a true gift, however, the § 1041(b)(2) basis rule differs in one important respect from the § 1015 basis rule applicable to *inter vivos* gifts between unmarried individuals: the lower-of-FMV-or-basis rule in § 1015(a) does not apply to gifts between spouses. Rather, § 1041(b)(2) controls, which does not contain such a rule. *See* § 1015(e). Return to Patti's painting, which she had purchased years earlier for $100, but assume now that the painting is worth only $70 today. If John and Patti were siblings instead of spouses, and Patti gave the painting to John as a gift, who then sold it for $60 (because it continued to lose value), John would use the lower $70 FMV of the property at the time of the gift (not Patti's $100 basis) in determining his realized loss, which would be $10 ($60 A/R *less* $70 A/B). Because John and Patti are spouses instead of

[28] *See, e.g.*, Collins v. Comm'r, 421 F.2d 211 (10th Cir. 1969); Imel v. U.S., 523 F.2d 853 (10th Cir. 1975); Cook v. Comm'r, 80 T.C. 513 (1983), *aff'd*, 742 F.2d 1431 (2d Cir. 1984); Boucher v. Comm'r, 710 F.2d 507 (9th Cir. 1983); *Bosch v. U.S.*, 590 F.2d 165 (5th Cir. 1979), *cert. denied*, 444 U.S. 1044 (1980); McIntosh v. Comm'r, 58 T.C. 4 (1986) (applying pre-1984 law); Laird v. U.S., 61 Cl. Ct. 441 (1989) (applying pre-1984 law).

siblings, however, a gift of the property from Patti to John would result in a $100 basis for John under § 1041(b)(2), which means that John realizes a $40 loss under § 1001 when he sells the property for $60 to a customer. In short, § 1015 does not apply to spousal transfers, even in the case of a true "gift." Rather, § 1041 occupies the field.

What tax consequences arise with respect to property transfers that occur *before* marriage under an ante-nuptial agreement, where § 1041 cannot apply? The taxpayer in *Farid-es-Sultaneh v. Commissioner*[29] was a 32-year-old American citizen known as Doris, who executed an ante-nuptial agreement in 1924 with Sebastian S. Kresge, a 57-year-old store magnate[30] with an estimated net worth of $375 million (more than $5 billion in today's dollars). Under the agreement, Doris received 2,500 shares of the S.S. Kresge Company from Sebastian, which were then worth $787,500 (more than $11 million in today's dollars). In consideration for the shares, Doris agreed that she would release all dower and other marital rights, including any support rights to which she would otherwise be entitled upon their marriage. Doris and Sebastian divorced in 1928, and Doris sold the shares in 1938, which raised the issue of her basis in the shares. Even though the ante-nuptial agreement used the word "gift" with respect to the share transfer, the Second Circuit Court of Appeals held that Doris should not take Sebastian's carryover basis under § 1015 but rather should take a § 1012 cost basis of $787,500 (their FMV on her receipt) because the shares were acquired for consideration. Under the modern-day *Duberstein* language that you explored in Chapter 7, the share transfer was not made out of "detached and disinterested generosity" but rather in expectation of the agreement's *quid pro quo*—the surrender of marital rights. Though Sebastian was not a party to the tax case, the natural consequence of this analysis is that he should have realized and recognized a § 1001 gain equal to the excess of the shares' $787,500 value over his (much lower) basis at the time of the 1924 transfer, just as did Mr. Davis. To avoid this recognition today, modern parties to an ante-nuptial agreement usually delay the property transfer until after marriage in order to ensure application of § 1041.

In light of the rules embodied in § 1041, divorcing parties dividing or transferring marital property should not focus solely on splitting up *value* fairly. The parties, if well advised, need to consider the *basis* of each piece of property, as well—unless the property is not going to be sold to third parties in the foreseeable future. An equal split of value can be very unequal *after taxes*, once the built-in gains and built-in losses are considered, especially if the property at issue is business or investment property, rather than personal-use property. Review, for example, § 165(c).

## Problems

**1.** Lori and Luke are planning to divorce. Their stock portfolio contains shares of High Tech, Inc., with a basis of $70,000 and a FMV of $100,000, and shares of Realty, Inc., with a basis of $130,000 and a FMV of $100,000. What tax consequences result if they sell both blocks of stock

[29] 160 F.2d 812 (2d Cir. 1947). For an interesting article that recounts and substantially expands upon the colorful story surrounding this case, as well as explores the interesting procedural and ethical questions for lawyers in such cases, see Linda Galler, *Everything You Always Wanted to Know About Farid But Were Afraid to Ask*, 13 FLA. TAX REV. 461 (2013). Among other interesting tidbits, the article relates that Doris married a Persian prince with the title "Farid-es-Sultaneh" in 1933. Though they divorced in 1936, Doris continued to use the name for the rest of her life (hence the exotic name in the tax proceedings). Sebastian Kresge's third marriage (after his divorce from Doris) lasted more than 35 years until his death at age 99 in 1966. The Kresge Foundation continues to exist today. With more than $3.1 billion in assets, it makes philanthropic grants exceeding $100 million each year in seven areas.

[30] He owned the Kresge five and dime stores and K Mart, among others.

to third parties while still married, split the cash, and then divorce?

**2.** Same as **1.**, except that Lori and Luke agree that Lori will take the shares of High Tech in kind and Luke will take the shares of Realty in kind under their divorce agreement. After the divorce, Lori sells the shares of High Tech for $100,000 to a third party, and Luke sells the shares of Realty for $100,000 to a third party. Who is happy and who is not?

**3.** Same as **1.**, except that Luke suggests that Lori take no property in kind. Instead, Luke suggests that they incorporate into the divorce agreement a requirement that he pay Lori cash payments of $20,000 annually for five years (or until her earlier death). Any advice for Lori?

## C. Unmarried cohabitants and members of an RDP or civil union

### *Unmarried cohabitants with no formal state-sanctioned legal relationship*

Unmarried cohabitants who have no formal legal relationship and who separate households after a long period can enter into contractual arrangements to effectuate the separation. How are cash payments made under such a contract treated for tax purposes? The answer may depend in part on whether state law recognizes an equitable interest in property with respect to the party without formal legal title under the written or oral contract. The most famous example is the case of *Marvin v. Marvin*, involving the actor Lee Marvin and his partner, though his partner was unable to prove such a contract. The case, which brought the colloquialism "palimony" into the lexicon, is cited in footnote 8 in *Reynolds*, below.

**REYNOLDS v. COMMISSIONER**

T.C. Memo. 1999-62

LARO, JUDGE: [Violet Reynolds and Gregg Kent met in 1957 in California, while both were married to others, through business dealings that Mr. Kent had with Ms. Reynolds's spouse. Beginning in 1967, Ms. Reynolds and Mr. Kent had an affair that lasted for one year, after which the parties left their spouses and moved in together in Washington State. Mr. Kent did not wish for Ms. Reynolds to work outside the home, and she did not. In 1970, the parties moved back to California, continued to cohabit, and divorced their respective spouses. Though they never married, they continued to cohabit for 24 years, during which time Ms. Reynolds did not work outside the home. Ms. Reynolds testified:

> Mr. Kent and I entered into an agreement whereby he was to be the provider and I was to take care of our nest. That agreement subsequently became more involved and included my taking care of him, the home, the interior of the boat, acting as a hostess for all parties and entertaining he wanted to do for personal and business reasons, doing laundry, housekeeping, ironing, cooking, shopping, supervising the service people who occassionally [sic] worked on the home and acting as nurse for Mr. Kent when he had health problems. In turn Mr. Kent agreed to provide for all of my living expenses.

They looked for and purchased a home in 1980, which was solely in the name of Mr. Kent. In 1989, Mr. Kent purchased a new Mercedes automobile and told Ms. Reynolds that he was giving

to her the 1987 Lincoln Town Car that he had used previously, though the car remained in the name of KENCOR, which was a corporation wholly owned by Mr. Kent. Mr. Kent gave Ms. Reynolds approximately $500 to $600 each week to purchase household goods and personal items. Over the years, Mr. Kent gave to Ms. Reynolds jewelry and other expensive items. In 1987 Mr. Kent bought a new boat, which cost approximately $260,000, to replace a smaller one, and he invested an additional $100,000 in upgrades to it. He referred to the boat as "our" boat, but title was in Mr. Kent's name. Ms. Reynolds testified that she had seen financial statements showing that Mr. Kent's assets were worth approximately $18 million. When they traveled, he held themselves out as "husband and wife."

In July 1991, Mr. Kent vacated the home in which they lived and demanded that Ms. Reynolds vacate the home and return the Lincoln Town Car. Ms. Reynolds refused, and Mr. Kent and KENCOR sued her "for ejectment, trespass, and conversion." Mr. Kent asked that the court enter a judgment confirming that Ms. Reynolds had no interest in the property purchased during their relationship, and Ms. Reynolds responded by asserting that she had an equitable interest in such property.

In October 1991, the parties entered into a settlement agreement, which required Mr. Kent to pay to Ms. Reynolds (1) a lump sum of $57,500 after she returned all property items except the Town Car and personal jewelry, which she could retain, (2) $2,000 per month for three years commencing in November 1991, and (3) $1,000 per month for two years commencing in November 1994 and concluding in October 1996.]

In accordance with the payment plan set forth in the settlement agreement, petitioner received $22,000 in 1994. This amount was received from KENCOR, and KENCOR issued a Form 1099-MISC, Miscellaneous Income, to petitioner reporting the amount as miscellaneous income. Petitioner did not perform services for KENCOR during that year, nor did she sell it any property during that year. Petitioner, allegedly relying on advice from her attorney and accountant, did not report this amount on her 1994 Federal income tax return.

DISCUSSION

We must decide whether the $22,000 amount is includable in petitioner's 1994 gross income. Respondent argues it is. Petitioner argues it is not. Respondent contends that petitioner received the disputed amount as compensation for her homemaking services. Petitioner contends that she received the disputed amount as a gift.

We agree with petitioner that the $22,000 amount is not includable in her 1994 gross income, but we do so for a reason slightly different than she espouses. The taxability of proceeds recovered in settlement of a lawsuit rests upon the nature of the claim for which the proceeds were received and the actual basis of recovery. *Sager Glove Corp. v. Comm'r*, 36 T.C. 1173, 1180 (1961), affd. 311 F.2d 210 (7th Cir. 1962). Ascertaining the nature of the claim is a factual determination that is generally made by reference to the settlement agreement in light of the facts and circumstances surrounding it. Key to this determination is the "intent of the payor" in making the payment. *Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo. 1964-33; *Agar v. Comm'r*, 290 F.2d 283, 284 (2d Cir. 1961), affg. per curiam T.C. Memo. 1960-21; *Seay v. Comm'r*, 58 T.C. 32, 37 (1972). We must ask ourselves: "In lieu of WHAT was the payment received?" See *Robinson v. Comm'*r, 102 T.C. 116, 126-127 (1994), affd. in part, revd. in part on an issue not relevant herein and remanded 70 F.3d 34 (5th Cir. 1995). Although the payee's belief is relevant to this inquiry, the payment's ultimate character depends on the payor's dominant reason for

making the payment. *Comm'r v. Duberstein*, 363 U.S. 278, 286 (1960); see *Agar v. Comm'*r, *supra* 290 F.2d at 298; *Fono v. Comm'r*, 79 T.C. 680 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984).

The settlement agreement indicates that Mr. Kent paid the disputed amount to petitioner in surrender of her rights in most of the property purchased during their relationship.[5] Respondent agrees with this characterization, but extrapolates therefrom that Mr. Kent paid petitioner the disputed amount to compensate her for past services that she rendered to him. We do not agree. Nothing in the record persuades us that petitioner ever sought in the lawsuit remuneration for services that she may have rendered to Mr. Kent during their relationship, let alone that Mr. Kent intended to compensate her for any such services by paying her the disputed amount. The written judgment sought by Mr. Kent and the settlement agreement both indicate that the only reason Mr. Kent commenced the lawsuit and paid the disputed amount to petitioner was to retain possession of most of the assets acquired during their relationship.

Although petitioner did refer in her Declaration to an agreement under which she would provide services to Mr. Kent in exchange for support, the facts of this case do not support an inference that she ever sought in the lawsuit to recover remuneration for these services, or, more importantly, that Mr. Kent paid her the disputed amount intending to compensate her for any services that she may have rendered to him.[6] The payor's intent controls the characterization of settlement payments, and, as we have found, Mr. Kent intended to perfect his sole possession of most of their joint property when he paid petitioner the disputed amount. In this regard, the cases of *Green v. Commissioner*, T.C. Memo 1987-503, affd. per curiam 846 F.2d 870 (2d Cir. 1988), *Cotnam v. Commissioner*, 263 F.2d 119, 122 (5th Cir. 1959), revg. in part and affg. in part 28 T.C. 947 (1957), and *Braddock v. United States*, 434 F.2d 631 (9th Cir. 1970), are factually distinguishable from the case at hand. The taxpayer in *Green*, unlike petitioner, sued her partner's estate as a creditor, seeking to recover the value of services that she rendered to him. The same is true with respect to the taxpayer in *Cotnam*, where the appellate court noted that "The pleadings in the * * * [State court] proceedings show clearly that Mrs. Cotnam's claim was based on the theory of a contract for services" As to *Braddock*, the payor there, unlike the payor here, had a legal obligation to pay the taxpayer for her services in cooking, cleaning, and helping him with his farm.

Our conclusion that Mr. Kent paid petitioner the disputed amount for her interest in the property does not end our inquiry. Petitioner's sale of her property interest to Mr. Kent is a taxable event for which she must recognize gain to the extent that the selling price exceeds her basis in the property. Sec. 1001(a). As to her basis, the record indicates that petitioner received her interest in the property by way of numerous gifts that Mr. Kent made to her throughout their relationship. Petitioner's declaration depicts a setting under which Mr. Kent repeatedly "gave" her property, and the facts of this case support the conclusion that he made these "gifts" with the "detached and disinterested generosity, * * * affection, respect, admiration, charity, or the like" required by

[5] We recognize that KENCOR paid petitioner the $22,000 amount and that KENCOR issued petitioner a Form 1099-MISC reporting that the amount was paid as miscellaneous income. The record, however, tends to disprove such a characterization. The more likely explanation of the payment, and the one we find from the facts herein, is that Mr. Kent, as principal shareholder of KENCOR, caused KENCOR to pay petitioner the $22,000 amount on his behalf.

[6] Even if we were to assume arguendo that Mr. Kent did agree to support petitioner in consideration for her homemaking services, it would not necessarily follow that every item of property that he gave her during their relationship was pursuant to this agreement. In fact, if we were to believe the allegations in petitioner's Declaration to the effect that Mr. Kent spent approximately $32,000 to $38,400 a year on their household and her personal expenses, it would seem most logical to conclude that many of the additional amounts that he gave her were gifts.

*Commissioner v. Duberstein*, *supra* at 285. Given the fact that petitioner and Mr. Kent for a long period of time lived as husband and wife in most regards, but for the obvious fact that they were not legally married, we find it hard to believe that their relationship was actually akin to a business arrangement.[8]

Our conclusion herein that the property received by petitioner from Mr. Kent was by way of a gift, rather than as compensation for her services, is consistent with prior decisions of this Court. First, in *Starks v. Commissioner*, T.C. Memo 1966-134, the taxpayer, a young unmarried, nonworking woman was involved with a much older man. The man, in return for the woman's companionship, gave her money to buy a house and to spend on her living expenses. He also gave her an automobile, jewelry, furniture, fur coats, and other clothing. Respondent determined that the money and other assets were taxable to the woman as compensation for services rendered to the man. We disagreed. We held that the woman received the money and other assets as gifts. *See also Libby v. Comm'r*, T.C. Memo 1969-184 (similar holding as to cash and property given to a young mistress by her older paramour).

Later, in *Pascarelli v. Commissioner*, 55 T.C. 1082, 1090-1091 (1971), affd. without published opinion 485 F.2d 681 (3d Cir. 1973), we held to the same effect. There, the taxpayer was a woman who lived with a man who was not her husband. The man gave money to the woman in exchange for "wifely services." Respondent determined that the money was taxable to the woman as compensation that she earned for her services. We disagreed. We held that the payments were gifts. We found that the man paid the money to the woman "motivated by sentiments of affection, respect, and admiration." Id. at 1091.

And later, in *Reis v. Commissioner*, T.C. Memo 1974-287, the taxpayer was a young female nightclub dancer who met an older man when he bought dinner and champagne for the performers in the show. The man paid each person at the table, other than the woman, $50 to leave the table so that he and she would be alone. The man gave the woman $1,200 for a mink stole and another $1,200 so that her sister could have an expensive coat too. Over the next 5 years, the woman saw the man "every Tuesday night at the [nightclub] and Wednesday afternoons from approximately 1:00 p.m. to 3:00 p.m. * * * at various places including * * * a girlfriend's apartment and hotels where [he] was staying." He paid her living expenses, plus $200 a week, and he provided her with money for other things, such as investing, decorating her apartment, and buying a car. We held that none of the more than $100,000 that he gave her over the 5 years was taxable to her. We concluded that she received the money as a gift. We reached this conclusion notwithstanding the fact that the woman had stated that she "earned every penny" of the money.

Given our conclusion in this case that petitioner received her interest in the property as gifts from Mr. Kent, her basis in the property equals Mr. Kent's basis immediately before the gifts, to

[8] We are mindful that all property acquired during the relationship was placed in the name of Mr. Kent or that of a corporation that he controlled. We do not find this fact to negate the presence of a gift under the facts herein. Federal law answers the question of whether a gift has occurred for Federal income tax purposes, *Commissioner v. Duberstein*, 363 U.S. 278, 286 (1960), and we believe that Mr. Kent's requested judgment and the settlement agreement speak loudly to the effect that he gave petitioner interests in property under the test set forth in *Duberstein*. To the extent that State law is relevant to this inquiry, applicable State (California) law does provide that a nonmarital partner may have an equitable interest in property titled solely in the other partner's name. *See* Marvin v. Marvin, 18 Cal. 3d 660, 684 n.24 (1976), and the cases cited therein at 669-670.

the extent that his basis is attributable to the gifted property.[9] Sec. 1015(a). Although the record does not indicate with mathematical specificity the amount of Mr. Kent's basis that passed to petitioner as a result of the gifts, we are satisfied from the facts at hand that her basis equaled or exceeded the amount that she realized on the sale; *i.e.*, $153,500. We conclude that petitioner had no gain to recognize upon receipt of the disputed payment.

We have carefully considered all arguments by respondent for a contrary holding, and, to the extent not discussed above, find them to be irrelevant or without merit.

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***RDPs and civil unions***

You learned in Revenue Ruling 2013-17[31] (Chapter 8) that members of an RDP or civil union are not considered married for Federal tax purposes. Until and unless this treatment changes, §§ 71, 215, and 1041 do not apply to such couples who dissolve their legal relationship using state law procedures. Moreover, such couples are prevented from using QDROs to apportion pension benefits. In the absence of §§ 71, 215, and 1041, how are cash and property transfers analyzed?

With respect to cash transfers, one possibility may be that *Gould* would continue to control support payments made under the legal compulsion of state law, even child support (though none was at issue in *Gould*).[32] If that assumption is correct, payments would be excludable by the payee and nondeductible by the payor, with no flexibility to achieve the sort of income shifting described in Part A., under which *both* parties may be made better off (after tax).

With respect to property transfers, the pre-*Davis* precedents described earlier would presumably govern—even though those precedents dealt with couples that were recognized as married for Federal income tax purposes—because they focused on the effect of state law on the parties' property ownership interests rather than on their marital status. As noted in Chief Counsel Advice 201021050 (Chapter 8), state law governs the *property interests* enjoyed by each member of an RDP for purposes of Federal income taxation. Thus, under Revenue Rulings 76-83 and 74-347 (described and cited earlier), approximately equal divisions of community property or property in "equitable division" states where the recipient is held to have an equitable interest should not result in gain or loss for the transferor, and the transferee should take a carryover basis. The same should result under Revenue Ruling 81-292 for approximately equal divisions of property held as joint tenants in common law states, even though some property goes in its entirety to one person and some goes in its entirety to the other. "The legal argument [in those rulings] is that there is *no realization* when two partners make an equal division of their jointly owned property. The same argument can be used to support non-realization in property divisions between … registered domestic partners."[33] If gain is not realized under § 1001, § 1041 is not needed to avoid recognition of that gain.

Under Revenue Ruling 74-347, however, unequal divisions of jointly owned property in common law states could result in taxation if § 1041 does not apply. Indeed, a transfer of property

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[9] If petitioner were claiming (which she is not) that she had realized a loss on her disposition of any of the gifted property, her basis in that property would equal the lesser of Mr. Kent's basis at the time of the gift or the property's fair market value at that time. Sec. 1015(a).

[31] 2013-2 C.B. 201.

[32] *See* Patricia Cain, *Planning for Same-Sex Couples in 2011*, 28-29, at http://ssrn.com/abstract= 1860217.

[33] Cain, *supra* note 31, at 26.

wholly owned by one party to the other in a common law state under legal compulsion of a civil decree dissolving the union would be a realization event for the transferor under *Davis*, itself.

In a community property state, the unequal division of community property in kind on dissolution of an RDP can be resolved by one partner agreeing to pay cash (earned in the future after dissolution and thus not community property but rather separate property of the earner) to the other partner in order, in effect, to equalize the unequal property split (sometimes referred to as an "equalization payment"). A common example involves a tax-preferred retirement account, such as a § 401(k) account. Assume, for example, that Mary and Lee are members of an RDP under California law when they decide to dissolve their RDP. Mary has a § 401(k) account with her employer with a $100,000 balance, which is community property under California law, at the time of dissolution. Because Mary and Lee are not married, they cannot use a QDRO with respect to Lee's interest. Moreover, assume that Mary wishes to retain ownership of the full account balance and thus agrees to pay to Lee $50,000 in several installments after the dissolution in order to purchase Lee's 50% community interest in the account.

The proper analysis of those payments under California community property law is reflected in the analysis in *Reynolds*, above, as though the couple had no formal state law relationship. Unlike the Tax Court's assumption in that case (that the cash payments received by Ms. Reynolds were less than her basis in the equitable property interests that she surrendered), Lee's basis in her share of this community property is clearly $0 on these facts.[34] Thus, 100% of each cash receipt constitutes §1001 realized gain for Lee and would be fully includable as ordinary income.[35] Mary should, in theory, be able to increase her $0 basis in the § 401(k) account by $50,000, equal to the $50,000 that she pays to Lee for her interest in the property.

## Problem

Matthew and William have been Registered Domestic Partners under California law for 10 years, but they are now dissolving their relationship. Under California community property law, both their primary personal residence and their vacation home are community property. As part of their property agreement, they agree that Matthew will keep their primary residence (A/B of $500,000 and FMV of $700,000) and that William will keep their vacation residence (A/B 600,000 and FMV of $1 million). Otherwise, they split all remaining community property equally.

Neither Matthew nor William plan to sell their properties soon. (William plans to move into what had been their vacation home and use it as his new primary residence.) To equalize the property split, William agrees to pay Matthew $150,000 (one-half of the $300,000 value difference between the two homes) in three equal annual installments of $50,000 each. What tax consequences arise on the cash payments for both Matthew and William? Specifically, can Matthew exclude any part of the $150,000 aggregate cash payment? What will be William's basis in the vacation residence after the payments are complete?

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[34] Recall from Chapter 2 that § 401(k) accounts are funded with pre-tax dollars, as under a cash-flow consumption tax, which means that neither Mary nor Lee would have any basis in their community interests in the account.

[35] The gain is ordinary because it reflects her share of the ordinary income that she would otherwise withdraw in the future. As you will learn in Chapter 15, a taxpayer cannot convert accrued ordinary income to capital gain by selling the income interest to another. Moreover, in Chapter 13, you will learn that Lee can defer inclusion of her realized gain on the sale of her property interest until receipt of the cash sale proceeds under the § 453 installment sale rules.

# Unit IV:

# Everything You Ever Wanted
# To Know About Debt but Were Afraid To Ask

## Introduction to Chapters 10 through 12

Debt, or leverage, is an extremely important (and growing) element of the economy, as many business and financial investments are made with borrowed money, often not because of need but because of an attempt to increase total returns, which also increases risk if the investment does not perform as anticipated.

For example, assume a no-tax world in which Veronica and Victor each have $100,000 in cash to invest. Veronica uses her funds to purchase one rental property (nondepreciable land rented to tenant farmers, to keep the analysis simple) for $100,000 in cash, which she rents to a tenant at a monthly rent of $1,000, or $12,000 per year. At the end of five years, the land has appreciated in value to $130,000, and she sells the property.

Victor uses his funds to purchase *five* rental properties (nondepreciable land rented to tenant farmers) for $100,000 each, making a $20,000 cash down payment and borrowing $80,000 at an interest rate of 4% with respect to each property. Thus, Victor borrows $400,000 in the aggregate and pays $16,000 in annual interest ($400,000 x .04). Like Veronica, he rents each property to a tenant at a monthly rent of $1,000, or $12,000 per year. At the end of five years, each property has appreciated in value to $130,000, and Victor sells them and repays the borrowed $400,000.

Putting tax consequences aside, compare the aggregate pre-tax profit for each on these identical $100,000 cash investments.

| **Veronica invests $100,000** | **Victor invests $100,000** |
|---|---|
| buys 1 land tract for $100,000 cash | buys 5 land tracts, paying $20,000 in cash and borrowing $80,000 at 4% interest for each, with $400,000 borrowed in the aggregate |
| annual rental income: $12,000 | annual gross rental income: $60,000<br>*less* annual interest cost: 16,000<br>annual net rental income: $44,000 |
| total rental income over 5 years: $60,000 | total net rental income over 5 years: $220,000 |
| sale: $130,000 *less* $100,000 cash investment = $30,000 profit | sale: $650,000 *less* $100,000 cash investment *less* $400,000 principal repayment = $150,000 profit |
| **total profit: $90,000** ($60,000 *plus* $30,000) = 90% ($90,000/$100,000) | **total profit: $370,000** ($220,000 *plus* $150,000) = 370% ($370,000/$100,000) |

| | |
|---|---|
| $190,000 cash in hand | $470,000 cash in hand |

The description above is a simple example of how private equity firms use leverage (borrowed cash) to increase their returns on investment. Of course, if the land falls in value by 50% (to $50,000) instead of increases in value by 30% (to $130,000), Veronica would still make an overall profit, while Victor would suffer a loss. In other words, leverage magnifies both profit and loss.

| **Veronica** | **Victor** |
|---|---|
| total rental income over 5 years: $60,000 | total net rental income over 5 years: $220,000 |
| sale: $50,000 *less* $100,000 cash investment = $50,000 loss | sale: $250,000 *less* $100,000 cash investment *less* $400,000 principal repayment = $250,000 loss |
| **total profit: $10,000** ($60,000 *less* $50,000) = 10% profit | **total loss: $30,000** ($220,000 *less* $250,000) = 30% loss |
| $110,000 cash on hand | $70,000 cash on hand |

The financial sector occupied about 2.8% of GDP in 1950 but occupies more than 8% today.[1] It has doubled since 1980, making the tax system's rules regarding debt increasingly important.

Chapter 10 examines the basic income tax rules pertaining to the borrowing and lending of money, including the receipt and repayment of principal, the receipt and payment of interest, the proper identification of principal and interest payments, and the proper timing of any interest inclusion or deduction. This material also includes a discussion of how basis is recovered in annuities (a type of financial instrument), which is subject to favorable tax rules. Because the so-called borrowing exclusion allows the receipt of cash without an income inclusion, taxpayers have long sought to squeeze all sorts of receipts within the borrowing exclusion, so this chapter will also examine the scope of the borrowing exclusion.

What tax consequences arise for both the lender and the borrower if events do not unfold according to original assumptions, and the borrower fails to repay principal or fails to pay required interest? Chapter 11 examines this issue.

Finally, Chapter 12 explores how these rules play out in the context of the purchase, ownership, and disposition of property. Because basis, generally speaking, is the tool that allows us to keep track of previously taxed dollars, can basis be created when property is purchased with (as-yet untaxed) borrowed money? How is relief from indebtedness analyzed when the relief accompanies a transfer of property ownership?

[1] *See* Justin Lahart, *Number of the Week: Finance's Share of Economy Continues to Grow*, at http://blogs.wsj.com/economics/2011/12/10/number-of-the-week-finances-share-of-economy-continues-to-grow. *See also* Paul Krugman, *Three Expensive Milliseconds*, at www.nytimes.com/2014/04/14/opinion/krugman-three-expensive-milliseconds.html?ref=paulkrugman (discussing the economic consequences of the growth in the financial sector compared to other sectors of the economy).

# Chapter 10: Borrowing and Lending

This chapter addresses the income tax treatment of the borrowing, lending, and repayment of principal, as well as the payment and receipt of interest, which compensates the lender for the time value of money. (You can think of interest as "rent" paid to use someone else's cash, just as "rent" can be paid to use someone else's real estate.) At least, this chapter describes those tax consequences when everything goes according to plan and all payments are made as expected.

## A. The basic rules of the road

Assume that Betty Borrower borrows $100,000 from Larry Lender on January 1 of Year 1 under a loan agreement that requires Betty to repay the $100,000 after 10 years (on December 31 of Year 10) and also requires that she pay 4% interest, compounded annually, on December 31 of Year 10 when she repays the original principal. In Year 10, she would have to pay to Larry $148,024.43.[1] What is the income tax treatment of these payments and receipts for each party?

Let's start with Larry Lender. Does Larry's transfer of $100,000 to Betty constitute a current wealth decrease—an "expense"? If it is an expense, it would be deductible because Larry is pursuing an investment return in the form of interest. Or has Larry merely changed the form in which he is holding his wealth—a nondeductible "capital expenditure"—because Larry has replaced his cash with a claim against Betty? In Chapter 4, you learned that Treas. Reg. §§ 1.263(a)-4(d)(2)(i)(B) and (d)(2)(vi), Ex. (1), confirm the latter characterization. Thus, Larry cannot deduct the $100,000 transferred to Betty in Year 1, but that nondeduction immediately creates a $100,000 basis in the loan. Of the aggregate $148,024.43 that Larry will receive in Year 10, $100,000 is tax-free basis recovery, but the remaining $48,024.43 is new wealth to Larry in the form of interest, includable in his Gross Income under § 61(a)(4). For now, we shall gloss over the *timing* of Larry's interest inclusions, discussed in Part C., *infra.*

Is Betty's Year-1 receipt of $100,000 in cash includable in her Gross Income? The usual response is that the receipt is not a wealth accession because of the offsetting obligation to repay the $100,000 in Year 10. For example, if we created a balance sheet for Betty, with assets listed on the left and liabilities listed on the right, we would add $100,000 to both sides, so her "net worth" (assets *less* liabilities) would remain unchanged.

| Assets | Liabilities (face amount of principal repayment obligation) |
|---|---|
| **$100,000** | **$100,000** |

**No increase in her net worth (assets *less* liabilities)**

Betty's ability to exclude borrowed loan principal is often referred to as the "borrowing exclusion," but it is important to appreciate that no statutory "exclusion" provision exists to prevent inclusion of her receipt. Rather, the receipt is not considered to rise to the level of Gross Income within the meaning of § 61's residual clause in the first place—*solely* because of the offsetting

[1] If you would like to find such figures yourself, the amount can be found using an online compound interest calculator, of which there are many, by filling in the appropriate slots with the necessary information, such as the interest rate, the number of times compounded, and the borrowed amount.

obligation to repay. Were it not for Betty's promise to repay in Year 10 the $100,000 cash received in Year 1, the receipt would clearly constitute an immediate wealth accession under *Glenshaw Glass*'s interpretation of the § 61 residual clause.

Does Betty's repayment of the $100,000 principal amount in Year 10 constitute a wealth reduction that might generate a deduction for her? If we stick with this "balance sheet" approach, the answer is "no." While we remove $100,000 in assets from the left side of her balance sheet—which might superficially look like a wealth reduction—we simultaneously remove the $100,000 liability from the right side of her balance sheet, which means that Betty's net worth (assets *less* liabilities) is not reduced.

Notice that Betty *is* effectively taxed on the loan proceeds, though not in the year of receipt but rather in the *year of repayment* (through deduction denial). In other words, borrowed principal is not intended to be permanently tax-free for Betty. As a sneak preview of what is coming in the next chapter, what would happen if the borrower never repays? The exclusion of the cash receipt in Year 1 was acceptable *solely* because she promised to repay it with *after-tax (i.e., undeducted) dollars*. Thus, § 61(a)(12) will generally generate Gross Income if her obligation to repay disappears, or else Betty will have received *permanently* tax-free cash back in Year 1. But we are getting ahead of ourselves!

Betty's interest payment, on the other hand, is another matter, as it does constitute a current wealth decrease, *i.e.*, an "expense." Section 163 provides the detailed rules under which interest expense is, or is not, deductible. If she spends the loan principal in her business, the interest would be deductible under § 163(a). If she uses the loan principal to, say, buy a personal-use boat, the interest would not be deductible. *See* § 163(h)(1). Deductible "qualified residence interest" (including a loan used to acquire a personal residence) is a tax expenditure that is carved out of otherwise nondeductible "personal" interest, which we shall explore in Chapter 18. We shall also examine the deductibility of "investment interest" under § 163(d) in Chapter 16.

As with the timing of Larry's interest inclusion, let's gloss over (for now) the timing of Betty's interest deduction, assuming that the interest is, in fact, deductible under § 163.

Notice that Larry's tax analysis was grounded in routine SHS analysis that you learned in Chapter 1. In contrast, the analysis described above for Betty—which looked to her balance sheet and permitted evaluating whether a cash receipt in Year 1 is a wealth accession by looking to what we expect to happen *in a future year*—is new and different. Other than § 83 (studied in Chapter 5, pertaining to the receipt of property as compensation for services rendered if that property is subject to a substantial risk of forfeiture), the ***annual accounting principle*** prevents the expectation of a *future* repayment to negate what would otherwise be a *current* accession to wealth (in the absence of considering that future repayment obligation). Rather, under the annual accounting principle introduced in Chapter 1, you learned that we usually analyze each year in isolation. Such an approach would require the inclusion of borrowed money in Gross Income when received and the deduction of principal repayments when made (similar to the approach under a cash-flow consumption tax). The ability of taxpayers to invest with pre-tax dollars under the borrowing exclusion has led to all sorts of distortions and tax shelter problems inconsistent with income tax principles, leading to the enactment of provisions like § 7872 (described below in Part B.) and those discussed in Chapter 16 (Tax Shelters).

So where does the borrowing exclusion come from? As recounted in earlier chapters, interpreters of the early income tax tended to borrow from other disciplines (such as trust and

financial accounting) in defining "income" prior to the work of Messers. Schanz, Haig, Simons (and others), who developed a uniquely tax-specific meaning. The borrowing exclusion under the income tax likely arose from a reflexive borrowing (pun intended) from financial accounting, under which borrowed principal is not included on a business's "income" statement. Financial accounting, however, uses *transactional accounting* (including the use of balance sheets), which is different from the *annual accounting principle* used in income taxation. Borrowed cash was (and is) excluded from the income statement in financial accounting because transactional accounting expressly permits (indeed, requires) a look forward to future years (and the obligation to repay) with respect to the front-end treatment of this "transaction" called borrowing.

As described more fully in Chapter 22, however, the purposes and goals of financial accounting (under which the tension between an income tax and consumption tax is irrelevant) are very different from those under an income tax. Nevertheless, the borrowing exclusion remains today—even when we now know that financial accounting principles can be inconsistent with SHS income tax principles and that the borrowing exclusion can cause mighty mischief under the income tax—likely for sheer administrative ease. As described above, the plain vanilla borrowing and repayment of principal (though not interest) can usually be ignored by both the borrower and lender for tax purposes, which is an easy rule to administer.

## B. Section 7872

Let's return to the analysis of Betty's receipt of that $100,000 in borrowed cash in Part A., which she had to repay in Year 10, together with $48,024.43 in interest. Part A. suggested that the reason why Betty did not realize Gross Income when she received the $100,000 in cold, hard cash is that she also incurred, at the same time, a future repayment obligation of that same $100,000 that negated any wealth accession in Year 1. Under the balance sheet approach, there is a more sophisticated way to analyze why Betty's receipt of the $100,000 does not constitute Gross Income, however. Notice that the analysis in Part A. ignored the critical time value of money and thus ignored her requirement to pay interest to compensate Larry for the use of his money. Instead, it focused only on the $100,000 *face amount* of the principal repayment obligation, ignoring both her obligation to pay interest and the length of time (whether one day or 10 years or 50 years) between the receipt of that $100,000 and her future obligation to repay that $100,000 to Larry.

Instead of putting the face amount of the $100,000 of borrowed cash on the liability side of her hypothetical balance sheet (and ignoring both interest and the passage of time before that repayment obligation ripens), a more accurate analysis recognizes that the reason why Betty did not realize a wealth accession on the $100,000 cash receipt is that she incurred, at the same time, a future obligation to pay $148,024.43 in aggregate principal *and interest* that had a *present value in Year 1* of $100,000, using a 4% discount rate.[2] In other words, the *present value* (as of the Year-1 receipt) of Betty's obligation to repay the $100,000 principal in Year 10 added to the *present value* (as of the Year-1 receipt) of her obligation to pay $48,024.43 in interest in Year 10 equals $100,000, which is precisely the amount of cash that she receives today, negating a wealth accession for her in Year 1 on the $100,000 receipt using a transactional accounting approach.

[2] Some lenders will necessarily charge interest rates that exceed the current "discount rate" for similar loans to other borrowers if the particular borrower, for example, is a risky bet. But for our purposes, we shall always assume (for the sake of simplicity) that the interest rate charged by the lender and the going "discount rate" is the same.

***Math alert*: The material that follows will use some mathematics. Do not be intimidated by this. These examples are here merely to illustrate the underlying economics of loans, which helps us to better understand the tax rules that apply to them. Read them with that goal in mind—to see how they lead to the tax rules described in this chapter. I now return you to our regularly scheduled program.**

**Example 1**

| Due at end of Year | Amount | Present Value as of beginning of Year 1 |
|---|---|---|
| 10 | $100,000.00 | $67,556.42 |
| 10 | 48,024.43 | 32,443.58 |
| | | $100,000.00 |

| **Assets** | **Liabilities (*present value* of future principal *and interest* payment)** |
|---|---|
| **$100,000** | **$100,000** |

**No increase in her net worth (assets *less* liabilities)**

Under this alternative view, Betty could be said to realize an immediate wealth accession on receipt of the $100,000 *if and only if* the present value (as of the Year-1 receipt) of her Year-10 payment obligation were less than $148,024.43.

For example, suppose that High Tech, Inc., makes a $100,000 loan to CEO Sam in Year 1 that he must repay at the end of Year 10 but that, under their loan agreement, High Tech and Sam agree that High Tech will charge no interest for the loan. If we apply the more simplistic rule described in Part A., which looked only at the *face amount* of the principal repayment obligation (ignoring both interest and the time value of money), our CEO has realized no wealth accession in Year 1: $100,000 received offset by his Year-10 obligation to repay that $100,000. But if we look at Sam's situation from the perspective of our more sophisticated alternative view, the *present value* (as of the Year-1 receipt) of his Year-10 $100,000 payment obligation of is only $67,556.42 if we use a 4% discount rate, compounded annually. To keep the numbers easy to read, let's just round that figure for purposes of discussion to $67,500. Under that view, Sam would realize an immediate Year-1 wealth accession equal to $32,500—the difference between the $100,000 that he received and the present-value of his future repayment obligation. Another way of saying this is that, regardless of the label attached to the $100,000 receipt, the *real* principal of Sam's loan *in substance* (rather than form, under the loan agreement) was only $67,500 because that is the present value (as of the Year-1 receipt) of his aggregate future payment obligation. The remaining $32,500 paid by Sam in Year 10 represents 4% compounded interest on the real principal amount of $67,500—compensation to the corporation (the lender) for the time value of money.

If only $67,500 of the $100,000 that Sam receives in Year 1 is, in substance, borrowed principal, which he can exclude under the borrowing exclusion, what is the nature of the remaining $32,500 that he receives in Year 1 from his employer? Compensation income under § 61(a)(1)! *The interest-free nature of the loan was merely a means by which High Tech paid additional compensation to Sam in substance, though not in form, which they attempted to disguise.*

And that analysis is precisely what § 7872 now requires. Section 7872, enacted in 1984, does not describe the actual tax consequences to the borrower and lender of the flow of cash between the parties in a below-market loan. Rather, the role of § 7872 is merely to correctly identify the *real* principal of the loan in substance and the *real* interest so that the payments can then be treated

properly under other Code sections. With respect to Sam and High Tech, for example, because only $67,500 is the *real* loan principal when Sam receives the $100,000, the remaining $32,500 would be immediately included on receipt by Sam under § 61(a)(1) as compensation, notwithstanding the loan document's designation of the entire $100,000 as loan principal. Similarly, while High Tech would be unable to deduct any part of the $100,000 transferred to Sam in Year 1 if it were treated entirely as loan principal (a nondeductible capital expenditure), High Tech can, in fact, deduct under § 162(a)(1) the $32,500 compensation paid to Sam in Year 1 in substance.

This example uses a 4% discount rate to determine how much of Sam's $100,000 Year-1 receipt is *real* loan principal that he must repay in Year 10 on our assumption that 4% is the going rate for similar loans in the marketplace. Section 7872 uses the "applicable Federal rate" (often referred to as the AFR),[3] which is the rate used by Treasury when selling Treasury bonds of varying maturities. The AFR is a favorable rate to use for Sam, as it is a lower rate than Sam would likely be able to negotiate in the private loan market. Moreover, compensation-related, below-market loans that do not exceed $10,000 are free of § 7872 under a *de minimis* rule.[4] For both of these reasons, the CEO Sams of the world are still better off, even with § 7872 on the books, when the corporations that employ them make no-interest or low-interest loans to them. The IRS publishes the AFR periodically in Revenue Rulings.

So much for the treatment (by both parties) of the $100,000 payment in Year 1. What about the $32,500 in implicit interest? High Tech will have to include the interest under § 61(a)(4), and Sam may or may not be able to deduct the interest under § 163, depending on how he used the borrowed money, as mentioned earlier. The *timing* of the interest receipt and payment will not, however, be respected as occurring in Year 10. Because the loan between Sam and High Tech is a "term" loan (a loan for a term of years), Sam's payment of the $32,500 interest (and High Tech's receipt of the $32,500 interest) is deemed to occur over the 10-year life of the loan under the original issue discount rules described in Part C., *infra*, rather than entirely in Year 10 (when actually paid and received) for reasons described in Part C.[5] But we are not there yet. Baby steps!

If, in contrast, the $100,000 loan is a "demand" loan rather than a "term" loan of 10 years, High Tech would have the right to demand repayment of the $100,000 at any time. In that case, we cannot compute how much of the $100,000 received by Sam in Year 1 is, in substance, disguised compensation by using present value analysis because we do not yet know when Sam will repay the $100,000 to High Tech. Thus, with demand loans, § 7872(a)(1) requires that the "forgone interest" be treated as paid to Sam as additional compensation (and repaid by Sam to High Tech as interest) on the last day of each year during which the demand loan is outstanding. "Forgone interest" is defined in § 7872(e)(2) as the interest that Sam would pay each year on the $100,000 amount received in Year 1 if the AFR had applied as the interest rate. If the AFR is 2%, for example, Sam would include $2,000 ($100,000 x .02) under § 61(a)(1) on December 31 of each year as additional compensation,[6] and he would be deemed to repay that $2,000 right back to High Tech as interest on the same date.[7] High Tech would include the deemed interest payment, and Sam may (or may not) be able to deduct it under § 163, again depending on how Sam uses the

[3] *See* §§ 7872(f)(1) and (2).
[4] *See* § 7872(c)(3).
[5] *See* § 7872(b).
[6] *See* § 7872(a)(1)(A).
[7] *See* § 7872(a)(1)(B).

borrowed money.

What if Sam is not an employee of High Tech but is a major shareholder—perhaps a controlling shareholder who could force High Tech to make a no-interest loan to him? The $32,500 that Sam receives in Year 1 in excess of the present value of his Year-10 payment obligation (under our original fact pattern involving the 10-year term loan and a 4% discount rate) is not disguised compensation, includable under § 61(a)(1), but rather a disguised *dividend*, includable under § 61(a)(7). For High Tech, the payment of the disguised dividend would not be deductible (as would be the payment of compensation), as no Code section provides the authority for a corporation to deduct dividends paid to its shareholders. If Sam is *both* an employee *and* a shareholder, the loan is generally treated as a corporation-shareholder loan (rather than a compensation-related loan).[8]

Does the existence of § 7872 mean that you have to worry about a Gross Income inclusion when you borrow money from a bank at below-market rates because of a special deal aimed at stealing you away from another bank or because you are a very good customer whose loyalty the bank is massaging? No. Section 7872 does not apply to *all* below-market loans. Rather, it applies only to specifically listed loans where Congress had evidence that wealth transfers were occurring between related parties that were a *substitute* for a clearly includable item, such as compensation or dividends (or transfers that were aimed at avoiding the gift tax rules under the integrated wealth transfer tax system described in Chapter 7).[9] Recall from Chapters 5 and 6 the concern when cash payments that clearly constitute Gross Income are replaced with a *substitute* intended to avoid the Gross Income inclusion that would otherwise clearly apply.

In other words, for most loans we measure whether or not there is a wealth accession by ignoring interest as well as ignoring the time value of money and simply comparing the principal amount received with the *face amount* of the principal repayment obligation (rather than the present value of the future principal and interest payments). If they are equal (and they will virtually always be equal in the usual case), the borrower realizes no wealth accession on the receipt of the principal. Nevertheless, § 7872, as a loophole closer, will apply in some contexts and use the more discerning present value approach in situations that are abusive. For our purposes, § 7872 is simply a helpful tool in better illuminating the real economics underlying the so-called borrowing exclusion.

## C. Identifying principal and interest (including original issue discount) and the timing of interest inclusions and deductions

We know that interest is includable under § 61(a)(4) by lenders (unless the lender is a state or local government issuing § 103 bonds). We also know that interest is generally deductible by the borrower under § 163 if the loan proceeds are used in an income-producing activity by the borrower. *When* should these inclusions and deductions occur, however? The answer to this inquiry could turn on both (1) properly identifying principal and interest and (2) the borrower's and lender's method of accounting.

### *Identifying principal and interest*

When payments are transferred from the borrower to the lender, how do we economically

[8] *See* Prop. Treas. Reg. § 1.7872-4(d)(2)(i).
[9] *See* § 7872(c).

identify interest from principal? After reading the material in Parts A. and B., you now know that merely calling a payment "interest" or "principal" does not necessarily make it so for tax purposes. Rather, the answer is intimately related to the time value of money and the realization requirement.

Let's return to Betty Borrower and Larry Lender, and let's assume that Betty borrows $10,000 from Larry for three years. At the end of each of Years 1, 2, and 3, Betty must pay 4% interest to Larry ($400 in each year), and she must also repay the $10,000 at the end of Year 3. Such a loan arrangement is usually called an "interest-only loan with a balloon payment" because Betty pays only interest over the loan term, with a large "balloon" payment at the end of Year 3 comprising both her final interest payment and the $10,000 loan principal. The $10,000 transferred to Betty is, indeed, the loan's real principal because, as of the beginning of Year 1, the present value of each of her $400 interest payments, as well as the present value of her obligation to repay the $10,000 at the end of Year 3, adds up to $10,000 (using our agreed-upon 4% discount rate).

**Example 2**

| Due at end of Year | Amount | Present Value as of beginning of Year 1 |
|---|---|---|
| 1 | $400 | $384.62 |
| 2 | 400 | 369.82 |
| 3 | 400 | 355.60 |
| 3 | 10,000 | 8,889.96 |
| | | $10,000.00 |

Can Larry exclude any part of the first $400 payment received from Betty at the end of Year 1 as tax-free basis recovery in the loan—Larry's original investment—or must he treat it entirely as includable interest? The answer is that he must treat the entire payment as interest but not because the loan documents call the $400 interest but rather because, if we again calculate the present value of the remaining payments at the beginning of Year 2, we see that the present value of his future receipts continues to add up to $10,000—the amount that he originally transferred to Betty.

| Due at end of Year | Amount | Present Value as of beginning of Year 2 |
|---|---|---|
| 2 | $400 | $384.62 |
| 3 | 400 | 369.82 |
| 3 | 10,000 | 9,245.56 |
| | | $10,000.00 |

Because Larry's future aggregate receipts continue to equal $10,000, we know that Larry has not yet recovered any of his original investment in the loan to Betty, which means that the $400 receipt must be interest, not repaid principal. The same analysis applies to his Year-2 receipt of $400. None of it is tax-free basis recovery because the present value of his future receipts from Betty remains $10,000.

| Due at end of Year | Amount | Present Value as of beginning of Year 3 |
|---|---|---|
| 3 | $400 | $384.62 |
| 3 | 10,000 | 9,615.38 |
| | | $10,000.00 |

When Larry receives $10,400 from Betty at the end of Year 3, he can finally recover his $10,000

basis tax-free, but he must include the remaining $400 as interest.

Suppose, however, that Larry and Betty agree that she will make three equal-amount annual payments to Larry to retire the $10,000 loan at a 4% annual interest rate, compounded annually, instead of interest-only payments coupled with a balloon payment at the end of the loan term. In that case, Betty would make three payments of $3,603.49,[10] adding up to $10,810.47. We know that this payment plan is correct because the present value of all three payments (as of the beginning of Year 1) is $10,000, using the agreed-upon 4% discount rate.

**Example 3**

| Due at end of Year | Amount | Present Value as of beginning of Year 1 |
|---|---|---|
| 1 | $3,603.49 | $3,464.89 |
| 2 | 3,603.49 | 3,331.63 |
| 3 | 3,603.49 | 3,203.49 |
| | | $10,000.00 |

We also know that Larry will include a total of $810.47 in interest and exclude $10,000 as tax-free basis (principal) recovery. But how much of each $3,603.49 represents interest and how much represents tax-free basis recovery? Because the payments are of equal amounts, can we allocate the $810.47 in interest equally across the three payments? No.

When Larry receives the first $3,603.49 payment, we determine how much is tax-free basis recovery for Larry by determining the present value of Larry's remaining two payments.

| Due at end of Year | Amount | Present Value as of beginning of Year 2 |
|---|---|---|
| 2 | $3,603.49 | $3,464.89 |
| 3 | 3,603.49 | 3,331.63 |
| | | $6,796.52 |

*For the first time, the present value of Larry's future receipts is less than the $10,000 originally loaned to Betty.* Larry has thus suffered a loss *in the underlying loan investment* (viewed alone) because of the receipt of that first $3,603.49 payment. If, for example, Larry were to attempt to sell his debt instrument to Bob Buyer on January 1 of Year 2 (after he received that first cash payment from Betty), he would be in a position to demand no more than $6,796.52 for it because that is the present value of the future payments that the holder of the loan (whether Larry or Bob) will be able to collect. Even though Larry has not actually sold the note to another, his loss can fairly be said to be "realized" because it is permanent and irretrievable. You learned in Chapter 1, Part A., that a "loss" in the tax sense is unrecovered basis and can be deducted under § 165(c)(1) or (2) if the loss arises with respect to a business or investment asset. In this context, however, the realized loss in the loan simply permits Larry to use the basis represented by that "loss" in his investment to shelter part of the cash receipt from Betty as tax-free basis recovery. Stated another way, Larry does not deduct that basis but rather can recover it tax free against the payment to the extent of the loss determined above because Larry's loss in his loan investment is realized. (This idea is explored more fully in a few pages.) The realized loss is $3,203.48: the $10,000 present value of his future payments as of the beginning of Year 1 *less* the present value of his future

[10] I used an online calculator found at www.free-online-calculator-use.com/fixed-payment-loan.html to derive this number.

payments as of the beginning of Year 2. This $3,203.48 represents the portion of the $3,603.49 received from Betty at the end of Year 1 that represents tax-free basis recovery of his original $10,000 investment, *i.e.*, that represents the return of loan principal. The remaining $400.01 received is interest.

At the end of Year 2, when Larry receives the second payment of $3,603.49, how much is tax-free basis recovery (principal) and how much is interest? Once again, we must compute the present value of Larry's remaining payment.

| Due at end of Year | Amount | Present Value as of beginning of Year 3 |
|---|---|---|
| 3 | $3,603.49 | $3,464.89 |

The difference between the present value of his investment as of the beginning of Year 2 ($6,796.52) and the present value of his remaining payment as of the beginning of Year 3 ($3,464.89) is $3,331.63, which represents the portion of his $3,603.49 Year-2 receipt that represents tax-free basis recovery, with the remaining $271.86 representing interest. As of the beginning of Year 3, Larry has recovered $6,535.11 of his original $10,000 basis in the loan to Betty ($3,203.48 at the end of Year 1 and $3,331.63 at the end of Year 2), leaving remaining basis of $3,464.89 in the loan. Thus, when Larry receives the final $3,603.49 payment, $3,464.89 is tax-free basis recovery, and $138.60 is interest. Here is a summary.

| | Payment | | Principal (loss in present value) | | Interest |
|---|---|---|---|---|---|
| Year 1 | $3,603.49 | - | $3,203.48 ($10,000 *less* 6,796.52) | = | $400.01 |
| Year 2 | 3,603.49 | - | 3,331.63 ($6,796.52 *less* 3,464.89) | = | 271.86 |
| Year 3 | 3,603.49 | - | 3,464.89 (remaining basis) | = | 138.60 |
| Totals | | | $10,000.00 | | $810.47 |

***Notice that the portion of each payment representing interest decreases as time passes, and the portion of each payment representing principal (basis recovery) increases as time passes.*** Anyone who has made equal-amount mortgage payments on a home loan (and who has deducted the "qualified residence interest" paid each year) is familiar with this relationship. In the early years, a large portion of each payment represents deductible interest, but as the years pass, the portion of each payment representing deductible interest decreases.

Notice also that the total interest paid by Betty in Example 3 ($810.47) is significantly less than she had to pay in Example 2 ($1,200) over the same three years. In Example 2, she paid only interest (and made no principal repayments) during the 3-year term. By retiring a portion of the principal with each payment in Example 3, Betty pays less aggregate interest over the 3-year payment term on the same amount of originally borrowed principal ($10,000).

The method illustrated above to determine how much of each payment is economically interest in a level-payment loan is referred to as the "declining balance method," as the portion representing interest is computed by reference to the declining balance of the loan principal over time, using the present-value analysis of remaining future payments. It is also sometimes referred to as the "economic accrual of interest method."

***Segue to a brief discussion of methods of accounting***

The last chapter of this textbook will delve into a taxpayer's method of accounting in greater detail, but we need to engage in a crash course on the basic rules here, as it will affect not only the

matters considered in this chapter but also the lender's potential bad-debt deduction (considered in the next chapter) if a borrower fails to pay required interest.

In particular, now that we have identified how much of each payment is economically interest and how much is principal, we must consider whether the borrower's and lender's method of accounting affects the timing of the lender's interest inclusion or the borrower's interest deduction (if the interest is, in fact, deductible under § 163). To set the stage, I shall announce the results up front. Generally speaking, the taxpayer's method of accounting will not affect the timing of interest inclusions and deductions! Regardless of the method of accounting used by Betty and Larry in Example 3, Betty would deduct (if the interest is, in fact, deductible under § 163) and Larry would include $400.01 of interest in Year 1, $271.86 in Year 2, and $138.60 in Year 3. Moreover, in Example 2, Betty and Larry would deduct and include, respectively, $400 in interest in each of Years 1, 2, and 3—regardless of their method of accounting.

More important (and perhaps most surprising to students), let's return to the loan described way back in Example 1, under which Betty received $100,000 in Year 1 and paid a total of $148,024.43 in Year 10 to Larry. Even here, Betty would generally have to deduct the interest as it economically accrues over the 10-year period, and Larry would have to include the interest as it accrues over the 10-year period—regardless of their method of accounting.

Let's explore why each of these conclusions is true.

**A taxpayer's method of accounting generally governs *only* the timing of (1) § 61 Gross Income inclusions and (2) "expense" deductions (under Code sections authorizing deduction of expenses, such as §§ 163 for interest, 162 business expenses, 212 investment expenses, *etc.*).** A taxpayer's method of accounting has no impact on other significant timing issues, such as whether an outlay is properly categorized as an "expense" or a "capital expenditure" in the first place or how property basis should be depreciated or amortized (if it is depreciable or amortizable).

The two major methods of accounting are the *cash method of accounting* and the *accrual method of accounting*. *See* Treas. Reg. § 1.446-1(a). **Under the cash receipts and disbursements method of accounting (typically shortened to the cash method of accounting or simply the cash method), taxpayers generally include Gross Income items in the year actually or constructively received[11] and deduct expenses in the year actually paid.**[12] Virtually all individual wage earners, for example, use the cash method of accounting. Thus, if Betty and Larry both use the cash method in Example 3, they deduct (Betty) or include (Larry) $400.01 in Year 1, $271.86 in Year 2, and $138.60 in Year 3 because those are the years in which these interest payments were actually paid and received.

**Under the accrual method of accounting, Gross Income accrues (*i.e.*, is included) in the year in which (1) all the events have occurred to fix the right to receive the income and (2) the amount can be determined with reasonable accuracy. Expenses are accrued (*i.e.*, are deducted) in the year in which (1) all the events have occurred to establish the fact of liability, (2) the liability can be established with reasonable accuracy, and (3) economic performance**

[11] Under the "constructive receipt doctrine," a cash method taxpayer cannot avoid including a Gross Income item to which he has a current right merely by delaying possession of the item. Thus, for example, a cash method taxpayer cannot move compensation income from December 31 of Year 1 to January 1 of Year 2 (thus gaining a full year's worth of the time value of money by including the compensation on his tax return filed in Year 3 instead of his tax return filed in Year 2) by failing to pick up his December paycheck until early January. *See* Treas. Reg. § 1.451-2.
[12] *See* Treas. Reg. § 1.446-1(c)(1)(i).

**within the meaning of § 461(h) has occurred.**[13] The first two requirements listed for both inclusion (of Gross Income items) and deduction (of expense items) are usually referred to as the "all-events test." Under the all-events test, the timing of actual payment or receipt is irrelevant.[14]

For an example unrelated to interest, suppose that Daniel Dentist, an accrual method taxpayer, has performed an examination and cleaned the teeth of a patient on November 15 of Year 1. On December 15, Daniel sends a bill for $100 to the patient, who pays the $100 on January 3 of Year 2. Because all of the events have occurred to fix Daniel's right to receive the patient's $100 payment when he sends the bill in December, Daniel must include the $100 in Year 1, not Year 2 (when he actually receives the payment). What tax consequences arise in Year 2 when he actually receives it? Recall from Chapter 1 that one way to create basis (in addition to the making of a nondeductible capital expenditure) is an income inclusion with respect to property (the property is called an "account receivable" here). When Daniel includes $100 in his Year-1 Gross Income, he creates a $100 basis in the "account receivable" represented by the amount owed by the patient. When Daniel actually receives the $100 in Year 2, therefore, the payment is *tax-free recovery of basis in the receivable*, rather than includable Gross Income.

On the deduction side, when can Daniel deduct his $150 office electricity bill for the month of November, which he receives on December 15 of Year 1 but pays in January of Year 2? He can deduct that $150 in Year 1 because the all-events test is satisfied by December 31 of Year 1, even though he pays in January of Year 2. That is to say, all the events have occurred to establish his liability to pay the $150 electricity bill by the end of Year 1, and the amount can be determined with precision.[15]

So when does interest accrue for an accrual method lender (inclusion under § 61(a)(4)) and for an accrual method borrower (possible deduction under § 163)? The accrual method lender includes interest *as the right to receive it is earned simply as time passes under the "economic accrual of interest" method* and the accrual method borrower deducts interest (if it is deductible under § 163) *as the liability to pay it is established simply as time passes under the "economic accrual of interest" method* because, in each case, all the events have occurred to establish the right to receive, or the liability to pay, the interest, which can be determined with accuracy.[16]

So let's return to Betty's three annual payments of $3,603.49 to Larry in Example 3 but now assume that both use the accrual method of accounting. If Betty's interest is deductible under § 163, she can deduct it at the rate of $400.01 in Year 1, $271.86 in Year 2, and $138.60 in Year 3, even if the loan documents recite that the aggregate $810.47 in interest should be considered as accruing under a different formula that would allocate more than $400.01 to Year 1.[17] Similarly,

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[13] *See* Treas. Reg. § 1.446-1(c)(1)(ii).

[14] The timing of receipt may be relevant in some circumstances not pertaining to interest under the additional economic performance requirement applicable to deductions, which is discussed in more detail in Chapter 22.

[15] Economic performance within the meaning of § 461(h) would also occur as he received the electricity. *See* § 461(h)(2)(A).

[16] In addition, economic performance (required for deduction of the interest payment by the accrual method borrower) occurs with respect to interest "as the interest cost economically accrues" under Treas. Reg. § 1.461-4(e). The reference to economic accrual in that regulation is a reference to the economic accrual of interest method.

[17] In the world of consumer credit agreements, the documents can sometimes describe the rate at which interest accrues on a loan under "the Rule of 78s," sometimes known as the "sum of the digits" method. The details of the Rule of 78s are not important for our purposes except to note that the timing of interest overstates the portion of each payment that would be considered "interest" in the early years under economic accrual principles reflected in the declining balance method (and, thus, understates interest in the later years of the loan period). Of course, because of

Larry accrues (includes) the interest payments in the same amount each year.

This analysis shows why the statement made at the beginning of this section was correct that Betty and Larry would deduct and include (respectively) $400.01 in Year 1, $271.86 in Year 2, and $138.60 in Year 3 in Example 3—*regardless of their method of accounting.*

Similarly, in Example 2, where Betty pays $400 in interest to Larry in each of Years 1, 2, and 3 and also repays the $10,000 principal to Larry in Year 3, both can deduct and include, respectively, $400 in interest in each of Years 1, 2, and 3—regardless of their method of accounting. If they each use the cash method of accounting, the interest is actually paid and received in those years. If they each use the accrual method of accounting, the interest economically accrues at $400 in each of the three years because the present value of Larry's Year-3 receipt never falls below $10,000 during the three-year loan term, which means that the interest accruals reflect the actual $400 payments. Thus, it also does not matter if one uses the cash method and the other uses the accrual method. Each still includes or deducts, respectively, $400 in each of Years 1, 2, and 3 of Example 2.

The sticky one is Example 1, where the borrower receives $100,000 on January 1 of Year 1 and pays $148,024.43 to the lender on December 31 of Year 10, which brings us to the topic of original issue discount.

***Original issue discount***

High Tech, Inc., uses the accrual method of accounting, and it intends to sell three-year bonds paying the going rate of 4% interest to the public as a means of borrowing money. While couched in the terms of "purchase" and "sale," High Tech is simply borrowing money when it sells bonds. Candace, who uses the cash method of accounting, is an individual interested in purchasing a three-year bond from High Tech.

Assume that High Tech wishes to avoid annual interest payments so that it can invest its cash elsewhere in the interim. Thus, Candace is informed that the face amount or principal amount of the bond is $11,248.64, which is the total amount that she will receive at the bond's maturity on December 31 of Year 3. How much would Candace be willing to pay on January 1 of Year 1 as the "issue price" for the bond if she knows that the current discount rate for similar loans is 4%, compounded annually? Using an online calculator, Candace determines that she should pay no more than $10,000 for the bond, as that is the present value of $11,248.64 using a 4% interest rate, compounded annually. The $1,248.64 difference between the bond's $10,000 "issue price" and the $11,248.64 stated principal amount at maturity is called "original issue discount" (OID), which obviously is economic interest.

Let's first consider High Tech's interest accruals (deductions) for this interest in the form of OID. How much of the aggregate $1,248.64 interest accrues *economically* in each of Years 1, 2, and 3? Here is how High Tech would calculate it:

Year 1: $10,000 x .04 = $400 interest, which is unpaid. High Tech now owes $10,400.

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the time value of money, accrual method borrowers paying deductible interest would love to be able to identify which portion of each payment is interest under the Rule of 78s in order to deduct the interest sooner rather than later. In Rev. Rul. 83-84, 1983-1 C.B. 97, however, the IRS exercised its authority under § 446(b) to reject such a method of accounting for interest because it does not clearly reflect income, and the Tax Court and 3rd Circuit agreed in Prabel v. Commissioner, 91 T.C. 1101 (1988) (reviewed), *aff'd* 882 F2d 820 (3rd Cir. 1989).

Year 2: $10,400 x. 04 = $416 interest, which is unpaid. High Tech now owes $10,816.

Year 3: $10,816 x. 04 = $432.64 interest. Added to $10,816, High Tech pays to Candace a total of $11,248.64, equal to the face amount of the bond, on December 31 of Year 3. We can summarize this result as follows:

**Example 4**

| | Interest accrued at 4% | Accumulated Principal & Interest |
|---|---|---|
| Jan 1 of Year 1 | — | $10,000 |
| End of Year 1 | $400 | 10,400 |
| End of Year 2 | 416 | 10,816 |
| Dec 31 of Year 3 | 432.64 | 11,248.64 |

If Candace is an accrual method taxpayer, she also includes $400 in Year 1, $416 in Year 2, and $432.64 in Year 3 as interest. But we previously stipulated that Candace uses the cash method of accounting. Does that mean that Candace can delay inclusion of her $1,248.64 in aggregate interest until it is received in Year 3?

If Candace were permitted such a deferral, notice the mismatch that would arise between the timing of High Tech's deduction and Candace's inclusion of the same amounts. Notice also that, even though High Tech deducts the interest in each of Years 1, 2, and 3, *the interest is not yet paid*, which means that High Tech could effectively invest the unpaid interest and earn a return on pre-tax (deducted) dollars, as though High Tech were accorded more favorable consumption tax treatment (rather than income tax treatment), as you learned in Chapter 2.

By the early 1980s, scholars such as Daniel Halperin demonstrated that, assuming that both High Tech and Candace are in the same tax bracket, no revenue is lost to the Treasury with respect to the implicit return on High Tech's investment of pre-tax (deducted) dollars—*so long as Candace immediately includes the interest as it accrues.* If *both* Candace were permitted to defer inclusion of the interest until received *and* High Tech were permitted to deduct the interest as it accrues (even though not yet paid), Treasury loses the tax revenue that would otherwise be owed on the return earned by High Tech on the accrued-but-as-yet-unpaid interest during the interim between High Tech's deduction and payment of the interest. In other words, because of the timing mismatch between Candace's inclusion and High Tech's deduction of the unpaid interest, investment earnings could effectively slip through the cracks between the two taxpayers and avoid being effectively taxed at all.[18]

Congress responded earlier to such timing mismatches between accrual method and cash method taxpayers *not* involving interest. For example, the accrual method employer's § 162 deduction for compensation paid to a cash method employee in the form of property paid in kind that is subject to a substantial risk of forfeiture (considered in Chapter 5) is deferred until the year in which the employee includes the compensation.[19] Similarly, other expense deductions of an accrual method taxpayer for amounts paid to "related" cash method taxpayers (such as family members or controlled corporations), who would not include the receipt in Gross Income until paid, is deferred until the year in which the related party includes it.[20]

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[18] *See, e.g.*, Daniel I. Halperin, *Interest in Disguise: Taxing the Time Value of Money*, 95 YALE L.J.506 (1986).
[19] *See* § 83(h).
[20] *See* § 267(a)(2).

In 1984—the same year that saw the enactment of § 7872, considered in Part B.—Congress enacted §§ 1272 and 163(e), both of which essentially provide that Candace must include the OID as it accrues daily (even though she uses the cash method), which effectively prevents the mismatch that would otherwise occur between High Tech's deduction of the three interest amounts and Candace's inclusion of the same interest.[21] Thus, Candace must include $400 in interest in Year 1 (and will increase her $10,000 basis in the bond to $10,400 to reflect the income inclusion), $416 in Year 2 (increasing her bond basis to $10,816), and $432.64 in Year 3 (increasing her bond basis to $11,248.64). When she actually receives the $11,248.64, the entire amount is tax-free recovery of basis. High Tech will send an information return to Candace so that she knows how much to include on each year's return.

Similarly, let's return to Example 1, where Betty Borrower borrows $100,000 on January 1 of Year 1 from Larry Lender and pays a total of $148,024.43 to him on December 31 of Year 10. While the OID rules do not apply to loans between natural persons (*i.e.*, human beings) so long as the loan amount does not exceed $10,000 and the loan is not made in the course of a trade or business of the lender, this particular loan exceeds $10,000. Thus, even if both Larry and Betty use the cash method of accounting, each would deduct and include, respectively, the interest as it economically accrues over the 10-year term of the loan.[22]

***OID pertains to realization rather than accounting methods***

In the end, however, OID is not really about methods of accounting at all. Instead, OID arises from the realization doctrine. Recall that increases and decreases in the value of property are generally ignored under the realization requirement until disposition occurs. In most cases, the many factors that affect value are by their nature transient, which means that any changes to value may well be temporary. Nevertheless, some value changes—or, more accurately stated, one strand of a property's aggregate change in value—may be permanent and irreversible and, in this sense, realized in a real and substantial sense, even if other factors affecting a property's value are not permanent (and thus value changes attributable to those other factors are not realized).

Such reasoning, for example, justifies deductions of property basis in the form of depreciation *even before the property is disposed of (where the basis would otherwise be used as an offset against "amount realized" under § 1001)*. Depreciation deductions can also superficially appear to be inconsistent with the realization doctrine. Nevertheless, *if and only if business property wastes away in a predictable manner with use just as time passes*, one strand of the property's aggregate fair market value may be fairly considered to be permanently and irretrievably lost—just as time passes—as it gets closer and closer to the end of its useful life, even if the property's aggregate fair market value is constantly fluctuating because of other factors that also affect market value, though in a way that is not permanent. Depreciation, in other words, can be thought of as deductions of realized losses—in the sense that they are permanent and irretrievable losses in value—that arise solely because of the passage of time with business use, even though the property has not yet been transferred to another. Even if the property's *aggregate* fair market value is rising because of other (perhaps transient) factors in the marketplace, one strand of the property's value is permanently and irretrievably lost each year as it gets one year closer to the end of its useful life. Or so the argument goes. We shall return to this theme and explore it more fully in Chapter 14, devoted to examining depreciation and amortization more closely.

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[21] *See* §§ 1272(a)(1) and (3).
[22] *See* § 1272(a)(2)(E).

The reasoning underlying Candace's treatment of OID is also similar (though on the flip side of the coin) to the Lender's treatment in Example 3 a few pages back, where Larry Lender is permitted to use a portion of the $10,000 basis in his loan to offset a portion of each $3,603.49 payment that he receives from Betty—*before* he disposes of his loan by, say, selling the debt instrument to a buyer in the market. He is permitted (in effect) to "deduct" portions of his loan basis while he still owns the loan because that portion of the loan is permanently and irretrievably lost as he receives payments and the loan maturity gets closer and closer. (Larry does not take an actual deduction, though. Rather, he uses that basis to prevent a portion of each cash payment received from Betty Years 1, 2, and 3 from being includable in Gross Income.) Even if the aggregate fair market value of his loan instrument fluctuates for other reasons (such as changes in interest rates since he first made the loan to Betty), this *one strand* of value is permanently reduced when he receives each $3,603.49 payment from Betty in Years 1 and 2. As described earlier, he could not, for example, successfully sell his debt instrument to Bob Buyer on January 1 of Year 2 for $10,000. Absent other market factors than can also affect the value of Larry's loan instrument, Larry is in a position to demand no more than $6,796.52 (and Bob Buyer would be willing to pay no more than that) because that is the present value of the remaining payments to be received under the debt instrument as of January 1 of Year 2. In other words, Larry rightly is permitted to use $3,203.48 of his original $10,000 basis in the debt instrument to offset a portion of the $3,603.49 payment from Betty at the end of Year 1—even though he still owns the debt instrument—because his property (the debt instrument) has permanently and irretrievably lost $3,203.48 of its original market value when he receives that payment from Betty. That $3,603.49 is rightly viewed as a "realized loss" at the end of Year 1 so that he can, in effect, deduct this portion of his original property basis (by using this basis as an offset against his receipt), even though he continues to own the debt instrument and has not sold it.

Candace's OID inclusions reflect the flip side of that same coin. Even though Candace does not receive a $400 interest payment at the end of Year 1, her debt instrument permanently and irreversibly increases in value by $400 because $400 of interest *economically* accrues just with the passage of time, as the loan instrument gets one year closer to its maturity. If Candace were to sell her High Tech bond in the market on January 1 of Year 2, she would clearly be able to demand $10,400 for it from Bob Buyer (not $10,000), assuming no other changes in market factors that affect other strands of her bond's value, such as interest rate changes. That is to say, this *one strand* of her bond's value permanently increases, which means that this *one strand* of increased value is "realized" in Year 1, even if other market factors that affect value mean that she can actually sell the bond on January 1 of Year 2 for, say, $10,500 (if market interest rates have dropped to less than 4% since she bought her High Tech bond, increasing the value of Candace's bond)[23] or, say, $10,300 (if market interest rates have increased to more than 4%, decreasing the value of Candace's bond).[24] The point is that the $400 of interest that economically accrues in Year 1 is a realized wealth accession in a substantial sense and thus should be included. Because Candace must include $400 in interest (which is ordinary income) for Year 1, she increases her bond basis to $10,400. Thus, if she sells for $10,500 on January 1 of Year 2, she would realize a $100 capital

[23] The $100 paid in excess of the $10,400 of principal and accrued interest is called "bond premium," and the buyer can "amortize" (deduct) the $100 premium over the remaining term of the bond to the extent allowed under § 171.

[24] The $100 discount enjoyed by the bond buyer is called "market discount," and the buyer will not include the $100 market discount before maturity (or a prior sale to yet a new owner), though the discount will be included as ordinary income when realized. *See* §§ 1276 and 1278. In contrast, the new buyer will continue to include the OID each year as it accrues, just as Candace would have included it had she not sold the bond.

gain. If she sells for $10,300 on the same date, she would realize a $100 capital loss. In either case, though, she will have already included $400 of ordinary income in Year 1, reflecting the Year-1 earned interest.

## D. Recovery of annuity basis under § 72

The material that you just learned in Part C. can be brought to bear with respect to the timing of basis recovery with respect to annuities, which is subject to favorable tax rules. A simple annuity is a financial instrument under which the buyer pays a either a lump sum or stream of premium payments to the annuity seller (often an insurance company) in order to obtain a future level-payment stream, usually (though not necessarily) in retirement. Some annuities are funded with pre-tax dollars through a tax-preferred employer pension plan, a § 401(k) plan, or Individual Retirement Account. The additional refinements and modifications applicable to these types of annuities are beyond the basic income tax course. Rather, the annuities described here are funded with after-tax (undeducted) dollars. That is to say, the premium payments are nondeductible capital expenditures, creating basis in the annuity contract.

You can think of the annuitant (the person purchasing the annuity) as a lender to the company selling the annuity, who will repay the principal lent, plus interest, to the annuitant in the future. When must the annuitant include the investment return, which represents interest?

Annuities are treated quite favorably for tax purposes. First, annuities are not subject to the OID rules. Thus, if Candace purchases an annuity instead of the High Tech bond, she need not include the inside buildup (the increase in the value of her contract because of the accrued but unpaid interest) over time. Rather, she is permitted to exclude all interest until payments begin.

As noted above, annuity contracts typically pay level payments once the payment period begins. At that time, the taxpayer must determine how much of each payment represents tax-free basis recovery, with the remaining amount includable in Gross Income as interest, and this is where the second tax preference arises. If the basis recovery schedule conforms to economic accrual of interest principles for a level-payment loan (Example 3 in Part C.), the percentage of each payment that represents tax-free basis recovery should start lower and increase over time, which means that the portion of each payment attributable to includable interest should start higher and decrease over time (as more and more of each payment constitutes tax-free basis recovery). In Example 3, Larry Lender received three equal payments of $3,603.49 over the repayment period, and he had to include $400.01 in Year 1, $271.86 in Year 2, and $138.60 in Year 3 as interest.

Section 72, however, departs from these normative principles by allowing the annuitant to recover basis *ratably*, which generally means in equal amounts from each payment. Start with § 72(a)(1), which appears to provide for 100% inclusion of all annuity payments. The real operative provision, however, is § 72(b)(1), which provides that the inclusion rule in subsection (a) shall not apply to the extent of the "exclusion ratio," defined as the amount of each payment received under the contract that "bears the same ratio … as the investment in the contract (as of the annuity starting date) bears to the expected return under the contract (as of such date)." We can reduce the language found in § 72(b)(1) to a formula.

$$\text{Excluded portion of each payment} = \text{Payments Received in the Year} \times \frac{\text{Investment in the Contract}}{\text{Expected Return under the Contract}}$$

The "investment in the contract" is, in essence, the annuitant's basis in the contract when

payments begin (the sum of prior nondeductible payments made to purchase the annuity), which the taxpayer should be able to recover tax free. The "expected return under the contract" is the aggregate gross amount expected to be received under the contract when payments begin, computed by multiplying the annual payment to be received under the contract by the anticipated number of annual payments.

Assume, for example, that Dora pays $1 million from her past savings for an annuity contract on January 1 of Year 1, which is Dora's 65th birthday. Under the annuity contract, Dora will receive $5,000 monthly payments beginning on January 31 of Year 1 and ending on Dora's death. In Year 1, Dora receives a total of $60,000 (12 payments of $5,000 each). How much of the $60,000 is she permitted to exclude under the § 72(b)(1) exclusion ratio as recovery of her original $1 million investment?

The numerator of Dora's exclusion ratio is $1 million. Under § 72(c)(3)(A), the denominator will be determined using actuarial tables issued by the Treasury Department, which can be found at Treas. Reg. § 1.72-9. Under Table V, Dora's life expectancy as of the annuity starting date is 20 years. Thus, her expected gross return under the contract is $1.2 million ($60,000 annual payments x 20 years). Dora can exclude 83.4% ($1 million/$1.2 million) of each $60,000 that she receives annually, or $50,040, as representing tax-free basis recovery. She must include $9,960 each year. Her exclusion ratio does not change over the following 19 years. Thus, she will exclude the same $9,960 from each $60,000 annual payment. *In short, she is permitted to recover her basis faster than could Larry Lender in Example 3, thus permitting the deferral of income.* Why is this deferral beneficial for Dora? All together now ….

If Dora exceeds her 20-year life expectancy, she will have recovered 100% of her $1 million basis tax-free upon reaching age 85. Thus, any additional annuity payments that she receives will be fully includable under § 72(b)(2)—often referred to as "mortality gain." On the other hand, Dora may die prematurely. Some annuity contracts will, in exchange for lower annual payments, provide a guarantee of a certain number of payment years, with any remaining payments at the time of the annuitant's premature death paid to a designated beneficiary or to the annuitant's estate. Dora's final tax return can deduct any remaining unrecovered basis. If the deduction exceeds her Gross Income in that final year, her executor can carry the unused portion of the deduction back to her two previous tax years (thus obtaining a refund for those two earlier years for her estate) under § 72(b)(3)(A) and (C), as though the deduction were incurred in business and created a "net operating loss" within the meaning of § 172.[25]

Annuities are commonly measured by two lives in the case of a married couple, with payments surviving the death of the first spouse. The life expectancy tables that determine the expected return under the contract will differ from those applicable to an annuity measured by a single life, and the survivor continues to apply the same exclusion ratio as before the death of the first spouse.

The price to pay for these favorable tax rules after the annuity starting date is that unfavorable rules will apply if an annuitant receives a distribution under the contract *prior* to the annuity starting date. First, the distribution is deemed to come from the untaxed inside buildup *first* and, thus, will be fully includable to the extent thereof.[26] Only after all accrued interest is distributed will further distributions prior to the annuity starting date be considered tax-free recovery of basis. Second, a loan under the annuity contract will usually be considered to be a distribution of inside

[25] Section 172 is considered in Chapter 21.
[26] *See* § 72(e)(2)(B).

buildup (and thus includable) rather than a true loan.[27] Third, with some hardship exceptions (such as in the case of disability), an additional 10% tax penalty will generally be imposed on withdrawals before the age of 59 and ½.[28]

On the face of § 72, Dora appears to be the target of these favorable tax rules, but who really benefits from them? Annuities are notorious for providing low returns (a low interest rate). Recall the concept of "capture" first discussed in Chapter 2 in connection with § 103 interest and further explored in Chapter 3.

**Problem**

Karen pays $150,000 to an insurance company for an annuity contract that will begin making annual $10,000 payments to her when she reaches age 65 on January 1 of a future year, at which time she will have a 20-year life expectancy. When Karen begins receiving payments at age 65, how much of each $10,000 annual payment must she include in her Gross Income? How much must Karen include if she succeeds in beating the odds and receives a $10,000 payment in her 86th year?

## E. Which receipts fall within the "borrowing exclusion"?

The borrowing exclusion is quite valuable because it allows the receipt of cash (in the usual case) to be excluded from Gross Income, *even though the cash does not represent basis recovery*. Not surprisingly, therefore, taxpayers have argued that all sorts of receipts fall within the borrowing exclusion. How is a "loan" defined for Federal income tax purposes? What portions of the *James* case, below, can be cobbled together to create a workable definition of a "loan" for Federal income tax purposes? How did the Court go so wrong in *Wilcox*, making contorted distinctions between embezzlers (*Wilcox*) and extortionists (*Rutkin*)? How was the language in *North American Oil*, which follows *James*, possibly misused by the *Wilcox* Court in arriving at its original, misguided decision? Note footnote 7 in *James*.

**JAMES v. UNITED STATES**

366 U.S. 213 (1961)

MR. CHIEF JUSTICE WARREN announced the judgment of the Court and an opinion in which MR. JUSTICE BRENNAN and MR. JUSTICE STEWART concur.

The issue before us in this case is whether embezzled funds are to be included in the "Gross Income" of the embezzler in the year in which the funds are misappropriated under § 22(a) of the Internal Revenue Code of 1939 and § 61(a) of the Internal Revenue Code of 1954.

The facts are not in dispute. The petitioner is a union official who, with another person, embezzled in excess of $738,000 during the years 1951 through 1954 from his employer union and from an insurance company with which the union was doing business. Petitioner failed to report these amounts in his Gross Income in those years and was convicted for willfully attempting to evade the Federal income tax due for each of the years 1951 through 1954 in violation of §

[27] *See* §§ 72(e)(4)(A) and (p).
[28] *See* §§ 72(q), (t) and (v).

145(b) of the Internal Revenue Code of 1939 and § 7201 of the Internal Revenue Code of 1954. He was sentenced to a total of three years' imprisonment. The Court of Appeals affirmed. Because of a conflict with this Court's decision in *Commissioner v. Wilcox*, 327 U.S. 404, a case whose relevant facts are concededly the same as those in the case now before us, we granted certiorari.

In *Wilcox*, the Court held that embezzled money does not constitute taxable income to the embezzler in the year of the embezzlement under § 22(a) of the Internal Revenue Code of 1939. Six years later, this Court held, in *Rutkin v. United States*, 343 U.S. 130, that extorted money does constitute taxable income to the extortionist in the year that the money is received under § 22(a) of the Internal Revenue Code of 1939. In *Rutkin*, the Court did not overrule *Wilcox*, but stated: "We do not reach in this case the factual situation involved in *Commissioner v. Wilcox*, 327 U.S. 404. We limit that case to its facts. There embezzled funds were held not to constitute taxable income to the embezzler under § 22(a)." *Id.*, at 138.

However, examination of the reasoning used in *Rutkin* leads us inescapably to the conclusion that *Wilcox* was thoroughly devitalized.

The basis for the *Wilcox* decision was "that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit within the reach of § 22(a)." Since Wilcox embezzled the money, held it "without any semblance of a bona fide claim of right," and therefore "was at all times under an unqualified duty and obligation to repay the money to his employer," the Court found that the money embezzled was not includible within "Gross Income." But Rutkin's legal claim was no greater than that of Wilcox. It was specifically found "that petitioner had no basis for his claim … and that he obtained it by extortion." Both Wilcox and Rutkin obtained the money by means of a criminal act; neither had a bona fide claim of right to the funds. [7] Nor was Rutkin's obligation to repay the extorted money to the victim any less than that of Wilcox. The victim of an extortion, like the victim of an embezzlement, has a right to restitution. Furthermore, it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title. Questions of Federal income taxation are not determined by such "attenuated subtleties." *Lucas v. Earl*, 281 U.S. 111, 114. Thus, the fact that Rutkin secured the money with the consent of his victim is irrelevant. Likewise unimportant is the fact that the sufferer of an extortion is less likely to seek restitution than one whose funds are embezzled. What is important is that the right to recoupment exists in both situations.

Examination of the relevant cases in the courts of appeals lends credence to our conclusion that the *Wilcox* rationale was effectively vitiated by this Court's decision in *Rutkin*. Although this case appears to be the first to arise that is "on all fours" with *Wilcox*, the lower Federal courts, in deference to the undisturbed *Wilcox* holding, have earnestly endeavored to find distinguishing facts in the cases before them which would enable them to include sundry unlawful gains within "Gross

[7] The Government contends that the adoption in *Wilcox* of a claim of right test as a touchstone of taxability had no support in the prior cases of this Court; that the claim of right test was a doctrine invoked by the Court in aid of the concept of annual accounting, to determine when, not whether, receipts constituted income. *See* North American Oil v. Burnet, 286 U.S. 417; U.S. v. Lewis, 340 U.S. 590; Healy v. Comm'r, 345 U.S. 278. In view of our reasoning set forth below, we need not pass on this contention. The use to which we put the claim of right test here is only to demonstrate that, whatever its validity as a test of whether certain receipts constitute income, it calls for no distinction between *Wilcox* and *Rutkin*.

Income."

It had been a well-established principle, long before either *Rutkin* or *Wilcox*, that unlawful, as well as lawful, gains are comprehended within the term "Gross Income." Section II B of the Income Tax Act of 1913 provided that "the net income of a taxable person shall include gains, profits, and income … from … the transaction of any *lawful* business carried on for gain or profit, or gains or profits and income derived from any source whatever …." (Emphasis supplied.) When the statute was amended in 1916, the one word "lawful" was omitted. This revealed, we think, the obvious intent of that Congress to tax income derived from both legal and illegal sources, to remove the incongruity of having the gains of the honest laborer taxed and the gains of the dishonest immune. Thereafter, the Court held that gains from illicit traffic in liquor are includible within "Gross Income." *See Johnson v. U.S.*, 318 U.S. 189; *U.S. v. Johnson*, 319 U.S. 503. And, the Court has pointed out, with approval, that there "has been a widespread and settled administrative and judicial recognition of the taxability of unlawful gains of many kinds," *Rutkin v. U.S.*, *supra*, at p. 137. These include protection payments made to racketeers, ransom payments paid to kidnappers, bribes, money derived from the sale of unlawful insurance policies, graft, black market gains, funds obtained from the operation of lotteries, income from race track bookmaking and illegal prize fight pictures. *Ibid.*

The starting point in all cases dealing with the question of the scope of what is included in "Gross Income" begins with the basic premise that the purpose of Congress was "to use the full measure of its taxing power." *Helvering v. Clifford*, 309 U.S. 331, 334. And the Court has given a liberal construction to the broad phraseology of the "Gross Income" definition statutes in recognition of the intention of Congress to tax all gains except those specifically exempted. *Comm'r v. Jacobson*, 336 U.S. 28, 49. The language of § 22(a) of the 1939 Code, "gains or profits and income derived from any source whatever," and the more simplified language of § 61(a) of the 1954 Code, "all income from whatever source derived," have been held to encompass all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431. A gain "constitutes taxable income when its recipient has such control over it that, as a practical matter, he derives readily realizable economic value from it." *Rutkin v. U.S.*, *supra*, at p. 137. Under these broad principles, we believe that petitioner's contention, that all unlawful gains are taxable except those resulting from embezzlement, should fail.

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 retain the money, and even though he may still be adjudged liable to restore its equivalent." *North American Oil v. Burnet*, *supra*, at p. 424. In such case, the taxpayer has "actual command over the property taxed—the actual benefit for which the tax is paid," *Corliss v. Bowers*, *supra*. This standard brings wrongful appropriations within the broad sweep of "Gross Income"; it excludes loans. When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "Gross Income" in the year received. *U.S. v. Lewis*, *supra*; *Healy v. Comm'r*, *supra*. We do not believe that Congress intended to treat a law-breaking taxpayer differently. Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "If, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a reduction in the embezzler's income." Brief for the

United States, p. 24.

Petitioner contends that the *Wilcox* rule has been in existence since 1946; that if Congress had intended to change the rule, it would have done so; that there was a general revision of the income tax laws in 1954 without mention of the rule; that a bill to change it was introduced in the Eighty-sixth Congress but was not acted upon; that, therefore, we may not change the rule now. But the fact that Congress has remained silent or has re-enacted a statute which we have construed, or that congressional attempts to amend a rule announced by this Court have failed, does not necessarily debar us from re-examining and correcting the Court's own errors. *Girouard v. U.S.*, 328 U.S. 61, 69-70; *Helvering v. Hallock*, 309 U.S. 106, 119-122. There may have been any number of reasons why Congress acted as it did. One of the reasons could well be our subsequent decision in *Rutkin* which has been thought by many to have repudiated *Wilcox*. Particularly might this be true in light of the decisions of the Courts of Appeals which have been riding a narrow rail between the two cases and further distinguishing them to the disparagement of *Wilcox*.

We believe that *Wilcox* was wrongly decided and we find nothing in congressional history since then to persuade us that Congress intended to legislate the rule. Thus, we believe that we should now correct the error and the confusion resulting from it, certainly if we do so in a manner that will not prejudice those who might have relied on it. We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.

But, we are dealing here with a felony conviction under statutes which apply to any person who "willfully" fails to account for his tax or who "willfully" attempts to evade his obligation. In *Spies v. U.S.*, 317 U.S. 492, 499, the Court said that § 145(b) of the 1939 Code embodied "the gravest of offenses against the revenues," and stated that willfulness must therefore include an evil motive and want of justification in view of all the circumstances. Willfulness "involves a specific intent which must be proven by independent evidence and which cannot be inferred from the mere understatement of income." *Holland v. U.S.*, 348 U.S. 121, 139.

We believe that the element of willfulness could not be proven in a criminal prosecution for failing to include embezzled funds in Gross Income in the year of misappropriation so long as the statute contained the gloss placed upon it by *Wilcox* at the time the alleged crime was committed. Therefore, we feel that petitioner's conviction may not stand and that the indictment against him must be dismissed.

Since MR. JUSTICE HARLAN, MR. JUSTICE FRANKFURTER, and MR. JUSTICE CLARK agree with us concerning *Wilcox*, that case is overruled. MR. JUSTICE BLACK, MR. JUSTICE DOUGLAS, and MR. JUSTICE WHITTAKER believe that petitioner's conviction must be reversed and the case dismissed for the reasons stated in their opinions. Accordingly, the judgment of the Court of Appeals is reversed and the case is remanded to the District Court with directions to dismiss the indictment.

[The separate opinions of Justice Black, Justice Clark, and Justice Whitaker, each concurring in part and dissenting in part, are omitted.]

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## NORTH AMERICAN OIL CONSOLIDATED v. BURNET

286 U.S. 417 (1932)

MR. JUSTICE BRANDEIS delivered the opinion of the Court.

The question for decision is whether the sum of $171,979.22 received by the North American Oil Consolidated in 1917, was taxable to it as income of that year.

The money was paid to the company under the following circumstances. Among many properties operated by it in 1916 was a section of oil land, the legal title to which stood in the name of the United States. Prior to that year, the Government, claiming also the beneficial ownership, had instituted a suit to oust the company from possession; and on February 2, 1916, it secured the appointment of a receiver to operate the property, or supervise its operations, and to hold the net income thereof. The money paid to the company in 1917 represented the net profits which had been earned from that property in 1916 during the receivership. The money was paid to the receiver as earned. After entry by the District Court in 1917 of the final decree dismissing the bill, the money was paid, in that year, by the receiver to the company. *U.S. v. North American Oil Consolidated*, 242 Fed. 723. The Government took an appeal (without supersedeas) to the Circuit Court of Appeals. In 1920, that Court affirmed the decree. In 1922, a further appeal to this Court was dismissed by stipulation.

The income earned from the property in 1916 had been entered on the books of the company as its income. It had not been included in its original return of income for 1916; but it was included in an amended return for that year which was filed in 1918. Upon auditing the company's income and profits tax returns for 1917, the Commissioner of Internal Revenue determined a deficiency based on other items. The company appealed to the Board of Tax Appeals. There, in 1927 the Commissioner prayed that the deficiency already claimed should be increased so as to include a tax on the amount paid by the receiver to the company in 1917. The Board held that the profits were taxable to the receiver as income of 1916. The Circuit Court of Appeals held that the profits were taxable to the company as income of 1917, regardless of whether the company's returns were made on the cash or on the accrual basis. This Court granted a writ of certiorari.

It is conceded that the net profits earned by the property during the receivership constituted income. The company contends that they should have been reported by the receiver for taxation in 1916; that if not returnable by him, they should have been returned by the company for 1916, because they constitute income of the company accrued in that year; and that if not taxable as income of the company for 1916, they were taxable to it as income for 1922, since the litigation was not finally terminated in its favor until 1922….

The net profits were not taxable to the company as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. *See Burnet v. Logan*, 283 U.S. 404, 413. *Compare Lucas v. American Code Co.*, 280 U.S. 445, 452; *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company's return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive.

The net profits earned by the property in 1916 were not income of the year 1922—the year in

which the litigation with the Government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. 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. *See Board v. Comm'r*, 51 F.2d 73, 75, 76. *Compare U.S. v. S. S. White Dental Mfg. Co.*, 274 U.S. 398, 403. If in 1922 the Government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. *Compare Lucas v. American Code Co., supra*.

Affirmed.

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In both *James* and *North American Oil*, the taxpayers had to include the cash in the year received; they could not exclude the receipt under the borrowing exclusion. What if Mr. James or the North American Oil company has to repay the funds in a future year? In *James*, the Court observed:

> When a law-abiding taxpayer mistakenly receives income in one year, which receipt is assailed and found to be invalid in a subsequent year, the taxpayer must nonetheless report the amount as "Gross Income" in the year received. *U.S. v. Lewis, supra*; *Healy v. Comm'r, supra*. We do not believe that Congress intended to treat a law-breaking taxpayer differently. Just as the honest taxpayer may deduct any amount repaid in the year in which the repayment is made, the Government points out that, "If, when, and to the extent that the victim recovers back the misappropriated funds, there is of course a reduction in the embezzler's income."

Similarly, the *North American Oil* Court said in its last sentence above that the company would be permitted to deduct a repayment in 1922 if the taxpayer had lost its appeal and disgorged the cash previously received in 1917.

***Lewis and the enactment of § 1341***

In the *Lewis* case cited in the above quotation,[29] Mr. Lewis was lucky enough to receive a $22,000 bonus from his employer in 1944 (more than $300,000 in 2016 dollars), which he dutifully included in his Gross Income. In 1946, however, he received the bad news that his employer had made a mathematical error in computing the amount to which he was entitled as a bonus under their employment contract, and Mr. Lewis had to return $11,000 of the $22,000 to his employer. While Mr. Lewis clearly would have been entitled to deduct the repayment in 1946 (as the outlay clearly pertained to his trade or business as an employee), tax rates had been reduced somewhat at the end of WWII, and Mr. Lewis would not have saved as much in tax with a 1946 deduction of $11,000 as he had previously paid in tax in 1944 when that $11,000 was included in his Gross Income. Thus, Mr. Lewis sought to file an amended return for 1944, excluding the $11,000 from his 1944 Gross Income that he returned to his employer in 1946, rather than deducting the repayment in 1946. The Supreme Court agreed with the government that Mr. Lewis could not file an amended return for 1944, even though the statute of limitations was still open for that year, because his 1944 return was correct as originally filed. Mr. Lewis's deductible wealth reduction

[29] U.S. v. Lewis, 340 U.S. 590 (1951).

did not occur until 1946.

The *Lewis* case is yet another example of the "annual accounting principle," first introduced in Chapter 1, under which each year is taken as it comes. If our expectations regarding what we thought would occur in a future year (Mr. Lewis thought that he would be able to retain the extra $11,000 for all time when he obtained it in 1944) turn out to be incorrect (he had to return $11,000 in 1946), we address those changed expectations or changed circumstances in that later year. We do not allow hindsight to alter what actually happened in a prior year.[30]

Congress eventually intervened, however, by enacting § 1341, which effectively would provide a Mr. Lewis of today with the economic result that he sought, though not by allowing him to file an amended return for the earlier year. If § 1341 had been in place for Mr. Lewis, he would have been effectively provided a choice to either (1) *deduct* the $11,000 in 1946 or (2) take a dollar-for-dollar *credit* against his 1946 income tax owed (determined without a deduction for the repayment) equal to the amount of additional tax that he paid in 1944 by reason of including the $11,000. Notice, therefore, that a Mr. Lewis of today gets the best of both worlds! If tax rates were higher in the earlier year than in the repayment year, as was the case for Mr. Lewis, the tax credit route would provide the better result. If, however, the taxpayer's marginal rate is higher in the repayment year (either because Congress increased rates generally or the taxpayer's income increased sufficiently to put him in a higher tax bracket in the repayment year than applied to him in the prior inclusion year), the deduction route would provide the better result.

Section 1341 does not apply to repayments of $3,000 or less, and it requires that, in the prior inclusion year, "it appeared that the taxpayer had an unrestricted right to such item." If the amount did not exceed $3,000, or if it were known in the year of receipt that the amount might have to be repaid, the taxpayer's only avenue upon repayment would be deduction in the repayment year, as in the *Lewis* case, itself.

***A workable tax definition of "loan": absolute versus contingent obligation to repay***

If we combine the first sentence of the fifth paragraph in *James* (referring to a "definite, unconditional obligation to repay") with the first sentence in the eighth paragraph (referring to a "consensual recognition, express or implied, of an obligation to repay"), we can arrive at a workable definition of **a "loan" for Federal income tax purposes: a *consensual* recognition [*i.e.*, known and agreed to by both parties] of a *definite, unconditional* [*i.e.*, absolute, as opposed to contingent] obligation to repay."**

In *North American Oil*, in contrast, the critical language was not that referring to a "claim of right" (though unfortunately that language is often seized upon) but that referring to the *contingent nature of the repayment obligation*. The *North American Oil* Court effectively held that **a receipt subject to a *contingent* (rather than absolute) obligation to repay is includable in the year of receipt. If the contingency ripens, and the taxpayer must return the earlier receipt, the matter is dealt with in that later year under the annual accounting principle**.

Suppose that CEO Sara receives stock from her employer corporation, subject to the condition that she must continue to work for the corporation for the next three years, or else she must surrender the stock back to her employer corporation. If *North American Oil* controlled, Sara

[30] As a sneak preview, we shall see this principle again and again, including in the next chapter (§ 61(a)(12) debt-discharge income), in the capital gains chapter (so-called depreciation recapture), and in Chapter 21 (the tax benefit rule).

would have to include the FMV of the stock on receipt. If the contingency ripens, and she must return the stock to her employer, she would be entitled to a deduction in that later year. You learned in Chapter 5, however, that Sara can, in fact, exclude the stock receipt from her Gross Income until the substantial risk of forfeiture lapses under § 83(a). Section 83(a), in other words, is a statutory override of *North American Oil* in the particular context of employee compensation paid in kind that is subject to a substantial risk of forfeiture. Sara can, if she wishes, effectively elect *North American Oil* treatment, however, by making an election under § 83(b) and including the FMV of the stock in the year of receipt, but she would lose her ability to deduct the repayment if the contingency ripens and she must return the stock (for unknown reasons that I shall never understand).

Thus, taking *North American Oil* and *James* together, we see that we have different rules that turn on whether the repayment obligation is "absolute"—loan and thus excludable—or "contingent"—*not* a loan and thus includable (unless § 83(a) applies), subject to a deduction if and when the contingency ripens and repayment actually occurs. How do these rules play out in the next case?

## COMMISSIONER v. INDIANAPOLIS POWER & LIGHT

493 U.S. 203 (1990)

JUSTICE BLACKMAN delivered the opinion of the Court.

Respondent Indianapolis Power & Light Company (IPL) requires certain customers to make deposits with it to assure payment of future bills for electric service. Petitioner Commissioner of Internal Revenue contends that these deposits are advance payments for electricity and therefore constitute taxable income to IPL upon receipt. IPL contends otherwise.

IPL is a regulated Indiana corporation that generates and sells electricity in Indianapolis and its environs. It keeps its books on the accrual and calendar year basis. During the years 1974 through 1977, approximately 5% of IPL's residential and commercial customers were required to make deposits "to insure prompt payment," as the customers' receipts stated, of future utility bills. These customers were selected because their credit was suspect. Prior to March 10, 1976, the deposit requirement was imposed on a case-by-case basis. IPL relied on a credit test but employed no fixed formula. The amount of the required deposit ordinarily was twice the customer's estimated monthly bill. IPL paid [0% interest for the first 6 months and] 3% interest on a deposit held for six months or more [which is substantially below market interest rates in the 1970s]. A customer could obtain a refund of the deposit prior to termination of service by requesting a review and demonstrating acceptable credit. The refund usually was made in cash or by check, but the customer could choose to have the amount applied against future bills.

In March 1976, IPL amended its rules governing the deposit program. Under the amended rules, the residential customers from whom deposits were required were selected on the basis of a fixed formula. The interest rate was raised to 6% but was payable only on deposits held for 12 months or more. [The 12 months without interest resulted in substantial below-market interest rates for the duration of the deposit.] A deposit was refunded when the customer made timely payments for either 9 consecutive months, or for 10 out of 12 consecutive months so long as the 2 delinquent months were not themselves consecutive. A customer could obtain a refund prior to that time by satisfying the credit test. As under the previous rules, the refund would be made in cash or by

check, or, at the customer's option, applied against future bills. Any deposit unclaimed after seven years was to escheat to the State.

IPL did not treat these deposits as income at the time of receipt. Rather, as required by state administrative regulations, the deposits were carried on its books as current liabilities. Under its accounting system, IPL recognized income when it mailed a monthly bill. If the deposit was used to offset a customer's bill, the utility made the necessary accounting adjustments. Customer deposits were not physically segregated in any way from the company's general funds. They were commingled with other receipts and at all times were subject to IPL's unfettered use and control.

…

We begin with the common ground. IPL acknowledges that these customer deposits are taxable as income upon receipt if they constitute advance payments for electricity to be supplied.[3] … And it is settled that receipt of a loan is not income to the borrower. *See Comm'r v. Tufts*, 461 U.S. 300, 307 (1983) ("Because of [the repayment] obligation, the loan proceeds do not qualify as income to the taxpayer"); *James v. U.S.*, 366 U.S. 213, 219 (1961) (accepted definition of Gross Income "excludes loans"); *Comm'r v. Wilcox*, 327 U.S. 404, 408 (1946). IPL, stressing its obligation to refund the deposits with interest, asserts that the payments are similar to loans. The Commissioner, however, contends that a deposit which serves to secure the payment of future income is properly analogized to an advance payment for goods or services. *See* Rev. Rul. 72-519, 1972-2 C.B. 32, 33 ("When the purpose of the deposit is to guarantee the customer's payment of amounts owed to the creditor, such a deposit is treated as an advance payment, but when the purpose of the deposit is to secure a property interest of the taxpayer the deposit is regarded as a true security deposit").

In economic terms, to be sure, the distinction between a loan and an advance payment is one of degree rather than of kind. A commercial loan, like an advance payment, confers an economic benefit on the recipient: a business presumably does not borrow money unless it believes that the income it can earn from its use of the borrowed funds will be greater than its interest obligation. Even though receipt of the money is subject to a duty to repay, the borrower must regard itself as better off after the loan than it was before. The economic benefit of a loan, however, consists entirely of the opportunity to earn income on the use of the money prior to the time the loan must be repaid. And in that context our system is content to tax these earnings as they are realized. The recipient of an advance payment, in contrast, gains both immediate use of the money (with the chance to realize earnings thereon) and the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.

The question, therefore, cannot be resolved simply by noting that respondent derives some economic benefit from receipt of these deposits. Rather, the issue turns upon the nature of the rights and obligations that IPL assumed when the deposits were made. In determining what sort of economic benefits qualify as income, this Court has invoked various formulations. It has referred, for example, to "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). It also has

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[3] This Court has held that an accrual-basis taxpayer is required to treat advance payments as income in the year of receipt. *See* Schlude v. Comm'r, 372 U.S. 128 (1963); American Automobile Assn. v. U.S., 367 U.S. 687 (1961); Automobile Club of Michigan v. Comm'r, 353 U.S. 180 (1957). These cases concerned payments—nonrefundable fees for services—that indisputably constituted income; the issue was when that income was taxable. Here, in contrast, the issue is whether these deposits, as such, are income at all. [Ed. note: This trilogy of cases, and the treatment more generally of advance payments received by accrual method taxpayers, is discussed in Chapter 22.]

stated: "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 . . . .'" *James v. U.S.*, 366 U.S., at 219, quoting *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932). 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.

The Commissioner stresses the fact that these deposits were not placed in escrow or segregated from IPL's other funds, and that IPL therefore enjoyed unrestricted use of the money. That circumstance, however, cannot be dispositive. After all, the same might be said of a commercial loan; yet the Commissioner does not suggest that a loan is taxable upon receipt simply because the borrower is free to use the funds in whatever fashion he chooses until the time of repayment. 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.

Nor is it especially significant that these deposits could be expected to generate income greater than the modest interest IPL was required to pay. Again, the same could be said of a commercial loan, since, as has been noted, a business is unlikely to borrow unless it believes that it can realize benefits that exceed the cost of servicing the debt. A bank could hardly operate profitably if its earnings on deposits did not surpass its interest obligations; but the deposits themselves are not treated as income. Any income that the utility may earn through use of the deposit money of course is taxable, but the prospect that income will be generated provides no ground for taxing the principal.

The Commissioner's advance-payment analogy seems to us to rest upon a misconception of the value of an advance payment to its recipient. An advance payment, like the deposits at issue here, concededly protects the seller against the risk that it would be unable to collect money owed it after it has furnished goods or services. But an advance payment does much more: it protects against the risk that the purchaser will back out of the deal before the seller performs. From the moment an advance payment is made, the seller is assured that, so long as it fulfills its contractual obligation, the money is its to keep. Here, in contrast, a customer submitting a deposit made no commitment to purchase a specified quantity of electricity, or indeed to purchase any electricity at all. IPL's right to keep the money depends upon the customer's purchase of electricity, and upon his later decision to have the deposit applied to future bills, not merely upon the utility's adherence to its contractual duties. Under these circumstances, IPL's dominion over the fund is far less complete than is ordinarily the case in an advance-payment situation.

The Commissioner emphasizes that these deposits frequently will be used to pay for electricity, either because the customer defaults on his obligation or because the customer, having established credit, chooses to apply the deposit to future bills rather than to accept a refund. When this occurs, the Commissioner argues, the transaction, from a cash-flow standpoint, is equivalent to an advance payment. In his view this economic equivalence mandates identical tax treatment.

Whether these payments constitute income when received, however, depends upon the parties'

rights and obligations at the time the payments are made. The problem with petitioner's argument perhaps can best be understood if we imagine a loan between parties involved in an ongoing commercial relationship. At the time the loan falls due, the lender may decide to apply the money owed him to the purchase of goods or services rather than to accept repayment in cash. But this decision does not mean that the loan, when made, was an advance payment after all. The lender in effect has taken repayment of his money (as was his contractual right) and has chosen to use the proceeds for the purchase of goods or services from the borrower. Although, for the sake of convenience, the parties may combine the two steps, that decision does not blind us to the fact that in substance two transactions are involved. It is this element of choice that distinguishes an advance payment from a loan. Whether these customer deposits are the economic equivalents of advance payments, and therefore taxable upon receipt, must be determined by examining the relationship between the parties at the time of the deposit. The individual who makes an advance payment retains no right to insist upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep. The customer who submits a deposit to the utility, like the lender in the previous hypothetical, retains the right to insist upon repayment in cash; he may choose to apply the money to the purchase of electricity, but he assumes no obligation to do so, and the utility therefore acquires no unfettered "dominion" over the money at the time of receipt.

When the Commissioner examines privately structured transactions, the true understanding of the parties, of course, may not be apparent. It may be that a transfer of funds, though nominally a loan, may conceal an unstated agreement that the money is to be applied to the purchase of goods or services. We need not, and do not, attempt to devise a test for addressing those situations where the nature of the parties' bargain is legitimately in dispute. This particular respondent, however, conducts its business in a heavily regulated environment; its rights and obligations vis-a-vis its customers are largely determined by law and regulation rather than by private negotiation. That the utility's customers, when they qualify for refunds of deposits, frequently choose to apply those refunds to future bills rather than taking repayment in cash does not mean that any customer has made an unspoken commitment to do so.

Our decision is also consistent with the Tax Court's long-standing treatment of lease deposits—perhaps the closest analogy to the present situation. The Tax Court traditionally has distinguished between a sum designated as a prepayment of rent—which is taxable upon receipt—and a sum deposited to secure the tenant's performance of a lease agreement. *See, e.g., J. & E. Enterprises, Inc. v. Comm'r*, 26 TCM 944 (1967). In fact, the customer deposits at issue here are less plausibly regarded as income than lease deposits would be. The typical lease deposit secures the tenant's fulfillment of a contractual obligation to pay a specified rent throughout the term of the lease. The utility customer, however, makes no commitment to purchase any services at all at the time he tenders the deposit.

We recognize that IPL derives an economic benefit from these deposits. But a taxpayer does not realize taxable income from every event that improves his economic condition. A customer who makes this deposit reflects no commitment to purchase services, and IPL's right to retain the money is contingent upon events outside its control. We hold that such dominion as IPL has over these customer deposits is insufficient for the deposits to qualify as taxable income at the time they are made.

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Does the previous discussion of *North American Oil* suggest that the government failed to make

an obvious argument in *Indianapolis Power & Light*, particularly in light of the phrase near the end that "IPL's right to retain the money is contingent upon events outside of its control"? At another point, Justice Blackmun noted: "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." At another, he observed: "IPL's right to keep the money depends upon the customer's purchase of electricity, and upon his later decision to have the deposit applied to future bills …."

Even if the obvious argument that you have astutely identified had been made, however, do you think the Court would have accepted it? How does the Court avoid the conclusion that the utility's obligation to repay the cash was merely contingent, even though it recognized that the utility sometimes keeps the money? Recall the following language from the opinion in particular:

> The problem with petitioner's argument perhaps can best be understood if we imagine a loan between parties involved in an ongoing commercial relationship. At the time the loan falls due, the lender may decide to apply the money owed him to the purchase of goods or services rather than to accept repayment in cash. But this decision does not mean that the loan, when made, was an advance payment after all. The lender in effect has taken repayment of his money (as was his contractual right) and has chosen to use the proceeds for the purchase of goods or services from the borrower. Although, for the sake of convenience, the parties may combine the two steps, that decision does not blind us to the fact that in substance two transactions are involved.

In other words, the Court applies the substance over form doctrine (or its progeny, the step transaction doctrine) to *deem* a repayment to the customer in those cases in which the utility actually keeps the money (thus placing the receipt in the "absolute obligation to repay" box rather than the "contingent obligation to repay" box), followed by a *deemed* repayment right back to the utility by the customer. Thus, the Court was able to conclude that the utility had an absolute obligation to repay these deposits *in every case*, permitting it to exclude the deposits under the borrowing exclusion. If the deposit is actually repaid, the utility never includes it in Gross Income. If the utility keeps it (*i.e.*, applies it against the customer's utility bill), the utility includes it in Gross Income *at that later time* (because it is deemed to repay the deposit to the customer who then is deemed to repay it right back to the utility at that time).

Was the Court's application of the substance over form doctrine to create an absolute obligation to repay in all cases convincing in this case? We tend to apply multi-step analysis only in those situations in which the alternative view of the "substance" of what occurred (as opposed to its form) actually could have realistically occurred. Indeed, the alternative reading is considered so likely that we deem it to be the true substance of what actually happened. Thus, when Mr. Wood's employer paid his income tax liability directly to the IRS (Chapter 5), the Court determined that, in substance, the payment was made to Mr. Wood (includable as compensation under § 61(a)(1)), who then paid his nondeductible income tax payment. This alternative construction not only could have realistically occurred but is the more persuasive reading of the substance of the parties' relationship. Are poor people who are credit risks typically willing to act as lenders to rich corporations? Could you argue that it is not realistic to treat these "deposits" as loans because they are not transferred voluntarily but only because the utility required these transfers as a condition of doing business with the electricity buyers? "I demand that you lend money to me or I will refuse to sell electricity to you or rent an apartment to you." Is that so far removed from the typical "loan" situation that the analogy breaks down?

On the other hand, doesn't the interest payments buttress the Court's determination to find an absolute obligation to repay in order to place the receipt in the "loan" box? Interest rates are so low today that we sometimes forget, when reading older cases, that interest rates were much higher in the 1970s and 80s. In 1976, for example, interest rates for home mortgages averaged nearly 9%. In 1976, the utility in *Indianapolis Power & Light* paid no interest for the first 12 months of a security deposits and paid 6% thereafter. Especially in light of the 0% rate for the first 12 months, the interest paid to the utility customers was clearly below market rates at the time. Does that affect how you think about this case? Does § 7872 apply?

## Problem

Joy, a landlord, demands a deposit equal to two months rent before she will rent an apartment to prospective tenant Joey. Under the lease agreement, the deposit will be returned to Joey at the end of the lease term so long as he has not damaged the property or defaulted on any lease payments. Joy pays no interest to Joey with respect to the deposit, but she puts it in a bank account that earns interest and includes the interest in her own Gross Income each year. Joey pays the required deposit and rents an apartment for three years. What are the tax consequences for Joy if she:

**a.** repays the deposit in full to Joey at the end of Year 3 when he leaves the apartment in good condition and without being arrears in rent payments; or

**b.** retains the deposit because Joey fails to pay the last two months rent before vacating the premises in good condition at the end of Year 3?

**c.** Recall what you learned in Chapter 2 regarding the difference between an income tax and a cash-flow consumption tax. In either **a.** or **b.**, is Joy's investment income earned on the deposit between the time that she receives the deposit from Joey and the end of Year 3 effectively taxed to her under income tax principles? Why or why not?

# Chapter 11: The Bad-Debt Deduction (for Lenders) and Debt-Discharge Income (for Borrowers)

What tax consequences arise when a borrower fails to repay borrowed principal? Interest? Part A. considers first the income tax consequences to the lender, and Part B. considers the income tax consequences to the borrower.

## A. The lender's deduction for a bad debt (or worthless security)

You learned in Chapter 10 that the transfer of loan principal to a borrower is a nondeductible capital expenditure (rather than a current expense) for the lender, which creates basis in the loan instrument to keep track of those after-tax dollars. Principal repayments received by the lender from the borrower thus represent tax-free recovery of basis (which reduces that basis, dollar for dollar, as principal repayments are received) rather than Gross Income. Interest, in contrast, represents new wealth to the lender and is includable in Gross Income under § 61(a)(4) (absent exclusion authority under § 103).

When the borrower fails to repay principal, the lender's basis in the loan becomes unusable. What tax consequences arise because of the inability to recover that basis tax-free with principal repayments because those principal repayments are not, in fact, forthcoming?

Notice that the activity of lending money to earn interest is an income-producing activity rather than an activity in pursuit of personal consumption—either business activity (if the lender is in the business of making loans, such as a bank or a store that sells inventory to its customers on credit) or investment activity (if the lender is Candace, who is purchasing a High Tech bond for her investment portfolio). Also recall from Chapter 1 that a "loss"—as a tax term of art—is, by definition, a deduction of *basis*. For example, if Candace were to purchase shares of stock in High Tech for $10,000, a nondeductible capital expenditure creating a $10,000 cost basis under § 1012, and later sold those shares for only $9,000, the $1,000 of unrecovered basis would produce a "loss" under § 1001 that would be deductible under § 165(c)(2) because the shares are investment property. Similarly, unrecovered basis of a lender should produce a "loss" deduction—a deduction of unrecovered basis—if the loan is bona fide and not, say, really a disguised gift to the supposed borrower (a nondeductible personal expense under § 262).

### *§ 165(g) deduction for a worthless security*

A loss deduction will arise under § 165(g) if a "security" within the meaning of § 165(g)(2) becomes "worthless" within the meaning of § 165(g)(1). Under § 165(g)(2)(A), a share of stock in a corporation is a security. Thus, if Candace's stock, which she purchased for $10,000, above, were to become entirely worthless, she could deduct her $10,000 of unrecovered stock basis under § 165(g). A High Tech bond also qualifies as a "security" under § 165(g)(2)(C). Thus, if the High Tech bond that Candace purchases for $10,000 becomes worthless, she can deduct her $10,000 of unrecovered bond basis under § 165(g).

In either case, the corporate stock or corporate bond qualifies as a capital asset because such property is *not* listed in § 1221(a). But recall from Chapter 1 that § 1222 requires that the disposition of a capital asset be by "sale or exchange" for any resulting gain or loss to qualify as

"capital" gain or loss (as opposed to ordinary gain or loss). When a share of stock or a corporate bond becomes worthless, the owner is not likely to find a buyer for it. Indeed, she still owns the stock or bond when she takes the deduction. The failure to satisfy the "sale or exchange" requirement in reality is why the language in § 165(g)(1) steps in to satisfy it artificially, simply by statutory fiat, by providing that the worthless security should "be *treated* as a loss *from the sale or exchange*" of the stock or bond on the last day of the taxable year. (Emphasis added.) Because the stock or bond is a capital asset, and because § 165(g)(1) artificially satisfies the § 1222 sale or exchange requirement, the worthless security deduction will produce a capital loss (rather than an ordinary loss) under § 1222, long-term or short-term, depending on how long Candace has held the stock or bond.

Why does § 165(g)(1) artificially satisfy the sale or exchange requirement? Without it, consider the disparity that would arise between Situation 1 and Situation 2, below.

> Situation 1: Candace sells High Tech stock (previously purchased for $10,000) for $10 just before it loses all value, deducting $9,990 under § 165.
>
> Situation 2: Candace retains the High Tech stock for a few more days until it becomes entirely worthless, taking a worthless security deduction of $10,000 under § 165.

In Situation 1, Candace's $9,990 loss is clearly a capital loss under § 1222 because she (1) sold or exchanged (2) a capital asset. Thus, her $9,990 capital loss, while deductible under § 165(c)(2), is limited by § 1211(b), which we have seen allows the deduction of Candace's otherwise deductible capital losses in any one year only to the extent of her includable capital gains plus up to an additional $3,000 (with a carryover under § 1212 of any remaining capital loss). If § 165(g)(1) did not artificially satisfy the sale or exchange requirement in Situation 2, Candace's § 165 loss deduction would be ordinary, even though the stock is a capital asset. Thus, Candace could conveniently avoid that pesky § 1211 capital loss limitation rule and fully deduct the loss against her high-taxed ordinary income. Section 165(g)(1) prevents this result because Candace's worthless security deduction is "treated" as arising from a sale or exchange, even though she did not, in fact, sell or exchange the stock.

***§ 166 bad-debt deduction***

Suppose that Candace does not buy a bond from High Tech but rather lends $10,000 to Charles, a friend in need. Charles and Candace execute a loan agreement under which Charles will repay that loan on a specified date, with 4% interest (the going market rate) in the interim. Charles pays the required interest payments, but when the date arrives for Charles to repay the $10,000 principal, he repays $3,000 but cannot repay the remaining $7,000. Can Candace deduct her remaining $7,000 of unrecovered basis in the loan, even though her loan to Charles is not described in § 165(g)(2)?

Section 166 may (or may not) come to her rescue. Stop and read that Code section now.

While § 166(a) applies to business bad debts, § 166(d) applies to nonbusiness bad debts. Under § 166(e), neither subsection applies if the loan qualifies as a "security" within the meaning of § 165(g), which will control in that case.

Let's start with business bad debts. Notice that the sale or exchange requirement is not artificially satisfied in § 166(a). Thus, a business bad-debt deduction is necessarily an "ordinary" one (rather than a capital loss), even if the loan instrument is a capital asset, because no sale or

exchange occurs. Rather, the lender simply continues to own a worthless claim against the borrower. For example, a bank deducts as an ordinary loss the basis in a loan that becomes uncollectible, unconstrained by § 1211. Similarly, an inventory seller who sells to customers on credit (*i.e.*, for future payments, with interest) can deduct as an ordinary loss any loan principal that becomes uncollectible. (Whether he can deduct uncollectible interest is considered shortly.)

Notice also that businesses can deduct debts that are only partially worthless under § 166(a)(2), though the burden of proof is high for the lender to establish how much of an outstanding loan is worthless. For example, suppose that Walter borrows $10,000 from National Bank. When the repayment date arrives, Walter repays only $3,000, reducing National Bank's loan basis from $10,000 to $7,000. National Bank believes that it will be able to recover an additional, say, $2,000 from Walter when it brings an action against him but will be unsuccessful in collecting the remaining $5,000. If National Bank can satisfy its burden of proving that the loan is partially worthless (to the tune of $5,000), it can deduct that $5,000 now, reducing its basis from $7,000 to $2,000. If, in fact, National Bank collects the remaining $2,000 from Walter, as it expects, the $2,000 would constitute tax-free basis recovery. If National Bank is wrong, however, and is unsuccessful in collecting anything more from Walter, National Bank could take a second bad-debt deduction equal to its $2,000 remaining basis. Because of the time value of money, National Bank likes to be able to take bad-debt deductions for loans that are only partially worthless, rather than waiting to see whether the entire remaining loan balance becomes uncollectible.

What if National Bank succeeds in taking a $5,000 partially worthless bad-debt deduction, as described above, but Walter surprises everyone by repaying the entire $7,000 owed? Because the prior $5,000 bad-debt deduction was a deduction of *basis*, reducing National Bank's basis from $7,000 to $2,000, only $2,000 obtained from Walter is now tax-free basis recovery. National Bank must include the remaining $5,000 in Gross Income—simply because the bank has no more basis in the loan to protect the additional cash receipt from constituting Gross Income.

Because § 166(d)(1)(A) provides that subsection (a) does not apply in the case of a nonbusiness bad debts, the outstanding balance of any nonbusiness debt must be wholly worthless before any deduction is allowed. Return to the same facts above, for example, where Walter repays $3,000 of a $10,000 loan on the repayment date, but assume that the lender is not a bank or other professional lender. Even if the nonbusiness lender is confident that it can prove that $5,000 of the remaining $7,000 balance is uncollectible, the nonbusiness lender cannot yet take a bad-debt deduction. Rather, the nonbusiness lender must wait for the remaining balance ($7,000) to become wholly worthless before taking any deduction. If Walter repays another $2,000, and it can be shown that the remaining $5,000 balance is now wholly worthless, the nonbusiness lender can take a bad-deduction for the wholly worthless $5,000 remaining debt at that time.[1]

Unlike in the case of business bad debts under § 166(a), § 166(d) *does* artificially satisfy the sale or exchange requirement, just as did § 165(g)(1) in the case of a deduction for a worthless security. There is a notable difference between the language in § 165(g)(1) and § 166(d), however. While the capital loss for a worthless security can be either long-term or short-term, depending on how long the security owner has held the security, the nonbusiness bad-debt deduction is *always*

[1] Once Walter repays the first $3,000 of the $10,000 owed, some students believe that the nonbusiness lender is forever denied any bad-debt deduction, even if the remaining balance becomes wholly worthless. That interpretation of the prohibition for nonbusiness lenders to deduct partially worthless debts is incorrect. The inability to deduct partially worthless debts means only that the nonbusiness lender, unlike the business lender, must wait for any remaining balance to become wholly worthless before taking any bad-debt deduction under § 166(d).

treated as short-term capital loss, even if the loan is outstanding for more than a year before it becomes wholly worthless. There is no legislative history explaining the rationale for this rule. Nevertheless, short-term capital losses are less harmful for the taxpayer than long-term capital losses for reasons that will become clear when we examine capital gains and losses more deeply in Chapter 15. Thus, the nonbusiness lender with a loan outstanding for more than a year before it becomes worthless is grateful that his loss is treated as short-term capital loss rather than long-term capital loss. Stay tuned.

***Bona fide debt***

Notice that the definition of "nonbusiness debt" in § 166(d)(2) appears to encompass *any* debt not incurred in the course of a trade or business, which means that a nonbusiness debt can be one made not only for investment reasons (*i.e.*, to earn a return in the form of interest) but for personal reasons. The nonbusiness lender who makes a loan for personal reasons, however, may have a tough time establishing that the transfer is a "bona fide debt" within the meaning of Treas. Reg. § 1.166-1(c), which provides that "[o]nly a bona fide debt" can generate a bad-debt deduction under § 166. It continues: "A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." Return to our initial hypothetical in the first paragraph of this section. What if Candace and Charles, who are friends, did not memorialize their loan in a document? What if Candace did not charge Charles (say that three times fast) any interest on the loan? Moreover, what if Charles never repaid any principal and Candace did not act like a real creditor and demand payment when it was due? A loan can still be "bona fide" even if no interest is charged, as indicated by the existence of § 7872 (recall the no-interest loan made by High Tech to CEO Sam in the last chapter), but the addition of each of these facts, in turn, makes it less and less likely that the purported loan (and thus Candace's desired $10,000 bad-debt deduction) will be respected. Instead of a loan, what may this transfer be in substance? The last sentence of the regulation quoted above reminds us that "[a] gift or contribution to capital shall not be considered a debt for purposes of section 166." If Candace and Charles, who are friends, did not document their purported loan, if Candace did not charge interest, and if Candace did not act like a real creditor and take action when Charles failed to repay, it looks like a gift, not a bona fide debt. And you know that gifts between friends are not deductible by the donor under § 262(a).

What is a "contribution to capital," also mentioned in that regulation? Suppose that Money Gal is sitting at a bar when she hears Idea Guy spouting off to the bartender about this brilliant idea for a new product. If only he could find the capital to pursue it! Money Gal listens to Idea Guy's big idea and introduces herself, saying that she has been looking for a new investment opportunity. She transfers $10,000 to him to pursue his big idea (a nondeductible capital expenditure creating basis). Alas, the idea proves to be a flop, and Money Gal never sees a dime from the venture, losing her entire $10,000 investment. So long as Money Gal can prove that she did not transfer the $10,000 to Idea Guy out of detached and disinterested generosity but rather out of a desire to earn a return on her capital, Money Gal should be able to take a deduction for her $10,000 of unrecovered basis. But under which Code section does she take her deduction?

If the $10,000 transferred to Idea Guy was a bona fide debt rather than a contribution to capital in their joint venture, Money Gal's bad-debt deduction is treated as a short-term capital loss under § 166(d)(1) because Money Gal is not in the business of lending money under § 166(d)(2). Thus, her resulting short-term capital loss would be subject to § 1211(b). If, on the other hand, she was a co-principal in the venture, along with Idea Guy—with the capital coming from her and the

expertise coming from him—her investment loss deduction could be taken under § 165(c)(2) and would be an ordinary deduction, as she did not sell or exchange a capital asset. Money Gal would prefer that her deduction be taken under § 165(c)(2) rather than § 166(d) because the former would not be subject to the § 1211 capital loss limitation rule.

In light of the definition of "bona fide debt" in the regulations, what facts would you need to explore with Money Gal to determine whether her transfer to Idea Guy was a contribution to capital or a bona fide debt? What if their understanding provided that both Idea Guy and Money Gal would share in all future profits from the venture in 50% shares? What if, instead, Money Gal was entitled to receive her $10,000 plus a stipulated return once Idea Guy's idea took off, but not more?

***Worthlessness***

In addition to being a "bona fide debt," the debt must be wholly (nonbusiness) or partially (business) "worthless" to generate a deduction under § 166. Treas. Reg. § 1.166-2 provides that legal action is not required to establish worthlessness so long as "the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in satisfaction of execution on a judgment …." In other words, a lender need not incur the costs to pursue legal action to enforce the debt if a showing of worthlessness can be made from the surrounding facts without such action.

One of the most troublesome issues in litigation has been determining the proper year in which the debt became worthless, as the statute, by its terms, authorizes deduction *only* in the year in which the debt became worthless—not in an earlier year or a later year—even if the lender would prefer to shift the deduction to a year in which the lender is, say, in a higher tax bracket (and would thus save more in tax from a deduction in that year). For example, Treas. Reg. § 1.166-2 provides:

> In bankruptcy cases, a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

Absent fraud, substantial omissions of Gross Income, or a failure to file a tax return, the normal statute of limitations for most issues is three years.[2] Because determining the proper year of worthlessness has proved to be so troublesome, however, Congress has extended the statute of limitations for worthless security and bad-debt deductions to seven years.[3] Thus, a taxpayer who believes that a debt becomes worthless in Year 6 and takes the bad-debt deduction in that year can file an amended return if it is later determined that the debt actually became worthless in Year 2, instead. The additional deduction for Year 2 on the amended return can then generate a tax refund for the lender.

***Deduction limited to basis***

What is the proper measure of a worthless security or bad-debt deduction under §§ 165(g) or 166? Suppose, for example, that Rachel purchases High Tech stock (a security under § 165(g)(2)(A)), which is publicly traded and thus easily valued, for $10,000 in Year 1. By the end

[2] *See* § 6511(a).
[3] *See* § 6511(d)(1).

of Year 1, Rachel is happy to find out that the stock has increased in value to $12,000 when she looks up the stock quotation in the newspaper on December 31. At the end of Year 2, she is even happier to learn that the stock is now worth $15,000. Even though Rachel gains economic wealth as the stock increases in value each year, you know from Chapter 1 that Rachel does not include these wealth accessions in Gross Income under the realization requirement because they are not final and irretrievable value changes.

If, in Year 3, the stock becomes worthless because of some calamity at High Tech, and you asked a nontax observer how much Rachel "lost" on the bad news at High Tech, the observer would likely respond "$15,000," as that was what the stock was worth immediately before the plunge. But also recall from Chapter 1 that, for income tax purposes, *deductions must always be supported by basis under normative income tax theory*, *i.e.*, if we are attempting to measure "income" accurately, in order to ensure that the same dollars do not provide a double tax benefit to the same taxpayer. Although Rachel lost $15,000 of wealth in the *economic* sense, her income tax deduction is limited to her $10,000 *basis* to prevent her from both excluding (under the realization requirement) and deducting the same dollars. If and only if the realization requirement were repealed for publicly traded stock and Rachel had to "mark to market" the stock each year by including $2,000 in Gross Income at the end of Year 1 (increasing her basis from $10,000 to $12,000) and an additional $3,000 at the end of Year 2 (increasing her basis to $15,000) would she then properly deduct $15,000 in Year 3 when the stock becomes worthless.

Sections 165(b) and 166(b) confirm that worthless security and bad-debt deductions are limited to basis. In the case of a bad debt, the basis is created by the lender when she originally transfers the loan principal to the borrower, a nondeductible capital expenditure. Merely becoming indebted to another (under a contract or legal action, for example) *without a prior transfer of funds creating basis* cannot generate a bad-debt deduction if that debt becomes uncollectible.

**REVENUE RULING 93-27**

1993-1 C.B. 32

ISSUE

Is a taxpayer entitled to a nonbusiness bad-debt deduction under section 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 section 166(a), the amount of the deduction for any worthless debt is the adjusted basis provided in section 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 section 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 section 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 section 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. Memo 1984-487; *Pierson v. Commissioner*, T.C. Memo 1984-452; and *Diez-Arguelles v. Commissioner*, T.C. Memo 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 section 166 (a)(1) of the Code with regard to an arrearage in those payments.

The Service does not accept certain arguments relating to basis that were raised in *Imeson v. Commissioner*, 487 F.2d 319 (9th Cir. 1973), cert. denied, 417 U.S. 917, 41 L. Ed. 2d. 222, 94 S. Ct. 2621 (1974). The Ninth Circuit affirmed an opinion of the Tax Court, *Imeson v. Commissioner*, T.C. Memo 1969-180, which held that a taxpayer was not entitled to a bad-debt deduction under section 166 of the Code in a situation in which the taxpayer's spouse had failed to make court-ordered child support payments. However, the Ninth Circuit's *per curiam* opinion was based on the narrow ground that the taxpayer had failed to prove the amount of her expenditures to support the children. The Ninth Circuit noted (without deciding) possible arguments to support a bad-debt deduction for the taxpayer based on an analogy to a homeowner who pays materialmen's liens on a house after the builder has defaulted, or to a guarantor who pays the creditor when the principal debtor defaults. The Tax Court, in its more recent *Perry*, *Meyer*, *Pierson*, and *DiezArguellos* decisions, has distinguished and declined to follow the Ninth Circuit's possible arguments in *Imeson*. The Service will follow the decisions of the Tax Court on this issue.

HOLDING

A taxpayer is not entitled to a bad-debt deduction under section 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.

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**A taxpayer obtains no deduction for a mere failure to gain expected wealth—even if the**

**taxpayer has a legal right to that wealth—because the taxpayer has no *basis* (previously taxed dollars) in mere expectations**. To be deductible, the failed expectation must have *basis* in order to prevent a double tax benefit for the same dollars to the same taxpayer.

A loan guarantor, mentioned in the ruling above, is someone who guarantees repayment by the borrower and accepts legal responsibility to make the borrower's loan payment if he fails to pay. When a guarantor makes such a payment to the lender, virtually all 50 states create a right of action for the guarantor (typically called a right of subrogation) to pursue reimbursement from the borrower for the amount paid on his behalf. The IRS accepts that the guarantor who has made such a payment under his guarantee obligation creates basis (after-tax dollars) that can be deducted under § 166 if the claim against the borrower (under his right of subrogation) becomes worthless.

Can a lender deduct uncollectible *interest* under § 166? Because the lender must have basis in the unpaid interest in order to have anything to deduct under § 166(b), the answer will turn on whether the lender has previously included the unpaid interest, either because the lender uses the accrual method of accounting or, if the lender otherwise uses the cash method of accounting, the interest was in the form of original issue discount under § 1272, as described in Chapter 10. In either case, the income inclusion required as time passes creates *basis* in the unpaid interest that can be deducted under § 166 if the claim becomes worthless. If the interest is not in the form of original issue discount (includable as time passes) and the lender uses the cash method of accounting, the lender would not include the interest (creating basis) until actually received. In that case, the lender is like taxpayer *A* in Revenue Ruling 93-27. That is to say, the lender's failure to collect the interest is a mere failed expectation to gain wealth with no basis.

## Problems

**1.** Daniel borrowed $10,000 from his sister Dora, to be repaid after one year. At the one-year mark, Daniel does not repay the $10,000 to Dora. Can Dora deduct her $10,000 basis in the loan? What questions would you need to explore with her? What additional facts do you need?

**2.** Miriam is injured by Maurice when he runs a red light and hits her with his automobile as she crosses the road in a crosswalk. She successfully sues him in a tort action, and she wins a jury award of $500,000. Maurice owes Miriam money! Maurice is a pauper and has no job and no assets, and legal action to enforce payment would in all probability not result in satisfaction of execution on a judgment. Can Miriam deduct $500,000 under § 166 with respect to her "bad debt"?

**3.** On January 1 of Year 1 Lucy lends $100,000 to Lonnie, a workaholic inventor who works in his garage all evening after he gets home from his day job and all weekends with an idea for a new computer chip that will revolutionize the tech world, at 4% interest. Assume that the loan is bona fide. The $4,000 annual interest is to be paid on December 31 of each year, and the $100,000 loan principal is to be repaid on December 31 of Year 8. Lonnie pays the $4,000 interest payments due at the end of Years 1, 2 and 3. When Lonnie fails to pay the interest due on December 31 of Year 4, Lucy hires a lawyer to demand repayment. The lawyer has a tough time finding Lonnie, but he finally learns in February of Year 8 that Lonnie sold all of his assets in Year 4 after his wife died, which moved him deeply. He quit his job and moved to a fishing village in Mexico, where he plans to live out his days simply.

**a.** What can Lucy deduct—and when can she deduct it—if she uses the cash method of

accounting?

**b.** Same as **a.**, except that Lucy uses the accrual method of accounting.

**c.** What tax result in both **a.** and **b.** for Lucy if, in Year 10, Lonnie recovers from what he now recognizes was a deep depression, returns to the U.S., and, to calm his conscience about the unpaid loan to Lucy, earns enough to pay to her both the $100,000 of unpaid principal and the $20,000 of unpaid interest that he owed to her under their original loan agreement?

## B. § 61(a)(12) income from the discharge of indebtedness

You learned in Chapter 10 that, under the borrowing exclusion, Betty Borrower does not include the principal amount that she borrows from Larry Lender in her Gross Income in the year of receipt because (under the balance sheet analysis, at least) her future obligation to repay negates a wealth accession in that year. You also learned in Chapter 10 that the borrowing exclusion is not entirely consistent with the annual accounting principle in tax, under which we usually take each year as it comes, without regard to our expectations about what will happen in future years. After all, the only way to squeeze the borrower's cash receipt (which is not basis recovery) into a no-wealth-accession box in the year of receipt is by taking into account the *future-year* obligation to repay.[4]

Suppose that—*contrary to current law*—Congress adopted a cash-flow approach to the receipt and repayment of loan principal, under which borrowed principal is included in Gross Income by the borrower on receipt and deducted when repaid. In that pretend world, we would need no special tax rules for the borrower on the failure to repay loan principal (and thus we would not need Part B. of this chapter). The borrower who fails to repay would simply lose the tax deductions that would arise on such repayment. Because this pretend world does not exist, however, we must generally create an offsetting income inclusion for the borrower on failure to repay loan principal under § 61(a)(12).

Another way of understanding the role of § 61(a)(12) is to note that the borrowing exclusion is a mere *deferral* provision, *not* a complete forgiveness provision. **The taxation of loan principal to the borrower effectively occurs *at the time of repayment* (rather than on initial receipt), when the principal is repaid with *after-tax (nondeductible) dollars***. If Betty Borrower never repays those untaxed dollars, we must create a Gross Income inclusion in the year of nonpayment, or else Betty would enjoy *permanently* untaxed wealth equal to the amount received (and excluded) in the earlier year.

We start with *Kirby Lumber*.

**UNITED STATES v. KIRBY LUMBER**

284 U.S. 1 (1931)

[4] In the last chapter of this textbook, you will learn that reflexive adoption of transactional accounting from financial accounting—such as the deferral of Gross Income for cash received but not yet earned by taxpayers using the accrual method of accounting—similarly allowed expectations of what would happen in future years to lead to tax results in the receipt year that are inconsistent with SHS income tax values. Unlike with the borrowing exclusion, however, some of these other results eventually led to statutory and doctrinal changes that deviate from financial (transactional) accounting principles to better accord with income tax values.

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 [Kirby Lumber Company] 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, 364.

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Another terse Holmes opinion! Exactly why did the Kirby Lumber Corporation realize income when it bought back its bonds on the open market for approximately $138,000 less than it had originally borrowed from the bond buyers? Ignore for now the reference to the *Kerbaugh-Empire* case, which we shall revisit in the next chapter. Rather, the important sentence in this opinion is: "As a result of its dealings it *made available $137,521.30 assets previously offset by the obligation of bonds now extinct*." (Emphasis added.) This language was interpreted at the time to mean that the reason why Kirby Lumber realized income was that nearly $138,000 of its balance sheet assets, which were previously encumbered by the corporation's outstanding liabilities, were effectively "freed" from these offsetting liabilities when it eliminated $138,000 of its outstanding debt at no cost. This "freeing of assets" or "balance sheet improvement" that arose on the debt discharge was thought to be the reason justifying the Gross Income inclusion.

If we construct a balance sheet for Kirby Lumber immediately after the bond sale, we would add $12,126,800—the amount of money that it effectively borrows from the public through selling bonds—to both sides. Because Kirby Lumber's net worth (assets *less* liabilities) does not increase by reason of the borrowing, the borrowed money does not constitute Gross Income.

| **Assets** | **Liabilities** |
|---|---|
| **$12,126,800** | **$12,126,800** |

**No increase in Kirby Lumber's net worth (assets *less* liabilities) at the time of borrowing.**

After Kirby Lumber is able to repurchase some of the bonds for $138,000 less than it had received on the bond sale, however, $138,000 of its assets (on the left side) are freed from offsetting liabilities (on the right), increasing Kirby Lumber's net worth by $138,000. Let's assume, for example, that Kirby Lumber is able to repurchase bonds issued for $2,000,000 for only $1,862,000. (This can occur, for example, if interest rates rise generally in the economy, depressing the value of Kirby Lumber's outstanding bonds that pay a lower interest rate than potential borrowers can obtain today.) While only $1,862,000 is spent from its $12,126,800 of assets, its liabilities are reduced by the full $2,000,000, thus increasing its net worth by $138,000.

| Assets | Liabilities |
|---|---|
| **$10,264,800** | **$10,126,800** |

**Net worth (assets *less* liabilities) increased by $138,000.**

Justice Holmes implied that it was this asset freeing or balance sheet improvement that creates the Gross Income.

If that analysis is correct, however, what if a borrower's net worth remains negative after a debt discharge because the debtor continues to have more liabilities than assets? A borrower with debt exceeding its assets is said to be "insolvent." Lower court opinions issued after *Kirby Lumber* took its asset-freeing language seriously to mean that no Gross Income is even *realized* unless the discharge creates or increases a positive net worth, as no assets are "freed" from offsetting liabilities if a debtor remains insolvent after the debt discharge. For example, assume that Martha has $100,000 in assets and debts of $130,000, *i.e.*, Martha is insolvent, when she negotiates with a creditor to forgive a $20,000 debt. Martha remains insolvent after the discharge and thus is not—at least under *Kirby Lumber's* rationale—considered to even *realize* income on the discharge.

| Assets | Liabilities |
|---|---|
| **$100,000** | **$130,000** |

**Martha is insolvent, with a negative net worth (liabilities exceed assets).**

**Now a $20,000 debt is discharged.**

| Assets | Liabilities |
|---|---|
| **$100,000** | **$110,000** |

**Martha remains insolvent. No assets are "freed" of offsetting liabilities**

If we stick with *Kirby Lumber's* rationale, Martha would realize debt-discharge income only to the extent that the discharge creates positive net worth, thus freeing some assets from debt. If, for example, Martha's creditor discharged a total of $50,000 in debt (instead of $20,000), Martha would realize $20,000 of Gross Income (because, to that extent, her assets were freed from offsetting liabilities) under the asset-freeing rationale but would *not realize* $30,000 of Gross Income.

**A total of $50,000 (instead of $20,000) of her $130,000 debt discharged.**

| Assets | Liabilities |
|---|---|
| **$100,000** | **$80,000** |

**Martha is solvent by $20,000 because the discharge created a $20,000 positive net worth.**

Is such a result correct as a normative matter? No. The conclusion that Martha does not realize $30,000 of Gross Income on our facts means that $30,000 *previously received in the borrowing year becomes permanently tax-free*, when the borrowing exclusion, properly understood, is merely a *deferral* provision, not a complete forgiveness provision. This error arises because of the "original sin" of using the balance sheet to analyze the consequences of nonpayment rather than consulting tax values.

Today, § 61(a)(12) confirms that "income from discharge of indebtedness" is Gross Income. (Some refer to such income as COD income, an acronym for "cancellation of debt.") Justice Holmes's asset-freeing or balance sheet improvement rationale, however, is no longer considered by most to be the modern justification underlying the realization of debt-discharge income, though (unfortunately) you will all too often still see such language in court opinions, as in *Payne* and *Zarin*, below.

***The modern rationale underlying § 61(a)(12): the borrowing exclusion***

*The modern rationale underlying the realization of debt-discharge income is premised on the borrowing exclusion—all by itself—and the permanently untaxed dollars that would result if those borrowed amounts are not repaid with after-tax dollars.* The modern rationale has nothing to do with balance sheets. Remember that borrowed cash is not intended to be forever free of tax for the borrower. If the parties' expectations had been fulfilled, the taxation of the borrowed money was to occur *in the year of repayment* because that repayment would be made with nondeductible, *i.e.*, after-tax, dollars. Indeed, the Year-1 receipt would have constituted a wealth accession *in that year* were it not for the promise to repay with after-tax dollars in the future, regardless of the solvency or insolvency of the borrower both before and after the receipt and repayment. If that promise proves to be unfounded because the repayment obligation in fact disappears without repayment with after-tax dollars, Gross Income must be created at that later time to prevent those previously received dollars from being made permanently tax-free. Notice that balance sheets are irrelevant to this analysis.

The modern rationale can thus be stated as a three-part syllogism:

**(1) The economic value received in Year 1 is not an "accession to wealth" under *Glenshaw Glass* principles *solely* because of the obligation to repay with after-tax dollars.**

**(2) The obligation to repay disappears.**

**(3) Because the exclusion justification is gone, the value received in Year 1 is *now* an accession to wealth (in the year the repayment obligation disappears) under § 61(a)(12).**

In a sense, you can think of the modern rationale as a version of an error-correction approach in that we *would have required the cash recipient to include the receipt in the earlier year* if we had known then that it would not, in fact, be repaid with after-tax dollars.

If a borrower's repayment obligation disappears, can the borrower simply file an amended return for the prior year of receipt (if the statute of limitations has not yet passed) and include the amount in Gross Income in that year, now that we know (with the benefit of hindsight only) that it will not, in fact, be repaid with after-tax dollars? No. The reason why the borrower must include Gross Income

in the year in which the repayment obligation disappears (rather than file an amended return for the year of receipt) is that the exclusion was *proper* in the borrowing year under the facts then known. Thus, even if the statute of limitations has not expired and the taxpayer wishes to file an amended return (*e.g.*, perhaps the tax rate was lower in the prior year when the proceeds were received), the taxpayer cannot file an amended return.

In this way, § 61(a)(12) income is yet another example of the annual accounting principle, the idea that we take each year as it comes. If our expectations turn out to be wrong about what would happen in the future, we deal with the issue in the year in which those prior expectations prove to be unfounded, just as Mr. Lewis in Chapter 10 could not file an amended return for 1944—even though the statute of limitations was still open—to exclude from Gross Income the portion of his compensation bonus that he was forced to return to his employer in 1946. The inclusion of the compensation was proper in 1944 because everyone expected that the entire amount was his to keep. When that expectation proved to be false in 1946 and he had to return $11,000 of the $22,000 bonus to his employer, Mr. Lewis's only recourse was to take a § 165 deduction in 1946—the year in which expectations about what was going to happen in the future were upended.[5]

***Deferral of § 61(a)(12) debt-discharge income under § 108***

Under Justice Holmes's outdated rationale, the insolvent borrower who escaped debt repayment was not considered to even *realize* Gross Income in the first place unless (and to the extent that) he was made solvent by the discharge. If he were not made solvent by the discharge, he was forever free from tax pertaining to the untaxed dollars originally received and never repaid. That favorable result is no longer true today, but a remnant of Justice Holmes's legacy remains in § 108(a)(1)(B). Before we get there, however, let's first consider § 108(a)(1)(A).

Section 108(a)(1) provides the authority for the borrower to exclude § 61(a)(12) debt-discharge income from Gross Income to the extent that one of the subsections found there apply. The first (and most important) exclusion is the bankruptcy exclusion found in § 108(a)(1)(A), which authorizes exclusion from Gross Income of § 61(a)(12) income if it "occurs in a title 11 case." As confirmed by § 108(d)(2), the reference to "title 11" is a reference to the entire Federal Bankruptcy Code, under which a borrower's debts can be reduced or eliminated by order of the bankruptcy judge. While there are several chapters in the Bankruptcy Code (including Chapter 7 liquidations, Chapter 11 reorganizations, and Chapter 13 consumer bankruptcy actions), the reference in § 108(a)(1)(A) is to *all* of Title 11, so it makes no difference which type of bankruptcy proceeding results in the debt discharge.

Viewed alone, § 108(a)(1) appears to be a complete tax forgiveness provision, but § 108(b) quickly disabuses us of this notion to the extent that it applies. Under § 108(b)(1) and (b)(3)(A), any amount excluded under the authority of the § 108(a)(1)(A), (B), or (C) must reduce—dollar for dollar—the favorable tax attributes owned by the taxpayer that are listed in § 108(b)(2), such as a § 1212 capital loss carryover under § 108(b)(2)(D) or property basis under § 108(b)(2)(E).[6] The effect of reducing these items immediately (in the year of the debt discharge) by the amount excluded should have the effect of *increasing* future Gross Income as a matter of course in an equal amount,

[5] As described in Chapter 10, a taxpayer in Mr. Lewis's position today can effectively take a tax credit under § 1341 in the later year if a credit would be more favorable, but the matter is still addressed entirely in that later year in which expectations changed.

[6] The ordering rules, as well as some special rules, that govern basis reduction under § 108(b)(2)(E) are found in the regulations under § 1017.

turning what appears to be a complete forgiveness provision into a mere deferral provision.

To illustrate, return to our earlier example, under which Martha has assets of $100,000 and debts of $130,000 when a $50,000 debt is discharged. If this discharge occurs in bankruptcy court, Martha excludes from her Gross Income the entire $50,000 of § 61(a)(12) income under the authority of § 108(a)(1)(A), but she would reduce any items listed in § 108(b)(2)(A) through (F) by exactly $50,000. Let's assume that Martha does not have any of the attributes listed in § 108(b)(2)(A) through (C), but she does have a $90,000 capital loss carryover under § 1212 that she has been carrying on her books for future use. Under § 108(b)(2)(D), Martha must reduce her $90,000 capital loss carryover by the $50,000 that she excludes under § 108(a)(1)(A) (*i.e.*, to $40,000), which should have the effect of increasing her future Gross Income by precisely $50,000 because she will have $50,000 *less to deduc*t in future years. If Martha does not have a capital loss carryover to reduce, but she owns property, she must generally reduce her property basis by $50,000 under §§ 108(b)(2)(E) and 1017. If the property is depreciable property, for example, the basis reduction results in $50,000 of fewer depreciation deductions in the future than she otherwise would have taken absent the basis reduction. If the property is not depreciable, a basis reduction should increase future § 1001 gain (or reduce future loss) when she sells the property. In either of these examples, however, no interest is charged by the government for the deferral privilege, which means that Martha is still better off under § 108 (because of the time value of money) than she would be if she had to include the $50,000 of § 61(a)(12) income immediately in the year of discharge.

Why does § 108(a)(1)(A) effectively defer taxation of the § 61(a)(12) income to a future year? The Bankruptcy Code and the Internal Revenue Code are *both* Federal bodies of law, which can be in tension with each other. Under the bankruptcy provisions, the IRS is often a preferred creditor that can jump to the head of the creditor line if the bankrupt debtor owes Federal tax. Thus, for example, if a taxpayer owes back taxes at the time of a bankruptcy filing, the IRS's debt may get first priority (ahead of other unsecured creditors) when assets of the bankruptcy estate are used to settle outstanding debts. Absent § 108(a)(1)(A), a taxpayer who owed no back taxes to the Treasury at the time of a bankruptcy filing could have a *new* tax debt created in the bankruptcy proceeding, itself, when the judge discharges debts owed to other creditors. Just as with back taxes owed at the time of the filing, this brand new tax debt could jump to the head of the creditor line. Section 108(a)(1)(A) effectively prevents this outcome, reflecting Congress's decision to allow *other* creditors of the bankrupt debtor to take first in the bankruptcy proceeding (except, of course, to the extent of Federal taxes previously owed at the time of the filing). The Treasury should, however, get its tax when the debtor's *future* income is higher than it otherwise would be by precisely the amount of § 61(a)(12) income that was excluded under § 108(a)(1)(A)—all because of the § 108(b) attribute reduction.

In the legislative history underlying §108, Congress said that it anticipated that most debtors would have at least one of the tax attributes listed in § 108(b)(2). Nevertheless, it also recognized that some debtors may not have any § 108(b) items to reduce, in which case the § 108(a) exclusion effectively becomes a complete forgiveness provision rather than a mere deferral provision.

Notice that our debtor Martha happens to be "insolvent" (with her $130,000 in liabilities exceeding her $100,000 in assets) before the bankruptcy proceeding, that the $50,000 in debt discharged in the bankruptcy proceeding has the effect of making her solvent by $20,000, but that these facts have absolutely no relevance to the analysis under § 108(a)(1)(A). Indeed, debtors need not even be insolvent to file for bankruptcy protection.

What if an insolvent debtor such as Martha negotiates a debt discharge *outside* bankruptcy

proceedings, where Federal bankruptcy policy is no longer in tension with Federal tax policy? In that case, Martha realizes § 61(a)(12) debt-discharge income—unlike in the *Kirby Lumber* era—but §§ 108(a)(1)(A), (a)(3), and (d)(3) nevertheless authorizes an exclusion to the extent that the discharge does not create a positive net worth for Martha, with § 108(b) tax attribute reduction for the excluded income, resulting in effective deferral (rather than forgiveness). Thus, Martha *immediately* includes $20,000 of her $50,000 of § 61(a)(12) income (to the extent that the discharge creates positive net worth), excludes the remaining $30,000 of § 61(a)(12) income (to the extent that it does not), and reduces the tax attributes listed in § 108(b) by the $30,000 that she excludes. Because the insolvency exclusion is not as generous as the bankruptcy exclusion, Martha may consider a bankruptcy filing instead of negotiating her debt discharge outside of a bankruptcy proceeding, though of course other collateral nontax consequences are important to consider in this regard, as well.

The fact that discharged debt of an insolvent debtor is not forgiven but merely deferred (to the extent that the discharged debt does make the debtor solvent) is clear evidence that Justice Holmes's asset-freeing rationale is a footnote in history. Under the asset-freeing test, Martha would not be considered to have even *realized* any debt-discharge income to the extent of the $30,000 that failed to free any of her assets from debt on her balance sheet. In contrast, under current law, Martha *does* realize the entire $50,000 of discharged debt as § 61(a)(12) income—even to the extent that it does not make her solvent. She can only *defer* the realized income (through attribute reduction) to a future year. Indeed, § 108(e)(1) confirms that the *Kirby Lumber*-era, common law insolvency exception to "realization" of debt-discharge income is defunct.

What justifies the insolvency exclusion in § 108 today? By definition, the taxpayer is not in bankruptcy court, where Congress had to balance Federal bankruptcy policy with Federal tax policy. Surely, insolvent workers cannot avoid including, say, their compensation merely because the income does not free any of their assets from debt or make them solvent. Many students, for example, are technically insolvent (with debts exceeding their assets), but they must nevertheless include all other types of § 61 Gross Income immediately, without deferral. It is hard to conclude that the insolvency deferral rule for this one, particular type of § 61 Gross Income is anything more than a remnant of the early (now outdated) doctrine first enunciated by Justice Holmes.

Other notable types of § 61(a)(12) income that can be excluded under § 108 pertain to discharged "qualified real property business indebtedness" under §§ 108(a)(1)(D) and (c) and certain "purchase money debt reductions" under § 108(e)(5), both of which we shall examine in the next chapter. We shall examine the discharge of "qualified principal residence indebtedness" under §§ 108(a)(1)(E) and (h) in Chapter 18, which considers the tax consequences of home ownership. Certain student loans that are discharged pursuant to the loan's original terms providing for such discharge upon working in certain professions for a set period of time and for a certain set of employers and populations can be excluded under § 108(f).

***Failure to grasp the modern rationale by some courts***

Review the three-step syllogism that underlies the modern rationale for § 61(a)(12), described above. The measure of the income inclusion is *the amount received in the prior year that was excluded in that year solely because of the promise to repay with after-tax dollars*. If no amount is received in the earlier year, no wealth accession arises in a later year, even if a "liability" is

discharged. Thus, the Second Circuit held in *Commissioner v. Rail Joint Company*[7] that no § 61(a)(12) debt-discharge income arises when a corporation repurchases corporate bonds at a discount when the bonds were previously issued as a dividend to its shareholders. That is to say, unlike the corporate bonds in *Kirby Lumber*, the corporation in *Rail Joint* did not sell its bonds *for cash* (which would otherwise have been a wealth accession on receipt absent the promise to repay with after-tax dollars) but rather simply distributed the bonds to its shareholders at no charge. When it bought some of those bonds back for less than the face amount of the bonds (which it would otherwise have had to pay at maturity), it realized no § 61(a)(12) debt-discharge income—*even though its balance sheet clearly improved as a result and even though some of its assets were "freed" from offsetting liability represented by the bonds*. In substance, the company simply paid a lower dividend than first appeared. *Rail Joint* provides a good example of the modern rationale underlying the creation of § 61(a)(12) debt-discharge income.

Similarly, no debt-discharge income is realized if a legal liability unconnected to any prior receipt disappears. **Merely avoiding an "expense" does not represent a wealth accession representing ability to pay and thus does not create Gross Income, even if that expense would otherwise have been legally obligated to be made if the facts had not changed.** For example, assume that, under their divorce agreement, Michael is required to pay Maria $20,000 each year as child support until their child Manny reaches age 18. When Manny is only 11 years old, Michael's income is substantially reduced and they renegotiate their legal agreement to reduce Michael's annual child support payments from $20,000 to $15,000. Michael does not realize § 61(a)(12) income (or any other kind of Gross Income) just because his legal obligation to pay money to his ex-wife (in the form of child support) is reduced—even though his balance sheet clearly improves as a result.

Another example can be drawn from the flip side of the coin in an earlier Problem in Part A. Miriam is injured by Maurice when he fails to stop at a red light and hits Miriam as she crosses the road in the crosswalk. She successfully sues him in a tort action and wins a jury award of $500,000. Maurice owes Miriam money! Unlike in the earlier problem, assume that Maurice has current assets (or at least future earning power) that will allow him to pay the $500,000 to Miriam. What if Miriam decides, for good business reasons,[8] to forgive the debt and tells Maurice that he need not pay the $500,000 that he owes to her? Does Maurice realize § 61(a)(12) debt-discharge income? Even though his balance sheet has improved (with assets on the left side freed of offsetting liabilities on the right side), Maurice does not realize § 61(a)(12) debt-discharge income under the modern rationale. He did not receive any economic value *in Year 1* that would have been a wealth accession *in that year* if he had not promised to repay the amount received with after-tax dollars.

Is *Payne*, below, wrongly decided? The Court's conclusion that § 108(e)(5), which we shall examine in the next chapter, did not apply was clearly correct. Nevertheless, should not the taxpayers have won for reasons having nothing to do with § 108(e)(5)? What—precisely—was discharged here? Is *Payne* an example of the Tax Court applying Justice Holmes's outdated "balance sheet improvement" rationale? The taxpayers represented themselves *pro se*.

## PAYNE v. COMMISSIONER

[7] 61 F.2d 751 (2d Cir. 1932).

[8] Let's stipulate that she has good business reasons driving her decision—rather than detached and disinterested generosity—to avoid any possibility of exclusion for Maurice under § 102 as a gift.

T.C. Memo. 2008-66 (2008), *aff'd* 2010-1 U.S.T.C. (CCH) ¶ 50,132 (8th Cir.) (per curiam)

HAINES, JUDGE: Respondent determined a deficiency of $5,410 in petitioners' Federal income tax for 2004. The sole issue for decision is whether petitioners should have included $16,678 of discharge of indebtedness income on their 2004 Federal income tax return. We hold that they should have done so and therefore sustain respondent's determination.

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. The stipulation of facts, together with the attached exhibits, is incorporated herein by this reference. At the time they filed their petition, petitioners resided in Minnesota.

At the end of 1992 petitioner Ancil N. Payne, Jr. (Mr. Payne), opened a credit card account with MBNA America Bank. Mr. Payne used the credit card to pay hospital bills and receive cash advances during periods of unemployment. By April 26, 2004, Mr. Payne had accumulated $21,407 of credit card debt. At no time did Mr. Payne challenge the accuracy of this amount. Petitioners were not insolvent in 2004, nor did they file for bankruptcy.

By October 19, 2004, Mr. Payne and MBNA entered into an agreement whereby MBNA agreed to accept $4,592 as a full settlement of the account balance of $21,270, payable in installments over 4 months. Mr. Payne made the necessary payments, and MBNA issued him a Form 1099-C, Cancellation of Debt, reporting $16,678 of discharge of indebtedness income.

On petitioners' 2004 Form 1040, U.S. Individual Income Tax Return, filed jointly in April 2005, petitioners did not report any discharge of indebtedness income. Instead, petitioners attached a statement to their return which disclosed that they received a Form 1099-C from MBNA that reported discharge of indebtedness income of $16,678. The statement also explained that petitioners believed the amount disclosed on the Form 1099-C was not subject to income tax.

Respondent's determination of a deficiency in petitioners' Federal income tax for the taxable year 2004 was attributable to petitioners' failure to report the discharge of indebtedness income.

OPINION

Section 61 generally defines Gross Income as "all income from whatever source derived". Section 61(a)(12) specifically provides that Gross Income includes income from the discharge of indebtedness. *See* also *Gitlitz v. Comm'r*, 531 U.S. 206 (2001); *U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931). Respondent determined that MBNA's agreement with Mr. Payne to accept $4,592 in full settlement of the undisputed account balance of $21,270 resulted in $16,678 of discharge of indebtedness income to petitioners. Petitioners bear the burden of proving respondent's determination incorrect….

I. *Reduction of Purchase Price*

Petitioners contend that their settlement with MBNA did not result in the discharge of indebtedness but was rather a retroactive reduction of the rate of interest charged by MBNA and thus a reduction of the "purchase price" of the loans under section 108(e)(5). Although the record does not indicate that MBNA agreed to retroactively reduce the rate of interest of its loans to petitioners, petitioners have nevertheless painstakingly calculated the various interest rates that applied to their outstanding balances from October 1994 through October 2004 and attempt to show that by the time of their settlement they had paid back all of the principal they had borrowed

from MBNA.

Section 108(e)(5) provides an exception to section 61(a)(12) where the buyer of property negotiates with the seller/creditor for a discharge of all or part of the purchase money indebtedness. Commonly such a discharge reflects a decline in the value of the property. The resulting discharge of indebtedness is characterized not as taxable income but in effect as a retroactive reduction of the purchase price. Where, however, the only relationship between the parties is that of debtor and creditor, "The rule of Kirby Lumber is clearly applicable". *OKC Corp. & Subs. v. Comm'r*, 82 T.C. 638, 647 (1984).

Petitioners argue that the lending of money in a generic credit card transaction constitutes the sale of "property" under section 108(e)(5). Petitioners are mistaken. MBNA effectively lent petitioners money to be used for health care costs and general living expenses.[5] The only relationship between the parties was that of debtor and creditor, and thus section 108(e)(5) does not apply. *See OKC Corp. & Subs. v. Comm'r*, *supra* at 647.

II. *Discharge of Indebtedness for Interest Payments*

Petitioners also allege that no income arises from the discharge of indebtedness for interest payments. In support of this proposition, petitioners reference *Earnshaw v. Comm'r*, T.C. Memo 2002-191.

Generally, when a solvent debtor's fixed obligation is reduced or canceled, the amount of the reduction or cancellation constitutes income. Sec. 61(a)(12); *U.S. v. Kirby Lumber Co.*, *supra*. In *Earnshaw v. Comm'r*, *supra*, we concluded that there had been a legitimate dispute between the debtor and creditor regarding the amount of the debtor's obligation. We held that the taxpayer recognized discharge of indebtedness income from the settlement, but the amount was based on the account balance that the taxpayer admitted to rather than the higher amount the Commissioner alleged. *Earnshaw* does not stand for the principle that discharge of indebtedness income does not include the cancellation of debt attributable to interest payments.

As no exclusion applies and the amount of petitioners' obligation was clearly fixed, petitioners should have included $16,678 of discharge of indebtedness income in their Gross Income on their 2004 tax return.

In reaching this holding, the Court has considered all arguments made and, to the extent not mentioned, concludes that they are moot, irrelevant, or without merit.

To reflect the foregoing,

*Decision will be entered for respondent*.

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The Tax Court did not dispute the taxpayers' contention that the $16,678 discharged by MBNA represented entirely *interest and fees* that had accrued from a substantial period of nonpayment on an originally modest principal amount of $4,592, which was entirely repaid. If the facts had been different, and the discharged amount reflected unpaid *principal*, which was used to buy property or services, § 61(a)(12) income would clearly have been realized. On those different facts, the

[5] Insofar as petitioners used the credit card to buy merchandise, the Commissioner treats debt forgiveness in third-party lender cases as a purchase price adjustment only if the forgiveness is directly related to an aspect of the sale, as where a seller inflates the purchase price by misrepresentation. Rev. Rul. 92-99, 1992-2 C.B. 35.

failure to repay the principal (with after-tax dollars) would reflect previously received wealth (the value of the property or services purchased with the borrowed money in the prior year) that was excluded *solely* because of the promise to repay with after-tax dollars under the § 61(a)(12) syllogism. If the borrowers had failed to repay unpaid principal, the taxpayers would have enjoyed a permanently tax-free wealth accession in that prior year (equal to the value of the goods and services purchased on credit) unless we create § 61(a)(12) income in the discharge year. But the Paynes apparently repaid 100% of the originally borrowed principal.

In other words, the Paynes did not receive the amount represented by the unpaid *interest and fees* in a previous year, a receipt that would have represented a wealth accession in that earlier year absent the promise to repay. Rather, they merely avoided an "expense"—as that word is used as a tax term of art—*i.e.*, an outlay that would represent a current wealth decrease when made. Do avoided "expense" create Gross Income? Recall the child support example a few pages back.

The *Payne* court did not cite or apply § 108(e)(2), but read it now. Does the presence of a statutory rule providing that no § 61(a)(12) income arises if the discharged liability would have given rise to a deduction carry with it the negative inference that if the discharged liability would *not* have given rise to a deduction (such as with payment of child support or credit card interest) § 61(a)(12) income *is* created on the discharge? The problem of the negative inference is a common one in statutory interpretation.

If the cancellation of the interest obligation is not § 61(a)(12) debt-discharge income, is it nevertheless residual Gross Income under *Glenshaw Glass* analysis? The parties effectively turned this borrowing transaction into a no-interest loan. Does a no-interest or below-market loan create a wealth accession in the amount of forgone interest? Return to § 7872, studied in Chapter 10. There, you learned that generally *only forgone interest that is a* ***substitute*** *for otherwise includable compensation or a dividend creates a wealth accession for income tax purposes.* Consistent with that treatment, Prop. Treas. Reg. § 1.7872-11(a) provides that cancellation of interest creates deemed § 7872 payments only if "the loan would have been subject to § 7872 had it been made without interest …." While only a proposed regulation that has not been made final, is not its logic persuasive?

## Problems

Sandra makes a bona fide loan of $100,000 to Sebastian on January 1 of Year 1 at 4% annual interest. Under the loan terms, Sebastian is required to pay $4,000 annual interest on December 31 of each year for 5 years, as well as repay the $100,000 principal on December 31 of Year 5. Sebastian's business begins to falter in Year 3, but Sebastian manages to make each annual $4,000 interest payment. When the $100,000 principal repayment becomes due at the end of Year 5, however, Sebastian does not make the payment. What tax consequences arise *for Sebastian* (we already considered Sandra's consequences in Part A.) if:

**a.** Sandra and Sebastian execute an agreement under which he will repay only $70,000 of the outstanding $100,000 loan principal over the next three years at 4% interest. Sandra cancels the remaining $30,000 of principal owed. Before the new agreement was negotiated, Sebastian's balance sheet showed that he owned only one piece of property with a value of $120,000 (and a basis of $80,000). His $100,000 debt to Sandra was his only debt. Sebastian makes the required payments under their new agreement.

**b.** Same as **a.**, except that Sebastian's balance sheet before they negotiate the repayment agreement showed that Sebastian owned only one property with a value of $80,000 (and basis of $50,000). His $100,000 debt to Sandra was his only debt.

**c.** Same as **a.**, except that the $30,000 debt cancellation occurs in bankruptcy court rather than by agreement with Sandra.

**d.** Same as **a.**, except that Sebastian stopped making interest payments after Year 2 when his business began to falter. Sandra and Sebastian execute an agreement that provides that Sebastian must repay the entire $100,000 principal owed over the next three years, but Sandra cancels the $12,000 in interest owed. Sebastian repays the entire $100,000 in principal under their new agreement. Do you need to know how Sebastian spent the loan proceeds? What if he used the loan proceeds for personal purposes, such as to take a year-long world tour in Year 1? What if he used the loan proceeds in his business?

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***Measuring the economic value received in the borrowing year with two-party debt***

When *cash* is borrowed in Year 1 (the usual case), the measure of § 61(a)(12) income upon the later failure to repay with after-tax dollars is clear: the amount of cash previously received in Year 1 and excluded. Moreover, whether the debt is enforceable under state law should be irrelevant to the question of whether a wealth accession is realized when that cash previously received is not repaid with after-tax dollars. For example, assume that Debby borrows $10,000—cold, hard cash—from a loan shark, Dastardly Dan, promising to repay with 50% interest. Debby excludes the $10,000 receipt from her Gross Income under the borrowing exclusion, using the cash to take a trip to Venice. (Lucky Debby!) Debby then learns that under her state's usury law Dastardly Dan would be unable to sue her for repayment in state court. She thus never repays the $10,000 that she borrowed. Does Debby realize § 61(a)(12) income? Or can she argue that § 61(a)(12) should be read in the literal sense to mean that she cannot be "discharged" from a debt within the meaning of § 61(a)(12)'s language if she cannot be forced to repay it in any event?

Would such a literal interpretation of the word "discharge" in § 61(a)(12) untether the relation of that provision to the underlying normative principles that inform it? If Debby does not include the $10,000 in her Gross Income in either the year received or the later year in which the repayment obligation is due but unenforceable, she would have received *permanently* tax-free cash. (Whether Debby can deduct the medical expenses that she incurs when Dastardly Dan breaks both of her knees is considered in Chapter 18. Unlucky Debby!)

In short, the enforceability of the loan should be irrelevant to the question of whether Debby *enjoys a wealth increase* when she (1) receives $10,000 in cash in Year 1 but does not include the amount in her Gross Income *solely* because she promises to repay it in a future year with after-tax dollars and (2) she learns that her state's usury law prevents enforcement of the loan so she decides not to repay. Under step (3) of our syllogism, Debby should have to include $10,000 of § 61(a)(12) income in order to avoid permanent nontaxation of that earlier $10,000 cash receipt. The focus, in other words, should be solely on *what the taxpayer previously received and excluded under the borrowing exclusion* when analyzing § 61(a)(12) income.

The *Payne* court lost sight of that focus. Perhaps the various judges in *Zarin*, below, also lost sight of that key focus. Complicating matters even further in *Zarin* is the fact that the seller of services on credit (gambling entertainment) was also the lender (two-party debt). The extent to

which debt is real when the seller of the services or property is *also* the lender financing the transaction is a perennial difficulty under an income tax. Indeed, you will read more about this problem in Chapter 16, pertaining to tax shelters.

Tax Court cases are usually heard and decided by a single judge. If a case involves a unique or difficult issue or involves facts that may cause the court to overrule its own prior precedent, the Chief Judge can designate the case to be heard by the entire 15-judge court. The decision in that case is called a "reviewed" decision and, by its nature, can involve a majority opinion coupled with dissenting and concurring opinions. After excerpts from the Tax Court opinions, you will read the Third Circuit decision on appeal.

*Zarin* has been called a "case without a right answer."[9] I think that the case is useful, however, because it causes us to revisit several issues that we have considered in the past, as well as causes us to think hard (again) about § 61(a)(12)'s underlying rationale, which is so easy to lose sight of if we think in shorthand terms that a cancelled liability equals § 61(a)(12) debt-discharge income.

## ZARIN v. COMMISSIONER

92 T.C. 1084 (1989) (reviewed)

COHEN, JUDGE: Respondent asserted that petitioners realized additional 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.

All of the facts have been stipulated. The facts set forth in the stipulation are incorporated as our findings by this reference. Petitioners resided in Atlantic City, New Jersey, at the time they filed their petition in this case. They timely filed joint Federal income tax returns for 1980 and 1981 with the Internal Revenue Service Center, Holtsville, New York.

David Zarin (petitioner) was a professional engineer involved in the development, construction, and management of multi-family housing and nursing home facilities. In 1978, 2 years after New Jersey passed the Casino Control Act, N.J. Stat. Ann. sec. 5:12-101 et seq. (West 1988), legalizing casino gambling in Atlantic City, petitioner began developing various housing projects in Atlantic City, New Jersey.

Petitioner occasionally stayed at Resorts International Hotel, Inc. (Resorts), in Atlantic City in connection with his construction activities. Prior to 1978, petitioner had gambled on credit both in Las Vegas, Nevada, and in the Bahamas. 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

[9] Daniel Shaviro, *The Man Who Lost Too Much:* Zarin v. Commissioner *and the Measurement of Taxable Consumption*, 45 TAX LAW REV. 215, 250 (1990).

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. Sec. 61(a)(12). Not all discharges of indebtedness, however, result in income. *See* sec. 1.61-12(a), Income Tax Regs., "The discharge of indebtedness, in whole or in part, may result in the realization of income." (Emphasis supplied.) 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 U.S. v. Kirby Lumber Co.*, 284 U.S. 1 (1931).

Respondent contends that the difference between the $3,435,000 in personal checks and markers that were returned by the banks as drawn against insufficient funds and the $500,000 paid by petitioner in settlement of the Resorts suit constitutes income from the discharge of indebtedness. Petitioner argues that the settlement agreement between Resorts and himself did not give rise to such 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.

… 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. sec. 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.

… Respondent has not proven facts from which we can conclude that the debts were legally enforceable. 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. Comm'r*, 790 F.2d 1409 (9th Cir. 1986), revg. a Memorandum Opinion of this Court, discussed at length, *infra*.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Supreme Court examined the economic realities associated with the cancellation of a nonrecourse obligation. Although a nonrecourse mortgage does not personally obligate the borrower or create a right against the borrower's general assets, the Supreme Court recognized the necessity of treating nonrecourse obligations as enforceable loans both when the obligations are made and when they are discharged. Thus, upon sale of mortgaged property, the seller-original borrower must include the amount of the nonrecourse mortgage assumed by the purchaser in calculating the amount realized from sale, even when the fair market value of the property is less than the outstanding amount of the nonrecourse obligation. Indicating a concern with symmetry, the Supreme Court observed in *Tufts*:

> 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 on 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. 461 U.S. at 309-310.

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 *U.S. v. Rosenthal*, 470 F.2d 837 (2d Cir. 1972), and *U.S. 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.

In *Vukasovich, Inc. v. Comm'r, supra*, the taxpayer borrowed approximately $2 million to finance a cattle feeding venture. The cattle were subsequently sold for less than the full amount of the taxpayer's liability, and he refused to pay the balance owed. The parties to the agreement settled their claims for less than the full amount, and the Commissioner asserted that the taxpayer realized income from cancellation of the debt. The Court of Appeals for the Ninth Circuit concluded that the principles of *Kerbaugh-Empire* had been rejected by the Supreme Court in the subsequent cases cited above, even though the 1926 case had not been specifically overruled. 790 F.2d at 1415-1416. Because we find the reasoning of the Court of Appeals for the Ninth Circuit persuasive, we quote it at length as follows:

> *Kerbaugh-Empire* depended on two premises. First, it held that the cancellation of indebtedness was not income, because income was "gain derived from capital, from labor, or from both combined." *Id.* at 174, 46 S.Ct. at 451. Second, it held that a unitary transactional approach to measuring income made it impermissible to look at receipts in a given year without determining whether they were offsets of losses in another year because while "the [loan] in question is cash gain[,] the borrowed money was lost." *Id.* at 175, 46 S.Ct. at 451. The Commissioner relies primarily on *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); [**19] and *Commissioner v. Tufts*, 461 U.S. 300 (1983), to show that these premises are no longer accepted.

Ordinarily the cancellation of indebtedness is Gross Income. *Kerbaugh-Empire*'s reluctance to tax income from the cancellation of indebtedness stemmed in part from *Eisner v. Macomber*, 252 U.S. 189, 207 (1920) (quoting *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179 (1918)), which defined income for the purposes of the Sixteenth Amendment as "'the gain from capital, from labor, or from both combined.'" Because the cancellation of indebtedness could not be attributed to a gain from capital or labor, the result in *Kerbaugh-Empire* followed from the then-existing interpretation of the Sixteenth Amendment. *See Kerbaugh-Empire*, 271 U.S. at 174-75. Since then, *Glenshaw Glass* has defined Gross Income in terms of "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. at 431.

In *Kirby Lumber*, a company sold its bonds and later repurchased them for less than the sale price. The Supreme Court held that the taxpayer achieved a taxable gain through the freeing of its

assets from the obligation to repurchase the bonds at the price of issue, and therefore realized income. Kirby Lumber shows that an increase in net worth from the discharge of indebtedness for less than the amount loaned is income, at least to the extent that it frees up the debtor's assets. Thus, the taxpayer's gain on the loan must be counted as income in the absence of something exceptional about the underlying transaction.

In *Tufts*, the taxpayer sold property subject to a nonrecourse mortgage. The property was worth less than the amount of the mortgage. Because the mortgage was nonrecourse, it could not be said, as it had been in *Kirby Lumber*, that the removal of the debt freed or enhanced the taxpayer's assets. Nonetheless, the Supreme Court ruled that the Commissioner could treat the difference between the initial amount of the loan and the amount repaid as income from the sale of the property.

The Commissioner argues that *Tufts* supports a general rule making irrelevant whether assets were freed because the Court focuses on the receipt of money unbalanced by an obligation to repay, rather than on the nonrecourse nature of the obligation or on the taking of deductions. *See* 461 U.S. at 310 n.8. The Commissioner's argument is supported by some authority, see Bittker & Thompson, Jr., *Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co.*, 66 CAL.L.REV. 1159, 1165-66, 1176, 1182 (1978).

However, requiring some benefit to the taxpayer from the transaction creating the indebtedness explains such cases as *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932), which held that no gain was realized when a corporation issued bonds as dividends and repurchased them at less than their face value, and *B.F. Avery & Sons, Inc. v. Commissioner*, 26 B.T.A. 1393 (1932), where a claim that cancellation of indebtedness should be treated as a reduction in the purchase price was analyzed according to whether prior tax benefits had resulted from the higher purchase price. *See generally* J. SNEED, THE CONFIGURATIONS OF GROSS INCOME 322-27 (1967).

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. Unlike *Tufts*, *Rail Joint* may not have provided an economic benefit to the taxpayer from the transaction, and the statement in *Tufts* may not apply to such cases. Because *Vukasovich* received money in exchange for the indebtedness, we need not determine the limits of *Tufts*. We decline to address the issue. 790 F.2d at 1414-1415.

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, section 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. U.S.*, 366 U.S. 213, 219 (1961). Under the "all events test," only the fact of liability and the amount owed need be fixed as of the end of a taxable year in order to give rise to a deduction by an accrual basis taxpayer; legal liability is not required. *Burlington Northern Railroad v. Comm'r*, 82 T.C. 143, 151 (1984). Unenforceability of an underlying gambling debt is not a bar to the recognition of income by an accrual method gambling casino. *Flamingo Resort, Inc. v. U.S.*, 664 F.2d 1387 (9th Cir. 1982). Enforceability may affect the timing of recognition of income; other factors fix the amount to be recognized.

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. Comm'r*, 40 B.T.A. 1263 (1939), cited with approval in *Colonial Savings Association v. Comm'r*, 85 T.C. 855, 862-863 (1985), affd. 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. The cases cited by petitioner merely require that there be a liquidated debt, *i.e.*, one in which the amount has been determined. *See Colonial Savings Association v. Comm'r*, 85 T.C. at 863; *N. Sobel, Inc. v. Comm'r*, 40 B.T.A. at 1265. In our view, petitioner's arguments concerning his defenses to Resorts' claim, which apparently led to Resort's 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.

[The discussion of § 165(d), pertaining to gambling losses, and § 108(e)(5), pertaining to purchase-money debt reductions, is omitted.] We have considered the other arguments of the parties and find them unnecessary to disposition of this case or unpersuasive.

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." Based upon that theory, the majority concludes that Mr. Zarin is seeking to reduce the amount of his loss and that this approach runs afoul of the now discredited (according to the majority) "diminution of loss" approach of the Supreme Court in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

I find it unnecessary to rely on *Kerbaugh-Empire* and, therefore, need not embrace or reject the approach of that case. I am constrained to note, however, that it does not follow from the "freeing of asset" approach adopted by the Supreme Court in *Commissioner v. Glenshaw Glass* Co., 348 U.S. 426 (1955), that *Kerbaugh-Empire* is moribund for all purposes. Nor does such moribundity flow from *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), or *Commissioner v. Tufts*, 461 U.S. 300 (1983). *See Colonial Savings Association v. Comm'r*, 85 T.C. 855, 862 n. 11 (1985), *affd*. 854 F.2d 1001 (7th Cir. 1988).

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. 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. sec. 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. sec. 5:12-101(f) (West 1988). Furthermore, strict compliance with those requirements is mandatory for a check to be enforceable. *GNOC, Corp. v. Endico*, 692 F. Supp. 1515 (S.D.N.Y. 1988); *Resorts International Hotel, Inc. v. Salomone*, 178 N.J. Super. 598, 429 A.2d 1078 (App. Div. 1981). 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 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 *U.S. v. Kirby Lumber Co.*, *supra*, and therefore there was no increase in petitioners' wealth that could constitute income. *Cf. Comm'r 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. Comm'r*, 22 B.T.A. 1277 (1931), *affd*. 61 F.2d 751 (2d Cir. 1932) (cited in *Comm'r 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. Comm'r*, 21 T.C. 600 (1954) (same holding)….

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. Comm'r*, 40 B.T.A. 1263 (1939), cited with approval in *Colonial Savings Association v. Comm'r*, 85 T.C. 855, 862-863 (1985), *affd.* 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 *U.S. 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.

[The separate opinions of Jacobs, J., dissenting, and Ruwe, J., dissenting, are omitted.]

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## ZARIN v. COMMISSIONER

916 F.2d 110 (3d Cir. 1990)

Before STAPLETON, COWEN, and WEISS, CIRCUIT JUDGES.

COWEN, CIRCUIT JUDGE: The sole issue before this Court is whether the Tax Court correctly held that Zarin had income from discharge of indebtedness. Section 108 and section 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.

Initially, we find that sections 108 and 61(a)(12) are inapplicable to the Zarin/Resorts transaction. Section 61 does not define indebtedness. On the other hand, section 108(d)(1), which repeats and further elaborates on the rule in section 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 come within the sweep of the discharge of indebtedness rules, then, the taxpayer must satisfy one of the two prongs in the section 108(d)(1) test. Zarin satisfies neither.

Because the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law, 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.

Moreover, Zarin did not have a debt subject to which he held property as required by section 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…." *Zarin*, 92 T.C. at 1099. We agree with the gist of these characterizations, and hold that gambling chips are merely an accounting mechanism to evidence debt.

Gaming chips in New Jersey during 1980 were regarded "solely as evidence of a debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them." N.J. Admin. Code tit. 19k, § 19:46-1.5(d) (1990). Thus, under 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. They could not have been used outside the casino. They could have been used to purchase services and privileges within the casino, including food, drink, entertainment, and lodging, but Zarin would not have utilized them as such, since he received those services from Resorts on a complimentary basis. In short, the chips had no economic substance.

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, *Zarin*, 92 T.C. at 1092, 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. Thus, the chips which Zarin held were not property within the meaning of I.R.C. § 108(d)(1)(B).

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.

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….

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. Comm'r*, 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. Comm'r*, 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 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 "there 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…." *U.S. 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 enforceability 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.

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. section 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: I respectfully dissent because I agree with the Commissioner's appraisal of the economic realities of this matter.

Resorts sells for cash the exhilaration and the potential for profit inherent in games of chance. It does so by selling for cash chips that entitle the holder to gamble at its casino. Zarin, like thousands of others, wished to purchase what Resorts was offering in the marketplace. He chose to make this purchase on credit and executed notes evidencing his obligation to repay the funds that were advanced to him by Resorts. As in most purchase money transactions, Resorts skipped the step of giving Zarin cash that he would only return to it in order to pay for the opportunity to gamble. Resorts provided him instead with chips that entitled him to participate in Resorts' games of chance on the same basis as others who had paid cash for that privilege. Whether viewed as a one or two-step transaction, however, Zarin received either $3.4 million in cash or an entitlement

for which others would have had to pay $3.4 million.

Despite the fact that Zarin received in 1980 cash or an entitlement worth $3.4 million, he correctly reported in that year no income from his dealings with Resorts. He did so solely because he recognized, as evidenced by his notes, an offsetting obligation to repay Resorts $3.4 million in cash. *See, e.g., Vukasovich, Inc. v. Comm'r*, 790 F.2d 1409 (9th Cir. 1986); *U.S. v. Rochelle*, 384 F.2d 748 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968); Bittker and Thompson, *Income From the Discharged Indebtedness: The Progeny of* United States v. Kirby Lumber Co., 66 CALIF. L. REV. 159 (1978). In 1981, with the delivery of Zarin's promise to pay Resorts $500,000 and the execution of a release by Resorts, Resorts surrendered its claim to repayment of the remaining $2.9 million of the money Zarin had borrowed. As of that time, Zarin's assets were freed of his potential liability for that amount and he recognized Gross Income in that amount. *Comm'r v. Tufts*, 461 U.S. 300 (1983); *U.S. v. Kirby Lumber Company*, 284 U.S. 1 (1931); *Vukasovich, Inc. v. Comm'r*, 790 F.2d 1409 (9th Cir. 1986). *But see U.S. v. Hall*, 307 F.2d 238 (10th Cir. 1962).

The only alternatives I see to this conclusion are to hold either (1) that Zarin realized $3.4 million in income in 1980 at a time when both parties to the transaction thought there was an offsetting obligation to repay or (2) that the $3.4 million benefit sought and received by Zarin is not taxable at all. I find the latter alternative unacceptable as inconsistent with the fundamental principle of the Code that anything of commercial value received by a taxpayer is taxable unless expressly excluded from Gross Income. *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955); *U.S. v. Kirby Lumber Co., supra*. I find the former alternative unacceptable as impracticable. In 1980, neither party was maintaining that the debt was unenforceable and, because of the settlement, its unenforceability was not even established in the litigation over the debt in 1981. It was not until 1989 in this litigation over the tax consequences of the transaction that the unenforceability was first judicially declared. Rather than require such tax litigation to resolve the correct treatment of a debt transaction, I regard it as far preferable to have the tax consequences turn on the manner in which the debt is treated by the parties. For present purposes, it will suffice to say that where something that would otherwise be includable in Gross Income is received on credit in a purchase money transaction, there should be no recognition of income so long as the debtor continues to recognize an obligation to repay the debt. On the other hand, income, if not earlier recognized, should be recognized when the debtor no longer recognizes an obligation to repay and the creditor has released the debt or acknowledged its unenforceability.

In this view, it makes no difference whether the extinguishment of the creditor's claim comes as a part of a compromise. Resorts settled for 14 cents on the dollar presumably because it viewed such a settlement as reflective of the odds that the debt would be held to be enforceable. While Zarin should be given credit for the fact that he had to pay 14 cents for a release, I see no reason why he should not realize gain in the same manner as he would have if Resorts had concluded on its own that the debt was legally unenforceable and had written it off as uncollectible.[5]

I would affirm the judgment of the Tax Court.

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[5] A different situation exists where there is a bona fide dispute over the amount of a debt and the dispute is compromised. Rather than require tax litigation to determine the amount of income received, the Commission treats the compromise figure as representing the amount of the obligation. I find this sensible and consistent with the pragmatic approach I would take.

Part of the difficulty in thinking about *Zarin* is that there are multiple ways to characterize the substance of the underlying facts.

If we analyze the facts solely under the rubric of debt-discharge income, what did Mr. Zarin receive in the prior year under the borrowing exclusion, which should measure any § 61(a)(12) income? Was the ostensible borrowing of $3.4 million mere form that did not properly reflect the underlying substance of the facts when we remember that the seller of the gambling services was *also* the lender of dollars used to gamble? There would be no doubt at all that Mr. Zarin clearly realized $2.9 million of § 61(a)(12) income if he had been able to borrow the $3.4 million from a *third party* (such as a bank) rather than Resorts (the seller of the gambling services to Mr. Zarin) and then settled his bank debt for $500,000. But Mr. Zarin ostensibly borrowed the $3.4 million from Resorts, itself—the seller of the services that he was purchasing. Does that make a difference?

Because Resorts wore two hats here—lender and seller of the services purchased with the borrowed money—do we have reason to doubt the reality of the amount borrowed (and used to gamble)? In other words, were the loan documents mere form that masked the underlying substance of a case that looks more simply like the provision of $2.9 million of free consumption (gambling) to Mr. Zarin by Resorts primarily for its own benefit because of the effect that Mr. Zarin had on other gamblers? What case that you read in a prior chapter might such a crafting of the facts raise?

You learned in Chapter 6 that the taxation of personal consumption under an SHS income tax is accomplished primarily via *deduction denial* for outlays used to purchase personal consumption. Thus, § 262(a) denies the deduction of personal expenses, § 167(a) denies depreciation deductions for personal-use assets, and § 165(c)(3) denies deduction of most § 1001 losses realized with respect to personal-use property. The taxation of personal consumption is not commonly accomplished via a Gross Income *inclusion*, except in cases where the free consumption serves as a *substitute* for a clearly includable item (such as compensation, a dividend, or a prize) in order to protect the integrity of those specified inclusions, where the tax base could be significantly put at risk if exclusion could be had merely by avoiding the cash step. Taxation of consumption received in kind solely under the residual clause, in contrast, where there is no employment or other relationship that makes us suspicious that the consumption is a cash substitute representing ability to pay, is more difficult. In that context, we cannot be as sure that the free consumption can fairly be considered the equivalent of the receipt of cash (clearly a wealth accession representing ability to pay) followed by a nondeductible free-spending choice on personal consumption.

In other words, is Mr. Zarin more like Mr. Gotcher in Chapter 6, who was held not to have realized Gross Income when he enjoyed free consumption (a free trip to Germany) provided by Volkswagen Germany primarily for its own benefit, or more like the casino patrons gambling beside him who gambled with their own (nondeductible) after-tax cash? Or perhaps Mr. Zarin merely bought the gambling entertainment from the seller (Resorts) at an arm's-length, bargained-for discount and should be able to avail himself of the bargain purchase rule, under which buyers do not realize Gross Income equal to the benefit of their bargain unless it represents disguised compensation, a dividend, rent, a prize, *etc.* The Tax Court majority opinion noted that Resorts provided to Mr. Zarin—at no charge—a luxury three-room suite, meals, entertainment, and 24-hour access to a limousine. The government did not claim that the value of this consumption was includable Gross Income under the residual clause. Why not? Was the free gambling on any different footing for tax purposes? Is the difference merely that the latter was dressed up with loan documents, which distracted both the government and the courts?

In holding for Mr. Zarin, the Third Circuit relied, first, on the definition of a "debt" in § 108(d)(1) and, second, on the "disputed debt" doctrine. With respect to the former, was *Zarin* a § 108 case? Did he argue that, though he realized debt-discharge income within the meaning of § 61(a)(12), the income was excludable under one of the provisions in § 108, which covers only a subset of the universe of all § 61(a)(12) income? Read the first five words of § 108(d)(1), which the court completely ignored. Very sloppy statutory analysis! The disputed-debt doctrine was created in cases in which the *amount* of cash originally borrowed was in dispute, which is an important fact because the amount originally borrowed and not repaid with after-tax dollars is the proper measure of § 61(a)(12) income. Was there any dispute regarding the *amount* ostensibly borrowed here? How did the judges use the possible lack of enforceability to create ambiguity about the *amount* at issue?

Notwithstanding the language of some of the judges to the effect that the debt was clearly unenforceable, there must have been real uncertainty about that fact, or else Mr. Zarin would never have agreed to pay $500,000 (a good chunk of change) to settle the state court litigation. While I think that the enforceability of the debt was a red herring for the reasons described before the opinion, I also think—for whatever my opinion may be worth (not much?)—that Mr. Zarin did not realize a $2.9 million wealth accession on these facts (which he spent on personal consumption), though not for any reasons actually described by the judges. With Resorts serving as both lender and services seller, we cannot trust that the entire $3.4 million "loan" was real (as we would with an independent third-party lender), and the best measure of the personal consumption purchased by Mr. Zarin was the $500,000 that he paid for it. What do you think?

Do you get the feeling that the Third Circuit and some of the dissenting Tax Court judges were searching for any means possible (as the saying goes) to hold in favor of Mr. Zarin and thus latched on to the supposed lack of enforceability of the debt to shoehorn the case uncomfortably into the disputed-debt doctrine by arguing that there was actually a dispute regarding how much was borrowed: either zero (because the debt was unenforceable) or the entire $3.4 million?

Even if you agree that Mr. Zarin should have won—though for other reasons—the reasoning in the cases lies there to infect future cases. The facts in *Rood v. Commissioner*[10] were essentially identical to the facts in *Zarin* with one, big difference: there was absolutely no question that the debt was enforceable under state law. The casino had dotted its "i"s and crossed its "t"s, and the debt was clearly enforceable. The gambling patron settled the casino debt for less than face amount, just as did Mr. Zarin. The Tax Court, in a memorandum opinion, stuck to its guns and concluded that Mr. Rood realized § 61(a)(12) income equal to the amount of the unpaid debt. The Eleventh Circuit, in a one-page *per curiam* opinion, affirmed the Tax Court's decision, relying on the fact that the lack of enforceability in *Zarin*—key to the Third Circuit's decision—was not present in *Rood*. Thus, there was no disputed debt that could fall under the newly revised version of the disputed-debt doctrine. Mr. Rood did not make any of the arguments suggested above that might perhaps be viable possibilities for a "no Gross Income" result. He represented himself *pro se* and tried to fit within *Zarin* by arguing that some of his golfing buddies gambled on his credit and paid back their losses but that the casino failed to credit Mr. Rood's account with these repayments, resulting in a dispute regarding the amount of the debt. The taxpayer failed to support his theory with any documentation, however, so the Tax Court rejected it, and the Eleventh Circuit deferred to the factual finding of the lower court.

[10] T.C. Memo. 1996-248, *aff'd*, U.S.T.C. ¶ 50,619 (11th Cir. 1997) (*per curiam*).

# Chapter 12: Debt and Property

The primary focus of this chapter is to explore the tax consequences of (1) the purchase of property with debt, (2) the transfer of property (other than by gift) subject to debt, and (3) the reduction of debt secured by property without a transfer of that property. Before we proceed to consider those issues, however, let's set the stage by considering the more straightforward tax consequences of debt repayment with property in kind, instead of with cash.

Suppose that Kent borrows $10,000 in cash from Kathy for five years at market-rate interest and that this debt is a bona fide debt. When the $10,000 principal repayment is due, Kathy agrees to accept Blackacre with a fair market value (FMV) of $10,000 from Kent rather than $10,000 in cash. Blackacre is not encumbered by any debt. Rather, Kent is simply using Blackacre to repay his $10,000 debt, rather than using cash to repay it. Assume that Kent's basis in Blackacre is $7,000. The $3,000 built-in gain in Blackacre was ignored under the realization requirement while Kent owned the property, but now he is disposing of that property in satisfaction of a debt.

You learned in Chapter 9 in connection with *Davis v. Commissioner*[1] that the transfer of property in satisfaction of a debt is a realization event under § 1001. Therefore, when Kent transfers Blackacre to Kathy in satisfaction of his $10,000 debt, Kent realizes a $3,000 gain under § 1001, equal to the difference between the $10,000 FMV of the property that he transfers in satisfaction of his debt and his $7,000 basis in that property. If Blackacre is a capital asset, this realized gain is capital gain under § 1222.

This outcome ensues notwithstanding the language in § 1001(b), which provides that the "amount realized" on the transfer of property (from which adjusted basis is subtracted to reach either "gain" or "loss") is equal to the "sum of money received plus the fair market value of the property (other than money) received." In *form*, Kent does not receive "money" or "property" from Kathy in exchange for Blackacre. Yet, in *substance*, the transaction is treated as though he (1) sells Blackacre for cash equal to its $10,000 FMV—comfortably producing an "amount realized" of $10,000 under the language in § 1001(b)—and (2) uses that $10,000 in deemed cash to repay the $10,000 that he owes to Kathy (with no tax consequences for either party on the debt repayment). The transfer of property in satisfaction of a debt is recast as a sale for cash for purposes of § 1001(b) because of the "economic benefit" that Kent enjoys by having his $10,000 debt retired with Blackacre's $10,000 FMV (unlike a transfer by gift, which is not a realization event).

This construct also governs the analysis of Kathy's cost basis in Blackacre under § 1012. She is treated as having taken that $10,000 in cash deemed received from Kent in repayment of his debt to her and using it to purchase Blackacre, which she now owns, for $10,000, producing a $10,000 cost basis under § 1012.

Now suppose that Blackacre is worth only $8,000, which means that Kent must transfer $2,000 of cash, in addition to Blackacre, to repay his $10,000 debt. The repayment of $2,000 of his debt with cash has no tax consequences for either party, but Kent realizes a $1,000 gain under § 1001, equal to the difference between his $7,000 property basis and its $8,000 FMV because he repays $8,000 of his $10,000 debt with that property. If Blackacre is a capital asset, Kent's $1,000 realized

[1] 370 U.S. 65 (1962). *Davis* led to the enactment of § 1041, but that provision applies only to transfers between spouses or former spouses incident to divorce.

gain is capital gain. Kathy takes an $8,000 cost basis in Blackacre, as she is treated as having taken $8,000 of the $10,000 in actual and deemed cash received from Kent and using it to purchase Blackacre for its $8,000 FMV. (Kathy also has $2,000 in cash, which always has a basis equal to face amount.)

Next iteration: Blackacre is again worth $10,000 (the full amount owed to Kathy), but Kent's basis in Blackacre is $14,000 instead of $7,000. Kent realizes a $4,000 loss under § 1001 on the transfer of Blackacre to Kathy in satisfaction of his $10,000 debt to her, as though he receives $10,000 in cash on a deemed sale and uses that cash to repay Kathy. Only if Blackacre is business or investment property would Kent's loss be deductible under §§ 165(c)(1) or (2). If the loss is deductible and Blackacre is a capital asset in Kent's hands, Kent's loss is a capital loss, subject to the § 1211(b) capital loss limitation rule applicable to otherwise deductible capital losses. Kathy, as before, takes a $10,000 cost basis in Blackacre under § 1012.

Finally, suppose that Kent, in severe financial distress, transfers Blackacre, worth only $8,000 but with a $7,000 basis in Kent's hands, to Kathy in satisfaction of his $10,000 debt, and Kathy agrees to cancel the remaining $2,000 debt. As before, Kent is treated as selling Blackacre for $8,000 in cash (Blackacre's FMV) and using that $8,000 in deemed cash to fully settle his debt with Kathy. The deemed sale for $8,000 in cash again produces a $1,000 realized gain under § 1001, which is capital gain if Blackacre is a capital asset in Kent's hands. In addition, Kent also realizes $2,000 of § 61(a)(12) debt-discharge income, as you learned in Chapter 11, which is ordinary income because it does not arise on the sale or exchange of a capital asset. Generally, Kent could exclude this § 61(a)(12) income only if he is either insolvent or in bankruptcy court, with tax attribute reduction equal to $2,000 under § 108(b) resulting in effective deferral only. If the debt satisfies the "worthlessness" standard, Kathy is entitled to a $2,000 bad-debt deduction under § 166.

In the above scenarios, Kent did not purchase property with debt. Nor did he transfer property to another *subject to* debt. What if he did? Part A. explores the purchase of property with borrowed money. Part B. considers the tax consequences of transferring property subject to encumbering debt to another. Finally, Part C. considers the tax consequences of a reduction in debt encumbering property without a transfer of the property.

## A. The purchase of property with borrowed money—the front-end rule in *Crane*

Suppose that Cain, who owns Blackacre, lists it for sale for $100,000. Connie, who wishes to purchase Blackacre, borrows $80,000 from National Bank and, together with $20,000 of her own previously saved (after-tax) cash, purchases Blackacre for its $100,000 purchase price in Year 1. What is Connie's basis in Blackacre in Year 1? We know for certain that it should be at least $20,000, as Connie spent $20,000 of her own cash—a nondeductible capital expenditure. The denial of a deduction for her $20,000 outlay (because it is a capital expenditure) clearly creates basis to that extent. We also know, however, that Connie is entitled to exclude from her Gross Income the $80,000 of borrowed cash under the borrowing exclusion. Thus, $80,000 of the purchase price represents pre-tax dollars, instead of after-tax dollars. Should that $80,000 of untaxed dollars create basis?

In Chapter 1, you learned that basis generally is a running record of previously or concurrently

taxed dollars. In Chapter 7, you learned of the first major exception to that rule when you studied § 1014, which allows the basis of property received on death to be stepped up to FMV without the recognition of gain by the decedent. The first rule pronounced in *Crane v. Commissioner*,[2] together with its progeny, is the second major exception to the rule that basis generally represents previously taxed dollars. ***Under Crane, debt used to purchase property is included in the basis of that property, even though the borrowed money represents pre-tax dollars***. Thus, Connie's Blackacre basis is $100,000 right from the moment of purchase in Year 1, notwithstanding the fact that only $20,000 of her purchase price represents after-tax dollars.

Moreover, Connie achieves the same result if she effectively borrows $80,000 from Cain, instead of from National Bank, through purchasing the property from him for $20,000 in cash coupled with her note requiring her to pay $80,000 in the future (with interest) to Cain (so long as the note represents bona fide indebtedness, a more difficult issue in the two-party note situation). Her Year-1 basis reflects the entire $100,000, equal to the $20,000 that she transfers to Cain in Year 1 and the $80,000 that she will pay to him in the future.

Finally, Connie achieves the same $100,000 basis if she pays $20,000 to Cain and takes the property "subject to" an $80,000 previously existing debt to National Bank, which Cain had incurred when he bought Blackacre. Connie steps into Cain's shoes with respect to that previously existing debt and continues to make the payments that Cain would have made had he not sold the property to her "subject to" the debt.

The ability to include borrowed money (pre-tax dollars) in basis in Year 1 is an extraordinary privilege when combined with the ability to depreciate the basis of certain business and investment property and to deduct business and investment interest on the loan. First, recall from Chapter 2 that two requirements must be met for business or investment income to be taxed under income tax principles instead of more favorable consumption tax principles (as under a cash-flow consumption tax or wage tax). First, the investment must be made with *after-tax* dollars. Second, the investment return must be fully included in the tax base. If either of those two requirements is missing, the investment is being taxed under more favorable consumption tax principles (rather than income tax principles). If the investment is made with pre-tax dollars, the investment is being taxed according to cash-flow consumption tax principles. If the investment is made with after-tax dollars but the return is explicitly excluded from the tax base, the investment is being taxed under wage tax principles, under which only labor income (not capital income) is taxed.

Moreover, you also learned in Chapter 2 that the economic outcome under a cash-flow consumption tax and wage tax can be the same and that both are better than the outcome under an income tax. Even though the investment return is *nominally* included in the cash-flow consumption tax base, the bottom-line, after-tax consequences can be the same as under a wage tax (at least with respect to the normal return expected when the asset is purchased), where the investment is made with after-tax dollars but the return is explicitly excluded from the tax base.

Finally, you learned that interest should not be deductible under either a cash-flow consumption tax or wage tax.

Because *Crane* basis consists of pre-tax dollars, the return on that investment can be perceived as *effectively* free from tax (even though nominally included on the tax return) between the time that the property purchased with debt begins to generate includable income and the time that the

[2] 331 U.S. 1 (1947).

debt is repaid with after-tax dollars. Moreover, the business or investment interest paid on the loan is nevertheless deductible under § 163, and *Crane* basis may be depreciated (deducted) beginning immediately, so long as the property satisfies the requirements in § 167(a), explored in Chapter 14. *See* § 167(c)(1) (providing that depreciation is calculated by using the property's basis). If *Crane* basis is depreciated before the loan principal is repaid with after-tax dollars, the taxpayer is enjoying a double tax benefit for the same dollars (exclusion of the loan proceeds and deduction of the *Crane* basis generated by those excluded collars) during that period. We have previously seen that, under normative income tax theory, deductions must be supported by basis (in the usual sense of *after-tax* dollars) in order to ensure that the same dollars do not provide a double tax benefit (both exclusion and deduction) to the same taxpayer. Indeed, the failure to have basis to deduct is what prevented the taxpayer in Revenue Ruling 93-27 from taking a § 166 bad-debt deduction in the last chapter! Because *Crane* violates these principles—allowing deductions to be created with pre-tax dollars—much business or investment property is purchased with debt, even if the taxpayer has sufficient cash to avoid debt. The tax treatment is just too favorable to pass up!

Even though the ability to create basis with untaxed dollars is an extraordinary privilege under *Crane*, we lack a practical alternative. Absent *Crane*, Connie's basis would be limited to the $20,000 that she paid with after-tax dollars in our hypothetical above. Only if and to the extent that she made principal payments to National Bank (or to Cain, if Cain acted as the lender) would her basis increase, as each principal payment is made, representing additional after-tax dollars that she has effectively invested in the property. Would the property's depreciation deductions (if the property is depreciable) be calculated by reference to the entire $100,000 value of the property, or would they be calculated by reference only to her initial $20,000 basis? If the latter, how would we calculate depreciation as she increased her basis with principal repayments, year by year?

Moreover, consider what would happen if Connie were to sell the property to Connor for $100,000 in cold, hard cash before its value changed, using $80,000 of the $100,000 in cash received from Connor to repay her loan to National Bank. While the debt repayment has no tax consequences for Connie (as you learned in Chapter 10), her § 1001 gain would be $80,000, equal to the difference between the $100,000 in cold, hard cash that she obtained from Connor on the sale (the amount realized under § 1001(b)) and her $20,000 basis if we did not permit her to include the borrowed funds in her basis. Such a result would be absurd, however, as the property did not increase in value at all between her purchase of it from Cain and her sale to Connor.

For these reasons, allowing her to include the entire sum of borrowed money in basis from the beginning—even though those dollars are pre-tax—is the only practical alternative. Therefore, the corollary is that her basis does *not* increase as and when she makes principal payments to National Bank because she was entitled to include the full amount of the borrowed principal in her basis from the beginning in Year 1.

Borrowed money is included in the property's basis under *Crane* so long as the borrower can prove that the loan proceeds were used to purchase the property. This burden of proof is easy when the loan proceeds go directly from the lender to the property seller (Cain, above), as is often the case, but *Crane* applies even if the loan amount does not go directly from the lender to Cain so long as Connie can show that the cash that she borrowed was, in fact, used to buy Blackacre. Moreover, ***Crane* applies to purchase debt regardless of whether the loan is secured by the property and, if it is secured by the property, regardless of whether the debt is "recourse" or "nonrecourse."**

**A *recourse loan* is one for which the borrower is personally liable for repayment, beyond any property securing the loan.** If, for example, the $80,000 that Connie borrows from National Bank to purchase Blackacre from Cain is also secured by Blackacre, and the loan is a recourse loan, Connie would be personally liable for any shortfall if she fails to repay any part of the $80,000 loan principal and the bank seizes Blackacre at a time when its value has fallen to, say, $70,000. Depending on the contours of state law, National Bank might be able to attach a lien against other property owned by Connie, even though she did not provide a security interest in such other property to the lender, or perhaps even garnish Connie's wages, in order to obtain the final $10,000 that she owes.

**A *nonrecourse loan* is one for which the borrower is not personally liable for repayment. The lender's only remedy on nonpayment is to seize the property security.** If the securing property is worth less than the outstanding balance, the lender is out of luck. For example, if the $80,000 loan described above is nonrecourse instead of recourse and Connie fails to repay it, National Bank has no further remedy beyond seizing Blackacre in a foreclosure action, even if it is worth only $70,000 at the time of the foreclosure. In other words, the only difference between a recourse loan and a nonrecourse loan is *the extent of the lender's remedies* under state law on nonpayment. By definition, all nonrecourse debt is secured by property, but recourse debt also may (or may not) be secured by property.

**If borrowed money is not used to purchase property, it cannot be included in the property's basis, even if the property is used to secure the loan (whether recourse or nonrecourse).** For example, assume that Ronnie purchases Redacre with $100,000 in cash drawn from his savings. Ronnie's Redacre basis is $100,000 under § 1012, equal to the cash that he uses to purchase it. After several years, Redacre appreciates in value to $120,000, and Ronnie borrows $90,000 from National Bank, using Redacre as property security for the recourse loan. Redacre's basis does *not* increase by the $90,000 in new debt because that debt was not used to purchase Redacre. Because that $90,000 is not used to purchase Redacre, that $90,000 is accounted for elsewhere in the tax system and, thus, should not also create Redacre basis. If, for example, Ronnie uses that $90,000 to pay salary to his employees, he deducts the $90,000 under § 162. If he uses that $90,000 to pay his child's summer camp costs, the outlay is a nondeductible personal expense under § 262. The point is that, because he does not use the cash to buy Redacre, it should not be included in Redacre's basis or else Ronnie would be doubly counting it, perhaps providing a double tax benefit (§ 162 deductions *and* Redacre basis) or providing a tax benefit where none should exist (creating Redacre basis when the funds were used in what should be nondeductible personal consumption). In short, no *Crane* basis is created for after-acquired debt.

## B. The transfer of property subject to debt— the back-end rule in *Crane*, *Tufts*, and Rev. Rul. 90-16

In determining the tax consequences of debt relief on the transfer of property subject to debt, we need to distinguish among several different contexts.

***Relief from recourse debt not in excess of property FMV***

Let's add some additional facts to Connie's purchase of Blackacre from Cain, above. Let's assume that the $80,000 that she borrows from National Bank is secured by Blackacre and that the loan is a recourse loan. Let's also assume that Blackacre is land, which is not depreciable under

§§ 167 and 168, so that her original $100,000 *Crane* basis is not reduced during her ownership period for any depreciation deductions under § 1016(a)(2). After Blackacre appreciates to $120,000, Connie sells Blackacre to Richard for $40,000 in cash, with Richard "assuming" the $80,000 recourse debt or taking it "subject to" the debt, which means that Richard essentially steps into Connie's shoes with respect to future debt repayments. With a recourse debt, National Bank may have to approve the sale (because Connie was personally liable for the loan) and Richard will likely have to formally "assume" the recourse loan. We know that Connie's Blackacre basis is $100,000 under *Crane*, but what is her "amount realized" within the meaning of § 1001(b) for purposes of computing her § 1001(a) realized gain or loss on the sale to Richard?

With recourse loans *less* than the FMV of the property securing the debt, Connie's amount realized has always been assumed to be the full $120,000, equal to the $40,000 in cash paid by Richard *plus* the $80,000 recourse debt that he assumes, even though § 1001(b) provides that "amount realized" is equal to "the money received plus the fair market value of the property (other than money) received." Just as in the hypotheticals discussed at the beginning of this chapter pertaining to Kent and Kathy, where a debtor transferred *unencumbered* property in kind (rather than cash) to repay a loan, the transaction is treated as though Connie sells the property entirely for $120,000 in cold, hard cash (comfortably fitting within the § 1001(b) language) and then repays her $80,000 loan. The deemed sale for $120,000 in cash produces a $20,000 gain ($120,000 A/R *less* $100,000 A/B), while the deemed loan repayment has no tax consequences for Connie. In short, she is treated as receiving an additional $80,000 in cash (equal to her debt relief) for purposes of determining her amount realized under § 1001(b) because of the "economic benefit" that Connie enjoys by having the debt, for which she was personally liable, assumed by Richard.

**Relief from recourse debt on the transfer of property to another is treated as "amount realized" under § 1001(b) (in addition to any cash consideration) to the extent that the assumed recourse debt is less than or equal to the property's FMV.**

This rule applies even if the debt was not earlier included in the basis of the property secured by the recourse debt because it was not used to acquire the property. Return, for example, to Ronnie's purchase of Redacre entirely with $100,000 in cash, creating a $100,000 cost basis. When that property appreciates in value to $120,000, he borrows $90,000 from National Bank in a recourse loan, using Redacre as property security. We earlier concluded that Ronnie does *not* increase his Redacre basis by the after-acquired debt because that debt is not used to acquire Redacre. Thus, Redacre's basis remains $100,000. Perhaps Ronnie uses that $90,000 loan to pay $90,000 in wages to his employees. Before Ronnie repays any of the $90,000 loan principal, Ronnie sells Redacre to Ryan for $30,000 in cash, with Ryan assuming the $90,000 recourse loan encumbering Redacre.

Even though the $90,000 debt encumbering Redacre was not earlier included in Redacre's basis, Ronnie's relief from that debt on the sale adds $90,000 of amount realized to the $30,000 cash, producing a total amount realized of $120,000 under § 1001(b) and, thus, a $20,000 realized gain under § 1001(a) ($120,000 A/R *less* $100,000 A/B). If Ronnie were not required to include the debt relief in amount realized, he would never be made to account for the $90,000 of borrowed money that he did not include in his Gross Income on receipt. Regardless of whether Ronnie deducted the $90,000 as salary or did not deduct the amount because spent on personal consumption, the important point is that he *excluded* that $90,000 on initial receipt under the borrowing exclusion. If he were not made to account for the debt relief by adding the $90,000 to his amount realized in computing his § 1001 gain, he would enjoy a double tax benefit for the same

dollars (exclusion from Gross Income and no addition to § 1001(b) amount realized, reducing his gain or creating or increasing a loss). Thus, the need to account for the $90,000 recourse loan encumbering Redacre on the sale of the property is not dependent on the inclusion of the debt in the property's basis. Rather, the need to account for the $90,000 on the transfer of property subject to the debt is the *prior receipt of tax-free dollars*, which were permitted to be received tax-free *solely* on Ronnie's promise that he would repay with after-tax dollars (which we now know he will not, in fact, do). While this rationale sounds very much like the rationale underlying § 61(a)(12) income, we cannot, on these facts, create § 61(a)(12) debt-discharge income for Ronnie because the value of the property exceeds the outstanding debt encumbering it. The only way to account for the debt relief, therefore, is to include it in § 1001(b) amount realized.

***Relief from nonrecourse debt—whether or not in excess of property FMV***

Should the same rule (including the debt relief in amount realized when calculating § 1001 gain or loss) apply if the debt is nonrecourse rather than recourse?

The debt at issue in *Crane* was, in fact, nonrecourse. In addition to holding that debt is included in the basis of property purchased with the debt, whether recourse or nonrecourse (the front-end rule in *Crane), Crane* also held (the back-end rule in *Crane*) that the same rule described just above for recourse debt (not in excess of the property's FMV) applies on the transfer of property to another "subject to" nonrecourse debt. Return, for example, to Connie's purchase of Blackacre with $20,000 in cash and $80,000 of debt, but let's change the nature of the debt from recourse to nonrecourse. Connie's initial basis in Blackacre is $100,000 under the front-end rule in *Crane*. She sells Blackacre to Richard when it is worth $120,000 for $40,000 in cash, "subject to" the $80,000 nonrecourse debt. Because Connie is not personally liable for the nonrecourse debt, National Bank may not be involved when Connie transfers the property "subject to" the nonrecourse debt to Richard, who may not have to formally "assume" the debt. But Richard knows that he owns it "subject to" the debt so that, if he stops making payments, National Bank could foreclose and take possession of Blackacre.

The *Crane* Court reasoned that, even though the debt is nonrecourse, Connie will *treat* it as though she were personally liable for it (*i.e.*, as though it were recourse) in the case in which the outstanding debt is less than the property's FMV (our facts) in order to protect her equity investment in it. That is to say, Connie will repay the $80,000 nonrecourse loan when due, even though she is not personally liable for it, because the property is worth $120,000; if she fails to repay the loan, she could risk losing her $40,000 equity investment (the excess of the property's $120,000 FMV over the $80,000 nonrecourse debt encumbering it). Thus, the *Crane* Court concluded that Connie enjoys an "economic benefit" within the meaning of § 1001(b) equal to the full $80,000 when she transfers the property subject to the nonrecourse debt, even though she is not personally liable for it because of its nature as nonrecourse debt.

All the talk about "economic benefit" aside, an easier way to think about why Connie's debt relief *must* create § 1001(b) amount realized on these facts is to think about her tax consequences if she sold Blackacre to Richard *entirely* for $120,000 in cash (the property's FMV) and then uses $80,000 of the cash obtained to repay her nonrecourse debt to National Bank. She clearly realizes a $40,000 gain under § 1001, as the $120,000 in *cash* clearly constitutes "amount realized" under the language in § 1001(b), and she has no tax consequences on the debt repayment. Thus, we must include the $80,000 nonrecourse debt relief in her amount realized in the economically equivalent transaction in which sells the property to Richard for $40,000 in cash, subject to the $80,000 debt.

Considering those two economically equivalent ways for Connie to structure this sale also illustrates that the *only* way for Connie to account for her $80,000 debt relief in this situation (in which the nonrecourse debt is less than the FMV of the securing property) is to include it in § 1001(b) amount realized. The debt relief could not create § 61(a)(12) income, instead, because a sale entirely for cash coupled with repayment of the debt would not create § 61(a)(12) debt-discharge income on these facts. The two economically equivalent ways to structure this sale should produce the same tax consequences under both the neutrality norm and horizontal equity, both studied in Chapter 3.

The *Crane* Court took its "economic benefit" language seriously, however, when it dropped footnote 37, the most famous footnote in tax (until *Tufts* was decided). In footnote 37, the Court said:

> 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.[3] That is not this 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, [Tufts] borrowed $1,850,000 to build a 120-unit apartment complex in Duncanville, Texas, a Dallas suburb. [Editor's note: The case actually involved a partnership, of which Mr. Tufts was one partner. The analysis in the case does not, however, turn on this distinction, and I have edited the opinion to indicate that Mr. Tufts operated as an individual.] He obtained the loan on a nonrecourse basis. Tufts invested no money in the complex beyond the borrowed nonrecourse loan proceeds. The construction of the complex was completed in August 1971. During 1971, Tufts claimed depreciation deductions equal to $400,000. Due to these deductions, the adjusted basis in the property in August 1972 was $1,450,000.

In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of

[3] The reference to "boot," above, refers back to one of the hypotheticals described at the beginning of this chapter, under which Kent, who owned Blackacre with a FMV of $8,000 and who owed $10,000 to Kathy had to throw $2,000 of cash in to boot, in addition to Blackacre, to settle his debt with Kathy. The extra cash that is required to even up the consideration on both sides (to $10,000 on our facts) is often referred to as "boot"—a nomenclature even more common in connection with § 1031 like kind exchanges, examined in the next chapter.

workers. As a result, the complex's rental income was less than expected, and Tufts was unable to pay the interest due on the mortgage. On August 28, 1972, Tufts sold the complex to an unrelated third party, Fred Bayles. As consideration, Bayles assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed $1,400,000. Mr. Tufts reported the sale on his Federal income tax return as realizing a loss of $50,000. The loss was the difference between the adjusted basis, $1,450,000, and the fair market value of the property, $1,400,000. The Commissioner of Internal Revenue, on audit, determined that the sale resulted in a capital gain of $400,000. His theory was that Mr. Tufts realized the full amount of the nonrecourse obligation. The Commissioner determined the gain on the sale by subtracting the adjusted basis, $1,450,000, from the liability assumed by Bayles, $1,850,000.

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

In *Crane* v. *Commissioner, supra*, this Court took the first and controlling step toward the resolution of this issue. [In holding that the relief from nonrecourse debt on the sale of property should be included in the amount realized under § 1001(b)], 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 [equal to the excess of the property's FMV over the nonrecourse debt encumbering it, and which the buyer had to pay to Mrs. Crane, in addition to taking the property subject to the nonrecourse debt]. 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.

In a footnote, pertinent to the present case, the Court observed [here the Court quoted footnote 37, reprinted above].

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 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, the Commissioner has chosen to accord it the same treatment he gives to a recourse mortgage loan.[5] The 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. *See U.S.* v. *Hendler*, 303 U.S. 564, 566-567 (1938). Because no difference between recourse and nonrecourse obligations is recognized in calculating basis,[7] *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.[8] The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.

The Commissioner in fact has applied this rule even when the fair market value of the property

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[5] 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). 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.

We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and *Crane* were not on the books, whether that approach would be preferred over *Crane*'s analysis. 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. Under the *Crane* approach, the mortgagee is entitled to no portion of the basis. 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).

[7] The Commissioner's choice in *Crane* 'laid the foundation stone of most tax shelters,' Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 283 (1978), by permitting taxpayers who bear no risk to take deductions on depreciable property. Congress recently has acted to curb this avoidance device by forbidding a taxpayer to take depreciation deductions in excess of amounts he has at risk in the investment. 26 U.S.C. § 465(a). Real estate investments, however, are exempt from this prohibition. § 465(c)(3)(D). Although this congressional action may foreshadow a day when nonrecourse and recourse debts will be treated differently, neither Congress nor the Commissioner has sought to alter *Crane*'s rule of including nonrecourse liability in both basis and the amount realized.

[8] Our analysis applies even in the situation in which no deductions are taken. It focuses on the obligation to repay and its subsequent extinguishment, not on the taking and recovery of deductions.

falls below the amount of the nonrecourse obligation. Treas. Reg. § 1.1001-2(b) [Ed. note: this regulation was issued during the pendency of the *Tufts* litigation]; Rev. Rul. 76-111, 1976-1 C.B. 214. 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); *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.[11]

Tufts 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. 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. *Comm'r*, 198 F.2d 357, 359 (CA2 1952); Bittker, *supra* n. 7, at 284. 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.

…

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

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[11] 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 respondent's basis in [property].

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 the context of a sale or disposition of property 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….

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. *See Estate of Levine* v. *Comm'r*, 634 F.2d 12, 15 (CA2 1980).

[Parts III and IV omitted]

The judgment of the Court of Appeals is therefore reversed.

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* [Ed. note: see footnote 7 of the majority opinion.]

*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. *See, e.g., U.S.* v. *Davis*, 370 U.S. 65, 72 (1962); *Gibson Products Co*. v. *U.S.*, 637 F.2d 1041, 1045, n. 8 (CA5 1981) (dictum); see generally Treas. Reg. § 1.1001-2(a)(3), 26 CFR § 1.1001-2(a)(3) (1982); 2 B. Bittker, Federal Taxation of Income, Estates and Gifts para. 41.2.2., pp. 41-10 -- 41-11 (1981).

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, 1976-1 C.B. 214, is now reflected in the regulations. Treas. Reg. § 1.1001-2. 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, see, *e.g.*, *Estate of Levine* v. *Commissioner*, 634 F.2d 12, 15 (CA2 1980); *Millar* v. *Commissioner*, 577 F.2d 212 (CA3), cert. denied, 439 U.S. 1046 (1978); *Estate of Delman* v. *Commissioner*, 73 T.C. 15, 28-30 (1979); *Peninsula Properties Co., Ltd.* v. *Commissioner*, 47 B.T.A. 84, 92 (1942), 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. *National Muffler Dealers Assn*. v. *U.S.*, 440 U.S. 472, 488-489 (1979. Accordingly, I concur.

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We can restate the *Tufts* holding as follows.

**Relief from nonrecourse debt on the transfer of property to another is treated as "amount realized" under § 1001(b)—regardless of whether the nonrecourse debt is less than, equal to, or in excess of the property's FMV.**

Before we get to whether the majority or the concurrence contained the better analysis, let's make sure that you understand why the result that Mr. Tufts requested—a $50,000 loss deduction under §§ 1001 and 165 and no other tax consequences—was *clearly* wrong. Did Mr. Tufts suffer any economic loss? Review the facts. He borrowed $1.85 million, which he never included in Gross Income for tax purposes under the borrowing exclusion, he deducted $400,000 in depreciation while he owned the property, which reduced his tax liability (and remember that those depreciation deductions were created by basis that was itself never taxed to him because it was created entirely by the untaxed debt), and then he walked away from a $1.85 million debt by transferring property worth only $1.4 million to Mr. Bayles. He was smelling like roses! He suffered no loss in either the economic or tax sense! So his requested result was clearly wrong. But was the government's requested result, which the Court adopted, clearly right?

Notice that the third sentence from the end of Justice O'Connor's concurrence describes the majority's approach as one that allows Mr. Tufts to "collapse" the tax consequences from his property disposition under § 1001 with his effective debt relief (because he transferred property with an FMV of only $1.4 million and escaped a $1.85 million debt). We can call this the "collapsed" approach. Under the majority's collapsed approach, *only* § 1001 is triggered for Mr. Tufts. The majority concluded that he realized a $400,000 § 1001 gain when he transferred property subject to a $1.85 million nonrecourse debt to Mr. Bayles (with no additional cash consideration) because his A/B in the property was $1.45 million ($1.85 million debt relief A/R *less* $1.45 million A/B). Under the majority's collapsed approach, he realized no § 61(a)(12) debt-discharge income.

In contrast, Justice O'Connor would have preferred that the majority adopt what we can call the "bifurcated approach" recommended by Professor Barnett, a tax law professor from Stanford, Justice O'Connor's *alma mater*. Under the bifurcated approach, *two* transactions are deemed to occur when the property subject to debt in excess of its FMV is transferred: (1) a sale of the property for its FMV (creating either gain or loss under § 1001, depending on the property's basis) and (2) settlement of the debt with the cash deemed obtained in step 1. If we use the numbers in *Tufts*, Mr. Tufts would be deemed to have (1) sold the property for its $1.4 million FMV, producing a $50,000 loss in light of its $1.45 million basis ($1.4 million A/R *less* $1.45 million A/B) and (2) used the $1.4 million sales proceeds deemed obtained in step 1 to settle his $1.85 million debt, producing $450,000 of § 61(a)(12) debt-discharge income.

What difference does it make, you might ask, between realizing a $400,000 gain under § 1001 (the majority's collapsed approach) or realizing a $50,000 loss under § 1001 *coupled with* $450,000 of § 61(a)(12) income (the bifurcated approach)? After all, do not the two approaches both ultimately produce the same amount of $400,000 of *net* income? By now, you can appreciate why the collapsed approach and the bifurcated approach may not result in the same bottom-line tax consequences.

- Property gain or loss can be capital whereas debt-discharge income is ordinary.
- Section 1001 gain cannot be deferred under § 108, whereas § 61(a)(12) debt-discharge income may be deferred by certain taxpayers.
- In *Tufts*, the choice was between a $50,000 deductible loss (because it was incurred with respect to investment property) coupled with $450,000 of includable income (under the bifurcated approach)—or—$400,000 of includable gain (under the majority's collapsed approach). Under the bifurcated approach, the deduction of the loss may be *deferred* if it is a capital loss under § 1211, but the loss is nevertheless allowable under § 165(c)(2). The loss, however, may not always be allowable.

Suppose, for example, that the property in *Tufts* was an expensive yacht used for personal purposes rather than investment property. Tufts would no longer have been able to take depreciation deductions, so his basis would have remained at $1.85 million. Under the majority's collapsed approach, Tufts would realize neither gain nor loss under § 1001 when he transfers the boat subject to its $1.85 million debt, as his $1.85 million debt relief A/R under §1001(b) would exactly equal his $1.85 A/B. Under the bifurcated approach, in contrast, Tufts would have been deemed to (1) sell the boat for its $1.4 million FMV and (2) settle the $1.85 million debt with the deemed sales proceeds from step 1. Step 1 would produce a $450,000 loss under § 1001 ($1.4 million A/R *less* $1.85 million A/B), *but this loss would be a nondeductible personal consumption*

*loss* under § 165(c)(3), as the value loss reflects personal consumption. Step 2, however, would produce $450,000 of § 61(a)(12) debt-discharge income, as he would settle a $1.85 million debt with only $1.4 million in deemed cash received in step 1. In other words, the *Tufts* majority approach inappropriately allows our yacht owner, in effect, to deduct his personal consumption loss through the back door.

Moreover, the collapsed approach is not consistent with the theory underlying § 1001 and the realization requirement. Section 1001 is intended primarily to capture the increases and decreases in the *value of property* that went unrecognized during the ownership period because of the realization requirement. In *Tufts*, the Court concluded that the taxpayer realized a $400,000 "gain" when the property had actually *lost* value since Tufts acquired it. The accession to wealth that *Tufts* realized was not "gain" but rather was due to being relieved of debt that he never included in Gross Income in Year 1 when he received (and excluded) the $1.85 million loan proceeds solely on his promise to repay it with after-tax dollars—the rationale underlying debt-discharge income, not § 1001 "gain."

The collapsed approach in *Tufts* is reminiscent of a very early (1926) Supreme Court decision in *Bowers v. Kerbaugh-Empire*,[4] which the *Kirby Lumber* Court in the last chapter cited but distinguished. The taxpayer in that case borrowed German Deutschmarks before WWI, converted them into U.S. dollars, lost them in a business transaction, and finally repaid the post-war devalued Deutschmarks with U.S. dollars that cost about $685,000 less than the borrowed marks were worth when received and originally converted into dollars. In other words, the taxpayer profited from the drop in value of the German Deutschmark. In effect, the taxpayer borrowed more than it repaid (measured in U.S. dollars), even though the transaction as a whole—*considering the use to which the borrowed funds were put*—resulted in a loss for the taxpayer. The *Kerbaugh-Empire* Court held that the difference between the FMV of the Deutschmarks when received and when repaid did not create Gross Income because "the whole transaction was a loss" and "the mere diminution of loss is not gain, profit, or income."[5]

In effect, the *Kerbaugh-Empire* Court applied the collapsed approach in considering the *net* effect of the borrowing transaction coupled with the transaction in which the proceeds were spent. The better approach would have been to analyze the tax consequences of the borrowing and repayment of the Deutschmarks independently of the business or investment success (or failure) to which those Deutschmarks were put because foreign currency gains or losses are (generally speaking) capital gains or losses, whereas the business income or loss would be ordinary. Collapsing the two transactions together can distort the proper treatment of each leg. Today, the income tax consequences of dealings in foreign currency are governed by §§ 985 to 989, studied in the course entitled The Federal Income Tax Consequences of International Transactions. They generally adopt the bifurcated approach that is at odds with the approach evident in *Kerbaugh-Empire*.

From the beginning, *Kerbaugh-Empire* was heavily criticized. Taken literally, it would require the tracing of all loan proceeds to evaluate whether a debt discharge produces § 61(a)(12) income, as no such income would be deemed realized if the borrowed amounts were *used* in an unprofitable transaction. While the facts in *Tufts* were easy in that sense because only a single piece of property was purchased with the borrowed money, "[i]t is usually impossible to make this latter

[4] 271 U.S. 170 (1926).
[5] *Id.* at 175.

determination … since the borrowed funds are ordinarily absorbed into the business so completely that tracing the travels of interchangeable dollars lacks even the surface plausibility that it could claim in *Kerbaugh-Empire*."[6] In addition to that practical consideration, there is a fundamental conceptual criticism to the *Kerbaugh-Empire* Court's approach. The business transaction in which the proceeds were lost may also produce deductions (*e.g.*, under §§ 162, 167, 165, *etc.*), thus producing the effect of a double deduction if the related § 61(a)(12) income is not taken into account. The *Kerbaugh-Empire* approach requires vigilance in assuring that, if § 61(a)(12) income is not taken into account, the functionally related loss that is thought to prevent realization of § 61(a)(12) income is not also separately deductible, which (depending on the facts) would be difficult to police.

Unfortunately, the *Kirby Lumber* Court did not expressly overrule *Kerbaugh-Empire*, but it did distinguish it, and *Tufts* did not cite it, even though the majority's collapsed approach could be characterized as coming uncomfortably close to it. Some lower courts have argued that *Kerbaugh-Empire* has been implicitly abandoned. For example, the Tax Court majority opinion in *Zarin* (considered in the last chapter) rejected *Kerbaugh-Empire* as implicitly overruled by later Supreme Court opinions, quoting at length a Ninth Circuit opinion concluding the same.[7] Even though, as you learned, the Third Circuit overruled the Tax Court decision in *Zarin*, it expressly stated, "We do not pass on the question whether or not *Bowers [v. Kerbaugh-Empire]* is good law."[8] The IRS itself has stated in a Revenue Ruling that *Kerbaugh-Empire* is no longer good law when it concluded that "[s]ubsequent Supreme Court decisions and other court cases, when viewed together, have discredited *Kerbaugh-Empire*."[9]

***Relief from recourse debt in excess of property FMV***

What would have been the result in *Tufts* if the debt had been *recourse* instead of nonrecourse and Tufts transferred the property to the creditor in full settlement of the debt? Now the authorities really begin to make no sense!

**REVENUE RULING 90-16**

1990-1 C.B. 12

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 sections 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 [*i.e.*, the debt was recourse]. The debt was secured by a mortgage on the subdivision.

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[6] Boris I. Bittker & Barton H. Thompson, Jr., *Income from the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber*, 66 CAL. L. REV. 1159, 1162 (1978).
[7] 92 T.C. 1084, 1093-94 (1989) (quoting Vukasovich, Inc. v. Comm'r, 790 F.2d 1409, 1414-15 (9th Cir. 1986)).
[8] 916 F.2d at 116 n.11.
[9] Rev. Rul. 92-99, 1992-2 C.B. 35.

*X* became insolvent (within the meaning of section 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 10,000*x* dollars, *X*'s adjusted basis in the subdivision was 8,000*x* dollars, and the amount due on the debt was 12,000*x* 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 section 108(a)(1)(B) applies, the amount excluded under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in section 108(d)(3)).

Section 1.61-6(a) of the Income Tax Regulations provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 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 section 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 section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) of the regulations provides that, except as provided in section 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 section 61(a)(12).

*Example (8)* under section 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 12,000*x* 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 section 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000*x* dollars, exceeds its adjusted basis, 8,000*x* dollars, *X* realizes and recognizes gain on the transfer. *X* thus recognizes 2,000*x* dollars of gain.

To the extent the amount of debt, 12,000*x* dollars, exceeds the fair market value of the subdivision, 10,000*x* dollars, *X* realizes income from the discharge of indebtedness. However, under section 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 section 1001 of the Code. *See Helvering v. Hammel*, 311 U.S. 504, 85 L. Ed. 303, 61 S. Ct. 368, 1941-1 C.B. 375, 1941-1 C.B. 375 (1941), 1941-1 C.B. 375; *Electro-Chemical Engraving Co. v. Comm'r*, 311 U.S. 513, 85 L. Ed. 308, 61 S. Ct. 372, 1941-1 C.B. 380 (1941), 1941-1 C.B. 380; and *Danenberg v. Comm'r*, 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 sections 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 section 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.

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In other words, Treas. Reg. § 1.1001-2(a)(2) adopts Justice O'Connor's and Professor Barnett's bifurcated approach, but it limits the bifurcated approach to *recourse* debt in excess of the FMV of the transferred property. Thus, the taxpayer in Rev. Rul. 90-16 is considered to (1) sell the property for its $10,000 FMV (producing a $2,000 § 1001 gain because the property's basis is $8,000) and (2) use the $10,000 of cash deemed obtained on the transfer to settle the $12,000 debt (producing $2,000 of § 61(a)(12) debt-discharge income, which the taxpayer, who is insolvent, can defer under § 108). In contrast, if the facts in the ruling were precisely the same except that the debt had been nonrecourse instead of recourse, *Tufts* would have controlled, and the taxpayer would have realized *only* a $4,000 § 1001 gain ($12,000 debt relief A/R under *Tufts less* $8,000 A/B) and no § 61(a)(12) debt-discharge income. Because § 1001 "gain" is not § 61(a)(12) debt-discharge income, § 108 and the taxpayer's insolvency would have been irrelevant.

What if the facts were the same as in Rev. Rul. 90-16 except that the creditor seizes the property in foreclosure and does *not* cancel the remaining $2,000 owed but rather pursues repayment by, say, garnishing wages, filing a lien against other property owned by *A*, *etc.*, depending on the rights provided to the creditor under state law? The Tax Court held on similar facts in *Aizawa v. Commissioner*[10] that only the first part of the bifurcated approach would apply at the time of the

[10] 99 T.C. 197 (1992).

property transfer. Thus, *A* would realize only the $2,000 § 1001 gain (equal to the difference between the $10,000 FMV of the transferred property and the $8,000 basis) at the time of the foreclosure. If the creditor's pursuit of the remaining $2,000 debt is successful and *A* pays it, she would avoid § 61(a)(12) income. At some point (when the statute of limitations runs?), however, *A* could be charged with $2,000 of § 61(a)(12) income if she fails to pay the remaining $2,000. In other words, *Aizawa* takes a "wait and see" approach with respect to excess recourse debt that is not formally cancelled by the creditor.

**If property subject to recourse debt in excess of the property's FMV is transferred in full settlement of the debt, *two* transactions are deemed to occur: (1) a sale of the property for its FMV (creating either gain or loss under § 1001, depending on the property's basis) and (2) settlement of the debt with the cash deemed obtained in step 1, creating § 61(a)(12) debt-discharge income. If the excess debt is not cancelled, step 2 is avoided at the time of transfer, but § 61(a)(12) income may be realized later.**

The *Tufts* Court did not appear to understand that it was cementing *different* approaches on the facts before it, depending on whether the excess debt is recourse or nonrecourse. Indeed, at many points it noted that there is no essential difference for tax purposes between recourse and nonrecourse debt. Examples include: (1) "Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property;" (2) "According to *Crane*, this treatment [including debt relief in amount realized] is no different when the obligation is nonrecourse;" and (3) "The only difference between [a nonrecourse mortgage] and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property."

The government's briefs did not alert the Court to the fact that adopting the collapsed approach for nonrecourse debt in excess of the property's FMV differed from the approach to the cancellation of recourse debt in excess of the property's FMV. At the time, there existed in § 108 a broad exclusion for most discharged business debt of even solvent debtors (since repealed) that would have allowed Mr. Tufts to exclude the $450,000 of § 61(a)(12) debt-discharge income (with a concomitant reduction in tax attributes under § 108(b)) if the Court had adopted the bifurcated approach recommended by Justice O'Connor (and which would, in fact, have applied if the debt had been recourse and the excess debt cancelled). The government's interest in maximizing current revenue likely caused it to argue for § 1001(b) amount realized in full, rather than the bifurcated approach, because § 1001 gain is not subject to § 108 deferral. In fact, the government's briefs repeatedly said that if the debt relief were not included in "amount realized," it would escape taxation altogether, [11] which the Court appeared to accept in the last paragraph of Section II of the opinion when it said: "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."

The brief's implication was wrong, of course, because the proceeds *would* be accounted for under the bifurcated approach, though not by creating additional § 1001(b) "amount realized" but rather *by creating § 61(a)(12) debt-discharge income* to the extent that the debt exceeded the FMV

[11] *See generally* Deborah A. Geier, Tufts *and the Evolution of Debt-Discharge Theory*, 1 FLA. TAX REV. 115 (1992) (describing briefs).

of the property. Moreover, remember that whether or not the debt is included in basis is unimportant, as revealed in the earlier Ronnie example, where after-acquired debt was not included in basis but *was* accounted for in amount realized on the later transfer of the property subject to that debt (where the nonrecourse debt did not exceed the property's FMV). Finally, even the Court appeared to understand this when it stated in footnote 8 that its holding was not premised on the taking of depreciation deductions (of basis) but rather on the fact that the original receipt of the $1.85 million was *excluded from Gross Income* as a "true loan."

Is the collapsed approach dictated by *Crane*, as the Court suggests in the first line in Part II of the opinion? No. There is no tension in the *Crane* situation (where the nonrecourse debt is *less* than the FMV of the securing property) between § 61(a)(12) income and § 1001(b) amount realized because the two economically equivalent ways of structuring the sale produce the same tax results. Recall Connie's sale of Blackacre, subject to $80,000 of nonrecourse debt, with an A/B in her hands of $100,000 and an FMV of $120,000. Regardless of whether she (1) sells the property entirely for $120,000 in cash and then repays the $80,000 of nonrecourse debt to National Bank or (2) sells the property for $40,000 in cash, subject to the $80,000 nonrecourse debt, Connie's § 1001(b) amount realized would necessarily be $120,000. That is to say, § 61(a)(12) could not, in fact, have applied. That is not true in the *Tufts* situation, where the two ways of structuring the transaction produce very different results: a $400,000 § 1001 realized gain, on the one hand, versus a $50,000 § 1001 realized loss coupled with $450,000 § 61(a)(12) debt-discharge income, on the other. The tension between § 1001(b) amount realized and § 61(a)(12) arises *only* in the *Tufts* situation—when the debt *exceeds* the FMV of the securing property. Whether the excess debt should be considered additional amount realized or should be considered § 61(a)(12) debt-discharge income was a new issue presented in *Tufts* that was not present in *Crane*, and the *Tufts* majority's decision to adopt the former was not dictated by *Crane*.

Finally, return to the very first set of hypotheticals in this chapter, where the transfer of property satisfies a debt, but the property itself is not purchased with debt or secured by any after-acquired debt, whether recourse or nonrecourse. Rather, Kent had simply earlier borrowed $10,000 in cash from Kathy and was now repaying his loan with Blackacre (A/B of $7,000 in Kent's hands), rather than with cash. In the case in which Blackacre was worth only $8,000, and Kathy accepted Blackacre in full settlement of the debt, cancelling the remaining $2,000 owed, we correctly concluded that Kent would clearly realize a $1,000 gain under § 1001 ($8,000 A/R *less* $7,000 A/B) coupled with $2,000 of § 61(a)(12) income (the $8,000 obtained on the deemed sale for cash that was then deemed used to settle his $10,000 debt to Kathy). Why should the tax consequences on the transfer be different if (1) Blackacre is originally purchased with $10,000 borrowed from Kathy in nonrecourse debt, secured by Blackacre, creating a $10,000 basis under the front-end rule in *Crane*, (2) Blackacre's basis is reduced from $10,000 to $7,000 because Blackacre is depreciable and Kent properly deducted $3,000 in depreciation deductions, and (3) Kent transfers Blackacre to Kathy in foreclosure at a time when Blackacre's value had fallen to $8,000? Under the *Tufts* collapsed approach, which clearly controls the analysis in this fact pattern, Kent realizes a $3,000 gain under § 1001 ($10,000 debt relief A/R *less* $7,000 A/B), instead of a $1,000 gain under § 1001 coupled with $2,000 of § 61(a)(12) debt-discharge income. Why should these two fact patterns be treated so differently?

One response may be that nonrecourse debt, unlike recourse debt, is *so closely intertwined with the ownership of the property securing the debt* (because the taxpayer is not personally liable for the debt, with the lender's remedy limited to taking the property security) that relief from

nonrecourse debt should be collapsed into the Code's *property rules* rather than analyzed separately under the bifurcated approach. If you find that argument convincing, what should happen if nonrecourse debt is cancelled *without* a transfer of the securing property? If the property is not transferred, we cannot analyze the debt relief as amount realized under § 1001(b) as there is no § 1001 property transfer, but we could still analyze the debt relief under the Code's *property rules* by reducing the property's *basis*. Can a taxpayer do that, citing the underlying analytical approach evidenced in *Tufts*? Or must she realize § 61(a)(12) income by analyzing the nonrecourse debt relief *separately* from the underlying property ownership? Through the looking glass we go, as we consider that question in Part C.

## C. Reduction of property debt without a property transfer

We begin with Revenue Ruling 91-31.

**REVENUE RULING 91-31**

1991-1 C.B. 19

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, section 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 facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 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. Section 1.61-12 (a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, 1982-2 C.B. 35, 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 section 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* section 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 *Tuft*'s 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 section 61(a)(12) of the Code.

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So much for the theory that the collapsed approach for excess nonrecourse debt in *Tufts* could be defended (as opposed to the bifurcated approach that applies to excess recourse debt) by arguing that nonrecourse debt is so closely intertwined with the securing property that such debt relief should be analyzed *entirely* under the Code's property rules. By rejecting basis reduction for

cancelled nonrecourse debt when property is retained instead of transferred (which some had argued occurred in the early and extremely vague *Fulton Gold* opinion cited in the ruling) and requiring, instead, that the cancelled nonrecourse debt be analyzed separately from the property ownership (creating § 61(a)(12) debt-discharge income), the ruling effectively rejects the collapsed approach in *Tufts*. But wait, you say! The ruling *cites* the *Tufts* decision as supporting its approach! "'Curiouser and curiouser!' cried Alice (she was so much surprised, that for the moment she quite forgot how to speak good English)."[12]

**A debt discharge without the transfer of property creates § 61(a)(12) debt-discharge income—even if the debt is nonrecourse—unless §§ 108(a)(1)(D) or (e)(5) applies.**

***§§ 108(a)(1)(D) and (e)(5)***

In 1991, § 108 did not contain §§ 108(a)(1)(D) and (c), which could apply today to facts identical to those Revenue Ruling 91-31, thanks to the quick action of the real estate lobby after that ruling was issued.

**Under §§ 108(a)(1)(D) and (c), a taxpayer with cancelled "qualified real property business indebtedness" (whether recourse or nonrecourse) can elect to reduce basis (instead of including the cancelled debt immediately under § 61(a)(12)) to the extent that the cancelled debt exceeds the fair market value of the securing property.**

Owners of personal property (such as machines) instead of real property cannot take advantage of § 108(a)(1)(D). They may nevertheless be able to reduce basis (instead of immediately including the cancelled debt under § 61(a)(12)) if the more stringent requirements of § 108(e)(5) are met, which can apply regardless of the nature of the property.

**Under § 108(e)(5), a debt reduction (whether recourse or nonrecourse) is "treated" like a purchase price adjustment (reducing basis) if (1) the lender and the seller of the property to the taxpayer are the same party (2-party debt) and (2) the debt reduction occurs outside bankruptcy court and while the debtor is solvent.**

Section 108(e)(5) can potentially apply only in the narrow situation in which the lender is also the seller of the property to the borrower/buyer, unlike the third-party debt at issue in Revenue Ruling 91-31. Section 108(e)(5) was enacted in 1980 in reaction to a very practical problem. Suppose that Jane buys a widget machine from George for $100,000, paying George $20,000 at the time of purchase and giving him her note for the remaining $80,000, to be paid in annual installments (along with market-rate interest) for the next five years. In Year 2, Jane discovers a significant malfunction with the machine, and she suspects that George knew about the problem when he sold the property to her. Jane threatens to sue George for breach of warranty, and George agrees to cancel $10,000 of the $80,000 aggregate debt that Jane owes to him under her original note. Jane agrees, and they redraft the note to reflect the lower $70,000 amount, which lowers her remaining annual installment payments, accordingly.

Alternatively, suppose that no malfunction is found with the machine but that Jane suffers significant cash-flow problems in Year 4. George agrees to cancel $10,000 of the debt in order to stave off default on the entire remaining debt, and they, as before, redraft the note to reflect the lower $70,000 amount, which lowers her remaining two annual installment payments by a significant amount, allowing her business to survive (and making it more likely that George will

[12] LEWIS CARROLL, ALICE'S ADVENTURES IN WONDERLAND (1865).

see those last two payments).

If we look at the real facts, Jane and George merely renegotiate their purchase price in the first instance (and the new note is issued to reflect the lower price), while Jane appears to have realized real § 61(a)(12) income in the second. The courts were clogged with such cases, where the trier of fact had to determine whether George had his seller's hat on or his lender's hat on when he cancelled the $10,000 debt. Thus, Congress enacted § 108(e)(5) "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."[13] Section 108(e)(5) avoids the necessity of examining the underlying facts. In *both* cases above, the parties are able to "treat" the cancelled debt as a purchase price adjustment. Thus, the cancelled debt results in a reduction in basis (reflecting the new purchase price) rather than includable § 61(a)(12) income.

While § 108(e)(5) reflects the collapsed approach in the sense that the debt relief is permitted to be accounted for under the Code's property rules (basis reduction) rather than separately as § 61(a)(12) income, § 108(e)(5) is not premised on grand theory but, rather, was enacted in reaction to a practical proof problem and the resulting case backlog in the unique context of seller-financed property sales. *Tufts*, in contrast, is ostensibly based in theory.

One of the arguments made by Mr. Zarin, our gambler from the last chapter, was that his cancelled debt was excludable under § 108(e)(5) because he bought casino chips (property) from Resorts for $3.4 million with money borrowed from Resorts, the seller of the chips, and that he and Resorts agreed to reduce the debt used to purchase the chips to $2.9 million. The Third Circuit did not address the argument, but the Tax Court rejected it by saying:

> 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. Recognition that foreign currency has, for some purposes, been held to be "property" that qualifies as a capital asset is not in point here. Foreign currency fluctuates in United States dollar value, whereas the chips in question do not. 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 section 108(e)(5).

Did Mr. Zarin really spend $3.4 million to purchase little pieces of plastic? Of course not. He purchased the opportunity to gamble, with the chips serving merely as an accounting mechanism to keep track of his gambling wins and losses. More important, § 108(e)(5) should not apply where the debt extinguishment also extinguishes the property itself. Mr. Zarin did not continue to own the chips (with a lower basis), which he could sell to another. In other words, the property must survive the debt cancellation in order for § 108(e)(5) to be able to operate properly through basis reduction.

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Do these rules, taken collectively, make sense? Consider the case of *Gershkowitz v. Commissioner*,[14] which was mentioned in Revenue Ruling 91-31. The simplified facts involved

[13] S. REP. NO. 96-1035 (1980), 1980-2 C.B. 620, 628.
[14] 88 T.C. 984 (1987).

the purchase of computer software for $250,000 for use in a business with nonrecourse debt borrowed from a third party (not the software seller), establishing a $250,000 basis under *Crane*. The software was depreciated over time so that its basis was reduced to $50,000 when a new generation of software was issued, resulting in a plummeting of the FMV of the taxpayer's software to $2,500. The taxpayer was insolvent when the lender threatened foreclosure on nonpayment of the $250,000 nonrecourse debt.

If a transfer in foreclosure occurred, the *Tufts* collapsed approach would apply, resulting in a $200,000 gain under § 1001 ($250,000 debt relief A/R *less* $50,000 A/B). The $200,000 gain would not be excludable under § 108, notwithstanding the taxpayer's insolvency, because § 1001 gain is § 61(a)(3) Gross Income, not § 61(a)(12) Gross Income, and § 108 can potentially apply only to the latter. Obtaining good tax advice, the taxpayer negotiated with the lender to accept a $40,000 cash payment to cancel the $250,000 debt in lieu of foreclosing and taking the property worth only $2,500. (What lender would refuse such an offer on similar facts?) Thus, the taxpayer realized $210,000 of § 61(a)(12) income instead, which the taxpayer could exclude under § 108(a)(1)(B), with a concomitant $210,000 reduction in tax attributes under § 108(b) (to the extent that the taxpayer had any § 108(b) items to reduce).

If *Tufts* had adopted the bifurcated approach, such traps for the unwary—or planning opportunities, depending on your point of view—would not arise. Instead of realizing a $200,000 gain on a foreclosure transfer, Mr. Gershkowitz would have been treated, under the bifurcated approach recommended by Justice O'Connor, as (1) selling the property for its $2,500 FMV and (2) using the $2,500 deemed sales proceeds to settle the $250,000 debt. Step (1) would producing a $47,500 loss under § 1001 ($2,500 A/R *less* $50,000 A/B), which would have been deductible under § 165(c)(1) as a loss incurred in business. Step (2) would produce $247,500 of § 61(a)(12) income, excludable under § 108(a)(1)(B) because of his insolvency but reducing his tax attributes under § 108(b).

Alas, however, *Tufts* is here to stay. Some academics may think that these rules are internally incoherent, but there is no constituency for change, as many in the business world like the "planning opportunities" presented by them. Thus, you need to understand how they operate in order to be in a position to advise your clients well.

## Problems

Describe the tax consequences for Brian in each of the following problems.

**1.** Brian borrows $20,000 in cash from Barbara in Year 1, unsecured by any property. The debt terms require Brian to pay market-rate interest each year and to repay the $20,000 principal amount in Year 5. In Year 5, Barbara agrees to repayment in kind rather than in cash, with Brian transferring Greenacre, FMV $20,000, to her, which Brian bought for $25,000 years earlier and has held for investment.

**2.** Same as **1.**, except that Greenacre's FMV is only $18,000, but Barbara nevertheless accepts Greenacre in full settlement of their debt.

**3.** Brian buys a widget machine for use in his business for $25,000, using $5,000 cash and borrowing $20,000 from National Bank in nonrecourse debt, secured by the machine. During his

ownership period, Brian pays market-rate interest on the loan but makes no principal payments. After properly deducting $10,000 in depreciation under §§ 167 and 168—do not forget § 1016(a)(2)—Brian sells the property to Barbara for $2,000 in cash, subject to the $20,000 nonrecourse debt.

**4.** Same as **3.**, except that Brian did not use debt to purchase the widget machine. Rather, he paid $25,000 in cash for the machine. The following year, he used the machine as security to borrow $20,000 in nonrecourse debt, which he used to pay employee salary. The remaining facts are the same.

**5.** Same as **3.**, except that, because Brian made no principal payments, National Bank forecloses, taking the property at a time when the property's FMV is $10,000. Brian is insolvent.

**6.** Same as **5.**, except that the debt is recourse instead of nonrecourse, and National Bank cancels the remaining unpaid debt at the time of foreclosure. Brian is insolvent.

**7.** Same as **3.**, except that, at a time when Brian's basis is $15,000 and the widget machine's FMV is $18,000, National Bank cancels $5,000 of the $20,000 nonrecourse debt. Brian is *not* insolvent.

**8.** Same as **7.**, except that the property is real estate instead of a widget machine.

**9.** Same as **7.**, except that Brian originally borrowed the $20,000 not from National Bank but from the widget machine seller.

**10.** Same as **3.**, except that, at a time when Brian's basis is $5,000 (and the outstanding nonrecourse debt principal is still $20,000), the property's value plummets to $3,000. National Bank is threatening foreclosure because Brian has made no principal payments. Brian is insolvent. Do you have any advice for Brian?

# Unit V:

# The Ownership and Disposition of Property

## Introduction to Chapters 13 through 16

By this point in the course, you already know quite a lot about the acquisition, ownership, and disposition of property. Chapter 1 introduced you to the basic principles, and you have learned in the last unit how debt affects § 1012 cost basis and § 1001(b) amount realized. Nevertheless, there are still a few more topics to be explored under this broad heading.

Chapter 13 will first consider the proper accounting for § 1001 gain or loss, including a discussion of accounting for inventory sales and installment sales. The bulk of the chapter, however, will be spent exploring several nonrecognition or deferral provisions.

Chapter 14 will review the rate of basis recovery in the case of debt instruments and compare it to the rate of basis recovery under the depreciation and related provisions.

You became acquainted in Chapter 1 with the fact that "net capital gain" is subject to a lower tax rate than "ordinary" gain or income and that "capital" losses that are otherwise deductible under § 165 are subject to deduction restrictions in §§ 1211 and 1212 that are not applicable to ordinary losses. It was important to introduce you to these important concepts early because they have affected so many of the topics that we have already explored. Now is the time, however, to take a closer look at these rules and to introduce you to some additional ones, such as depreciation recapture and § 1231 gains and losses. Welcome to Chapter 15!

Finally, Chapter 16 will consider the topic of tax shelters. While the subject may not appear to fit precisely within the topic of property ownership and disposition, I think that all of the knowledge that you have learned up to this point in the course comes together to make this a good point in time to examine the problem. Thus, I shoehorn it in right here.

# Chapter 13: Properly Accounting for, and the Nonrecognition of, § 1001 Realized Gain or Loss

There is a logical order in the steps to take when analyzing the tax consequences of a realization event, *i.e.*, when property is sold (for cash), exchanged (for other property), destroyed, stolen, *etc.*

***On the disposition of property***

**Step 1: What is the § 1001 realized gain or loss?** This step must *always* come first in the analysis, as this amount is what may possibly be included in § 61(a)(3) Gross Income (if a gain) or deducted under § 165 (if a loss). Moreover, do not lose sight of the fact that basis must *always* be recovered tax free under § 1001, regardless of the manner of disposition, if we are to avoid doubly taxing the same dollars to the same taxpayer. If property is subject to debt, your determination of § 1001 realized gain and loss will necessarily take into account the material that you just learned in Chapter 12.

**Step 2: If a gain, is it includable? *See, e.g.*, §§ 61(a)(3), 1041(a), 1033, 1031, 121. If a loss, is it deductible? *See, e.g.*, §§ 165(c), 1041(a), 1031, 267(a)(1), 1091.** Section 61(a)(3) provides that "gain derived from dealings in property" is an item of Gross Income, and § 1001(a) defines "gain" as the excess of § 1001(b) amount realized over adjusted basis. The introductory clause to § 61 ("except as otherwise provided in this subtitle") reminds us, however, that other Code sections may provide authority for a *realized gain* to go *unrecognized*, which means not taken into account now. You encountered your first nonrecognition provision in Chapter 9 when you studied § 1041, which applies to transfers between spouses or, if incident to divorce, between former spouses. Although the gain or loss may be realized within the meaning of § 1001 under *Davis v. Commissioner*,[1] it goes unrecognized under the authority of § 1041(a). In this chapter, you will study §§ 1033 and 1031, which also permit realized gain to go unrecognized.

Realized losses within the meaning of § 1001—the excess of adjusted basis over amount realized—may go unrecognized not only under § 1041 but also under §§ 1031, 267(a)(1), and 1091, each of which we shall examine in this chapter. Do not forget, however, that even if a realized loss under § 1001 is *recognized* (because no nonrecognition provision applies), the loss may nevertheless not be *deductible*. Recall from Chapter 1 that, for a wealth reduction to be deductible, a taxpayer must find a Code section saying "there shall be allowed as a deduction" and satisfy its terms. For a "loss," the Code section providing that authority is § 165. With respect to individuals, the loss must be described in § 165(c), which generally provides for deduction of business and investment losses only. If the realized loss pertains to personal-use property, the loss is generally not deductible, except for a limited category of personal casualty and theft loss, which we shall examine in Chapter 18.[2]

**Step 3: If (and only if) the answer to (2), above, is "yes," what is the *character* of the gain or loss (ordinary, capital, or § 1231), and why does that character matter? *See* §§ 1221, 1222,**

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[1] 370 U.S. 65 (1962).

[2] Section 1001(c), which provides that, "[e]xcept as otherwise provided in this subtitle," realized gains and losses "shall be recognized," is mere surplusage. Section 61(a)(3) requires inclusion of realized gains in any event, "[e]xcept as otherwise provided by this subtitle." And no realized loss can be deducted unless § 165 is satisfied. Thus, § 1001(c) has no independent force.

**1211, 1212, 1245, 1250, 1231, 1(h).** Only if a realized gain is includable or a realized loss is deductible does it matter whether it is capital, ordinary, or § 1231 gain or loss. If the realized gain is not includable or realized loss is not deductible, its character is irrelevant. We shall explore characterization issues in Chapter 15.

**Step 4: If new property is obtained, what is the basis of the new property? *See* §§ 1012, 1041(b)(2), 1033(b)(2), 1031(d).** Determining the basis of new property (if any) obtained is the very last step in the analysis. This step must come last because the determination of basis sometimes requires knowing the outcome of the analysis in Step 2.

You learned in Chapter 9 that unrecognized § 1041 gain or loss is not laundered out of the tax system, as it is under § 1014 on the transfer of property at death (studied in Chapter 7). Rather, the unrecognized gain is preserved for future reckoning because the transferee spouse takes the same basis that the transferor spouse had in the property under § 1041(b)(2). Similarly, you also learned in Chapter 7 that gifts are not realization events and that the donee generally takes the same basis that the donor had in the property under § 1015(a). Such a basis was historically referred to as *a carryover basis*—and, as an old dog, I still refer to it as a carryover basis—though now it is technically called a *transferred basis*. *See* § 7701(a)(43).

Another kind of basis that preserves unrecognized gain for future reckoning is a *substituted basis* (or *exchanged basis*), a concept that you will shortly learn when we examine § 1031. *See* § 7701(a)(42) and (44). In general, a substituted basis in property received in an exchange (property 2) is determined by reference to the basis of the property exchanged (property 1) if some or all of the realized gain or loss with respect to property 1 is unrecognized. In either case, carryover and substituted bases are instrumental tools that are used to transform what may look like a complete forgiveness provision at first glance into a mere deferral provision.[3]

Part A. explores both (1) how to properly measure § 1001 realized and recognized gain or loss in Step 1 and (2) the proper timing of inclusions and deductions of such gain or loss. Part B. then considers several nonrecognition provisions: involuntary conversions (§ 1033), like kind exchanges (§ 1031), sales of built-in loss property between related parties (§ 267), and so-called wash sales of securities with built-in loss.

## A. Properly accounting for realized and recognized gain and loss

Section 1001 must generally be applied separately to each piece of property sold or exchanged, even if the dispositions occur in a single transaction, in order to ensure that the tax consequences of each are not distorted.

Assume, for example, that Barbara owns (1) a diamond ring that she purchased many years ago for $5,000, which she wears for personal purposes, and (2) a personal-use car that she purchased for $20,000 a few years ago. Barbara, who needs to raise cash, decides to sell both properties, and she finds Bob Buyer, who is interested in purchasing both for $30,000. Barbara cannot simply add the $5,000 basis in her ring to the $20,000 basis in the car and subtract this aggregate $25,000 basis from the $30,000 paid by Bob Buyer, resulting in a § 1001 gain of $5,000. Rather, she must allocate the $30,000 sales proceeds to each property according to their relative fair market values

[3] In contrast, § 121, a nonrecognition provision that we shall examine in Chapter 18, allows certain gain realized on the sale of a principal residence to be completely forgiven.

(FMVs) and calculate her § 1001 realized gain (or loss) separately for each property. Assume, for example, the personal-use car is today worth $10,000. Thus, $10,000 of the $30,000 sales proceeds is allocated to the car sale, and the remaining $20,000 of the sales proceeds is allocated to the ring sale. The car sale produces a $10,000 realized *loss* under § 1001 ($10,000 A/R *less* $20,000 A/B), which is a nondeductible personal loss under § 165(c)(3). The ring sale produces a $15,000 realized *gain* under § 1001 ($20,000 A/R *less* $5,000 A/B), which is includable under § 61(a)(3) and is a capital gain because the ring is not listed in § 1221(a). Collapsing the sales of the two properties into a single § 1001 analysis would effectively allow Barbara to deduct her $10,000 personal consumption loss through the backdoor (by realizing less gain).[4]

Similarly, Bob Buyer must allocate the $30,000 purchase price between the two properties according to their relative FMVs for purposes of determining his § 1012 cost basis in each. Therefore, Bob Buyer allocates $10,000 of his purchase price to the car, taking a $10,000 cost basis under § 1012, and allocates the remaining $20,000 to the ring as its cost basis.

When an entire business is sold, the allocation of the purchase price among the assets for purposes of calculating both the seller's realized gains and losses under § 1001 and the buyer's § 1012 cost basis in each asset is done under rules provided in § 1060, the details of which are beyond this course. This allocation can make a big difference to the buyer if only some of the acquired assets are depreciable while others are not. The allocation also matters to the seller if some assets produce ordinary gain and loss while others produce capital (or § 1231) gain and loss.

While Barbara's sale (and Bob's purchase) of two, distinct assets (a ring and a car) is obvious, sometimes the fact that two distinct assets are in play is not so obvious. A simple example of this idea can be illustrated with Marty's $500,000 purchase of Blackacre, which consists of both (1) land and (2) a building. At the time of purchase, Marty must allocate his $500,000 aggregate basis between the land and the building based on their relative FMVs because the land is not depreciable under § 167(a) while the building is depreciable if Marty uses it in a business or investment activity. Suppose that Marty properly allocates $100,000 of the $500,000 aggregate basis to the land and the remaining $400,000 to the building and that he properly deducts $100,000 in depreciation with respect to the building before selling the land and building for $600,000. While Marty's basis in the land remains $100,000, his original $400,000 building basis will be reduced by $100,000 (equal to the depreciation deductions) under § 1016(a)(2) to $300,000.

Once again, on the sale for $600,000 Marty cannot simply add his land basis to his building basis (equal to the sum of $400,000) and subtract this aggregate basis from the $600,000 aggregate amount realized on the sale to reach a $200,000 gain. Rather, just as Barbara did, he must allocate the $600,000 aggregate amount realized between the land and the building based on their relative FMVs at the time of sale. For example, assume that the value of the land had decreased to $75,000 by the time that Marty sold it. In that case, $75,000 of the aggregate $600,000 amount realized is allocated to the land sale, producing a § 1001 *loss* of $25,000 ($75,000 A/R *less* $100,000 A/B). Marty also realizes a § 1001 *gain* of $225,000 ($525,000 A/R *less* $300,000 A/B) with respect to the building sale. (Chapter 15 will explore the character of these gains and losses under Step 3.)

***Inventory sales***

Inventory accounting is a major exception to the rule that § 1001 must be applied separately to

[4] Astute students may realize that collapsing these two sales into a single tax analysis creates just the kind of distortion that the collapsed analysis in *Tufts* can create, as described in the last chapter.

each sale of property. Can you imagine if the owner of a hardware store had to calculate his § 1001 gain or loss separately with respect to each individual nail that he sold? Instead of calculating § 1001 gain and including that gain in Gross Income under § 61(a)(3), taxpayers who sell inventory include Gross Income under § 61(a)(2) ("Gross Income derived from business") and calculate that Gross Income by subtracting the Cost of Goods Sold from Gross Receipts.[5] The resulting amount, of course, is merely *Gross Income*. The business would then deduct any allowable business expenses under § 162, business interest expense under § 163(a), depreciation in any business equipment or building that it owns under §§ 167 and 168, *etc.*, in reaching Taxable Income.

| | |
|---|---|
| | Gross Receipts |
| *less* | Cost of Goods Sold |
| | Gross Income derived from business under § 61(a)(2) |
| *less* | allowable deductions |
| | Taxable Income |

You can think of the Cost of Goods Sold as an *aggregate* basis concept. The taxpayer determines the Cost of Goods Sold for the year as follows:

| | |
|---|---|
| | Opening Inventory |
| *plus* | Purchased Inventory (new inventory purchased during the year) |
| *less* | Closing Inventory (inventory on hand at the close of the year) |
| | Cost of Goods Sold |

Closing Inventory becomes Opening Inventory for the next year's calculation of Cost of Goods Sold. Closing Inventory is determined by doing a physical count of inventory items left on the shelves at the end of the year and then determining the cost basis of that remaining inventory using conventions, often referred to as FIFO (first in, first out) or LIFO (last in, first out).

Here is an example. Suppose that John opens a new store that sells toy trains in Year 1, purchasing 50 trains for $50 each (a total of $2,500) but selling none of them in Year 1. In Year 2, John's Opening Inventory for his trains would be $2,500. In Year 2, John purchases 10 additional trains for $70 each (a total of $700) and sells 8 trains for $100 each (a total of $800).

At the end of the year, John's physical count shows that he has 52 trains left on his shelves. If John uses the FIFO convention (which is the default convention), the 8 trains that he sold this year would be assumed to come from the trains purchased in Year 1 for $50 each (a total of $400), leaving $2,100 left of the $2,500 that he spent in Year 1 on inventory and the entire $700 that he spent in Year 2 on inventory. In contrast, if John is eligible to elect use of the LIFO convention, the 8 trains that he sold this year would be assumed to come from the trains that he purchased in Year 2 for $70 each (a total of $560), leaving only $140 left of the $700 that he spent in Year 2 on inventory and the entire $2,500 that he spent in Year 1. Notice that John's Cost of Goods Sold would be *higher* under the LIFO method than under the FIFO method.

| Cost of Goods Sold (FIFO) | | | Cost of Goods Sold (LIFO) | | |
|---|---|---|---|---|---|
| | Opening Inventory: | $2,500 | | Opening Inventory: | $2,500 |
| *plus* | Purchased Inventory: | 700 | *plus* | Purchased Inventory: | 700 |

[5] *See* Treas. Reg. § 1.61-3.

| | | | | | |
|---|---|---|---|---|---|
| *less* | Closing Inventory: | 2,800 | *less* | Closing Inventory: | 2,640 |
| | | $400 | | | $560 |

Thus, John's § 61(a)(2) Gross Income derived from business would be *lower* under the LIFO method than under the FIFO method.

| § 61(a)(2) Gross Income using FIFO | | | § 61(a)(2) Gross Income using LIFO | | |
|---|---|---|---|---|---|
| | Gross Receipts: | $800 | | Gross Receipts: | $800 |
| *less* | Cost of Goods Sold: | 400 | *less* | Cost of Goods Sold: | 560 |
| | | $400 | | | $240 |

For those of you who are in a panic about now, my main reasons for describing inventory accounting are to illustrate both that (1) inventory accounting departs from the usual rule that § 1001 gain or loss must be computed by using an asset-by-asset approach and that (2) the LIFO method has been an important tool in reducing the tax burden of businesses that are eligible to use it. The ability to elect LIFO treatment has been front and center in tax reform proposals because a lot of revenue is at stake. Moreover, International Financial Reporting Standards do not permit use of the LIFO method. President Obama has advocated repeal of the method in his Budget proposals for each year since 2010. In 2014, the elimination of LIFO was estimated to generate about $80 billion in revenue over the 10-year window between 2014 and 2023.[6]

***Timing of § 1001 realized and recognized gain inclusion***

When is realized and recognized § 1001 gain (*i.e.*, gain that is not protected from inclusion under a nonrecognition provision, such as §§ 1033 or 1031) included on the tax return? As you learned in Chapter 10, the timing of § 61 Gross Income inclusions (including § 61(a)(3) and (a)(2) Gross Income) usually depends on the taxpayer's method of accounting, whether the cash method or the accrual method. Some students interpret the word "cash" in the term "cash method of accounting" to imply that Gross Income is not included by a cash method taxpayer until *cash* is received. That assumption is not correct. While use of the word "cash" may be unfortunate, you learned in Chapter 10 that cash method taxpayers include Gross Income when *the Gross Income item* is actually or constructively received—*even if that item is not in the form of cash*.[7] Thus, for example, you learned in Chapter 5 that an employee using the cash method of accounting must include the $100,000 FMV of Blackacre received as compensation for services rendered from her employer under § 61(a)(1) in the year in which Blackacre is received (unless subject to a substantial risk of forfeiture within the meaning of § 83). Similarly, a cash method taxpayer must include the $100 FMV of free home cleaning services received in kind (paid for by the employer) as compensation in kind under § 61(a)(1) in the year in which those cleaning services are received. Note that neither of these receipts is in the form of cash. Similarly, absent application of § 453 (discussed below), § 1001 gain must be included in the year in which the § 1001(b) amount realized is received, even if the seller uses the cash method of accounting and the amount realized is not in the form of cash.

For example, assume that Nora, who uses the cash method of accounting, owns undeveloped land with an A/B of $10,000 and a FMV of $100,000, which she exchanges for a boat owned by Nick with a FMV of $100,000. (Any classic film "Thin Man" fans out there? We'll bring Asta into

[6] *See* www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf.
[7] *See* Treas. Reg. § 1.446-1(c)(1)(i).

the picture shortly.) While we ignored the $90,000 wealth accession in the form of the increase in land value during her ownership period under the realization requirement, the property exchange is a realization event under § 1001, and Nora realizes and recognizes a $90,000 gain ($100,000 A/R *less* $10,000 A/B) because no nonrecognition provision would apply on these facts. Moreover, because Nora uses the cash method of accounting, she must include that $90,000 realized and recognized gain immediately in the year in which she obtains the boat. (She may have to mortgage the boat to pay the tax due on the exchange. Or she may have cash from, say, a salary or her past savings with which to pay the tax.)

Nora would include her $90,000 realized gain in the sale year on the facts described above if she uses the accrual method of accounting, as well, because (1) all the events have occurred to fix her right to receive the income and (2) the amount can be determined with reasonable accuracy.[8]

***Installment sale reporting***

Suppose that Nora sells her land (A/B $10,000) to Nick for $100,000 of cash consideration on July 1 of Year 1 (rather than exchanges her land for Nick's boat) but that Nick pays to Nora only $20,000 at the time of sale. He also transfers to her a note for the remaining $80,000, to be paid in four annual installments of $20,000 each on June 30 of each of Years 2, 3, 4, and 5, plus market-rate interest. Just as the boat is § 1001(b) amount realized in the form of property, so is the note. Absent application of § 453, Nora must include her $90,000 realized and recognized § 1001 gain entirely in Year 1, just as she would if she exchange her land for Nick's boat.[9]

Nora may, however, be able to take advantage of § 453 installment sale reporting in the case of the note, which would permit her to defer including her realized and recognized gain until payments are received on the note. Under § 453(b)(1), an installment sale is any sale in which at least one payment will be received after the close of the taxable year in which the sale occurs. We can reduce the language found in § 453(c) to a formula. The amount of total realized and recognized gain to be included in any year is equal to:

$$\text{Payments Received in the Year} \times \frac{\text{Gross Profit}}{\text{Total Contract Price}}$$

The Gross Profit is the entire § 1001 realized and recognized gain: $90,000 on our facts. The Total Contract Price is the entire § 1001(b) amount realized: $100,000. Of each annual $20,000 Payment that Nora receives (including the Year-1 Payment), 90% (or $18,000) represents includable § 1001 gain, while 10% (or $2,000) represents tax-free recovery of her $10,000 basis.

$$\$20{,}000 \times \frac{\$90{,}000}{\$100{,}000}$$

In addition, of course, Nora must include in her Gross Income the interest that she receives from Nick under § 61(a)(4).

Section 453 contains several important exceptions. Under § 453(i), any depreciation recapture under §§ 1245 and 1250 (discussed in Chapter 15) must be recognized immediately in the year of sale. Only the remaining gain, if any, would be eligible for installment sale reporting. Because land

[8] *See* Treas. Reg. § 1.446-1(c)(1)(ii).

[9] *See* Treas. Reg. § 1.1001-1(g). If the note does not pay market-rate interest, the amount realized would actually be less than the $80,000 because part of that $80,000 would really be disguised interest. The rules that achieve this result are found in §§ 1274 and 483, both of which are beyond the scope of this course.

is not depreciable, there could be no depreciation recapture on our facts. Dispositions of inventory and dispositions of real estate by dealers in real estate are big exceptions under §§ 453(b)(2) and (*l*), but let's assume that Nora is not a real estate dealer. Because of the inventory and real estate dealer exceptions, § 453 is primarily used on the sale of a closely held business to a new owner with the new owner paying the retiring seller under a note funded with the business's future profits. If the note that Nick transfers to Nora is a demand note (entitling Nora to require Nick's payment of principal on her demand) or is readily tradable on an established securities market, installment sale reporting is unavailable, as such a note is a cash equivalent.[10] Finally, taxpayers otherwise eligible to use the installment method can elect out of installment reporting under § 453(d).

Installment sale reporting is very valuable because of the time value of money; no interest is usually charged by the government for this deferral privilege.[11] Why, therefore, would anyone who is otherwise eligible to use installment sale reporting elect out of it under § 453(d), thus including the entire sale gain in the year of sale? Perhaps Nora does not want to leave the future tax obligation to her heirs but would rather allow them to receive payments on the note after her death entirely free of tax. For example, if Nora reports her sale under the installment method (under which she would include in Gross Income $18,000 of every $20,000 payment to be received) but dies before receiving the final two note payments, her heirs will step into her shoes and include $18,000 of each of the two remaining $20,000 payments that they receive. If, in contrast, Nora elects out of installment sale reporting, she will include her entire $90,000 realized gain in Year 1. Thus, when her heirs receive the final two payments of $20,000, they can exclude the entire amount. Or perhaps Nora's realized gain is capital gain and Nora has a large capital loss carryover under § 1212(b) that would make immediate recognition painless.

***Open transaction reporting***

Finally, suppose that Nora owns land with an A/B of $80,000 and an uncertain FMV because she knows that iron ore resides beneath the land but does not know the extent of the deposit. With this uncertainty, Nora is unwilling to sell the land to Nick (who wishes to mine the ore) for a sum certain. Rather, she sells the land to Nick for, say, $50,000 at closing in Year 1 plus 10% of the value of each ton of iron ore that he mines from the land over the next 5 years. Thereafter, Nora receives $40,000 in Year 2, $50,000 in Year 3, $10,000 in Year 4, and $40,000 in Year 5.

Because at least one payment is made after the sale year, the transaction is an installment sale under § 453(b), but neither the Gross Profit nor the Total Contract Price is known in Year 1. In this case, Nora may be eligible to use "open transaction reporting" with respect to the sale, a method first described in *Burnet v. Logan*[12] and now found in Treas. Reg. § 15A.453-1(d)(2)(iii). Under open transaction reporting, Nora would be permitted to treat 100% of each payment as tax-recovery of basis until her basis is fully recovered. Thus, Nora would fully exclude 100% of the Year-1 $50,000 payment, as well as $30,000 of the $40,000 Year-2 payment (including the remaining $10,000 received in her Gross Income as § 1001 gain). She would also fully include the payments received in Years 3, 4, and 5 as § 1001 gain. Because of the time value of money, open transaction reporting is the most favorable reporting method because the gain is maximally deferred. For this reason, Treas. Reg. § 15A.453-1(d)(2)(ii) permits open transaction reporting *only* if both the FMV of the sold property and the total consideration to be received are not ascertainable.

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[10] *See* §§ 453(f)(4) and (5).
[11] *But see* § 453A (imposing an interest charge under certain circumstances).
[12] 283 U.S. 404 (1931).

## B. The nonrecognition of § 1001 realized gain or loss

This section explores several important nonrecognition provisions in the Code. Those of you who go on to other income tax courses will learn that the basic paradigm in §§ 1033 and 1031 are used in many other contexts, such as with the transfer of property to controlled corporations or to partnerships and LLCs, the transfer of property and stock in tax-free corporate mergers and other combinations, the tax-free division of a single corporation into two or more corporations, *etc.* In each case, the gain or loss that goes unrecognized on these property dispositions is merely deferred (rather than forgiven) by manipulating the basis rules in such a way as to perfectly preserve the unrecognized gain or loss. Wealthy taxpayers often take advantage of many of these rules again and again to diversify their property and financial holdings during life. Then, at death, the final property transfers to heirs is not a realization event, even though the heirs take a fresh FMV basis under § 1014, forever eliminating the deferred gain from the income tax system.

***§ 1033 involuntary conversions of built-in gain property***

Suppose that Mark purchases a boat for $100,000 for use in his fishing business. After properly deducting $60,000 of depreciation under §§ 167 and 168, his basis is reduced under § 1016(a)(2) to $40,000, though its FMV is $90,000 when a storm destroys the boat on March 2 of Year 1. Luckily, the boat is fully insured, and Mark receives insurance proceeds of $90,000 on July 1 of Year 1. Because Mark has been thinking about downsizing his business on the way to retirement, he decides to replace his boat with a smaller one that costs only $70,000, which he purchases on September 30 of Year 3, and he pockets the remaining $20,000 in insurance proceeds.

Mark obviously did not wish to engage in a realization event, but a realization event it was when he received $90,000 in cash for his destroyed boat. Thus, Mark realizes a $50,000 gain under § 1001 in Year 1 ($90,000 A/R *less* $40,000 A/B), which he must include in his Gross Income under § 61(a)(3)—*unless* he is eligible to make (and does make) an election under § 1033 to defer recognition of all or a portion of his realized gain.

Read §§ 1033(a)(2)(A) and (B) and (b)(2). If Mark makes the election referred to in § 1033(a)(2)(A) in Year 1 (by submitting the proper form with his Year-1 tax return) and purchases property "similar or related in service or use" to his destroyed property by the end of Year 3, he can avoid recognizing a portion of his $50,000 realized gain. How much can he avoid recognizing? Under § 1033(a)(2)(A), he must recognize his $50,000 realized gain "only to the extent that the amount realized upon such conversion … exceeds the cost of [the replacement] property." Because Mark's "amount realized" was $90,000 (equal to the insurance proceeds), and the cost of his new boat was $70,000, Mark must recognize only $20,000 of his $50,000 realized gain in Year 1 if he properly makes a § 1033 election.

The $30,000 of unrecognized gain is not forgiven, however, as § 1033(b)(2) requires Mark to reduce his $70,000 § 1012 cost basis in his new boat by the $30,000 portion of his realized gain that is not recognized in Year 1. Thus, his new boat's basis of $40,000 ($70,000 cost basis *less* $30,000 of unrecognized gain) perfectly preserves the unrecognized gain. If he sold his new boat for exactly $70,000 (what he paid for it), he would realize and recognize the $30,000 of realized gain that was not recognized in Year 1.

You can think of § 1033 as a "rollover" provision that allows Mark to avoid recognizing his realized gain so long as he "rolls over" 100% of the insurance proceeds that he receives on the

involuntary conversion into the replacement property. To the extent that Mark does *not* roll over 100% of the insurance proceeds, he must recognize his realized gain—*but no more than his realized gain*. If Mark's new boat costs at least $90,000 (equal to 100% of the insurance proceeds that he receives), Mark recognizes none of his $50,000 realized gain in Year 1, though the cost basis of the new boat is reduced by the entire $50,000 in that case.

Section 1033, in effect, mimics cash-flow consumption tax treatment. Recall from Chapter 2 that, under a cash-flow consumption tax, the entire "amount realized" on the sale of property is includable in the tax base (as potential consumption) but that business or investment outlays are immediately deductible in full, even if the property has a long life and would be a nondeductible capital expenditure under income tax principles. The end result is that only amounts that are withdrawn from investment and spent on consumption are taxed. In our hypothetical, only the $20,000 that Mark does not roll over into the replacement property but rather withdraws from investment is included in his Gross Income.

One difference between § 1033 and a real cash-flow consumption tax is that § 1033 is not limited to business or investment property. Realized gain can be deferred even if the property that is involuntarily converted is personal-use property. For example, return to Barbara's diamond ring from earlier in the chapter, which she purchases for $5,000 but which is worth $20,000 when she sells it, except let's change the facts so that the ring is stolen, instead, and she obtains $20,000 from her insurance company. If Barbara uses the entire $20,000 insurance proceeds to buy a replacement diamond ring, she can defer recognizing her $15,000 realized gain, so long as she properly files a § 1033 election. If she uses only $13,000 of the $20,000 insurance proceeds to buy a diamond ring, she must recognize $7,000 of her $15,000 realized gain. In either case, she must reduce her § 1012 cost basis in the new ring by any unrecognized gain on the involuntary conversion under § 1033(b)(2).

Do not fall into the trap of thinking that any cash that is not rolled over into the replacement property is includable in Gross Income, however. The taxpayer must *always* be permitted to recover his basis tax-free to avoid doubly taxing the same dollars to the same taxpayer. Let's return to Mark's example. Suppose that Mark's A/B in the boat is $80,000 (instead of $40,000) but that all of the other facts are the same as in the original fact pattern. That is to say, Mark receives $90,000 in insurance proceeds when his boat is destroyed but rolls over only $70,000 in the new boat, pocketing the remaining $20,000. Mark does *not* include $20,000 in Gross Income on these changed facts (as he did in our original example), as his *realized gain* under § 1001 under these changed facts (Step 1 in the analysis) is only $10,000 ($90,000 A/R *less* $80,000 A/B). Revisit the language in § 1033(a)(2)(A), which provides that "*the gain* shall be recognized only to the extent that the amount realized upon such conversion … exceeds the cost of [the replacement] property." (Emphasis added.) The words "the gain" refers to Mark's *§ 1001 realized gain* of $10,000. This analysis reminds us why Step 1 in any property disposition is to calculate the § 1001 realized gain (or loss). Mark's $10,000 realized gain is the most that he can be forced to include in Gross Income, as that amount is the only new wealth that has not yet been included in his Gross Income. If Mark simply sold his boat (A/B $80,000) for $90,000 in cash (where § 1033 would be irrelevant), he would realize and recognize no more than his $10,000 realized gain; the same applies even if the facts are described in § 1033. Of the $20,000 of cash that he does not roll over into replacement property, $10,000 is tax-free basis recovery. In effect, § 1033 provides no benefit for Mark if he retains insurance proceeds in excess of his realized gain.

What is "property similar or related in service or use"? With one exception noted below, the

standard is rigorous. The Tax Court, for example, has said that the test is a "functional" one because of the reference to "service or use." In *Collins v. Commissioner*,[13] for example, the Tax Court held that rental real estate and a retail establishment were not functionally related to condemned chicken houses because they are *used* in quite different ways. In Revenue Ruling 76-319,[14] the IRS ruled that a billiards hall is not similar or related in service or use to a bowling alley destroyed by fire. In a private letter ruling the IRS concluded that art in other media, such as oil paintings, water colors, sculptures, and graphic art, is not similar or related in service or use to destroyed lithographs.[15]

Under § 1033(g), however, real estate used in business or held for investment has a much easier standard to meet if it is involuntarily converted "as the result of its seizure, requisition, or condemnation or threat or imminence thereof" (rather than destroyed by fire, as in the case of the bowling alley, above). Section 1033 can be satisfied in that case if the conversion proceeds are rolled over into "like kind" property—a much easier standard to meet, as you will learn below—even if the property is not similar or related in service or use under the functional relation test.

***§ 1031 like kind exchanges***

While § 1033 is a rollover provision, allowing the taxpayer who receives *cash* on an involuntary disposition to avoid gain recognition to the extent that the cash is used to purchase qualified replacement property, § 1031 applies only on the *exchange* of property (and only if the properties exchanged are of "like kind"). Moreover, while § 1033 avoids the recognition of only realized gain, § 1031 prevents recognition of both realized gain and realized loss. Finally, unlike § 1033, § 1031 is not explicitly elective. Thus, a taxpayer wishing to avoid nonrecognition (because, for example, she realizes a loss that she would like to deduct currently under § 165) must intentionally fail to satisfy at least one requirement in § 1031—typically the "exchange" requirement. Like § 1033, however, § 1031 manipulates the basis of the new property obtained by the taxpayer in the exchange (under § 1031(d)) to preserve any unrecognized gain (or loss) for future reckoning.

Let's work our way through § 1031 in a series of fact patterns that start with the simple and progress through the more complex. After you have a better understanding of the mechanics of § 1031, we shall consider whether it makes sense as a normative or policy matter. Take your time in working through these examples. *Stop and read the statutory language at issue as you progress*.

Nora owns ranchland in Montana, which she purchased for $40,000 but which is now worth $100,000. In each case, we are interested only in Nora's tax consequences when she exchanges her property for property owned by Nick. Assume that she holds the ranchland as business property and will hold the property obtained from Nick as business or investment property.

**Example 1**

| | | |
|---|---|---|
| Nora | *exchanges with* | Nick |
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000 | | Boat:<br>FMV $100,000 |

Nora must recognize her $60,000 § 1001 realized gain immediately because not all of the

[13] 29 T.C. 670 (1958).
[14] 1976-2 C.B. 242.
[15] PLR 8127089 (Apr. 10, 1981).

requirements of §§ 1031(a)(1) and (2) are satisfied. Because she must recognize her realized gain, she takes a § 1012 cost basis in the boat equal to its $100,000 FMV.[16]

Carefully read § 1031(a)(1) and (2) to derive the list of requirements found there.

- The properties must be "exchanged" in kind. Thus, a "sale" of property 1 for cash followed by the purchase of property 2 fails the "exchange" requirement.
- The properties exchanged must be of "like kind" within the meaning of Treas. Reg. §§ 1.1031(a)-1(b) & (c) and -2.
- "Solely" like kind property must be received in the exchange.
- Both the property exchanged and the like kind property received in the exchange must be held for productive use in a trade or business or for investment.
- The property listed in § 1031(a)(2) is not eligible for § 1031 treatment.

Even though she exchanged her property (rather than sold it for cash), ranchland and a boat are not of "like kind" within the meaning of the cited regulations because real property is not of like kind with personal property (*i.e.*, property other than real estate). So let's fix that problem.

**Example 2**

| | | |
|---|---|---|
| Nora | *exchanges with* | Nick |
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000 | | Land & office building in Manhattan:<br>FMV $100,000 |

Is Montana ranchland of "like kind" with land and an office building in Manhattan? Yes! Treas. Reg. § 1.1031(a)-1(b) provides that "the words 'like kind' have reference to the nature or character

[16] The rule that the § 1012 cost basis of property received in a *taxable* exchange is the FMV of the property received is found in Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl 1954), where the Court said:

> The succinct statement in section [1012] that "the basis of property shall be the cost of such property," although clear in principle, is frequently difficult in application. One view is that the cost basis of property received in a taxable exchange is the fair market value of the property *given* in the exchange. The other view is that the cost basis of property received in a taxable exchange is the fair market value of the property *received* in the exchange…. The view that "cost" is the fair market value of the property given is predicated on the theory that the cost to the taxpayer is the economic value relinquished. The view that "cost" is the fair market value of the property received is based upon the theory that the term "cost" is a tax concept and must be considered in the light of the designed interrelationship of [§§ 1001 and 1012] and the prime role that the basis of property plays in determining tax liability. We believe that when the question is considered in the latter context that the cost basis of the property received in a taxable exchange is the fair market value of the property *received* in the exchange.
>
> … To maintain harmony with the fundamental purpose of [§§ 1001 and 1012], it is necessary to consider the fair market value of the property received as the cost basis to the taxpayer. The failure to do so would result in allowing the taxpayer a stepped-up basis, without paying a tax therefor, if the fair market value of the property received is less than the fair market value of the property given, and the taxpayer would be subjected to a double tax if the fair market value of the property received is more than the fair market value of the property given. By holding that the fair market value of the property received in a taxable exchange is the cost basis, the above discrepancy is avoided and the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, or that should have been recognized, or minus any loss recognized, or that should have been recognized.

of the property and not to its grade or quality…. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class." Treas. Reg. § 1.1031(a)-1(c) goes on to describe each of the following exchanges as satisfying the like kind requirement: "a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate." Congress has periodically considered replacing this very generous standard with the one found in § 1033 that the property received be "similar or related in service or use" to that of the property exchanged, under which ranchland in Montana could not be exchanged for land and office building without gain recognition. The real estate lobby has worked hard, however, to preserve the § 1031 "like kind" standard for real estate as broad as it is. Virtually all real estate is of like kind with all other real estate, so long as land is part of both sides of the exchange.

The standard for "like kind" is much more rigorous with respect to personal property. Treas. Reg. § 1.1031(a)-1(c) provides that an exchange "of a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose" satisfies the like kind requirement, thereby implying that an exchange of a truck for an automobile would fail the like kind requirement. Revenue Ruling 79-143[17] rules that numismatic coins, which are valued on the basis of their age, number minted, history, art and aesthetics, condition, and metal content, are not of like kind with bullion-type coins, which are valued on the basis of their metal content alone. Moreover, the statute provides that livestock of different sexes are not of like kind.[18] For this reason, the vast majority of like kind exchanges pertain to real estate. Nevertheless, additional Treasury regulations issued in 1991 provide more guidance regarding how to determine which types of personal property will be considered of like kind.[19]

Because Nora's exchange in Example 2 satisfies each of § 1031(a)'s requirements, her $60,000 realized gain (Step 1) will go unrecognized (Step 2). Step 4 requires that she determine her new basis in the Manhattan property. Under the first sentence in § 1031(d), she will substitute her $40,000 basis in the property exchanged (the ranchland) for the basis of the Manhattan property received in the exchange (referred to as a "substituted basis" or "exchanged basis"), allocating the $40,000 between the land and the building according to their relative FMVs. If the land represents 10% of the total value of the land and building, she will allocate 10% of her $40,000 basis ($4,000) to the land and the remaining 90% (36,000) to the building. *The substituted basis provided in § 1031(d) ensures that the $60,000 of realized but unrecognized gain is preserved for future reckoning in the like kind property that Nora now owns.*

Because her basis in the new property is determined by reference to the basis in the property that she exchanges, § 1223(1) allows Nora to tack on to her holding period in the new property the period for which she held the ranchland (often referred to as a "tacked holding period") *if* the property that she exchanges is either a capital asset or § 1231 property (examined in Chapter 15), which should almost always be the case. If, for example, she held the ranchland for 5 years before the exchange, her holding period on the first day that she owns the Manhattan property is 5 years.[20]

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[17] 1979-1 C.B. 264.

[18] *See* § 1031(e).

[19] *See* Treas. Reg. § 1.1031(a)-2.

[20] While § 1223(1) applies to substituted basis property, § 1223(2) applies to carryover basis (or "transferred basis") property. Thus, property received by *inter vivos* gift takes a tacked holding period in the hands of the donee that includes the period for which the donor held the property because the donee's basis is determined by reference to the

**Example 3**

| | | |
|---|---|---|
| Nora | *exchanges with* | Nick |
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000 | | Land & office building in Manhattan:<br>FMV $80,000<br>$20,000 cash |

Because Nick's land and office building are worth only $80,000, Nora is not willing to engage in a straight-up exchange. Rather, she demands that Nick transfer $20,000 in cash to boot, which is why non-like kind property or cash is typically referred to as "boot" in tax jargon. This exchange fails the § 1031(a) requirement that Nora receive *solely* like kind property in exchange for her ranchland because she received not only like kind property (the land and building) but also boot.

Congress *could* have provided, on these facts, that Nora effectively (1) sold 20% of the value of the ranchland for cash and (2) exchanged the remaining 80% of the value of her ranchland for the Manhattan property. Under (1), she would allocate 20% of her $40,000 basis ($8,000) to the sale transaction, realizing and recognizing a $12,000 gain. Under (2), she would take a substituted basis of $32,000 in the Manhattan property, equal to 80% of her ranchland basis.

*But that is not what Congress has provided.* Instead, § 1031(b) provides that, if every requirement in § 1031(a) is satisfied *except* the requirement that she receive "solely" like kind property, Nora must recognize the gain realized on the disposition of the like kind property ($60,000) but *only* to the extent of the boot received. To be specific, it provides that, if the property received by Nora "consists not only of property permitted … to be received without the recognition of gain [the like kind property], but also of other property or money [non-like kind property or money, *i.e.*, boot], then the gain [$60,000] … shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property [*i.e.*, not in *excess* of the boot]." Thus, Nora recognizes her $60,000 realized gain *only* to the extent of the $20,000 boot that she receives. Unlike in the potential alternative analysis that Congress could have adopted (described in the last paragraph), **§ 1031(b) effectively provides that boot obtained in exchange for like kind property is allocated entirely to any built-in gain in the like kind property *first* (before being allocated to tax-free basis recovery).** Notice that this approach is not as favorable to Nora, as she must recognize $20,000 (instead of only $12,000) of her $60,000 realized gain.

Just as in Example 2, Nora's $40,000 unrecognized gain is not forgiven but only deferred under the § 1031(d) basis rule. **Under § 1031(d), the aggregate basis of property (other than money) received in a like kind exchange is "the same as that of the property exchanged** [$40,000], **decreased by any money received by the taxpayer** [*less* $20,000] **and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange** [*plus* $20,000]," or $40,000. The reason why Nora must *reduce her basis in the Manhattan property by any money received* is because cash automatically has a basis equal to its face amount. If, for example, Nora uses that $20,000 in cash to purchase Blackacre, she would take a $20,000 cost basis under § 1012 in Blackacre. Thus, we cannot allow her to *also* include that same $20,000 in the basis of the Manhattan property received from Nick, or Nora would be getting a double tax benefit (double basis) for the same dollars. Alternatively, if Nora uses that

donor's basis under § 1015, regardless of the property's status as capital, ordinary, or § 1231 property. Property received at death, the basis of which is stepped up (or down) to its FMV under § 1014, is assumed to be held for more than one year under § 1223(9), regardless of how long the decedent held the property before death.

$20,000 to take a vacation to Paris, the $20,000 outlay is a nondeductible personal expense under § 262(a), and Nora should not obtain a tax benefit indirectly by allowing that $20,000 to create basis in the Manhattan property. Moreover, the reason why Nora must *increase her basis by any gain that is recognized on the exchange* is to ensure that she is not taxed a second time on that same $20,000 gain when she sells the Manhattan property or else she would be doubly taxed on the same dollars.

Thus, Nora's basis in the new property will be $40,000 ($40,000 *less* $20,000 *plus* $20,000). Because the Manhattan property has an FMV of $80,000, Nora's $40,000 unrecognized gain is perfectly preserved in the basis of her new property. In contrast, if Nora's exchange fails § 1031 (because, say, she plans to use the new property as her personal residence rather than as business or investment property), then Nora would recognize her entire $60,000 realized gain on the exchange, and she would take an $80,000 FMV basis in the new property under § 1012 instead of a substituted basis under § 1031(d).

**Example 4**

| Nora | *exchanges with* | Nick |
|---|---|---|
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000 | | Land & office building in Manhattan:<br>FMV $30,000<br>$70,000 cash |

Because Nick's property is worth only $30,000, Nora demands that he transfer $70,000 in cash to boot. Do not fall into the trap of thinking that § 1031(b) can be shortened to "include the boot." That is not what § 1031(b) says. Indeed, if Nora were forced to include the entire $70,000 in cash received, she would include $10,000 of what should be tax-free basis recovery! If Nora *sold* her ranchland entirely for $100,000 in cash, she would realize and recognize only a $60,000 gain. This result is not changed simply because she receives only $70,000 in cash and property worth $30,000. Nora realizes no wealth accession in the tax sense to the extent of basis recovery.

Because the boot that Nora receives exceeds her realized gain, § 1031 provides no benefit to Nora. Under § 1031(b), Nora is required to recognize her $60,000 realized gain but not in *excess of* (*i.e.*, no more than) the $70,000 boot received. Thus, she must recognize 100% of her $60,000 realized gain. The final $10,000 of boot that Nora receives is tax-free basis recovery. Under § 1031(d), she takes a basis in the like kind property obtained equal to her $40,000 ranchland basis *less* the $70,000 money received *plus* the $60,000 recognized gain, or $30,000 (the property's FMV). Because Nora has recognized 100% of her realized gain, this result is not surprising, as there is no unrecognized gain to preserve.

**Example 5**

| Nora | *exchanges with* | Nick |
|---|---|---|
| Ranchland in Montana:<br>FMV $100,000<br>A/B $120,000 | | Land & office building in Manhattan:<br>FMV $80,000<br>$20,000 cash |

Notice that Nora's property has a built-in loss rather than a built-in gain. Under Step 1, she realizes a $20,000 loss on this exchange under § 1001. Can she recognize this loss, which would allow her to deduct it now under § 165 under Step 2? She would prefer that result because of the time value of money. While § 1031(a) prevents the recognition of both realized gain and realized

loss, notice that she fails the "solely" requirement in § 1031(a). In the case of *gain*, you learned that § 1031(b) forces gain recognition on the receipt of boot. What about loss?

Alas, § 1031(c) denies loss recognition on the receipt of boot. Nora's loss is not forever lost, as it is preserved in the basis of the like kind property received, which will take a basis under § 1031(d) equal to her $20,000 ranchland basis *less* the $20,000 in "money" received, or $100,000. Because the new property is worth only $80,000, her $20,000 realized but unrecognized loss is preserved. Because of the time value of money, however, this result is cold comfort to Nora. What should Nora have done? She should have *sold* her property for $100,000 in cash (to Nick or to someone else), thus ensuring that she would fail the "exchange" requirement in § 1031(a). If she really wants the Manhattan property, she can purchase it with the cash obtained on the sale.

**Example 6**

| Nora | *exchanges with* | Nick |
|---|---|---|
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000 | | Land & office building in Manhattan:<br>FMV $80,000<br>Boat: FMV $20,000 |

These facts are the same as Example 3, except that Nora's boot receipt is in the form of property in kind with an FMV of $20,000 (the boat) rather than $20,000 in cash. The boat is, indeed, boot for Nora because it is not of like kind with the real estate that she exchanges. Thus, Nora must recognize $20,000 of her $60,000 realized gain under § 1031(b), just as she does in Example 3.

What is her basis in each property under § 1031(d)? Under the *first* sentence in § 1031(d), her aggregate new basis in the property (other than money) received is the same as that of the ranchland that she exchanges ($40,000) *less* "money" received ($0), *plus* recognized gain ($20,000), or $60,000. But how does she allocate this $60,000 basis between the two properties that she now owns: the like kind Manhattan property and the boot property (the boat)? Read the *second* sentence in § 1031(d). The boot property (the boat) takes an FMV basis of $20,000, with the remaining amount ($40,000) allocated to the like kind Manhattan property. If she sells the Manhattan property for $80,000 in cash, she realizes and recognizes the $40,000 gain that went unrecognized on the initial exchange. If Nora sells the boat, instead, for $20,000 in cash, she realizes no gain or loss, as her amount realized is equal to her basis. In short, the second sentence in § 1031(d) ensures that the entire $40,000 unrecognized gain is reflected in the like kind property (not the boot property), as the like kind property permits this $40,000 gain to go unrecognized in the first place.

**Example 7**

| Nora | *exchanges with* | Nick |
|---|---|---|
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000<br>Boat<br>FMV $30,000<br>A/B $40,000 | | Land & office building in Manhattan:<br>FMV $130,000 |

Because Nick's property is worth $130,000 while Nora's Montana ranchland is worth only $100,000, Nick is now the one who demands that Nora throw in additional cash or property to boot. Thus, Nora disposes of two pieces of property in exchange for Nick's property. Recall from

Part A. that Nora cannot simply add the basis of the two pieces of property together and determine a single § 1001 realized gain or loss in Step 1. Rather, she must separately apply § 1001 to *each piece of property*. Thus, Nora realizes (1) a $60,000 gain (on the exchange of the ranchland for $100,000 worth of the Manhattan property) and (2) a $10,000 loss (on the exchange of the boat for $30,000 worth of the Manhattan property). Because a boat is not of like kind with real estate, the second exchange fails § 1031(a), which means that Nora's $10,000 realized loss is *immediately recognized*. Even though the loss is recognized, it may not be deductible, however. If she uses this boat in her business, this recognized loss would be deductible under § 165(c)(1). In contrast, if she uses this boat for recreation, this recognized loss would be nondeductible under § 165(c)(3).

In contrast to the boat/Manhattan property exchange, the ranchland/Manhattan property exchange satisfies each requirement in § 1031(a). Thus, none of the $60,000 realized gain on the exchange of the ranchland for $100,000 worth of the Manhattan like kind property is recognized.

What would be Nora's basis in the Manhattan property? Walk through that first sentence in § 1031(d) very carefully. Her substituted basis includes the basis in *both* of the properties that she transfers to Nick (a total of $80,000) *less* "money" received ($0) *less* recognized loss ($10,000), or $70,000. Because the Manhattan property has an FMV of $130,000, Nora's $70,000 basis perfectly preserves her $60,000 realized gain that is not recognized on the exchange.

Notice that § 1031(b) is irrelevant to *Nora's* tax consequences in Example 7. It would be relevant to Nick's tax consequences if he, too, were applying § 1031 because the boat receipt would be boot to him, forcing him to recognize some or all of any realized gain on the exchange of the like kind property (but not, under § 1031(c), allowing him to recognize any realized loss). Because we do not know Nick's bases in the land and building, however, we do not have sufficient information to determine how the boat receipt would affect his tax consequences.

Finally, how does § 1031 operate if property is encumbered with debt? Does debt relief constitute boot? And how does *Crane* apply in the context of § 1031 exchanges? The applicable rules have to be deduced from working through the examples found at Treas. Reg. § 1.1031(d)-2. In effect, they provide three important rules.

- For purposes of possible gain recognition under § 1031(b), *net* liability relief is treated as boot received. If the taxpayer enjoying net liability relief *also* transfers cash boot, however, the cash transferred will reduce the boot deemed received.
- *Gross* liability relief is treated as "money received" for purposes of computing basis in the property received under § 1031(d).
- *Gross* liability assumption is added to the basis of the property received under § 1031(d) to implement *Crane*'s front-end rule that acquisition debt is included in property basis.

These rules are illustrated in Example 8.

**Example 8**

| Nora | *exchanges with* | Nick |
|---|---|---|
| Ranchland in Montana:<br>FMV $100,000<br>A/B $40,000<br>subject to $30,000 debt | | Land & office building in Manhattan:<br>FMV $80,000<br>subject to $20,000 debt<br>$10,000 cash |

These facts are a variation on Example 2, except that both properties are encumbered by debt. In determining how much boot Nora would demand in exchange for her encumbered ranchland, she would determine the *net value* that she has in her land and demand the same *net value* in the package to be received from Nick. Because Nora's ranchland has an FMV of $100,000 but is subject to a $30,000 debt, the net value that she is transferring to Nick is $70,000. Thus, she would demand $70,000 in net value from Nick. Because Nick's Manhattan property has an FMV of $80,000 but is subject to a $20,000 debt, the like kind property reflects $60,000 of net value. Thus, Nora would demand $10,000 of cash boot to even up the deal, and Nick agrees.

In Step 1, Nora's realized gain under § 1001 remains $60,000 (as in Example 2). The easy way to determine this is simply to compare the ranchland's A/B and FMV.[21] In Step 2, she is deemed to receive $20,000 in boot for purposes of § 1031(b), which is equal to the $10,000 in cash *plus* the $10,000 of *net* liability relief that she enjoys (the amount by which the $30,000 debt encumbering her ranchland exceeds the $20,000 debt encumbering the Manhattan property received from Nick). Thus, Nora must recognize $20,000 of her $60,000 realized gain under § 1031(b).

Under § 1031(d), her basis in the like kind property received is equal to the $40,000 basis in the ranchland that she transfers *less* $40,000 in "money" deemed received ($10,000 in actual cash and $30,000 in *gross* liability relief) *plus* $20,000 recognized gain *plus* $20,000 *Crane* basis (equal to the gross debt assumed), or $40,000. Because the FMV of the like kind property received is $80,000, this basis perfectly preserves her $40,000 realized but unrecognized gain.

You may have noticed as we moved along that there is a handy dandy shortcut for determining Nora's basis in the like kind property obtained in the exchange. Simply determine its FMV and reduce it to reflect any realized but unrecognized gain (or increase it to reflect any realized but unrecognized loss). (Any boot property received in kind takes a FMV basis.) We expressly took this approach when we applied § 1033(b)(2) in the case of an involuntary conversion followed by a rollover into property similar or related in service or use. Better yet, do it both ways (under § 1031(d)'s very precise formula and under the shortcut) to double check yourself. Either way, if you applied § 1031 correctly, the basis in the like kind property obtained in the exchange should perfectly preserve the unrecognized gain or loss on the exchange.

***Three-corner exchanges***

In the real world, it is rare to find two property owners who happen to each want what the other one owns. More often, only one (tax conscious) party wishes to engage in an exchange rather than a sale. Suppose, for example, that Nora wishes to dispose of her property in a § 1031 exchange that will allow some of her $60,000 built-in gain to go unrecognized. She likes Nick's Manhattan property, but Nick is not interested in engaging in a like kind exchange. Rather, he has listed his property for sale because he wants cash. Suppose further that Asta (I told you that we would bring Asta into the picture) has $100,000 in cash, that she is interested in acquiring Nora's property, but that Nora has refused to sell to Asta because, as just noted, she wants at least some of her realized gain to go unrecognized under § 1031. What can the parties do?

One possibility is that they could engage in *two* transactions. In the first, Asta could buy Nick's

[21] The more convoluted way to determine this is to compute her § 1001(b) "amount realized" as equal to the $10,000 cash received *plus* the $60,000 net value in the Manhattan property received *plus* the $30,000 liability relief under *Crane*'s back-end rule. The excess of this $100,000 A/R over her $40,000 A/B produces a $60,000 realized gain.

Manhattan property for $80,000. In the second, Asta could exchange the land and building just purchased from Nick, along with $20,000 in cash, for Nora's ranchland. That would work, but it could trigger four real estate transfer taxes (instead of two) because Nick's property is located in Manhattan. Both New York City and New York State impose real estate transfer taxes. Moreover, suppose that Asta does not wish to take title to the Manhattan property, even for a nanosecond, because she is concerned about, say, toxic sludge that may lie beneath the building, for which she could become liable under environmental law as an owner in the chain of title. If they wish to avoid two transactions, is there another viable option?

They could engage in a deferred, three-corner exchange, but they would need to ensure that they avoid the problem illustrated in *Crandall*.

## CRANDALL v. COMMISSIONER

T.C. Summary Opinion 2011-14

PANUTHOS, CHIEF SPECIAL TRIAL JUDGE: This case was heard pursuant to the provisions of section 7463 of the Internal Revenue Code in effect when the petition was filed. Pursuant to section 7463(b), the decision to be entered is not reviewable by any other court, and this opinion shall not be treated as precedent for any other case.

Respondent determined a deficiency of $14,475 in petitioners' 2005 Federal income tax and an accuracy-related penalty of $2,895. After concessions, the sole issue for decision is whether petitioners are entitled to nonrecognition of gain under section 1031 for a 2005 real estate transaction.

*Background*

Petitioners resided in California at the time the petition was filed. Petitioners owned an undeveloped parcel of property in Lake Havasu City, Arizona (Arizona property). Petitioners held the Arizona property for investment. Petitioners desired to own investment property closer to their California residence. After receiving some limited advice concerning a tax-free exchange of properties, petitioners took steps to sell the Arizona property and purchase new property with the intention of executing a tax-free exchange. On March 4, 2005, petitioners sold the Arizona property for $76,000. The buyers of the property paid petitioners $10,000, and the remaining $66,000 was placed in an escrow account with Capital Title Agency, Inc. (Capital Title). At petitioners' direction $61,743.25 was held in the escrow account. Capital Title initially released $4,256.75 to petitioners. Petitioners' basis in the Arizona property was $8,500. This payment was transferred from the Capital Title escrow account to the Chicago Title escrow account as petitioners directed.

The Capital Title and Chicago Title escrow agreements did not reference a like kind exchange under section 1031, nor did they expressly limit petitioners' right to receive, pledge, borrow, or otherwise obtain the benefits of the funds.

*Discussion*

The general rule regarding recognition of gain or loss on the sale or exchange of property is that the entire amount of the gain or loss is recognized. Sec. 1001(c). An exception to the general rule is found in section 1031.

Section 1031 provides that no gain or loss is recognized when business or investment property

is exchanged solely for other business or investment property of like kind. The regulations define "like kind" as a reference to the nature or character of the property and not the property's grade or quality. Sec. 1.1031(a)-1(b), Income Tax Regs. In order to take advantage of the nonrecognition provisions of section 1031 through a deferred exchange, a taxpayer must satisfy a number of technical requirements. Sec. 1031(a)(3); sec. 1.1031(k)-1, Income Tax Regs.

A deferred exchange is defined as "an exchange in which, pursuant to an agreement, the taxpayer transfers property held for * * * investment * * * and subsequently receives property to be held * * * for investment". Sec. 1.1031(k)-1(a), Income Tax Regs. To qualify as a deferred exchange the transaction must be an exchange of property, not a transfer of property for money. *Id*. The reinvestment of the proceeds from a cash sale of one property into a second property of like kind will not qualify as a section 1031 exchange. *Greene v. Comm'r*, T.C. Memo. 1991-403 (citing *Carlton v. U.S.*, 385 F.2d 238, 242 (5th Cir. 1967), *Coastal Terminals, Inc. v. U.S.*, 320 F.2d 333, 337 (4th Cir. 1963), and *Estate of Bowers v. Comm'r*, 94 T.C. 582, 589 (1990)); *Lee v. Comm'r*, T.C. Memo. 1986-294; *Gibson v. Comm'r*, T.C. Memo. 1982-342; sec. 1.1031(k)-1(a), Income Tax Regs. Gain or loss may be recognized if the taxpayer actually or constructively receives money that does not meet the qualifications of section 1031(a) before the taxpayer actually receives like kind property. Sec. 1.1031(k)-1(a), Income Tax Regs.

"The taxpayer is in constructive receipt of money or property at the time the money or property is credited to the taxpayer's account, set apart for the taxpayer, or otherwise made available so that the taxpayer may draw upon it at any time." Sec. 1.1031(k)-1(f)(2), Income Tax Regs. If the taxpayer's control of receipt of the money or property is subject to substantial limitations or restrictions, then there is no constructive receipt. *Id.* To avoid being in constructive receipt of money or property, a taxpayer may use a qualified escrow account. Section 1.1031(k)-1(g)(3), Income Tax Regs., defines a qualified escrow account as the following:

(ii) A qualified escrow account is an escrow account wherein—

(A) The escrow holder is not the taxpayer or a disqualified person * * *, and

(B) The escrow agreement expressly limits the taxpayer's right to receive, pledge, borrow, or otherwise obtain the benefits of the cash or cash equivalent held in the escrow account * * *.

The taxpayer's own limitation of use of the funds does not convert the escrow account into a qualified escrow account. *Klein v. Comm'r*, T.C. Memo. 1993-491.

The Arizona property and the California property are like kind properties. At issue is whether there was an exchange within the meaning of the statute and the regulations. We have no doubt that petitioners intended the transaction to qualify under the provisions of section 1031. However, it is well established that a taxpayer's intention to take advantage of tax laws does not determine the tax consequences of his transactions. *Bezdjian v. Comm'r*, 845 F.2d 217 (9th Cir. 1988), affg. T.C. Memo. 1987-140; *Carlton v. U.S., supra* at 243 (citing *Comm'r v. Duberstein*, 363 U.S. 278, 286 (1960)). To support their argument, petitioners testified that the funds in the Capital Title escrow account were held solely for the purchase of the California property and that they received no proceeds from the sale of the Arizona property.

Respondent argues that petitioners' transactions were a sale and reinvestment of the proceeds because the Capital Title escrow agreement did not expressly restrict petitioners' access to and use of the funds held in the escrow account. Respondent asserts that petitioners were in constructive receipt of the proceeds from the sale of the Arizona property and that the gain on the sale must be

recognized in 2005.

The underlying purpose of section 1031 is to permit a taxpayer to defer gain with respect to "an ongoing investment, rather than ridding himself of one investment to obtain another." *Teruya Bros., Ltd. v. Comm'r*, 580 F.3d 1038, 1042 (9th Cir. 2009) (citing *Starker v. U.S.*, 602 F.2d 1341, 1352 (9th Cir. 1979) ("The legislative history [of sec. 1031] reveals that the provision was designed to avoid the imposition of a tax on those who do not 'cash in' on their investments in trade or business property.")), affg. 124 T.C. 45 (2005).

Neither escrow agreement expressly limited petitioners' right to receive, pledge, borrow, or otherwise obtain the benefit of the funds nor made any mention of a like kind exchange. Because of the lack of limitations, neither escrow account was a qualified escrow account. *See Hillyer v. Comm'r*, T.C. Memo. 1996-214; *Lee v. Comm'r*, *supra*. Although petitioners used the funds in the Capital Title escrow account to purchase the California property, the lack of express limitations in the escrow agreement results in petitioners' being treated as having constructively received the proceeds.

We conclude that the disposition of the Arizona property was a sale and the funds deposited in the Capital Title escrow account represent the receipt of the proceeds. *See* sec. 1001(c). Consequently, this transaction does not qualify for section 1031 nonrecognition, and petitioners must recognize gain for 2005. *See* sec. 1001(c). The Court notes that the tax consequences are not what petitioners intended and the result may seem somewhat harsh. However, Congress enacted strict provisions under section 1031 with which taxpayers must comply.

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Nora, Nick, and Asta—once they found each other through a § 1031 firm that specializes in helping real estate owners find each other—can structure a three-corner exchange using a qualified intermediary (arranged by the § 1031 firm). Nick and Nora would transfer their titles to the Montana ranchland and the Manhattan property, respectively, and Asta would transfer the $100,000 in cash—all to the qualified intermediary. The intermediary would then transfer $80,000 in cash to Nick, the Montana ranchland to Asta, and the Manhattan property plus the remaining $20,000 cash to Nora. Nick would realize and recognize any realized gain. If the transaction is structured correctly, however, Nora's exchange would be governed by § 1031(b), and she would have the tax consequences described in Example 3, above. (Asta simply takes a cost basis under § 1012 in the Montana ranchland.)

The parties must ensure that the transaction complies with the timing requirements found in § 1031(a)(3) and that the qualified intermediary arrangement is structured properly to ensure that Nora is not considered to be in constructive receipt of the full $100,000 in cash (rather than only the $20,000 boot). Treas. Reg. § 1.1031(k)-1(g) provides several "safe harbors the use of which will result in a determination that the taxpayer is not in actual or constructive receipt of money or other property." As cited in *Crandall*, a "qualified escrow account" requires that "[t]he escrow agreement expressly limits the taxpayer's rights to receive, pledge, borrow or otherwise obtain the benefits of the cash or cash equivalent in the escrow account."

In *Crandall*, the taxpayer retained power over the escrow agent to have *all* of the proceeds from the sale of his property transferred to himself. The Tax Court thus concluded that Mr. Crandall failed to engage in an "exchange" of his Arizona property for the California property; rather, he was considered to have *sold* his Arizona property for cash and then reinvested most of the cash in the

California property because he was in constructive receipt of the cash paid to the escrow agent by the purchasers of his Arizona property.

*Crandall* (and many cases like it) illustrate an important lesson. If the intermediary is under the control of the taxpayer, the intermediary is considered to be the taxpayer's agent. Receipt of cash by the taxpayer's agent is considered receipt by the taxpayer (remember *Poe v. Seaborn* in Chapter 8?), and the "exchange" requirement in § 1031(a) is failed. As noted earlier, there may be times when the taxpayer *wishes* to deliberately fail the exchange requirement, such as when the transferred property has a built-in loss that would go unrecognized under § 1031. Because § 1031 is not formally elective, the taxpayer could deliberately fail § 1031 by intentionally failing the "exchange" requirement by interposing an all-cash step.

The outcome in *Crandall* may bother some students. After all, he had every intention of using § 1031 and tried in good faith to come within the provision by setting up the escrow account. What are judges to do, however, when Congress deliberately writes an "exchange" requirement into § 1031—particularly when Congress has shown that it knows well how to draft a rollover provision when it wants one? Indeed, numerous bills have been introduced over the years to transform § 1031 from an "exchange" provision to a "rollover" provision, but the (lucrative) § 1031 industry works very hard to keep § 1031 as it is, under which professional help is usually needed to avoid just the kind of traps for the unwary that tripped up Mr. Crandall. Under these circumstances, a court has no choice but to give effect to the exchange requirement if it is to act like a court and not a legislature. What *is* the difference between a "sale" and an "exchange"? The fundamental difference is the receipt of unfettered cash in the former.

Should Congress amend the statute to make it a rollover provision? Well, that might depend on whether you think § 1031 is a good idea in the first place and what rationale you think underlies § 1031 ... which provides a nice segue to a discussion of the policy ramifications of § 1031.

***Does § 1031 reflect sound policy?***

Supporters of § 1031 typically use several rationales to justify it. First, some argue that it allows the parties to avoid having to establish a value for the properties (in order to calculate § 1001 realized gain) because the taxpayers simply substitute their old basis for the basis in the property received in the exchange, with some adjustments noted in § 1031(d). Convincing? In the real world, every property exchanged under § 1031 is formally appraised in order for each party to determine whether he or she should demand boot to even up the deal. Indeed, a § 1031 deal without boot is a very rare species.

Second, some argue that the lack of liquidity (cash) justifies deferral. Convincing? The lack of liquidity is self-imposed *because* § 1031 continues to exist. That is to say, one might wonder if people in a modern economy would ever exchange real estate if § 1032 were repealed. Moreover, in other contexts, the receipt of an asset in kind provides no justification for deferral of § 61 Gross Income. Thus, when an employer transfers Blackacre to an employee as compensation for services rendered, you know well by now that the employee must include the FMV of the property in his Gross Income under § 61(a)(1). The employee may have to sell Blackacre or mortgage it to pay the resulting tax due. Why should § 61(a)(3) *gain* be on any different footing? Moreover, unlike in the § 1033 context, the realization event here is not involuntary.

Those shortcomings leave us with two alternative ways to view § 1031. Because the taxpayer has continued his investment in the same kind of property under the "like kind" requirement, some argue

that he should not be considered as having "realized" the built-in gain or loss in the exchanged property, even though of course it is *technically* "realized" when he disposes of the property. This view was encapsulated in § 1031's legislative history when it was originally enacted way back in 1921. (Apparently, it was common at the time for ranchers to swap acreage.) But if that is the rationale, the "like kind" standard is woefully inadequate. Rural farmland and a skyscraper on an urban lot are quite different investments with very different risks and returns, and yet they are considered to be of like kind. In short, under this rationale, § 1031 is *too broad* as drafted.

The alternative view is that § 1031 implements a consumption tax value. Because the investment remains tied up, rather than spent on consumption, the built-in gain should be deferred until it is no longer rolled over into another investment. Under this view, the "like kind" requirement is far *too narrow*; an exchange of any sort of investment property for investment property should qualify, whether or not the properties are of "like kind." Recall, however, that Nora's exchange of her farmland for a boat is outside § 1031 because the properties are not of like kind. Moreover, an exchange of stocks, bonds, *etc.*, is not eligible under § 1031(a)(2). And rollovers, rather than merely exchanges, should qualify, as well, if that is § 1031's rationale.

In other words, current § 1031 appears to be incoherent; it is either too broad or too narrow, depending on which view you take regarding the rationale underlying § 1031.

Another serious concern is that § 1031 violates the neutrality economic norm discussed in Chapter 3 and thus exacts efficiency costs. That is to say, taxpayers may funnel resources into less profitable before-tax properties rather than into more economically profitable investments that would reflect a more efficient allocation of capital across the economy because the latter would result in immediate gain recognition that is avoided under the former.

Finally, when combined with the § 1041 step up in basis at death, nonrecognition provisions like § 1031 (and those studied in other income tax courses) contribute meaningfully to the avoidance of income tax on property gain, while the types of wealth accessions more commonly realized by middle-class taxpayers (wages) are taxed. In short, these provisions contribute meaningfully to wealth inequality over time.

As intimated above, however, § 1031 has created an exchange industry,[22] which keeps a lot of real estate professionals gainfully employed. Thus, notwithstanding its conceptual weaknesses, the real estate lobby works very hard to keep it intact, just as it is.

Public finance economist Martin A. Sullivan summarizes the economic case against § 1031 as follows.[23]

> In 2013 then-Senate Finance Committee Chair Max Baucus [Democrat] suggested repealing § 1031. And in 2014 then-House Ways and Means Committee Chair Dave Camp [Republican] proposed a sweeping tax reform plan that included repeal of § 1031…. The Joint Committee on Taxation estimated that Camp's proposed elimination of like-kind exchanges would raise $41 billion over 10 years.
>
> There is a massive lobbying effort to preserve § 1031. Supporters of retaining current law include the National Association of Realtors, the National Association

[22] For example, § 1031 firms have placed half-page advertisements in the New York Times with "1031 Exchanges—Preserving Wealth Using the Tax Code" in large type. *See, e.g.*, N.Y. TIMES, Oct. 8, 2008, at B15.
[23] Martin A. Sullivan, *The Simple Economics of Like-Kind Exchanges*, 148 TAX NOTES 491 (2015).

> of Real Estate Investment Trusts, and the Federation of Exchange Accommodators. Despite this loud clamor for keeping current law, the economic case for repealing § 1031 is straightforward. Like-kind exchanges distort investment within the real estate industry …; they distort investment across industries; and qualifying for § 1031 benefits requires engaging in transactions and complying with rules that are costly to the taxpayer and unproductive for the economy….
>
> Section 1031 distorts the allocation of investments across industries. In general, in order to promote maximum economic growth, the tax system should tax all industries equally. Otherwise, there will [be] too much investment in tax-favored sectors and too little in others.
>
> An exception to the level-playing-field rule arises when industries generate positive externalities. Businesses that conduct significant amounts of research and development generate positive spillover benefits for the economy for which they are not fully compensated. Therefore, there is an economic justification for a tax subsidy directed to research-intensive industries. Assets of the real estate, construction, and car rental businesses are the assets most often exchanged in § 1031 transactions. There are no readily apparent positive externalities associated with these industries. So there appears to be no economic justification for the beneficial treatment made available to them by § 1031….
>
> Commentators often remark on the generous breadth of [the like kind standard for real estate], but from an economics perspective it is not broad enough. It does not help the economy for tax rules to encourage an investor to remain in real estate if other investments offer a higher pre-tax rate of return….
>
> [R]evenue raised from the repeal of § 1031 could be used to lower income tax rates as part of a 1986-style tax reform…. Or revenues from repeal could be used to enlarge economically justified tax subsidies, such as the research credit.

***§ 267(a)(1) sales of loss property to a related party***

Mom owns Blackacre as investment property, which she purchased years before her marriage to Dad for $150,000, but which is now worth only $140,000. Thus, it has a juicy $10,000 built-in loss, just waiting to be realized, recognized, and deducted under § 165(c)(2). While the loss would be capital, subject to the § 1211(b) capital loss limitation rule, Mom can generate sufficient capital gain to allow immediate deduction of the loss.

Under the mark-to-market approach to changes in property value explored in Chapter 1, Part A., Mom would be able to deduct those losses in Blackacre value as they occur each year, but the realization requirement prevents this result. Mom could, of course, sell Blackacre to a stranger and obtain her desired deduction, but Mom really does not wish to do that, as she likes the location and thinks that future development will be profitable. What to do?

A sale of Blackacre to Dad for $140,000 in cash would keep the property in the family but would not permit immediate deduction, as you learned in Chapter 9 that her realized loss would not be recognized under § 1041(a)(1). What if she sells the property for $140,000 to Junior, their son, who is not described in § 1041? Will that strategy work to allow Mom to deduct the $10,000 built-in loss while nevertheless keeping the property all in the family?

No. Read §§ 267(a)(1), (b)(1), and (c)(4). Under § 267, Mom's $10,000 realized loss is

disallowed. The $10,000 loss is preserved for possible future use, though in an unusual manner. Junior does not take Mom's $150,000 basis in the property but rather takes a $140,000 cost basis under § 1012, as usual. If Junior is later able to sell the property for, say, $180,000, however, his $40,000 § 1001 realized gain ($180,000 A/R *less* $140,000 A/B) is recognized only to extent of $30,000 under the language in § 267(d). What if Junior is later able to sell Blackacre for only $120,000 (instead of $180,000)? In that case, his realized loss is only $20,000 ($120,000 A/R *less* $140,000 A/B); no provision in § 267 allows him to augment his $20,000 realized loss by the $10,000 loss deduction that was denied to Mom on her earlier sale to him.

***§ 1091 wash sales of loss securities***

Mom owns stock in High Tech Corp, which she purchased years before her marriage for $150,000 but which is now worth only $140,000. Thus, it has a juicy $10,000 built-in loss, just waiting to be realized, recognized, and deducted under § 165(c)(2). While the loss would be capital, subject to the § 1211(b) capital loss limitation rule, Mom can generate sufficient capital gain to allow immediate deduction of the $10,000 loss. Mom could, of course, sell her High Tech stock and obtain her desired deduction, but Mom really does not wish to do that, as she likes High Tech's potential for future profitability. What to do?

What if she sells the High Tech stock for $140,000 over the New York Stock Exchange (thus realizing the $10,000 loss) but then buys it back, say, 20 days later, at a price of $142,000?

Read §§ 1091(a) and (d). Mom's $10,000 loss deduction is denied, and she increases her $142,000 cost basis in the new High Tech shares by the $10,000 loss deduction denied to her. Thus, her new basis is $152,000.

## Problems

Review the four steps to take when analyzing a property disposition described at the beginning of this chapter. In particular, *remember that Step 1 is always to calculate the § 1001 realized gain or loss, as that is what may be included (if a gain) or deducted (if a loss).* In each problem below, describe the tax consequences for each, skipping Step 3, as we have not yet fully considered characterization issues.

**1.** Jacob owns High Tech stock with an FMV of $60,000 and A/B of $30,000 and a personal-use car with an FMV of $10,000 and A/B of $20,000, both of which he sells to Becky for $70,000 in the aggregate.

**2.** Hallie owns a diner with an FMV of $200,000 and A/B of $70,000 when it burns to the ground on June 15 of Year 1. Luckily, Hallie's business is fully insured, and she obtains $200,000 in insurance proceeds on October 30 of Year 1. She decides to rebuild the diner, spending not only the $200,000 in insurance proceeds but an additional $30,000, as well, re-opening for business on March 1 of Year 3. (I know that you just learned in this chapter that Hallie must compute her § 1001 realized gains and losses with respect to her diner using an asset-by-asset approach, but for the sake of simplicity, you may calculate a single § 1001 gain for her.)

**3.** Same as **2.**, except that she decides to rebuild on a smaller scale, spending only $150,000 of the insurance proceeds and putting the remaining $50,000 in the bank.

**4.** Lori owns High Tech stock with an FMV of $10,000 and A/B of $2,000, which she exchanges for Info Tech stock owned by Becky that has an FMV of $10,000 and A/B of $13,000.

**5.** Lori owns a boat, which she uses in her fishing business, with an FMV of $100,000 and A/B of $30,000. She exchanges it for a boat owned by Mark that has an FMV of $100,000, which she will also use in her fishing business. Mark's A/B in the boat that he exchanges is $70,000. While Mark uses his old boat in his fishing business, he is about to retire and will use the boat obtained from Lori for personal purposes, sailing up and down the Mississippi River in contentment.

**6.** Lori owns Blackacre, which she holds for investment, with an FMV of $100,000 and A/B of $30,000. She exchanges it with Jacob for Whiteacre, which she will also hold for investment and which has an FMV of $90,000, and $10,000 cash. Jacob's A/B in Whiteacre is $60,000. Jacob also holds Whiteacre for investment and will hold Blackacre for investment.

**7.** Same as **6.**, except that Jacob transfers to Lori a diamond ring with an FMV of $10,000 and A/B in his hands of $5,000, instead of the $10,000 cash.

**8.** Same as **6.**, except that Whiteacre's FMV is only $20,000, so Jacob must transfer $80,000 cash (instead of $10,000) to boot. If the parties are well advised, will they engage in this exchange? If Jacob really wants Blackacre and Lori really wants Whiteacre, how should the parties structure their transaction? Remember that § 1031, unlike § 1033, is not explicitly elective.

**9.** Same as **6.**, except that Jacob wants $90,000 in cash instead of Blackacre with an FMV of $90,000. Hallie has $100,000 in cash and wants to buy Blackacre, but Lori wants to take advantage of § 1031 and wants Whiteacre. What can the parties do to accommodate all of their wishes in a tax-efficient manner?

**10.** Lori owns High Tech stock with an FMV of $12,000 and A/B of $15,000, which she sells to her brother Jim for $12,000 in Year 1. In Year 3, Jim sells the High Tech stock for $20,000.

# Chapter 14: Depreciation and Amortization in a Realization-Based Income Tax

In the early days of the income tax, before Messrs. Schanz, Haig, and Simons developed a tax-specific meaning of the term "income," you have learned that both Congress and the courts often borrowed from other disciplines, such as financial accounting or trust accounting, in providing content to the term. Indeed, an allowance for depreciation was likely imported into the income tax reflexively from financial accounting, where depreciation is required to further the goal underlying the "matching principle."

In financial accounting (*not* tax accounting), the "matching principle" is a very important one, and sometimes those steeped in a financial accounting background have trouble letting go of it when they cross over the great divide into the tax realm.[1] Indeed, even Tax Court Judge Laro in the *Simon* case (Part C., below) fell into this trap when he wrote: "The primary purpose of allocating depreciation to more than 1 year is to provide a more meaningful matching of the cost of an income-producing asset with the income resulting therefrom; this meaningful match, in turn, bolsters the accounting integrity for tax purposes of the taxpayer's periodic income statements."[2] Notice his reference to "income statements," which is a financial accounting document, as opposed to tax returns. This quotation (with the exception of the reference to "tax purposes") is consistent with the following description of the role of depreciation in furthering the matching principle for financial accounting purposes found at "Accounting-Simplified.com (the easy way to learn accounting online, for free!)."

> Depreciation results in a systematic charge of the cost of a fixed asset to the income statement over several accounting periods spanning the asset's useful life during which it is expected to generate economic benefits for the entity. Depreciation ensures that the cost of fixed assets is not charged to the profit & loss at once but is "matched" against economic benefits (revenue or cost savings) earned from the asset's use over several accounting periods.
>
> [The] matching principle therefore results in the presentation of a more balanced and consistent view of the financial performance of an organization than would result from the use of cash basis of accounting.[3]

That last sentence illustrates the role of the matching principle in financial accounting: to provide a more informative view of the economic health of a business over time to those interested in its performance, such as shareholders of a corporation housing the business or a bank contemplating making a loan to the business. That is to say, the role of the financial accountant is only to provide helpful *information* to interested parties; no payment obligations (such as a tax) depend on the computation of "income" for an "income statement." Indeed, because of this goal, a range of reasonable ways to account for costs—usually referred to as "generally accepted

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[1] *See generally* Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. TAX POL'Y 17 (1998) (exploring how reflexively borrowing the matching principle from financial accounting for purposes of measuring "income" for income tax purposes can undermine income tax values).

[2] Simon v. Comm'r, 103 T.C. 247, 253 (1994).

[3] http://accounting-simplified.com/financial/concepts-and-principles/matching.html.

accounting principles" or GAAP—can be used by the accountant, depending on the individual circumstances of the business. A "one size fits all" approach would be inappropriate if using different rules for different businesses can actually boost the usefulness and reliability of the resulting information for the consumer. But depreciation of some sort is common for all businesses under GAAP.

Assume, for example, that Widget Company purchases in Year 5 a new factory building for $10 million to replace its outdated one. In Year 7, Widget Company replaces an expensive widget-making machine for $500,000. Widget Company has a steady stream of contracts and consistently earns gross proceeds from sales of its widgets of $300,000 each year. If Widget Company, in preparing its annual "income statement" for shareholders and lenders, shows "income" of $300,000 in each of Years 3 and 4, a "loss" of $9.7 million in Year 5, "income" of $300,000 in Year 6, and a $200,000 "loss" in Year 8, consumers of that information might assume that Widget Company's business is risky, suffering from roller coaster profits and losses, when in fact the business has nice, steady sales. "Matching" the cost of the factory and equipment to the future revenue expected to be earned by using the assets (which can vary from industry to industry or even company to company under GAAP) provides a more accurate impression of the company's economic health over time to those who might rely on this information to make important economic decisions, such as whether to invest in the company's stock or whether to make a loan to Widget Company.

In the income tax world, some might argue that depreciation is inconsistent with the realization principle, as it allows a deduction for an asset's cost before its disposition. Nevertheless, a principled argument can be made that a realization-based income tax demands an allowance for depreciation before disposition *but only with respect to certain types of assets*, described below in Part A. But "matching" has nothing to do with this principled argument. Indeed, importing financial accounting's "matching principle" into the tax realm can do fundamental damage to income tax values, inadvertently providing consumption tax treatment through the backdoor—an irrelevant concern in financial accounting, where no payment obligation arises with respect to the "income statement." [4]

## A. Economic depreciation in a realization-based income tax

Recall from Chapter 2 that the capitalization principle defines the difference between an income tax and a cash-flow consumption tax.

Under a cash-flow consumption tax, the cost of business or investment property would be fully "expensed" (deducted) in the year of purchase, regardless of the expected useful life of the property. Under an income tax, in contrast, the purchase of property with a useful life extending substantially beyond the end of the taxable year is not a current "expense" (a current wealth decrease) but rather a nondeductible capital expenditure because the taxpayer has not yet lost wealth but rather has merely changed the form in which his wealth is held. The nondeduction of the outlay, however, immediately creates basis, which can reduce the tax base in the future as that wealth is lost if such loss occurs in an income-producing activity.

If our income tax abandoned the realization requirement in favor of a mark-to-market system,

[4] *See infra* Chapter 22, Part B., for a more extended discussion of GAAP and the different goals and purposes of financial accounting and tax accounting.

changes in property value would be taken into account as they occurred. The amount by which property increased in value would be included in Gross Income year by year, with a concomitant increase in basis to avoid taxing the same dollars twice to the same taxpayer in the future. Similarly, the portion of basis reflecting a decrease in business or investment property value would be deductible year by year, with a concomitant reduction in basis to avoid providing a double tax benefit for the same dollars to the same taxpayer in the future. But we *do* have a realization requirement, so you have learned that changes in value are ignored during the ownership period.

Nevertheless, a normative income tax with a realization requirement does allow deductions of property basis in the form of "depreciation" (the term used for tangible property) or "amortization" (the term used for intangible property) during the ownership period—before disposition of the asset—but only if certain requirements are met. Why?

**Economic depreciation or amortization is consistent with a realization-based income tax to the extent that they are limited to deduction of final, irretrievable losses in value. Because these losses in value are final and irretrievable, they are "realized" in a nontrivial sense, even though the taxpayer continues to own the property. Losses that are not final and irretrievable should *not* be deducted in a realization-based income tax as a normative matter, which means that some assets that are depreciable for financial accounting (information) purposes should not be depreciable for income tax (wealth accessions and reductions) purposes.**

Several ingredients combine to establish changes in the *aggregate* fair market value (FMV) of an asset over time, such as changes in supply or demand for the asset or changes in interest rates (if the asset is, for example, a debt instrument). Only one strand of value, however, can produce final and irretrievable losses in an asset's aggregate FMV, and that strand is the passage of time *if and only if* that asset wastes away predictably over time from use in an income-producing activity. Take, for example, a machine used in the manufacturing of widgets. As the widget-making machine gets each year closer to the end of its income-producing life, one strand of its value is permanently and irretrievably lost and cannot be restored with normal maintenance or with a shift from one income-producing use to another income-producing use. In contrast, land used by a farmer is not depreciable, even though it is used in an income-producing activity, because it does not waste away in a predictable manner simply with the passage of time. If the land becomes unsuitable for farming, it can be used for, say, real estate development. A building rented to tenants or a factory building is depreciable, however, even if the building's aggregate FMV is temporarily rising, because buildings do—eventually—fall down, even with good maintenance. Just as time passes with business use, and the building gets one year closer to the end of its useful life, that one strand of value is permanently reduced, even if the building's popular location means that its overall FMV is temporarily rising, *i.e.*, even if other strands contributing to the building's overall FMV are temporarily masking the permanent loss in this one strand of value.

As a normative matter, the analysis just described should inform the determination of both (1) which assets are properly depreciable or amortizable and (2) the scheduling of those depreciation and amortization deductions over time.

Let's assume that (1) Tom purchases a widget-making machine for $10,000, (2) he expects to earn a return from using this machine in his business sufficient to recover his original $10,000 investment *plus* a 4% profit, and (3) this machine has a useful life of 3 years in producing widgets before it becomes worthless. Under such assumptions, Tom expects to earn about $3,609.49 in gross receipts each year from use of the machine in his business.

Because this widget-making machine wastes away predictably from Tom's business use, it is properly depreciable during his ownership period, even under a realization-based income tax. Thus, we know that Tom will deduct $10,000 (the machine's basis) over the machine's 3-year useful life—even if its overall FMV temporarily rises in Year 2 because of, say, a shortage of widget-making machines. But at what rate should Tom's basis be recovered as deductions, effectively offsetting (in reaching Taxable Income) a portion of each year's $3,603.49 in anticipated gross receipts?

We know the answer by reviewing the proper rate of basis recovery with respect to a 3-year debt instrument with a principal amount of $10,000 and an interest rate of 4%, under which the borrower makes three annual payments of $3,603.49, an amount sufficient for the lender to recover *both* his original $10,000 investment *plus* the 4% profit. We explored this analysis in Chapter 10, Part C., Example 3, where Larry Lender made a nondeductible capital expenditure by lending $10,000 to Betty Borrower, creating a $10,000 basis. Betty repaid the principal *plus* 4% interest by making three annual payments of $3,603.49 to Larry. Let's review our analysis from that Chapter.

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When Larry receives the first $3,603.49 payment, we determine how much is tax-free basis recovery for Larry by determining the present value of Larry's remaining two payments.

| Due at end of Year | Amount | Present Value as of beginning of Year 2 |
|---|---|---|
| 2 | $3,603.49 | $3,464.89 |
| 3 | 3,603.49 | 3,331.63 |
| | | $6,796.52 |

*For the first time, the present value of Larry's future receipts is less than the $10,000 originally loaned to Betty.* Larry has thus suffered a loss *in the underlying loan investment* (viewed alone) because of the receipt of that first $3,603.49 payment. If, for example, Larry were to attempt to sell his debt instrument to Bob Buyer on January 1 of Year 2 (after he received that first cash payment from Betty), he would be in a position to demand no more than $6,796.52 for it because that is the present value of the future payments that the holder of the loan (whether Larry or Bob) will be able to collect. Even though Larry has not actually sold the note to another, his loss can fairly be said to be "realized" because it is permanent and irretrievable. You learned in Chapter 1, Part A., that a "loss" in the tax sense is unrecovered basis and can be deducted under § 165(c)(1) or (2) if the loss arises with respect to a business or investment asset. In this context, however, the realized loss in the loan simply permits Larry to use the basis represented by that "loss" in his investment to shelter part of the cash receipt from Betty as tax-free basis recovery. Stated another way, Larry does not deduct that basis but rather can recover it tax free against the payment to the extent of the loss determined above because Larry's loss in his loan investment is realized. (This idea is explored more fully in a few pages.) The realized loss is $3,203.48: the $10,000 present value of his future payments as of the beginning of Year 1 *less* the present value of his future payments as of the beginning of Year 2. This $3,203.48 represents the portion of the $3,603.49 received from Betty at the end of Year 1 that represents tax-free basis recovery of his original $10,000 investment, *i.e.*, that represents the return of loan principal. The remaining $400.01 received is interest.

At the end of Year 2, when Larry receives the second payment of $3,603.49, how much is tax-

free basis recovery (principal) and how much is interest? Once again, we must compute the present value of Larry's remaining payment.

| Due at end of Year | Amount | Present Value as of beginning of Year 3 |
|---|---|---|
| 3 | $3,603.49 | $3,464.89 |

The difference between the present value of his investment as of the beginning of Year 2 ($6,796.52) and the present value of his remaining payment as of the beginning of Year 3 ($3,464.89) is $3,331.63, which represents the portion of his $3,603.49 Year-2 receipt that represents tax-free basis recovery, with the remaining $271.86 representing interest. As of the beginning of Year 3, Larry has recovered $6,535.11 of his original $10,000 basis in the loan to Betty ($3,203.48 at the end of Year 1 and $3,331.63 at the end of Year 2), leaving remaining basis of $3,464.89 in the loan. Thus, when Larry receives the final $3,603.49 payment, $3,464.89 is tax-free basis recovery, and $138.60 is interest. Here is a summary.

| | Payment | | Principal (loss in present value) | | Interest |
|---|---|---|---|---|---|
| Year 1 | $3,603.49 | - | $3,203.48 ($10,000 *less* 6,796.52) | = | $400.01 |
| Year 2 | 3,603.49 | - | 3,331.63 ($6,796.52 *less* 3,464.89) | = | 271.86 |
| Year 3 | 3,603.49 | - | 3,464.89 (remaining basis) | = | 138.60 |
| Totals | | | $10,000.00 | | $810.47 |

***Notice that the portion of each payment representing interest decreases as time passes, and the portion of each payment representing principal (basis recovery) increases as time passes.*** Anyone who has made equal-amount mortgage payments on a home loan (and who has deducted the "qualified residence interest" paid each year) is familiar with this relationship. In the early years, a large portion of each payment represents deductible interest, but as the years pass, the portion of each payment representing deductible interest decreases.

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With respect to Larry's debt instrument, notice that basis is recovered at the § 61 Gross Income stage. That is to say, because of the basis offset, only a portion of each year's $3,603.49 payment is includable in Larry's § 61 Gross Income in the first place each year; no affirmative "deduction" is actually taken by Larry. With respect to Tom's widget machine, in contrast, *every dollar of the $3,603.49 gross receipts* produced by the machine must be included in Tom's § 61 Gross Income. Thus, we must create an actual deduction from Gross Income (in reaching Taxable Income) for Tom. This mechanical difference in how basis is used to reduce profit in each case should not mask the fact, however, that the *schedule* of Tom's basis deductions should precisely mirror the *schedule* of Larry's tax-free basis recovery if we want to avoid premature deduction of that basis, as under a cash-flow consumption tax.

Thus, Tom should deduct his basis each year in an amount equal to the loss in present value of the remaining expected gross return from use of the widget-making machine. In other words, Tom should deduct $3,203.48 in Year 1, $3,331.63 in Year 2, and $3,464.89 in Year 3. This schedule is called "economic depreciation" and reflects the final, irretrievable passage-of-time losses as the machine gets closer each year to the end of its useful life. Notice the slope of the deduction curve. If we graphed Tom's deductions, with the amount of the deduction on the vertical access and time along the horizontal access, the line would slope gently upward from left to right, with lower deductions in the early years and higher deductions in the later years.

While this schedule of capital recovery, which reflects the declining-balance method of identifying principal and interest in a loan, is normatively correct, Congress permits much faster basis recovery in the case of depreciation and amortization of tangible and intangible assets, respectively, under §§ 179, 167, 168, and 197. These deviations from economic depreciation are tax expenditures—departures from normative principles because of nontax policy or because of the raw lobbying power of affected industries.

The ability to deduct basis prematurely is a subtle but important cash-flow consumption tax feature of the current Code. Because of the premature deduction of basis before the economic loss is realized, a portion of the investment's return is effectively earned on pre-tax (rather than after-tax) dollars, garnering the investor preferable treatment compared to a normative income tax. But at least some of this favorable effect is "captured" by the sellers of these assets through the price mechanism. That is to say, the sellers of these assets can charge a higher price than they would be able to charge for these same assets if they were subject to normative economic depreciation. As with other instances of capture, the asset buyer may not fully appreciate that the asset seller is the one indirectly benefiting from a tax expenditure that appears to be directed, on the face of the statute, at the buyer.

More important, purchases of quickly depreciable business assets with borrowed money (very common in the real world) can result in *better* than consumption tax treatment because the business interest can be deducted under § 163(a), while interest would be nondeductible under a cash-flow consumption tax—a significant tax arbitrage problem discussed in Part F.

## B. "Wear and tear" within the meaning of § 167(a)

The primary authority to deduct depreciation with respect to property, whether tangible or intangible, is found in § 167(a), which contains the magic words "there shall be allowed as a depreciation deduction." To be depreciable, the property must be (1) subject to "wear and tear" and (2) used in a trade or business or held for investment. Under the second requirement, inventory is not depreciable, as it is not *used* in the trade or business.[5] A personal residence, as personal-use property, is generally not depreciable, though a taxpayer can depreciate the portion of the home's basis used exclusively and regularly for business to the extent that the taxpayer satisfies the stringent requirements of § 280A(c), explored in Chapter 20.

The wear-and-tear language had always been interpreted—prior to *Simon v. Commissioner*, below—to mean that the property wasted away on a predictable basis, even with proper maintenance, *i.e.*, that it had an ascertainable useful life that could be determined in the year that it was placed into service in the business or investment activity. This interpretation is consistent with the rationale underling depreciation described in Part A. In addition to the land example noted earlier,[6] shares of corporate stock, though held for investment, do not waste away due solely to the

[5] *See* Treas. Reg. § 1.167(a)-2.

[6] Although land is not depreciable, a different issue arises when a buyer purchases land along with rights to extract oil, gas, or minerals underneath the land. For example, assume that Joseph purchases Blackacre and the right to extract oil from Blackacre for $1 million. Joseph would first allocate his $1 million purchase price between the land and the oil. Let's say that the land would be worth only $200,000 without the oil rights, so $200,000 of the $1 million purchase price is allocable to the land, and the remaining $800,000 is allocable to the oil. As Joseph extracts and sells the oil, he should be (and is) permitted to recover his $800,000 cost basis in that oil as a series of annual deductions in the years in which he sells oil. The rate at which he can schedule his deductions is determined under either § 611 (cost

passage of time and thus are not depreciable. Artwork hanging on the walls of a corporate headquarters building is not depreciable, even though the artwork is being used in an income-producing activity, as it does not waste away in a predictable fashion due solely to the passage of time. Finally, collectibles, though held for investment (hoped-for gain on later sale), are not depreciable because they have a potentially infinite life in the collector market. We cannot know when tastes in the collector market will change, affecting the item's useful life as a collectible. Thus, we cannot know that a realized loss arises due solely to the passage of time.

While the authority to take depreciation is found in § 167(a), the manner in which *tangible* (but not intangible) property is depreciated is now found in § 168, first enacted in 1981. While its title remains the Accelerated Cost Recovery System (ACRS), its provisions were amended in the Tax Reform Act of 1986 so that cases and other sources sometimes refer to it as MACRS for "Modified Accelerated Cost Recovery System." Professional musicians are clearly permitted to depreciate the typical types of musical instruments used in their professions to earn income under §§ 167(a) and 168, including violin bows, that have no value in the collector market. The violin bows at issue in *Simon*, however, had potentially infinite lives in the collector market—even after they were "played out," *i.e.*, even after they were no longer useful in making music—because of their unique provenance. You can think of the relationship of François Xavier Tourte to bows as that of Stradivarius to violins. Even a Stradivarius violin that can no longer be played has a potentially infinite life in the collector market.

## SIMON v. COMMISSIONER

103 T.C. 247 (1994) (reviewed), *aff'd*, 68 F.3d 41 (2d Cir. 1995)

LARO, JUDGE: Richard Simon and Fiona Simon petitioned the Court for a redetermination of respondent's determinations in a notice of deficiency issued to them on December 11, 1991. [T]he sole issue for decision is whether petitioners are entitled to deduct depreciation claimed under the accelerated cost recovery system (ACRS) for the year in issue. Petitioners claimed depreciation on two 19th-century violin bows that they used in their trade or business as full-time professional violinists. As discussed below, we hold that petitioners may depreciate their violin bows during the year in issue.

FINDINGS OF FACT

*Petitioners' Backgrounds*

Richard Simon started playing and studying the violin in 1943, at the age of 7. In 1945, he was awarded a full scholarship to the Manhattan School of Music. He studied the violin there through college and received a bachelor of music degree in 1956. Following his graduation, Richard Simon pursued a master's degree in music by taking additional courses at the Manhattan School of Music and Columbia University. Throughout his education, Richard Simon studied the violin under many renowned musicians.

In 1965, Richard Simon joined the New York Philharmonic Orchestra (orchestra) and began playing in its first violin section. In 1981, he joined and began playing with the New York Philharmonic Ensembles (ensembles) (hereinafter, the orchestra and the ensembles are collectively referred to as the Philharmonic). Since 1965, Richard Simon has maintained two careers, one as a

depletion) or § 613 (percentage depletion). The details of each are beyond the scope of this course.

player with the orchestra (and later with the Philharmonic) and the second as a soloist, chamber music player, and teacher.

Fiona Simon began playing and studying the violin at the age of 4. Her musical studies included courses at Purcell School in London from 1963-71 and at the Guildhall School of Music from 1971-73. Throughout her career, Fiona Simon studied the violin with renowned musicians.

In 1985, Fiona Simon joined the Philharmonic and began playing in its first violin section. Since 1985, Fiona Simon has maintained two careers, one as a full-time player with the Philharmonic and a second as a soloist, chamber music player, teacher, and free-lance performer.

During the year in issue, petitioners were both full-time performers with the Philharmonic, playing locally, nationally, and internationally in the finest concert halls in the world. In 1989, petitioners performed four concerts per week with the Philharmonic, playing over 200 different works, and attended many rehearsals with the Philharmonic that were more demanding and more time-consuming than the concerts. Petitioners also carried out the busy schedules connected with their second careers.

*Construction of a Violin Bow*

A violin bow consists of a flexible wooden stick, horsehair, a frog, and a ferrule (screw). The stick, which varies in thickness, weight, and balance, is the working part of the bow and is an integral part in the production of sound through vibration. It is designed so that horsehair can be stretched between its ends.

The horsehair is a group of single strands of hair that come from the tails of Siberian horses. A hatchet-shaped head holds one end of the horsehair, and the other end is attached to a frog. The frog, which is inserted into the stick, is a movable hollow piece by which the bow is held. The frog has an eyepiece on the end that catches the screw. The screw is the small knob at the end of the bow that is adjusted to tighten or loosen the horsehair in order to change the tension on the horsehair. The horsehair is the part of the bow that touches the violin strings. Rosin is applied to the horsehair to supply the frictional element that is necessary to make the violin strings vibrate.

Old violins played with old bows produce exceptional sounds that are superior to sounds produced by newer violins played with newer bows. The two violin bows in issue were made in the 19th century by François Xavier Tourte (1747-1835). François Tourte is considered the premier violin bow maker. In particular, he is renowned for improving the bow's design. (Hereinafter, the two bows in issue are separately referred to as bow 1 and bow 2, and are collectively referred to as the Tourte bows.)

*Purchase of the Tourte Bows*

On November 13, 1985, petitioners purchased bow 1 for $30,000; the bow was purchased from Moes & Moes, Ltd., a dealer and restorer of violins and violin bows. On December 3, 1985, petitioners purchased bow 2 from this dealer for $21,500. The sticks, frogs, and screws were originals of François Tourte at the time of each purchase. No cracks or other defects were apparent in the sticks at the time of each purchase. The frogs and screws, however, were not in playable condition. Therefore, petitioners replaced them.

Petitioners acquired the Tourte bows for regular use in their full-time professional employment as violinists. Petitioners purchased the Tourte bows for their tonal quality, not for their monetary value. In the year of acquisition, petitioners began using the Tourte bows with the original sticks

in their trade or business as full-time professional violinists. Petitioners continued to use the Tourte bows with the original sticks during the year in issue.

*Depreciation Deductions Claimed for the Tourte Bows*

On their 1989 Form 1040, petitioners claimed a depreciation deduction of $6,300 with respect to bow 1 and $4,515 with respect to bow 2; these amounts were in accordance with the appropriate ACRS provisions that applied to 5-year property. Respondent disallowed petitioners' depreciation deduction in full and reflected her disallowance in the notice of deficiency at issue here.

*Conditions Affecting the Wear and Tear of Violin Bows*

Playing with a bow adversely affects the bow's condition; when a musician plays with a bow, the bow vibrates up, down, sideways, and at different angles. In addition, perspiration from a player's hands enters the wood of a bow and ultimately destroys the bow's utility for playing. Cracks and heavy-handed bearing down while playing certain pieces of music also create wear and tear to a bow. A player who has a heavy hand may cause the stick to press against the horsehair; in turn, this may cause the bow to curve and warp. The appendix illustrates the wear and tear that was suffered by a violin bow that was used for 20 to 25 years.[4] Petitioners' use of the Tourte bows during the year in issue subjected the bows to substantial wear and tear.

Frequent use of a violin bow will cause it to be "played out," meaning that the wood loses its ability to vibrate and produce quality sound from the instrument. From the point of view of a professional musician, a "played out" bow is inferior and of limited use. The Tourte bows were purchased by petitioners, and were playable by them during the year in issue, only because the Tourte bows were relatively unused prior to petitioners' purchase of them; the Tourte bows had been preserved in pristine condition in collections. At the time of trial, the condition of the Tourte bows had deteriorated since the dates of their purchase. Among other things, the sticks on the Tourte bows were worn down.

*Value of the Tourte Bows*

On November 21, 1985, bow 1 was appraised for insurance purposes as having a fair market value of $ 35,000. On December 3, 1985, bow 2 was appraised for insurance purposes as having a fair market value of $25,000. Petitioners obtained both appraisals from Moes & Moes, Ltd.

In 1994, at the time of trial, the Tourte bows were insured with the Philharmonic for $45,000 and $35,000, respectively. These amounts are based on an appraisal dated May 14, 1990, from Yung Chin Bowmaker, a restorer and dealer of fine bows. The record does not indicate whether these appraised amounts were the fair market values of the Tourte bows or were their replacement values.

An independent market exists for the Tourte bows and other antique bows. Numerous antique bows (including bows made by François Tourte) are regularly bought and sold in this market. The Tourte bows are unadorned; they are not as lavish or decorative as some other bows (including other bows made by François Tourte) that are sold in the independent market. Adornments on

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[4] The appendix (petitioners' Exhibit 15) is not one of the Tourte bows. The appendix is provided to show the nature of the types of wear and tear that a bow can suffer. The large indentation at the bottom of the stick immediately before the frog was caused by perspiration and pressure from the player's thumb. *See* 1 *infra* the appendix. Further down the stick towards the right is a second indentation that was caused by perspiration and pressure from the player's hand. *See* 2 *infra* the appendix.

other bows include engravings, gold, silver, ivory, and mother-of-pearl.

One factor that adds value to the Tourte bows is the fact that Pernambuco wood, the wood that was used to make the sticks, is now very scarce. The wood that is currently used to make the sticks of violin bows is inferior to Pernambuco wood.

OPINION

Taxpayers have long been allowed asset depreciation deductions in order to allow them to allocate their expense of using an income-producing asset to the periods that are benefited by that asset. The primary purpose of allocating depreciation to more than 1 year is to provide a more meaningful matching of the cost of an income-producing asset with the income resulting therefrom; this meaningful match, in turn, bolsters the accounting integrity for tax purposes of the taxpayer's periodic income statements. *Hertz Corp. v. U.S.*, 364 U.S. 122, 126 (1960); *Massey Motors, Inc. v. U.S.*, 364 U.S. 92, 104 (1960)…. In this sense, an allocation of depreciation to a given year represents that year's reduction of the underlying asset through wear and tear. Depreciation allocations also represent a return to the taxpayer of his or her investment in the income-producing property over the years in which depreciation is allowed. *Virginian Hotel Corp. v. Helvering*, 319 U.S. 523, 528 (1943); *Detroit Edison Co. v. Comm'r*, 319 U.S. 98, 101 (1943).

Section 167(a) provide[s]:

> SEC. 167(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.

The regulations under this section expanded on the text of section 167 by providing that personal property was only depreciable before [enactment of § 168] if the taxpayer established the useful life of the property. *See* sec. 1.167(a)-1(a) and (b), Income Tax Regs.

The "useful life" of property under pre-[§ 168] law was the period over which the asset could reasonably be expected to be useful to the taxpayer in his or her trade or business, or in the production of his or her income. *Fribourg Navigation Co. v. Comm'r*, 383 U.S. 272, 277 (1966); *Massey Motors, Inc. v. U.S., supra;* sec. 1.167(a)-1(b), Income Tax Regs. This useful life period was not always the physical life or maximum useful life inherent in the asset. *Massey Motors, Inc. v. U.S., supra;* sec. 1.167(a)-1(b), Income Tax Reg. A primary factor to consider in determining an asset's useful life was any "wear and tear and decay or decline from natural causes" that was inflicted upon the asset. Sec. 1.167(a)-1(b), Income Tax Regs.

Before [§ 168], the primary method that was utilized to ascertain the useful life for personal property was the asset depreciation range (ADR) system. Under the ADR system, which was generally effective for assets placed in service after 1970 and before 1981, property was grouped into broad classes of industry assets, and each class was assigned a guideline life. *See, e.g.*, sec. 1.167(a)-11, Income Tax Regs.; Rev. Proc. 83-35, 1983-1 C.B. 745, superseded by Rev. Proc. 87-56, 1987-2 C.B. 674. A range of years, *i.e.*, the ADR, was then provided for each class of personal property; the ADR extended from 20 percent below to 20 percent above the guideline class life. For each asset account in the class, the taxpayer selected either a class life or an ADR that was utilized as the useful life for computing depreciation. If an asset was not eligible for ADR

treatment, or if the taxpayer did not elect to use the ADR system, the useful life of that asset was generally determined based on either the particular facts and circumstances that applied thereto, or by agreement between the taxpayer and the Commissioner. *Massey Motors, Inc. v. U.S., supra;* sec. 1.167(a)-1(b), Income Tax Regs. *See generally* Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 67 (J. Comm. Print 1981) (hereinafter referred to as the 1981 Bluebook).

In enacting [§ 168], the Congress found that the pre-[§ 168] rules for determining depreciation allowances were unnecessarily complicated and did not generate the investment incentive that was critical for economic expansion. The Congress believed that the high inflation rates prevailing at that time undervalued the true worth of depreciation deductions and, hence, discouraged investment and economic competition. The Congress also believed that the determination of useful lives was "complex" and "inherently uncertain", and "frequently [resulted] in unproductive disagreements between taxpayers and the Internal Revenue Service." S. Rept. 97-144, at 47 (1981), 1981-2 C.B. 412, 425. *See generally* 1981 Bluebook, at 75. Accordingly, the Congress decided that a new capital cost recovery system would have to be structured which, among other things, lessened the importance of the concept of useful life for depreciation purposes. S. Rept. 97-144, *supra* at 47, 1981-2 C.B. at 425. *See generally* 1981 Bluebook, at 75. This new system is ACRS. ACRS is mandatory and applies to most tangible depreciable assets placed in service after 1980….

Thus, through [§ 168], the Congress minimized the importance of useful life by: (1) Reducing the number of periods of years over which a taxpayer could depreciate his or her property from the multitudinous far-reaching periods of time listed for the ADR system to the … short periods of time listed in [§ 168] … and (2) basing depreciation on an arbitrary statutory period of years that was unrelated to, and shorter than, an asset's estimated useful life. This minimization of the useful life concept through a deemed useful life was in spirit with the two main issues that [§ 168] was designed to address, namely: (1) Alleviating the income tax problems that resulted mainly from complex depreciation computations and useful life litigation, and (2) responding to economic policy concerns that the pre-[§ 168] depreciation systems spread the depreciation deductions over such a long period of time that investment in income-producing assets was discouraged through the income tax system. S. Rept. 97-144, *supra* at 47, 1981-2 C.B. at 425. *See generally* 1981 Bluebook, at 75.

Rev. Rul. 68-232, 1968-1 C.B. 79 states:

> A valuable and treasured art piece does not have a determinable useful life. While the actual physical condition of the property may influence the value placed on the object, it will not ordinarily limit or determine the useful life. Accordingly, depreciation of works of art *generally* is not allowable. [Emphasis added.]

In the instant case, respondent determined that petitioners were not entitled to deduct depreciation for the Tourte bows. On brief, respondent supports her disallowance with two primary arguments. First, respondent argues that the useful lives of the Tourte bows are indeterminable because the bows are treasured works of art for which it is impossible to determine useful lives. According to respondent, the Tourte bows are works of art because the Tourte bows have existed for more than 100 years and have increased in value over that time; the presence of an independent market for the Tourte bows also gives them a value independent of their capacity to be used to play music, and serves to extend their useful lives indefinitely.

As an alternative to this first argument, respondent argues that the Tourte bows are depreciable

under section 168 only if petitioners first prove that each bow has a determinable useful life within the meaning of section 167. In this regard, respondent contends that petitioners must prove a specific or reasonable estimate of the number of years that the Tourte bows will be useful in order to depreciate them under ACRS. Given that the Tourte bows have existed for more than 100 years, respondent concludes, petitioners may not depreciate the Tourte bows because petitioners cannot determine the number of remaining years during which the Tourte bows will continue to be useful.

Petitioners' argument is more straightforward. According to petitioners, they may claim depreciation on the Tourte bows because the Tourte bows: (1) Were necessary to their profession as full-time professional violinists, and (2) suffered wear and tear attributable to their use in that profession. In this regard, petitioners contend, the Tourte bows can be used to produce beautiful sounds superior to those produced by any newer bow, and the Tourte bows harmonize this beautiful music with the reputation of the Philharmonic as one of the most prestigious orchestras in the world.

We agree with petitioners that they may depreciate the Tourte bows under [§ 168]. [Section 168] was enacted partially to address and eliminate the issue that we are faced with today, namely, a disagreement between taxpayers and the Commissioner over the useful lives of assets that were used in taxpayers' trades or businesses….

[P]etitioners regularly used the Tourte bows in their trade or business as professional violinists during the year in issue. We are convinced that petitioners' frequent use of the Tourte bows subjected them to substantial wear and tear during the year in issue. Petitioners actively played their violins using the Tourte bows, and this active use resulted in substantial wear and tear to the bows.[11] Indeed, respondent's expert witness even acknowledged at trial that the Tourte bows suffered wear and tear stemming from petitioners' business; the witness testified that the Tourte bows had eroded since he had examined them 3 years before, and that wood had come off them. Thus, we conclude that petitioners have satisfied the final prerequisite for depreciating personal property under section 168, and, accordingly, hold that petitioners may depreciate the Tourte bows during the year in issue.

With respect to respondent's arguments in support of a contrary holding, we believe that respondent places too much reliance on the fact that the Tourte bows are old and have appreciated in value since petitioners acquired them. We disagree; section 168 does not support her proposition that a taxpayer may not depreciate a business asset due to its age, or due to the fact that the asset may have appreciated in value over time. *Noyce v. Comm'r, supra* at 675, 691 (taxpayer allowed to deduct depreciation under section 168 on an airplane that had appreciated in economic value).

We also reject respondent's contention that the Tourte bows are nondepreciable because they have value as collectibles independent of their use in playing musical instruments, and that this value prolongs the Tourte bows' useful life forever. First, it is firmly established that the term "useful life" under pre-[§ 168] law refers to the period of time in which a particular asset is *useful*

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[11] In this regard, we do not believe that the Tourte bows are so-called works of art. We define a "work of art" as a passive object, such as a painting, sculpture, or carving, that is displayed for admiration of its aesthetic qualities. *See* Webster's New World Dictionary 1539 (3d coll. ed. 1988). The Tourte bows, by contrast, functioned actively, regularly, and routinely to produce income in petitioners' trade or business. Although a computer utilized by a child to play games is not a depreciable asset, the same computer becomes a depreciable asset if it is used actively, regularly, and routinely by a data processor in his or her trade or business. By the same token, the Tourte bows could have been collector's items except for the fact that petitioners used them actively, regularly, and routinely in their full-time business.

*to the taxpayer* in his or her trade or business. *Fribourg Navigation Co. v. Comm'r, supra* at 277; *Massey Motors, Inc. v. U.S.*, 364 U.S. 92 (1960); sec. 1.167(a)-1(b), Income Tax Regs. Thus, the fact that an asset such as the Tourte bows may outlive a taxpayer is not dispositive of the issue of whether that asset has a useful life for depreciation purposes under pre-[§ 168] law. Second, the same argument concerning a separate, nonbusiness value can be made of many other assets. Such types of assets could include, for example, automobiles, patented property, highly sophisticated machinery, and real property. For the Court to delve into the determination of whether a particular asset has a separate, nonbusiness value would make the concept of depreciation a subjective issue and would be contrary to the Congress' intent to simplify the concept and computation of depreciation.

With respect to respondent's contention that petitioners must prove a definite useful life of the Tourte bows, we acknowledge that the concept of useful life was critical under pre-[§ 168] law. Indeed, the concept of useful life was necessary and indispensable to the computation of depreciation because taxpayers were required to recover their investments in personal property over the estimated useful life of the property. However, the Congress enacted [§ 168] in part, to avoid constant disagreements over the useful lives of assets, to shorten the writeoff periods for assets, and to encourage investment by providing for accelerated cost recovery through the tax law. S. Rept. 97-144, at 47 (1981), 1981-2 C.B. 412, 425. *See generally* 1981 Bluebook, at 75…. Respondent's argument that a taxpayer must first prove the useful life of personal property before he or she may depreciate it … would bring the Court back to pre-[§ 168] law and reintroduce the disagreements that the Congress intended to eliminate by its enactment of [§ 168]. This the Court will not do.

Respondent mainly relies on … *Browning v. Commissioner*, T.C. Memo. 1988-293, affd. 890 F.2d 1084 (9th Cir. 1989), to support a holding contrary to the one that we reach today.[14] *Browning v. Commissioner*, T.C. Memo. 1988-293, affd. 890 F.2d 1084 (9th Cir. 1989), is … distinguishable. In *Browning*, the taxpayer was a musician who performed in nightclubs and bars and for private engagements. Prior to and during 1980 and 1981, the taxable years in issue there, the taxpayer purchased several expensive antique violins, including a Ruggeri, a Stradivarius, and a Gabrielli. The Ruggeri and the Stradivarius violins were purchased in 1978 and 1979, respectively, and were subject to the pre-[§ 168] rules for depreciation. The Gabrielli violin was purchased in 1981, and was subject to ACRS. During 1980 and 1981, the taxpayer claimed depreciation deductions with respect to the Ruggeri and Stradivarius violins; the taxpayer amended his petition in this Court to claim that section 168 … allowed him to deduct depreciation on the Gabrielli violin for his 1981 taxable year.

The Court in *Browning* sustained respondent's determination that the taxpayer was not entitled to any depreciation deductions on the violins. In so doing, the Court first stressed that the taxpayer had presented no credible evidence to support a contrary holding with respect to the Stradivarius violin. Indeed, neither the taxpayer nor his wife testified at trial; we also found unpersuasive the

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[14] Respondent also relies on sec. 1.168-3(a), Proposed Income Tax Regs., 49 Fed. Reg. 5957 (Feb. 16, 1984), and Rev. Rul. 68-232, 1968-1 C.B. 79. We find this reliance misplaced; neither proposed regulations nor revenue rulings are entitled to judicial deference. *See, e.g.*, Tandy Corp. v. Comm'r, 92 T.C. 1165, 1170 (1989); Natomas North America, Inc. v. Comm'r, 90 T.C. 710, 718 n.11 (1988); North Ridge Country Club v. Comm'r, 89 T.C. 563, 579-580 (1987), revd. on other grounds 877 F.2d 750 (9th Cir. 1989). Moreover, we conclude that the Tourte bows are not "works of art" because, *inter alia*, the bows were used by petitioners in their trade or business as professional violinists. *See supra* note 11.

evidence that the taxpayer did present at trial, an expert's report and that expert's testimony. With respect to the other two violins (including the one subject to ACRS), we held for respondent because the taxpayer failed to present any evidence with respect to those violins.

The record in the instant case, by contrast to the record in *Browning*, is replete with evidence showing clearly that the Tourte bows suffered substantial wear and tear while petitioners used them in their trade or business. To state the obvious, violin bows are subject to wear and tear when in use by a professional violinist. Indeed, as stated by Publilius Syrus circa 42 B.C.: "The bow too tensely strung is easily broken." Bartlett, Familiar Quotations 1103 (12th ed. 1951).

We have considered all other arguments made by respondent and find them to be without merit.

PARKER, SWIFT, WRIGHT, PARR, WELLS, RUWE, and COLVIN, JJ., agree with this majority opinion.

[The separate concurring opinions of Judges Ruwe and Beghe are omitted.]

HAMBLEN, C.J., dissenting: I must disagree with the majority opinion. I respectfully submit that the basis for the majority's allowance of a depreciation deduction in this instance is sophistical and wrong…. The statutory interpretation of sections 167 and 168 is wrong in this context. Pertinent legislative history regarding determinable useful life is ignored. The antique violin bows are treasured "works of art" that for 71 years the Internal Revenue Service has treated, with congressional acquiescence, as nondepreciable property because as instruments and collectibles they have an indeterminable useful life. The majority's holding is contrary to legal precedent. *See Browning v. Comm'r*, T.C. Memo. 1988-293, affd. 890 F.2d 1084 (9th Cir. 1989); *see also Clinger v. Comm'r*, T.C. Memo. 1990-459.

I. *Legal Analysis*

A. *Statutory Construction*

The majority opinion concludes, as a matter of law, that if a taxpayer uses in his trade or business tangible personal property which suffers some wear and tear, irrespective of whether the wear and tear can be restored by ordinary maintenance, irrespective of whether it has a determinable useful life, and irrespective of whether it declines in value, the taxpayer is entitled to depreciate the property under ACRS (section 168). I cannot agree. That conclusion contradicts the basic underpinnings of the depreciation allowance and the holdings of this Court and other courts.

It is true that section 168 represents a restructuring of the concept of depreciation deductions and that Congress has deemphasized the concept of useful life and abandoned the concept of salvage value. But Congress did not release the concept of depreciation from the moorings of useful life. In *Newark Morning Ledger Co. v. United States*, 113 S. Ct. 1670, 1680 (1993), the Supreme Court noted that "The entire justification for refusing to permit the depreciation * * * evaporates, however, when the taxpayer demonstrates that the asset in question wastes over an ascertainable period of time." The corollary is that, if property suffers no waste and lacks a determinable useful life, it is not depreciable. *Tunnell v. U.S.*, 512 F.2d 1192 (3d Cir. 1975); *S.S. Ballin Agency, Inc. v. Comm'r*, 446 F.2d 554 (3d Cir. 1971), affg. T.C. Memo. 1969-203; *Westinghouse Broadcasting Co. v. Comm'r*, 309 F.2d 279 (3d Cir. 1962), affg. 36 T.C. 912 (1961); *Citizens & Southern Corp. v. Comm'r*, 91 T.C. 463, 479 (1988), affd. 919 F.2d 1492 (11th Cir. 1990); *Judge v. Comm'r*, T.C. Memo. 1976-283.

Although section 168 effects significant changes in the calculation of the depreciation

allowance, useful life remains a hallmark of the basic concept of depreciation in both sections 167 and 168. Property depreciable under section 167 must be subject to waste and have a determinable useful life. *See Browning v. Comm'r, supra*. While the majority opinion apparently acknowledges that this is correct as far as section 167 is concerned, it ignores this requirement in discussing section 168. As we stated in *Clinger v. Commissioner, supra*, "the concept of useful life was not eliminated by the enactment of ACRS; hence * * * petitioner must establish that an asset used in a trade or business has a determinable useful life". Accord *Arkla, Inc. v. U.S.*, 27 Fed. Cl. 226 (1992).

The premise underlying the depreciation allowance is that wear and tear or obsolescence causes a corresponding *reduction in the value* of an asset and *diminishes its useful life*. The end product of the depreciation allowance is the taxpayer's recovery of capital expenditures (costs) made in acquiring a wasting asset used in a trade or business or held for the production of income. *See Noyce v. Comm'r*, 97 T.C. 670, 688 (1991). Depreciation is therefore keyed to wear and tear or obsolescence because they generally cause corresponding reductions in the useful life and value of property.

Consequently, sections 167 and 168 are connected or linked so that an asset, such as a Tourte bow, that has an indeterminable useful life is not depreciable. It seems to me that the majority opinion has twisted these depreciation provisions beyond the contours of their clear and unambiguous language so as to defeat the plain purpose of Congress.

B. *Legislative History, Proposed Regulations, and Rulings*

The legislative history of section 168, as revealed in the "Overview" section of the Senate Finance Committee (S. Rept. 97-144 (1981), 1981-2 C.B. 412) and the House Ways and Means Committee (H. Rept. 97-201 (1981), 1981-2 C.B. 352) reports states:

> In general, property is depreciable if it is (1) used in a trade or business or for the production of income, and (2) subject to wear and tear, decay or decline from natural causes, exhaustion, or obsolescence. Land, goodwill, stock, and *other assets* that do not have a determinable useful life and that do not decline in value predictably are not depreciable. * * * [S. Rept. 97-144, *supra*, 1981-2 C.B. at 421; emphasis supplied.]

Substantially similar language is used in the conference committee report, H. Conf. Rept. 97-215 (1981), 1981-2 C.B. 481, 487, under the heading "Eligible Property", which states that "ACRS does not apply to (1) property not depreciated in terms of years." Moreover, the Joint Committee on Taxation summary (the so-called Blue Book) states that ACRS "does not change the determination under prior law as to whether property is depreciable or nondepreciable". Staff of Joint Comm. on Taxation, General Explanation of the Economic Recovery Tax Act of 1981, at 77 (J. Comm. Print 1981). The majority opinion essentially ignores these statements. The Joint Committee on Taxation summary likewise reiterates the statements made in the committee reports that assets that do not decline in value on a predictable basis or that do not have a determinable useful life are not depreciable.

Section 1.168-3(a)(1)(ii), Proposed Income Tax Regs., 49 Fed. Reg. 5957 (Feb. 16, 1984), tracks and is entirely consistent with the legislative history. It provides in part: "Property is considered recovery property only if such property would have been depreciable under section 167. ACRS does not apply to * * * works of art". I think Congress was aware of the longstanding

rulings of the Internal Revenue Service that "works of art" are not depreciable….

C. *Legal Precedent*

The majority opinion has dubiously attempted to distinguish *Browning v. Commissioner*, T.C. Memo. 1988-293, affd. 890 F.2d 1084 (9th Cir. 1989), and *Clinger v. Commissioner*, T.C. Memo. 1990-459. Candor requires that we not try to discard or overrule them sub silentio. In *Browning*, we held that the Stradivarius, Ruggeri, and Gabrielli violins were nondepreciable because the taxpayer, a professional musician, could not prove they had a determinable useful life. In affirming our decision, the Court of Appeals stated:

> As the Tax Court noted, antique violins such as a Stradivarius are considered collectible items and not all purchasers need necessarily be professional musicians. Therefore, the violins have a value independent of their tonal qualities and that value may extend their useful lives which makes the violins more like pieces of art. * * *

[890 F.2d at 1086-1087.]

The majority opinion relies principally on one case, *Noyce v. Commissioner*, 97 T.C. 670 (1991), which stands in sharp contrast to and is distinguishable from *Browning*. In *Noyce* we concluded that the taxpayer's use of his private airplane and payment of related expenses in the course of his employment were part of his trade or business of being a corporate official. Thus, it was held that he may deduct depreciation and expenses related to such travel to the extent such amounts exceed amounts reimbursable under his employer's policy. *Noyce* is distinguishable from this case. At issue in *Noyce* was the second section 168 requirement—whether the taxpayer used the airplane in his trade or business. It was undisputed that, if properly used, the airplane suffered wear and tear and could be depreciated. The Commissioner did not argue that the airplane was not depreciable property under section 167, but only that the [plane was not used in the taxpayer's business]. We rejected that argument. By contrast, the key issue in the present case is the first requirement—whether the Tourte bows are the type of property subject to depreciation. Petitioners have not shown that they are.

…

D. *Work of Art Vel Non*

The majority opinion characterizes the Tourte bows as not being "works of art" because they are actively and regularly used in petitioners' trade or business as professional musicians. I would not characterize a "work of art" so narrowly. I think the term should be given a broad, expansive meaning. One definition of a "work of art" contained in Webster's New 20th Century Dictionary (unabridged 1983) is "anything beautifully made, played, sung or acted." That definition would certainly include an antique musical instrument or bow, a Shakespearean play, a Verdi opera, or a Navajo rug. And "art" is defined in the same dictionary as "products of creative work." In the final analysis the answer probably lies in the eyes of the beholder or owner. In any event, this Court has rejected the notion that "works of art and commercial equipment necessarily are mutually exclusive concepts." *London Displays Co. v. Comm'r*, 46 T.C. 511, 514 (1966). Even if used in a trade or business, a "work of art" retains its character as a work of art because it does not have a determinable useful life and generally does not decline in value over a predictable period. *See Clinger v. Comm'r, supra; Associated Obstetricians & Gynecologists, P.C. v. Comm'r*, T.C. Memo. 1983-380, affd. per curiam 762 F.2d 38 (6th Cir. 1985). To say the least, I expect the

Smithsonian curator of musical instruments would be shocked to learn that a Stradivarius violin or a Tourte bow is not regarded as a treasured "work of art." Consequently, in my view, the Tourte bows in this case should be considered as a type of property which is not subject to depreciation. In cases of this kind it seems that our role should begin and end with assuring that the Commissioner's authority to implement the congressional mandate has been exercised in a reasonable manner. *See U.S. v. Correll*, 389 U.S. 299 (1967). I respectfully submit that the majority has not done so.

…

D. *Determinable Useful Life*

The record in this case clearly shows that the Tourte bows have no determinable useful life. Nobody knows how long they will last as either usable works of art in petitioners' hands or ultimately as collectibles.

…

Finally, Wiley Grant, respondent's expert, stated in his report that the bows were treasured works of art that had no determinable useful life. Who can say with any degree of certainty how long these bows will last if given reasonable care?

CHABOT, JACOBS, WHALEN, and HALPERN, JJ., agree with this dissent.

[The separate dissenting opinions of Judges Gerber and Halpern are omitted.]

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The fact that the Tourte bows increased in value after purchase should be irrelevant to the issue of whether they are properly depreciable under §§ 167 and 168. As described in Part A., a property's aggregate FMV has several strands, and the one strand of value that is permanently and irretrievably lost as time passes may be transiently overcome by other strands of value that temporarily mask the permanent loss in that one strand of value. Thus, rental real estate buildings that were appreciating spectacularly during the real estate bubble were nevertheless properly depreciable during that time period because buildings will eventually fall down, even with adequate maintenance, in a predictable way.

As noted earlier, the majority's reference to the "matching principle" from financial accounting is unfortunate. Capitalization and depreciation under a realization-based "income" tax has nothing to do with "matching," *i.e.*, smoothing out the hills and valleys of the business's revenue stream in order to provide more accurate information regarding the business's overall economic health to someone that is considering, say, making a loan to the business.

Rather, capitalization and depreciation in a realization-based income tax serves to ensure *effective taxation of the property's capital return*. In other words, allowing premature deduction of the cost of an asset with a potentially infinite life means that the return on that investment is not fully taxed, as though the asset were being conferred preferable cash-flow consumption tax treatment. Recall from Chapter 2 that, under a cash-flow consumption tax, the cost of even long-lived assets is deducted in the year of purchase. Even though the investment's return is included in the tax base, the normal (expected) return is not effectively taxed—as though the property's basis were *not* prematurely deducted but the asset's return was explicitly excluded from the tax base (as under a wage tax). Also recall from Chapter 2 that, for an investment to be taxed under income tax principles, two requirements must be satisfied: (1) *the investment must be made with*

*after-tax dollars*, which means that the investment should not be prematurely deducted, and (2) the investment's return must be fully included in the tax base.

A case decided in the same year and similar to *Simon* was *Liddle v. Commissioner*,[7] pertaining to a 17th century bass viol created by "Francesco Ruggeri (c. 1620-1695), a luthier active in Cremona, Italy. He studied stringed instrument construction under Nicolo Amati, who also instructed Antonio Stradivari. His other contemporaries include the craftsmen Guadanini and Guarneri. These artisans are members of the so-called Cremonese School of instrument makers."[8] The IRS issued an AOD announcing "nonacquiescence" to both *Simon* and *Liddle*, which means that the IRS will continue to litigate the issue on similar facts.[9] Nevertheless, I was not surprised to see some tax advisors advocating that their clients begin to depreciate all sorts of assets that were not previously thought to satisfy the "wear and tear" language in § 167(a).[10]

Section 168 contains both normative elements (the allowance of depreciation deductions in wasting assets in order to measure "income" properly in a realization-based income tax) and tax expenditure elements (faster deduction than would be allowed under economic depreciation). Let's finally turn to the mechanics of § 168 to see why these statements are true.

## C. Depreciation of tangible assets

While the authority to take a depreciation deduction is found in § 167(a), the rules under which the deductions are taken over time are found in § 168 *if* the property is tangible. In the case of intangible property, amortization deductions, if allowable, are taken under the rules found in either §§ 167 or 197, discussed in Part E.

There is a logical order of steps to take when analyzing the extent to which business or investment tangible property can be depreciated.

**(1) Can all or a portion of the purchase price be treated as an "expense" that is deducted immediately under § 179 (as opposed to a capital expenditure, which is not deductible but which creates basis that can be depreciated)?**

**(2) After taking any § 179 expense deduction that is allowable, what is the initial basis that can be depreciated under § 168(a)? Under § 168(b)(4), salvage value can be ignored.**

**(3) What is the property's classification under § 168(e)? You need this information in order to determine ….**

**(4) What is the property's recovery period under § 168(c)? If 20 years or less, is "bonus" depreciation available under § 168(k) or has § 168(k) expired?**

**(5) What is the property's applicable depreciation method under § 168(b)?**

**(6) What is the property's applicable convention under § 168(d) regarding when it is deemed to be placed in service in the first year (or taken out of service if disposed of before the property's basis has been fully deducted)?**

[7] 103 T.C. 285 (1994), *aff'd*, 65 F.3d 329 (1995).
[8] 103 T.C. at 287.
[9] *See* 1996-2 C.B. 2.
[10] Deborah A. Geier, *Loose Application of Depreciation Doctrine*, 120 TAX NOTES 989 (2008).

The material below first explores non-real estate tangible assets (such as business equipment) and then considers real estate (buildings).

***Non-real estate***

Let's use the following fact pattern below to explore each of these steps in the analysis.

> **Sally purchases a widget-making machine for $700,000 on April 3, 2017, for use in her profitable business, and she places the equipment into service on May 18, 2017. The IRS has assigned a "class life" of 7 years to this equipment in a Revenue Procedure. This is the only depreciable business property that Sally purchases for her business in 2017.**

***Section 179 expensing***

Absent § 179, Sally's entire $700,000 outlay would be a nondeductible capital expenditure under the standards explored in Chapter 4 rather than its opposite, an "expense" (a current wealth decrease), because the widget-making machine will last beyond the end of the current year. Because a widget-making machine satisfies the "wear and tear" language (*i.e.*, has an ascertainable useful life or, under *Simon*, demonstrates physical manifestations of use under a literal approach to "wear and tear"), Sally's equipment satisfies § 167(a), and she would depreciate her $700,000 basis under the rules found in § 168.

To the extent that Sally is eligible to make (and does make) an election under § 179, however, Sally can "treat" all or a portion of the outlay as a current expense rather than a nondeductible capital expenditure, which permits her to deduct the cost immediately in 2017. Read §§ 179(a), (d)(1), and (b)(1) & (2). The reference to "section 1245 property" in the definition of "section 179 property" means that the property generally must *not* be real property, such as a building.[11] (You will learn about § 1245 in the next chapter.) Because a widget-making machine is not real property, it is § 1245 property that is eligible for immediate deduction to the extent not exceeding the limits found in §§ 179(b)(1) and (2).

Section 179(b) is the means by which Congress effectively limits § 179 to small businesses. Indeed, when § 179 was first enacted in 1981 (the same year in which § 168 was enacted), it was originally entitled "Additional First-Year Depreciation Allowance For Small Business." For most of its life, the § 179(b)(1) deduction was capped at $25,000, and the phaseout threshold in § 179(b)(2) was $200,000. Sporadically over the last 15 years, however, these amounts have increased substantially—albeit only temporarily (usually for one year only in reaction to economic recessions). In late 2015, however, Congress permanentaly amended § 179 in the Protecting Americans from Tax Hikes Act of 2015 (PATH Act) to provide for a $500,000 "expense" cap under § 179(b)(1) and a § 179(b)(2) phaseout threshold of $2 million, but both of these amounts are indexed for inflation. The 2017 figures are $510,000 and $2.03 million, respectively. Thus, no more than $510,000 of Sally's purchase price can be treated as a current expense, and this $510,000 deduction is phased out, dollar for dollar, as the aggregate amount of § 179 property that Sally places into service in the year exceeds $2,030,000.

Because Sally does not place into service more than $2.03 million of § 179 property this year,

[11] Narrow exceptions to the rule that § 179 property cannot be real property are found in § 179(f). "Qualified leasehold improvement property," "qualified restaurant property," and "qualified retail improvement property,"—each as defined in §§ 168(e)(6), (7), and (8)—can be the subject of § 179 expensing.

her $510,000 deduction is not phased out to any extent under § 179(b)(2). If we changed the facts so that she purchases a second piece of § 179 property for, say, $1.6 million, her $510,000 § 179 deduction would be reduced by $270,000: $2.3 million (the aggregate of § 179 property) *less* $2,030,000. In that case, she could treat only $240,000 of her aggregate $2.3 million cost of § 179 property as a current expense ($510,000 *less* $270,000). If Sally purchases, in the aggregate, $2.51 million of § 179 property, she will fully phase out of § 179. Returning to our original hypothetical, however, Sally can take full advantage of the $510,000 maximum § 179 deduction.

***Section 168 depreciation***

When Sally turns to § 168 under Step (2), she knows that her basis in the equipment is only $190,000 (instead of $700,000) because only capital expenditures (not "expenses") create basis. Indeed, if Sally were permitted to treat $510,000 of her purchase price *both* as an immediately deductible "expense" under § 179 *and* as a capital expenditure creating basis (to be deducted under § 168), she would inappropriately enjoy a double tax benefit for the same dollars. Sally can ignore any potential salvage value of the machine under § 168(b)(4). Ignoring salvage value was one of the simplification measures enacted in § 168, as only the basis in excess of the property's anticipated scrap or salvage value at the end of its useful life could be depreciated prior to 1981.

Next, Sally must determine her property's "classification" in Step (3) because she needs this information in order to determine the property's "recovery period" in Step (4). With respect to real property, Congress has described the requirements to be classified as either "residential rental property" or "nonresidential real property" in § 168(e)(2). In addition, Congress has determined the classification of many types of property that are explicitly described there, such as certain race horses (classified as 3-year property), automobiles and light purpose trucks (5-year property), railroad track (7-year property), municipal wastewater treatment plant (15-year property), *etc.* For property that is not explicitly classified in the statute, the IRS has published lengthy Revenue Procedures that assign class lives to virtually any type of property that you can imagine. Notice that our fact pattern provides that Sally's widget-making machine has been assigned a 7-year class life by the IRS. Using the table found in § 168(e)(1), Sally determines that property with a class life of 7 years (right side of the table) is classified as 5-year property (left side of the table).

Armed with this information, Sally can now proceed to Step (4) and determine the property's "recovery period" under § 168(c). Under § 168(c)(1), 5-year property (left side of the table) is assigned (not surprisingly) a 5-year recovery period (right side of the table). Notice that property with a "class life" of 7 years does *not* have a "recovery period" of 7 years but rather 5 years.

For many of the years since 2001, though not all, Congress inserted an extra step in the analysis at this point under § 168(k), a provision typically referred to as "bonus depreciation." For 2016 and 2017, § 168(k)(1)(A) permits 50% of basis to be deducted *before* computing regular depreciation *if*, in general, the property has a recovery period of 20 years or less or is either depreciable computer software or certain improvements made by tenants to leased nonresidential property. Basis is then reduced under § 168(k)(1)(B) by the amount of bonus deprecation for purposes of computing "regular" depreciation for the first year. Unlike § 179, bonus depreciation has no caps or phaseout and thus is not limited to small businesses. The PATH Act extended bonus depreciation under § 168(k) at 50% for 2016 and 2017 only, however, and then phases it out in steps. The percentage amount of bonus depreciation will be 40% for 2018, 30% for 2019, and 0% in 2020 and thereafter. *See* § 168(k)(6). Because Sally purchased this equipment in 2017, Sally is able to deduct $95,000 of her $190,000 basis in the equipment in Year 1 under § 168(k)(1)(A),

reducing her basis under § 168(k)(1)(B) to $95,000 for purposes of computing regular depreciation for Year 1 and future years.

In Step (5), Sally learns that her equipment will be depreciated under § 168(b)(1) using the 200% declining balance method, switching to straight-line depreciation in the first year in which that method would provide a larger deduction. You need not know how the 200% declining balance method works, as the depreciation tables (described below) will do the work for you. For the geeks among you, though, the declining balance method means that a constant percentage (determined by the number of years in the recovery period) is multiplied by the declining adjusted basis of the property each year.

To illustrate, assume that Andrew will depreciate property with an initial basis of $100,000 over 5 years. The constant percentage that would apply against the property's adjusted basis would be 20%, as 20% reflects one-fifth of the recovery period. (If the property's recovery period were 10 years instead of 5 years, the constant percentage would be 10%.) Because Andrew's recovery period is 5 years, Andrew would deduct 20% of $100,000 (or $20,000) in Year 1 if he is entitled to a full year of depreciation in Year 1, reducing his basis to $80,000, 20% of $80,000 (or $16,000) in Year 2, reducing his basis to $64,000, 20% of $64,000 (or $12,800) in Year 3, and so on. Notice, therefore, that the declining balance method, under which deductions start higher and move lower over time, is much faster than economic depreciation, where the deductions start lower and move higher over time, as described in Part A.

The 200% declining balance method is even *better* though, as it *doubles* the percentage (the 200% reference) that would otherwise be multiplied against the property's declining adjusted basis each year. Thus, instead of deducting 20% of $100,000 ($20,000) in Year 1, Andrew deducts 40% of $100,000 ($40,000) in Year 1 if he is entitled to a full year of deprecation in that year, reducing his basis to $60,000, 40% of $60,000 ($24,000) in Year 2, reducing his basis to $36,000, and 40% of $36,000 ($14,400) in Year 3, reducing his basis to $21,600. If we continued to apply the 200% declining balance method to Year 4, he would deduct 40% of $21,600, or $8,640. Under § 168(b)(1), however, he would abandon the 200% declining balance method and switch to straight line (ratable deduction of remaining basis over the remaining years) in the first year in which that method would provide a higher deduction. If the $21,600 basis remaining at the end of Year 3 were deducted in equal amounts in Years 4 and 5, his Year-4 deduction would be $10,800, which is higher than $8,640. Thus, Andrew would switch to the straight-line method for Years 4 and 5.

But we cannot yet jump to applying the 200% declining balance method to Sally's facts without considering the half-year convention in Step (6). Under § 168(d)(1), Sally is assumed to place her equipment into service precisely in the middle of 2017 (rather than on May 18) so that the IRS can issue depreciation tables for easy taxpayer use (avoiding the need for taxpayers to calculate depreciation by hand). Absent this simplifying convention, Sally would have to determine her allowable depreciation for Year 1 by multiplying the depreciation deduction that would be allowable for the full year by a fraction, the numerator of which would be 228 (the number of days from May 18 to December 31, inclusive) and the denominator of which would be 365. The half-year convention in § 168(d)(1) avoids this tedium. Thus, Sally will deduct her remaining $95,000 basis (after applying §§ 179 and 168(k)) over 5 years, with a half year of depreciation in Year 1 (because she is deemed to place the property into service precisely in the middle of Year 1) and a half year of deprecation in Year 6 (completing the 5-year recovery period).

Armed with this information, Sally finds the correct table in Revenue Procedure 87-57,[12] which you can find online. Rev. Proc. 87-57 provides:

> Taxpayers use the appropriate table for any property based on the depreciation system, the applicable depreciation method, the applicable recovery period, and the applicable convention. *The tables list the percentage depreciation rates to be applied to the* ***unadjusted*** *basis of property in each taxable year.*

(Emphasis added.) In other words, taxpayers do not actually have to keep track of the property's declining adjusted basis over time, as Andrew did, above, in order to multiply it against the proper *constant* percentage under the declining balance method. Rather, to make life simple, the IRS has figured out the *declining percentage amount* that, when multiplied by the property's *unadjusted basis*, will arrive at the correct depreciation deduction for each year of the recovery period.

Table 1, below, incorporates the 200% declining balance method switching to straight line, as well as the half-year convention, for properties with recovery periods of 3, 5, 7, and 10 years.

| Recovery | Recovery Period: | | | |
|---|---|---|---|---|
| Year | 3-Year | 5-Year | 7-Year | 10-Year |
| 1 | 33.33 | 20.00 | 14.29 | 10.00 |
| 2 | 44.45 | 32.00 | 24.49 | 18.00 |
| 3 | 14.81 | 19.20 | 17.49 | 14.40 |
| 4 | 7.41 | 11.52 | 12.49 | 11.52 |
| 5 | | 11.52 | 8.93 | 9.22 |
| 6 | | 5.76 | 8.92 | 7.37 |
| 7 | | | 8.93 | 6.55 |
| 8 | | | 4.46 | 6.55 |
| 9 | | | | 6.56 |
| 10 | | | | 6.55 |
| 11 | | | | 3.28 |

The column under 5-Year Recovery Period provides the percentages of Sally's *unadjusted basis* (after applying §§ 179 and 168(k)) that she can deduct in each year of the recovery period. The percentage for Year 1 to multiply against Sally's $95,000 unadjusted basis is 20% (.20). Under the 200% declining balance method and a 5-year recovery period, Sally would be entitled to deduct 40% in Year 1 if she were entitled to a full year of deprecation in Year 1, but Table 1 properly incorporates the half-year convention, reducing the 40% figure to 20% *for Year 1 only*. Thus, Sally's regular deprecation deduction for Year 1 is $19,000 ($95,000 x .20). If we had to determine her Year-2 deduction without the table, we would have to reduce her $95,000 basis by the $19,000 deducted in Year 1 to reach $76,000 and then multiply that amount by 40% to reach $30,400. Table 1, however, allows us to avoid having to figure Sally's adjusted basis at this point. Rather, Sally simply multiplies her original $95,000 *unadjusted basis* (after applying §§ 179 and 168(k)) by 32%, the figure supplied for Year 2, and we reach the same $30,400 amount ($95,000 x .32). Similarly, Sally would deduct $18,240 in Year 3 ($95,000 x .1920). Notice the switch to straight-line depreciation in Year 4 of the table, as well as the half year of depreciation allowable in Year 6, completing the 5-year recovery period.

What if Sally sells the machine on February 3 of Year 3 for, say, $550,000 because it has lost

[12] 1987-2 C.B. 687.

$150,000 of value since her original purchase for $700,000? Before computing her § 1001 gain or loss, Sally must remember to take her Year-3 depreciation deduction. Even though Sally sells on February 3, under the half-year convention she is deemed to sell precisely in the middle of Year 3, meaning that she deducts one-half of the $18,240 depreciation deduction that she would otherwise have taken had she not sold, or $9,120. *While the half-year convention is incorporated into the Table for Year 1, the IRS cannot know when Sally may sell, so she must remember to apply the half-year convention herself in the sale year.*

Her A/B for purposes of § 1001 is equal to her original $700,000 outlay reduced under § 1016(a)(2) by *all* of the deductions taken under §§ 179 and 168 ($510,000 under § 179, $95,000 under § 168(k), and $19,000 regular depreciation under § 168(a) in Year 1, $30,400 in Year 2, and $9,120 in Year 3). That is to say, Sally's A/B at the time of sale in Year 3 is $36,480 ($700,000 *less* $663,520). Yes, in the 20 months (plus a few days) that Sally owns this property, she deducts nearly 95% of its original purchase price—almost cash-flow consumption tax treatment. Thus, her § 1001 realized gain is $513,520 ($550,000 A/R *less* $36,480 A/B). Even though her depreciation deductions were excessively generous in that they allowed her to deduct much more than the property's actual loss in FMV, the § 1016(a)(2) basis reductions ensure that gain (equal to the excess deprecation) will be realized if Sally sells the property rather than using it up in her business. Nevertheless, Sally is still better off because of the time value of money. With respect to the "character" of this gain (ordinary, capital, or § 1231 gain), stay tuned, as we shall turn to that issue in the very next chapter.

**While § 179 is explicitly elective, regular depreciation under § 168 is *not* elective.[13] To police the mandatory nature of § 168(a) depreciation, § 1016(a)(2) provides that Sally's basis will be reduced by depreciation deductions "allowed as deductions in computing taxable income … *but not less than the amount allowable*…."** (Emphasis added.) The amount "allowed" refers to the amounts that Sally actually deducted in Years 1, 2, and 3 under §§ 179 and 168. If Sally had taken only the § 179 deduction ($510,000) but had failed to deduct § 168 depreciation, her basis would nevertheless have been reduced to $36,480 for purposes of computing her § 1001 gain or loss on later sale. In this manner, Congress does not permit Sally to delay deductions if, say, she anticipates being in a much higher marginal rate bracket in the near future than in the current year so that she would save more in tax by deducting under the future higher marginal rates than she would lose because of the time value of money. In short, § 168 is mandatory.

***Real estate***

In contrast to Sally's business equipment, the depreciation of buildings is much more straightforward. Because a building is not § 1245 property, it is also not § 179 property within the meaning of § 179(d)(1), so no § 179 expensing is permitted. Moreover, because real property has recovery periods exceeding 20 years, such property is not eligible for § 168(k) bonus depreciation. Thus, only regular § 168(a) depreciation is allowable.

> **Sally purchases land and an apartment building that is rented to tenants for $1.1 million on May 18, 2017, $100,000 of which is allocable to the land. Because it is already rented to tenants, the building is placed into service simultaneously with her purchase date.**

[13] Unlike regular depreciation, § 168(k) bonus depreciation is elective, but the taxpayer is presumed to make the election to take bonus depreciation unless she expressly opts out. *See* § 168(k)(2)(D)(iii).

In Step (2), Sally can depreciate the entire $1 million basis allocable to the building (and none of the $100,000 allocable to the land). In Step (3), Sally determines that the property is classified as "residential rental property" within the meaning of § 168(e)(2)(A), rather than "nonresidential real property" within the meaning of § 168(e)(2)(B). In Step (4), Sally determines that the recovery period is 27.5 years under § 168(c), as opposed to the 39-year recovery period applicable to nonresidential real property. In Step (5), Sally must use the straight-line method of depreciation under § 168(b)(3), which means that her $1 million basis will be deducted in relatively equal amounts over each year of the 27.5-year recovery period, with the exception of the first and last years. In Step (6), the mid-month convention applies to real property, rather than the mid-year convention that applies to Sally's business equipment. Thus, Sally will be deemed to place her apartment building into service precisely in the middle of May (rather than on May 18).

Armed with this information, Sally finds the depreciation table in Rev. Proc. 87-57 that incorporates a 27.5-year recovery period, straight-line depreciation, and a mid-month convention, which is reproduced below.

**Month Placed In Service**

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year 1 | 3.485 | 3.182 | 2.879 | 2.576 | 2.273 | 1.970 | 1.667 | 1.364 | 1.061 | 0.758 | 0.455 | 0.152 |
| Years 2-9 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 |
| Years 10, 12, 14, 16, 18, 20, 22, 24, 26 | 3.637 | 3.637 | 3.637 | 3.637 | 3.637 | 3.637 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 |
| Years 11, 13, 15, 17, 19, 21, 23, 25, 27 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.637 | 3.637 | 3.637 | 3.637 | 3.637 | 3.637 |
| Year 28 | 1.97 | 2.273 | 2.576 | 2.879 | 3.182 | 3.485 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 | 3.636 |

Just as with her business equipment, the tables instruct Sally to multiply her $1 million *unadjusted basis* by the percentages listed under column 5 (May) for each year of her recovery period. Using this table, Sally multiplies her $1 million basis by 2.273% (.02273) and deducts $22,730 in Year 1 because that is the percentage listed under "5" for the 5th month of the year (May) for Year 1. Sally then deducts $36,360 or $36,370 (because of rounding) in each of Years 2 through 27. In Year 28, she deducts $31,820 ($1 million x .03182). The amounts in Years 1 and 28 differ from the other years because of both the mid-month convention for Year 1 (which means that Sally deducts 7.5 months of depreciation in Year 1) and, in Year 28, the remaining half year in the 27.5-year recovery period, coupled with the 4.5 months of depreciation not deducted in Year 1 under the mid-month convention.

What if Sally spends $150,000 on a new addition, which is placed into service on August 4 of Year 5? The new addition is a nondeductible capital expenditure, creating $150,000 of new basis that Sally can depreciate. Under § 168(i)(6), Sally does not *add* the $150,000 to her previous basis and depreciate it over the remaining 22 years or so of her recovery period for the original building. Rather, Sally starts depreciating the $150,000 of new basis over 27.5 years, using the mid-month convention and the straight-line method. Thus, Sally deducts $2,046 ($150,000 x .01364) in Year 1, as that is the Year-1 percentage in column 8 (for the 8th month), $5,454 ($150,000 x .03636) in

Year 2, the same amount in Year 3, and so on.

What if the property had been a factory (nonresidential real property), instead of an apartment building (residential rental property)? While Sally would still use straight-line depreciation and the mid-month convention, § 168(c) now requires Sally to depreciate the factory over 39 years instead of over 27.5 years. She finds the depreciation table that incorporates this longer recovery period, which is reproduced below.

**Month Placed In Service**

| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year 1 | 2.461 | 2.247 | 2.033 | 1.819 | 1.605 | 1.391 | 1.177 | 0.963 | 0.749 | 0.535 | 0.321 | 0.107 |
| Years 2-39 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 | 2.564 |
| Year 40 | 0.107 | 0.321 | 0.535 | 0.749 | 0.963 | 1.177 | 1.391 | 1.605 | 1.819 | 2.033 | 2.247 | 2.461 |

Prior to 1986, even real estate was depreciable using the declining balance method. One of the revenue-raising measures imposed in 1986 to pay for marginal rate reductions was straight-line depreciation for real estate. Recall, however, that deductions would start lower and increase over time under economic depreciation, so even straight-line depreciation is accelerated by comparison. Moreover, the recovery periods of 27.5 years and 39 years are shorter than the probable useful lives of many buildings.

***§ 280F limitations***

As noted earlier, both §§ 179 and 168 were first enacted in 1981, and together they operated to allow much higher deductions in the early years for non-real estate than had been previously allowed. After it became apparent both that many were using these provisions to purchase luxury cars instead of business equipment on the taxpayers' dime and that deficits were increasing, Congress enacted § 280F in The Deficit Reduction Act of 1984 to limit the use of §§ 179 and 168 in the case of luxury automobiles. Here is an excerpt from the legislative history.

> Congress believed that the investment incentives afforded by … accelerated cost recovery should be directed to encourage capital formation, rather than to subsidize the element of personal consumption associated with the use of very expensive automobiles. The transportation necessary for conducting a business can be obtained from a luxury car or another car. To the extent an automobile is required for this necessary transportation, the generally allowable tax benefits should be available. Beyond that point, however, the extra expense of a luxury automobile provides, in effect, a tax-free personal emolument which Congress believed should not qualify for … acceleration of depreciation deductions because such expenditures do not add significantly to the productivity which these incentives were designed to encourage.[14]

Although § 280F uses the words "luxury automobiles" in its title, note that the operative statutory language in § 280F(a) refers only to "passenger automobiles." Nevertheless, at the time it effectively applied mainly to luxury cars because of the numbers involved. The 1984 version of § 280F limited the amount that could be deducted in Year 1 under both §§ 179 and 168 to $4,000,

[14] JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, JCS-41-84 (Dec. 31, 1984) at 559-60, at www.jct.gov/publications.html?func=startdown&id=3343.

with no more than $6,000 deducted in subsequent years. The average price of a new car in 1984 was $6,294.[15] Thus, the new provision effectively applied mainly to luxury automobiles as a matter of course.

The amounts allowable in each year were reduced in subsequent amendments. Today, the maximum amount of §§ 179 and 168 deductions allowed under § 280F(a)(1)(A) appears to be $2,560 in Year 1, $4,100 in Year 2, $2,450 in Year 3, and $1,475 in each year thereafter, but these figures have been increased by inflation adjustments under § 280F(d)(7) for several years. For 2016 (the last year for which figures are available as this textbook goes to press), the applicable limits for passenger automobiles are: $3,160 in Year 1 (increased to $11,160 if § 168(k) bonus depreciation is taken), $5,100 in Year 2, $3,050 in Year 3, and $1,875 in each year thereafter if § 168.[16] The increase under § 168(k) will decrease as § 168(k) phases out. In 2018, the increase to Year-1 depreciation under § 280F because of § 168(k) will be $6,400 (instead of $8,000), and the increase will be $4,800 in 2019.

Absent § 280F, Mary's purchase of a passenger automobile (weighing less than 6,000 pounds) for $30,000 in 2017, which she uses exclusively in her business (keeping very good records establishing her exclusive business use), would result in a deduction of either the entire $30,000 as an "expense" under § 179 or, if Mary's other 2017 purchases of equipment phases her out of § 179, a deduction of $18,000 under § 168: 50% of her $30,000 basis under § 168(k) and 20% of her remaining $15,000 basis ($3,000) because automobiles have a class life and recovery period of 5 years under §§ 168(e)(3)(B)(i) and (c). Because § 280F applies to her passenger car, however, she can deduct no more than $11,160 in 2017 (if the 2017 figures are unchanged from 2016).

In addition, personal use of Mary's car results in a proportionate reduction of the amount allowable each year. If Mary uses the car for business purposes 60% of the time and for personal purposes 40% of the time, she can deduct only $6,696 in 2017 ($11,160 x .60).[17] If her business use falls below 50%, she is subject to additional restrictions.[18]

One of the more interesting stories about § 280F pertains to what is now commonly called the "SUV loophole." In 1984, Congress wanted to ensure that the new § 280F limits did not apply to heavier vehicles typically used for farming, construction, and other hauling work (such as in timber operations). Thus, it defined "passenger automobile" to exclude vehicles rated at more than "6,000 pounds unloaded gross vehicle weight."[19] In 1984, so-called sport utility vehicles (SUVs) were rare, and those that existed were not yet commonly used by members of the general public for everyday transportation. Today, of course, SUVs are ubiquitous. The end result is that environmentally conscious individuals who purchase a hybrid for business use are subject to the § 280F limits, whereas individuals who purchase an SUV for business use are subsidized with taxpayer dollars, so long as the SUV weighs enough. The industry heavily advertises this loophole, maintaining lists of SUVs that exceed the 6,000 pound threshold.[20] While bills are routinely introduced to overturn the SUV loophole in § 280F, none have been enacted, though § 179(b)(5) was enacted in 2004 to limit the § 179 deduction (for those eligible to take it) to $25,000 for SUVs

[15] *See* http://wiki.answers.com/Q/What_was_the_average_car_price_IN_1984?#slide=2.
[16] *See* Rev. Proc. 2016-23, 2016-16 I.R.B. 581.
[17] *See* § 280F(a)(2).
[18] *See* § 280F(b).
[19] *See* § 280F(d)(5).
[20] *See, e.g.*, www.alphaleasing.com/businessaspects/over6000gvwr.asp (web site containing list of 6,000 lb. SUVs).

not exceeding 14,000 pounds gross weight.

## D. Amortization of intangible assets

While § 168 applies only to tangible property, the legislative history described the § 167(a) standard for depreciable property generally. Recall the following passage from the legislative history when § 168 was enacted, which was quoted in Judge Hamblen's *Simon* dissent.

> Assets used in a trade or business or for the production of income are depreciable if they are subject to wear and tear, decay or decline from natural causes or obsolescence. *Assets that do not decline in value on a predictable basis or do not have a determinable useful life, such as land,* ***goodwill****, and stock, are not depreciable*.

(Emphasis added.)

The word "goodwill" in that passage generally refers to the value of a going business beyond the identifiable tangible and intangible assets (such as patents or licenses) of the business. If Frank is willing to pay, say, $20,000 to purchase a hot dog stand from Fannie, the excess of $20,000 over the value of the cart, umbrella, apron, transferable city licenses, hot dogs, buns, mustard, *etc.*, is the value of the goodwill purchased by Frank. It reflects the customer base already in place that frequents the hot dog stand, the stand's reputation for selling good hot dogs, the value of having trained employees in place (previously hired and trained by Fannie but retained by Frank) who know how to operate the stand when Frank is not present, *etc.* Fannie, who built the business from scratch, would likely have no basis in this goodwill because the outlays that she made to build that goodwill would typically have been deducted as ordinary and necessary business expenses under § 162. But *purchasers* of going concerns, such as Frank, can have a basis in goodwill equal to the portion of the $20,000 purchase price for the business as a whole that is properly allocable to the goodwill (under the rules of § 1060).

Until the enactment of § 197, described below, goodwill was one of those assets always used as an example of property that clearly was *not* depreciable or amortizable because it does not waste away on any predictable basis. Other types of intangible property have long been amortizable under § 167(a), so long as they had an ascertainable useful life, such as purchased patents, which have a life that will expire at a time certain under patent law. But purchased goodwill was not amortizable under § 167(a).

Taxpayers who purchased businesses in the 1980s and 1990s began to argue that *certain strands* of goodwill could be carved out and amortized because those particular strands had an ascertainable useful life. Bank purchasers, for example, attempted to amortize the basis attributable to the "core deposits" of the bank on the theory that depositors left their cash in bank accounts for predicable periods of time.[21] The taxpayer in *Newark Morning Ledger Co. v. United States*[22] bought a newspaper business in Newark, New Jersey, for approximately $328 million and argued that the one strand of goodwill represented by the current customer subscription base had an ascertainable useful life (even though the rest of the purchased goodwill did not) because it could be shown through statistical sampling how long the average current subscriber would remain a

[21] *See, e.g.*, Citizens & Southern Corp. v. Comm'r, 91 T.C. 463 (1988), *aff'd*, 919 F.2d 1492 (11th Cir. 1990).
[22] 507 U.S. 546 (1993).

subscriber. Thus, the taxpayer argued, the $67.8 million portion of the purchase price properly allocable to the current customer subscription base should be amortizable under § 167(a), notwithstanding the general rule that goodwill is not amortizable. The government chose not to challenge the quality of the taxpayer's statistical evidence regarding the duration of the paid subscribers but rather stressed that (1) the paid subscribers list was part of goodwill, (2) goodwill has no ascertainable useful life and thus is not amortizable, and (3) even if the paid subscriber list could be carved out from goodwill, it is a self-replenishing asset because new subscribers generally replace customers who drop their subscription. Over four dissents, however, the Supreme Court agreed with the taxpayer.

Only very wealthy taxpayers had the ability to commit the time and effort to the kind of exacting statistical techniques that are described in these cases when trying to show that one strand of overall goodwill had an ascertainable useful life. When these cases went to litigation, they consumed vast resources on the part of both the government and the taxpayer. Thus, Congress enacted § 197 in 1993 as a measure intended to level the playing field between wealthy taxpayers and small business taxpayers (like Frank) and to save litigation costs all around. Under § 197, purchased goodwill is now amortizable using the straight-line method over 15 years—regardless of whether it has an ascertainable useful life. Thus, the entire basis attributable to the purchased goodwill in *Newark Morning Ledger* (not limited to the $67.8 million allocable to the paid subscribers list) would have been amortizable under § 197 had it been in effect then.[23] In short, Congress chose simplicity over theoretical purity.

The definition of a "§ 197 intangible" is broad, including not only goodwill in general but also most of its constituent parts, such as going concern value, workforce in place, customer-based intangibles, licenses, permits, franchise, trademarks, covenants not to compete, and even the "core deposits" sought to be amortized by the bank buyer noted earlier.[24] Notable exceptions are listed in § 197(e), including items purchased separately and not part of a going business.[25] Thus, for example, if Janice purchases a patent (and nothing else) with a remaining life of 10 years, the patent is not amortizable under § 197, but she can amortize that patent under § 167(a) using the straight-line method over its remaining 10-year life. If, however, Janice purchases an entire business, one asset of which is a patent with a remaining life of 10 years, she must amortize that basis (along with the basis of the purchased goodwill generally) over 15 years because it is a § 197 intangible.[26] Whether amortizable under § 167(a) or § 197(a), intangible property is amortized using the straight-line method, starting on the first day of the month in which the intangible is placed in service.[27]

## E. Amortization of start-up costs

One of the § 162 requirements for deduction of business expenses is that they must be incurred in "carrying on" a trade or business. The carrying-on requirement generally means that even outlays that *otherwise qualify as "expenses"* (current wealth decreases) are not currently deductible if incurred *before* the business begins operation. Rather, these outlays must be

[23] *See* §§ 197(a) and (d)(1)(A).
[24] *See* § 197(d)(2)(B).
[25] *See* § 197(e)(4).
[26] *See* § 197(b) (providing that § 197 is the exclusive provision governing amortization of any § 197 intangible).
[27] *See* Treas. Reg. §§ 1.167(a)-3(b)(3); 1.197-2(f)(1).

capitalized in the basis of the new business as a whole. Absent § 195, this basis would usually be recovered only as an offset against amount realized under § 1001 when the business is eventually sold. Section 195, however, allows such start-up costs to be deducted sooner.[28]

How much sooner depends on how substantial they are. *See* § 195(b)(1). In the year the business opens, an electing taxpayer may deduct an amount equal to the *lesser* of (1) the aggregate start-up costs or (ii) $5,000 reduced (but not below zero) by the amount by which the start-up costs exceed $50,000. The remainder (if any) of the start-up costs is deductible ratably (*i.e.*, straight-line amortization) over the 180 months (15 years) beginning with the month in which the business begins. The amortization of the remainder (if any), in other words, is patterned after § 197.

Assume, for example, that Annie opens her new business on November 1 of Year 1. How much can she deduct in Years 1 and 2 if her aggregate start-up costs total $4,000? $54,500? $540,000?

If Annie's start-up costs total $4,000, she can deduct the entire $4,000 in Year 1, leaving no remainder to deduct in later years. If Annie's start-up costs total $54,500, she can deduct in Year 1 $500 ($5,000 *less* [$54,500 *less* $50,000] or $5,000 *less* $4,500) *plus* 2 months of amortization of the remaining $54,000, calculated at $300 per month ($54,000/180). Thus, she can deduct $1,100 in Year 1 and $3,600 in Year 2 ($300 x 12 months).

If Annie's start-up costs total $540,000, she can deduct 2 months of amortization of the $540,000, calculated at $3,000 per month ($540,000/12). Thus, she can deduct $6,000 in Year 1 and $36,000 in Year 2 ($3,000 x 12).

While the language in § 195 refers to a taxpayer election, the regulations deem the election to have been made unless the taxpayer affirmatively elects to capitalize the costs.[29] A taxpayer who is amortizing start-up costs under § 195 but disposes of the business before the 15-year amortization period expires can deduct the remaining basis as a loss under § 165.[30]

## F. Tax arbitrage: an interest deduction for debt-financed purchases of expensed (or nearly expensed) assets

As described above, depreciation is normative in a realization-based income tax (*i.e.*, necessary to measure the tax base properly) to the extent that it is allowed (1) only with respect to assets that predictably waste away over time and (2) at a rate no faster than economic depreciation. The portion of allowable depreciation (and § 179 deductions) in the Internal Revenue Code that exceeds these constraints is a tax expenditure—a provision that exists for nontax reasons, such as to encourage larger investments in business equipment than would otherwise occur. They are non-neutral by their nature, as they interfere with the market price of such assets, causing behavior changes that otherwise might not occur. Notice that these behavior changes may include a nudge toward investing in depreciable assets rather than labor, *i.e.*, hiring and jobs.

For example, if Caleb decides that his business is sufficiently profitable to allow either (1) the purchase of a new machine for $1 million that will last for 5 years or (2) the hiring of several additional employees at a cost of $1 million over 5 years, the tax expenditure components of §§

[28] Subchapters C (pertaining to corporations) and K (pertaining to partnerships) have similar rules for start-up costs incurred by businesses operated by those entities rather than by an individual. *See* §§ 248 and 709.
[29] *See* Treas. Reg. § 1.195-1(b).
[30] *See* § 195(b)(2).

179 and 168 may artificially tip the scale toward the equipment purchase rather than toward the hiring because employee salary can be deducted only as paid, while the equipment's depreciation deductions will not only be frontloaded but can also create tax-arbitrage profits if Caleb uses debt to purchase the equipment (described below). The extent to which behavior is actually influenced is difficult to measure as an empirical matter because we cannot conduct a study in which one set of businesses is limited to economic depreciation while the other is allowed the benefits of accelerated depreciation and § 179 so that we could, if we are able to mathematically control for other differences between the two sets of businesses, examine the difference in hiring between the two. Nevertheless, anecdotal evidence suggests that these tax expenditures may tip the scale toward capital investment at the expense of labor investment.[31]

Many economists would prefer Caleb to make his decision without this interference in the marketplace, as the price distortion can result in an inefficient allocation of resources. Other economists wish that we would replace the income tax with a consumption tax, so providing accelerated basis deduction, which can approach cash-flow consumption tax expensing, is a "distortion" that they like.

But the tax arbitrage that can result when interest is deducted (under the income tax rules for debt) with respect to debt used to purchase assets accorded consumption-tax-like treatment is an outcome that even those in the second camp do not support, as it provides *better* than consumption tax treatment. Under an income tax, borrowed principal is excluded from the tax base, repaid principal is not deducted, but business interest *is* deducted. Under a cash-flow consumption tax, in contrast, borrowed principal is included in the tax base (as potential consumption), and both repaid principal and interest are deductible (as non-consumption outlays). To avoid the messiness of including borrowed principal and deducting principal reapyments, the rules applicable to debt under a wage tax could be used, instead, as these two tax systems are (with caveats) economically equivalent. Under a wage tax, borrowed principal is not included and repaid principal is not deducted (as under an income tax) *but business interest is not deducted* (unlike under an income tax). Thus, to the extent that the Internal Revenue Code allows premature deduction of basis (as under a cash-flow consumption tax), it should disallow the interest deduction on debt used to purchase the property.

The tax arbitrage that results when a taxpayer uses debt to purchase assets that can be entirely expensed (under § 179) or depreciated at a rate faster than economic depreciation reflects inefficient rent in the sense described in Chapter 3—resulting in a mere transfer of wealth from taxpayers in general to the debt-financed equipment purchaser, rather than an increase in aggregate societal wealth. In this context, tax arbitrage, introduced in Chapter 2, is the mixing of the rules of one tax regime with the rules of another tax regime to achieve a result that is inconsistent with (and better than) both. The *combination* of allowing both (1) cash-flow consumption taxation of an investment (or nearly so) and (2) an interest deduction accompanying the purchase of that tax-preferred investment with debt can result in *better*-than-consumption-tax treatment. This tax arbitrage "profit" is not the result of entrepreneurial daring but the effective equivalent of a simple transfer payment from other taxpayers.

## Problems

[31] *See, e.g.*, Catherine Rampell, *Man v. Machine*, at http://economix.blogs.nytimes.com/2011/06/10/man-vs-machine (reporting that spending on equipment and software rose by 25.6% while spending on labor rose by only 2.2% during the seven quarters of the recovery that began in June 2009).

In each problem, describe how much Fiona (or Frank, as the case may be) can deduct in each of Years 1, 2, and 3. For ease of calculation, you can ignore the inflation adjustments to the figures in § 179(b). That is to say, you can assume that the § 179 expense limit is $500,000 and that the phaseout threshold is $2 million.

**1.** On January 20, Year 1, Fiona purchases a personal residence for $400,000.

**2.** On March 4, Year 1, Fiona purchases shares of High Tech stock for $400,000.

**3.** On September 24, Year 1, Fiona purchases a desk once used by Louis XIV for $400,000. She uses it as her factory office desk (see **4**.)

**4.** On August 2, Year 1, Fiona purchases land and a factory building for $1.2 million in which she will produce widgets, with $200,000 allocable to the land and $1 million allocable to the building. The factory is already in service.

**5.** Same as **4.**, except that Fiona spends $100,000 on a significant addition to the building, which is placed in service on September 2, Year 2.

**6.** On May 12, Year 1, Fiona purchases a widget-making machine for use in her factory for $1.5 million, which she places into service immediately. The IRS has assigned a class life of 7 years to the machine. Fiona will purchase the machine with borrowed money, paying market-rate interest.

**7.** Same as **6.**, except that the machine cost $3 million.

**8.** Same as **7.**, except that Fiona sells the machine on August 18 of Year 3 to Frank for $2.5 million.

**9.** On September 4, Year 1, Frank purchases a Cadillac CTS (a passenger car) for $35,000, which he uses exclusively in his business. The car is the only new business property that Frank purchases this year.

**10.** Same as **10.**, except that Frank buys a Buick Enclave SUV, instead, for $35,000.

**11.** On January 8, Year 1, Frank purchases a secret formula owned by Fiona but no longer used by her for use in his own business, paying $15,000 and placing it into service on the same date.

# Chapter 15: Capital Gains and Losses

In Chapter 13, you learned that the first step in analyzing the tax consequences of a property disposition is to determine the realized gain or loss under § 1001 (the difference between amount realized and adjusted basis). The second step is to determine whether the realized gain is includable in Gross Income under § 61(a)(3) or realized loss is deductible under § 165. Only if the gain is includable or the loss is deductible is it necessary to go on to the third step: characterizing the includable gain or deductible loss as ordinary, capital, or § 1231 gain or loss (and determining why that characterization matters). This chapter explores that third step in more detail.

A gain or loss is "capital" if described in § 1222(1) through (4). The common ingredients found in each of those four subsections provide that an otherwise includable § 1001 gain or otherwise deductible § 1001 loss (under § 165) is "capital" only if the gain or loss arises from the "sale or exchange" of a "capital asset." Section 1221 defines "capital asset." Moreover, those subsections also confirm that an includable capital gain or deductible capital loss is short term if the property sold or exchanged was held for one year or less and long term if held for more than one year.

You were introduced in Chapter 1 to the two most important consequences that arise when a gain or loss is characterized as "capital" because they had immediate relevance to many topics already explored.

- Otherwise deductible (under § 165) capital losses are treated less favorably than deductible ordinary losses because only the former are subject to the § 1211(b) capital loss limitation rule (cross-referenced in § 165(f)).
- "Net capital gain," as defined in § 1222(11), is treated more favorably than ordinary income and gain because it is taxed at a preferential rate under § 1(h) when realized by individuals.[1]

Part A. examines the § 1211(b) capital loss limitation (and the § 1212(b) carryover rule) more closely. Part B. explores the asserted rationales for a tax preference for net capital gain, the definition of net capital gain, and the planning possibilities implied by that definition. Part C considers the § 1221 definition of "capital asset," including the *Arrowsmith* doctrine, as well as the sale or exchange requirement. Part D. considers the treatment of § 1231 gains and losses, as well as so-called depreciation recapture under §§ 1245 and 1250. Finally, Part E. briefly describes the various special rates applicable to net capital gain found in § 1(h).

## A. Capital losses

A taxpayer who realizes more capital losses than capital gains in a given year cannot have any hope of preferentially taxed "net capital gain" within the meaning of § 1222(11). The only question at issue in this scenario is the extent to which the capital losses are deductible.

Section 165(f) reminds us that an otherwise deductible § 1001 loss—*i.e.*, a loss described in §

[1] The rate schedule for corporations is found in § 11, which has no counterpart to § 1(h). Thus, the net capital gain realized by corporations is not subject to a reduced tax rate. Corporations are nevertheless subject to the deduction restriction (and carryover) for capital losses, though these rules differ from those applied to individuals. *See* §§ 1211(a) and 1212(a).

165(c) in the case of an individual—is subject to limitation under § 1211 if the deductible loss is "capital" in nature. **Under the language in § 1211(b), the aggregate of otherwise deductible capital losses (whether long term or short term) is allowed in the year realized *only* to the extent of the sum of (1) the aggregate of realized and included capital gains (whether long term or short term) and (2) up to $3,000 of included ordinary income. Any excess (undeducted) capital loss is carried forward and treated as realized in each succeeding taxable year under § 1212(b) until either the loss is deducted or the taxpayer dies.**[2]

Section 1211(b) is needed so long as the law incorporates both the realization requirement (as opposed to a mark-to-market system, described in Chapter 1) and a preferential rate for net capital gain. It addresses the cherry-picking problem that would, in the absence of § 1211, otherwise allow a taxpayer (1) to deduct what looks like a wealth decrease when in fact the taxpayer is wealthier or (2) to engage in rate arbitrage by using capital losses to offset high-taxed ordinary income instead of low-taxed capital gain.

To illustrate, assume that Lindsey, who earns $100,000 in wages each year, purchases both Whiteacre and Blackacre for investment on January 1 of Year 1. By December 31 of Year 1, Whiteacre has increased in value by $10,000, and Blackacre has decreased in value by $8,000. If the realization requirement were abolished and Lindsey had to mark to market both Whiteacre and Blackacre each year, she would include the $10,000 Whiteacre gain in her Gross Income (and increase her Whiteacre basis by $10,000) and deduct the $8,000 Blackacre loss (and reduce her Blackacre basis by $8,000), accurately reflecting her $2,000 net wealth increase for the year. Because of the realization requirement, however, Lindsey has the power to choose when (and if) to realize the Whiteacre gain and the Blackacre loss. Absent § 1211(b), Lindsey could choose to realize and deduct only the $8,000 Blackacre loss (and not the $10,000 Whiteacre unrealized gain) in Year 1, making it appear that she has suffered an $8,000 wealth reduction when, in fact, she has actually enjoyed an *economic* net wealth *increase* of $2,000 for the year when both Blackacre and Whiteacre are considered together. Moreover, absent § 1211(b), Lindsey could use that $8,000 deduction to offset $8,000 of her high-taxed wages, saving the $10,000 of capital gain to be taxed at the low net capital gain rate in, say, Year 3 (a year in which she realizes no capital losses) by waiting to sell Whiteacre until then.

In essence, § 1211(b) forces Lindsey to sell *both* Whiteacre and Blackacre if she wishes to fully deduct the $8,000 Blackacre loss in Year 1. If Lindsey sells only Blackacre in Year 1 and realizes no capital gain, she can deduct only $3,000 of her $8,000 realized loss and must carry forward the remaining $5,000 undeducted loss under § 1212(b). If Lindsey again fails to sell Whiteacre in Years 2 and 3, she could deduct only $3,000 of her $5,000 carryover loss in Year 2, carrying the remaining $2,000 loss to Year 3, when she could finally deduct it. The $3,000 in capital losses that Lindsey is permitted to deduct in excess of her realized and included capital gains each year is nothing more than a *de minimis* rule intended to allow individuals like Lindsey to deduct small capital losses without the bother of carrying them to future years. Nevertheless, the $3,000 *de minimis* rule is valuable for Lindsey, as it allows capital losses to offset high-taxed income. (More on tax planning possibilities in Part B., below.)

[2] Unused deductions at the time of a decedent's death, including capital loss carryovers, cannot be transferred to the decedent's heirs for their use. Recall from Chapter 7 that, as described by Henry Simons, an income tax is not a tax on income *per se* but rather is a tax imposed on *people*—as measured by *their* wealth accessions and wealth reductions (representing *their* ability to pay). Do not feel too sorry for the heirs for being unable to deduct wealth decreases suffered by others, however. Remember §§ 102 and 1014, which benefit heirs mightily.

How does Lindsey know whether any capital loss carryover should be treated as a long-term capital loss or as a short-term capital loss in any future carryover year? While its nature as a long-term loss or short-term loss is irrelevant under § 1211(b) in determining the deductibility of capital losses, this determination might have an impact on possible "net capital gain" in the future year to which she carries the loss. Thus, Lindsey needs to know whether any carryover loss under § 1212(b) is to be considered short term or long term in future years.

As I have made clear many times before, I think that it is important for students to become comfortable with pulling apart statutory language and figuring out what it means, which is why I have always encouraged you to do so with respect to the relevant statutory language under study. Every rule has its exceptions, however, and I do not think it is worth the trouble in connection with § 1212(b). You can take my word for it that I am accurately describing here the mechanics of § 1212(b).

**To determine the nature of a capital loss carryover as short term or long term under § 1212(b), the taxpayer must net together any long-term capital gains and long-term capital losses in the realization year and do the same with short-term capital gains and short-term capital losses. The taxpayer's capital loss carryover maintains the same character (as long term or short term) as the taxpayer's *net* loss position in the realization year.**

For example, assume that Lindsey, who earns $100,000 in wages each year, realizes the following includable gains and deductible losses (under § 165(c)) in Year 1:

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $13,000 | $12,000 | $3,000 | $10,000 |

Because Lindsey realizes more capital losses ($22,000) than capital gains ($16,000), she has no hope of any preferentially taxed "net capital gain." Her only questions are (1) the extent to which she can deduct her capital losses under § 1211(b) and (2) the character of any capital loss carryover under § 1212(b). The answer to the first question is that she can deduct $19,000 of her $22,000 in aggregate capital losses, equal to the $16,000 in realized and included capital gains *plus* $3,000. She must carry forward the remaining $3,000 of her otherwise deductible capital losses to Year 2 under § 1212(b). Moreover, because she realizes a $1,000 net long-term capital *gain* ($13,000 long-term capital gain *less* $12,000 long-term capital loss) and a $7,000 net short-term capital *loss* ($10,000 short-term capital loss *less* $3,000 short-term capital gain) in Year 1, her $3,000 capital loss carryover is treated as a short-term capital loss in Year 2 (the same as her net loss position in the realization year).

What if Lindsey realizes a net loss in *both* her long-term and short-term columns? For example, assume the same facts except that Lindsay realizes a $14,000 long-term capital loss instead of a $12,000 long-term capital loss in Year 1.

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $13,000 | $14,000 | $3,000 | $10,000 |

As in the prior iteration, Lindsey can deduct $19,000 of her aggregate capital losses, equal to the $16,000 in realized and included capital gains *plus* $3,000. She now has a $5,000 carryover loss under § 1212(b), however, instead of a $3,000 carryover loss. In Year 1, Lindsey realized a $1,000 net long-term capital *loss* ($14,000 long-term capital loss *less* $13,000 long-term capital gain) and a $7,000 net short-term capital *loss* ($10,000 short-term capital loss *less* $3,000 short-term capital

gain). **The convoluted language in § 1212(b) provides that, when a taxpayer has both a net long-term capital loss and net short-term capital loss in the realization year, the carryover loss is deemed to come *first* from the net long-term pot (to the extent thereof) and, if necessary, from the net short-term pot.** Thus, the first $1,000 of Lindsey's $5,000 carryover loss is treated as long-term capital loss in Year 2 (equal to her $1,000 net long-term capital loss in Year 1), with the remaining $4,000 treated as a short-term capital loss in Year 2. Lindsey would again apply §§ 1211(b) to determine how much of these Year-2 losses (in addition to any other capital losses actually realized in Year 2) could be deducted.

**Problem**

Jacob earns $100,000 in wages each year. In addition, he realizes and recognizes the capital gains and losses listed below in each year. Each of the realized and recognized capital losses are otherwise deductible under § 165(c). Describe how §§ 1211(b) and 1212(b) apply to Jacob in each year.

| | long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|---|
| **Year 1** | $5,000 | $0 | $2,000 | $10,000 |
| **Year 2** | 0 | 6,000 | 3,000 | 2,000 |
| **Year 3** | 4,000 | 5,000 | 1,000 | 5,000 |

## B. Net capital gain

If capital gains exceed capital losses for the year, the taxpayer has a chance (though not the certainty) of having preferentially taxed "net capital gain." The extent of the tax preference for net capital gain has varied widely over time, as shown in the chart below.[3]


As illustrated above, there was no preference before 1922 and between 1987 and 1990. In the 1920s and early 1930s, and again since 1990, the top net capital gain rate was separately stated. Between the mid-1930s and 1986, no separate statutory rate was stated, but only a percentage of capital gains was included in the tax base, effectively reducing the tax rate that applied. Since

[3] The chart is from Roberton Williams, *Tax Rates on Capital Gains*, 124 TAX NOTES 251 (2012). Reprinted with permission of Tax Analysts.

WWII, when the income tax moved from a class tax to a mass tax, the maximum capital gains tax rate has fluctuated in fairly significant ways—from 25% in the 1950s and 1960s to 35% in the 1970s (when the highest marginal rate on ordinary income was 91% and 70%, respectively) to 20% immediately before the Tax Reform Act of 1986 (when the highest marginal rate on ordinary income was 50%).[4] As you read in Chapter 3, the 1986 Act *increased* the rate applicable to net capital gain from 20% to 28% and *reduced* the highest marginal rate on ordinary income and gain from 50% to 28% so that net capital gain was no longer taxed at a preferential rate beginning in 1987. That state of affairs lasted only three years, however. When the highest marginal rate on ordinary income and gain was raised from 28% to 31% in the George H.W. Bush administration, the 28% rate applicable to net capital gain remained unchanged, thus re-introducing a modest rate differential once again. During the Clinton administration, the top rate on ordinary income increased to 39.6% while the top rate applicable to most net capital gain was reduced to 20%. During the George W. Bush administration, the top ordinary rate was reduced to 35%, and the top net capital gain rate was generally reduced to 15% (and extended to certain dividend income).

The American Taxpayer Relief Act of 2012 restored the highest marginal rate on ordinary income and gain to 39.6% and restored the 20% net capital gain rate for such gain within Taxable Income exceeding $400,000 ($450,000 for married couples filing jointly). Net capital gain within Taxable Income below those thresholds remains generally at 15%. As you learned in Chapter 1, Part B., however, most net capital gain is concentrated in high-income households.

***Why is net capital gain taxed at a preferential rate?***

The first issue in considering this question is to ask why net capital gain should be taxed more lightly than labor income. Prior to the first Reagan-era tax legislation enacted in 1981, the highest marginal rate on ordinary income *other* than labor income was 70%, but labor income was subject to a maximum marginal rate of 50%. This preference meant that labor income could be taxed more lightly than capital income *other* than net capital gain, such as interest, rents, royalties, and dividends. The now-repealed preferential rate for labor income may have had its roots in notions that labor income not only preceded capital income but was more fleeting in nature.

For example, President Abraham Lincoln's State of the Union address on December 3, 1861, contained the following passage: "Labor is prior to and independent of capital. Capital is only the fruit of labor, and could never have existed if labor had not first existed. Labor is the superior of capital, and deserves much the higher consideration."[5] Even the extremely wealthy Treasury Secretary Andrew W. Mellon, no knee-jerk liberal,[6] argued in the 1920s that earned income ought

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[4] The mechanism used prior to 1986 to effectuate the reduced capital gains tax rate was to allow exclusion of 60% of realized net long-term capital gains (the excess of long-term capital gains over long-term capital losses). With a top tax rate of 50%, the 60% exclusion resulted in an effective maximum capital gains tax rate of 20% (40% includable amount of net long-term capital gains x .50 maximum tax rate). Congress replaced the exclusion method in 1986 with § 1(h), specifying tax rates for various types of net capital gain, explored in Part E., below.

[5] *See* www.infoplease.com/t/hist/state-of-the-union/73.html.

[6] For example, Al Gore, Sr., criticized the post-WWII income tax rate decreases proposed by Republicans as "right out of the Andrew Mellon primer on special privilege." JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 132 (1985). Professor Michael Graetz refers to William Simon—President Ford's Treasury Secretary—as "probably the most conservative Treasury Secretary since Andrew Mellon." MICHAEL GRAETZ, THE DECLINE (AND FALL?) OF THE INCOME TAX 225 (1997). Mellon was the first to argue adamantly in the political arena for supply-side reductions of high marginal rates on the wealthy as the "scientific" way to raise revenue through a growing economy. He analogized the "right" tax rate to the right "price" charged by a business to maximize overall profit. *See* ANDREW W. MELLON, TAXATION: THE PEOPLE'S BUSINESS 93-107 (1924).

to be more lightly taxed than capital income.

> The fairness of taxing more lightly incomes from wages, salaries and professional services than the incomes from business or from investments is beyond question. In the first case, the income is uncertain and limited in duration; sickness or death destroys it and old age diminishes it. In the other, the source of the income continues; the income may be disposed of during a man's life and it descends to his heirs.
>
> Surely we can afford to make a distinction between the people whose only capital is their mental and physical energy, and the people whose income is derived from investments. Such a distinction would mean much to millions of American workers and would be an added inspiration to the man who must provide a competence during his few productive years to care for himself and his family when his earning capacity is at an end.[7]

Similarly, E.R.A. Seligman of Columbia University, an influential early scholar on income taxation, also supported "differentiating between earned and unearned income, on the grounds that unearned income is a reliable symptom of greater freedom to choose how the income will be used."[8]

A tax credit equal to a portion of earned income was thus introduced in 1924. While it waxed and waned over the years, the idea was reinvigorated in 1969, when the top rate for earned income was capped at 50%, while the top rate for other (capital) income was 70%. As noted above, this preferential tax rate was repealed in the first Reagan tax legislation in 1981, when the top rate on capital income (other than net capital gain) was also reduced to 50% without further reduction in the maximum rate applicable to labor income.

A second issue when considering the rate preference for net capital gain is to ask why net capital gain should be taxed more lightly than other forms of capital income, such as interest, rents, and royalties. The early reasoning was likely connected to doubts about whether capital appreciation constituted "income" at all under early notions of that term borrowed from trust accounting, as described in Chapter 1. Recall the example provided there. Father died 200 years ago. In his will he directed that all of his land, rented to tenant farmers, be contributed to a trust. The trust document instructed the trustee (who managed the trust property) to distribute the "income" from the trust annually to his surviving wife for the rest of her life (a life estate), with the "remainder" distributed to his son on his wife's death. Upon his wife's demise, the trust would distribute the land to the son, and the trust (which would no longer own any property) would be dissolved.

Under trust law at the time, rent collected from the tenant farmers was "income" that was distributed to the wife annually. If, however, the trustee decided to sell a plot of land for $100 that had been purchased by Father before his death for, say, $75, the $25 profit from that sale was not considered "income" to be distributed to the wife but rather part of the trust "corpus," which was eventually distributed to the son under his remainder interest. Does that mean that the $25 profit should not constitute "income" for *tax* purposes, as well? Early on, some argued that it did. The lower tax rate first imposed on such "capital gain" in the early 1920s can be viewed as a compromise between the position that property gain did not constitute "income" at all and the

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[7] MELLON, *supra* note 6, at 56-58.
[8] Stephen Utz, *Ability to Pay*, 23 WHITTIER L. REV. 867, 913 (2002).

position that such gain is income in the same sense as other forms of realized wealth accessions.

After George Schanz, Robert Haig, and Henry Simons succeeded in developing a tax-specific meaning of the term "income" that would encompass all wealth accessions, including capital appreciation, other reasons were developed over time (particularly by those who benefited from it) to maintain the preference. Economist and Professor Leonard E. Burman has written extensively on the topic,[9] and he provided a concise and effective summary of those reasons (and responses to them) in testimony to both the House Ways and Means Committee and the Senate Finance Committee on September 20, 2012,[10] concluding:

> To summarize, while targeted relief from capital gains tax may be warranted for some corporate stock, the current blanket income tax preference for capital gains is very poorly targeted and, on balance, may do more harm than good to the economy. The capital gains preference also creates gross inequities, significantly undermining the progressivity of the income tax.
>
> Capital gains reform was the lynchpin of the 1986 reform and several recent bipartisan reform proposals. It could be an important element of the next tax reform. The best option, in my view, would be to tax capital gains as ordinary income and use the revenue gained to lower individual and corporate income tax rates. Reform might also tackle the largest capital gains tax loophole—the non-taxation of capital gains held until death. Mitigating this loophole could substantially reduce the lock-in effect and help protect the capital gains tax base.[11]

There is no doubt that the capital gains preference undermines the progressivity of the income tax. Recall the data in Chapter 1, Part B., which showed how the concentration of capital gains in the very highest income households results in lower effective tax rates for the very wealthy than for the merely wealthy. "In 2010, the highest-income 20 percent realized more than 90 percent of long-term capital gains according to the Tax Policy Center…. The top 1 percent realized almost 70 percent of gains and the richest 1 in 1,000 households accrued about 47 percent. It is hard to think of another form of income that is more concentrated by income."[12] Only 1.1% of the tax preference accorded to net capital gain and qualified dividends is enjoyed by taxpayers in the bottom 60%.[13]

The preferential rate also significantly complicates the Code and encourages tax-motivated transactions that seek to transform high-taxed ordinary income into low-taxed net capital gain. Examples include tax shelters (described in Chapter 16) that seek ordinary deductions through depreciation, interest, and depletion that offset high-taxed income but that are essentially recouped through low-taxed capital gain on later sale of the shelter, as well as the transformation of high-taxed compensation income into low-taxed capital gain through "carried interest" arrangements or

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[9] *See, e.g.*, LEONARD E. BURMAN, THE LABYRINTH OF CAPITAL GAINS AND TAX POLICY (1999).

[10] *See* STATEMENT OF LEONARD E. BURMAN BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS AND THE SENATE COMMITTEE ON FINANCE , TAX REFORM AND THE TAX TREATMENT OF CAPITAL GAINS, at www.finance.senate.gov/imo/media/doc/092012%20Burman%20Testimony.pdf [hereinafter Burman, TESTIMONY].

[11] *Id.* at 3.

[12] *Id.* at 5.

[13] *See* Annie Lowrey, *Tax Credits or Spending? Labels. But in Congress, Fighting Words*, N.Y. TIMES, March 18, 2013, at A1 and at www.nytimes.com/2013/03/18/business/economy/taxes-or-spending-budget-fight-in-congress-focuses-on-a-distinction.html?_r=0 (accompanying chart).

founders stock, the appreciation on which represents a return on labor income.

> [W]hen capital gains are taxed at much lower rates than other income, the tax code needs complex rules to delimit the boundary between capital gains and other income. In addition, complex anti-tax shelter provisions, such as the passive loss rule, limitations on the deductibility of interest, and a host of other provisions are necessary to deter abuse. Tax lawyers have told me that half the Internal Revenue Code is devoted to defining the difference between capital gains and ordinary income. If capital gains were taxed as ordinary income, much of that complexity could be eliminated.[14]

The most common modern-day rationales forwarded for a tax preference for net capital gain are discussed below.

***The double tax argument regarding capital returns***

Those reading the subheading above might think that I am going to talk chiefly about shares of corporate stock as capital assets and the double taxation that can occur if income earned by a corporation is taxed *both* to the corporation under § 11 *and* to the owners of the corporation's stock when those profits are realized by the shareholders through the receipt of dividends or by sale of the stock reflecting retained corporate earnings.[15] But I am not. The net capital gain rate preference is not limited to shares of corporate stock but rather extends to all "capital assets," as defined in § 1221 (explored in Part C.), which includes such items as real estate, collectibles, patents, jewelry, gold and other precious minerals, *etc.*, so long as these assets are held by nondealers. In 2007, for example, "only 30 percent of long-term capital gains were on corporate stock or mutual funds…. [I]t's likely that most capital gains are from other sources."[16] Indeed, the net capital gain rate reduction does not apply to withdrawals from pension plans, § 401(k) accounts, and IRAs owning stock, and most stock owned by average taxpayers below the top 1% are owned through such accounts.

Rather, this "double tax" argument is different. In Chapter 2, you learned that a common way to describe how the market arrives at the fair market value (FMV) of an asset is to say that FMV is the market's best guess at the present, discounted value of the future stream of payments expected to be generated by that asset. Thus, for example, the FMV of a plot of land that is rented to tenant farmers may be calculated by discounting to present value the anticipated future stream of rental payments expected to be paid by the tenant farmers to the land's owner, coupled with the present value of the future sales proceeds, including the anticipated future appreciation in the land. Let's say that the market's best guess of this figure is $10,000, so Brenda is able to purchase the land for $10,000 from its current owner in Year 1. If Brenda is prevented from immediately deducting that $10,000 purchase cost (as she is under an income tax because the outlay is a nondeductible capital expenditure), some argue that she is doubly taxed on that same $10,000 if

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[14] Burman, TESTIMONY, *supra* note 10, at 6-7.

[15] Subchapter C of the Internal Revenue Code, studied in a course exploring the taxation of business enterprises, is nominally a double tax system in that corporate profits may be taxed under § 11 at the corporation level when earned and then, when the after-tax profits are distributed as nondeductible dividends, to the shareholders under §§ 61(a)(7), 301(c)(1), and 316. In reality, however, a significant proportion of corporate-earned income is not doubly taxed. First, more than half of Subchapter C corporate stock is owned by tax-exempt shareholders, such as IRAs, pension plans, § 401(k) plans, and foreign investors. Second, much corporate income escapes tax at the corporation level through various mechanisms, including corporate tax expenditures and the international tax provisions.

[16] Burman, TESTIMONY, *supra* note 10, at 10.

she is required to include the rents when received from the tenant farmers or the appreciation in value that she realizes if she is able to sell the land for more than $10,000, as both the rents and the appreciation were (or so the argument goes) effectively taxed to her previously when she was denied a deduction of the $10,000 purchase cost.

In Chapters 2 and 3, you also studied rejoinders to this argument. More to the point for purposes of this chapter, the "double tax" argument—even if you are persuaded by it—does not support a reduced tax rate on capital gain but rather complete exemption of tax on *all* capital returns: capital gain, interest, rents, royalties, *etc.* That is to say, the "double tax" argument is relied on chiefly by consumption tax proponents who support either a wage tax on labor income only (explicitly exempting capital returns from tax) or a cash-flow consumption tax.[17] In short, a tax preference for only one form of capital return (capital gain) cannot be defended using the double tax argument.

***Lock-in effect***

Some argue that the preferential taxation of net capital gain can be defended as reducing the so-called lock-in effect that arises because of the realization requirement. The argument is that owners of appreciated property will hold on to it, rather than sell it to a new user who could operate the property more efficiently, to avoid the tax that would accompany the sale, thus reducing overall economic efficiency and aggregate societal wealth. Reducing the tax applicable to the gain thus reduces the lock-in effect by encouraging sales that would otherwise not occur to those who would put the property to a higher and better use, contributing to a more efficient economy.

The rejoinders to this argument are several. First, even if the lock-in effect is real and significant, the argument that a new owner could use the property more efficiently than the current holder (thus increasing aggregate societal wealth) could conceivably apply only to a narrow range of unique capital assets, including certain tracts of land, patents, or the assets of a small business. Many capital assets, such as corporate stock, works of art, or antiques and collectibles are simply passive investment assets.

Second, empirical data finds little evidence that the overall realization response is significantly affected by the net capital gain rate. Evidence does show that short-term decisions regarding the timing of a *planned* sale can be affected by scheduled *changes* in the rate (with increased sales, for example, in late 1986 before the net capital gains rate was scheduled to increase from 20% to 28% on January 1, 1987) but that the overall realization response reverts to a fairly constant norm over time.[18]

Finally, § 1014 (the tax-free step up in property basis at death, studied in Chapter 7) is far more responsible for any lock-in effect that does exist. If policymakers are concerned that owners are not selling property to higher and better users, making death a realization event (as in Canada), imposing a carryover basis on property passed at death, or expanding mark-to-market taxation to easily valued property would go much farther in ameliorating the lock-in effect than does a

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[17] As you learned in Chapter 2, a cash-flow consumption tax—under which non-consumption outlays are immediately deducted (even if they would constitute nondeductible capital expenditures under income tax principles) and 100% of the returns are included in the tax base—can reach the same end result as a tax that reaches only labor returns and explicitly exempts the normal capital return (though it would reach the "supranormal return," which is never taxed under the wage tax paradigm).

[18] *See, e.g.*, Alan J. Auerbach, et al., *Capital Gains Taxation and Tax Avoidance: New Evidence from Panel Data*, in DOES ATLAS SHRUG: THE ECONOMIC CONSEQUENCES OF TAXING THE RICH at 355 (Joel B. Slemrod ed. 2000) [hereinafter ATLAS]; Jane Gravelle, *Commentary on Chapter 11*, in ATLAS, *supra*, at 389.

preferential net capital gain rate during life, as indicated in Professor Burman's earlier quoted comment.

***Inflation gain***

The net capital gain rate preference is often defended on the ground that the gain reflects in part merely the effects of inflation and not a real increase in inflation-adjusted wealth. A reduced tax rate compensates for the fact that gain is measured in nominal rather than inflation-adjusted dollars.

Inflation adjustments are incorporated into many parts of the Internal Revenue Code. The floors and ceilings of each rate bracket found in § 1, for example, are increased each year to reflect inflation so that an increase in income will not fall into a higher tax bracket if the increase merely reflects, say, a raise matching the increase in the consumer price index rather than a real increase in purchasing power. Similarly, the Standard Deduction, the Personal Exemption and Dependent Deduction, and many tax expenditure credits and deductions (as well as phase-out floors pertaining to those credits and deductions) are indexed for inflation. But *basis* (whether pertaining to Blackacre, a savings account, or any other debt instrument) is not indexed for inflation. Thus, a portion of any includable capital return (whether in the form of gain, interest, rent, *etc.*) may not actually represent an increase in inflation-adjusted wealth, though it is treated as a wealth increase for income tax purposes. The higher the inflation rate and the longer the asset is held, the greater the inflation gain problem. If inflation is low and an asset is not held for a long period of time, the problem of inflation gain is reduced. For this reason, some argue that a reduced net capital gain rate should apply only to long-held assets (say, a 5-year holding period? 10 years?), but notice that allowing only long-held assets to enjoy a rate reduction would exacerbate the lock-in effect—discouraging sales in the short term to more efficient users—if lock-in is, in fact, a serious problem.

To illustrate the inflation problem, let's assume that Parker deposits $10,000 in a savings account at National Bank on January 1 of Year 1 and that the account terms entitle Parker to receive 2% interest each year. Parker is a "lender" to National Bank, who is borrowing Parker's money to use in its business of lending to others (for, say, a home loan). On January 2 of Year 2, Parker withdraws the $10,000 principal (a tax-free recovery of basis), as well as the $200 interest, and spends the $10,200 on a lovely trip to London and Paris. (I'm jealous.) Under § 61(a)(4), Parker must include in his Year-1 Gross Income the $200 interest, even if inflation for Year 1 is also 2% so that his inflation-adjusted wealth remains unchanged between January 1 of Year 1 and January 2 of Year 2 when he withdraws the $10,200 principal and interest. Indeed, because Parker's interest is deemed realized as it accrues, Parker must include the $200 Year-1 interest even if he fails to withdraw it in Year 2 but rather leaves it in the account to earn further interest.

Similarly, assume that Parker purchases Blackacre (a capital asset in his hands) on January 1 of Year 1 for $10,000, that he sells Blackacre for $10,200 on January 2 of Year 2, and that inflation is 2% during Year 1. Parker's § 1001 realized gain under current law is $200 ($10,200 A/R *less* $10,000 A/B), which he must include in his Gross Income under § 61(a)(3), even though his inflation-adjusted wealth remains unchanged from its January 1, Year-1 level.

Finally, assume the same facts as immediately above except that Parker is a real estate dealer so that Blackacre is inventory in his hands and not a capital asset. *See* § 1221(a)(1). Once again, Parker would measure his wealth increase on the sale in nominal dollars, not inflation-adjusted dollars, and he would include $200 in his Gross Income.

In each case, we could amend the law so that Parker's basis in his savings account and

Blackacre, respectively, are increased for inflation each year so that any possible wealth accession is measured in inflation-adjusted real terms instead of nominal terms. The 2% inflation in Year 1 would result in an increase in his savings account (loan) basis from $10,000 to $10,200, as well as an increase in his Blackacre basis from $10,000 to $10,200. The $200 labeled "interest" paid into his savings account would actually be a tax-free increase in his "principal," and he would realize no § 1001 gain when he sells Blackacre for $10,200, whether he holds Blackacre as a capital asset or as inventory, as the sale price would equal his inflation-adjusted basis of $10,200.

As these simple examples illustrate, introducing a reduced tax rate for net capital gain on the argument that it ameliorates taxation of inflation gain is nonsensical. First, a rate reduction applicable only to net capital gain (and not other forms of capital return) violates the neutrality norm studied in Chapter 3, as *every kind of capital income* is subject to the inflation problem, not merely capital asset gain. Indeed, **capital gain is the form of capital return *least* in need of a preferential rate to account for inflation's effects because of the deferral privilege inherent in the realization requirement, an economic benefit that does not accompany other forms of capital return**. Parker must include the $200 interest earned on his savings account annually as it accrues and pay tax at ordinary income rates—even if he does not withdraw the interest from his savings account but rather leaves it in the account to continue to earn more interest. Parker's savings account is taxed according to income tax principles because the increase in his savings account (by $200) is taxed each year and thus the future interest earned on that $200 increase in his account balance (if he fails to withdraw it) is earned on after-tax dollars.[19]

In contrast, the appreciation in Parker's Blackacre (whether held as a capital asset or as inventory) is not taxed until sale or exchange. Thus, as described in Chapter 2, the realization requirement is a subtle consumption tax feature embedded in current law because it allows a future return to be earned on pre-tax dollars (the untaxed appreciation) during the ownership period. Stated another way, **apart from any preferential tax rate, § 1001 property gain is subject to reduced taxation under consumption tax principles during the ownership period—even if it is taxed at the same statutory rate as other types of income when finally realized. In short, the deferral privilege inherent in the realization requirement offsets potential inflation gain in whole or in part**. Thus, if inflation is said to be at the heart of the rate preference, the preference is directed at exactly the *wrong kind* of capital return.

Second, the net capital gain rate reduction does not depend on actual inflation rates and is the same whether the capital asset has been held for one year and a day or for 50 years. The inflation rate was negative for January through May 2015 and was .20% in August 2015 (at a time when the maximum net capital gain rate was 20% and the top ordinary rate was 39.6%), while the inflation rate was 12.61% in November of 1979 (when the net capital gain rate was 35% and the top ordinary rate was 70%).[20] Rather than a tax rate reduction applied to nominal gain, the proper cure for inflation gain is to index basis by the inflation rate each year so that only inflation-adjusted wealth increases are taxed. As illustrated in the above examples, if inflation is 2% in the year, the basis of all assets (whether a capital asset, inventory, a savings account, or any other form of debt instrument or loan) would be increased by 2%, decreasing the amount of taxable capital return, whether that return is in the form of § 1001 gain or, as in the case of Parker's savings account,

[19] Recall from Chapter 2 that, in order for an investment to be taxed according to income tax principles, both (1) the investment must be made with after-tax dollars and (2) the return must be fully included. If either of those two requirements is absent, the investment is accorded more preferential consumption tax treatment.

[20] *See* http://inflationdata.com/inflation/Inflation_Rate/HistoricalInflation.aspx.

interest. But not only would such a system be very complex to administer,[21] the optics would be difficult to explain to voters.

For example, assume that Sara and Jonathan purchase a home for $100,000 on January 1 of Year 1, borrowing the entire $100,000 from National Bank at 5% interest each year ($5,000) until the $100,000 loan principal is repaid in a single, balloon payment at the end of Year 10. Also assume that inflation is 3% each year and that Sara's and Jonathan's interest payments satisfy the definition of deductible "qualified residence interest" within the meaning of § 163(h)(3) (studied in Chapter 18). Under current law, Sara's and Jonathan's home basis remains unchanged as time passes, they can deduct 100% of their $5,000 interest payments each year under § 163(h)(3), and National Bank must include 100% of the $5,000 annual interest payments under § 61(a)(4).

If current law were amended to index basis for inflation, however, both Sara's and Jonathan's home basis and the bank's $100,000 loan principal basis would increase by 3% each year. Upon the payment and receipt of the $5,000 in nominal interest each year, $3,000 would be recharacterized as principal payments ($100,000 x .03): nondeductible by Sara and Jonathan (notwithstanding the "interest" label in their loan documents) and excludable as a "principal" receipt by the bank (ditto). Can you imagine politicians trying to explain to voters why a portion of their annual interest payment on their home loan is not *really* "interest" (regardless of what their loan documents said) and thus not deductible, notwithstanding § 163(h)(3), thereby increasing their tax burden? And can you imagine politicians trying to explain why banks are henceforth permitted to exclude for income tax purposes a portion of each "interest" payment received from borrowers, thereby reducing their tax burden?

Because of these political difficulties, what if all assets *except* debts (whether Parker's loan to National Bank in the form of his savings account or National Bank's loan to Sara and Jonathan) were indexed for inflation? That outcome would be even worse, as it would create enormous arbitrage problems. To illustrate, assume that Doug purchases land for investment at a cost of $100,000 on January 1 of Year 1, borrowing the entire $100,000 from National Bank at 3% interest each year ($3,000). Also assume that Doug sells the land on January 2 of Year 2 for $103,000 and repays his debt (both principal and interest) to National Bank.

If we ignore the tax consequences for a moment, we can see that Doug's purchase, ownership, and sale of the land is an *economic* wash for him. While he is able to sell the land for $103,000 after purchasing it for only $100,000 (entirely with borrowed money), Doug must use the entire $103,000 obtained on the sale to repay the $103,000 of total principal ($100,000) and interest ($3,000) owed to National Bank. He walks away with nothing, neither suffering a wealth reduction nor enjoying a wealth increase. Thus, his income tax consequences should also be a wash. In particular, recall from Chapter 1 that a deduction under SHS income tax principles requires that the taxpayer have suffered a wealth decrease.

What tax consequences would arise, however, if (1) inflation is 3% each year, (2) the land's basis is indexed for inflation, (3) the bank's loan basis is *not* indexed for inflation, and (4) Doug can deduct the interest that he pays to National Bank under § 163?

If we index Doug's land basis for inflation, Doug's initial $100,000 land basis would be increased to $103,000 at the time of sale to account for the 3% annual inflation that occurred during his ownership. Thus, when Doug sells for $103,000, he would realize neither a gain nor a loss

[21] England introduced basis indexing in 1982 but repealed it in 1988 because of its complexity.

under § 1001 ($103,000 A/R *less* $103,000 A/B, as increased for inflation). If National Bank's debt basis is *not* indexed for inflation but analyzed in nominal dollars, however, only $100,000 of the $103,000 that Doug pays to National Bank is characterized as principal, while $3,000 would be respected as "interest," which we have stipulated that Doug would be permitted to deduct under § 163, offsetting other investment income that Doug realizes. Though Doug's leveraged investment was an *economic* wash, he would treat it for tax purposes as resulting in a *wealth reduction* if we permitted him to index his land basis for inflation but did not require him to index debt basis.

The reduced tax burden that Doug would enjoy by deducting $3,000 that does not represent an actual wealth reduction suffered by him is essentially funded by other taxpayers. It would represent pure "rent" in the manner defined in Chapter 3—a mere transfer of wealth from other taxpayers (you and me) to Doug. Such a result would not only be unfair but economically inefficient, as it would encourage such arbitrage behavior on the part of taxpayers, which does nothing to generate wealth for the economy as a whole. The only way to avoid this result is to index *both* the land basis and the debt basis for inflation or to index *neither* basis for inflation. Indexing only the land basis but not the debt basis is both unfair and inefficient, violating the tax policy norms described in Chapter 3 that should govern analysis of available tax policy choices.

***Encouraging risk-taking entrepreneurship to stimulate economic growth***

Some argue that a reduced tax rate applicable to net capital gain (and not other forms of capital income, such as interest, rent, or royalties) is necessary to encourage more capital investment in new and risky enterprises that ultimately lead to more robust economic growth. One obvious rejoinder is that the net capital gain rate is not limited to new or incremental investment capital in a new or growing business (which can expand the economy). First, the net capital gain rate can apply to property that, by its nature, is limited in supply, where all the tax preferences in the world cannot encourage the creation of "more," such as land, old master paintings, antiques and collectibles, *etc.* Even in the case of traditional entrepreneurial risk capital, such as shares of stock in a new corporation pursuing the next big idea, the net capital gain rate can apply not only with respect to new capital put at risk in the business but also to churning sales of old capital among previously existing shareholders.

For example, assume that Rachel has a great new technology idea but no money to pursue it. She convinces Victor Venture Capitalist to provide the initial $500,000 in capital for her to begin pursuing the idea. Together, they form a corporation called Snapshot, with each taking shares. Rachel (and the new staff that she hires with Victor's capital infusion) develops the idea, and eventually it takes off in the marketplace. Snapshot "goes public" by hiring an investment bank to help it engage in an "initial public offering" of new shares for cash. The IPO is a hit, and Snapshot raises an additional $30 million to expand the business. After this point in time, the outstanding shares are now bought and sold frequently among members of the public, providing no additional new capital to Snapshot.

The reduced net capital gain rate is not limited to the gain realized on the shares held by Rachel, Victor, and the first buyers in the IPO (the cash from which went entirely to Snapshot as risk capital). Rather, the reduced net capital gain rate applies to churning sales from one Snapshot shareholder to another long after the IPO, as well—the money from which goes to the shareholder-seller (and not to Snapshot).

A much better targeted tax expenditure in this regard is § 1202, which allows exclusion of all

or a portion of gain realized on the sale of "qualified small business stock" that is held for more than 5 years. One of the many requirements for the exclusion to apply is that the stock must have been acquired at original issue for cash or, in the case of Rachel, for services. This preference for initial risk capital does not apply to churning transactions of old stock.

Moreover, it is not clear that a tax preference that arises only at the back end of an investment (on sale) and only if the risky capital investment is a success (where the stock is sold at a gain) is the best way to encourage more risk capital investment at the front end. A tax credit on the front end (at the time of the investment) may be more effective in encouraging the intended behavior change. At various times in our history, Congress has enacted (and repealed) various "investment tax credits" along this line. In addition, more new businesses fail than succeed, so a better targeted tax expenditure in this regard is § 1244, which permits losses realized on later sale of certain shares of original issue stock to be treated as ordinary losses instead of capital losses. Section 1244 allows Victor to fully deduct his lost risk capital in the year realized (unhampered by § 1211(b)) with respect to those far more numerous venture capital investments that fail (unlike his successful investment in Snapshot). It also allows such losses to offset high-taxed ordinary income (such as compensation, interest, rents, *etc.*), rather than Victor's low-taxed, long-term capital gains (in the first netting step in the "net capital gain" calculation, described below).

In short, §§ 1202 and 1244 are better targeted. An additional broad tax preference that applies to all types of net capital gain is very poorly targeted and overbroad.

The more serious rejoinder is that empirical data do not support the proposition. While tax rates were much higher in the 1950s on both ordinary income and capital gains than they were in the 2000s, economic growth rates were also much higher in the earlier period.[22] Professor Burman examined the data for years between 1950 and 2011 and testified:

> The heated rhetoric notwithstanding, there is no obvious relationship between tax rates on capital gains and economic growth…. If low capital gains tax rates catalyzed economic growth, we'd expect to see a negative relationship—high [capital] gains rates, low growth, and vice versa—but there is no apparent relationship …. I've tried lags up to five years and using moving averages, but there is never a … statistically significant relationship.
>
> I also posted [this conclusion] on my blog on Forbes.com and offered the [underlying] data to all comers. A half dozen or so people, including at least one outspoken critic of taxing capital gains, took me up on the offer, but nobody to my knowledge has been able to tease a meaningful relationship between capital gains tax rates and GDP out of the data.
>
> Does this prove that capital gains taxes are unrelated to economic growth? Of course not. Many other things have changed at the same time as tax rates on capital gains and many other factors affect economic growth. But the [data] should dispel the notion that capital gains taxes are a very important factor in the health of the economy. Cutting capital gains taxes will not turbocharge the economy and raising

[22] *See generally* Floyd Norris, *Tax Reform Might Start with a Look Back to '86*, N.Y. TIMES, Nov. 23, 2012, at B1 and at www.nytimes.com/2012/11/23/business/a-starting-point-for-tax-reform-what-reagan-did.html (showing a chart comparing economic growth and the capital gains rate preference during various periods).

them would not usher in a depression.[23]

Similarly, Anne Christensen and Angela Woodland conducted an empirical study examining whether a correlation exists between job growth in particular (as opposed to economic growth in general) and marginal tax rates, including the net capital gains rate, and they found no clear correlation.[24]

***Bunching effect from the realization requirement***

The final argument typically advanced to support a reduced tax rate applicable to net capital gain is to ameliorate the bunching effect, if any. Because of the realization requirement, the appreciation is often included in Gross Income entirely in one taxable year, instead of piecemeal over multiple years as it economically accrues. Thus, a portion of gain that would otherwise have fallen within, say, the 28% bracket each year under a mark-to-market system may be taxed at, say, 35% or 39.6% if taxed entirely in the (later) realization year.

One rejoinder is that because most taxable capital gain is realized by taxpayers who are already otherwise in the highest tax brackets, year after year, there is no bunching effect in the great majority of cases. Moreover, for taxpayers below the top tax bracket, the deferral privilege accompanying the realization requirement can offset the tax effect of any bunching effect. Finally, the accurate response to any bunching effect that does exist is mark-to-market taxation or, if infeasible, income averaging. For example, determining the appropriate tax applicable to gain realized entirely in Year 4 could be computed by, say, hypothetically including 25% of the gain in each of Years 1, 2, 3, and 4. For a taxpayer already in the highest bracket each year, such an exercise would not reduce the tax due in Year 4 on the realized gain. If, however, a taxpayer's marginal dollars were taxed at only 15% in Years 1, 2, and 3, figuring out the Year-4 tax on a large realized gain by looking back at the rates that would have applied to it if 25% were included in each of Years 1 through 4 could reduce the aggregate tax due on the gain in Year 4. In short, a blanket and substantial rate reduction for all net capital gain is a vastly disproportionate response to any bunching effect in the real world.

***The definition of "net capital gain"***

You learned in Part A. that a taxpayer with more capital losses than capital gains has no hope of any preferentially taxed "net capital gain." But even a taxpayer with more capital gains than capital losses may not have any preferentially taxed "net capital gain." Not all capital gains are subject to the rate preference in § 1(h). Not even all *long-term* capital gains are subject to the rate preference. Nevertheless, as explored below, a taxpayer must have at least *some* long-term capital gain to have any hope of preferentially taxed "net capital gain."

The preferential § 1(h) rates apply only to **"net capital gain,"** which is defined in § 1222(11) as **the excess of *net* long-term capital gain over *net* short-term capital loss**. The "excess-over" language is Codespeak for subtraction. More precisely stated, net capital gain is equal to [long-term capital gain *less* long-term capital loss] *less* [short-term capital loss *less* short-term capital gain]. That's a lot of "*less*"es!

In effect, there are *two* netting steps in determining net capital gain. In the first netting step, long-term gains and long-term losses are netted together to arrive at a *net* long-term figure, and

[23] Burman, TESTIMONY, *supra* note 10, at 12-13.
[24] *See* Anne L. Christensen & Angela M. Woodland, *Tax Rates and Jobs*, 138 TAX NOTES 343 (2013).

the same is done with short-term gains and losses. At the end of this first netting step, the taxpayer must have some *net long-term capital gain* or else the analysis stops; there can be no net capital gain without net long-term capital gain. If the taxpayer does have net long-term capital gain, the taxpayer proceeds to the second netting step, under which net short-term capital loss (if any) reduces the net long-term capital gain to arrive at preferentially taxed "net capital gain." If the taxpayer's net short-term position is not a loss (but rather a gain), the second-step reduction is zero, meaning that the entire net long-term capital gain satisfies the definition of net capital gain.

Time for a few examples! In each case, Hallie realizes and recognizes the capital gains and losses described below in a single year, and the capital losses are otherwise deductible under § 165(c). Assume that Hallie earns enough wage income to have any additional marginal income taxed at 28% if it is not eligible for the § 1(h) rate preference applicable to net capital gain.

**Example 1**

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $14,000 | $10,000 | $3,000 | $5,000 |

Hallie can fully deduct the $15,000 in aggregate capital losses because she has sufficient capital gains to allow it under § 1211(b). Furthermore, Hallie has a $4,000 *net* long-term capital gain ($14,000 long-term capital gain *less* $10,000 long-term capital loss) and a $2,000 *net* short-term capital loss ($5,000 short-term capital loss *less* $3,000 short-term capital gain), resulting in $2,000 of "net capital gain" within the meaning of § 1222(11).

**Example 2**

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $10,000 | $0 | $0 | $5,000 |

Hallie can fully deduct the $5,000 in aggregate capital losses under § 1211(b). Furthermore, Hallie has a $10,000 *net* long-term capital gain ($10,000 long-term capital gain *less* $0 long-term capital loss) and a $5,000 *net* short-term capital loss ($5,000 short-term capital loss *less* $0 short-term capital gain), resulting in $5,000 of "net capital gain" within the meaning of § 1222(11).

**Example 3**

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $2,000 | $3,000 | $7,000 | $2,000 |

Hallie can fully deduct the $5,000 in aggregate capital losses under § 1211(b). Even though Hallie realizes more capital gains this year than capital losses, she has no net capital gain. The first required ingredient under § 1222(11) is net long-term capital gain, and Hallie has none. Rather, she realizes a net long-term capital *loss*. The analysis stops. Although Hallie can deduct 100% of her $5,000 in aggregate capital losses under § 1211(b), the remaining $4,000 of capital gain that is not offset by her capital losses will be subject to the 28% bracket that the initial facts state otherwise applies to any marginal gain or income not eligible for the § 1(h) rate preference.

When you look at Example 3 closely, you can appreciate that the $4,000 of remaining capital gain (after deducting her capital losses) is necessarily short-term gain, and Congress has never allowed short-term capital gains to qualify for reduced taxation. Only long-term gains could plausibly implicate the assorted rationales described in Part B., above, for a reduced tax rate, such

as bunching, inflation gain, risk capital, *etc.*

**Example 4**

| long-term cap gain | long-term cap loss | short-term cap gain | short-term cap loss |
|---|---|---|---|
| $9,000 | $1,000 | $5,000 | $0 |

Hallie can fully deduct the $1,000 in aggregate capital losses under § 1211(b). Furthermore, Hallie has an $8,000 *net* long-term capital gain ($9,000 long-term capital gain *less* $1,000 long-term capital loss) and no *net* short-term capital loss (her net short-term position is not a loss but rather a gain), resulting in $8,000 of "net capital gain" within the meaning of § 1222(11). Her remaining $5,000 in capital gain is necessarily short-term gain, subject to the 28% bracket that the initial facts state otherwise applies to any marginal gain or income not eligible for the § 1(h) rate preference.

***Planning possibilities regarding the timing of realized capital gains and losses***

We have noted several times in this course that—*all else being equal*—taxpayers prefer to defer Gross Income inclusions as long as possible and accelerate deductions as soon as possible to take advantage of the ever-critical time value of money. But sometimes all else is not equal because of (1) the rate preference accorded net capital gain and (2) the ability to use capital losses to offset high-taxed short-term capital gain (in the first netting step described above) or high-taxed ordinary income (under the $3,000 § 1211(b) *de minimis* rule).

Taxpayers who have realized long-term capital gain often read in December year-end tax planning articles found in the popular press that they should harvest sufficient capital losses before year end to fully offset the long-term capital gains, thus effectively eliminating taxation of those gains. But for the small investor, this may be bad advice. Rather than using capital losses to offset potentially low-taxed, long-term capital gain, those losses are often put to more efficient tax use by deducting them against high-taxed, short-term capital gain or ordinary income to the extent feasible. The tax saved by using capital losses to offset high-taxed income instead of low-taxed income can often more than offset any time-value-of-money cost from deferring a deduction to the next taxable year.

For example, assume that Ryan has already realized a $3,000 long-term capital gain in Year 1. It is December of Year 1, and he is considering selling shares of corporate stock (a capital asset in his hands) with an unrealized long-term capital loss of $3,000, but he believes the stock will maintain its value for a few weeks longer so that he could sell in January of Year 2 if that would result in better tax consequences. He does not believe, at this time, that he will realize any other capital gains or losses in Year 2. Should Ryan realize that $3,000 capital loss in Year 1, effectively offsetting the $3,000 in long-term capital gain, or should he wait and realize the $3,000 capital loss in Year 2? Assume that (1) Ryan's Taxable Income without regard to capital gains and losses is $100,000 in each year and that (to keep the math simple) his ordinary Taxable Income is taxed at a flat 28% rate and (2) Ryan's net capital gain, if any, is taxed at 15% under § 1(h).

Notwithstanding the common wisdom that Ryan should realize and deduct his capital loss in Year 1 (offsetting the realized capital gain) rather than delay the sale until Year 2, Ryan's *after-tax* consequences would in fact be better if he waited until January of Year 2 to sell the loss stock. Let's see why.

**If Ryan sells in Year 1**

In Year 1, Ryan includes the $3,000 in long-term capital gain, deducts the $3,000 in long-term

capital loss, and has no net capital gain subject to the 15% preferential tax rate. His remaining $100,000 of Taxable Income produces a tax of $28,000 in our simplified world in which his Taxable Income is taxed at a flat 28% rate ($100,000 x .28).

In Year 2, Ryan has no capital gain to include or capital loss to deduct, again has $100,000 of Taxable Income, and again pays $28,000 in tax ($100,000 x .28).

Over both years, Ryan pays a total tax of $56,000.

**If Ryan sells in Year 2**

In Year 1, Ryan includes the $3,000 in long-term capital gain and does not deduct the $3,000 of unrealized loss, producing a $450 tax on the $3,000 of net capital gain under § 1(h) ($3,000 x .15). In addition, Ryan owes $28,000 in tax on his remaining $100,000 of Taxable Income ($100,000 x .28). Thus, he would pay total tax of $28,450.

In Year 2, Ryan realizes the $3,000 capital loss, which he deducts under the § 1211(b) *de minimis* rule against his high-taxed wage income, leaving $97,000 in Taxable Income. He pays tax of $27,160 ($97,000 x .28).

Over both years, Ryan pays a total tax of $55,610.

By waiting for a few weeks to sell the loss stock in January of Year 2 (instead of December of Year 1), Ryan saves $390 in tax! This $390 represents the difference between the $450 in 15% tax that he paid on his $3,000 net capital gain in Year 1 and the $840 in Year-2 tax *savings* by deducting the $3,000 capital loss against income that otherwise would have been taxed at 28%.

Of course, Ryan lost one year of time value of money by deferring his $3,000 deduction for one year, so we would have to discount his $840 in Year-2 tax savings by the current discount rate, which we shall assume is 3%. Using the present value table in Chapter 1, the present value of his $840 Year-2 tax savings, when viewed from the perspective of Year 1 (which is when he is considering whether or not to sell the loss stock), is $815.64 ($840 x .971). Thus, Ryan should be advised that, when viewed in Year-1 present value terms, he can effectively save $365.64 in tax by deferring the sale of the loss stock from December of Year 1 to January of Year 2 ($815.64 present value of his $840 in Year-2 tax savings *less* $450 present cost of the Year-1 tax on his unreduced $3,000 net capital gain).

**Individual taxpayers should attempt to use capital losses whenever possible to offset high-taxed ordinary income under the § 1211(b) *de minimis* rule or high-taxed, short-term capital gain under the first netting step in the § 1222(11) definition of "net capital gain" rather than using capital losses to offset low-taxed, long-term capital gain.**

Step back and cogitate about that definition of net capital gain: *net long-term capital gain less net short-term capital loss*. If Ryan has already realized a long-term capital gain and short-term capital loss and is engaging in year-end tax planning, he may consider harvesting a like-amount of short-term capital gain, if possible. In that way, he would accomplish two goals: (1) he would use his short-term capital loss to offset gain (short-term capital gain) that is otherwise not eligible for the § 1(h) rate preference, and (2) he would protect his long-term capital gain.

There are, of course, exceptions to every rule, and Ryan should go ahead and harvest capital losses to offset even low-taxed net capital gain if the gains and losses are substantial, where the $3,000 *de minimis* rule is cold comfort and the time-value-of-money cost of deferring deductions for many years is large. Thus, for example, assume that Ryan has already sold Whiteacre at a

$500,000 long-term capital gain in Year 1 and is considering whether to sell Blackacre, which has a built-in capital loss of, say, $400,000, in Year 1 or to defer the sale of Blackacre until Year 2. You should advise him to sell Blackacre in Year 1, even though the $400,000 capital loss would wholly offset low-taxed net capital gain (instead of high-taxed ordinary income or gain or short-term capital gain). If Ryan deferred Blackacre's sale until Year 2, he may die before fully deducting that $400,000 in $3,000 increments each year (absent further capital gain realizations).

## C. The meaning of "capital asset" and "sale or exchange"

The introductory language in § 1221(a) defines the universe of capital assets as consisting of *all* property—whether held for business, investment, or personal purposes—*except* those listed in the paragraphs that follow. This approach can be criticized as allowing property to qualify for reduced taxation in an unexamined fashion, even property that does not implicate any of the purported rationales for reduced taxation discussed in Part B. The law could be improved if Congress instead listed those specific assets that *do* qualify as capital assets, with unlisted assets ineligible for preferential treatment.

The material below discusses a few of the more significant exceptions to capital asset treatment found in § 1221.

***§ 1221(a)(1): the inventor or dealer exception***

The very first listed item that fails to qualify as a capital asset is inventory or other property "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business"—often referred to as the "inventory exception" or "dealer exception" to capital asset treatment. Thus, both taxpayers selling services and taxpayers selling inventory include ordinary income and gain. The Supreme Court has held that the word "primarily" in § 1221(a)(1) means "principally" or "of first importance."[25] In many cases application of the inventory exception is obvious, but sometimes property that was *not* inventory when originally acquired can *become* inventory over time as the taxpayer's activities change. Simply because property was a capital asset when first acquired does not mean that it is forever protected as a capital asset in the taxpayer's hands.

**BYRAM v. UNITED STATES**

705 F.2d 1418 (5th Cir. 1983)

Before WISDOM, GEE, and REAVLEY, CIRCUIT JUDGES.

GEE, CIRCUIT JUDGE: "*If a client asks you in any but an extreme case whether, in your opinion, his sale will result in capital gain, your answer should probably be, 'I don't know, and no one else in town can tell you.'*"[1]

Sadly, the above wry comment on Federal taxation of real estate transfers has, in the twenty-

[25] *See* Malat v. Riddell, 383 U.S. 569 (1966).

[1] Comment, *Capital Gains: Dealer and Investor Problems*, 35 Taxes 804, 806 (1957) *quoted in* 3B MERTENS, LAW OF FEDERAL INCOME TAXATION § 22.138 n. 69 (Zimet & Weiss rev. 1958); Biedenharn Realty Co. v. U.S., 509 F.2d 171, 175 (5th Cir.1975), *rev'd en banc*, 526 F.2d 409 (5th Cir.), *cert. denied*, 429 U.S. 819 (1976); Thompson v. Comm'r, 322 F.2d 122, 123 n 2 (5th Cir.1963); Cole v. Usry, 294 F.2d 426, 427 n.3 (5th Cir.1961).

five years or so since it was penned, passed from the status of half-serious aside to that of hackneyed truism. Hackneyed or not, it is the primary attribute of truisms to be true, and this one is: in that field of the law—real property tenure—where the stability of rule and precedent has been exalted above all others, it seems ironic that one of its attributes, the tax incident upon disposition of such property, should be one of the most uncertain in the entire field of litigation. But so it is, and we are called on again today to decide a close case in which almost a million dollars in claimed refunds are at stake. The trial court, sitting without a jury in this taxpayer's suit for refund, found the following facts:

During 1973, John D. Byram, the taxpayer, sold seven pieces of real property. Mr. Byram was not a licensed real estate broker, was not associated with a real estate company which advertised itself, and did not maintain a separate real estate office. He advertised none of the seven properties for sale, nor did he list any of them with real estate brokers. To the contrary, all of the transactions were initiated either by the purchaser or by someone acting in the purchaser's behalf.

None of the properties sold was platted or subdivided. Byram devoted minimal time and effort to the sales in question, occupying himself chiefly with his rental properties. Byram's income for 1972 and 1973 included substantial amounts of rental income and interest income.

The district court's findings do not reflect the following additional facts, which apparently are not disputed by the parties. From 1971 through 1973, Byram sold 22 parcels of real property for a total gross return of over $9 million and a net profit of approximately $3.4 million. The seven properties at issue in this case sold for approximately $6.6 million gross, resulting in a profit of approximately $2.5 million. Six of the seven properties were held by Byram for periods ranging from six to nine months, intervals just exceeding the then-applicable holding periods for long-term capital gains. The seventh property had been held for two years and six months.

Although, as noted above, Mr. Byram received substantial rent and interest income in 1973, nevertheless his rental activities for that year resulted in a net tax loss of approximately $186,000. He received rental income from only one of the seven properties sold in 1973. The record does not reflect the exact relative amounts of income attributable to the sales in question and Byram's other activities.

Certain facts are disputed by the parties. The government asserts in its brief that Byram had entered into contracts to sell at least three of the seven properties in issue before he actually acquired them. Byram first responds that the record reflects only two such instances, not three; and at oral argument the government appeared to concede the point. As to those two transactions, Byram asserts that he acquired the right to purchase the properties by executing a contract before he entered into a contract to sell them; it was only closing on the purchases that postdated his contracts to sell. Finally, the government asserts, and Byram denies, that by virtue of Byram's civic activities in Austin, Texas, Byram's business of selling real estate was well-known in the community.

Based on its subsidiary findings indicated, the district court made ultimate findings that Byram held each of the seven properties for investment purposes and not primarily for sale to customers in the ordinary course of his trade or business. Judgment was therefore entered granting Byram the capital gains treatment that he sought. The government brought this appeal.

Profits derived from the sale of "capital assets," known as "capital gains," are entitled to favorable tax treatment under the Internal Revenue Code (the "Code"). The term "capital asset" is

defined in relevant part as "property held by the taxpayer," not including property held "primarily for sale to customers in the ordinary course of [the taxpayer's] trade or business." § 1221. The district court found that Byram "was not engaged in the real estate business" during the relevant years and that each of the seven properties in issue was held "for investment purposes and not primarily for sale to customers in the ordinary course of [Byram's] trade or business." Accordingly, the district court held that Byram was entitled to treat the profits from his 1973 sales as capital gains and ordered an appropriate refund.

Our first task is to decide the correct standard by which to review the district court's principal finding that Byram's holding purpose was for investment rather than for sale. The choice of a standard will determine the outcome of many cases; if the issue is treated as factual, the district court's decision is final unless clearly erroneous, F.R.C.P. 52(a), but if a question of law is presented, we may decide it *de novo*. [The Court decided that whether an asset is held primarily for sale to customers in the ordinary course of business is a question of fact.]

The record and the district court's findings of fact indicate that in determining Byram's holding purpose, the court considered all the factors this court has called the seven pillars of capital gains treatment":

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

*U.S. v. Winthrop*, 417 F.2d 905, 910 (5th Cir.1969). Recent cases have placed particular emphasis on four of these factors, noting that frequency and substantiality of sales is the most important factor, and that improvements to the property, solicitation and advertising efforts, and brokerage activities are also especially relevant considerations. *Biedenharn Realty*, 526 F.2d at 415-16; *Suburban Realty*, 615 F.2d at 176. At the same time, it has been repeatedly emphasized that these factors should not be treated as talismans. *Winthrop*, 417 F.2d at 911. Rather, "each case must be decided on its own peculiar facts…. Specific factors, or combinations of them, are not necessarily controlling." *Biedenharn Realty*, 526 F.2d at 415 (quoting *Thompson v. Comm'r*, 322 F.2d 122, 127 (5th Cir.1963)).

The district court found most of the *Winthrop* factors absent in Byram's case. Byram made no personal effort to initiate the sales; buyers came to him. He did not advertise, he did not have a sales office, nor did he enlist the aid of brokers. The properties at issue were not improved or developed by him. The district court found that Byram devoted minimal time and effort to the transactions.[11] The government does not contend that any of these findings are clearly erroneous.

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[11] This factor has been slighted in recent cases, not because it is unimportant, but because it was irrelevant to our consideration of the activities of large corporate organizations. *See, e.g.*, Suburban Realty, 615 F.2d 171; Houston Endowment, 606 F.2d 77; Biedenharn Realty, 526 F.2d 409. However, in a case like the present one, where the government seeks to show that an individual taxpayer is holding property for sale in a certain business, the quantum of that individual's activity becomes very relevant. Long before the proliferation of tests and factors engulfed the capital gains field, this court made the common sense observation that the word "business" means "busyness; it implies that one is kept more or less busy, that the activity is an occupation." Snell v. Comm'r, 97 F.2d 891, 892, 21 A.F.T.R. (P-H) 608 (5th Cir.1938); *see also* Stern v. U.S., 164 F. Supp. 847, 851 (E.D.La.1958) ("[A] court should not be quick

Rather, the government argues that the frequency and substantiality of Byram's sales, together with the relatively short duration of his ownership of most of the properties, establishes that Byram intended to hold the properties for sale in the ordinary course of his business. In light of our decision regarding the standard of review, the government's argument must be that the district court clearly erred in finding these factors outweighed by the other relevant evidence. We cannot reasonably say that the district court's finding that Byram held his properties for investment was clearly erroneous.

The record reveals that during a three-year period, Byram sold 22 parcels of real estate for over $9 million, netting approximately $3.4 million profit.[12] Though these amounts are substantial by anyone's yardstick, the district court did not clearly err in determining that 22 such sales in three years were not sufficiently frequent or continuous to compel an inference of intent to hold the property for sale rather than investment. *Compare Suburban Realty*, 615 F.2d at 174 (244 sales over 32-year period); *Biedenharn Realty*, 526 F.2d at 411-12 (during 31-year period, taxpayer sold 208 lots and twelve individual parcels from subdivision in question; 477 lots were sold from other properties). This is particularly true in a case where the other relevant factors weigh so heavily in favor of the taxpayer. "Substantial and frequent sales activity, standing alone, has never been held to be automatically sufficient to trigger ordinary income treatment." *Suburban Realty*, 615 F.2d at 176. Moreover, Byram's relatively short holding periods for some of the properties do not tip the balance in favor of the government. Ranging from six to nine months, these periods exceeded the then-applicable threshold for long-term capital gain treatment. In establishing those thresholds, Congress clearly expressed its intent that sales of otherwise qualified capital assets held for six to nine months be accorded capital gains treatment. To avoid frustration of that intent, a court should avoid placing too much weight on duration of ownership where other indicia of intent to hold the property for sale are minimal.[13]

Mr. Byram has presented us with a close case. Had we been called upon to try or retry the facts, perhaps we would have drawn different inferences than did the district court. However, … [o]ur review of the evidence convinces us that the district court was not clearly erroneous in finding that Byram held his properties for investment and not for sale in the ordinary course of his trade or business.

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In most of the other cases cited by the *Byram* court, the taxpayer lost. For example, the appellate court overturned a taxpayer win at the trial level in *Biedenharn Realty Co. v. United States*.[26] The

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to put a man in business … simply because he has been successful in earning extra income through a hobby or some other endeavor which takes relatively small part of his time."), aff'd 262 F.2d 957 (5th Cir.), *cert. denied*, 359 U.S. 969 (1959). The district court was entitled to give great weight to Byram's time and effort devoted to sales in determining whether he held his property for sale in the ordinary course of his business.

[12] Although only the seven sales completed in 1973 are at issue in this case, prior years' activities are relevant to the characterization of the 1973 transactions. *See* Thompson v. Comm'r, 322 F.2d 122, 127 (5th Cir.1963).

[13] A variation of the argument based on short holding periods is that Byram's execution of contracts to sell two properties before acquiring title to them indicates lack of investment intent. The record shows that Byram contracted to purchase one of the properties and a portion of the other before engaging to sell them. *See* Record, Volume IV, p. 304-07, 310; Plaintiffs' Exhibits 15, 19, & 20. For these, the timing of passage of title is irrelevant for our purposes. Even if we assume that Byram contracted to sell the remaining portion of property before acquiring it, our view of the district court's finding remains unaltered. Though this fact undoubtedly favors the government's position, the district court reasonably could have found it outweighed by the other evidence.

[26] 526 F.2d 409 (5th Cir. 1976).

taxpayer bought a 973-acre farm called Hardtimes Plantation in 1935 and farmed it for several years. The nearby city of Monroe, Louisiana, developed and expanded toward Hardtimes, and the taxpayer began subdividing and selling lots from the farm for development as early as 1939. Between 1939 and 1966, the taxpayer sold 208 lots in 158 sales at a profit in excess of $800,000, after adding paved roads, curbs, sewers, and utilities. Between 1964 and 1966 (the tax years in question) the taxpayer sold 38 lots. The government did not dispute that Hardtimes was not held for sale in the ordinary course of the taxpayer's business when first acquired but argued that the taxpayer's activities changed to such an extent over time that the lots were described in § 1221(a)(1) when finally sold as residential lots in several named subdivisions. While the trial court disagreed, the appellate court held in favor of the government, concluding:

> We cannot write black letter law for all realty subdividers and for all times, but we do caution in words of red that once an investment does not mean always an investment. A simon-pure investor forty years ago could by his subsequent activities become a seller in the ordinary course four decades later. The period of Biedenharn's passivity is in the distant past; and the taxpayer has since undertaken the role of real estate protagonist. The Hardtimes Plantation in its day may have been one thing, but as the plantation was developed and sold, Hardtimes became by the very fact of change and activity a different holding than it had been at its inception. No longer could resort to initial purpose preserve taxpayer's once upon a time opportunity for favored treatment.

Today, § 1237 provides a very narrow "safe harbor" enabling an individual that subdivides real property before sale to avoid dealer status if he (1) has not held the tract of land at issue for sale in the ordinary course of his trade or business in the past, (2) does not hold other tracts for sale in the ordinary course of business in the year of sale, (3) has held the tract of sold property for investment purposes for at least 5 years (unless inherited) before subdividing it and engaging in advertising, promotion, and other selling activities, and (4) has made "no substantial improvement that substantially enhances the value of the lot or parcel sold." Improvements made by the buyer, related parties, certain lessees, and government entities are attributable to the selling taxpayer in applying this test. Substantial improvements include utility lines, paved roads, and buildings. Under Treas. Reg. § 1.1237-1(c)(3), improvements are not considered "substantial" unless they increase the value of the land by more than 10%. Furthermore, under § 1237(b)(3), "water, sewer, or drainage facilities or roads" are not considered substantial improvements if (1) the tract has been held for at least 10 years, (2) the taxpayer can prove that the improvements were necessary to make the lots marketable, and (3) the taxpayer does not increase the tract's basis by the cost of the improvements (or otherwise deduct the costs as expenses), thereby increasing the amount of includable gain. Even if all of its requirements are satisfied, the § 1237 safe harbor fully applies only to the first five lots or parcels sold from the tract of land. Section 1237(b)(1) provides that any additional realized gain "shall be deemed to be gain from the sale of property held primarily for sale to customers in the ordinary course of the trade or business to the extent of 5 percent of the selling price." Because of these stringent limitations, § 1237 appears to be little used.

While the authorities above all deal with real estate, it is important to note that the issue of whether property first acquired as a capital asset has crossed the line to property held for sale in

the ordinary course of the taxpayer's trade or business is not limited to real estate.[27]

***§ 1221(a)(2): certain property "used" in the taxpayer's trade or business***

Section 1221(a)(2) removes from capital asset treatment real or personal property *used* in the taxpayer's trade or business but only if, in the case of personal property, the property is depreciable. Thus, neither the non-depreciable land plowed and planted by a farmer in the business of selling crops nor the depreciable equipment (and depreciable factory) used in a taxpayer's manufacturing business qualifies as a capital asset. In this fashion, the means of producing services or inventory income are also denied capital asset treatment, just as the services and inventory income themselves are denied preferential treatment.

Nevertheless, Congress used precisely the same language found in § 1221(a)(2) to describe so-called § 1231 property in § 1231(b) (with the added requirement that the property be held for more than one year). Thus, while such assets do not produce capital gain or loss, they can sometimes produce gain or loss that is *treated* like long-term capital gain or long-term capital loss, as further discussed below in Part D. Stay tuned.

***§ 1221(a)(3): certain copyrights, works of art, musical compositions, and similar property***

Suppose that Jacob is an artist who paints a canvas and sells it to an art gallery for $1,000, which in turn sells the painting to one of its customers, a lawyer, for $2,500 in the ordinary course of the gallery's trade or business. The lawyer hangs the painting on her living room wall, but she tires of it after a few years and sells it to a friend for $5,000, as Jacob's reputation in the art world has increased by then. What are the tax consequences of each of these three sales?

Jacob's basis in the painting would be very low, equal to the nondeductible cost of the canvas and paints (capital expenditures) that he used to create the work of art, say, $100. Thus, he realizes a $900 gain when he sells it to the gallery for $1,000. The gallery's basis in the painting is its $1,000 purchase cost under § 1012, and it realizes a $1,500 gain when it sells it to the lawyer for $2,500. Finally, the lawyer's basis in the painting is her $2,500 purchase cost under § 1012, and she realizes a $2,500 gain when she sells it to her friend for $5,000. Each of these taxpayers must include the realized gain in Gross Income, as no nonrecognition provision is available, so each must determine the character of the gain.

Section 1221(a)(3) provides that "a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property" is not a capital asset if "held by" certain taxpayers. Under § 1221(a)(3)(A), the canvas is not a capital asset in Jacob's hands, as his personal efforts created the painting. Thus, Jacob's $900 realized gain is ordinary, not capital, gain. While not compensation *per se* under § 61(a)(1), Jacob's § 1001 gain represents a return on his personal effort akin to a labor return and is, thus, taxed at ordinary income rates. For the gallery, the painting is described in § 1221(a)(1)—considered above—as the gallery held the painting for sale in the ordinary course of its trade or business, resulting in $2,500 of ordinary gain. The painting is not described in either § 1221(a)(1) or any of the subsections in § 1221(a)(3) in the hands of the lawyer, however, which means that the painting *is* a capital asset in her hands under the introductory clause

[27] *See, e.g.,* U.S. v. Hollis, 121 F. Supp. 191 (N.D. OH 1954). Mr. Hollis was a curator of the Cleveland Museum of Art when he resigned to become an advisor to General MacArthur as Chief of the Arts and Monuments Division of the Allied Forces in Japan. After the war, he began to sell many Japanese art objects from his home in Cleveland Heights and attempted to report these sale gains as capital gain, but he lost. My thanks go to Professor Bridget Crawford for bringing this case to my attention.

of § 1221(a), resulting in $2,500 of capital gain when she sells it to her friend.

Suppose that Jacob gives the painting to his mother Lori as a birthday gift (instead of selling it to the art gallery). A few years later, after Jacob has established a reputation in the art world, Lori sells the painting to an art gallery for $5,000. What is the amount and character of Lori's realized gain under § 1001? Is Lori, like the lawyer, entitled to treat the painting as a capital asset because she neither painted it nor held it as inventory? Because she obtained the painting by *inter vivos* gift, Lori would take the same $100 basis that Jacob had under § 1015(a), resulting in a $4,900 realized gain when she sells the painting for $5,000. Even though Lori is *not* described in § 1221(a)(3)(A) because she did not paint the canvas herself, she *is* described in § 1221(a)(3)(C) because her basis in the painting is determined "in whole or in part" by reference to Jacob's basis, and Jacob is described in § 1221(a)(3)(A). Thus, Lori's $4,900 gain is ordinary gain. In short, Jacob's gift does not launder out the "ordinary" taint.

Suppose, instead, that Jacob does not give the painting to his mother while he was alive. Rather, after a very long and fruitful life, Jacob dies and leaves the painting to his sister Becky in his will. The painting is appraised at $20,000 at the time of Jacob's death. Becky sells the painting 9 months after Jacob's death for $30,000 (after the usual bump in value caused by the artist's death). What is the amount and character of Becky's § 1001 gain?

Becky does not take Jacob's $100 basis under § 1015(a) but rather takes a basis equal to the painting's appraised value at Jacob's death of $20,000 under § 1014(a), producing a $10,000 realized gain on the sale for $30,000. Moreover, on these facts, Becky is described in *neither* subsection (A) *nor* subsection (C) of § 1221(a)(3). Becky did not paint the painting herself, and her basis was not determined "in whole or in part" by reference to Jacob's basis in the painting. Thus, Becky's gain is capital gain. Moreover, even though she held the painting for only 9 months prior to its sale, she is deemed to have held it for more than a year under § 1223(9), so Becky's gain is long-term capital gain.

Finally, what is § 1221(a)(3)(B) all about? The history majors among you might know that the first scandal of the Nixon administration involved this provision. To understand the genesis of its enactment in 1969, we have to take a sneak preview of the amount of a § 170 charitable contribution deduction when property is contributed in kind to an eligible charity or government (examined in Chapter 18). You learned in Chapter 7 that the making of a gift is not a realization event in the United States. Thus, when Mark contributes property with a basis of $100 and FMV of $500 to an eligible charity, he does not realize the $400 of built-in gain under § 1001. If we wish to avoid allowing Mark to enjoy a double tax benefit for the same dollars (both exclusion of the $400 built-in gain and deduction of that same $400 built-in gain), his charitable contribution deduction should be limited to his $100 basis in the contributed property under § 170, representing after-tax dollars, rather than the property's $500 FMV. Nevertheless, as you will learn in Chapter 18, Mark is permitted to deduct the full $500 FMV of the property (thus enjoying a double tax benefit—both exclusion and deduction—of the same $400 built-in gain) if, among other requirements, the property's built-in gain represents long-term capital gain (rather than ordinary gain or short-term capital gain).

Because of this favorable treatment accorded long-term capital gain property contributed to charity or government, it had become common by the mid-1960s for Presidents of the United States to contribute to the National Archives the papers that they collected over the years of their public careers. President Nixon donated 21 boxes containing 41,300 items from his congressional

and vice presidential terms, such as speeches, correspondence, and audiotapes documenting the 1960 campaign, before December 31, 1969.[28] The contribution lawfully permitted him to deduct the FMV of the contributed items on his 1968 tax return because the built-in gain with respect to the papers (essentially their entire FMV) would have constituted long-term capital gain, and the other requirements in § 170 allowing a full FMV deduction were satisfied.

In early 1969, Congress proposed amending the law by adding what is now § 1221(a)(3)(B), which excludes letters, memoranda, and similar property from capital asset treatment if they are held by "a taxpayer for whom such property was prepared or produced." Because the papers held by Nixon would no longer qualify as capital assets in his hands, his charitable contribution deduction for any additional contributions to the National Archives would be limited to his basis in the papers, essentially nothing. While President Nixon and others in the White House lobbied heavily against the enactment of the provision, the Tax Reform Act of 1969 retained the provision, with an effective date of July 25, 1969. Donations made after that date would not qualify for the FMV deduction. President Nixon signed the law on December 30, 1969. Shortly before the tax filing deadline in 1970, the President's lawyer prepared documents backdated to March of 1969, claiming that more than 1,000 boxes of additional papers were donated to the National Archives at that time so that the President could take a full FMV deduction, even though the boxes were not donated until 1970. The *Washington Post* broke the story in June of 1973, and the Joint Committee on Taxation investigated, concluding that President Nixon owed a total of $432,787 in back taxes and interest for tax years 1969 to 1973. The President claimed that he had no knowledge of the backdating and was not charged with a crime. In 1974, Congress enacted the Presidential Recordings and Materials Preservation Act, which declared "official presidential papers to be public property and the papers of all presidents beginning in 1981 to be the property of the United States."[29]

You cannot make this stuff up!

### *§ 1221(b)(3): the election for self-created musical works*

Enacted in 2005 as a temporary measure but made in permanent in 2006, § 1221(b)(3) is perhaps the best example of the strength of sheer lobbying power. The Country Music Association lobbied Congress heavily for this provision,[30] which permits song writers to elect to treat their songs as capital assets, notwithstanding §§ 1221(a)(1) and (a)(3)(A) (though not for purposes of the charitable contribution deduction). Why should the sale of self-created songs create low-taxed capital gain while the sale of self-created paintings or books do not? The legislative history contains a single sentence: "The Congress believes it is appropriate to allow taxpayers to treat as capital gain the income from a sale or exchange of musical compositions or copyrights in musical works the taxpayer created."[31] But *why* is it "appropriate"? The sale of a song's copyright by the composer represents a return on labor just as much as Jacob's sale of his painting to the art gallery or an author's sale of her copyright to a book, both of which produce ordinary gain.

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[28] The story recounted here is from Matthew G. Brown, *The First Nixon Papers Controversy: Richard Nixon's 1969 Prepresidential Papers Tax Deduction*, 26 ARCHIVAL ISSUES (2001).
[29] *Id.* at 10.
[30] *See* Brody Mullins, *Music to Songwriters' Ears: Lower Taxes—Country Artist's Group Presses Lawmakers to Slash the Levy on Lyricists*, at http://online.wsj.com/article/SB113322576138408618.html.
[31] JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS 277 (2007).

The sale of a patent also qualifies for capital gain treatment under § 1235—even if the patent is sold by the inventor, in which case the sale represents a return on his or her labor. Moreover, the gain is treated as capital gain even if the consideration is contingent on use of the patent akin to a royalty (which is otherwise treated as ordinary income). While a stretch, perhaps such favorable treatment for patents sold by their inventors can be justified by the positive externalities that scientific and technology advancements can sometimes generate. Can preferential treatment for musical compositions sold by their composers be defended on similar terms?

***§ 1221(a)(7): hedging transactions***

To understand the history behind § 1221(a)(7), we need to take a little detour first to talk about commodities futures contracts.

Commodities futures contracts were developed to reduce the risk of future price fluctuations for buyers and sellers of commodities. Farmer Frank, who is planting corn today and wants to be sure of the price at which he can eventually sell it, can enter into a contract for *future sale* at a price agreed to *now*. By doing so he would remove the risk that spot prices on the delivery date would be lower. (The "spot" price is the price paid for an asset when the exchange of goods and money between buyer and seller takes place in the present, *i.e.*, "on the spot.") On the other side, Paul Producer, a corn syrup manufacturer wanting to be sure of the price at which he can *buy* corn, can enter into a contract for *future delivery* at a price agreed to *now*, removing the risk that spot prices on the delivery date will be higher. Exchanges developed over which Farmer Frank and Paul Producer could buy and sell these contracts to take advantage of interim price fluctuations. In other words, commodities futures trading involves the buying and selling of contracts for the future delivery of physical raw materials, such as corn, gold, copper, soybeans, and even livestock (cattle or pigs).

But the exchanges are not limited to those, like Frank and Paul, who might actually transfer and take delivery of the underlying commodities that are the subject of the contract. Indeed, the bulk of those who trade futures contracts over exchanges are speculators who are merely betting on future price swings.

For example, assume that Samantha Speculator signs in to her online trading account at 10:00 a.m. on February 3 of Year 1 and buys one Year-1 June corn futures contract for the current market price of $1.00 per bushel. Later that day, Samantha notices that one June corn futures contract is now trading at $1.04 per bushel, and she sells the contract that she bought earlier that day. One corn futures contract is 5,000 bushels, which means that Samantha actually paid $5,000 for her one corn futures contract (typically with borrowed money to a large extent), and she realizes $5,200 on the sale, for a profit of $200.

What is the character of Samantha's gain? Under § 1256, 60% of any gain or loss realized on the sale of a regulated futures contract is treated as long-term capital gain or loss, and 40% is treated as short-term capital gain or loss—*regardless of how long Samantha owns the contract*. In addition, such contracts are marked to market at the end of each year. Thus, if Samantha buys a futures contract on December 15 of Year 1 and sells it on January 10 of Year 2, she must mark the contract to market on December 31, treat any gain or loss as 60% long term and 40% short term, and adjust her basis in the contract, accordingly. When she sells on January 10 of Year 2, any further § 1001 realized gain or loss is again treated under the 60-40 rule.

Why are futures contracts sold at a gain treated so favorably, with ownership of mere minutes

creating 60% long-term capital gain? As Warren Buffett said, "There are so many ways to attack the logic of it. It doesn't make sense."[32] This tax expenditure loses about $2 billion in tax revenue each year. But I digress….

Under § 1256, losses realized on the sale of a futures contract are capital losses (60% long-term loss and 40% short-term loss), and you know from Part A. that capital losses that are otherwise deductible under § 165 are nevertheless subject to the § 1211(b) limitation rule. That is to say, capital losses (whether long term or short term) are deductible in the realization year only to the extent of realized and recognized capital gains (whether long term or short term) plus, for individuals, up to $3,000 of included ordinary income.

Nevertheless, in a year before either § 1256 or § 1221(a)(7) was enacted (and commodities futures contracts were treated as capital assets because not otherwise listed in the predecessor to § 1221), the Supreme Court held that some futures contracts were *not* capital assets if held as an integral part of the taxpayer's business operations. The taxpayer in *Corn Products Refining Company v. Commissioner*[33] used between 35 and 60 million bushels of corn each year in the manufacture of various products, including corn starch, syrup, and sugar, as well as their byproducts, such as corn oil and animal feed. To partially hedge against unpredictable price swings in corn, Corn Products bought corn futures contracts. Sometimes Corn Products actually took delivery of corn under the futures contracts, but at other times it sold the futures contracts, realizing either a gain or loss. In 1940, it realized a gain of approximately $600,000 on such sales, while it realized a loss of approximately $110,000 in 1941. Corn Products treated these gains and losses as capital gains and losses. The IRS, however, argued that the futures contracts were ordinary assets in the hands of Corn Products, and the Supreme Court agreed.

> Nor can we find support for petitioner's contention that hedging is not within the exclusions of [§ 1221]. Admittedly, petitioner'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 of [§ 1221] must not be so broadly applied as to defeat rather than further the purpose of Congress. 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 preferential treatment provided by [§ 1221] 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." *Burnet* v. *Harmel*, 287 U.S., at 106. 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. This Court has always construed narrowly the term "capital assets" in [§ 1221]. *See Hort* v. *Comm'r*, 313

[32] Andrew Ross Sorkin, *An Addition to the List of Tax Loopholes*, at http://dealbook.nytimes.com/2011/07/11/an-addition-to-the-list-of-tax-loopholes. Moreover, the amounts invested in such futures contracts is not trivial. One 2013 estimate put the value of futures contracts at $24 trillion. "The value of the American stock market is only $23 trillion." *Swapping Bad Ideas*, THE ECONOMIST, April 27, 2013, at 69.

[33] 350 U.S. 46 (1955).

U.S. 28, 31; *Kieselbach* v. *Comm'r*, 317 U.S. 399, 403.[34]

Thus, the Court distinguished between "speculative transactions in commodity futures" on the one hand and "hedging transactions" on the other and held that "hedging transactions were essentially to be regarded as insurance rather than a dealing in capital assets and that gains and losses therefrom were ordinary business gains and losses."[35]

For many years thereafter, businesses who bought and sold commodities futures contracts relating to their businesses attempted to walk a fine line in their attempts to capture the best of both worlds, arguing that they held the futures contracts as hedges under *Corn Products* when they sold the contracts at a loss (which would be ordinary, avoiding the § 1211 capital loss limitation rule) and arguing that they held those contracts sold at a gain as mere speculators, garnering capital gain treatment. As you can imagine, much litigation ensued, as courts were required to examine the facts of each case to determine the business's purpose in holding the contracts.

Moreover, taxpayers argued that *Corn Products* created an additional common law exception to the definition of capital asset that went beyond commodities futures contracts. They argued that *any* asset integrally related to the taxpayer's business (rather than held for investment) was not a capital asset under *Corn Products*, even though not otherwise described in § 1221. For example, the taxpayer in *Commissioner v. Bagley & Sewell Company*[36] entered into a contract to sell two paper-making machines to the government of Finland for $1.8 million. The government of Finland required that Bagley & Sewell purchase and deposit into escrow U.S. Government bonds as security for performance under the contract. Upon satisfactory completion of the contract, the bonds were released to Bagley & Sewell, who then sold the bonds at a loss and sought to deduct the loss as ordinary (unhampered by § 1211) under *Corn Products*. The IRS argued that the bonds were capital assets because not described in § 1221's list of exclusions, but the Second Circuit agreed with the taxpayer, holding that the bonds were not capital assets under *Corn Products* because they were integrally related to the performance of the taxpayer's business contracts.

Finally, the Supreme Court clarified its prior *Corn Products* holding in *Arkansas Best Corporation v. Commissioner*,[37] where it rejected the idea that *Corn Products* created a common law exception to the definition of a capital asset. "We conclude that *Corn Products* is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business's inventory-purchase system fall within the inventory exclusion of § 1221[(a)(1)]."

The Court's holding still not address the whipsaw problem, however. Taxpayers who realized losses on their inventory hedges could often claim that the hedge was an integral part of the business's inventory-purchase system (and thus were not capital assets under the inventory exclusion in § 1221(a)(1) under *Corn Products* and *Arkansas Best*), while those who realized gains could attempt to quietly include them as capital gains. Congress finally enacted § 1221(a)(7). Today, a taxpayer who enters into a hedging transaction (such as purchasing a corn futures contract to hedge against price fluctuations in corn when corn is a raw material in the manufacturing process) must identify the contract as a hedge on the date of acquisition to avoid capital asset treatment (under § 1256 if the hedge is in the form of a regulated futures contract). Thus, they cannot quietly wait until they sell the hedge to decide whether to argue that the asset was—or was

[34] *Id.* at 51-52.
[35] *Id.* at 52-53.
[36] 221 F.2d 944 (2d Cir. 1955).
[37] 485 U.S. 212 (1988).

not—integrally related to their inventory-purchase system.

Section 1221(a)(7) also extends the hedging exception beyond those hedges involving inventory. Hedges entered into to manage the risk of interest rate and foreign currency fluctuations that can affect the taxpayer's business, for example, can also be identified as hedges under § 1221(a)(7).

Whew!

***The sale of a right to collect ordinary income in the future***

A taxpayer selling his services or inventory often has "accounts receivables," which represent amounts owed to them by customers who purchased goods or services on credit and which the taxpayer will include as ordinary income. A taxpayer using the cash method of accounting will not include the ordinary income until actually or constructively received and, thus, will have a zero basis in the receivables. A taxpayer not wishing to wait until the future payment is received from the customer can sell the receivables in the marketplace at a discount, with the buyer often called a "factor." The factor then collects from the customer. Under § 1221(a)(4), the accounts receivables are not capital assets, so the gain on sale of the receivables to the factor is ordinary.

The idea behind the capital asset exception for accounts receivables informs the analysis when nonbusiness taxpayers sell a future right to receive ordinary income. For example, a lottery winner may sell to a factor for a discounted lump sum the future right to collect ordinary income over, say, 20 years. While taxpayers have often argued that their right to receive future income is a capital asset so that their sale gain is capital gain, they have uniformly lost.[38]

This line of analysis has particular relevance to the sale of a carved-out income interest in property, where the selling taxpayer otherwise retains the underlying property. In *Commissioner v. P.G. Lake*,[39] for example, the Supreme Court held that amounts received on the sale of a carved-out working interest in oil and gas wells (with the selling taxpayer otherwise retaining the land) represented a substitute for the ordinary income that would have been earned on the wells by the taxpayer absent the sale of the carved-out interest.[40]

***The sale or exchange requirement***

The phrase "sale or exchange" in § 1222(1) through (4) is not defined in the statute or regulations and has not had a major impact in the capital gains area. Nevertheless, common law has clarified that the requirement is generally not satisfied unless the property survives the transfer in the hands of the other party; a transfer in which the property is merely extinguished or matures is not a sale or exchange.[41] Thus, while tenure held by college professors could feasibly be considered a property right under state law, payment to a professor in consideration for his tenure rights cannot generate capital gain because tenure does not survive the transaction as a property right in the hands of the college, to be bestowed on another candidate.[42] Similarly, abandonment,

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[38] *See, e.g.*, Lattera v. Comm'r, 437 F.3d 399 (3rd Cir. 2006).
[39] 356 U.S. 260 (1958).
[40] Congress has now addressed the sale of certain carved-out income interests more comprehensively. For example, the treatment of stripped bonds, where the owner of the bond sells only the right to future interest payments while retaining the underlying bond and its right to principal repayments, is addressed in § 1286.
[41] *See, e.g.*, General Artists Corp. v. Comm'r, 205 F.2d 360 (2d Cir. 1953); Comm'r v. Starr Bros, 204 F.2d 673 (2d Cir. 1953); Comm'r v. Pittson Co., 252 F.2d 344 (2d Cir. 1958).
[42] *See, e.g.*, Foote v. Comm'r, 81 T.C. 930 (1983), *aff'd*, 751 F.2d 1257 (5th Cir. 1985).

destruction, or theft of property is not a "sale or exchange."

In some instances, the statute artificially satisfies the sale or exchange requirement by statutory fiat so that a realized gain or loss can be capital. Here are a few of the more notable examples.

- Upon the liquidation of a corporation, the outstanding stock does not survive the transaction. Nevertheless, the sale or exchange requirement is deemed satisfied under § 331(a) so that the shareholders can treat their realized gains and losses (the difference between the consideration received from the corporation in retirement of their stock and their adjusted bases in the stock) as capital gain or loss rather than ordinary gain or loss.
- When a borrower repays a debt, the retired debt instrument does not survive the transaction in the hands of the lender. Nevertheless, the sale or exchange requirement is deemed satisfied under § 1271(a) so that the difference between the lender's basis in the instrument and the amount received on retirement (other than interest), if any, can be treated as capital gain or loss.
- When a security or other debt instrument held for investment becomes worthless, the holder can usually treat the worthlessness as arising on sale or exchange under §§ 165(g) or 166(d).
- If personal casualty gains exceed personal casualty losses (considered in Chapter 18), the gains and losses are treated as arising on sale or exchange under § 165(h)(2)(B).
- The loss arising from the failure to exercise an option to buy a capital asset (equal to the basis of the option) is deemed to arise from the sale or exchange of a capital asset on the day the option expires under § 1234.
- An amount received by a lessee in cancellation of a lease is deemed to be an amount received in exchange for the lease under § 1241.

***The Arrowsmith doctrine***

The taxpayer in *Commissioner v. Arrowsmith*[43] was the successor in interest to a corporation that liquidated in 1940. The taxpayer had properly included in his 1940 Gross Income capital gain equal to the difference between the liquidation proceeds that he received and his basis in the corporation's stock. For purposes of illustration, let's assume that Arrowsmith had an A/B of $30,000 in his stock and that he received $100,000 from the liquidating corporation, resulting in a $70,000 realized gain under § 1001. Even though the stock was a capital asset in Arrowsmith's hands, his realized gain would be ordinary absent § 331(a) because the stock does not survive the liquidation. As you learned just above, however, § 331(a) steps in to artificially satisfy the sale or exchange requirement in this situation, which means that Arrowsmith's $70,000 realized gain was properly treated as capital gain in 1940.

In 1944, however, Arrowsmith was called upon (as successor in interest under state law) to pay a judgment rendered against the old corporation, which Arrowsmith could properly deduct in 1944 because the outlay was related to his prior stock investment (not to personal consumption). Let's assume that Arrowsmith had to pay $10,000 on this claim. The issue was whether the 1944 deduction was ordinary because it did not arise on the "sale or exchange" of a "capital asset" under § 1222 (which Arrowsmith preferred) or whether it was capital, subject to the § 1211(b) capital

[43] 193 F.2d 734 (2d Cir. 1952).

loss limitation rule.

The taxpayer's argument was premised on the annual accounting principle. There was no sale or exchange of a capital asset *in 1944*—only the payment of a claim.

The court held, however, that Mr. Arrowsmith's $10,000 deduction should be treated as a capital loss on the theory that, if the old corporation had properly paid the liability before liquidating, he would have realized less capital gain (or even a capital loss) on the liquidation. That is to say, suppose that the claim had ripened and the corporation had paid that $10,000 before the liquidation. In that case, Mr. Arrowsmith would have received only $90,000 (instead of $100,000) on the liquidation and, thus, would have included only $60,000 of capital gain instead of $70,000 in 1940. For this reason, the court concluded that the character of the Year-2 deduction was determined by reference to the character of the Year-1 inclusion (upon the liquidation) with which it was transactionally linked. In a sense, Mr. Arrowsmith was forced to "recapture" $10,000 of capital gain that, with the benefit of hindsight only, we now know was too much.

This characterization rule, now known as the *Arrowsmith* doctrine, provides a good segue to the consideration of depreciation recapture, described in Part D., which you can think of as a codification of the *Arrowsmith* doctrine in the particular context of a sale of depreciable property.

## D. Section 1231 gains and losses and depreciation recapture

You learned in Part B. that § 1221(a)(2) excepts from the capital asset definition real and depreciable personal property *used* in the taxpayer's trade or business. Thus, neither the land tilled by a farmer growing crops, the factory building in which widgets are manufactured, nor the widget-making machine in the factory are capital assets. Absent §§ 1231, 1245, and 1250, therefore, the gains arising on sale or exchange of these assets would always be ordinary gain, ineligible for the preferential rates in § 1(h), and the losses arising on sale or exchange of these assets would always be ordinary losses, free from the § 1211 capital loss limitation rule. Section § 1231 (on both the gain and loss sides) and §§ 1245 and 1250 (on the gain side only) can alter these characterizations.

### *§ 1231 gains and losses*

Prior to 1938, assets used in business *were* treated as capital assets, contrary to current § 1221(a)(2). During the Great Depression, however, many businesses realized losses on the sale or exchange of such business assets. These capital losses were difficult to deduct under the capital loss limitation rule, and Congress responded in 1938 by enacting the predecessor to § 1221(a)(2), removing assets used in business from capital asset treatment.[44] Because very few taxpayers realized gains on the sale of such assets at this time in our history, § 1221(a)(2) operated chiefly to benefit taxpayers.

Then came WWII. In exercising its right under the 5th amendment to take private property for public use so long as just compensation is paid, the Federal government appropriated many business assets, particularly ships and WWI-vintage submarines, for the war effort (especially in the early years of the war, before the massive building of new factories, ships, and submarines). Many of these assets were fully depreciated in the hands of their former owners, with a zero or

[44] *See* Myron C. Grauer, *A Case for Facilitation of a Collaborative Model of Statutory Interpretation in the Tax Area: Lessons to be Learned from the* Corn Products *and* Arkansas Best *Cases and the Historical Development of the Statutory Definition of "Capital Asset)s),"* 84 KY. L.J. 1, 48-55 (1995-1996) (describing this evolution).

low basis, and the taking (with FMV consideration) resulted in a substantial § 1001 realized gain. With the top marginal rate on ordinary income and gain exceeding 90% during WWII, the formerly beneficial § 1221(a)(2), which had operated mainly as a shield against the § 1211 capital loss limitation rule, became a sword.

Congress could simply have repealed § 1221(a)(2), restoring assets used in business to their pre-1938 status as capital assets, with the result that taxpayers realizing a gain on these takings would likely have had the gain taxed at low rates. But then taxpayers would have lost the bright side of § 1221(a)(2) if they sold such business assets at a loss. Congress responded to this dilemma by enacting § 1231, which gave these taxpayers essentially the best of both worlds.

Section 1231(b) generally defines § 1231 property with precisely the same words found in § 1221(a)(2) with the additional requirement that the property must be held for more than one year.[45] **If the taxpayer's realized and recognized § 1231 gains exceed the taxpayer's realized and recognized § 1231 losses for the year, § 1231(a)(1) provides that the gains and losses are "treated" like long-term capital gains and losses—even though the assets are *not* capital assets (because described in § 1221(a)(2)).** For this reason, they are sometimes called "quasi" capital gains and losses. If § 1231(a)(1) applies, the taxpayer's chances of having favorably taxed net capital gain are very good (unless the taxpayer realizes a lot of real capital losses from other sources). **In contrast, if the taxpayer's § 1231 losses equal or exceed the taxpayer's § 1231 gains, § 1231(a)(2) provides that their real status as ordinary gains and losses will control.** If § 1231(a)(2) applies, the taxpayer's chances of avoiding the § 1211 capital loss limitation rule are very good (unless the taxpayer realizes a lot of real capital losses from other sources). In other words, it's "heads I win, tails you lose" to the Federal Treasury!

Section 1231 is best seen as a provision enacted as an immediate response to the exigent circumstances of WWII rather than as a provision grounded in tax theory. Nevertheless, once a provision broadly benefiting taxpayers is enacted, it is often very difficult to repeal. Hence, § 1231 lingers on.

A relatively minor deviation from the best-of-both-worlds result was added in 1981 in the form of the 5-year look-back rule in § 1231(c). The taxpayer's *net* § 1231 gain for any taxable year (the excess of § 1231 gains over § 1231 losses) is treated as ordinary gain (instead of long-term capital gain) to the extent that it does not exceed the taxpayer's favorably treated *net* § 1231 losses (which were treated like ordinary losses) for the prior 5 years. In other words, to the extent that the taxpayer benefited from avoiding the § 1211 capital loss limitation rule because of § 1231(a)(2) in the prior 5 years, he has to give up the favorable treatment provided by § 1231(a)(1) in the current year until all such favorably treated net § 1231 losses have been "recaptured."

For example, assume that Craig realizes the following § 1231 gains and losses in Years 1 through 3 from the sale of assets used in his business, that additional inclusions not eligible for the favorable § 1(h) net capital gain rate would be taxed at 28%, and that Craig realizes no real capital gains or losses in any year.

| | § 1231 gains | § 1231 losses |
|---|---|---|
| **Year 1** | $20,000 | $15,000 |
| **Year 2** | 10,000 | 17,000 |

[45] It also throws in additional property, such as certain timber, coal, livestock, unharvested crops

| | | |
|---|---|---|
| **Year 3** | 40,000 | 10,000 |

Under § 1231(a)(1), Craig "treats" the $20,000 Year-1 gain as long-term capital gain and the $15,000 Year-1 loss as long-term capital loss because his § 1231 gains exceed his § 1231 losses for the year. Because Craig realizes no additional real capital gains or losses, we know that Craig can fully deduct his $15,000 loss, notwithstanding § 1211(b), and that Craig has net capital gain of $5,000 under § 1222(11), eligible for a reduced tax rate under § 1(h).

In Year 2, Craig's $10,000 gain and $17,000 loss are respected as the ordinary gains and losses that they really are under § 1221(a)(2) because his § 1231 losses exceed his § 1231 gains under § 1231(a)(2). Thus, § 1211(b) does not apply, and Craig can fully deduct his $17,000 loss, effectively offsetting not only the $10,000 gain but also $7,000 of ordinary income from other sources.

Absent § 1231(c), Craig would treat the $40,000 gain realized in Year 3 as entirely long-term capital gain (and the $10,000 loss as long-term capital loss) under § 1231(a)(1) because his § 1231 gains exceed his § 1231 losses; his $10,000 loss would reduce $10,000 of his gain, and the remaining $30,000 of net gain would qualify as net capital gain subject to a reduced tax rate under § 1(h). Under § 1231(c), however, Craig must treat $7,000 of his remaining $30,000 of net gain as ordinary gain (equal to the $7,000 Year-2 net loss that escaped the grasp of § 1211(b)).

Finally, while rental property is often not considered "business" property (but rather investment property) for other purposes unless significant services are provided by the lessor, some courts have construed "business" in § 1231(b) more broadly. For example, the taxpayer in *Wasnok v. Commissioner*[46] held only a single rental property for four years before it was sold at a loss. The court concluded that the rental property was "business" property for purposes of § 1231(b), which permitted the loss to be treated as an ordinary (not capital) loss under § 1231(a)(2). On the other hand, the IRS issued a 1983 Technical Advice Memorandum opining that land rented to a tenant who built, managed, and operated a hotel under a net lease (the lessee was responsible for taxes, insurance, and maintenance) was not business property for the lessor for purposes of § 1231.[47]

***§§ 1245 and 1250 "depreciation recapture"***

Sections 1245 and 1250 were enacted in 1962 and are commonly referred to as "depreciation recapture" provisions. They trump all other characterization provisions, including § 1231 and the capital gain provisions in §§ 1221 and 1222.[48] To the extent required under these provisions, realized gain on the sale of depreciable § 1231 property or a depreciable capital asset is treated as ordinary gain. Let's consider § 1245 first, which is the much more powerful of the two provisions.

Suppose that Jim purchases a widget-making machine for $1 million for use in his business, properly deducts $700,000 in depreciation (reducing the machine's basis to $300,000 under § 1016(a)(2)), and then sells the machine for $900,000 in a later year. You learned in Chapter 14 that an important tax expenditure component of the depreciation provisions is that the deductions are intentionally frontloaded, allowing Jim to deduct his basis much faster than would occur under economic depreciation and much faster than any actual reduction in the property's FMV. While Jim's property lost only $100,000 in value, he was permitted to deduct $700,000 during his ownership period. Nevertheless, the basis reduction required under § 1016(a)(2) ensures that the too-fast depreciation will result in realized § 1001 gain if the property is sold before being used up

[46] T.C. Memo. 1971-6.
[47] *See* TAM 8350008 (Aug. 23, 1983).
[48] *See* §§ 1245(d) and 1250(h).

in Jim's business. Thus, Jim realizes and recognizes a $600,000 gain on the sale ($900,000 A/R *less* $300,000 A/B), an amount precisely equal to the excess of the depreciation allowed to Jim during his ownership years over the property's loss in value.

Even though the § 1016(a)(2) basis reduction effectively recaptures the *amount* of excessive depreciation, it does nothing about the possible character arbitrage. Jim's $600,000 in excessive depreciation deductions were ordinary deductions, offsetting high-taxed ordinary income, while the property sale would (absent § 1245) produce § 1231 gain, which would be "treated" like long-term capital gain under § 1231(a)(1) if this is Jim's only § 1231 transaction for the year.

This is where § 1245 steps in. In effect, **§ 1245(a) requires *all* realized gain on the disposition of § 1245 property (non-real estate) *up to the amount of prior depreciation and § 179 deductions* to be characterized as ordinary gain**. Only the remaining gain—if any—can be § 1231 gain or capital gain, as the case may be. To be specific, § 1245(a)(1) provides that the *lower* of (1) "recomputed basis" or (2) amount realized (FMV in the case of a disposition other than by sale or exchange) *less* A/B is ordinary gain. Recomputed basis, as defined in § 1245(a)(2), is the taxpayer's original cost basis (*i.e.*, his current basis *plus* all § 179 and depreciation deductions taken during his ownership period). Thus, when Jim sells the machine for $900,000, the lower of recomputed basis ($1 million) and amount realized ($900,000) is the amount realized. The excess of this figure ($900,000) over the machine's A/B ($300,000) is $600,000, which must be treated as ordinary gain. Thus, 100% of Jim's $600,000 realized § 1001 gain must be characterized as ordinary depreciation recapture gain under § 1245(a).

Section 1245 can be thought of as a codification, of sorts, of the *Arrowsmith* doctrine in that we must characterize a current-year gain by reference to the prior-years' excessive depreciation that created that built-in gain. Jim realizes a gain on sale only *because of* the excessively generous depreciation deductions allowed (and the concomitant reduction in basis) in prior years. Thus, we must characterize this current-year gain by reference to the too-generous *ordinary deductions* taken in prior years, essentially reversing the effect of those ordinary deductions. Because of the time value of money, however, Jim is still better off than he would be if his earlier depreciation deductions were, instead, limited to the actual $100,000 reduction in the machine's FMV, producing no realized gain on sale for $900,000.

Another way of saying this is that the prior (ordinary) depreciation deductions were appropriate in the year taken in the sense that they were based on the expectation that the depreciated assets would be used up in Jim's business producing (ordinary) business income. When that expectation proves to be false because the asset is sold at a gain that can be taxed as capital gain (because the asset is either a capital asset or a § 1231 asset), we do not go back and take away what is now—with the benefit of hindsight only—known to be excessive ordinary deductions, in a sense. Rather, we take care of the problem entirely in the year of sale under the annual accounting principle by recharacterizing some or all of the resulting sale gain as ordinary gain.[49]

Because most depreciable non-real estate—such as Jim's business equipment—loses some

[49] This use of the annual accounting principle is evidenced in § 61(a)(12) debt-discharge income, as well. As described in Chapter 11, a borrower who fails to repay debt (unconnected with property) does not go back and include the borrowed loan principal in the year originally received (and excluded). Exclusion in the year of receipt was proper based on what we anticipated would happen in the future: repayment of the loan principal with after-tax dollars. When repayment fails to occur, we take care of the problem in that later year by creating an income inclusion to reverse, in effect, the prior exclusion of the loan proceeds that we now know, with the benefit of hindsight only, to be unjustified.

value after purchase (though not as much as allowed to be deducted under §§ 179 and 168), § 1245 typically recharacterizes 100% of the realized gain as ordinary depreciation recapture, completely supplanting § 1231 (or §§ 1221 and 1222 in the case of a capital asset). In the unusual case in which the equipment *appreciates* in value after purchase, however, there may be some remaining gain to analyze as § 1231 gain or capital gain after applying § 1245(a).

For example, assume the same facts except that Jim is able to sell the machine for $1,100,000 (instead of $900,000), realizing a $800,000 gain under § 1001 ($1,100,000 A/R *less* $300,000 A/B). Now the lower of recomputed basis ($1 million) and amount realized ($1,100,000) is the recomputed basis of $1 million. The excess of this figure ($1 million) over the machine's $300,000 A/B is $700,000. Thus, only $700,000 (equal to 100% of the prior depreciation deducted by Jim) of the $800,000 realized gain is characterized as ordinary depreciation recapture under § 1245(a). The remaining $100,000 gain is § 1231 gain that will be "treated" like long-term capital gain under § 1231(a)(1) if this is Jim's only § 1231 transaction for the year.

While § 1245 is very powerful, § 1250 is essentially irrelevant today. **Under § 1250(a) and (b), realized gain on the disposition of § 1250 property (depreciable real estate, such as a factory or rental real estate) is ordinary gain *only* to the extent of the excess of depreciation *actually taken* by the taxpayer over the amount that *would have been taken* had the property been depreciated using the straight-line method.** Before the Tax Reform Act of 1986, real estate could be depreciated using an accelerated method. Assume, for example, that a taxpayer purchased a factory in 1980 for $1 million, properly deducted $600,000 using an accelerated depreciation method (reducing the factory's basis to $400,000), and sold the property in a later year for $900,000, realizing a $500,000 gain ($900,000 A/R *less* $400,000 A/B). Had the taxpayer depreciated the factory using the straight-line method, assume that that the taxpayer would have deducted only $400,000 (instead of $600,000). Under § 1250, the taxpayer's $500,000 realized gain would have been ordinary only to the extent of $200,000, equal to the excess of the $600,000 of depreciation actually taken over the $400,000 that would have been taken using the straight-line method. The remaining $300,000 of realized gain would have been § 1231 gain.

One of the base-broadening measures adopted in 1986 to pay for the significant reduction in marginal rates was to require that all real estate be depreciated under the straight-line method, as described in Chapter 14. Moreover, real estate is not eligible for the § 179 deduction. Thus, § 1250 depreciation recapture is zero for virtually all real estate today. Because § 1250 is basically deadwood, § 1231 has its greatest impact on the sale of real estate, permitting rate arbitrage. Many propose extending § 1245 to real estate,[50] but remember the strength of the real estate lobby!

## Problems

In addition to each of the transactions described below, Rebecca, who is unmarried, has $100,000 of AGI consisting of ordinary income. Can her capital losses, if any, be fully deducted? Does she realize any net capital gain within the meaning of § 1222(11)? Notice that you must first analyze the tax consequences of each transaction individually.

**a.** Rebecca sells stock of Gaggle, Inc., for $100,000, which she purchased 2 years ago for $90,000.

[50] *See, e.g.*, Richard L. Schmalbeck & Jay A. Soled, *Reforming Real Estate Depreciation Recapture*, 146 TAX NOTES 887 (2015).

**b.** Rebecca sells stock of Blapple, Inc., for $20,000, which she purchased 3 years ago for $40,000.

**c.** Rebecca made a bona fide loan of $30,000 to a friend 2 years ago. She received interest payments on the loan, but she was informed by the Bankruptcy Court this year that the loan is discharged by the court and that Rebecca will never receive the $30,000 loan principal.

**d.** Rebecca purchased rental real estate 10 years ago for $1 million, which she actively manages. She properly deducted $350,000 in depreciation over the years before selling the property this year for $1.2 million.

**e.** Rebecca purchased equipment for use in her business 3 years ago for $900,000 and properly deducted $400,000 in depreciation before selling the equipment this year for $700,000.

**f.** Two years ago, Rebecca sold vacant land, which she held for investment and which had a $220,000 basis, to Mark for $300,000. She properly included $80,000 of long-term capital gain on her tax return in the sale year. This year, Mark threatens to sue Rebecca when he finds toxic sludge buried in one corner of the lot, as he suspects that Rebecca either was responsible for it or at least knew about it at the time of sale and failed to disclose the problem. To avoid litigation, Rebecca agrees to Mark's demand that she pay him $30,000 to clean up the sludge.

## E. The § 1(h) rates applicable to "net capital gain"

I think that it is more important to know that "net capital gain" within the meaning of § 1222(11) is subject to a reduced tax rate than to know precisely what that reduced tax rate may be. Nevertheless, I highlight below a few of the more important rules.

- Unless otherwise provided below, most net capital gain is subject to a maximum tax rate of 20% to the extent falling within AGI exceeding $400,000 ($450,000 for a married couple filing jointly) and 15% to the extent falling within AGI below those thresholds. For example, a married couple with $500,000 of AGI, consisting of $300,000 ordinary income and $200,000 net capital gain (none of which is unrecaptured § 1250 gain or collectibles gain) would have $150,000 of the net capital gain taxed at 15% and the remaining $50,000 taxed at 20%.
- Because § 1250 is so weak, most real estate gain realized by nondealers produces long-term capital gain or § 1231 gain that is "treated" like long-term capital gain under § 1231(a)(1) (if § 1231 gains for the year exceed § 1231 losses). Nevertheless, net capital gain arising from real estate is subject to a maximum tax rate of 25% to the extent that it represents "unrecaptured § 1250 gain," which is the amount of realized gain that would have been ordinary depreciation recapture had § 1245 applied instead of § 1250. This special rate could be repealed if § 1245 were extended to real estate, as it should be.
- Net capital gain attributable to the sale or exchange of "collectibles" is subject to a maximum tax rate of 28%.
- Net capital gain otherwise falling in the 10% or 15% brackets is taxed at 0%, though empirical data show that vanishingly little net capital gain falls within these brackets.

# Chapter 16: Tax Shelters

What is a "tax shelter"? That question is a difficult one on which there is no broad agreement. Nevertheless, I think it helpful to think of tax shelters as generally falling within two categories: (1) the mismeasurement of SHS wealth increases and decreases or (2) an attempted conversion of high-taxed ordinary income or gain into low-taxed capital gain (or other manipulation of the applicable tax rate).

In each category, in turn, there are three types of response: (1) clearly intended by Congress and permissible because of an economic, social policy, or administrative reason, *i.e.*, they are tax expenditures, (2) not intended by Congress and comprising a common pattern that lends itself well to statutory amendment to address it, or (3) not intended by Congress and a one-off or idiosyncratic transaction more efficiently addressed through individual adjudication and application of the substance over form doctrine and its progeny, including the step transaction doctrine, sham debt, tax ownership, the business purpose doctrine, and the economic substance doctrine.[1] Sometimes certain tax shelters are first addressed through common law adjudication but then result in statutory amendment, particularly if the shelter becomes common and clogs up the courts with expensive and inefficient case-by-case litigation. Even the economic substance doctrine, itself, has been codified, though the chief effect of its codification lies in the application of a strict liability penalty, as described below. Part A. will explore the various common law doctrines that are used in common law adjudication, and Part B. will consider a few of the more important statutory responses to tax shelter activity.

You learned in Chapter 1 that **SHS income comprises wealth increases *less* wealth reductions but only if the wealth reduction does not represent personal consumption**. Moreover, you learned that **a wealth reduction in the SHS sense means—in particular—an outlay or loss of previously or concurrently taxed dollars, *i.e.*, of *after-tax* dollars, to ensure that the same taxpayer does not enjoy a double tax benefit (both exclusion and deduction) for the same dollars**.

You have already studied numerous provisions that deviate from these core concepts, but these deviations are clearly intended tax expenditures (whether wise or unwise). Simple examples are contributions to § 401(k) plans, IRAs, and other qualified pension plans, which are accorded consumption tax treatment, as described in Chapter 2. Some personal consumption expenses (which would be nondeductible under either a pure income or pure consumption tax) are permitted to be deducted under current law, such as qualified residence interest, charitable contributions, and state and local income and real property taxes—all examined in Chapter 18. Similarly, the amount of wages received in the form of employer-provided health insurance is excludable from Gross Income, also discussed in Chapter 18, notwithstanding the *Old Colony Trust* two-step (under which the compensation in the form of employer-provided health care costs would be includable in Gross Income under § 61(a)(1) and the individual's deemed payment of the health care costs would be nondeductible under § 262(a) as a personal expenses). The receipt of a substantial gift or bequest

[1] In my view, each of these common law doctrines can be viewed as simply a variant of the substance over form doctrine, but courts often treat them as separately identifiable doctrines. Because of the recent codification of the economic substance doctrine and a strict-liability penalty that applies if the transaction is held to lack economic substance, discussed *infra*, the treatment of these doctrines as separate and independent doctrines has significance.

represents a wealth increase evidencing ability to pay but is nevertheless fully excludable under § 102, as you learned in Chapter 7. Property appreciation represents a wealth increase under SHS principles, but (except for those properties required to be marked to market each year under §§ 475 and 1256) this appreciation is not included in Gross Income until a realization event occurs and, moreover, is completely forgiven at death. You learned in Chapter 12 that untaxed borrowed principal can create basis immediately under *Crane* that can generate depreciation deductions of before-tax (rather than after-tax) dollars—thus allowing a double tax benefit for the same dollars to the same taxpayer (both exclusion and deduction) between the time that the deductions are taken and the principal is repaid with after-tax dollars. You also learned in Chapter 14 that statutory depreciation under current law is allowed at a rate that is much faster than economic depreciation. Each of these examples represents a permissible mismeasurement of SHS income, in the sense that it is clearly intended by Congress.

But even though these deviations are intended in isolation, the attempted *combination* of the last three in particular (the realization requirement which ignores property appreciation during ownership, the deduction of pre-tax dollars when borrowed funds generate expense and depreciation deductions before principal repayment, and the front-loading of depreciation) has often resulted in deduction of significant *non-economic losses*, resulting in both common law challenges and statutory amendment.

As with some forms of mismeasurement of SHS wealth increases and decreases, some forms of tax rate manipulation are clearly permissible (in the sense that they are intended by Congress). You have already learned, for example, of several instances in which a return on labor is permissibly treated as capital gain rather than (high-taxed) labor income. In Chapter 15, for example, you learned that the sale of a patent by the creator of the patented invention will generate capital gain under § 1235, that the music composer can elect, if she wishes, to have the gain realized on the sale of the composition treated as capital gain under § 1221(b)(3), but that the painter, sculptor, and author are out of luck under § 1221(a)(3)(A). (Go figure ….) We can now add additional examples to our list.

The gain realized by an entrepreneur who sells founders shares with a zero basis at a large gain (while paying himself a low salary until then) reflects much of his personal work effort. Yet, the sale gain is entirely capital gain.

Another example that has been much in the popular press in recent years is the taxation of so-called carried interest earned by private equity fund managers, who earn a return for their management skills in picking and managing investments purchased almost entirely with other people's money (the fund's investors), with only a nominal capital contribution by the managers. Their arrangements with the funds (organized as partnerships) typically provide that their return should be measured by two components (often referred to as "two and twenty"): (1) an amount equal to 2% of the funds under management each year and (2) an amount equal to 20% of any increase in the value of the fund assets each year (after a preferred return to the fund investors). While these managers include the portion described in (1) as ordinary income under § 61(a)(1) each year, they include the amount described in (2) as net capital gain or qualified dividend income (taxed at 15% or 20%) to the extent that the income earned by the fund consists of such income[2]—notwithstanding that *both* components are used mainly as benchmarks in valuing the *services that they perform for the fund*. In contrast, a corporate executive whose bonus is determined by how

[2] They also can often defer the inclusion until future years.

much the corporation's share price increases realizes ordinary income (whether paid in cash or in corporate shares under § 83). Why should private equity fund managers be treated differently?[3] The example exploits the failure to adequately differentiate between a return on human capital (a labor return) and a return on conventional capital. Many have called for reforms, but thus far none has been enacted.

But sometimes tax rate manipulation is unintended, resulting in statutory change or, in some cases, common law adjudication. For example, §§ 1258, 1259, and 1260 are complex provisions enacted in response to financial transactions that ostensibly convert high-taxed ordinary income into low-taxed net capital gain or that permits gain to go unrecognized for tax purposes even though certain hedging transactions (such as short sales against the box, forward contracts, and notional principal contracts) effectively lock in the gain. These provisions are beyond the scope of the basic income tax course, but they are indicative of the constant conversation between creative taxpayers (and their advisors) and Congress in the tax-avoidance tango (to mix my metaphors).

***Policy concerns***

Tax shelter activity can implicate the two main tax policy variables discussed in Chapter 3 that affect the soundness of any tax system: fairness and economic efficiency. Recall that Congress chose "income" as a tax base, as well as a progressive rate structure, because Congress decided that these choices best represent the resources under the control of the taxpayer and, thus, best represent the taxpayer's ability to contribute to the fisc. A mismeasurement of SHS income or a manipulation of the tax rate can result in a misallocation of the tax burden across the members of the population in a manner that deviates from ability to pay, which raises horizontal equity concerns if taxpayers with similar *economic* income can pay radically different amounts of tax. Moreover, tax shelters exact efficiency costs under the neutrality norm because they can alter taxpayer behavior, causing a misallocation of resources across the economy, thus diminishing aggregate societal wealth.

Most tax shelters reflect mere rent-seeking behavior of the sort described in Chapter 3—a mere shift of wealth from the Treasury (*i.e.*, other taxpayers, including you and me) to the tax shelter owner (in the form of reduced tax) without an increase in aggregate societal wealth. In that sense, much tax shelter activity is wasteful to the economy at large because it encourages the devotion of resources to merely shifting wealth rather than creating new wealth. At the least, the tax law ought not to encourage such waste.

Finally, tax shelters affect everyone because tax shelter activity that reduces revenue collection results in statutory marginal tax rates that are higher than they otherwise would need to be to raise *$X*, which further reduces economic efficiency. Remember—the less leaky the tax base (*i.e.*, the broader and the more impermeable the tax base), the lower tax rates can be, and the lower the rates, the less likely the tax will interfere in economic behavior. At bottom, your effective and marginal tax rates—particularly on labor income—are higher than they need to be because of tax shelter activity (both permissible and not) engaged in by other taxpayers.

Many tax shelters involve the corporate, partnership, or international tax provisions of the Internal Revenue Code and thus are not easy to discuss in a course focused on taxation of the

[3] *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L.REV. 1 (2008); Steven M. Davidoff. *A Chance to End a Billion-Dollar Tax Break for Private Equity*, at http://dealbook.nytimes.com/2013/10/22/chance-to-end-billion-dollar-tax-break-for-private-equity/?_r=0. Those who go on to study the taxation of business enterprises will study the partnership tax provisions at issue.

individual.[4] This chapter nevertheless begins with an early tax shelter case involving an individual and then explores a few examples from each of the categories described above to provide a general understanding of both the phenomenon and responses to it. Those of you who go on to upper-level tax courses will likely study other examples, as well as how the corporate, partnership, and international tax provisions have evolved in attempts to address them. The resulting colloquy between Congress and taxpayers inevitably results in additional statutory complexity.

## A. Common law doctrines used in tax shelter litigation

### *Sham debt*

Quoting the late Boris Bittker of Yale Law School, the Supreme Court noted in the first sentence of footnote 7 of *Tufts* in Chapter 12: "The Commissioner's choice in *Crane* 'laid the foundation stone of most tax shelters,' Bittker, *Tax Shelters, Nonrecourse Debt, and the* Crane *Case*, 33 TAX L. REV. 277, 283 (1978), by permitting taxpayers who bear no risk to take deductions on depreciable property."

Debt is often a key ingredient in packaged tax shelters because the receipt of borrowed principal is excludable from Gross Income even though, at the same time, the debt generates deductions in the form of interest and (often) basis depreciation (though depreciation was not at issue in the *Knetsch* case immediately below). Moreover, the property ostensibly purchased with debt may appreciate in value, but that appreciation most often goes untaxed until realized. For all of these reasons, the taxpayers attempting to take these deductions have often not actually suffered a *real* SHS wealth decrease in substance, *i.e.*, have not suffered an *economic* loss.

As you read the material below, keep in mind that the potential for abuse involving debt is highest when the debt is both (1) nonrecourse (limiting the taxpayer's economic exposure to the value of the securing collateral) and (2) extended by the other party to the transaction (often the tax shelter promoter) rather than an independent third party. With that combination, the debt may not be real in the sense that the tax shelter seller/lender may never expect "repayment" of the amount nominally lent, but the pretend debt nevertheless generates deductions (or so the shelter buyer hopes) with little risk of loss in view of the nonrecourse nature of the debt.

**KNETSCH v. UNITED STATES**

364 U.S. 361 (1960)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

This case presents the question of whether deductions from Gross Income claimed on petitioners' 1953 and 1954 joint Federal income tax returns, of $143,465 in 1953 and of $147,105 in 1954, for payments made by petitioner, Karl F. Knetsch, to Sam Houston Life Insurance Company, constituted "interest paid … on indebtedness" within the meaning of § 163(a) of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue disallowed the deductions

[4] For example, some may have heard through the popular press of the notorious so-called Boss (Bond Option Sales Strategy) and Son of Boss tax shelters, which essentially attempted to create non-economic paper losses through the use of contingent debt coupled with a strained interpretation of the rules in Subchapter K pertaining to partnerships. *See IRS Offers Settlement for Son of Boss Tax Shelter*, at www.irs.gov/uac/IRS-Offers-Settlement-for-Son-of-Boss-Tax-Shelter.

and determined a deficiency for each year. The petitioners paid the deficiencies and brought this action for refund in the District Court for the Southern District of California. The District Court rendered judgment for the United States, and the Court of Appeals for the Ninth Circuit affirmed. Because of a suggested conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States v. Bond*, 258 F.2d 577, we granted certiorari.

On December 11, 1953, the insurance company sold Knetsch ten 30-year maturity deferred annuity savings bonds, each in the face amount of $400,000 and bearing interest at 2½% compounded annually. The purchase price was $4,004,000. Knetsch gave the Company his check for $4,000, and signed $4,000,000 of nonrecourse annuity loan notes for the balance. The notes bore 3½% interest and were secured by the annuity bonds. The interest was payable in advance, and Knetsch on the same day prepaid the first year's interest, which was $140,000. Under the Table of Cash and Loan Values made part of the bonds, their cash or loan value at December 11, 1954, the end of the first contract year, was to be $4,100,000. The contract terms, however, permitted Knetsch to borrow any excess of this value above his indebtedness without waiting until December 11, 1954. Knetsch took advantage of this provision only five days after the purchase. On December 16, 1953, he received from the company $99,000 of the $100,000 excess over his $4,000,000 indebtedness, for which he gave his notes bearing 3 ½% interest. This interest was also payable in advance and on the same day he prepaid the first year's interest of $3,465. In their joint return for 1953, the petitioners deducted the sum of the two interest payments, that is $143,465, as "interest paid … within the taxable year on indebtedness," under § 23(b) of the 1939 Code [the predecessor to § 163(a)].

The second contract year began on December 11, 1954, when interest in advance of $143,465 was payable by Knetsch on his aggregate indebtedness of $4,099,000. Knetsch paid this amount on December 27, 1954. Three days later, on December 30, he received from the company cash in the amount of $104,000, the difference less $1,000 between his then $4,099,000 indebtedness and the cash or loan value of the bonds of $4,204,000 on December 11, 1955. He gave the company appropriate notes and prepaid the interest thereon of $3,640. In their joint return for the taxable year 1954 the petitioners deducted the sum of the two interest payments, that is $147,105, as "interest paid … within the taxable year on indebtedness," under § 163(a) of the 1954 Code.

The tax years 1955 and 1956 are not involved in this proceeding, but a recital of the events of those years is necessary to complete the story of the transaction. On December 11, 1955, the start of the third contract year, Knetsch became obligated to pay $147,105 as prepaid interest on an indebtedness which now totalled $4,203,000. He paid this interest on December 28, 1955. On the same date he received $104,000 from the company. This was $1,000 less than the difference between his indebtedness and the cash or loan value of the bonds of $4,308,000 at December 11, 1956. Again he gave the company notes upon which he prepaid interest of $3,640. Petitioners claimed a deduction on their 1955 joint return for the aggregate of the payments, or $150,745.

Knetsch did not go on with the transaction for the fourth contract year beginning December 11, 1956, but terminated it on December 27, 1956. His indebtedness at that time totalled $4,307,000. The cash or loan value of the bonds was the $4,308,000 value at December 11, 1956, which had been the basis of the "loan" of December 28, 1955. He surrendered the bonds and his indebtedness was canceled. He received the difference of $1,000 in cash.

The contract called for a monthly annuity of $90,171 at maturity (when Knetsch would be 90 years of age) or for such smaller amount as would be produced by the cash or loan value after

deduction of the then-existing indebtedness. It was stipulated that if Knetsch had held the bonds to maturity and continued annually to borrow the net cash value less $1,000, the sum available for the annuity at maturity would be $1,000 ($8,388,000 cash or loan value less $8,387,000 of indebtedness), enough to provide an annuity of only $43 per month.

The trial judge made findings that "there was no commercial economic substance to the . . . transaction," that the parties did not intend that Knetsch "become indebted to Sam Houston," that "no indebtedness of [Knetsch] was created by any of the … transactions," and that "no economic gain could be achieved from the purchase of these bonds without regard to the tax consequences ...." His conclusion of law, based on this Court's decision in *Deputy v. du Pont*, 308 U.S. 488, was that "while in form the payments to Sam Houston were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham."

We first examine the transaction between Knetsch and the insurance company to determine whether it created an "indebtedness" within the meaning of § 163(a) of the 1954 Code, or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction." As was said in *Gregory v. Helvering*, 293 U.S. 465, 469, "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted…. But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

When we examine "what was done" here, we see that Knetsch paid the insurance company $294,570 during the two taxable years involved and received $203,000 back in the form of "loans." What did Knetsch get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000, which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000. Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax…." *Gilbert v. Comm'r*, 248 F.2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $233,297.68. There may well be single-premium annuity arrangements with nontax substance which create an "indebtedness" for the purposes of § 23(b) of the 1939 Code and § 163(a) of the 1954 Code. But this one is a sham.

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Mr. Knetsch borrowed (on a nonrecourse basis, entirely eliminating any economic risk to him) all but $91,570 of the cost incurred both to purchase the $4,004,000 annuity initially and to fund the aggregate $290,570 in (ostensibly deductible) interest payments owed for each of the two years at issue. The second paragraph of the opinion recites that the annuity contract would earn a 2½% interest return from the insurance company, while Mr. Knetsch agreed to pay 3½% interest to the insurance company on the borrowed amounts. Why would he borrow at 3½% interest to purchase an investment paying a 2½% return? Taxes aside, this investment is a sure *economic* loser!

If the scheme worked, Mr. Knetsch's before-tax sure loser would turn into an after-tax big winner, with the "profit" coming entirely from the Treasury (*i.e.*, other taxpayers). To be specific (math alert!), the 1953 interest deduction of $143,465 would have saved him approximately $130,553 in tax if the income from other sources that was sheltered with the deduction would have otherwise been taxed at 91%. (The top marginal tax rate in 1953 and 1954 was 91%.) Similarly, the 1954 interest deduction of $147,105 would have saved him approximately $133,866 in tax. Because those Year-2 savings would have occurred one year in the future as of 1953, however, we must discount the future tax savings to their present value in Year 1 in order to determine Mr. Knetsch's anticipated after-tax profit from his $91,570 initial investment, measured as of Year 1. Under the present value table in Chapter 1, the Year-1 present value of the Year-2 tax savings using a 3% discount rate (interest rates were relatively low in these years) would have been $129,984 ($133,866 x .971). Thus, measured as of Year 1, the present value of Mr. Knetsch's tax savings would have totaled $260,537 ($130,553 *plus* $129,984). After subtracting his $91,570 cash investment, he would have earned an after-tax profit of $168,967, measured as of Year 1—a rate of return of 185% on his $91,570 cash investment!

But the aggregate $290,570 of ostensible interest payments did not represent a *real* SHS wealth decrease suffered by Mr. Knetsch. Indeed, the $91,570 that he paid to the insurance company was merely—in substance—a fee to the company to help him to create the *appearance* of a $290,570 wealth decrease. Neither the annuity's increase in value nor the "borrowed" cash used to fund the interest payments were included in Mr. Knetsch's Gross Income (under the realization requirement and borrowing exclusion, respectively). Mr. Knetsch ostensibly borrowed against this untaxed appreciation to fund the deductible interest payments owed to the insurance company (the other party to the transaction in this 2-party debt scenario) each year. In short, Mr. Knetsch's attempted deductions were funded by untaxed dollars, resulting in a double tax benefit for the same dollars (exclusion and deduction) that only *mimicked* a wealth reduction—all at no economic risk to him.

Mr. Knetsch is a "rentier," whose "investment" represented inefficient rent-seeking behavior, *i.e.*, an attempt to merely shift wealth to himself (from other taxpayers) rather than to create new wealth for the economy as a whole. Had his attempt succeeded, well-advised taxpayers would have duplicated it, resulting in ever more wealth shifting, ever more lost tax revenue, and ever more pressure to increase marginal rates to make up the lost revenue from non-rentiers, with no increase in aggregate societal wealth. The resulting allocation of the country's aggregate tax burden would not be measured by real wealth accessions and reductions but by mere paper shuffling. Not only would this result in a misallocation of the tax burden across the members of the population in a manner inconsistent with both ability to pay and horizontal equity; it would also result in sheer economic waste. That $91,570 fee paid to the insurance company to create the appearance of a wealth reduction would do much more good to the economy if it were invested in real, productive activity, thus increasing GDP.

The Supreme Court recited the lower court's holding that "there was no commercial economic substance to the … transaction," but the Court appeared to rely primarily on the sham debt doctrine (rather than the economic substance doctrine, described below) in concluding that the nonrecourse debt, which was extended by the tax shelter seller, *i.e.*, the insurance company, was a sham—not real debt. Because there was no real debt, there could be no interest to deduct in substance.

Mr. Knetsch purchased his tax shelter investment directly, but many others are owned through limited partnerships or LLCs, as in *Estate of Franklin*, below. Those of you who go on to study the taxation of business enterprises will learn that partnerships and LLCs are transparent entities

for tax purposes, meaning that the entity is not subject to tax, itself (as are so-called C corporations). Rather, the entity's net profit (excess of Gross Income over deductions) or—in the case of a tax shelter—net loss (excess of deductions over Gross Income) is allocated to each partner or LLC owner for inclusion (or deduction) on his or her individual tax return. In this way a tax shelter's losses can be easily shared by many investors (and bought and sold) efficiently, offsetting income from unrelated wages or other profitable investments on each owner's individual tax return. Moreover, because of the nature of limited partnership and LLC interests, the partners' or LLC owners' exposure to real economic risk of loss is limited.

As in *Knetsch*, the property seller in *Estate of Franklin* was also the nonrecourse lender that financed the sale to the buyer, where—as indicated above—the potential for abuse is highest. A third-party lender can be an independent check on the underlying economics of the transaction, as a third-party lender is not typically willing to lend more than the purchased property is worth. A lender who is also the seller of the property, in contrast, has no reason not to ostensibly "lend" as much as possible to the buyer/borrower, thus creating (depreciable) basis under *Crane* for the buyer, as well as high (deductible) interest payments. The seller/lender may know that the loan amount is fictional and will never be collected in full, as no rational borrower would be willing to fully repay a nonrecourse loan that substantially exceeds the fair market value (FMV) of the property security. During the interim, however, the buyer/borrower can enjoy inflated deductions—if the shelter works. Moreover, although the (inflated) nonrecourse debt would be included in amount realized on a later sale by the buyer (or foreclosure transfer) under *Tufts*,[5] as you learned in Chapter 12, the resulting gain may well be low-taxed capital gain or § 1231 gain, while the prior inflated depreciation and interest deductions were ordinary, offsetting high-taxed income. This state of nirvana occurs, however, only if the tax shelter transaction is respected.

## ESTATE OF FRANKLIN v. COMMISSIONER

544 F.2d 1045 (9th Cir. 1976)

SNEED, CIRCUIT JUDGE: This case involves another effort on the part of the Commissioner to curb the use of real estate tax shelters. In this instance he seeks to disallow deductions for the taxpayers' distributive share of losses reported by a limited partnership with respect to its acquisition of a motel and related property. These "losses" have their origin in deductions for depreciation and interest claimed with respect to the motel and related property. These deductions were disallowed by the Commissioner on the ground either that the acquisition was a sham or that the entire acquisition transaction was in substance the purchase by the partnership of an option to acquire the motel and related property on January 15, 1979. The Tax Court held that the transaction constituted an option exercisable in 1979 and disallowed the taxpayers' deductions. We affirm this disallowance although our approach differs somewhat from that of the Tax Court.

The interest and depreciation deductions were taken by Twenty-Fourth Property Associates (hereinafter referred to as Associates), a California limited partnership of which Charles T. Franklin and seven other doctors were the limited partners. The deductions flowed from the purported "purchase" by Associates of the Thunderbird Inn, an Arizona motel, from Wayne L.

[5] Recall from Chapter 12 that the relief from nonrecourse debt on the transfer of property creates § 1001(b) A/R under *Tufts* to the full extent of the debt, even if the nonrecourse debt exceeds the FMV of the property, contrary to the bifurcated approach adopted in the case of excess recourse debt that is discharged on transfer.

Romney and Joan E. Romney (hereinafter referred to as the Romneys) on November 15, 1968.

Under a document entitled "Sales Agreement," the Romneys agreed to "sell" the Thunderbird Inn to Associates for $1,224,000. The property would be paid for over a period of ten years, with interest on any unpaid balance of seven and one-half percent per annum. "Prepaid interest" in the amount of $75,000 was payable immediately; monthly principal and interest installments of $9,045.36 would be paid for approximately the first ten years, with Associates required to make a balloon payment at the end of the ten years of the difference between the remaining purchase price, forecast as $975,000, and any mortgages then outstanding against the property.

The purchase obligation of Associates to the Romneys was nonrecourse; the Romneys' only remedy in the event of default would be forfeiture of the partnership's interest. The sales agreement was recorded in the local county. A warranty deed was placed in an escrow account, along with a quitclaim deed from Associates to the Romneys, both documents to be delivered either to Associates upon full payment of the purchase price, or to the Romneys upon default.

The sale was combined with a leaseback of the property by Associates to the Romneys; Associates therefore never took physical possession. The lease payments were designed to approximate closely the principal and interest payments with the consequence that with the exception of the $75,000 prepaid interest payment no cash would cross between Associates and Romneys until the balloon payment. The lease was on a net basis; thus, the Romneys were responsible for all of the typical expenses of owning the motel property including all utility costs, taxes, assessments, rents, charges, and levies of "every name, nature and kind whatsoever." The Romneys also were to continue to be responsible for the first and second mortgages until the final purchase installment was made; the Romneys could, and indeed did, place additional mortgages on the property without the permission of Associates. Finally, the Romneys were allowed to propose new capital improvements which Associates would be required to either build themselves or allow the Romneys to construct with compensating modifications in rent or purchase price.

In holding that the transaction between Associates and the Romneys more nearly resembled an option than a sale, the Tax Court emphasized that Associates had the power at the end of ten years to walk away from the transaction and merely lose its $75,000 "prepaid interest payment." It also pointed out that a *deed* was never recorded and that the "benefits and burdens of ownership" appeared to remain with the Romneys. Thus, the sale was combined with a leaseback in which no cash would pass; the Romneys remained responsible under the mortgages, which they could increase; and the Romneys could make capital improvements.[2] The Tax Court further justified its "option" characterization by reference to the nonrecourse nature of the purchase money debt and the nice balance between the rental and purchase money payments.

Our emphasis is different from that of the Tax Court. We believe the characteristics set out above can exist in a situation in which the sale imposes upon the purchaser a genuine indebtedness within the meaning of section 167(a), which will support both interest and depreciation deductions. They substantially so existed in *Hudspeth v. Commissioner*, 509 F.2d 1224 (9th Cir. 1975), in which parents entered into sale-leaseback transactions with their children. The children paid for the property by executing nonnegotiable notes and mortgages equal to the fair market value of the property; state law proscribed deficiency judgments in case of default, limiting the parents' remedy

[2] There was evidence that not all of the benefits and burdens of ownership remained with the Romneys. Thus, for example, the leaseback agreement appears to provide that any condemnation award will go to Associates. Exhibit 6-F, at p. 5.

to foreclosure of the property. The children had no funds with which to make mortgage payments; instead, the payments were offset in part by the rental payments, with the difference met by gifts from the parents to their children. Despite these characteristics this court held that there was a bona fide indebtedness on which the children, to the extent of the rental payments, could base interest deductions. *See also American Realty Trust v. U.S.*, 498 F.2d 1194 (4th Cir. 1974); *Manuel D. Mayerson*, 47 T.C. 340 (1966).

In none of these cases, however, did the taxpayer fail to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property. Just such a failure occurred here. The Tax Court explicitly found that on the basis of the facts before it the value of the property could not be estimated. 64 T.C. at 767-768.[4] In our view this defect in the taxpayer's proof is fatal.

Reason supports our perception. An acquisition such as that of Associates if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.

No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then-existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase. While this chance undoubtedly influenced the Tax Court's determination that the transaction before us constitutes an option, we need only point out that its existence fails to supply the substance

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[4] The Tax Court found that appellants had "not shown that the purported sales price of $1,224,000 (or any other price) had any relationship to the actual market value of the motel property . . .." 64 T.C. at 767.

Petitioners spent a substantial amount of time at trial attempting to establish that, whatever the actual market value of the property, Associates acted in the good faith belief that the market value of the property approximated the selling price. However, this evidence only goes to the issue of sham and does not supply substance to this transaction. "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers." Lynch v. Comm'r, 273 F.2d 867, 872 (2d Cir. 1959). *See also* Bornstein v. Comm'r, 334 F.2d 779 (1st Cir. 1964); MacRae v. Comm'r, 294 F.2d 56 (9th Cir. 1961).

In oral argument it was suggested by the appellants that neither the Tax Court nor they recognized the importance of fair market value during the presentation of evidence and that this hampered the full and open development of this issue. However, upon an examination of the record, we are satisfied that the taxpayers recognized the importance of presenting objective evidence of the fair market value and were awarded ample opportunity to present their proof; appellants merely failed to present clear and admissible evidence that fair market value did indeed approximate the purchase price. Such evidence of fair market value as was relied upon by the appellants, *viz.* two appraisals, one completed in 1968 and a second in 1971, even if fully admissible as evidence of the truth of the estimates of value appearing therein does not require us to set aside the Tax Court's finding. As the Tax Court found, the 1968 appraisal was "error-filled, sketchy" and "obviously suspect." 64 T.C. at 767 n.13. The 1971 appraisal had little relevancy as to 1968 values. On the other side, there existed cogent evidence indicating that the fair market value was substantially less than the purchase price. This evidence included (i) the Romney's purchase of the stock of two corporations, one of which wholly-owned the motel, for approximately $800,000 in the year preceding the "sale" to Associates ($660,000 of which was allocable to the sale property, according to Mr. Romney's estimate), and (ii) insurance policies on the property from 1967 through 1974 of only $583,200, $700,000, and $614,000. 64 T.C. at 767-768.

Given that it was the appellants' burden to present evidence showing that the purchase price did not exceed the fair market value and that he had a fair opportunity to do so, we see no reason to remand this case for further proceedings.

necessary to justify treating the transaction as a sale *ab initio*. It is not necessary to the disposition of this case to decide the tax consequences of a transaction such as that before us if in a subsequent year the fair market value of the property increases to an extent that permits the purchaser to acquire an equity.

Authority also supports our perception. It is fundamental that "depreciation is not predicated upon ownership of property *but rather upon an investment in property. Gladding Dry Goods Co.*, 2 BTA 336 (1925)." *Mayerson, supra* at 350. (italics added). No such investment exists when payments of the purchase price in accordance with the design of the parties yield no equity to the purchaser. *Cf. Decon Corp.*, 65 T.C. 829 (1976); *David F. Bolger*, 59 T.C. 760 (1973); *Edna Morris*, 59 T.C. 21 (1972). In the transaction before us and during the taxable years in question the purchase price payments by Associates have not been shown to constitute an *investment in the property*. Depreciation was properly disallowed. Only the Romneys had an investment in the property.

Authority also supports disallowance of the interest deductions. This is said even though it has long been recognized that the absence of personal liability for the purchase money debt secured by a mortgage on the acquired property does not deprive the debt of its character as a bona fide debt obligation able to support an interest deduction. *Mayerson, supra* at 352. However, this is no longer true when it appears that the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged. Under these circumstances the purchaser has not secured "the use or forbearance of money." *See Norton v. Comm'r*, 474 F.2d 608, 610 (9th Cir. 1973). Nor has the seller advanced money or forborne its use. *See Bornstein v. Comm'r*, 334 F.2d 779, 780 (1st Cir. 1964); *Lynch v. Comm'r*, 273 F.2d 867, 871-872 (2d Cir. 1959). Prior to the date at which the balloon payment on the purchase price is required, and assuming no substantial increase in the fair market value of the property, the absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise. This is not enough to justify an interest deduction. To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price. *See Mayerson, supra* at 352.[6] Associates, during the taxable years in question, confronted no such situation. *Compare Crane v. Comm'r*, 331 U.S. 1, 11-12 (1947).

Our focus on the relationship of the fair market value of the property to the unpaid purchase price should not be read as premised upon the belief that a sale is not a sale if the purchaser pays too much. Bad bargains from the buyer's point of view—as well as sensible bargains from buyer's, but exceptionally good from the seller's point of view—do not thereby cease to be sales. *See Comm'r v. Brown*, 380 U.S. 563 (1965); *Union Bank v. U.S.*, 152 Ct. Cl. 426, 285 F.2d 126, 128 (1961). We intend our holding and explanation thereof to be understood as limited to transactions substantially similar to that now before us.

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What tax consequences were the parties hoping to create in *Estate of Franklin*? Please do not

[6] Emphasis on the fair market value of the property in relation to the apparent purchase price animates the spirit, if not the letter, of Rev. Rul. 69-77, 1969-1 C. B. 59.

be intimidated by the math to follow, which I use only to illustrate roughly what the parties were attempting to accomplish.

Footnote 4 of the case tells us that Wayne and Joan Romney[6] had purchased the motel (in part with borrowed money) for $660,000[7] a little more than a year before the 1968 sale to Associates Partnership for $1,224,000, with Associates ostensibly borrowing the entire amount with a nonrecourse loan extended from the Romneys. Associates paid only $75,000 of "prepaid interest" in 1968. The annual debt service on the $1,224,000 note that Associates owed to the Romneys consisted mostly of interest, with only small amounts of principal paid each year until a balloon payment of nearly $1 million was due in Year 10. To simplify the discussion, we can assume that the entire $1,224,000 was due to be paid in Year 10. (This small change does not alter the economics much and makes the analysis shorter and simpler.)

Frankly, the Romneys would have been better off to negotiate with Associates to characterize that 1968 payment of $75,000 as a down payment in their contract rather than as prepaid interest. Let's see why.

Under the § 453 installment sale rules that you studied in Chapter 13, the Romneys would recognize their § 1001 gain on the ostensible sale to Associates only as payments are received—mostly in Year 10 (if that payment occurred at all, which is unlikely). Let's assume, for example, that the Romneys deducted $60,000 in depreciation with respect to the property during their one year of ownership before its ostensible sale to Associates, leaving them with a $600,000 A/B at the time of sale. Their § 1001 realized gain would have been $624,000 ($1,224,000 A/R *less* $600,000 A/B). Under § 453(c), however, the amount of recognized gain to be included by the Romneys in any year would be equal to:

$$\text{Payments Received in the Year} \times \frac{\text{Gross Profit}}{\text{Total Contract Price}}$$

Thus, if the $75,000 that the Romneys received in 1968 were a down payment (rather than prepaid interest), they would have recognized a portion of their §1001 realized gain equal to:

$$\$75{,}000 \times \frac{\$624{,}000}{\$1{,}224{,}000} = \$38{,}235$$

Even if this gain were taxed at the top capital gain rate of approximately 25% in the late 1960s, they would have owed only approximately $9,500 in tax, leaving them with a tidy $65,550 of after-tax cash in hand in Year 1 for participating in the transaction. In Year 10, Associates would clearly have defaulted on the remaining balloon payment because of the economics of the deal, and the Romneys would foreclose, retaking title. Section 1038 is a special provision that applies in the case of a repossession of real property in a seller-financed sale. Under it, the Romneys would have been denied a § 166 bad-debt deduction (which you studied in Chapter 11) for the unpaid remaining balance of the note. Moreover, they would be required to recharacterize all or a portion of the payments received from Associates prior to Year 10 as gain (rather than tax-free recovery

[6] Professor James Edward Maule of Villanova University School of Law, who engages in genealogy as a hobby, figured out that Governor and Presidential candidate Mitt Romney was the "half-first-cousin-once-removed" of Wayne Romney. Email submission to Taxprof, a closed, Internet discussion group for tax law professors at AALS-accredited law schools, Feb. 12, 2012 (copy on file with author).

[7] Actually, they bought the stock of two corporations, one of which owned the motel, but for purposes of illustration we can simplify these facts, as this nuance makes no difference to the ultimate analysis.

of basis) equal to the *lesser* of (1) the total realized gain ($624,000) or (2) the total payments previously received ($75,000) *less* previously reported gain ($38,235), or $36,765. In other words, the Romneys would have been retroactively denied treating any of the $75,000 payment received in 1968 as tax-free basis recovery. Taxed at the 25% capital gains rate, they would have owed additional tax in Year 10 of $7,353 ($36,765 x .25). If we use a discount rate of 7% (interest rates were much higher in the late 1960s) under the present value table in Chapter 1, the Year-1 present-value cost of that future Year-10 tax would have been approximately $3,735 ($7,353 x .508). Thus, the Romneys' after-tax profit for this deal—measured in Year 1 (1968)—would have been equal to the $75,000 cash received from Associates *less* the present value tax cost of $13,235 ($9,500 paid in Year 1 *plus* the $3,735 present value cost of the $7,353 paid in Year 10), or $61,765. To put this figure into perspective, that figure is approximately $430,000 in 2016 dollars.

Because the parties did *not* designate the $75,000 as a down payment but rather as prepaid interest, however, the Romneys would have included no part of their realized § 1001 gain in 1968 under § 453(c) because they received no purchase price payments in that year. Rather, they would have included the entire $75,000 "prepaid interest" as ordinary income under § 61(a)(4). If we assume that this interest fell within the highest 70% tax bracket, the Romneys would have owed $52,500 in tax, leaving them an after-tax profit of $22,500. To put that figure into perspective, that figure is approximately $156,000 in 2016 dollars—not nearly as favorable.[8] But Associates was better off characterizing the $75,000 payment as "prepaid interest" rather than as a down payment because the interest would have been deductible under § 163(a), whereas the down payment would not, and Associates probably had more bargaining power (or more sophisticated advice).

Associates immediately leased the property back to the Romneys in a "net lease" arrangement, under which the lessee (rather than the lessor) is responsible for the insurance, real estate taxes, utility costs, maintenance of the property, *etc.* The lease payments due from the Romneys to Associates essentially mirrored the debt service payments due to them, so neither possession of the property nor cash changed hands (other than the $75,000 prepaid interest). While the interest deemed received from Associates each year would be included in the Romneys' Gross Income under § 61(a)(4), they would also have been entitled to deduct the lease payments deemed paid to Associates each year under § 162(a). Thus, the only tax consequences arising for the Romneys from this sale/leaseback transaction, if respected, would have been the ones described above.

What was Associates (and its partners) really buying? Tax deductions! If Associates were respected as the real owner of the hotel, what would be its net loss each year (excess of deductions over Gross Income), which generally could be deducted on the individual tax returns of the partners? Associates would include in Gross Income the rent deemed paid by the Romneys under § 61(a)(5), but the partnership would also be permitted to deduct the interest deemed paid to the Romneys in approximately the same amount under § 163(a). So far, the partnership has no net loss to allocate to its partners. But don't forget (1) the $75,000 Year-1 prepaid interest deduction and, more important, (2) the depreciation of the $1,244,000 basis created under *Crane*!

In essence, the depreciation deductions allowed each year to Associates, as owner of the property, would create a net loss (excess of deductions over Gross Income) that would be allocated

[8] When Associates defaulted in Year 10, § 1038 would once again have applied, denying the Romneys a § 166 bad-debt deduction for the unpaid $1,224,000 balance of the note, but they would have had no prior tax-free recovery of basis to recharacterize as gain under §1038. In other words, because the only cash received by the Romneys was "prepaid interest" under our simplifying assumption, § 1038 would not have resulted in any tax-free basis recovery "recapture" on default in Year 10.

among the partners and deducted on their individual tax returns, sheltering income from other sources, such as the income from the partners' medical practices—even though the partners suffered no *real* SHS wealth decrease beyond the $75,000 paid to the Romneys. You learned in Chapter 14 that residential rental property must be depreciated today using the straight-line method over 27.5 years under § 168. These current rules would generate a depreciation deduction of approximately $44,500 each year. Under the law at the time, however, the property would have been depreciated over a much shorter period and using a front-loaded accelerated depreciation method, permitting Associates to take much larger deductions in the early years. Indeed, why didn't Associates offer to pay $2 million for the property? $10 million? If respected, the higher the price, the better! While Associates would also realize a larger gain under *Tufts* on the foreclosure, the gain would have been deferred (reducing its effective cost) and would have been taxed at approximately 25% as either real capital gain or § 1231 quasi capital gain, while the depreciation deductions would have offset income otherwise taxed at rates as high as 70% each year.[9]

Assume, for example, that the building would have been fully depreciated by Year 10 when Associates failed to pay the $1,224,000 million balloon payment. Under *Tufts*, the foreclosure transfer back to the Romneys would generate a $1,224,000 million § 1001 gain ($1,224,000 million A/R under *Tufts* equal to the debt relief *less* $0 A/B). If taxed at 25%, the partners would collectively owe $306,000 in tax. If we use a discount rate of 7% under the present value table in Chapter 1, the Year-1, present value cost of that future Year-10 tax would have been $155,448 ($306,000 x .508). As of Year 1, the present value of the tax savings arising from deducting $1,224,000 million in depreciation deductions over 10 years, offsetting income otherwise taxed at 70% ordinary income tax rates, would have been far, far higher, however.

Even if we assume simple straight-line depreciation (rather than the front-loaded, accelerated depreciation to which they would have been entitled at the time), the partners would have collectively deducted $122,400 each year of the 10-year period, saving $85,680 in tax each year, if we assume that the sheltered income would otherwise have been taxed at 70% ($122,400 x .70). Over 10 years, the nominal tax saved would have been $856,800. Because those savings occur over time, however, we must discount the future tax savings to their present value to calculate the after-tax profit for Associates from this deal as of Year 1. The Year-1 sum of the present values of each year's anticipated tax savings from depreciation using a 7% discount rate would have been $643,885.[10] Add to that figure the $52,500 tax saved in Year 1 from deducting the $75,000 in prepaid interest ($75,000 x .70), and Associates realized total tax savings of $696,385, measured as of Year 1.

When the smoke clears, what is the partners' collective after-tax profit from this deal, measured in Year 1? The $696,385 present value of their tax savings *less* the $155,448 present value cost of their Year-10 tax due on the *Tufts* gain realized on the transfer back to the Romneys *less* the $75,000 in cash that they paid to the Romneys to participate in the deal equals $465,937—more than $3.2 million in 2016 dollars. That figure represents a rate of return of more than 620% on

[9] Indeed, surtaxes of 5.25% in 1968, 7% in 1969, and 1.75% in 1970, which were added to the top 70% rate, likely would have increased the partners' tax savings in those three years beyond that described in the text.

[10] This figure is arrived at by adding together the present values, as of Year 1, of each year's tax savings: $85,680 for Year 1, $80,110.80 for Year 2 ($85,680 x .935), $74,798.64 for Year 3 ($85,680 x .873), $69,914.88 for Year 4 ($85,680 x .816), $65,373.84 for Year 5 ($85,680 x .763), $61,089.84 for Year 6 ($85,680 x .713), $57,062.88 for Year 7 ($85,680 x .666), $53,378.64 for Year 8 ($85,680 x .623), $49,865.76 for Year 9 ($85,680 x .582), and $46,609.92 for Year 10 ($85,680 x .544).

their $75,000 cash investment—even better than what Mr. Knetsch attempted to obtain!

But it did not work. Just as with Mr. Knetsch, the net losses did not represent *real* SHS wealth decreases suffered by the medical doctor/partners. Indeed, the $75,000 that they paid to the Romneys was merely a fee to help them to create the *appearance* of significant wealth decreases. Thus, the Ninth Circuit Court of Appeals relied on the sham debt doctrine in holding that no sale actually occurred by focusing on the substantially overstated purchase price.

***Tax ownership***

What if the purchase price in *Estate of Franklin* had equaled the actual FMV of the property but Associates leased the property back to the Romneys for, say, 50 years—the entire anticipated useful life of the property? Would the transaction have been respected as a real sale to Associates (entitling Associates to the depreciation deductions as owner of the property) because the purchase price was no longer highly inflated?

The Ninth Circuit quoted language from the Tax Court opinion concluding that "the 'benefits and burdens of ownership' appeared to remain with the Romneys." This test is commonly used to determine "tax ownership." Aside from any sham debt problem, the nominal owner of the property for purposes of state law may not be considered the "tax" owner for purposes of Federal income taxation—*i.e.*, may not be the taxpayer entitled to the property's depreciation deductions—if the benefits and burdens of ownership have not shifted to the nominal owner. This issue most often arises in sale/leaseback transactions, but it can also arise in other contexts.[11] If the leaseback to the Romneys was for a term equal to the entire remaining useful life of the property, would the benefits and burdens of ownership really have shifted to Associates? No. They would have received nothing back of value when the lease term expires. What if Associates, anticipating this problem, had leased the premises to the Romneys for only, say, 20 years, but the lease also provided that at the end of the lease term the Romneys would have an option to extend the lease for 30 more years at a bargain price that makes the exercise of their renewal option virtually certain?

Revenue Procedure 2001-28[12] contains the most recent guidelines that the IRS will use for purposes of issuing a private letter ruling to taxpayers requesting assurance that a proposed sale/leaseback transaction will be respected for Federal income tax purposes. For example, to obtain a favorable advance ruling, the purported owner/lessor (Associates in the *Estate of Franklin* case) must have, at minimum, 20% of the cost of the property placed "at risk" throughout the lease term. Amounts "at risk" include, for example, the cash down payment or third-party recourse debt. Moreover, the property must be expected (at the beginning of the lease term) to have at least 20% of its anticipated useful life remaining at the end of the lease term and must be expected to be worth at least 20% of what it was worth at the beginning of the lease term. For these purposes, the lease term includes all renewals (except those only at the option of the lessee at fair rental value at the time of the renewal). Finally, the purported owner/lessor must "represent and demonstrate that it expects to receive a profit from the transaction, apart from the value of or benefits obtained from the tax deductions, allowances, credits, and other tax attributes arising from such transaction," which requires that the purported owner/lessor reasonably anticipate realizing an overall *economic* profit from its ownership, as well as a positive cash flow.

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[11] *See, e.g.*, Granite Trust Co. v. U.S., 238 F.2d 670 (1st Cir. 1956) (considering whether the benefits and burdens of ownership shifted on a purported sale of corporate stock).
[12] 2001-1 C.B. 1156.

***The business purpose doctrine***

The case of *Gregory v. Helvering*[13] is one that students who go on to study corporate reorganizations in an upper-level tax course will surely read. While the details of the particular transaction are beyond the basic tax course, we need not dwell on the particulars of the transaction to understand that Mrs. Gregory tried to transform high-taxed ordinary income into low-taxed capital gain (along with some tax-free recovery of basis, to boot) and was thwarted in her attempt in a case that produced the business purpose doctrine.

Mrs. Gregory was the sole owner of a corporation that, in turn, owned stock of the Monitor Securities Corporation (MSC stock) as a portfolio investment. Mrs. Gregory wished to sell the MSC stock and found a buyer for it. How could Mrs. Gregory obtain the MSC stock from her corporation in order to sell it? As sole owner of the corporation that held the MSC stock, she could simply cause the corporation to declare and pay a dividend to her of the MSC stock, which she could then sell to her buyer. But this straightforward transaction would have produced a dividend for Mrs. Gregory at a time when dividends were not eligible to be taxed under the preferential tax rate applicable to net capital gain but rather were treated as plain vanilla (high-taxed) ordinary income. Mrs. Gregory wanted low-taxed capital gain (and some tax-free recovery of basis). Thus, she purported to engage in a series of transactions in which a new corporation was momentarily created and shortly thereafter liquidated in a manner that, under the law in effect at the time, could conceivably produce her desired result of transferring the MSC stock to her hands at only the cost of low-taxed capital gain (and even some tax-free recovery of basis, to boot).

Judge Learned Hand of the Second Circuit Court of Appeals penned the language that tax shelter purveyors have quoted ever since:

> [A] transaction otherwise within an exception of the tax law, does not lose its immunity because it is actuated by a desire to avoid or, if one choose, to evade, taxation. Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes.[14]

What the purveyors typically downplay is that Judge Hand ruled *against* Mrs. Gregory, and the Supreme Court affirmed. Moreover, Judge Hand was referring to *substantively* arranging one's own economic affairs (*e.g.*, waiting to sell appreciated stock until Day 366 of the ownership period instead of selling on Day 365 in order to obtain the reduced tax rate for net capital gain), not creating meaningless transactions that do not fairly reflect the underlying *substance* of what was done. Notwithstanding the attempt to dress up the transaction in the guise of a corporate reorganization, which would have produced the low-taxed capital gain and tax-free basis recovery that Mrs. Gregory wanted, both the Second Circuit Court of Appeals and Supreme Court concluded that the corporation had no *business purpose* in arranging the transfer of the MSC stock to Mrs. Gregory in such a convoluted manner. In effect, the Court treated the corporation's transfer of the MSC stock to Mrs. Gregory in substance, though not in form, as a simple dividend, taxed as ordinary income in full. The reason for rejecting the taxpayer's chosen form was the lack of business purpose for structuring the transaction in that form. Ever since, both courts and the IRS have invoked the business purpose doctrine to reject the form of a transaction in favor of looking at the underling substance of what actually occurred when there is no purpose germane to the

[13] 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934).
[14] *Gregory*, 69 F.2d at 810.

taxpayer's business (aside from favorable tax consequences) for structuring the transaction in the manner chosen.

***The economic substance doctrine***

The 1990s and first decade of the 21st century saw a significant increase in the number of tax shelters marketed particularly to corporations. These corporate tax shelters are sometimes uniquely designed to take advantage of a particular tax characteristic of the potential buyer. For example, if a corporation sells a subsidiary corporation at a substantial capital gain, the corporation might be approached with a shelter purporting to manufacture a substantial capital loss (to offset the recently realized capital gain) that does not require the buyer to suffer a *real* wealth decrease or expose the buyer to significant (if any) economic risk of loss. The marketers often insert nondisclosure clauses in their contracts so that they can market the shelter to other corporations. Nevertheless, if and when such shelters come to the attention of the government (sometimes in unmarked packages sent anonymously), the government often litigates the transactions and often invokes the economic substance doctrine. Most of these shelters pertain to the mismeasurement of SHS income, and they typically involve corporate, partnership, and international tax provisions beyond the scope of the basic tax course. Nevertheless, there is one simple, older case that is useful in illustrating the economic substance doctrine and which involved an individual who attempted, in effect, tax rate manipulation.

In *Goldstein v. Commissioner*,[15] Tillie Goldstein and her husband were retired and living on his pension of approximately $780 per year and $125 in interest from savings accounts when Tillie won $140,218.75 in the Irish Sweepstakes in 1958 ($1.17 million in 2016 dollars). In 1958, Taxable Income between $140,000 and $160,000 of a married couple filing jointly fell in the 81% tax bracket, between $120,000 and $140,000 in the 78% bracket, between $100,000 and $120,000 in the 75% bracket, and so on.[16] Their son Bernard, who was a certified public accountant, volunteered to help in "investing the sweepstakes proceeds and in minimizing the 1958 tax consequences … of the sudden increase in her income for that year."[17] After consulting with an attorney and several brokerage houses, he arranged for his mom to borrow $465,000 from the First National Bank of Jersey City and $480,000 from the Royal State Bank of New York, with both loans at 4% interest. The borrowed cash and some of the sweepstakes winnings were used to buy $1 million of U.S. Treasury notes paying between ½% and 1½% interest, which were due to mature in 1961 and 1962. Both loans were recourse, but in each case Tillie nevertheless provided a security interest in the Treasury notes to the banks.

Taxes aside, these investments were a clear *economic* loser when viewed from a *pre-tax* perspective. Indeed, contemporaneous documents created by Bernard (which were introduced by the government) estimated that his mother's before-tax economic loss, equal to the excess of the 4% interest that she had to pay to the banks and the ½% to 1½ % interest that she was to receive on the Treasury notes (plus appreciation, if any, in the value of the notes), would be about $18,500.[18] But what did Tillie then do? In 1958—the same year in which she included the sweepstakes winnings in her Gross Income—she used the remainder of her winnings to prepay the

[15] 364 F.2d 734 (2d Cir. 1966).
[16] *See* http://taxfoundation.org/article/us-Federal-individual-income-tax-rates-history-1913-2013-nominal-and-inflation-adjusted-brackets (containing historical tax brackets).
[17] *Goldstein*, 364 F.2d at 736.
[18] Tillie actually ended up realizing a $25,091 economic loss because some of the Treasury notes lost value with an increase in interest rates generally.

interest due for the next 1½ years on one loan and for nearly 3 years on the other, deducting the $81,396.61 aggregate amount of prepaid interest under § 163(a). (Section 163(d), explored in Part B., did not then exist.) A few years later, Tillie instructed the banks to sell the Treasury notes to repay the loans. The *$18,500 economic loss* that Bernard anticipated would be more than made up with the anticipated *tax savings of more than $55,000* arising on the prepaid interest deduction.[19] Thus, her *after-tax* profit would have effectively come from the Treasury. Once again, Tillie (and her son Bernard) engaged merely in rent-seeking behavior, an attempt to shift wealth from other taxpayers to Tillie rather than to create new wealth in the economy.

The Second Circuit considered the debts to be bona fide and not a "sham" (as in *Knetsch* and *Estate of Franklin*) because (1) the money was borrowed from third-party banks rather than from the U.S. government (the seller of the Treasury bonds—the investment purchased with the borrowed money), (2) the loans were recourse, and (3) the Treasury bonds were pledged as collateral security for a significant period of time. Nevertheless, the Second Circuit Court of Appeals affirmed the Tax Court's denial of Tillie's prepaid interest deduction under what has come to be known as the economic substance doctrine.

> [T]he Tax Court was justified in concluding that petitioner entered into the [bank] transactions without any realistic expectation of economic profit and "solely" in order to secure a large interest deduction in 1958 which could be deducted from her sweepstakes winnings in that year. This conclusion points the way to affirmance in the present case.
>
> We hold … that Section 163(a) … does not permit a deduction for interest paid or accrued in loan arrangements like those before us that cannot with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences. …
>
> Section 163 … should not be construed to permit an interest deduction when it objectively appears that a taxpayer has borrowed funds in order to engage in a transaction that has no substance or purpose aside from the taxpayer's desire to obtain the tax benefit of an interest deduction: and a good example of such purposeless activity is the borrowing of funds at 4% in order to purchase property that returns less than 2% and holds out no prospect of appreciation sufficient to counter the unfavorable interest rate differential…. Indeed, to allow a deduction for interest paid on funds borrowed for no purposive reason, other than the securing of a deduction from income, would frustrate Section 163(a)'s purpose; allowing it would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress. *See Knetsch v. U.S.*, 264 U.S. at 367.
>
> In many instances transactions that lack all substance, utility, and purpose, and which can only be explained on the grounds that the taxpayer sought an interest deduction in order to reduce his taxes, will also be transparently arranged as "shams."… The present case makes plain, however, that these rationales are distinct from each other, and that a court need not always first label a loan transaction a "sham" in order to deny a deduction for interest paid in connection with the loan….

[19] Her tax deficiency was stated at the Tax Court level as $55,193.34. This amount represents the tax saved from the prepaid interest deduction that the Commissioner sought to deny her.

> It follows therefore from the foregoing, and from the Tax Court's finding as a matter of "ultimate" fact that the petitioner entered into the [bank] transactions without any expectation of profit and without any other purpose except to obtain an interest deduction, and thus the Tax Court's disallowance of the deductions in this case must be affirmed.[20]

Under the economic substance doctrine, as it was developed by most courts under the common law, the taxpayer seeking to defend the structure of a tax shelter transaction had the burden of showing (1) a nontrivial chance of pre-tax *economic* profit (How much? Is a peppercorn of profit enough?) and (2) a non-tax motive (such as a business purpose) for engaging in the transaction. Also typically present in these transactions is the lack of any real risk of significant economic loss. In other words, most of these taxpayers desire the tax benefits without incurring a meaningful chance that they could lose much money in the transaction. Notice that the investment property that was purchased in *Goldstein* was Treasury notes—among the safest of investments (at least until recent "debt ceiling" shenanigans).

Congress codified the economic substance doctrine in 2010 when it enacted § 7701(o). Under § 7701(o), a transaction must satisfy a two-pronged, conjunctive test to qualify as having economic substance: (1) the transaction must change in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer must have a substantial purpose (apart from Federal income tax effects) for entering into the transaction. If the possibility of pre-tax profit is relied upon to satisfy these requirements, the taxpayer must show that "the present value of the reasonably expected pre-tax profit from the transaction is substantial in relation to the present value of the expected net tax benefits that would be allowed if the transaction were respected." *And you thought that all of that present value analysis illustrated earlier in this chapter was an unnecessary waste of time!* In a unique provision, § 7701(o)(5)(C) provides that determining whether the economic substance doctrine is relevant to a transaction "shall be made in the same manner as if this subsection had never been enacted." In other words, the new provision is not intended to either expand or diminish the scope of transactions that implicate the doctrine.

So why did Congress enact it? In the same legislation, Congress adopted a strict liability penalty in § 6662(b)(6) that applies to transactions that lack economic substance within the meaning of § 7701(o). So was Congress merely after the additional revenue obtained under the new penalty? Some say codification was justified to bring uniformity in application of the doctrine among the various courts, though others believe that Congress wished to be able to score the tax revenue arising on enforcement of the doctrine to pay for statutory tax reductions elsewhere that one or another member of Congress wished to introduce in a revenue-neutral fashion. In other words, the revenue obtained each year upon the routine application of common law doctrines by courts cannot be counted as revenue that can "pay for" other revenue-losing provisions that Congress wishes to enact *by statute*. By *codifying* the doctrine, however, the *same* revenue that would have been obtained under the common law doctrine is now considered to have arisen because of the change in *statutory law*, allowing it to count (in addition to the new revenue obtained under the new penalty) toward paying for revenue-losing amendments to the Code.

The various civil (and criminal) penalties that can be imposed on taxpayers who fail to comply with their obligations under the Internal Revenue Code are typically studied in a course devoted to examining tax procedures, tax penalties, and (at some law schools) tax crimes. Nevertheless, a

[20] *Id*. at 740-42.

brief introduction to the topic places the economic substance strict liability penalty into context.

One of the most common tax penalties is the 20% penalty imposed under § 6662(a) on any "substantial understatement of income tax," defined with respect to individuals as the greater of $5,000 or 10% of the tax due for the year. If, however, the taxpayer either (1) has "substantial authority" for the position taken on the return (even though that position turns out to have been incorrect) or (2) discloses the details of the transaction on his or her tax return, the penalty is excused—*unless* the transaction is a "tax shelter."[21] For this purpose, a "tax shelter" is defined in § 6662(d)(2)(C)(ii) as a partnership or other entity, an investment plan or arrangement, or any other plan or arrangement "if a significant purpose of such partnership, entity, plan, or arrangement is the avoidance or evasion of Federal income tax." Under § 6662(d)(3), the Secretary of Internal Revenue has the authority to publish so-called listed transactions in the Internal Revenue Bulletin or Federal Register that he or she believes qualifies as a "tax shelter" under these rules. Finally, § 6664(c)(1) excuses the 20% penalty if the taxpayer can show that "there was a reasonable cause" for the understatement and that "the taxpayer acted in good faith."

These rules go out the window for any transaction that fails the economic substance test under § 7701(o). First, § 6662(b)(6) subjects any transaction failing § 7701(o) "or failing to meet the requirements of any similar rule of law" to the 20% penalty without regard to the amount of understatement. Second, § 6664(c)(2) denies the reasonable cause exception for any transaction failing § 7701(o). Third, § 6662(i) increases the 20% penalty to 40% if the taxpayer fails to disclose the details of the transaction on his or her tax return. When the smoke clears, a taxpayer that runs afoul of § 7701(o) is subject to a 20% strict liability penalty that is increased to 40% with failure to disclose the transaction on the tax return.

Because of the significance of this new penalty regime imposed by Congress, the IRS announced in 2010[22] that any proposed strict liability economic substance penalty raised in audit must be reviewed and approved by the appropriate Director of Field Operations to ensure consistent administration of the penalty among taxpayers. In addition, in 2011 the IRS announced[23] that the economic substance penalty should be imposed only with respect to transactions that fail to satisfy § 7701(o) and should not be imposed due to the application of any other "similar rule of law" or judicial doctrine, such as the step transaction or substance over form doctrines, notwithstanding the § 6662(b)(6) language quoted above. At the same time, it issued guidelines for its examiners to consider in assessing whether or not to recommend the new penalty, including whether or not the transaction is highly structured, contains unnecessary steps, creates a meaningful pre-tax economic change in present value terms, generates deductions that are not matched by an equivalent economic wealth reduction, and more.

Because of the prospective effective date of § 7701(o), no decided cases have yet applied the codified economic substance doctrine. Cases dealing with pre-2010 transactions continue to apply the common law doctrine, as well as the penalty analysis that pre-dated enactment of § 7701(o). It will be interesting to see how, if at all, codification of the doctrine will affect tax shelter litigation, including whether codification will bring greater uniformity among the courts in its application.

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[21] *See* §§ 6662(d)(2)(B) and (C).

[22] *See* www.irs.gov/Businesses/Codification-of-Economic-Substance-Doctrine-and-Related-Penalties.

[23] *See* www.irs.gov/Businesses/Guidance-for-Examiners-and-Managers-on-the-Codified-Economic-Substance-Doctrine-and-Related-Penalties.

## B. Statutory tools in combatting tax shelters

While *Knetsch* and similar cases were making their way through the courts, Congress got into the game by enacting § 264(a)(2) in 1954, which explicitly denies interest deductions incurred on debt to purchase single-premium annuity contracts after March 1, 1954. One of the arguments made by Mr. Knetsch was that the enactment of § 264(a)(2) for contracts purchased after March 1, 1954, implicitly blessed interest deductions on debt incurred to purchase single-premium annuity contracts before that date. The Court rejected the argument (in a portion of the opinion not reprinted above) by reasoning that new § 264(a)(2) denied deductions on *real* debt and that its enactment was irrelevant to sham debt of the type at issue in *Knetsch*.

Similarly, Congress enacted § 461(g) after *Goldstein* and similar cases. Tillie's prepaid interest would not be entirely deductible in Year 1 today in any event. *See* § 461(g). In essence, § 461(g) accurately characterizes prepaid interest as a nondeductible capital expenditure, the basis of which must be properly amortized over the term of the loan. If 461(g) had been operative in 1958, Tillie's tax shelter would have been unsuccessful without regard to the economic substance doctrine.

These statutory amendments show how Congress can sometimes enact a statutory provision to make case-by-case, common law adjudication unnecessary when it (1) suspects that an abusive transaction that has come to its attention is beginning to be replicated by others and (2) believes that a statutory change can be crafted that would adequately target the specific transaction at issue.

***The § 465 at-risk rules and § 469 passive activity loss rules***

Aside from the sale/leaseback transaction described in Part A., the combination of *Crane*, nonrecourse debt (limiting the taxpayer's economic risk of loss), accelerated depreciation (which offsets high-taxed ordinary income while generating low-taxed capital or § 1231 gain on later disposition), the realization requirement (ignoring property appreciation until realized), and limited partnerships (allowing both the easy sharing of net losses and the easy sale of ownership interests) made the broad marketing of real estate and other tax shelters a growing problem in the 1970s and early1980s. Some blame the profusion of ugly strip malls built during this period across the country (which would not have been built on their own merits) on this proliferation of tax shelter activity. It became common for ordinary doctors, dentists, lawyers, architects, and other upper-middle-class taxpayers to arrive home from work to find a limited partnership tax shelter prospectus in their mailboxes, promising large annual tax deductions each year, many times the amount of the required cash investment after just a few years. Because of the nature of limited partnership interests, the buyer's economic risk was limited to the cash that he or she invested.[24] The net losses allocated to the limited partners consisted mainly of interest and other expense deductions, as well as depreciation created with before-tax *Crane* basis, in excess of the Gross Income generated by the property. Common examples include real estate, oil and gas wells, even the making of bad B movies (which could be amortized really quickly at the time).

Congress reacted to this phenomenon first by enacting the § 465 at-risk rules in 1976 and then, ten years later, enacting the § 469 passive activity loss rules in 1986. Note that neither section *authorizes* the taking of deductions, as neither contains those magic words discussed in Chapter 1:

[24] The fine print may have informed the taxpayer of the *Tufts* gain that would be realized on later sale of the tax shelter ownership unit, but many taxpayers often overlooked this fine print and were angry when they were informed in the sale year of the resulting gain that they had to include on their tax returns—even if it was low-taxed capital gain. For that reason, some argued that § 469, in particular, could be defended as consumer protection legislation.

"there shall be allowed as a deduction." Rather, these sections, like § 1211 in the case of otherwise deductible (under § 165) capital losses, are sections that *limit otherwise allowable* deductions (authorized under other Code sections that do contain those magic words).

**Under §§ 465(a)(1) and (b)(5), individuals and closely held C corporations may deduct the net loss (the excess of deductions over Gross Income) arising from an activity[25] for the year only to the extent of the aggregate amount that the taxpayer has "at risk" in the activity, as reduced by net losses deducted in prior years.** In other words, a dollar "at risk" in the activity can justify deduction of a dollar of *net loss* only once. In general, § 465(b) provides that amounts considered "at risk" include only the cash and the A/B of property contributed by the taxpayer to the activity, as well as *recourse* debt borrowed for use in the activity.

Assume, for example, that Michael is a professional baseball player who plays outfield for a major league team (go Tribe!) and who earns $10 million each year. Michael also owns a substantial investment portfolio of stocks and bonds that generates $50,000 in dividends, interest, and capital gains each year. Michael wishes to shelter some of his baseball earnings and portfolio investment income from tax, and he buys an apartment building for $1 million (its FMV), using $50,000 in cash and borrowing $950,000 from National Bank on a recourse basis at 5% annual interest, with the principal due in a balloon payment in Year 10. During each of his first two years of ownership, the property generates $70,000 in rent, $47,500 in interest deductions, $40,000 in depreciation, $10,000 in real estate taxes, $9,000 in insurance costs, and $3,500 in maintenance costs (a total of $90,000 in deductions). Notice that Michael need not contribute any additional cash flow to the activity beyond his initial $50,000 investment, as the $70,000 rent is sufficient to pay the $70,000 out-of-pocket costs each year equal to the interest, real estate taxes, insurance, and maintenance costs each year. (While depreciation is deductible, it does not represent a cash-flow outlay.) Michael must include the $70,000 rent in his Gross Income under § 61(a)(5) each year, but that $70,000 is effectively offset entirely by deductions each year, generating no net additional tax liability for him. Can he use the remaining $40,000 net loss (the excess of the $110,000 in aggregate deductions over the $70,000 of Gross Income generated by the activity) to offset (*i.e.*, "shelter") income from his baseball salary and investment portfolio in Years 1 and 2?

If Michael had to worry only about § 465, the answer would be "yes." His at-risk amount for Year 1 is $1 million, consisting of the $50,000 cash that he invested and the $950,000 in recourse debt, which is sufficient to allow him to deduct the entire $40,000 net loss (offsetting his income unrelated to the rental property). At the beginning of Year 2, his at-risk amount is reduced to $960,000 ($1 million at risk at the beginning of Year 1 *less* $40,000 net loss deducted in Year 1), which again is sufficient to permit Michael to deduct his $40,000 Year-2 net loss (again offsetting unrelated income). His at-risk amount at the beginning of Year 3 is $920,000 ($960,000 at risk at the beginning of Year 2 *less* $40,000 net loss deducted in Year 2). Section 465 is obviously not a bar to Michael's sheltering of unrelated income with his real estate net losses.

How would § 465 apply if the $950,000 debt were *nonrecourse* instead of recourse? Absent § 465(b)(6), Michael's at-risk amount in Year 1 would be limited to the $50,000 cash that he contributed to the activity. While this figure would be sufficient to permit deduction of his entire Year-1 $40,000 net loss (sheltering unrelated income), his at-risk amount at the beginning of Year 2 would be only $10,000 ($50,000 at risk at the beginning of Year 1 *less* $40,000 net loss deducted

[25] For the first two years after enactment, § 465 applied only to certain types of activities listed in § 465(c)(1), but it was extended to all business and investment activities under § 465(c)(3) for years after 1978.

in Year 1), permitting deduction of only $10,000 of his $40,000 Year-2 net loss. The $30,000 that is rendered nondeductible is not lost, however. Rather, it is carried forward under § 465(a)(2) until such time as Michael's at-risk amount increases sufficiently to permit deduction. On our facts, that would not likely happen until Michael paid the $950,000 balloon payment due in Year 10 on the nonrecourse debt—a contribution of additional cash to the activity.

Enter § 465(b)(6). The real estate lobby worked hard for this provision! Under it, "qualified nonrecourse financing" in connection with the holding of real estate (only) is considered "at risk." To satisfy the definition, the nonrecourse financing must generally be extended by an independent third party (such as a bank) rather than a related party or the tax shelter seller. Because Michael's loan was extended by National Bank, his nonrecourse debt would satisfy the definition, and § 465 would not bar Michael's net losses from sheltering unrelated income. In short, "qualified nonrecourse financing" is treated as though it were recourse debt for purposes of determining the amount "at risk" in the activity.

Because both (1) § 465 was so impotent in denying deduction of net losses against unrelated income (at least in the case of real estate) and (2) Congress needed to broaden the tax base in 1986 to pay for significant marginal rate reductions (from a top rate of 50% to 28%), Congress added § 469 (and required real estate to be depreciated using the straight-line method over longer periods of time) in 1986.

Treas. Reg. § 1.469-2T(d)(6) provides that § 465 applies before § 469, but § 465 did not limit Michael's ability to fully deduct the real estate net losses against unrelated income. Thus, we finally need to move on to § 469. Let's drive along the § 469 roadmap to see how it affects Michael.

**Sections 469(a)(1)(A) and (2) deny individuals and closely held C corporations the ability to deduct any "passive activity loss," or PAL, arising in the year.** What is a PAL? Under § 469(d)(1), a **PAL** is defined, in essence, as **the excess of passive activity deductions over passive activity Gross Income arising in all of the taxpayer's passive activities.** In other words, like § 465, § 469 does not deny *all deductions* but rather prevents only the sheltering effect—the ability of the *net loss* (the excess of deductions over Gross Income) to shelter income from other sources. Thus, while $70,000 of Michael's aggregate $110,000 in deductions would be allowable even if § 469 otherwise applies (enough to offset the $70,000 in Gross Income generated by the rental real estate), Michael's $40,000 net loss from the rental real estate may be disallowed, which would prevent him from using the net loss (the excess deductions) to shelter his unrelated income.

What is a "passive activity"—an oxymoron if ever I heard one? Subject to important exceptions noted below, §§ 469(c)(1) and (6) provide that a passive activity is any business or investment activity in which the taxpayer does not "materially participate," and § 469(h)(1) defines material participation as involvement that is "regular, continuous, and substantial." Treas. Reg. § 1.469-5T(a) describes seven alternative tests that are used in determining whether these standards have been met, the most important of which is participation for more than 500 hours in the year. Section 469(h)(2) provides, however, that participation only as a limited partner is generally *per se* passive—regardless of the nature of the activity conducted by the limited partnership or the number of hours devoted to the activity by the limited partner. Moreover, §§ 469(c)(2) and (4) provide that a rental real estate activity (even if held directly rather than through a limited partnership) is also generally *per se* passive. These last two rules reflect the central place that both real estate tax shelters and limited partnerships had in driving enactment of § 469. Full-time real estate professionals, such as Donald Trump, were incensed that no exception was made for real

estate professionals, and Congress added (c)(7) in 1993 in response. Under it, real estate activities will not be considered *per se* passive if both (1) more than one-half of the taxpayer's work hours for the year are performed in real estate business activities in which the taxpayer "materially participates" and (2) more than 750 hours are spent in such activities in the year

Under these rules, Michael's $40,000 net loss arising with respect to this rental real estate in each of Years 1 and 2 (described above) are nondeductible PALs that cannot be used to offset either his labor income (from playing baseball) or the income generated by his investment portfolio because his baseball career means that he clearly fails the § 469(c)(7) tests for real estate professionals. "Wait," you say. "Investing in stocks and bonds seems awfully passive to me! Does not the $50,000 in interest, dividends, and capital gains that he realizes each year with respect to his investment portfolio constitute passive Gross Income, which can absorb the remaining $40,000 in passive deductions, thus preventing the creation of any nondeductible PAL?" No. Read § 469(e)(1). If Michael's $40,000 net loss were prevented from sheltering *only* his labor income and not income from his investment portfolio, it would be a feeble tool, indeed, as most of the tax shelter buyers that Congress intended to reach also realized such income. Section 469 would be only a minor speed bump on the road to deducting net losses against unrelated income. Thus, for purposes of § 469, interest, dividends, annuities, royalties, and § 1001 gain arising on the sale or exchange of property producing such income are not considered "passive."

Michael does not lose his $40,000 net loss, however. Under § 469(b), Michael carries forward his nondeductible PAL each year until either (1) he earns sufficient passive net income (excess of passive Gross Income over passive deductions for the year) to absorb it or (2) he disposes of the tax shelter in a taxable sale or exchange under § 469(g).

When Michael eventually sells the rental real estate, any remaining nonrecourse debt will augment his § 1001(b) amount realized under *Tufts* (Chapter 12), likely producing a sizable § 1001 gain.[26] This § 1001 gain will be passive gain (because it does not arise from the sale of property producing interest, dividends, annuities, or royalties under § 469(e)(1)), which will absorb any carryover PALs. If the gain is insufficient to allow deduction of all carryover PALs generated in previous years by the sold tax shelter, the carryover *PALs are nevertheless allowed to be deducted in full in the year of sale* under § 469(g), which would offset unrelated income. Why? Section 469 is not intended to disallow the deduction of *real* SHS wealth decreases. Rather, § 469 is intended merely to defer deduction of the net loss (the sheltering effect) until such time as we can be sure that it does, indeed, represent a *real* economic loss. We can know whether or not the carryover losses represent *real economic losses* only upon final disposition of the tax shelter. Many real estate tax shelters like Michael's are actually *not* economic losers over time. Rather, the problem is that they frontload deductions (funded with pre-tax debt dollars under *Crane*) in such a way that makes it *appear* that the taxpayer has lost wealth in the SHS sense. Indeed, Michael may actually be wealthier each year from his rental real estate if the property is appreciating in value, but the appreciation is ignored under the realization requirement.

Notice that § 469 does not generally operate on an activity-by-activity basis. Rather, passive Gross Income from *all* passive activities are used to absorb passive deductions arising from *all* passive activities, with the resulting net loss (if any) constituting the nondeductible PAL. At the

[26] Gain is very likely, even if the property does not appreciate in value but rather merely maintains or even loses value. As you learned in Chapter 14, his depreciation deductions, which reduce his basis under § 1016(a)(2), will in virtually all cases exceed any real loss in the property's value.

same time, however, § 469(g) does operate on an activity-by-activity basis. Thus, taxpayers with more than one tax shelter need to maintain good records in order to show how much of an overall PAL carryover is properly attributable to the particular tax shelter that is sold if the resulting sale gain is insufficient to absorb the PAL carryover properly attributable to that shelter.

One final provision is worthy of mention: § 469(i). While rental real estate activities are *per se* passive (except in the case of the professional able to satisfy the tests in § 469(c)(7)), Congress nevertheless wished to extend a *de minimis* rule to the small rental real estate investor. Under §§ 469(i)(1) and (2), a taxpayer that "actively" participates (as opposed to "materially" participates) in a rental real estate activity can deduct up to a $25,000 PAL each year, subject to a phase-out rule based on Adjusted Gross Income (AGI). The legislative history underlying this provision indicates that "active" participation is a lower standard than "material" participation and can be satisfied by management activities "such as approving new tenants, deciding rental terms, and arranging services and repairs."[27] To limit the provision to the small investor § 469(i)(3) reduces the $25,000 allowable PAL by 50% of the excess of the taxpayer's AGI over $100,000, so taxpayers with an AGI of at least $150,000 (including Michael) lose all benefit from § 469(i).

For purposes of applying the phase-out rule, AGI is measured before determining how much (if any) of the PAL is allowable under § 469(i), itself. Moreover, remember that passive deductions not exceeding passive Gross Income are allowable without regard to § 469, as only the *net loss* (the *excess* of passive deductions over passive Gross Income) is potentially disallowed under § 469. Also recall from Chapter 1, Part B., that deductions attributable to property producing rental income are taken above the line, directly from Gross Income in reaching AGI, under § 62(a)(4). Thus, taxpayers can ignore the tax shelter's Gross Income in determining AGI for purposes of the § 469(i)(3) phase-out rule because the tax shelter's clearly allowable deductions without regard to § 469(i) (equal to that Gross Income) will precisely offset that Gross Income above the line.

For example, contrary to our facts above, suppose that Michael is not a baseball player but rather a lawyer, who has $120,000 in AGI from his law practice. With respect to the rental real estate, he (1) realizes $40,000 in gross rental income, (2) incurs $35,000 in interest, insurance, and repair expenses, as well as $25,000 in deprecation (a total of $60,000), and (3) selects the tenants and arranges all repairs. Michael has a $20,000 PAL equal to the excess of his $60,000 in aggregate passive deductions over his $40,000 in passive Gross Income. Before applying § 469(i), Michael will add to his Gross Income the $40,000 in rent, but he will also be permitted to deduct $40,000 of his $60,000 in aggregate deductions under §§ 162, 163, 167, and 168 without regard to § 469, and this $40,000 will be deducted above the line under the authority of § 62(a)(4). Thus, Michael's AGI is *still* $120,000 before determining how § 469(i) applies to the $20,000 PAL.

Absent § 469(i), Michael would have to carry his $20,000 PAL forward under § 469(b). Because Michael satisfies the more lenient "active participation" test in § 469(i)(1), however, he can potentially deduct all or a portion of his $20,000 PAL because it is less than the $25,000 ceiling in § 469(i)(2). But that $25,000 ceiling is reduced by $10,000, which is 50% of the amount by which Michael's AGI before applying § 469(i) ($120,000) exceeds $100,000. Michael's applicable ceiling is therefore reduced from $25,000 to $15,000. When the smoke clears, Michael can deduct only $15,000 of his $20,000 PAL (above the line under § 62(a)(4)), which means that $15,000 will offset unrelated income from his law practice or investment portfolio of stocks and bonds. He

[27] McCormack v. Comm'r, T.C. Summary Op. 2013-9 (Feb. 11, 2013), www.ustaxcourt.gov/InOpHistoric/mccormacksumm.sum.WPD.pdf.

must, alas, carry forward the remaining $5,000 PAL for use in future years.

## Problems

In each of the problems below, advise your clients regarding the extent to which they can currently deduct in each of Years 1 and 2 the described amounts.

**1.** Monica is a dentist who has an AGI, without regard to the limited partnership investment described here, of $140,000 each year, including not only her salary as a dentist but also $10,000 in interest each year on corporate bonds. After reading a prospectus that she found in her mailbox one day, she purchases one limited partnership unit in a California windmill energy project for $5,000 in cash. The partnership uses the cash paid by the many limited partner investors, coupled with significant amounts of nonrecourse debt lent by the entity marketing the tax shelter, to build and operate a windmill farm near the Sierra Nevada mountain range.

At the end of each of Years 1 and 2, Monica receives a Schedule K-1 in the mail that informs her that the partnership suffered a net loss for each year (excess of deductions over Gross Income) and that her share of this net loss in each year is $3,000. Assume that no rule in Subchapter K (pertaining to the taxation of partners) prevents Monica from deducting this $3,000 net loss on her individual tax returns in Years 1 and 2. The letter accompanying the Schedule K-1 reminds Monica, however, that she should consult her tax advisor to determine the extent to which provisions outside Subchapter K affect her ability to deduct her allocated net losses.

**2.** Jim is an electrical engineer living in Ohio who has an AGI, without regard to the investment described here, of $140,000 each year. On January 1 of Year 1, Jim buys a duplex for $300,000, paying $50,000 in cash and borrowing $250,000 from National Bank on a nonrecourse basis (using the duplex as security) at 5% interest for a 30-year term. The property is already rented to tenants when Jim buys it. After a few months, one tenant informs Jim that he will not be renewing his lease when it ends shortly. Jim advertises the unit, but unfortunately it takes seven months to find a suitable new tenant, decreasing Jim's aggregate rent receipts for the year.

In Year 1, Jim receives $22,000 in aggregate rent from his tenants and pays $16,000 to National Bank on the loan, of which $13,000 is interest, with the remaining amount constituting principal repayment. Depreciation under § 168 for Year 1 is $10,400.[28] Jim hires a company to maintain the landscaping on the property and to clear the snow in the winter. He had to call a plumber to fix the plumbing in one unit and an electrician to replace some faulty wiring in the other unit. (An electrical engineer knows *nothing* about replacing faulty wiring!) Jim pays a total of $3,000 in these and other maintenance expenses for the year, and he pays $2,000 in property insurance.

In Year 2, Jim receives $29,000 in aggregate rent from his tenants. He pays $16,000 to National Bank on the loan, of which $12,500 is interest, and incurs depreciation of $11,000. Unfortunately, his maintenance expenses increase to $5,000 this year because of some unexpected repairs, and he pays $2,000 in property insurance.

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[28] This amount is less than the approximately $11,000 that he will generally deduct in each of the other years because of the mid-month convention for Year 1 that applies to real estate under § 168(d)(2), as you learned in Chapter 14.

***The § 163(d) investment interest deduction rules***

Before examining § 163(d), let's first review a topic that you first explored in Chapter 2.

Suppose that Emma borrows $50,000 from National Bank to buy $50,000 of § 103 bonds issued by the state of Ohio, the interest on which is excludable from Emma's Gross Income. In addition to the excludable § 103 interest, Emma also realizes includable interest (from corporate bonds that she owns), dividends (on stock), and capital gain from the sale of stock. Can Emma deduct the interest that she pays to National Bank with respect to her loan under § 163(a)? While Emma is borrowing from a third party (rather than from the issuer of the bonds) and thus need not worry about a possible sham debt challenge to her interest deductions *à la* Mr. Knetsch, she nevertheless is denied her § 163 interest deduction under § 265(a)(2).

As you learned in Chapter 2, the exclusion of § 103 interest is a consumption tax provision of the wage tax variety. Recall that, under a wage tax, only labor income is included in the tax base, capital returns are excluded, and *no business or investment deductions associated with capital returns are permitted*.[29] Because the capital return (in the form of interest) on the § 103 bonds is excluded from Gross Income, § 265(a)(2) properly denies the deduction of the expense that Emma incurs to produce it—the interest with respect to the National Bank loan that might otherwise be deductible under § 163(a). If § 265(a)(2) did not deny Emma her interest deduction, the deduction would necessarily offset (shelter) income from other sources because the § 103 bond purchased with the borrowed cash does not produce includable Gross Income.

So let's change the facts to take § 265(a)(2) out of the picture. Suppose that Emma uses the $50,000 borrowed from National Bank to purchase, say, growth stocks from corporations that retain their profits (rather than distributing them as dividends) to expand the corporations' businesses. Emma realizes no other interest, dividends, or capital gain. Because the type of income that will be generated by the growth stocks (§ 1001 gain on eventual sale) is not exempt from tax (unlike the interest paid on § 103 bonds), § 256(a)(2) is irrelevant to Emma's potential interest deduction under § 163. But notice that Emma does not *currently* realize any includable Gross Income with respect to the growth stocks. Even though the stock appreciates in value each year (reflecting the undistributed corporate profits), the appreciation in value—though representing a SHS wealth increase—is ignored under the realization requirement. If she is nevertheless permitted to deduct the interest payments made to National Bank each year under § 163(a), we would mismeasure her SHS changes in wealth with respect to this investment. To be specific, the interest deductions, if allowed, would necessarily shelter income from other sources, such as her wages.

Enter § 163(d). The general approach taken in § 163(d) is similar to that taken in §§ 465 and 469 in that net losses (the excess of deductions over Gross Income) are deferred to future years to prevent a sheltering effect. To be specific, § 163(d)(1) permits the deduction of "investment interest" in any year *only* to the extent of "net investment income" for the year, with the excess (net loss) carried over to future years under § 163(d)(2). "Investment interest" is identified under rather elaborate tracing rules in Treas. Reg. § 1.163-8T. In essence, if the amount borrowed was used to purchase investment property, the interest is investment interest. Section 163(d)(3)(B) specifically excepts interest used to purchase a personal residence in which the taxpayer resides (which is governed by § 163(h)(3), studied in Chapter 18) and interest incurred in any passive activity, which is governed by § 469, instead. Similarly, § 163(d)(4)(D) excludes passive income

[29] If the capital return is, itself, not going to enter the tax base, no deductions are necessary to avoid doubly taxing the same dollars to the same taxpayer, as you learned in Chapter 2.

and deductions from being taken into account in determining "net investment income." In short, income and deductions (including interest) arising in a passive activity are *wholly* governed by § 469, with § 163(d) having no effect. (These rules explain why we never mentioned § 163(d) when we analyzed Jim's payment of interest in connection with his rental property in Problem 2.) But remember that, under § 469(e)(1), interest, dividends, annuities, royalties, and § 1001 gain arising on the sale or exchange of property producing such income are not considered "passive." It is with respect to *these* kinds of income (and interest incurred on debt used to purchase property producing these kinds of income) that § 163(d) applies, made explicit by the cross-reference to § 469(e)(1) in § 163(d)(5)(A)(i).

A significant exception applies, however, to the information provided in the last two sentences. Net capital gain and qualified dividends[30]—both of which can be taxed at 15% or 20% instead of the taxpayer's higher ordinary rate—are taken into account in computing "net investment income" *only* if the taxpayer expressly elects to use this income as "investment income" under § 163(d)(4)(B). The purpose of the election is to prevent the taxpayer from engaging in tax-rate arbitrage by simultaneously claiming that the net capital gain and qualified dividends are offset by interest deductions under § 163(d) and, at the same time, survive intact to be taxed at a reduced rate under § 1(h).

Assume, for example, that Mary, whose marginal ordinary income is otherwise taxed at 28%, borrows $10,000 at 5% interest to purchase shares of stock for $10,000. One year and one day later, after the stock has appreciated by 5%, Mary sells it for $10,500 and uses the sale proceeds to repay the $10,000 debt principal and $500 interest owed. The transaction is an *economic* wash. Economically, Mary is no better off or worse off (no wealthier or less wealthy) than if she did not engage in this transaction in the first place. The transaction, therefore, should be a wash for tax purposes, as well. If, however, Mary is allowed to claim *both* that her $500 gain is "net capital gain" that is taxed at only 15% (generating a $75 tax) *and* that her $500 interest expense is deductible against her 28% taxed income, such as her wages (saving $140 in tax), she would realize an after-tax profit of $65, consisting once again of dollars coming from the Treasury, not from any real economic profit. Section 163(d)(4)(B)(iii) prevents this result. If she wants to use her $500 gain as "investment income" that allows her to currently deduct her $500 of investment interest under § 163(d), she cannot *also* use that same $500 gain toward creating "net capital gain." In other words, § 163(d)(4)(B)(iii) creates a matching rule. Because "qualified dividends" are also subject to the net capital gain rate under § 1(h)(11), the same rule applies to such dividend income.

Let's illustrate these rules with an example. Assume that Eli borrows $100,000 at 5% interest in Year 1 to purchase various investment assets, including stocks, bonds (none of which are § 103 bonds), annuities, and a patent (which produces royalty income). In Year 1, he pays $5,000 in interest and $500 in investment advisory fees that are deductible under § 212. In Year 1, he receives $2,000 in interest with respect to his bonds and annuities, $1,000 in royalties, and $1,700 in dividends on his stocks. He sells none of the stocks, thus realizing no § 1001 gains or losses. In Year 2, Eli pays the same $5,000 in interest on the loan but no investment advisory fees. He realizes $2,000 in interest, $6,000 in royalties, and no dividends or §1001 gains or losses. How much of

[30] Dividends are subject to the same reduced tax rate (either 15% or 20%) that generally applies to net capital gain if they satisfy the definition of "qualified dividends" within the meaning of § 1(h)(11). Even though dividends can be subject to the same reduced tax rate that applies to net capital gain, you must remember that dividends are not real capital gain. Thus, for example, dividends do nothing to help a taxpayer with a large capital loss carryover under § 1212(b) to deduct those carryovers under § 1211(b).

his $5,000 in interest payments can Eli deduct in each of Years 1 and 2?

In Year 1, Eli's "net investment income" is either $4,200 ($4,700 *less* the $500 in investment advisory fees) or $2,500 ($3,000 *less* $500), depending on whether Eli elects under § 163(d)(4)(B) to treat his $1,700 in dividend income as investment income for purposes of § 163(d), thus giving up the reduced tax rate that could otherwise apply to that income under § 1(h)(11)(D). Should he make the election? If he does, he can deduct $4,200 of his $5,000 in investment interest, carrying forward $800 to Year 2 under § 163(d)(2). If he does not, he can deduct only $2,500 of his $5,000 interest, carrying forward $2,500. Eli would have to weigh the time-value-of-money cost of deferring $1,700 of his interest deduction to a future year with the preferential 15% rate that he would surrender if he uses this otherwise low-taxed income to absorb his ordinary interest deduction this year. That interest deduction would be better used to offset high-taxed interest or royalty income (or short-term capital gain). In other words, the planning considerations are similar to those we considered in the last chapter regarding the timing of capital loss realizations. How good is Eli's crystal ball?

Let's suppose that Eli knew in Year 1 that he would be receiving a considerably larger (high-taxed) royalty payment in Year 2, so he decides *not* to make the election to treat his qualified dividend income as "investment income" for purposes of § 163(d). Eli deducts only $2,500 of his $5,000 interest, carrying forward the remaining $2,500 to Year 2, and he would enjoy the low 15% tax rate on his $1,700 in dividend income. In Year 2, he deducts the entire $7,500 of interest (both the $5,000 paid in Year 2 and the $2,500 carried forward from Year 1) against high-taxed interest and royalty income because $7,500 is less than his $8,000 in net investment income.

## Problem

In Year 1, Samantha borrows $100,000 from National Bank. Under the loan terms, she will pay 5% interest each year ($5,000) until Year 10, when the $100,000 principal will be repaid. She uses $20,000 to buy a § 103 bond from the city of Cleveland, $60,000 to buy corporate bonds, and $20,000 to buy corporate stocks (the only properties in her investment portfolio in Year 1). Samantha incurs no investment expenses other than the annual $5,000 interest payments. How much of the $5,000 interest can she deduct in Year 1 if she realizes the following amounts? Do not forget § 163(d)(4)(B)(iii) and the sentence following it.

**Year 1:** $800 in interest from the Cleveland bonds
$3,600 in interest on the corporate bonds
$1,000 in "qualified dividends" received on the corporate stock

In Year 2, Samantha buys a patent, which produces royalty income for her investment portfolio, using her past savings (rather than debt). She once again pays $5,000 in interest on her loan. How much can Samantha deduct in Year 2 if she realizes the following amounts?

**Year 2:** $800 in interest from the Cleveland bonds
$3,600 in interest on the corporate bonds
$2,000 in net capital gain from the sale of corporate stock
$1,000 in royalty income

# Unit VI:

# Distinguishing Between Income-Producing Activities and Personal Consumption and the Personal Consumption Tax Expenditures

## Introduction to Chapters 17 through 20

In Chapter 1, you learned that a current expense, § 1001 loss, or depreciation should be deducted *only* if the expense, loss, or depreciation is incurred in an income-producing activity (business or investment) if we seek to reach a tax base of SHS "income." In Chapter 2, you learned that even a consumption tax base, as an alternative to an income tax base, requires taxation of personal consumption. How do we distinguish between income-producing activities, on the one hand, and personal consumption, on the other?

Chapter 17 explores the tax consequences pertaining to both the acquisition of and loss of "human capital." In particular, the costs of acquiring human capital in the form of education challenges the dividing line between income-production activities and personal consumption. In Chapter 3, you learned that the current Internal Revenue Code contains numerous provisions—referred to as "tax expenditures"—that allow personal consumption outlays to reduce the tax base through deductions, credits, or gross income exclusions that are inconsistent with either an SHS income tax base or a consumption tax base, resulting in nearly $1 trillion of lost revenue each year and, thus, marginal tax rates that are higher than they would otherwise need to be to raise the same *$X* in revenue. Significant tax expenditures are found in the education sphere. What justifies them? In light of their justifications, are they well-crafted provisions to meet those ends without losing revenue unnecessarily (requiring rates to be higher)? To what extent are these tax preferences effectively captured by other actors in the marketplace through the price mechanism?

Chapter 18 examines the major personal tax expenditures surrounding home ownership, personal casualty losses, health care, charitable contributions, and more.

Chapter 19 considers gambling losses and so-called hobby losses. If these activities are placed in the personal consumption sphere, should deductions nevertheless be allowed if Gross Income is earned in the activity (unlike in the case of most personal consumption activities)? If deductions are denied, would the same dollars be twice taxed to the same taxpayer, undermining a fundamental precept of a tax on "income"? Should that precept matter if the taxpayer is engaging in the activity for fun rather than profit?

Chapter 20 explores a slightly different issue from that considered in Chapter 19. Even when there is no doubt that an activity rises to the level of a trade or business, which outlays should be allocated to that business, and which should be allocated to the taxpayer's personal sphere? This chapter considers, for example, business travel expenses, entertainment expenses incurred in a business context, so-called home office deductions, and similar issues.

# Chapter 17: On Human Capital

What is "human capital" and how do we distinguish it from other forms of capital, such as financial capital (*e.g.*, shares of stock in a corporation or a corporate bond) or tangible capital (*e.g.*, plants and equipment)? Just as financial capital and physical capital can earn a return, so can human capital—in the form of labor income, *i.e.*, a return earned on one's personal effort.

"Human capital" refers literally to the human body and all of the attributes of an individual that allow him or her to earn services income. Much human capital is inherited through good genes, such as an able body, physical attractiveness, height (with research showing that the more attractive and taller earn more than the less attractive and shorter), and a functioning mind. Other aspects of human capital are an unknowable mix of genes, environment, and effort, such as IQ, creativity, sociability, the ability to work diligently, to work cooperatively with others, to lead, and to focus on and complete tasks efficiently. Human capital is even affected by how well the child has chosen his or her parents, with research showing that those born into wealthy families tend to earn significantly higher incomes than those born in poverty. That is to say, it is not surprising to learn that human capital is affected by social and family connections. Some human capital, however, can be *purchased*, with the most important of these examples being education and skills training. *All* of these facets contribute to allowing the person to earn personal services income.

How do we distinguish between human capital and other forms of capital? ***You cannot sell your human capital and thereby divest yourself of it***, as you can with non-human capital, such as business equipment or corporate stock. I can share my human capital with you—my knowledge of the income tax—but I do not thereby divest myself of that knowledge. Nevertheless, human capital can sometimes create a property interest that can be bought and sold in the marketplace, such as goodwill or a patent owned by the inventor of the patented process (as opposed to a later purchaser of that same patent, who holds it as conventional capital). The inability to differentiate easily between the return on human capital and the return on conventional capital in some contexts leads to difficulties throughout the Internal Revenue Code—particularly in the case of differentiating capital gain from ordinary income, as discussed in the previous two chapters.

Part A. of this chapter will focus on one aspect of human capital: education costs. To what extent should tuition scholarships be excluded from Gross Income? When an employer pays for an employee's education, to what extent should this compensation be excluded? Are the education tax expenditures justified? Well crafted? To what extent should tuition costs be deducted as a business expense?

Part B. will explore the tax consequences of receiving a settlement or jury award on account of the loss of human capital.

## A. Education costs

Education costs implicate both (1) wealth accessions (possible § 61 Gross Income) when the taxpayer obtains a scholarship from an educational institution or a fringe benefit from an employer that pays for the taxpayer's education costs and (2) wealth reductions (possible deductions or credits) when the taxpayer pays for education costs herself. With respect to the latter, they also

implicate the line between an income-producing activity (deductions are allowed) and personal consumption (no deductions in a pure SHS income tax or pure consumption tax).

**Human capital acquisition costs are generally relegated to the personal sphere, including education costs, because the acquisition of human capital is inextricably intertwined with the taxpayer's personal life.** Even though education augments the taxpayer's ability to earn income in exchange for services, it also inevitably brings personal benefits, as well, including the ability to consume life more fully as one's mind is opened to art, music, literature, history, political thought, psychology, *etc.* Research shows that education even contributes significantly toward one's ability to meet a life mate. Thus, many of the tax-reducing provisions attributable to education costs in the Internal Revenue Code are properly categorized as "tax expenditures," a concept that you first learned about in Chapter 3, Part B.

Because tax expenditures are not normative income tax provisions, *i.e.*, they are not necessary to measure "income" accurately, how do we evaluate the wisdom or folly of a particular tax expenditure or evaluate its efficacy as a policy matter? The answer: cost-benefit analysis, which is not an easy task. In a cost-benefit analysis, the policy analyst must define the goal of this particular government action and ask whether the tax expenditure is the best means (in the sense of economic efficiency, fairness, and administrative ease) to accomplish that goal. Could the goal be better accomplished outside the tax system or inside the tax system? Recall that only about 60% of households earn enough to owe income tax, which means that delivering social spending through the Internal Revenue Code fails to reach many households. Moreover, some of these provisions are delivered in the form of an Itemized Deduction, which is worthless to the approximately 70% of filers that take the Standard Deduction, as described in Chapter 1, Part B. If the tax system is going to be used, is the goal with respect to a higher education tax expenditure to provide a subsidy (to those having trouble financing education) or to change behavior (to increase the number of students attending college)? In either case, how should the provision be structured to deliver the benefits to the targeted population? Tax expenditures often have complex definitions, income ceilings, and phase-out rules—all in order to limit the indirect government spending to the targeted population. In employing cost-benefit analysis, the policy analyst must also be concerned with windfall losses (rewarding people for engaging in behavior that they would have engaged in anyway) if the goal of the tax expenditure is to change behavior and upside-down benefits (with more of the lost revenue absorbed by high-income families than low-income families) if the goal is to provide a subsidy. Finally, we need to discuss "capture" through the price mechanism, which is the flip side of the coin of tax "incidence," also discussed in Chapter 3.

On the face of the statute, the education deductions and credits are aimed at the student or the student's family. The exclusion for employer-provided health care in § 106 (discussed in the next chapter) is aimed at the employee on the face of the statute. The deduction of qualified residence interest in § 163(h)(3), exclusion of home sale gain under § 121, and deduction of real estate property taxes under § 164(a)(1) (also discussed in the next chapter) are each aimed at the home owner. And so on. These tax benefits, however, can often be captured by other actors in the marketplace through the price mechanism. *The more broadly available a tax expenditure, the more easily it can be captured by raising the price of the purchased asset or service at large.* If a tax benefit is limited to a small, select population, providers find it difficult to raise prices generally.

In the context of the education tax expenditures, capture can mean that universities are able to raise tuition to higher levels than they would be able to charge absent the tax expenditure. When the Hope Credit was enacted in 1997, for example, California community colleges charged an

average annual tuition of less than $1,500, and they immediately raised their tuition to the $1,500 that could be credited each year under § 25A. Even in the case in which tuition is already higher than the amount currently creditable, the very existence of § 25A can result in tuition inflation, as universities generally raise tuition to capture all or part of the benefit. Whether that is a good or bad development may depend on what the university or college does with the extra tuition dollars. If the institution uses them to replace reductions in state funding (in the case of a public university), the Federal dollars merely maintain the *status quo*. If it uses the increased tuition to provide more scholarship dollars to needy students, perhaps the capture is a good thing. If it uses the increased tuition to raise professors' salaries, perhaps not so much….

### Tax Incentives for Education: Not Making the Grade[1]

Marie Sapirie

Do education tax benefits produce more educated Americans? Congress has no idea.

That was the conclusion drawn by witnesses at a July 25 Senate Finance Committee hearing on education tax incentives. It is a critical question, because tax benefits have become a secondary conduit for education financing, possibly to the detriment of students.

At the hearing, James White, director of tax issues for the Government Accountability Office, said Congress lacks basic information about how education tax incentives affect tuition costs, enrollment and graduation rates, follow-up resulting in postsecondary education, and related issues….

As the costs of postsecondary education have increased, Federal tax expenditures on higher education, as well as the number of education-related tax provisions, have grown significantly. In a recent report to Congress on education tax benefits, the Joint Committee on Taxation noted that while the average tuition, fees, and room and board at a public institution for the 1986-1987 school year cost $7,414 in constant 2009-2010 dollars, the price in 2010-2011 was $13,297. Costs at private institutions rose from $18,854 to $31,395 over the same period, according to the report….

The JCT estimates that the revenue forgone from all the education tax incentives will total $78.4 billion between 2011 and 2015. By comparison, the mortgage interest deduction is estimated to cost about $84 billion in 2012 alone. Of course, with complexity come additional costs for the IRS and taxpayers. There is an increased risk of error and fraud with the recent advent of refundable education tax credits.

The GAO reported that in 2009, 12.8 million students received Title IV aid, and about 18 million return filers claimed a higher education tax benefit for current expenses.

There are four main types of education tax incentives: benefits for current expenses, benefits for saving for education expenses, benefits related to past expenses, and benefits for educational institutions. Within those categories are about 18 different provisions, ranging from the charitable deduction for education to the exclusion of interest earned on education savings bonds.

The tax benefits, as well as other government spending on education, are intended to remedy a perceived market failure. The JCT said in its report that "because an individual chooses to invest in education based on the private benefits he expects to accrue, in the absence of government

[1] 137 TAX NOTES 335 (2012). Reprinted with permission of Tax Analysts.

intervention he may choose a level of investment that is lower than socially optimal."

**Roll Call**

The following is an overview of [some of] the current tax benefits available for education, with descriptions and explanations from the JCT and GAO reports. The benefits are listed in order of estimated cost. [Editor's note: In the interest of space, I did not reprint descriptions of some provisions.]

**Charitable Contributions to Education**

The JCT estimates that the deduction for charitable contributions to education will cost the government $ 32.4 billion between fiscal 2011 and 2015.

**HOPE Credit/American Opportunity Credit**

President Clinton introduced the HOPE scholarship credit in 1997 with the intent of helping low- to middle-income families. It is one of the two largest expenditures for education, totaling $24.4 billion for fiscal 2011-2015, and it has the lowest income phase-out among education tax benefits. It is not refundable. When the HOPE credit was temporarily replaced by the partially refundable American opportunity tax credit (AOTC) for tax years 2009-2012, the annual limit was raised from $1,800 to $2,500 and the income phase-out was significantly increased. Also, the credit applied to the first four years of undergraduate education rather than just the first two, and it was expanded to cover not just tuition and fees, but also supplies and books.

The HOPE credit income phase-out was between $53,000 and $63,000 in 2008 dollars for individuals, and $106,000 and $126,000 for married joint filers. If it is reinstated by the expiration of the AOTC on December 31, 2012, the thresholds will be adjusted for inflation. By contrast, the AOTC phases out for individuals with income between $80,000 and $90,000, and for married couples filing joint tax returns with income between $160,000 and $180,000. Inflation does not account for the differences in income levels. The Urban-Brookings Tax Policy Center noted that most students qualify for the AOTC and that extending the credit would cost an estimated $137.4 billion over the next 10 years.

President Obama proposed making the AOTC permanent in his fiscal 2013 budget and indexing for inflation both the maximum expenditures eligible for the credit and the income phase-out thresholds.

**Parental Exemption for Students**

Parents of full-time students who are between the ages of 19 and 23 may take a dependency exemption for their children. Starting in 2013, the deductions for personal exemptions will be phased out for higher incomes.

The parental exemption is estimated by the JCT to cost $13.1 billion between 2011 and 2015. The GAO estimates that 50 percent of the benefit of the exemption goes to taxpayers with incomes greater than $100,000.

**Lifetime Learning Credit**

The lifetime learning credit under section 25A allows eligible taxpayers to claim a credit of 20 percent of qualified tuition and related expenses incurred during the tax year by the taxpayer or his spouse or dependents. The maximum credit per return is $2,000, and the credit is nonrefundable. The credit begins to phase out at $52,000 for individuals and $104,000 for joint filers. Taxpayers

can claim the credit for an unlimited number of tax years but they cannot claim both the lifetime learning credit and either the HOPE credit or the AOTC for the same student for the same year.

The lifetime learning credit will cost $12.9 billion between 2011 and 2015, according to the JCT.

**Scholarship and Fellowship Income**

Qualified scholarships and fellowships are excluded from Gross Income under section 117. The JCT estimates that the exclusion will cost $12.6 billion between 2011 and 2015.

**Employer-Provided Education Benefits**

Employees can exclude up to $5,250 of education assistance from their employers per year if the employer has a program that meets the requirements under section 127. The provision was initially temporary, but it was extended and is now subject to the December 31, 2012, sunset provision of the Economic Growth and Tax Relief Reconciliation Act of 2001. The JCT estimates that it will cost $4.7 billion between 2011 and 2015.

**Deduction for Interest on Student Loans**

Section 221 provides an above-the-line deduction for interest on qualified education loans. There is a maximum annual deduction of $2,500 and an income phase-out starting at $60,000 for individuals and $125,000 for married joint filers. The JCT estimates that the deduction will cost $4.1 billion between 2011 and 2015.

**Section 529 Plans**

Section 529 plans, also called qualified tuition programs, were added to the code in 1996. Section 529 authorizes states to set up programs that allow taxpayers to create accounts on behalf of a designated beneficiary. The income earned in the accounts accumulates tax free, and contributions qualify for the gift tax annual exclusion. There are no income caps on contributors to 529 plans.

The JCT reported that the tax-preferred savings accounts for education have grown substantially in recent years, particularly under the qualified tuition programs. In 2011, 10.7 million qualified tuition program accounts held $164.9 billion in assets, up from 4.4 million accounts holding $26.8 billion in 2002. The estimated cost of the plans is $3.6 billion between 2011 and 2015. The GAO reported that in 2006, 4.2 million households with a median Gross Income of $122,400 had a 529 plan or a Coverdell account.

**Other Benefits**

… The JCT estimates that between 2011 and 2015, the [§ 222] deduction for higher education expenses will cost $1 billion. The GAO report found that for 2009, 1.7 million taxpayers with a median income of $73,277 received the deduction.

About 45 percent of the benefit of the tuition and fees deduction went to taxpayers with incomes greater than $100,000 in 2009, while about 34 percent went to taxpayers with incomes less than $60,000, according to the GAO's estimate. The tuition and fees deduction is mutually exclusive in its application with the AOTC and the lifetime learning credit, which may explain some of the regressivity.

Another benefit that is designed to help save for education expenses is the Coverdell account.

Section 530 allows taxpayers to open an education savings account to pay for a designated beneficiary's qualified education expenses, which include elementary and secondary education expenses as well as higher education expenses. The JCT reported that in 2009, 644,000 taxpayers contributed more than $718 million to Coverdell accounts.

There are also … employer-provided tuition reduction benefits, and income attributable to the discharge of some student loan debt; … and a deduction for classroom expenses incurred by teachers.

**Honor Roll**

Some of the education tax benefits have income caps that are designed to direct the benefits toward the taxpayers who need them most. For example, when the HOPE credit was introduced, it targeted students from low-income families.

The education savings plans are meant to encourage families to save for college. Assets under management in 529 and Coverdell accounts are increasing, indicating that the programs might be succeeding in that goal.

However, for families to save for college, they need discretionary income. Not surprisingly, the Coverdell accounts and 529 plans are used primarily by households with incomes greater than the national median, according to the GAO. Among the sobering findings from the GAO's study are that in 2007, households with Coverdell and 529 accounts had a median income of $122,400, whereas households without them had a median income of $43,400. The GAO found that 12 percent of households with incomes greater than $100,000 held Coverdell or 529 accounts, but that about 4 percent of households with incomes from $50,001 to $100,000 and about 1 percent of households with incomes less than $50,000 held them.

One education tax incentive that benefits higher-income taxpayers in the short run is worth keeping because of the external benefits it produces. Even if Congress doesn't know what it's getting out of most of its education tax initiatives, the beneficiaries of the charitable deduction do. Many *Tax Notes* readers are familiar with the glossy alumni magazines that universities send out and other aggressive fundraising campaigns by postsecondary institutions. Private elementary and secondary schools actively seek donations and publicize their tax-exempt status. But public K-12 institutions also enjoy the generosity encouraged by the charitable donation. For example, the public schools in Fairfax County, Va., receive donations of—among many other things—about 400 cars a year for the use of high school students studying automotive technology. Last year the students made 170 of the vehicles road-worthy and sold them. The proceeds were funneled back into their courses, scholarships, and fees for the student-operated dealership. (For more on this program, see www.fatefacts.org/Student_Auto_Sales.php.)

To be sure, Fairfax County is the third richest county in the United States, according to *Forbes*, and its donation program is well organized, so the number of public-school benefactors in the county may be larger than is typical. Jay Garant, coordinator of business and community partnerships for Fairfax County Public Schools, said that individual donations have ranged from $50 to $800,000. At a time of declining state and local tax revenue for many areas, private contributions are an important resource.

**Needs Improvement**

Education tax incentives have some serious problems. They are generally too complex, likely encourage institutions to raise tuition and fees, and frequently have higher than necessary income

caps.

A good way to ensure that even the most well-intentioned incentives don't work properly is to make them complex. Unfortunately, complexity is a common feature of many education tax benefits. IRS Publication 970, *Tax Benefits for Education*, is 83 pages long. Form 8863, "Education Credits (American Opportunity and Lifetime Learning Credits)," and Form 8917, "Tuition and Fees Deduction," appear fairly straightforward, but they are still susceptible to taxpayer error because taxpayers must decide which of the forms to file. The AOTC and the lifetime learning credit are also mutually exclusive, but both are claimed on Form 8863.

So it is unsurprising that in analyzing IRS data for 2009 for selected returns, the GAO found that return filers do not always choose tax expenditures that maximize their potential tax benefits. "We found about 14 percent of filers (1.5 million of almost 11 million eligible returns) failed to claim a credit or deduction for which they appear eligible," it wrote.

The dismal report card on complexity has changed little in the last 10 years. In 2001 the JCT proposed simplifications such as establishing a uniform definition of qualified higher education expenses and combining the HOPE and lifetime learning credits. Congress has done neither.

The JCT also recommended that Congress consider the advantages and disadvantages of deferral or exclusion from income, income limits, and transition issues. The report notes: "Although the existence of a variety of tax incentives for education may mean that more taxpayers are able to take advantage of one or more education incentives, understanding the tax benefits provided by the different provisions, the various eligibility requirements, the interaction between different incentives and provisions within each incentive, as well as the recordkeeping and reporting requirements, may be time consuming and confusing for taxpayers who are interested in reducing their current educational expenses or saving for future expenses.

For taxpayers to take advantage of incentives, they must know about and understand them. In addition to being simplified, the incentives should be permanent, because temporary provisions, like the AOTC, are more difficult to plan for….

Education is expensive, but the Federal government can make it even more so. Tax benefits for individuals may be reduced or even canceled out by educational institutions through higher tuition and fees, a result that undermines the legislative goal of making higher education more accessible.

For their part, colleges maintain that they need more money because their costs are increasing. MIT President L. Rafael Reif said in his inaugural address earlier this year that intensive, hands-on science and engineering research requires MIT "to invest more than three times as much to educate our undergraduates as we receive in net tuition—that is, tuition minus financial aid." MIT estimates its 2012-2013 cost of attendance for undergraduates at $57,010. Thanks to a $10.3 billion endowment from its enterprising alumni base, MIT has no liquidity problems….

For other schools, the picture is different. The 2012 JCT report says that raising tuition "may be particularly attractive to community colleges that charge less than the amount of the subsidy provided by a Federal education credit, because tuition can be raised to the amount of the credit without requiring the student to pay more out-of-pocket on an after-tax basis, provided the student or parent has tax liability to offset." That distortion in the price of higher education could eliminate much of the incentive that benefits like the AOTC are supposed to provide at the margin.

A problem with the increasing income phase-outs is that they introduce regressivity. The GAO reported that with the introduction of the AOTC, the distribution of benefits among taxpayers in

the lowest and highest income categories changed. Between 2008 and 2009, the percentage of return filers with incomes less than $20,000 claiming the AOTC increased from 14 percent to 28 percent and the percentage of total benefits those filers received rose from 6 percent to 15 percent. But during that same period, the percentage of AOTC filers making more than $100,000 rose from 5 percent to 16 percent of all AOTC filers, and their percentage of the benefits rose from 4 percent to 22 percent.

Other unintended consequences of education tax credits could include decreased donations and reduced state and local funds being allocated to public education. However, the JCT noted that while private contributions decrease in response to increases in public contributions, the reduction is less than 100 percent of the Federal support.

The statutory income caps on many of the education tax provisions get a mention in the failing-grade category, too, because many of them are high enough to funnel benefits to families with six-figure incomes. Even accounting for regional cost of living differences, families with incomes greater than $100,000 are probably not in the subset of the population that is likely to be motivated to pursue higher education as a result of tax incentives.

**Tax Reform**

Finance Committee Chair Max Baucus, D-Mont., recently said, "Many tax benefits, including for education, currently give the most help to those who already have the most opportunities. . . . We should ensure more students get more education." He added that "promoting education and opportunity will pay dividends. We can accomplish all of this with tax reform." But before the government "invests" more in education, it should figure out exactly what it is buying with taxpayer funds, because it is not at all clear that the benefits are reaching the people who need them the most.

It seems likely that education tax incentives do more than just influence behavior, heightening the need for them to be scrutinized as a part of reform. In 2001 the JCT noted that "it is possible to create inefficient outcomes by over-subsidizing a good that produces positive externalities. Given that the United States already provides substantial subsidies to post-secondary education, it is not possible to say whether such subsidies would increase or decrease economic efficiency without some empirical analysis of the social benefits that would arise from creating new subsidies."

Obama's National Commission on Fiscal Responsibility and Reform recommended eliminating most tax expenditures, which would appear to include almost all of the education tax incentives. It also proposed turning the tax deduction for charitable giving into a tax credit, with the goal of giving all donors the same level of tax benefit. The proposal limited the credit to donations worth more than 2 percent of a taxpayer's adjusted Gross Income. Obama effectively rejected the proposal.

Using the tax code for education initiatives, instead of the loan and grant programs already administered by the Department of Education, adds unnecessary complexity for students and their families, as well as the IRS. Moreover, Federal initiatives might be contributing to the cost of tuition for students and the families that are funding their educational pursuits. It would be worthwhile for Congress to consider which provisions should be discarded or at least reformed.

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The American Opportunity Tax Credit (AOTC), which was scheduled to expire at the end of 2012, was extended for five years as part of the American Taxpayer Relief Act of 2012. The Protecting Americans from Tax Hikes Act of 2015 made the AOTC permanent, effectively replacing the Hope Credit.

Recall that, under a pure SHS income tax, borrowed principal is excluded from Gross Income, repaid principal is not deducted, and personal consumption interest is not deductible. The § 221 deduction for interest on education loans (taken above the line under § 62(a)(17)) described in the above article is, thus, a tax expenditure. Recall also, however, that under a cash-flow consumption tax borrowed principal would be included, and *repaid principal as well as interest would both be deducted*. Finally, recall from Chapter 3 that the current Internal Revenue Code generally functions as a consumption tax for the middle class because the primary savings of most middle-class taxpayers (retirement savings in qualified pension plans, § 401(k) accounts, and IRAs, built-in gain in a primary residence, and life insurance) are accorded consumption tax treatment under current law. The Code functions more as an income tax for wealthier taxpayers, whose savings exceed the limits that can be protected from taxation under current law.

Professor Larry Zelenak has provocatively suggested that students be permitted to elect to treat their student loans under cash-flow consumption tax principles.[2] Because they would include the borrowed principal in their low- or no-earning student years, perhaps much of the borrowed funds could be sheltered from taxation under the Standard Deduction and Personal Exemption and Dependent Deduction (if they are not claimed as a dependent of another) with the remainder falling in the lowest tax brackets. In their later, higher-earning years, they would be permitted to deduct not only the interest (as under current § 221, within limits) but also *repaid principal*, offsetting Gross Income that would otherwise be taxed under higher marginal rates than applied in the earlier borrowing year, thus reducing the aggregate tax paid over time. In short, many students could benefit by shifting tax base inclusions from higher-bracket years to lower-bracket years by taxing at the *earlier* of consumption (with borrowed funds) or income (the repayment of the borrowed funds), notwithstanding the time value of money. Currently, however, students are deprived of that choice and must exclude borrowed principal and not deduct repaid principal.

## Problems

Read §§ 117, 127, and 25A (including the AOTC in § 25A(i), which effectively replaces the Hope Credit) and consider the extent to which they apply to John, Janice, or Jerry this year in each of the following problems. Notice that the AOTC phase-out threshold of $80,000 modified AGI ($160,000 for married taxpayers filing jointly) is not adjusted for inflation. The phase-out threshold for the Lifetime Learning Credit is lower than for the AOTC and, in contrast to the AOTC, is adjusted for inflation. For 2017, the threshold for the Lifetime Learning Credit is $56,000 modified AGI ($112,000 for married taxpayers filing jointly). Helpful hint: Unlike the dollar-for-dollar phase-out rule that you encountered in §§ 179(b)(2) and 469(i), the phase-out rules for both the AOTC and Lifetime Learning Credit decrease the *percentage* of the credit available once the income threshold is exceeded. If relevant, assume that any educational institution is described in both § 170(b)(1)(A)(ii) and § 481 of the Higher Education Act of 1965.

[2] *See* Lawrence Zelenak, *Debt-Financed Consumption and a Hybrid Income-Consumption Tax*, 64 TAX LAW REV. 1 (2010).

**1.** It is December 2017, and this year John completed the spring semester of his sophomore year and the fall semester of his junior year at Yowl University, which awarded to him a full tuition scholarship (otherwise priced at $50,000), free room and board (otherwise priced at $10,000), and $5,000 toward required books and supplies each academic year.

**2.** Same as **1.**, except that the terms of John's scholarship will require him to work for 10 hours each week in the cafeteria at no pay as a condition of receiving a portion of his scholarship. Cafeteria workers who are not students earn $100 for 10 hours of work. With John working for 14 weeks during each of the spring and fall semesters in 2017, he thus would have been paid $2,800 if the work were not part of his scholarship conditions. *See* § 117(c). How should the institution draft the terms of the work requirement to maximize John's exclusion?

**3.** Same as **2.**, except that John is offered only a full tuition scholarship valued at $50,000 (no room and board or books scholarship). How will § 25A be relevant to these changed facts? Because John is a full-time student, his AGI is low (from a part-time job).

**4.** Janice, who has an undergraduate degree in computer programming, works at High Tech Corp., which creates and sells sophisticated, individualized software to clients. In 2017, her "modified AGI" is $90,000. The corporation pays up to $3,000 annually toward tuition for any employee, as well as the dependent of any employee, who enrolls at an accredited institution of higher education. Janice enrolls part-time at the local community college, where she takes a course in studio painting for fun, paying $500. High Tech reimburses her for this expense.

**5.** Same as **4.**, except that Janice's employer is High Tech University, where she is a professor in computer science. High Tech U. allows any of its employees to enroll in courses at High Tech U. at no charge, and Janice enrolls as a non-degree student in the course in studio painting for fun. Other (non-employee) students must pay $1,000 for the course.

**6.** Same as **4.**, except that Janice's son, Jerry, is enrolled full-time at State U. Janice, who is a single mom, pays $8,000 in tuition in 2017 for Jerry: $4,000 in January for the spring semester of his junior year and $4,000 in August for the fall semester of his senior year. High Tech Corp. reimburses Janice for $3,000 of these 2017 expenses.

**7.** Same as 6**.**, except that Janice is married to Jerry's dad (Jack), and together Janice and Jack have "modified AGI" of $150,000.

***Treas. Reg. § 1.162-5: education costs as deductible business expenses under § 162***

As described at the beginning of this section, education costs are generally allocated to the taxpayer's personal life. For this reason education outlays usually create neither immediately deductible business expenses under § 162 nor basis that can be amortized over the taxpayer's working life under § 167.[3] Nevertheless, a narrow category of costs can be deducted as § 162 business expenses if they satisfy the standards in Treas. Reg. § 1.162-5.

[3] Indeed, deduction of such expenses would largely be a regressive move, as higher earners typically pay more higher education costs than do lower earners. The lost income would have to be paid for with higher tax rates, which would likely mean higher tax rates on all, not just the higher earners who are taking the deductions.

These regulations use by analogy the distinction explored in Chapter 4 between a "repair" expense (immediately deductible) and an "improvement or betterment" (nondeductible) under capitalization theory more generally. That is to say, these regulations attempt to identify those costs that seek merely to repair education already in place (potentially deductible business expenses under § 162) from those costs that create significant new human capital (nondeductible). If an outlay merely repairs previously existing education used by the taxpayer in her business, the benefit to her business life can reasonably be considered primary, with the benefit to her personal life (the acquisition of new human capital) only incidental.

To be specific, Treas. Reg. § 1.162-5(a) requires that the education must satisfy one of two alternative tests to be potentially deductible as § 162 business expenses. The education must

> **(1) maintain or improve skills required by the individual in his employment or other trade or business, or**
>
> **(2) meet 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.**

Such outlays are in the nature of a repair of skills already in place. If neither threshold test is satisfied, the analysis stops, and no deduction is allowed.

If one of the two tests above is met, the analysis proceeds to the next level, under which the deduction will nevertheless be disallowed if it is described in Treas. Reg. §§ 1.162-5(b)(2) or (3). Thus, no deduction is allowed for education that meets one of the threshold tests if it also

> **(1) is required in order to meet the minimum education requirements for qualification in the taxpayer's employment or other trade or business, or**
>
> **(2) will lead to qualifying the taxpayer in a new trade or business.**

Such outlays describe an acquisition of new human capital in the nature of a capital expenditure with a long life. For this reason, they are disallowed as primarily benefitting the taxpayer's personal life (under the usual rule that education costs are placed in the taxpayer's personal sphere).

Finally, even if the education satisfies one of the two threshold tests and does not run afoul of either disqualifying rule, the taxpayer must also satisfy the remaining requirements found in § 162, including that the expense be incurred in "carrying on" a trade or business. Taxpayers who have not yet established themselves in business,[4] or who have left employment for a substantial period of time, cannot deduct business expenses. Nevertheless, it is well established that the deduction for education expenses is not limited to those who continue to work *at the same time* that they are incurring education costs (as, say, a part-time student). Once a taxpayer establishes herself in business, she can deduct education business expenses even if she quits her job and attends school on a full-time basis for a period of time before returning to the same or similar employment.[5] In a

[4] As described in Chapter 14, certain "start-up costs" that otherwise qualify as current business "expenses" but are incurred before a new business opens must be capitalized and can be amortized under § 195. To be eligible for § 195 amortization, however, the outlay must be one that, if incurred in connection with an existing operating business, would be allowable as a deduction for the taxable year in which paid or incurred. Thus, § 195 amortization is not generally relevant to education costs.

[5] *See, e.g.*, Rev. Rul. 68-591, 1968-2 C.B. 73 (allowing deduction of education expenses incurred by teacher who left her position to pursue a graduate degree as a full-time student for one academic year).

sense, the taxpayer is deemed to continue "carrying on" her prior business during the hiatus for additional schooling.

The one aspect of the regulations described above that has by far led to the most litigation is the rule denying deduction for education leading to qualifying the taxpayer for a "new trade or business." The authorities are inconsistent and constantly in flux. The analysis depends on how *broadly* one defines the scope of a particular "trade or business" in the first place. Examples provided in the Treasury regulations imply that education leading merely to specialization within a larger field should *not* be considered as leading to a new trade or business. Thus, education allowing an elementary school teacher to move to secondary school teaching, allowing a classroom teacher to become a guidance counselor or principal, or allowing a math teacher to become a science teacher does not lead to qualifying the taxpayer for a new trade or business.[6] Similarly, education allowing a psychiatrist to specialize in psychoanalysis does not lead to qualifying the psychiatrist for a new trade or business,[7] and education allowing a general dentist to specialize in orthodontia does not lead to qualifying the dentist for a new trade or business.[8]

But what one adjudicator considers specialization another may consider a completely different business, which reinforces the point that whether education leads to qualifying the taxpayer for a new trade or business depends first on how broadly one defines the scope of the particular trade or business. If, for example, the scope of the business is defined as "law," education leading to specialization within that larger business of "law" should not be considered education leading to a new trade or business. If, on the other hand, tax law is considered to be a different trade or business from criminal law, education allowing a criminal law lawyer to change to a tax law specialization would be education qualifying the taxpayer for a new trade or business.

The Tax Court has adopted a "tasks and activities" test in defining the scope of a trade or business, which seems inconsistent with the Regulations and rulings described above that conclude, for example, that a guidance counselor is not in different trade or business from a classroom teacher. The tasks and activities engaged in by a guidance counselor on a day-to-day basis are clearly different from the tasks and activities engaged in by a classroom teacher. Moreover, although the court recites the "tasks and activities" test in *Sharon*, below, the court does not extensively compare the actual tasks and activities performed by Mr. Sharon in his New York law practice with those he performed in his California law practice before concluding that the education costs for a California bar review course led to qualifying him for a new trade or business. Why?

## SHARON v. COMMISSIONER

66 T.C. 515 (1976) (reviewed), *aff'd*, 591 F.2d 1273 (9th Cir. 1978) (*per curiam*)

SIMPSON, JUDGE: Due to concessions, the following issues remain for decision: … [(1)] whether the petitioners are entitled to amortization deductions under section 167(a)(1) with respect to certain educational and other expenses incurred to enable the petitioner Joel A. Sharon to obtain a license to practice law in the State of New York; [(2)] whether the petitioners may deduct or amortize costs incurred by the petitioner Joel A. Sharon in taking the California bar examination and miscellaneous expenses incurred in obtaining admission to courts in that State; [and (3)]

[6] *See* Treas. Reg. § 1.162-5(b)(3)(i).
[7] Treas. Reg. § 1.162-5(b)(3)(ii), Ex. (4).
[8] Rev. Rul. 74-78, 1974-1 C.B. 44.

whether the petitioners may deduct under section 162, or amortize pursuant to section 167, the cost of petitioner Joel A. Sharon's admission to the Supreme Court of the United States.

FINDINGS OF FACT

The petitioner attended Brandeis University from September 1957 to June 1961 and received a bachelor of arts degree upon his graduation. After graduation from Brandeis University, the petitioner entered Columbia University School of Law, receiving a bachelor of laws degree in June 1964. In order to be eligible to take the New York bar examination, the petitioner was required to graduate from a fully accredited 4-year undergraduate institution and give evidence of his successful completion of 3 years of study at an accredited law school.

The petitioner expended a total of $210.20 in gaining admission to practice law in the State of New York. This amount included $175.20 for bar review courses and materials related thereto and a New York State bar examination fee of $25.

The petitioner was admitted to practice law in the State of New York on December 22, 1964. Thereafter, he was employed as an attorney by a law firm in New York City until 1967 [where he practiced tax law], when he accepted a position in the Office of Regional Counsel, Internal Revenue Service, and moved to California.

Although not required by his employer to be a member of the California bar, the petitioner decided to become a member of that State's bar after moving there. However, he found that the study of California law, which he undertook in preparation for the California bar examination, was helpful in his practice of law as an attorney in the Regional Counsel's office. The petitioner spent [$801, including $230 for a California bar review course.]

In 1969, the petitioner also spent a total of $11 in order to be admitted to practice before the U.S. District Court for the Northern District of California and the U.S. Court of Appeals for the the Ninth Circuit. The petitioner's employer required only that he be admitted to practice before the U.S. Tax Court.

In 1970, the petitioner incurred expenses in connection with his admission to the U.S. Supreme Court. The petitioner's employer did not require that he be admitted to practice before the U.S. Supreme Court but did assist him in this matter. The Chief Counsel of the IRS personally moved the admission of a group of IRS attorneys, including the petitioner. Furthermore, two of his supervisors signed his application as personal references. During 1970, the U.S. Supreme Court rules required a personal appearance before it in Washington, D.C., to be admitted to practice.

On their return for 1969, the petitioners claimed a deduction for "Dues and Professional Expenses" of $492. The Commissioner disallowed $385 of such deduction on the grounds that the disallowed portion was not a deductible business expense, but was a nondeductible capital expenditure. On their return for 1970, the petitioners claimed a deduction of $313.35 for the cost of petitioner Joel A. Sharon's admission to practice before the U.S. Supreme Court. The Commissioner also disallowed such deduction. In addition to challenging the disallowed deductions, the petitioners alleged in their petition that they were entitled to amortize or depreciate the cost of petitioner Joel A. Sharon's education. The Commissioner denied this allegation in his answer.

OPINION

*Amortization of License to Practice Law in New York*

The issue to be decided is whether the petitioner may amortize the cost of obtaining his license to practice law in New York. The petitioner contends that he is entitled under section 167 to amortize the cost of such license over the period from the date of his admission to the bar to the date on which he reaches age 65, when he expects to retire. In his cost basis of this "intangible asset," he included the costs of obtaining his college degree ($11,125), obtaining his law degree ($6,910), a bar review course and related materials ($175.20), and the New York State bar examination fee ($25). As justification for including these education expenses in the cost of his license, he points out that, in order to take the New York bar examination, he was required to have graduated from college and an accredited law school.

The petitioners rely upon section 1.167(a)-3 of the Income Tax Regulations, which provides in part:

> If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. * * *

There is no merit in the petitioner's claim to an amortization deduction for the cost of his education and related expenses in qualifying himself for the legal profession. His college and law school expenses provided him with a general education which will be beneficial to him in a wide variety of ways. *See James A. Carroll*, 51 T.C. 213, 216 (1968). The costs and responsibility for obtaining such education are personal. Section 1.262-1(b)(9) of the Income Tax Regulations provides that expenditures for education are deductible only if they qualify under section 162 and section 1.162-5 of the regulations. In the words of section 1.162-5(b), all costs of "minimum educational requirements for qualification in * * * employment" are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures." There is no "rational" or workable basis for any allocation of this inseparable aggregate between the nondeductible personal component and a deductible component of the total expense. *Fausner v. Comm'r*, 413 U.S. 838, 839 (1973). Such expenses are not made any less personal or any more separable from the aggregate by attempting to capitalize them for amortization purposes. *David N. Bodley*, 56 T.C. 1357, 1362 (1971); *Nathaniel A. Denman*, 48 T.C. 439, 446 (1967); *Huene v. U.S.*, 247 F. Supp. 564, 570 (S.D. N.Y. 1965). Since the inseparable aggregate includes personal expenditures, the preeminence of section 262 over section 167 precludes any amortization deduction. Cf. *Comm'r v. Idaho Power Co.*, 418 U.S. at 17; *Bodzin v. Comm'r*, 509 F.2d at 681. The same reasoning applies to the costs of review courses and related expenses taken to qualify for the practice of a profession. *William D. Glenn*, 62 T.C. 270, 274-276 (1974).

In his brief, the petitioner attempts to distinguish our opinion in *Denman* by asserting that he is not attempting to capitalize his educational costs, but rather, the cost of his license to practice law. Despite the label which the petitioner would apply to such costs, they nonetheless constitute the costs of his education, which are personal and nondeductible. Moreover, in his petition, he alleged that the capital asset he was seeking to amortize was his education.

There remains the $25 fee paid for the petitioner's license to practice in New York. This was not an educational expense but was a fee paid for the privilege of practicing law in New York, a nontransferable license which has value beyond the taxable years, and such fee is a capital expenditure. Cf. *Arthur E. Ryman, Jr.*, 51 T.C. 799 (1969); *Glenn L. Heigerick*, 45 T.C. 475 (1966); *S.M. Howard*, 39 T.C. 833 (1963); O.D. 452, 2 C.B. 157 (1920). The Commissioner has limited

his argument to the educational expenses and apparently concedes that the fee may be amortized.

*License to Practice Law in California*

The next issue to be decided is whether the petitioner may deduct or amortize the expenses he incurred in gaining admission to practice before the State and Federal courts of California. The Commissioner disallowed the amounts paid in 1969 to take the attorney's bar examination in California and the amounts paid for admission to the bar of the U.S. District Court for the Northern District of California and for admission to the U.S. Court of Appeals for the Ninth Circuit. He determined that such expenses were capital expenditures. In his brief, the petitioner argues for a current deduction only if the costs of his license to practice in California are not amortizable.

It is clear that the petitioner may not deduct under section 162(a) the fees paid to take the California attorney's bar examination and to gain admission to practice before two Federal courts in California. In *Arthur E. Ryman, Jr., supra*, an associate professor of law sought to deduct as an ordinary business expense the cost of his admission to the bar of the State in which he resided. We held that since the taxpayer could reasonably expect the useful life of his license to extend beyond 1 year, the cost of such license was a capital expenditure and not a currently deductible business expense.

In connection with his alternative claim that he be allowed to amortize the costs of acquiring his license to practice law in California, the petitioner asserts that such costs total $801. Such amount includes the cost of a California bar review course, registration fees, and other items specified in our Findings of Fact. However, the petitioner is in error in including the cost of his bar review course, $230, in the capital cost of his license to practice in California.

It is clear that the amount the petitioner paid for the bar review course was an expenditure "made by an individual for education" within the meaning of section 1.162-5(a) of the Income Tax Regulations. *See William D. Glenn*, 62 T.C. 270, 273-274 (1974); sec. 1.162-5(b)(2)(iii), example (3), Income Tax Regs. Although the petitioner was authorized to practice law in some jurisdictions when he took the California bar review course, such course was nevertheless educational in the same sense as the first bar review course. The deductibility of such educational expenses is governed by the rules of section 1.162-5 of the regulations.

Nor may the petitioner treat the payment for the California bar review course as a part of the costs of acquiring his license to practice in California. Educational expenses which are incurred to meet the minimum educational requirements for qualification in a taxpayer's trade or business or which qualify him for a new trade or business are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures." Sec. 1.162-5(b), Income Tax Regs. We find that the bar review course helped to qualify the petitioner for a new trade or business so that its costs are personal expenses.

We have previously adopted a "commonsense approach" in determining whether an educational expenditure qualifies a taxpayer for a "new trade or business." *Kenneth C. Davis*, 65 T.C. 1014, 1019 (1976); *William D. Glenn*, 62 T.C. at 275; *Ronald F. Weiszmann*, 52 T.C. 1106, 1110 (1969), affd. 443 F.2d 29 (9th Cir. 1971). If the education qualifies the taxpayer to perform significantly different tasks and activities than he could perform prior to the education, then the education qualifies him for a new trade or business. *William D. Glenn, supra*; *Ronald F. Weiszmann, supra*. Thus, we have held that a professor of social work is in a different trade or business than a social caseworker. *Kenneth C. Davis, supra*. A licensed public accountant is in a different trade or

business than a certified public accountant. *William D. Glenn, supra*. A registered pharmacist is in a different trade or business than an intern pharmacist, even though an intern performs many of the same tasks as a registered pharmacist, but under supervision. *Gary Antzoulatos*, T.C. Memo. 1975-327.

Before taking the bar review course and passing the attorney's bar examination, the petitioner was an attorney licensed to practice law in New York. As an attorney for the Regional Counsel, he could represent the Commissioner in this Court. However, he could not appear in either the State courts of California, the Federal District Courts located there, nor otherwise act as an attorney outside the scope of his employment with the IRS. *See* Cal. Bus. & Prof. Code sec. 6125 (West 1974); 20 Op. Cal. Atty. Gen. 291 (1952). If he had done so, he would have been guilty of a misdemeanor. Cal. Bus. & Prof. Code sec. 6126 (West 1974). Yet, after receiving his license to practice law in California, he became a member of the State bar with all its accompanying privileges and obligations. He could appear and represent clients in all the courts of California. By comparing the tasks and activities that the petitioner was qualified to perform prior to receiving his license to practice in California with the tasks and activities he was able to perform after receiving such license, it is clear that he has qualified for a new trade or business. Consequently, the expenses of his bar review course were personal and are not includable in the cost of his license to practice law in California.

It is true that even before he became a member of the bar of California, the petitioner was engaged in the business of practicing law. Cf. *David J. Primuth*, 54 T.C. 374 (1970). However, in applying the provisions of section 1.162-5 of the regulations to determine whether educational expenses are personal or business in nature, it is not enough to find that the petitioner was already engaged in some business—we must ascertain the particular business in which he was previously engaged and whether the education qualified him to engage in a different business. Before taking the bar review course and becoming a member of the bar of California, the petitioner could not generally engage in the practice of law in that State, but the bar review course helped to qualify him to engage in such business.

The Commissioner does not argue that the capital expenditures incurred in obtaining his license to practice law in California may not be amortized. In a series of cases, the courts have held that the fees paid by physicians to acquire hospital privileges are not current business expenses but are capital expenditures amortizable over the doctor's life expectancy. *Walters v. Comm'r*, 383 F.2d 922, 924 (6th Cir. 1967), affg. a Memorandum Opinion of this Court; *Glenn L. Heigerick*, 45 T.C. 475, 478-479 (1966); *S.M. Howard*, 39 T.C. 833, 838-839 (1963); compare *Wells-Lee v. Comm'r*, 360 F.2d 665, 672-673 (8th Cir. 1966), revg. and remanding in part a Memorandum Opinion of this Court. We hold that the petitioner may treat the costs of acquiring his license to practice in California in a similar manner. Although the petitioner testified that he would retire at age 65 if he were financially able to do so, such testimony is not sufficient to establish the shorter useful life for which he argues.

*Supreme Court Admission*

The [next] issue to be decided is whether the petitioner may either deduct or amortize the cost of gaining admission to practice before the U.S. Supreme Court. The petitioner deducted the travel costs he incurred in 1970 in traveling to Washington, D.C., to be personally present for the Supreme Court admission, as required by that Court's rules. The Commissioner disallowed the deduction and argued in his brief that such expenditures were capital in nature since the petitioner

acquired an asset with a useful life beyond 1 year.

In his brief, the petitioner concedes that he may not deduct the costs he incurred if we find that his license to practice before the Supreme Court is an intangible asset with a useful life of more than 1 year. For the same reasons that we have concluded that the petitioner's New York and California licenses were intangible assets with a useful life of more than 1 year, we also hold that his Supreme Court license is an intangible asset with a useful life exceeding 1 year. Thus, the petitioner may not deduct under section 162 the cost of obtaining such license. We find that the intangible asset acquired by becoming a member of such bar was used by the petitioner in 1970 and hold that he may amortize the costs of acquiring such asset over his life expectancy.

IRWIN, J., dissenting: I disagree with that portion of the majority opinion which holds that petitioner may not treat the payment for the California bar review course as a part of the cost of acquiring his license to practice law in California. In the past, we have indeed adopted a "commonsense approach" in determining whether an educational expenditure qualifies a taxpayer for a new trade or business. *Kenneth C. Davis*, 65 T.C. 1014, 1019 (1976); *William D. Glenn*, 62 T.C. 270, 275 (1974); *Ronald F. Weiszmann*, 52 T.C. 1106, 1110 (1969), affd. 443 F.2d 29 (9th Cir. 1971). However, I think we depart from that approach when we hold that an attorney, licensed to practice law in New York, qualifies for a new trade or business when he obtains a license to practice law in California. In *William D. Glenn, supra* at 275, we stated:

> We have not found a substantial case law suggesting criteria for determining when the acquisition of new titles or abilities constitutes the entry into a new trade or business for purposes of section 1.162-5(c)(1), Income Tax Regs. What has been suggested, and we uphold such suggestion as the only commonsense approach to a classification, is that a comparison be made between the *types of tasks and activities which the taxpayer was qualified to perform before the acquisition of a particular title or degree, and those which he is qualified to perform afterwards. Ronald F. Weiszmann*, 52 T.C. 1106, 1110 (1969), affd. 443 F.2d 29 (C.A. 9, 1971). Where we have found such activities and abilities to be significantly different, we have disallowed an educational expense deduction, based on our finding that there had been qualification for a new trade or business. *Ronald F. Weiszmann, supra*. [Emphasis supplied.]

In my view there is no difference in the *types* of tasks and activities which petitioner was qualified to perform before and after he acquired his California license. By virtue of being licensed to practice in California, petitioner could perform the same types of tasks and activities in that state as he was already qualified to perform in New York. In this regard, respondent takes the position that once an individual is qualified to teach in State A, a college course taken in order to qualify for a teaching position in State B is neither a minimum educational requirement of his trade or business nor education qualifying him for a new trade or business. Rev. Rul. 71-58, 1971-1 C.B. 55. I would similarly conclude that once an individual is qualified to practice law in one State, a bar review course taken in preparation for the bar exam of another State is not education leading to qualification for a new trade or business.

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While the court denied any expense or amortization deduction with respect to Mr. Sharon's education costs, it did allow him to amortize the costs incurred to obtain his state law licenses (which are not education costs) over his remaining life expectancy. Today, the license satisfies the

definition of a "section 197 intangible" under § 197(d)(1)(D), allowing such costs to be amortized over 15 years. If the lawyer is not an employee of another, the § 197 amortization deduction is a business deduction that is taken above the line under § 62(a)(1), as you learned in Chapter 1, Part B. For the employee lawyer, however, the § 197 deduction is not listed in § 62 unless reimbursed, rendering it an Itemized Deduction and, because § 197 is also not listed in § 67(b), a disfavored "miscellaneous itemized deductions" (or MID), as also described in Chapter 1, Part B.

With respect to the bar review (education) costs, Mr. Sharon had practiced as a tax lawyer in New York before moving to California, so there was no doubt that he satisfied the threshold "carrying on" requirement in § 162. Nevertheless, the Tax Court majority disallowed deduction of the costs that he paid for the California bar review course because the education led to qualifying him to be licensed as a California lawyer—which the majority concluded was a new trade or business within the meaning of Treas. Reg. § 1.162-5(b)(3)—even though he likely performed the same sorts of tasks and activities as a tax lawyer in California that he performed as a tax lawyer in New York. Thus, the Tax Court appears to hold that education leading to a job that is *licensed* is automatically categorized as education leading to a new trade or business. Similarly, education leading to the J.D. degree leads to qualifying for a new trade or business even when undertaken by an accountant who has no intention of practicing law and who performs similar tasks and activities after earning her J.D. as she performed before earning it.[9] And education undertaken by a public accountant that allows her to become a "certified public accountant" leads to a new trade or business.[10] Why should licensure alter the analysis so dramatically? Is not a license merely a manifestation of the acquired human capital?

An LL.M. degree, which generally helps an attorney to advertise herself as specializing in an area of law, including tax law, does not involve licensure. Indeed, most tax lawyers do not have LL.M. degrees. Similarly, an MBA degree does not lead to licensure. For this reason, taxpayers have had greater success in deducting these education costs so long as the taxpayer has established herself in business prior to the education (satisfying the § 162 "carrying on" requirement) and so long as she returns to the same or similar job (performing the same sorts of "tasks and activities"). For example, the taxpayers won in *Blair v. Commissioner*[11] and *Allemeier v. Commissioner*,[12] each allowing deduction of MBA expenses, as well as *Ruehmann v. Commissioner*[13] and PLR 9112003 (Dec. 18, 1990), each allowing deduction of LL.M. expenses.

In other cases, however, the Tax Court appears to take a more discerning approach to the "tasks and activities" test that downplays the inference drawn from the Treasury regulations that education leading to mere specialization within a larger field does not lead to a new trade or business. The Tax Court denied deduction of LL.M. expenses in *Hudgens v. Commissioner*,[14] for example. After earning his J.D. degree, Mr. Hudgens worked for an accounting firm in the tax area. After obtaining his tax LL.M. degree, Mr. Hudgens worked for a trust company where he engaged in some of the same activities, but the Tax Court concluded that these activities were ancillary to managing client assets and acquiring new clients—a "new" trade or business.

More recently, the Tax Court appeared to come to inconsistent conclusions in *Foster v.*

[9] *See* Treas. Reg. § 1.162-5(b)(3)(ii), Ex. (1).
[10] *See* Glenn v. Comm'r, 62 T.C. 270 (1974).
[11] T.C. Memo. 1980-488.
[12] T.C. Memo. 2005-207.
[13] T.C. Memo. 1971-57.
[14] T.C. Memo. 1997-33.

*Commissioner*[15] and *Singleton-Clarke v. Commissioner*,[16] both of which are small tax cases that cannot be cited as precedent under § 7463(b) and both of which dealt with MBA costs. Prior to obtaining her MBA at Harvard, Ms. Foster worked for a beverage company "as a project manager on the upgrade of a milk factory" in Sydney, Australia. During her MBA studies, she worked at the Snapple beverage company as a "corporate strategy consultant," where she "completed marketing projects related to beverage consumption in the United States and to Snapple strategy and profitability." After she completed her MBA, she accepted the job of "vice president of marketing" at a beverage company in California. The Tax Court denied deduction of her MBA expenses because she did not work in "marketing" prior to matriculating into the MBA program. The fact that she worked in the beverage industry both before and after earning her MBA and that she worked as a corporate strategy consultant, including with respect to marketing projects, at a beverage company during her studies were not sufficient to show that the MBA did not qualify her for a new trade or business. The Tax Court also upheld a § 6662 accuracy-related penalty.

Ms. Singleton-Clarke, on the other hand, was permitted to deduct the $14,787 cost of earning an on-line MBA degree with a specialization in Health Care Management (MBA/HCM) from the University of Phoenix. During the three years (from 2005 through 2008) that Ms. Singleton-Clarke, a registered nurse, pursued her on-line degree, she worked as a quality control coordinator at three successive hospitals and nursing homes after more than 20 years in direct patient care and nursing management. Each position required that she be a registered nurse but did not require an advanced degree. The Tax Court noted that an MBA degree, unlike a law degree, does not lead to attaining a professional license, confirming the trend that a degree leading to professional licensure may lead to a conclusion that the education qualifies the taxpayer for a new trade or business for that reason alone. The Tax Court reviewed MBA cases that denied deduction as well as those that allowed deduction and reiterated that the "tasks and activities" test was controlling. In holding for the taxpayer, the court noted that Ms. Singleton-Clarke "worked for 1 year as a quality control coordinator and had more than 20 years of directly related work experience, gaining vast clinical and managerial knowledge in acute and subacute health care settings, before beginning at the University of Phoenix MBA/HCM program" and concluded that "the MBA/HCM may have improved petitioner's preexisting skill set, but objectively, she was already performing the tasks and activities of her trade or business before commencing the MBA."

The latest case was also a taxpayer win. In *Kopaigora v. Commissioner*,[17] the taxpayer was employed as a senior assistant controller for the Marriott hotel in Los Angeles International Airport, where he managed employees (including hiring and training activities), prepared financial reports and budgets, analyzed financial data, and ensured compliance with reporting requirements. He enrolled in an Executive MBA program at Brigham Young University in 2010, flying to Salt Lake City on the weekends for classes. In 2011, he was terminated from his Marriott position for reasons that were later found to be unjustified. One month after completing his EMBA degree in 2012, he was hired as Vice President of Finance at Drivett Financial Services, where he supervised a team of employees (including hiring and training activities) responsible for auditing, accounting for taxes, preparing reports, and enforcing internal controls. Applying the tasks and activities test, the Tax Court held that the EMBA did not lead to qualifying the taxpayer for a new trade or business.

[15] T.C. Summary Opinion 2008-22.
[16] T.C. Summary Opinion 2009-182.
[17] T.C. Summary Opinion 2016-35.

Can you articulate a coherent principal underlying the Tax Court's approach to "new trade or business" under Treas. Reg. § 1.162-5? At the least, taxpayers wishing to deduct the costs of post-graduate education that does not lead to licensure should be encouraged to return to the same job, or take a job as close as possible to the old job, for a period subsequent to completing the education.

Education costs that are deductible as business expenses encompass travel expenses, as well, under Treas. Reg. § 1.162-5(e) if the education takes place away from the taxpayer's home city. The taxpayer can deduct not only tuition or registration costs but also the costs for transportation to the place of education, lodging while there (even for extended periods of time, so long as she expects to and does return within one year), and 50% of meals.[18] If the taxpayer is an employee and her employer directly pays the costs to the educator (or reimburses these costs if initially paid by the employee), the employee can exclude the payment under either § 132(d) (as a working-condition fringe benefit) or under Treas. Reg. § 1.62-2(c) (described in Chapter 1, Part B.), so long as the amount is otherwise deductible under Treas. Reg. § 1.162-5.

**Problems**

**1.** Jonah, a California tax lawyer in solo practice, is in the 25% tax bracket. He attends the 3-day ABA Section of Taxation meeting in Washington, D.C., paying $250 in registration fees, $500 in air fare, $600 in hotel costs, $200 for meals, and $50 in taxi fares. What can Jonah deduct under Treas. Reg. § 1.162-5?

**2.** Jeanine can find no other work with her English major undergraduate degree than working the night shift at a convenience store as she contemplates whether she should attend graduate school. As a dog lover, she also earns extra money as a dog walker. She begins to advertise her services as a dog groomer, as well, and her client base expands sufficiently to enable her to quit her job at the convenience store and live solely on her dog-related earnings. Jeanine realizes that she needs more training, however, and (abandoning any thought of grad school) she enrolls in a course in which she learns advanced grooming techniques for show dogs, paying $1,000 for the 6-month course. Jeanine is in the 15% tax bracket this year.

**a.** What can she deduct under Treas. Reg. § 1.162-5? Should Jeanine take the § 25A Lifetime Learning Credit, instead? (Assume that the program is described in § 481 of the Higher Education Act of 1964.)

**b.** What if dog grooming is a licensed profession in Jeanine's state?

## B. Compensation received on account of the loss of human capital

Recall that a cash receipt does not constitute a wealth accession within the meaning of § 61 to the extent that it represents tax-free basis (or "capital") recovery. Assume, for example, that Mel destroys Meghan's automobile, which Meghan had previously purchased for $20,000 but which was worth $8,000 when destroyed. Meghan sues Mel, and she receives $8,000 from Mel's insurance company in settlement of her claim. The $8,000 that she receives is not a wealth

[18] The one-year rule for business travel expense is found in the middle sentence of the paragraph following § 162(a)(3), and § 274(n)(1) generally reduces by 50% the deduction for meal and entertainment costs otherwise allowable as business expenses. Section 162 deductions for meal and travel expenses are considered more generally in Chapter 20.

accession, and thus not includable under § 61(a), but rather a tax-free recovery of the basis that was created when Meghan spent $20,000 to purchase the automobile—a nondeductible capital expenditure. In other words, that $8,000 represents dollars that were already taxed to Meghan and should not be taxed to her a second time under SHS income tax principles.[19]

Alternatively, assume that Mel destroys an original Renoir painting that hung on Meghan's living room wall. Meghan had purchased the Renoir for $1 million years earlier, but it was worth $2.5 million when destroyed by Mel. Meghan sues Mel, and she receives $2.5 million from him in settlement of her claim. While $1 million is tax-free basis recovery, the remaining $1.5 million is newly realized wealth for Meghan, which she must include in her Gross Income.[20]

What tax consequences arise if we move our inquiry from damaged tangible property to damaged human capital—a damaged body? Mel injures Meghan herself by hitting her with his car. She sues him for her physical injuries in tort, settling for $500,000 in compensatory damages (such as lost past and future wages and pain and suffering). Meghan has no basis in her body, representing previously taxed dollars. Nevertheless, in the early days of the income tax, the lump-sum award received on account of personal injuries was thought by some to be a tax-free "capital" receipt rather than an "income" receipt, though early authorities were inconsistent on this point.

### *Excerpt from Murphy* and the Evolution of "Basis"[21]

Deborah A. Geier

In the modern use of the term, "capital" (when it is used in connection with the income tax) is synonymous with "basis." Thus, a return of "capital" means a (tax-free) recovery of "basis." In the early days of the income tax, however, basis (or "capital") was *not* well understood as having the core function of being a running record of previously taxed dollars. Indeed, the term "income" had no early *tax* meaning of its own. But the terms "income" and "capital" had developed meanings in the worlds of business accounting and trust accounting, and some early tax authorities appeared to borrow from these fields in trying to determine the meaning of "income" for purposes of the income tax until it became apparent that the different purposes of these other fields ill served a tax purpose.

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[19] Indeed, Meghan suffered a $12,000 loss within the meaning of § 1001(a) when she recovered only $8,000 of her $20,000 basis in the car. The loss is a nondeductible personal loss, however, under § 165(c)(3).

[20] Can Meghan elect nonrecognition under § 1033? Recall from Chapter 13 how strictly the standard "similar or related in service or use" is interpreted, perhaps making it difficult for her to find eligible replacement property.

[21] 113 TAX NOTES 576 (2006). Reprinted with permission of Tax Analysts. The *Murphy* case alluded to in the title was an odd beast. Ms. Murphy received compensatory damages of $45,000 for "emotional distress or mental anguish" and $25,000 for "injury to professional reputation" after bringing a complaint with the Department of Labor under various whistleblower statutes. She alleged that the New York Air National Guard provided unfavorable employment references after she complained to state authorities about environmental hazards at the base. A three-judge panel of the D.C. Circuit Court of Appeals initially held that Ms. Murphy could not exclude the damages under § 104(a)(2) because her injuries were not "physical" but that the government's attempt to tax them as "income" was nevertheless unconstitutional. *See Murphy v. IRS*, 460 F.3d 79 (2006). After heavy criticism in the academic community, the D.C. Circuit took the rare step of *sua sponte* vacating its judgment and issuing a replacement opinion, which held that the tax is constitutional as an indirect tax satisfying the uniformity requirement even if the damages did not constitute "income." *See* Murphy v. IRS, 493F.3d 170 (2007). (Chapter 3, Part A., discussed the difference between an "indirect" and "direct" tax, as well as the constitutional ramifications of the distinction.) In my view there is no question that her award constituted income, as Ms. Murphy had no basis in her human capital. Nevertheless, the issue is moot if a tax on non-physical damages is nevertheless constitutional on other grounds.

For example, trust accounting distinguished between "capital" receipts and "income" receipts. A trust might provide that its "income" be distributed to Mary for life with "remainder" to John. Under early trust accounting principles, a non-periodic lump sum contribution to the trust would be considered "not income" to be distributed to Mary but rather a "capital" receipt that would be invested (and which would eventually go to John) in order to produce future income (for distribution to Mary). Moreover, if the trust purchased stock for $100, sold it for $150, and bought new stock for $150, the $50 gain might not be considered "income" to be distributed to Mary but rather might be considered "capital" to be invested to produce future income.

Notice that the role of the term "income" in those contexts had nothing to do with ensuring that dollars were not twice taxed our doubly deducted or exempted from a tax. The trust principles were simply a set of rules that determined who got what from the trust between the life estate and remainder. It took time for the term "income" to evolve as a *tax* concept. Thus, "basis" (or "capital") was initially (and crudely) thought essentially to be synonymous with "value"—simply because *purchased* property took a "cost" basis (as under current section 1012), which was essentially a basis equal to value.

[A] 1918 Opinion of the Attorney General[19] and a subsequent Treasury Decision of the same year[20] conclude[ed] that proceeds of an accident insurance policy were not income. I believe it was this antiquated notion that "basis" meant the taxpayer's fair market value in his or her body, which could be recovered free of tax as a "return of capital," that led to these early decisions. The crucial language in the Attorney General Opinion provides:

> [I]n 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.

Thus, the Opinion smacked strongly of the distinction between "capital" receipts and "income" receipts that had developed in trust accounting. This non-periodic lump sum was like the trust contribution that does not go to the life-estate recipient as "income" but rather is "capital" that will be invested to produce future "income" (or will be distributed to the remainderman). The way to capture this non-tax notion in the tax world was to conclude that it was a tax-free return of "capital," where the taxpayer's body was the capital, and its basis was fair market value, determined by the damage award itself.[21] In short, the notion of "tax-free return of capital" was not yet well understood to mean a return of previously taxed dollars.

Similarly, under these early notions pertaining to "capital" receipts and "basis," property received as a gift (and excluded under the predecessor to section 102) was permitted to take a "cost" basis under the predecessor to section 1012 equal to fair market value. Propertied families realized that periodically making *inter vivos* gifts of appreciated property among family members resulted in a fresh, fair-market-value basis to the recipient upon each gift, even though the transfer was not a realization event to the transferor. This allowed the recipient to sell the gifted property at no gain (or at a gain equal only to the appreciation occurring since the gift)….

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[19] 31 Op. Att'y Gen. 304, 308 (1918).

[20] T.D. 2747, 20 Treas. Dec. Int. Rev. 457 (1918).

[21] The notion that personal injury damage awards were tax-free "capital" receipts was not uniform, however. [T]here were other authorities in this early time period concluding that personal injury damages were, indeed, includable in Gross Income. *See* …T.D. 2135, 17 Treas. Dec. 39, 42 (1915) and T.D. 2570, 19 Treas. Dec. 321, 323 (1917)).

Congress began to appreciate that basis or "capital" as a *tax* term of art (as opposed to its meaning in trust or business accounting) must reflect only dollars that have already been taxed. It thus enacted the predecessor to section 1015 in 1921, which generally requires a carryover basis (previously taxed dollars) to the recipient when appreciated property is transferred as an *inter vivos* gift, not a fair market value basis. It wasn't long before a taxpayer argued that Congress's enactment was unconstitutional under the 16th Amendment in that it deprived the recipient of a fair market value basis in the "capital" receipt. In *Taft v. Bowers*,[22] however, the Supreme Court upheld the constitutionality of the new basis rule that allowed basis to reflect *only* previously taxed dollars, notwithstanding prior practice.

The taxpayer's counsel specifically made the argument that the receipt of the gift was a "capital" receipt that must, under the Constitution, take a fair market value basis to prevent any part of the value from creating "gain" (and thus "income") when converted to cash:

> [U]ntil the Revenue Act of 1921 became effective, the Department laid down the rule that gain on the sale of property acquired by gift could be computed only by taking into consideration the value of the gift when it was acquired. This was an express recognition by the Treasury Department that a gift is a capital transaction … and that the donee can have "gain" only to the extent that the proceeds in his hands exceed the *value of his capital* at the time of acquisition.[23]

And later:

> [T]he corpus of the gift is capital in the hands of the donee at the time of its receipt. But the mere conversion of such capital into money does not constitute income…. An amount sufficient to restore the *capital value* that existed at the commencement of the taxing period must be withdrawn from the gross proceeds in order to determine whether there has been a gain or loss, and the amount of the gain, if any.[24]

But the Court upheld the constitutionality of the new basis rule, notwithstanding that it was inconsistent with early notions of "income" and "capital" that were borrowed from business and trust accounting. The term "capital" was permitted to evolve as a *tax* concept that protected tax values. The new rule meant that "capital" meant "basis," and a "tax-free return of capital" meant only a "tax-free return of basis" where "basis" meant "previously taxed dollars." Thus, the 16th Amendment does not require that basis must equal "fair market value" that can be recovered free of tax just because it was commonly thought in 1913 that "capital" receipts could be received free of tax at a time when "capital" did not necessarily mean "previously taxed income." Rather, Congress is empowered to change the basis rule to ensure that it reflects only previously taxed income; the 16th Amendment is no bar.

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The early (though inconsistent) rulings concluding that personal injury awards did not constitute Gross Income led to the enactment of the predecessor to § 104(a)(2) in 1918, which provided explicit statutory authority to exclude from Gross Income awards received "on account of personal injuries or sickness." This statutory exclusion was a sleepy little provision garnering little attention

[22] 278 U.S. 470 (1929).
[23] *Id.* at 471-72 (emphasis added).
[24] *Id.* at 476 (emphasis added).

prior to 1955 because, even absent the statutory exclusion, the scope of the Gross Income residual clause was itself interpreted narrowly under *Eisner v. Macomber*.[22] As described in Chapter 6, *Eisner v. Macomber* interpreted the residual clause to reach a receipt *only* if it could be traced back to labor, capital, or both combined. A personal injury award is not a return for services rendered (labor) or on invested capital (such as interest, rent, a royalty, or a capital gain on the sale of an asset). Thus, even in the absence of the § 104(a)(2) predecessor, personal injury awards were often not considered Gross Income under the § 61(a) residual clause, as narrowly interpreted under the *Macomber* standard.

All that changed in 1955, however, when *Glenshaw Glass*[23] was decided. As recounted in Chapter 6, *Glenshaw Glass* replaced *Macomber'*s source-based interpretation of the scope of the residual clause with one more consistent with SHS principles. Instead of asking whether the receipt could be traced back to labor or capital, the *Glenshaw Glass* Court asked only whether the taxpayer has been enriched by interpreting the residual clause to reach all *accessions to wealth*, clearly realized, over which the taxpayer has complete dominion. Because of the absence of basis in one's body, the cash personal injury award would, after 1955, be includable in Gross Income—*unless* the taxpayer could fit within the newly important longtime *statutory* exclusion in § 104(a)(2). Suddenly, litigation exploded as courts attempted to define the term "personal injuries or sickness."

Under a now-withdrawn Treasury Regulation, an injury was determined to be "personal" if the cause of action sounded in tort rather than in contract. Many modern causes of action, however, are created by statute, with no prior history in either contract or tort law, such as personal causes of action under the Civil Rights Act pertaining to race and sex discrimination, under the Age Discrimination in Employment Act, under the Fair Labor Standards Act, under state and Federal whistleblower statutes, under § 1983 pertaining to suits against state government employees and others acting "under color of state law" for civil rights violations, *etc.* The authorities were divergent and difficult to reconcile. The Supreme Court granted *certiorari* in 1992 in *United States v. Burke*,[24] a sex discrimination suit under the Civil Rights Act, in an attempt to bring order to the analysis and held that a statutory cause of action sounds in tort (and thus can generate excludable damages under § 104(a)(2)) if the statutory remedies are broad, as is common in a tort action. Because only back pay could be awarded in Ms. Burke's statutory suit, the Court concluded it did not sound in tort, which meant that § 104(a)(2) exclusion was not available.

The Supreme Court heard two more § 104(a)(2) cases in short order. In *Commissioner v. Schleier*,[25] the Court held that the liquidated damages available under the Age Discrimination in Employment Act were not sufficiently broad to be categorized as sounding in tort. The Court held in *O'Gilvie v. United States*[26] that punitive damages could not be excluded even in a case sounding in tort because they were not awarded "on account of" the personal injury within the meaning of § 104(a)(2) but, rather, "on account of" the tortfeasor's egregious conduct.

Finally, Congress acted in 1996, amending § 104(a)(2) in two significant ways. First, it essentially codified *O'Gilvie* by inserting the parenthetical containing "other than punitive damages." Second, it inserted the word "physical" twice. Today, § 104(a)(2) provides authority to exclude personal injury damages only if they are awarded on account of "personal physical injuries

[22] 252 U.S. 189 (1920).
[23] 348 U.S. 426 (1955).
[24] 504 U.S. 229 (1992).
[25] 515 U.S. 323. (1995).
[26] 519 U.S. 79 (1996).

or physical sickness." The legislative history clarified the extent to which an injury could be considered "physical."[27]

> The … bill provides that the exclusion from Gross Income only applies to damages received on account of a personal physical injury or physical sickness. If an action has its origin in a physical injury or physical sickness, then all damages (other than punitive damages) that flow therefrom are treated as payments received on account of physical injuries or physical sickness whether or not the recipient of the damages is the injured party. For example, damages (other than punitive damages) received by an individual on account of a claim for loss of consortium due to the physical injury or physical sickness of such individual's spouse are excludable from Gross Income. In addition, damages (other than punitive damages) received on account of a claim of wrongful death continue to be excludable from taxable income as under present law.
>
> The … bill also specifically provides that emotional distress is not considered a physical injury or physical sickness.[56] Thus, the exclusion from Gross Income does not apply to any damages received (other than for medical expenses as discussed below) based on a claim of employment discrimination or injury to reputation accompanied by a claim of emotional distress. Because all damages received on account of physical injury or physical sickness are excludable from Gross Income, the exclusion from Gross Income applies to any damages received based on a claim of emotional distress that is attributable to a physical injury or physical sickness. In addition, the exclusion from Gross Income specifically applies to the amount of damages received that is not in excess of the amount paid for medical care attributable to emotional distress.

The matters described in the second quoted paragraph are found in the last two sentences in § 104 (in the paragraph appearing after subsection (5)), which you should read now.[28] For example, Marta files suit alleging sex discrimination because of a hostile work environment. Marta's treatment by her employer is so distressing that she seeks psychological counseling to deal with the emotional distress that she experiences, for which she owes $10,000 in treatment costs. When she settles for compensatory damages of $500,000 in the same year, no portion would be excludable absent the last two sentences of § 104 because her injury was not a "physical" one. Nevertheless, she can exclude the $10,000 that pays for her emotional distress counseling costs because such costs would qualify for deduction under § 213 as medical expenses. This provision was not in the original bill but rather was added only by the conference committee—likely because no part of the $10,000 would exceed the steep 10% floor found in § 213(a) (discussed in the next chapter) for deduction in light of the substantial damage award itself.

Moreover, new Treas. Reg. § 1.104-1(c)(2) confirms that whether the cause of action sounds in tort is now irrelevant, as is the scope of remedies, thus effectively interring the Supreme Court's analysis in *Burke* and *Schleier*.

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[27] H.R. CONF. NO. 104-737, at 300 (1996).

[56] It is intended that the term emotional distress includes symptoms (*e.g.*, insomnia, headaches, stomach disorders) which may result from such emotional distress.

[28] *See also* Treas. Reg. § 1.104-1(c)(1).

Finally, the IRS has withdrawn Revenue Ruling 74-77[29] as obsolete in Revenue Ruling 98-37.[30] The withdrawn ruling had previously concluded that amounts received as damages for alienation of affection or for surrender of custody of a child were not includable in Gross Income.

***§ 104(a)(2) as tax expenditure***

As a cash receipt that does not represent basis recovery, personal injury awards would be includable under a pure SHS income tax. What justifies the § 104(a)(2) exclusion under the cost-benefit policy analysis relevant to a tax expenditure (described in Part A.)? A taxpayer who is physically injured by an uninsured party cannot deduct his lost past and future wages, for example, because (as discussed in Chapter 11, Part A.) the taxpayer has no basis to deduct in failed expectations to obtain income. Deduction of dollars that were never included in Gross Income would provide a double tax benefit (exclusion and deduction) of the same dollars to the same taxpayer, violating fundamental precept (2), described in Chapter 1, Part A. Thus, a taxpayer who is injured and receives compensation that is excludable under § 104(a)(2) is treated more favorably for tax purposes than the less fortunate injured party who fails to receive any compensation for her injuries.

Moreover, who really benefits from the § 104(a)(2) exclusion? Recall the discussion of "capture" in Part A. of this chapter. Assume that (1) all personal injury awards were includable in Gross Income, (2) the jury is instructed of this fact, (3) an injured plaintiff produces evidence establishing that his net (after-tax) pay from lost past and future wages would have been, absent the injury, $500,000, and (4) the jury is instructed that any award will be taxed at an effective rate of 30% because falling partly within the 28% bracket, partly within the 33% bracket, and partly within the 35% bracket. How much would the jury presumably award to make the plaintiff whole? An award of $714,285 would make the victim whole with $500,000 in hand after paying a 30% tax of $214,285. How much will the jury award if it is informed that the taxpayer is permitted to exclude 100% of these compensatory damages? In light of your answers, is current § 104(a)(2) consistent with tort policy? The same tax consequences will also shape settlement discussions with the tortfeasor, as the vast majority of cases are never tried before a jury but rather settled. You are probably not surprised to learn that business interests lobbied against the 1996 narrowing of the § 104(a)(2) exclusion, as the narrowing effectively increased settlement costs for defendants in non-physical (but personal) injury cases.

If § 104(a)(2) treats compensated injured parties more favorably for tax purposes (excluded income) than uncompensated injured parties (denied deductions), and if it benefits tortfeasors more than plaintiffs (who could be made whole regardless of whether or not the damages are includable by a gross-up in the damage amount), why does the § 104(a)(2) exclusion persist? Its most usual rationale was stated memorably by Professor Phillip D. Oliver:[31]

> The real reason that section 104[(a)(2)] is part of the law—whatever the tax theorists may say about it—is the idea that tort victims should be pitied rather than taxed. But if society is being solicitous of folks who are injured, why pick the most fortunate subset—injured folks who, unlike most victims of personal injury, receive monetary compensation? And, given the vagaries of the tort system ... why give the

[29] 1974-1 C.B. 33.
[30] 1998-2 C.B. 182.
[31] Professor Oliver wrote these words in a discussion over Taxprof, a listserve for tax law professors over which we ramble on about all sorts of tax issues. E-mail on file with author.

> biggest tax benefit to the most fortunate sub-subset, those who are fortunate enough both to be injured by a deep pocket and to be able to convince a jury to award massive damages? ... Repeal of 104[(a)(2)] would merely recognize that compensated victims are better off than uncompensated victims. They are also better off than the still larger contingency of people who suffer as a result of natural causes, but are unable to sue God.

Even though repeal could hurt tortfeasors more than their injured victims, the optics look bad to the general public not familiar, as you now are, with deeper policy analysis.

***Determining the excludable amount: deducted medical costs, structured settlements, prejudgment interest, and punitive damages***

Suppose that (1) Mel physically injures Meghan in Year 1, (2) she incurs and pays $12,000 of uninsured medical expenses in Year 1 because of her injuries, (3) she is able to deduct only $2,000 of this amount under § 213 (examined in more detail in the next chapter), equal to the portion of the $12,000 exceeding 10% of her $100,000 AGI, and (4) Meghan receives a settlement award in Year 3 of $200,000, which comprises, in part, a reimbursement of the $12,000 in medical expenses paid by Meghan in Year 1.

Because Meghan's injury is a physical one, § 104(a)(2) authorizes her exclusion of compensatory (but not punitive) damages. She is not, however, entitled to enjoy a double tax benefit—both deduction and exclusion—of the same dollars. Thus, the introductory language in § 104(a) before paragraph (1) requires that Meghan include the first $2,000 of her award.[32] Even though Meghan must nominally include $2,000 in Year 3, do not lose sight of the fact that she still is effectively not taxed on this amount; the tax benefit simply took place in the earlier year through the vehicle of her medical expense deduction. For example, if both Meghan's payment of medical expenses and her receipt of the settlement had occurred in the *same taxable year* (rather than in different taxable years under the original facts), Meghan would have been denied a medical expense deduction under § 213(a) because her expenses would have been "compensated for by insurance *or otherwise*." (Emphasis added.) Because she would have been denied a medical expense deduction, she would fully exclude under § 104(a)(2) the compensatory damages received in the same taxable year.

Returning to our original facts, where Meghan deducted $2,000 of her medical expenses in Year 1 and received a $200,000 damage award in Year 3, she would be able to exclude all but the first $2,000 from Gross Income, assuming that no part of the award constitutes punitive damages (or prejudgment interest, mentioned below). If Meghan invests the lump sum and earns 2% interest equal to $4,000 each year, the $4,000 interest is not excludable under § 104(a)(2); rather, the interest return on her investment is included under § 61(a)(4). Suppose, however, that Meghan and Mel agree that he will not pay the $200,000 to Meghan but rather will purchase an annuity for $200,000 that he will continue to own but that will pay to Meghan—as the annuity beneficiary—approximately $2,000 each month for the next 10 years. Over this period, Meghan will effectively receive under the annuity contract not only the original $200,000 annuity purchase price but also a 2% return (the same 2% return described above). On these changed facts, Meghan can exclude the *entire* amount received each month (after including the first $2,000, equal to the previously deducted medical expenses)—*even to the extent of the implicit interest component*. Her exclusion

[32] *See* Rev. Rul. 75-230, 1975-1 C.B. 93 (requiring allocation of an award first to previously deducted medical expenses).

authority is the phrase "whether as lump sums *or as periodic payments*" in § 104(a)(2).

This arrangement is called a "structured settlement" and, because of the ability to essentially transform an includable investment return (if Meghan invested the $200,000 herself) into an excludable investment return, structured settlements are quite common in the case of physical injury awards. Meghan and Mel must be careful, however, to ensure that Mel (or Mel's insurance company) is the annuity owner, with Meghan's only rights limited to being the payee-beneficiary under the annuity. If Mel purchases the annuity but transfers outright ownership of it to Meghan, she must include the annuity investment return, as she would be considered to be in constructive receipt of the $200,000 amount, which she then used to purchase the annuity.[33]

As the plaintiffs in *Jarndyce v. Jarndyce* can tell you,[34] lawsuits can take many years before being reduced to judgment. In addition to any compensatory and punitive damages, prejudgment interest may be added to the award to compensate the plaintiff for the time value of money between the time of the injury and the time reduced to judgment. The Tax Court and various Circuit Courts of Appeal have held that prejudgment interest is includable in Gross Income under § 61(a)(4) and not excludable as part of the damage award under § 104(a)(2) because the amount is received "on account of" the delay in payment and not "on account of" the injuries within the meaning of § 104(a)(2).[35]

Finally, how do we know whether any of the $200,000 that Mel pays to Meghan constitutes includable punitive damages under the first parenthetical in § 104(a)(2)? If no punitive damages are requested in the original complaint, the issue is resolved easily, as it is if punitive damages are requested, the matter goes to a jury, and the jury explicitly awards (or fails to award) punitive damages. In the case in which punitive damages are requested in the plaintiff's complaint but the suit is settled without trial, the matter is more ambiguous. As you can imagine, the parties would rarely recite in their settlement agreement that any amount is allocable to punitive damages. If they did, the physically injured plaintiff would thereby acknowledge that this portion of the damage award is includable in Gross Income, and the tortfeasor would thereby admit to conduct so egregious as to deserve a punitive damage payment. If the settlement agreement is silent, the IRS may be successful in allocating the same percentage of the aggregate settlement payment to punitive damages as the plaintiff requested in her original complaint, which means that plaintiff lawyers should be aware of this possibility when drafting the complaint (and should avoid silence in the settlement agreement on this issue). Thus, if a plaintiff requests in his original complaint $1 million in compensatory damages for a physical injury and $2 million in punitive damages (twice the amount of compensatory damages), a settlement for, say, $600,000 that fails to state the nature of the settlement amount may be held to consist of $200,000 of compensatory damages and $400,000 of punitive damages in any later tax litigation.[36] At bottom, it is a factual issue in the later tax litigation.

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[33] *See* Rev. Rul. 79-220, 1979-2 C.B. 74. Students interested in reading about an example of such an arrangement can take a sneak preview of the *Ford Motor Company* case reprinted in Chapter 22, Part B., *infra*, which considers the timing of the tortfeasor's business expense deductions for the settlement payments.

[34] *See* CHARLES DICKENS, BLEAK HOUSE (1853).

[35] *See, e.g.*, Kovacs v. Comm'r, 100 T.C. 124 (1993); Chamberlain v. U.S., 401 F.3d 335 (5th Cir. 2005); Francisco v. U.S., 267 F.3d 303 (3d Cir. 2001); Rozpad v. Comm'r, 154 F.3d 1 (1st Cir. 1998); Brabson v. U.S., 73 F.3d 1040 (10th Cir. 1996).

[36] *See, e.g.*, Rev. Rul.. 85-98, 1985-2 C.B. 51.

In *Bagely v. Commissioner*,[37] for example, a jury awarded to the plaintiff $1 million in compensatory damages and $1.725 million in punitive damages. After a motion for a new trial made by the defendant was granted, however, the parties settled for $1.5 million in damages, and the settlement agreement specifically stated that none of the $1.5 million constituted punitive damages. In the subsequent tax litigation, the Tax Court reasoned that the settlement included the entire $1 million that the previous jury found was owed in compensatory damages and concluded that the remaining $500,000 of the $1.5 million settlement should be allocated to punitive damages. The Eighth Circuit Court of Appeals upheld the Tax Court's factual determination.

In the more usual case in which a settlement is reached *without* a jury's opinion regarding whether punitive damages are warranted under the particular facts at issue, however, the parties' agreement that the settlement consists exclusively of compensatory damages will not likely be disturbed in later tax litigation absent unreasonableness of the allocation on its face. For example, assume that plaintiff's physical injury is minor but the tortfeasor's behavior that caused the injury is particularly outrageous, causing the plaintiff to request nominal compensatory damages (say, $10,000) but large punitive damages (say, $10 million). A settlement for $2 million that recites that the entire amount comprises compensatory damages would be considered unreasonable on its face in tax litigation challenging 100% exclusion.

***The treatment of attorney fees***

You learned in Chapters 2 and 16 that interest incurred on a loan used to buy § 103 bonds (which earn *tax-exempt* interest) is not deductible—even if the taxpayer has sufficient *includable* investment income from other sources to otherwise allow the deduction under § 163(d)—because the interest is described in § 256(a)(2). Similarly, if compensatory damages are excludable under § 104(a)(2) because the award is made on account of physical injuries, no expense deduction for attorney fees is permissible, as the expense is described in § 265(a)(1) (rather than § 265(a)(2)). In each case, allowing the taxpayer to deduct costs incurred to produce tax-exempt income would allow him to enjoy a double tax benefit for the same dollars (exclusion of the return *and* deduction of the costs incurred to produce that return).

You also learned in Chapter 1, however, that the costs incurred to produce an *includable* return (such as a personal injury award that is not excludable under § 104(a)(2)) must reduce the tax base to ensure that the same dollars are not taxed twice to the same taxpayer. Sometimes this value is honored by allowing "basis" to offset a receipt so that only the net wealth accession enters § 61 "Gross Income" in the first place. For example, if Marcy purchases Blackacre for $100 (a nondeductible capital expenditure creating a $100 basis) and later sells it for $150, only the $50 portion of her $150 § 1001(b) amount realized that exceeds her basis is includable as "Gross Income" under §§ 1001 and 61(a)(3). Marcy is permitted to use her basis as an offset in determining § 61 Gross Income in the first place because her $100 outlay on purchasing Blackacre is so clearly and intimately associated *solely* with the receipt of the later Blackacre sales proceeds.

In the case of "expense" outlays, in contrast, the relationship between any particular cost and any particular cash receipt is often much more ambiguous, so Congress adopted the "deduction" mechanism (as opposed to the "basis offset" mechanism) to avoid doubly taxing the same dollars to the same taxpayer. Thus, the netting does not occur at the "Gross Income" stage under § 61 (as it did with respect to Blackacre and its basis) but rather later in the process of reaching "Taxable

[37] 121 F.3d 393 (8th Cir. 1997).

Income." In Chapter 1, for example, John was a dentist who paid salary to his dental assistant. Rather than attempting to tie the dental assistant's salary cost to any particular patient's bill payment and including only the "net" wealth accession in John's "Gross Income" under § 61, John must include the *entire* amount received from the patient in his § 61 "Gross Income" and then later in the calculation process deduct the salary paid to his dental assistant under § 162 in reaching "Taxable Income." (Note, by the way, that John's analysis is unaffected by whether the dental assistant must include the salary that she receives from John in her own § 61 Gross Income under § 61(a)(1)). Because John is not an employee of another, his § 162 expense deductions are taken above the line under § 62(a)(1)(A), thus ensuring that every dollar of his dental assistant's salary expense will, in fact, reduce his § 61 Gross Income in reaching "Taxable Income."

On the other hand, John may have some deductions that are not only Itemized Deductions (because not listed in § 62) but also MIDs (because also not listed in § 67(b)). For example, perhaps John pays $100 each year to rent a safety deposit box to hold rare gold coins that John holds for investment purposes. While the $100 would be deductible under § 212(2) as an expense incurred "for the management, conservation, or maintenance of property held for the production of income," this § 212 deduction is not listed in § 62 and thus is an Itemized Deduction. Moreover, it would also be a § 67 MID (because § 212 is not listed in § 67(b)), deductible for regular tax purposes only to the extent that it (along with any other MIDs) exceeds 2% of John's AGI. Worse yet, MIDs are completely nondeductible for purposes of the Alternative Minimum Tax (AMT) under § 56(b)(1)(A)(i). Review Chapter 1, Part B., if this analysis sounds unfamiliar to you.

If the attorney fees incurred to produce an includable damage award are categorized as "expenses," the plaintiff would fully include the damage award in § 61 Gross Income—encompassing the portion paid to the attorney as well as the "profit" portion—just as John fully included the amounts received from his patients, encompassing the portion paid to his dental assistant as well as his "profit" portion. Then the plaintiff would deduct the attorney fees—just as John deducted his dental assistant's salary—under either § 162(a) (if incurred in connection with the plaintiff's business) or § 212(1) (if the suit is unconnected to the plaintiff's business). If, however, this § 212(1) deduction or § 162 deduction (as the case may be) is a MID and the plaintiff is subject to the AMT for the year, the attorney fees are effectively nondeductible under § 56(b)(1)(A)(i)! Indeed, the very denial of what would typically be a sizable deduction for the attorney fees is what likely makes the AMT tax liability larger than the individual's "regular" tax liability. Thus, some plaintiffs began to argue that the portion of awards paid to their attorney was not includable in their § 61 Gross Incomes *in the first place*. Our dentist John cannot argue that he need not include a patient's payment in his § 61 Gross Income just because he used the receipt to pay his (deductible) dental assistant's salary, however. Are plaintiffs paying attorney fees on a different footing?

In *Commissioner v. Banks*,[38] the taxpayer sued his former employer for employment discrimination under the Civil Rights Act after being dismissed from his job. The parties settled for a total of $464,000. Of that amount, $150,000 was paid to Mr. Banks's attorney under a contingent fee arrangement. Because the injuries complained of were not "physical," Mr. Banks could not exclude any portion of the award under § 104(a)(2). Instead of including the full award in Gross Income and then deducting the attorney fees under § 212(1), however, Mr. Banks included in the first instance only the $314,000 portion of the award that exceeded the attorney fee (and

[38] 543 U.S. 426 (2005).

then did not deduct the fee under § 212) in order to avoid expense disallowance under § 56(b)(1)(A)(i) for AMT purposes.

The taxpayer made several arguments for the proposition that the portion of the award paid to his attorney was not includable in his Gross Income in the first place, but the Supreme Court rejected them all. For example, the Court rejected the argument that the victim had created a "partnership" with his attorney with respect to the claim and that each partner was simply including his share of the partnership's Gross Income. The Court also rejected the argument that state attorney lien laws effectively assigned the award to the attorney to the extent of his fees. The Court rejected these arguments because the cause of action belonged wholly to the injured plaintiff and could not be sold or assigned as a property right, either privately or by operation of state attorney lien statutes. With respect to the latter, the Court reasoned that state attorney lien statutes merely provide attorneys with a security interest in their clients' awards in order to ensure prompt payment of their fees. Finally, the Court also rejected the argument that the fee arrangement resulted in a successful assignment of income under the assignment-of-income doctrine. Citing *Lucas v. Earl* and *Horst*, among other cases that you studied in Chapter 8, the Court concluded that Mr. Banks "cannot exclude an economic gain from Gross Income by assigning the gain in advance to another party." At bottom, the Court concluded that Mr. Banks merely paid his attorney for services rendered from his (100% includable) damage award, just as our dentist John paid his dental assistant for services rendered from his (100% includable) patient receipts. If these costs are categorized as "expenses," neither Mr. Banks nor John can net together the inflow and outflow and include only the net profit as "Gross Income" in the first place.

But is Mr. Banks and our dentist John really in the same position in view of Mr. Banks's deduction denial under § 56(b)(1)(A)(i) of the AMT? After all, John can clearly fully deduct his dental assistant salary under § 162 (above the line under § 62) without limit.

As a matter of SHS income tax theory, disallowance of Mr. Banks's costs, which directly produced *includable Gross Income*, is clearly wrong, just as it would be wrong to deny our dentist John an expense deduction for his dental assistant's salary or to deny a basis offset on a sale of Blackacre. In each case, the taxpayer is doubly taxed on the same dollars if the gross proceeds are *fully* included in the tax base without an explicit deduction (or basis offset) that effectively reduces the amount taxed to a net profit.

Congress could have cured this problem entirely in several ways. If the costs must be considered "expenses," Congress could have either made all such expense deductions "above the line" under § 62 or, if they must be itemized, amended § 56(a)(1)(A) so that MIDs with a direct and clear connection to includable Gross Income are allowed under the AMT.

There is another way to think about this issue, however. As a theoretical matter, an alternative analysis would categorize these attorney fees as capital expenditures that create basis in the (hoped-for) damage award, rather than as current expenses. By analogy, see Treas. Reg. §§ 1.263(a)-2(f)(3) and -4(e) (requiring certain transaction costs to be capitalized rather than treated as expenses). If the award comes to fruition, the basis would then offset the gross award, with only the excess included in § 61 Gross Income—just as, on the sale of Blackacre described earlier, only the excess of the $150 amount realized over Blackacre's $100 basis is includable in § 61 Gross Income in the first place. If the award does not come to fruition, any basis created by a payment of attorney fees (in the situation not involving a contingent fee arrangement, where the attorney can go entirely unpaid in an unsuccessful suit) would be deducted as a "loss" under § 165(c)(2).

(Remember that a § 165 "loss" deduction *is* a deduction of unrecovered basis.)

Because the outlay for attorney fees incurred because of a *single litigated case* is so closely and intimately linked to *that particular hoped-for receipt*, this argument is entirely persuasive, in my view. These costs are unlike those incurred by John for his dental assistant's salary, where the connection between a particular patient's payment and the dental assistant's salary is tenuous, making the "deduction" route (rather than the "basis offset" route) the only administratively feasible one. Unfortunately, this argument was not developed at the trial or Court of Appeals stage in *Banks* but was made in *amicus* briefs for the first time only at the Supreme Court level, which is why the Court declined to consider it at that late date.

Could a lower court adopt this reasoning now in a newly litigated case where the basis argument is well developed? Congress may have implicitly concluded that these outlays are "expenses" rather than "capital expenditures" creating basis in the future income stream as a matter of law when it amended § 62 by adding subsections (a)(20) and (e), providing that §§ 162 or 212 expense deductions for attorney fees incurred in certain types of cases are now deductible above the line, rather than as Itemized Deductions. These new provisions would solve the problem for Mr. Banks if his case arose today.[39] But this remedy is woefully incomplete. What about attorney fees paid in settlement of a suit for, say, personal defamation? Attorney fees allocable to the includable punitive damages portion in a physical injury case? Can a taxpayer develop the "basis offset" argument in a new case today, or is the § 62 amendment an implicit rejection of the "basis offset" argument in favor of an "expense deduction" approach? We have seen this "negative inference" problem—a common one in statutory interpretation—many times before in this course.

Before embarking on the case below, review the second paragraph under "Discussion" in *Reynolds v. Commissioner*, found in Part C. of Chapter 9. That paragraph provides that an initial consideration in determining the tax consequences of settlement proceeds is to determine the nature of the claim for which the settlement proceeds are received. In *Amos*, below, the court decided that the settlement was only partly received on account of the physical injury claim. What was the nature of the remaining payment? And how does the court allocate the settlement amount between these two components?

## AMOS v. COMMISSIONER

T.C. Memo. 2003-329

CHIECHI, JUDGE: Respondent determined a deficiency of $61,668 in petitioner's Federal income tax (tax) for 1997.

The only issue remaining for decision is whether the $200,000 settlement amount that petitioner received in 1997 in settlement of a claim is excludable under section 104(a)(2) from petitioner's Gross Income for that year. We hold that $120,000 is excludable and that $80,000 is not.

FINDINGS OF FACT

During 1997, petitioner was employed as a television cameraman. In that capacity, on January 15, 1997, petitioner was operating a handheld camera during a basketball game between the Minnesota Timberwolves and the Chicago Bulls. At some point during that game, Dennis Keith Rodman (Mr. Rodman), who was playing for the Chicago Bulls, landed on a group of

[39] *See* §§ 62(a)(20) and (e)(1).

photographers, including petitioner, and twisted his ankle. Mr. Rodman then kicked petitioner. (We shall refer to the foregoing incident involving Mr. Rodman and petitioner as the incident.)

On January 15, 1997, shortly after the incident, petitioner was taken by ambulance for treatment at Hennepin County Medical Center. Petitioner informed the medical personnel at that medical center (Hennepin County medical personnel) that he had experienced shooting pain to his neck immediately after having been kicked in the groin, but that such pain was subsiding. The Hennepin County medical personnel observed that petitioner was able to walk, but that he was limping and complained of experiencing pain. The Hennepin County medical personnel did not observe any other obvious signs of trauma. Petitioner informed the Hennepin County medical personnel that he was currently taking pain medication for a preexisting back condition. The Hennepin County medical personnel offered additional pain medications to petitioner, but he refused those medications. After a dispute with the Hennepin County medical personnel concerning an unrelated medical issue, petitioner left Hennepin County Medical Center without having been discharged by them.

While petitioner was seeking treatment at Hennepin County Medical Center, he contacted Gale Pearson (Ms. Pearson) about representing him with respect to the incident. Ms. Pearson was an attorney who had experience in representing plaintiffs in personal injury lawsuits. After subsequent conversations and a meeting with petitioner, Ms. Pearson agreed to represent him with respect to the incident.

On January 15, 1997, after the incident and petitioner's visit to the Hennepin County Medical Center, petitioner filed a report (police report) with the Minneapolis Police Department. In the police report, petitioner claimed that Mr. Rodman had assaulted him.

On January 16, 1997, petitioner sought medical treatment at the Veterans Affairs (VA) Medical Center. The medical personnel at that medical center (VA medical personnel) took X-rays of petitioner's back. Petitioner complained to the VA medical personnel about his groin area, but he did not advise them that he was experiencing any symptoms related to that complaint. The VA medical personnel determined that there was no swelling of, but they were unable to ascertain whether there was bruising around, petitioner's groin area. The VA medical personnel gave petitioner some pain medication and told him to continue taking his other prescribed medications. The VA medical personnel prepared a report regarding petitioner's January 16, 1997 visit to the VA Medical Center. That report indicated that, except for certain disk problems that petitioner had since at least as early as February 14, 1995, "the vertebrae are intact and the remaining disk spaces are normal."

Very shortly after the incident on a date not disclosed by the record, Andrew Luger (Mr. Luger), an attorney representing Mr. Rodman with respect to the incident, contacted Ms. Pearson. Several discussions and a few meetings took place between Ms. Pearson and Mr. Luger. Petitioner accompanied Ms. Pearson to one of the meetings between her and Mr. Luger, at which time Mr. Luger noticed that petitioner was limping. Shortly after those discussions and meetings, petitioner and Mr. Rodman reached a settlement.

On January 21, 1997, Mr. Rodman and petitioner executed a document entitled "CONFIDENTIAL SETTLEMENT AGREEMENT AND RELEASE" (settlement agreement). The settlement agreement provided in pertinent part:

> For and in consideration of TWO HUNDRED THOUSAND DOLLARS

($200,000), the mutual waiver of costs, attorneys' fees and legal expenses, if any, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Eugene Amos [petitioner], on behalf of himself, his agents, representatives, attorneys, assignees, heirs, executors and administrators, hereby releases and forever discharges Dennis Rodman, the Chicago Bulls, the National Basketball Association and all other persons, firms and corporations together with their subsidiaries, divisions and affiliates, past and present officers, directors, employees, insurers, agents, personal representatives and legal counsel, from any and all claims and causes of action of any type, known and unknown, upon and by reason of any damage, loss or injury which heretofore have been or heretoafter may be sustained by Amos arising, or which could have arisen, out of or in connection with an incident occurring between Rodman and Amos at a game between the Chicago Bulls and the Minnesota Timberwolves on January 15, 1997 during which Rodman allegedly kicked Amos ("the Incident"), including but not limited to any statements made after the Incident or subsequent conduct relating to the Incident by Amos, Rodman, the Chicago Bulls, the National Basketball Association, or any other person, firm or corporation, or any of their subsidiaries, divisions, affiliates, officers, directors, employees, insurers, agents, personal representatives and legal counsel. This Agreement and Release includes, but is not limited to claims, demands, or actions arising under the common law and under any state, Federal or local statute, ordinance, regulation or order, including claims known or unknown at this time, concerning any physical, mental or emotional injuries that may arise in the future allegedly resulting from the Incident.

* * * * * * *

It is further understood and agreed that the payment of the sum described herein is not to be construed as an admission of liability and is a compromise of a disputed claim. It is further understood that part of the consideration for this Agreement and Release includes an agreement that Rodman and Amos shall not at any time from the date of this Agreement and Release forward disparage or defame each other. It is further understood and agreed that, as part of the consideration for this Agreement and Release, the terms of this Agreement and Release shall forever be kept confidential and not released to any news media personnel or representatives thereof or to any other person, entity, company, government agency, publication or judicial authority for any reason whatsoever except to the extent necessary to report the sum paid to appropriate taxing authorities or in response to any subpoena issued by a state or Federal governmental agency or court of competent jurisdiction * * * Any court reviewing a subpoena concerning this Agreement and Release should be aware that part of the consideration for the Agreement and Release is the agreement of Amos and his attorneys not to testify regarding the existence of the Agreement and Release or any of its terms.

* * * * * * *

It is further understood and agreed that Amos and his representatives, agents, legal counsel or other advisers shall not, from the date of this Agreement and Release, disclose, disseminate, publicize or instigate or solicit any others to disclose, disseminate or publicize, any of the allegations or facts relating to the Incident,

> including but not limited to any allegations or facts or opinions relating to Amos' potential claims against Rodman or any allegations, facts or opinions relating to Rodman's conduct on the night of January 15, 1997 or thereafter concerning Amos. In this regard, Amos agrees not to make any further public statement relating to Rodman or the Incident or to grant any interviews relating to Rodman or the Incident. * * *
>
> It is further understood and agreed that any material breach by Amos or his attorney, agent or representative of the terms of this Agreement and Release will result in immediate and irreparable damage to Rodman, and that the extent of such damage would be difficult, if not impossible, to ascertain. To discourage any breach of the terms of this Agreement and Release, and to compensate Rodman should any such breach occur, it is understood and agreed that Amos shall be liable for liquidated damages in the amount of TWO HUNDRED THOUSAND and No/100 Dollars ($200,000) in the event such a material breach occurs. Amos agrees that this sum constitutes a reasonable calculation of the damages Rodman would incur due to a material breach.
>
> It is further understood and agreed, that, in the event Rodman or Amos claim a material breach of this Agreement and Release has occurred, either party may schedule a confidential hearing before an arbitrator of the American Arbitration Association for a final, binding determination as to whether a material breach has occurred. If, after the hearing, the arbitrator finds that Amos has committed a material breach, the arbitrator shall order that Amos pay the sum of $200,000 in liquidated damages to Rodman. * * *
>
> Amos further represents, promises and agrees that no administrative charge or claim or legal action of any kind has been asserted by him or on his behalf in any way relating to the Incident with the exception of a statement given by Amos to the Minneapolis Police Department. Amos further represents, promises and agrees that, as part of the consideration for this Agreement and Release, he has communicated to the Minneapolis Police Department that he does not wish to pursue a criminal charge against Rodman, and that he has communicated that he will not cooperate in any criminal investigation concerning the Incident.
>
> Amos further represents, promises and agrees that he will not pursue any criminal action against Rodman concerning the Incident, that he will not cooperate should any such action or investigation ensue, and that he will not encourage, incite or solicit others to pursue a criminal investigation or charge against Rodman concerning the Incident.

Petitioner filed a tax return (return) for his taxable year 1997. In that return, petitioner excluded from his Gross Income the $200,000 that he received from Mr. Rodman under the settlement agreement. In the notice that respondent issued to petitioner with respect to 1997, respondent determined that petitioner is not entitled to exclude from his Gross Income the settlement amount at issue.

OPINION

We must determine whether the settlement amount at issue may be excluded from petitioner's

Gross Income for 1997. Petitioner bears the burden of proving that the determination in the notice to include the settlement amount at issue in petitioner's Gross Income is erroneous. *See* Rule 142(a); *Welch v. Helvering*, 290 U.S. 111, 115, 78 L. Ed. 212, 54 S. Ct. 8 (1933).

Section 61(a) provides the following sweeping definition of the term "Gross Income": "Except as otherwise provided in this subtitle, Gross Income means all income from whatever source derived." Not only is section 61(a) broad in its scope, *Commissioner v. Schleier*, 515 U.S. 323, 328, 132 L. Ed. 2d 294, 115 S. Ct. 2159 (1995), exclusions from Gross Income must be narrowly construed, *id.*; *U.S. v. Burke*, 504 U.S. 229, 248, 119 L. Ed. 2d 34, 112 S. Ct. 1867 (1992).

Section 104(a)(2) on which petitioner relies provides that Gross Income does not include:

> (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;

Where damages are received pursuant to a settlement agreement, such as is the case here, the nature of the claim that was the actual basis for settlement controls whether such damages are excludable under section 104(a)(2). *U.S. v. Burke*, *supra* at 237. The determination of the nature of the claim is factual. *Robinson v. Comm'r*, 102 T.C. 116, 126 (1994), affd. in part, revd. in part, and remanded on another issue 70 F.3d 34 (5th Cir. 1995); *Seay v. Comm'r*, 58 T.C. 32, 37 (1972). Where there is a settlement agreement, that determination is usually made by reference to it. *See Knuckles v. Comm'r*, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo. 1964-33. If the settlement agreement lacks express language stating what the amount paid pursuant to that agreement was to settle, the intent of the payor is critical to that determination. *Knuckles v. Comm'r*, *supra*; *see also Agar v. Comm'r*, 290 F.2d 283, 284 (2d Cir. 1961), affg. per curiam T.C. Memo. 1960-21. Although the belief of the payee is relevant to that inquiry, the character of the settlement payment hinges ultimately on the dominant reason of the payor in making the payment. *Agar v. Comm'r*, *supra*; *Fono v. Comm'r*, 79 T.C. 680, 696 (1982), affd. without published opinion 749 F.2d 37 (9th Cir. 1984). Whether the settlement payment is excludable from Gross Income under section 104(a)(2) depends on the nature and character of the claim asserted, and not upon the validity of that claim. *See Bent v. Comm'r*, 87 T.C. 236, 244 (1986), affd. 835 F.2d 67 (3d Cir. 1987); *Glynn v. Comm'r*, 76 T.C. 116, 119 (1981), affd. without published opinion 676 F.2d 682 (1st Cir. 1982); *Seay v. Comm'r*, *supra*.

The dispute between the parties in the instant case relates to how much of the settlement amount at issue Mr. Rodman paid to petitioner on account of physical injuries. It is petitioner's position that the entire $200,000 settlement amount at issue is excludable from his Gross Income under section 104(a)(2). In support of that position, petitioner contends that Mr. Rodman paid him the entire amount on account of the physical injuries that he claimed he sustained as a result of the incident.

Respondent counters that, except for a nominal amount (*i.e.*, $1), the settlement amount at issue is includable in petitioner's Gross Income. In support of that position, respondent contends that petitioner has failed to introduce any evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident. Consequently, according to respondent, the Court should infer that petitioner's physical injuries were minimal. In further support of respondent's position to include all but $1 of the settlement amount at issue in petitioner's Gross Income, respondent contends that, because the amount of any liquidated damages (*i.e.*, $200,000) payable by petitioner to Mr. Rodman under the settlement agreement was

equal to the settlement amount (*i.e.*, $200,000) paid to petitioner under that agreement, Mr. Rodman did not intend to pay the settlement amount at issue in order to compensate petitioner for his physical injuries.

On the instant record, we reject respondent's position. With respect to respondent's contentions that petitioner has failed to introduce evidence regarding, and that Mr. Rodman was skeptical about, the extent of petitioner's physical injuries as a result of the incident, those contentions appear to ignore the well-established principle under section 104(a)(2) that it is the nature and character of the claim settled, and not its validity, that determines whether the settlement payment is excludable from Gross Income under section 104(a)(2). *See Bent v. Comm'r, supra*; *Glynn v. Comm'r, supra*; *Seay v. Comm'r, supra*. In any event, we find below that the record establishes that Mr. Rodman's dominant reason in paying the settlement amount at issue was petitioner's claimed physical injuries as a result of the incident.

With respect to respondent's contention that Mr. Rodman did not intend to pay the settlement amount at issue in order to compensate petitioner for his physical injuries because the amount of liquidated damages (*i.e.*, $200,000) payable by petitioner to Mr. Rodman under the settlement agreement was equal to the settlement amount (*i.e.*, $200,000) paid to petitioner under that agreement, we do not find the amount of liquidated damages payable under the settlement agreement to be determinative of the reason for which Mr. Rodman paid petitioner the settlement amount at issue.

On the record before us, we find that Mr. Rodman's dominant reason in paying the settlement amount at issue was to compensate petitioner for his claimed physical injuries relating to the incident. Our finding is supported by the settlement agreement, a declaration by Mr. Rodman (Mr. Rodman's declaration), and Ms. Pearson's testimony.

The settlement agreement expressly provided that Mr. Rodman's payment of the settlement amount at issue

> releases and forever discharges * * * [Mr.] Rodman * * * from any and all claims and causes of action of any type, known and unknown, upon and by reason of any damage, loss or injury * * * sustained by Amos [petitioner] arising, or which could have arisen, out of or in connection with * * * [the incident].

Mr. Rodman stated in Mr. Rodman's declaration that he entered into the settlement agreement "to resolve any potential claims" and that the settlement agreement was intended to resolve petitioner's "claim without having to expend additional defense costs." The only potential claims of petitioner that are disclosed by the record are the potential claims that petitioner had for the physical injuries that he claimed he sustained as a result of the incident. Furthermore, Ms. Pearson testified that Mr. Rodman paid the entire settlement amount at issue to petitioner on account of his physical injuries. As discussed below, Ms. Pearson's testimony that Mr. Rodman paid that entire amount on account of petitioner's physical injuries is belied by the terms of the settlement agreement. Nonetheless, her testimony supports our finding that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for claimed physical injuries relating to the incident.

We have found that Mr. Rodman's dominant reason in paying petitioner the settlement amount at issue was to compensate him for his claimed physical injuries relating to the incident. However, the settlement agreement expressly provided that Mr. Rodman paid petitioner a portion of the

settlement amount at issue in return for petitioner's agreement not to: (1) Defame Mr. Rodman, (2) disclose the existence or the terms of the settlement agreement, (3) publicize facts relating to the incident, or (4) assist in any criminal prosecution against Mr. Rodman with respect to the incident (collectively, the nonphysical injury provisions).

The settlement agreement does not specify the portion of the settlement amount at issue that Mr. Rodman paid petitioner on account of his claimed physical injuries and the portion of such amount that Mr. Rodman paid petitioner on account of the nonphysical injury provisions in the settlement agreement. Nonetheless, based upon our review of the entire record before us, and bearing in mind that petitioner has the burden of proving the amount of the settlement amount at issue that Mr. Rodman paid him on account of physical injuries, we find that Mr. Rodman paid petitioner $120,000 of the settlement amount at issue on account of petitioner's claimed physical injuries and $80,000 of that amount on account of the nonphysical injury provisions in the settlement agreement. On that record, we further find that for the year at issue petitioner is entitled under section 104(a)(2) to exclude from his Gross Income $120,000 of the settlement amount at issue and is required under section 61(a) to include in his Gross Income $80,000 of that amount.

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## Problems

**1.** Confidentiality clauses like the one in *Amos* are common. What might the attorneys who drafted the settlement agreement have done to avoid the necessity for the Tax Court to divine how much of the aggregate award was due to the physical injury claim and how much was consideration paid for the confidentiality clause? Why may they have avoided the solution that you devised?

In view of the Tax Court's allocation, how would Mr. Amos have treated the amount paid to Ms. Pearson, his attorney, from the $200,000 award, which you should assume was 25% (or $50,000)? (As for Mr. Rodman's possible business expense deduction for the $200,000 payment, stay tuned. We shall consider that issue in Chapter 20.) In particular, what would be the tax consequences if the attorney fee outlay is categorized as an "expense"? Review §§ 162(a), 212(1), 62(a)(20) and (e), 67, 56(b)(1)(A)(i), and 265(a)(1). Alternatively, what would be the tax consequences of the attorney fee outlay if it is categorized as a nondeductible capital expenditure that creates basis, instead?

**2.** Linda, a young business executive, is injured in Year 1 by a malfunctioning snow blower operated by her husband Larry. The blower's blade flies off just as she walks in front of him on their driveway on the way to her parked car, deeply slicing her femoral artery (and the muscles) in her thigh. Linda almost bleeds to death. By the time she reaches the hospital, she has lost so much blood that she is in a coma. Linda eventually recovers, but she does suffer some lingering cognitive deficiencies as a result of the lack of oxygen, and she requires extensive physical therapy to rehabilitate the use of her leg. Linda and her husband sue the snow blower manufacturer. They request punitive damages when they discover that the manufacturer had learned of the defect that caused the blade to fly off but had not recalled the blowers to fix them. Their complaint requests the following amounts:

- $10 million in lost past and future income;
- Reimbursement of $100,000 of medical expenses, $20,000 of which are properly deducted in Year 1 under § 213;

- $20 million in pain and suffering;
- $100,000 in loss of consortium for Larry; and
- $10 million in punitive damages.

The case is tried before a jury in Year 3, which awards Linda and Larry $20 million in compensatory damages but no punitive damages. The manufacturer pays $15 million to Linda and Larry and $5 million to their lawyer under their contingent fee arrangement. Linda and Larry invest the $15 million in Treasury bonds maturing in 10 years, earning 2% annual interest.

**3.** Same as **2.**, except that Linda and Larry settle with the manufacturer before trial for $20 million. Under their settlement agreement, (1) the entire amount is allocated to compensatory damages, with no part of the settlement allocated to punitive damages, (2) the manufacturer must pay $5 million of the $20 million to Linda and Larry's lawyer, and (3) the manufacturer's insurance company must purchase an annuity for $15 million, with Linda and Larry designated as the sole beneficiaries of the annuity, under which they will be paid annual payments for the next 10 years of approximately $1.67 million each year, reflecting a 2% return.

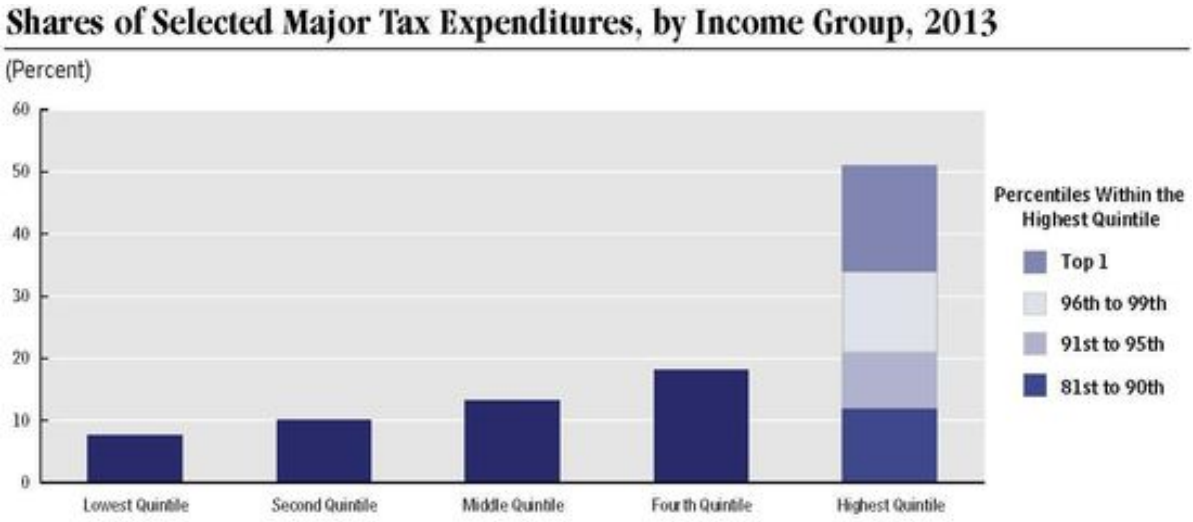
**4.** Same as **3.**, except that the attorneys who drafted the settlement agreement fail to state that the settlement comprises entirely compensatory damages. What risk arises on this failure?

# Chapter 18: Homes, Health, Charity, and More

This chapter considers a few of the largest and most important personal consumption tax expenditures that pertain to individuals. Below is the chart from Chapter 3, which lists a few of the more notable income tax expenditures aimed at individuals and their anticipated revenue costs for 2015 and from 2015-2019 (in billions).[1]

| | 2015 | 2015-2019 |
|---|---|---|
| Employer-provided and individual retirement savings incentives | $149.4 | $937.1 |
| Exclusion of employer-provided health care | 145.5 | 769.8 |
| Deductions for nonbusiness state income (or sales) and property taxes | 133.2 | 762.1 |
| Reduced rate on net capital gain and qualified dividends | 131.7 | 689.6 |
| Deduction of mortgage interest on owner-occupied residences | 71.0 | 419.8 |
| Earned income tax credit | 72.7 | 371.4 |
| Step-up in basis at death | 32.4 | 171.3 |
| Capital gains exclusion for sales of primary residences | 24.1 | 149.9 |

The chart below, also from Chapter 3, shows the shares enjoyed by each income quintile of 10 of the major individual tax expenditures.[2]




[1] JOINT COMMITTEE ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURE FOR FISCAL YEARS 2015-2019, JCX-141-15 (Dec. 7, 2015), at www.jct.gov/publications.html?func=startdown&id=4855. These revenue estimates do not incorporate the revenue loss under the payroll taxes (Social Security and Medicare) pertaining to the exclusions for employer-provided health care and retirement savings.

[2] CONGRESSIONAL BUDGET OFFICE, THE DISTRIBUTION OF MAJOR TAX EXPENDITURES IN THE INDIVIDUAL INCOME TAX SYSTEM, at www.cbo.gov/sites/default/files/cbofiles/attachments/43768_DistributionTaxExpenditures.pdf. The tax expenditures reflected here include the exclusions for employer-provided health care and long-term care insurance, pension contributions and earnings, built-in gain at death under § 1014, and Social Security and Railroad Retirement benefits; the deductions for qualified residence interest, nonbusiness state and local income, sales, real estate, and personal property taxes, charitable contributions; the reduced tax rates applied to net capital gain and qualified dividends; and the child tax and earned income tax credits.

Most of the personal consumption tax expenditures that take the form of a deduction are categorized as Itemized Deductions, as described in Chapter 1, Part B., which means that those who take the Standard Deduction, instead, do not benefit from these deductions.

As you consider each topic, remember the cost-benefit analysis that applies to tax expenditures described in Chapter 17, Part A. What is the goal sought to be accomplished? Is that goal better accomplished inside or outside the tax system? If the tax system is used, is the provision crafted well to avoid windfall losses (if intended to change behavior) or to target the intended beneficiaries (if intended as a subsidy)? Is the distribution of the tax expenditure's benefits among income groups fair? Is the benefit likely to be captured by other actors in the marketplace through the price mechanism? Remember always that these provisions, because they are not costless, mean that tax *rates* are higher than they otherwise would be to raise *$X* in revenue.

# A. Owner-occupied housing

Owner-occupied housing is one of the most tax-preferred investments in the U.S. economy, encompassing (1) the exclusion of imputed income, (2) the § 163(h)(3) deduction of qualified residence interest, (3) the § 164(a)(1) deduction of state and local real property taxes, even if unconnected to income-producing activity, and (4) the exclusion for gain realized on the sale or exchange of a principal residence under § 121.

### *The exclusion of imputed income with respect to owner-occupied housing*

While you may be somewhat familiar in your capacity as taxpayers with the deductions for qualified residence interest and real property taxes (as well as the exclusion of certain home sale gain), the exclusion for imputed income pertaining to owner-occupied housing may be a new concept to you. But the qualified residence interest and property tax deductions are tax expenditures *only because* imputed income from owner-occupied housing is not included in Gross Income. Remember that deductions are normatively required to measure SHS income accurately *if and only if* the investment return is includable in the tax base. If the return is excluded, deductions should be disallowed, just as they are under § 265(a)(2) for interest paid on a loan used to buy § 103 bonds (the interest on which is excludable) and under § 265(a)(1) for attorney fees incurred to generate compensatory damages that are excludable under § 104(a)(2).

Here is a description from a recent CBO report:[3]

> **Net Imputed Rental Income.** People receive economic benefits by purchasing homes and residing in them, but they are unaccustomed to assigning a dollar value to those benefits. For example, one of the touted advantages of buying a home is that homeowners no longer pay rents to landlords. But viewed from another perspective, homeowners' incomes increase by the value of the shelter and other services that they receive from their investment in owner-occupied housing.
>
> Imputed rental income is the analog to the actual rental income on which landlords are taxed. When a person buys a house and rents it out, he or she receives rental income from the tenant. If instead of renting out the house, the owner lives in it, no rent is paid from one party to another, but the owner-occupant receives the

[3] Larry Ozanne, CONGRESSIONAL BUDGET OFFICE, *Taxation of Owner-Occupied and Rental Housing*, at www.cbo.gov/sites/default/files/cbofiles/attachments/11-2-2012-Taxation_of_Housing.pdf.

> same value of housing services as the renter would have. Thus, the owner-occupant effectively receives the same rental income as when he or she rents it to another, but the income is in the form of housing services.
>
> Gross Income of the homeowner thus includes the amount that an owner-occupied home would rent for if it were rented to a tenant. Net rental income would be that gross rent less expenses, such as maintenance and operating expenses, mortgage interest payments, property taxes, and an allowance for actual depreciation of the structure. Because the tax code does not require that owners compute the net rental income from their home and include it in adjusted Gross Income, that omission is treated by the Treasury Department as a tax expenditure in the Federal budget. However, people do not observe how much imputed rent they receive, and thus taxing that income would present administrative challenges….
>
> **Deduction for mortgage interest.** The deductibility of mortgage interest is considered a tax expenditure only because the tax code does not require that owners include the imputed gross rental value of their home as income. If that imputed rent were included, then mortgage interest would be a legitimate business deduction, just as it is for landlords….
>
> **Deduction for Property Tax.** Homeowners who itemize are allowed to deduct property taxes levied by state and local governments. As with the deduction for mortgage interest, this deduction would be a legitimate business expense rather than a tax expenditure if owners were required to include their imputed gross rent as income.

Thus, compare Greg and Greta, each of whom live in rented apartments at a cost of $12,000 annually when each inherits $100,000 from a deceased grandparent. Greg uses his $100,000 to purchase a house that he rents to a tenant for $12,000 annually, while Greta uses her $100,000 to purchase a house that she moves into herself (allowing her to cease paying rent). Greg receives $12,000 from his tenant and pays $12,000 to his landlord (an economic wash), but Greg must include in Gross Income the $12,000 rent that he receives from his tenant, and he cannot deduct (under § 262(a)) the $12,000 rent that he, in turn, continues to pay to his own landlord. Greta does not receive $12,000 and does not pay $12,000 (an economic wash). Each owns a $100,000 home and consumes $12,000 in housing each year, but Greg must include $12,000 in Gross Income, while Greta does not. Greta is permitted to exclude the $12,000 of imputed income that she enjoys in kind by living in the house herself (rather than renting it to a paying tenant).

***Tax policy critiques of the homeownership tax expenditures***

While, as suggested in the excerpt, it would be virtually impossible as a political matter to tax imputed income from owner-occupied housing in the U.S.,[4] the other owner-occupied housing subsidies are perennial topics for reform. The current income tax treatment of owner-occupied

[4] While never taxed in the U.S., imputed income from owner-occupied housing was more commonly taxed in European countries, such as Spain, Denmark, Austria, France, Greece, Ireland, Norway, and the U.K., in an effort to reduce income and wealth inequality. One report states that, as of 2008, only Italy and Holland continued to tax such income. *See* www.ecineq.org/milano/WP/ECINEQ2009-112.pdf at Table A.2. A more recent article, however, mentions Switzerland as continuing to tax imputed income from owner-occupied housing, measured by looking at market rents for similar properties. *See* Robert J. Shiller, *Owning a Home Isn't Always a Virtue*, at www.nytimes.com/2013/07/14/business/owning-a-home-isnt-always-a-virtue.html?_r=0.

housing is recognized by virtually all economists to be dysfunctional. Eugene Steuerle, for example, observes that "theorists of all types … especially do not like the ways that the current income tax system favors owner-occupied housing over other forms of capital investment."[5] He notes that "[i]n a number of economic models, this is one of the larger sources of inefficiency arising from the income tax."[6] Martin Sullivan is blunt when he says that "nowhere is the surrender of economic principles to political expediency more complete than in the U.S. tax policy for housing."[7] The distortions are well known. As Sullivan pithily summarized them, while focusing in particular on the deduction for home mortgage interest:

> The economic case against the mortgage interest deduction is clear-cut. It is a huge subsidy that causes massive efficiency-draining distortions in the economy. Capital and saving channeled by the tax code into housing is largely drawn from the business sector. The mortgage interest deduction means the economy has less business capital, lower productivity, lower real wages, and a lower standard of living.… Most economists understand—but hate to waste their breath explaining—that probably the most sure-fire way to improve the competitiveness of the American economy is to repeal the mortgage interest deduction.
>
> What does the economy get in return for its sacrifice? For the most part, just bigger houses.[8]

A 2005 CBO study[9] concluded that the average tax rate on owner-occupied housing is a negative 5.1% (because of the tax subsidies described here), while the average tax rate on all capital returns is 13.8%. That big divergence violates the neutrality norm (recall Chapter 3, Part B.) in a huge way. The resulting misallocation of capital across the economy exacts efficiency costs, making us less wealthy as a nation than we otherwise would be. If the efficiency costs are thought to be necessary in pursuing the quest of increasing the homeownership rate, we are sorely disappointed there, as well. Homeownership rates in similar economies, such as Canada and Australia, are virtually identical to that in America, even though no deduction for home mortgage interest is permitted in those countries. Moreover, the value of the subsidies has changed dramatically over the past several decades as tax rates and interest rates have fluctuated, but the homeownership rate has remained remarkably constant at 66 to 69%.

The deductions for qualified residence interest and real property taxes are also suspect on fairness grounds. The upside-down nature of these subsidies is well known. "Nearly 80% of the benefits from the mortgage interest and property tax deductions go to the top 20% of taxpayers in terms of income …. Only 5% of the benefits go to people in the bottom 60% of the income scale—those who may be struggling to own a home."[10]As phrased by Edward L. Glaeser and Jesse M. Shapiro, who published an extensive empirical study on the effects of the home mortgage deduction, "the home mortgage interest deduction is a particularly poor instrument for encouraging home ownership because it is targeted at the wealthy, who are almost always homeowners."[11]

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[5] C. EUGENE STEUERLE, CONTEMPORARY U.S. TAX POLICY 241 (2004).
[6] *Id.* at 257 n.5.
[7] Margin A. Sullivan, *The Economics of the American Dream*, 106 TAX NOTES 407, 407 (2005).
[8] *Id.*
[9] *See* CONGRESSIONAL BUDGET OFFICE, TAXING CAPITAL INCOME: EFFECTIVE RATES AND APPROACHES TO REFORM, Oct., 2005, at www.cbo.gov/sites/default/files/cbofiles/ftpdocs/67xx/doc6792/10-18-tax.pdf.
[10] James R. Hagerty, *Housing Sector Seeks No Tax Remodeling*, WALL ST. J., Jan. 31, 2005, at A2.
[11] Edward L. Glaeser & Jesse M. Shapiro, *The Benefits of the Home Mortgage Interest Deduction*, *in* 17 TAX POL'Y

They found that the deduction "serves mainly to increase housing consumption [by encouraging people to buy larger houses than they otherwise would absent the deduction] and to change the progressiveness of the tax code."[12]

Glaeaer and Shapiro focus on both the positive and negative externalities of encouraging people to own more housing by buying larger houses than they otherwise would. While they found some evidence that owning a home and owning a *larger* home encourages "aesthetic externalities" (*e.g.*, good home maintenance and gardening),[13] they found far more evidence of negative externalities. For example, the encouragement to buy ever larger homes hurts inner cities with older, smaller housing. And because it disproportionately encourages spending on housing among the wealthy rather than the poor, it increases segregation by income.[14]

The benefit of these tax preferences for owner-occupied housing is, on the face of the statute, ostensibly aimed at the home owner. **The more broadly available the tax expenditure, however, the more likely it is to be captured (at least in part) by other actors in the marketplace through the price mechanism.** Thus, another possible side effect of the tax subsidies for owner-occupied housing is that they artificially inflate the value of housing as the preferences get captured by sellers and lenders through higher home prices and higher before-tax interest rates. If only a small segment of buyers were accorded the tax expenditure (such as first-time home buyers), sellers and banks would be less able to capture the benefit through the price mechanism, as posted prices cannot be segregated by buyer (with a higher posted price for first-time buyers and a lower price for those who get no benefit from the tax expenditure). American homeowners pay "significantly higher mortgage rates, roughly 1.5 percentage points more, than those in Europe. That means that even if homeownership is a worthy policy goal, subsidizing mortgages is not the way to do it."[15]

Finally, the deduction for qualified residence interest, in particular, encourages mortgage debt or, stated differently, discourages the incentive to build equity (the excess of the home's FMV over encumbering debt), as noted by Harris, Steuerle, and Eng.

> The mortgage interest deduction reduces incentives to build equity in a home, with negative effects on housing stability and wealth accumulation. Poterba and Sinai … found that homeowners with sufficient financial assets to repay their mortgage still carry mortgages presumably because of the tax benefits of doing so. This design flaw was evident during the Great Recession, when underwater homeowners included not just those who had recently purchased homes but also long-time homeowners who had taken on new mortgages as the value of their homes increased. In effect, the design of the home mortgage interest deduction added to the risk that homeowners would have negative equity in their homes.[16]

The real estate industry has vociferously argued against reducing the tax preferences on the ground that housing prices would fall with repeal (indirect evidence of the capture problem),

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& THE ECONOMY 37, 40 (James M. Poterba ed., 2003).

[12] *Id.*

[13] *Id.* at 52-56 and 64-65.

[14] *Id.* at 58-59.

[15] Agnes T. Crane, *Five Prized Myths About Mortgages*, N.Y. TIMES, Feb. 7, 2011, at B2.

[16] Benjamin H. Harris, C. Eugene Steuerle & Amanda Eng, *New Perspectives on Homeownership Tax Incentives*, 141 TAX NOTES 1315, 1319 (2013).

though most economists believe that the effect would be temporary and would result in a more efficient allocation of resources across the economy.[17] For example, England phased out its home mortgage interest deduction over a 12-year period ending in 2000, and housing prices did not dramatically fall. The move would undoubtedly disgruntle current homeowners, however, who tend to vote.

***The deduction for qualified residence interest under § 163(h)(3)***

The current deduction for qualified residence interest can be seen as an accident of history.

> The [qualified residence interest deduction] was not originally placed in the Federal tax code to subsidize home ownership. When the modern Federal income tax was enacted [in 1913], all interest payments were made deductible on the grounds that interest payments were an expense of earning business and investment income. The deduction had little effect on housing investment before World War II because only the very highest income individuals paid any income tax. The extension of the income tax to middle-class families and the increase in home ownership that accompanied the post-World War II economic boom, however, turned the [qualified residence interest deduction] into a major subsidy for middle- and upper-middle-income homeowners. For decades it has enjoyed broad political support, often characterized as a critical support for the American Dream of homeownership.[18]

In other words, before 1986, home mortgage interest was deductible only because *all* interest (even personal consumption interest) was deductible. When Congress amended § 163 in the Tax Reform Act of 1986 to generally disallow deduction of personal consumption interest (such as interest paid on credit card debt), it crafted the special deduction for "qualified residence interest" so that the deduction of most interest paid on home mortgage debt would remain deductible.

Before considering possible reform of the qualified residence interest deduction, let's explore its mechanics. While § 163(a) contains those magic words "there shall be allowed a deduction" for interest paid or accrued during the taxable year, we have already seen in connection with § 163(d) investment interest (discussed in Chapter 16) that other subsections under § 163 reduce or eliminate the blanket § 163(a) language. Here, we examine personal consumption interest (other than the § 221 deduction for certain student loan interest).

Read §§ 163(h)(1) and (2)(D). While the former appears to disallow deduction of all "personal interest," the latter defines "personal interest" in such a way that it does not apply to "qualified residence interest," as defined in (h)(3), meaning that interest satisfying that definition is deductible under § 163(a) *notwithstanding § 163(h)(1)*. The deduction is an Itemized Deduction

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[17] *See* Jane G. Gravelle, *Effects of Flat Taxes and Other Proposals on Housing: An Overview*, CONGRESSIONAL RESEARCH SERVICE REPORT FOR CONGRESS, at www.environmentors.org/NLE/CRSreports/economics/econ-32.cfm (stating that current housing tax preferences encourages an inefficient overinvestment in housing and consequent underinvestment in business assets and that though housing prices would fall with repeal of preferences the effect would likely be transitory).

[18] Margery Austin Turner, Eric Toder, Rolf Pendall, and Claudia Sharygin, *How Would Reforming the Home Mortgage Interest Deduction Affect the Housing Market?*, at www.taxpolicycenter.org/UploadedPDF/412776-How-Would-Reforming-the-Mortgage-Interest-Deduction-Affect-the-Housing-Market.pdf [hereinafter URBAN INSTITUTE]. *See also* Dennis J. Ventry, *The Accidental Deduction: A History and Critique of the Tax Subsidy for Mortgage Interest*, 73 LAW & CONT. PROB. 233 (2009) (describing this history in more detail).

(because not listed in § 62) but not a MID subject to the 2% floor (because listed in § 67(b)(1)).

Under § 163(h)(3), interest is "qualified residence interest" only if it is paid on one of two kinds of debt—"acquisition indebtedness" or "home equity indebtedness"—and each is defined in §§ 163(h)(3)(B) and (C), respectively.

Under § 163(h)(3)(B), "acquisition indebtedness" has (1) a use test, (2) a security test, and (3) a $1 million ceiling. Under § 163(h)(3)(C), "home equity indebtedness" must (1) not be acquisition indebtedness, (2) satisfy the security test, and (3) not exceed a ceiling equal to the *lesser* of $100,000 or, essentially, the taxpayer's equity in the home (the excess of the home's FMV over acquisition indebtedness).

Under the use test, acquisition indebtedness must be used to *construct, acquire, or substantially improve* a "qualified residence" of the taxpayer. A "qualified residence" is the taxpayer's principal residence *plus* one other personal residence designated by the taxpayer, such as the taxpayer's vacation or weekend home.[19] While no Treasury Regulations tell us the meaning of "substantially improve" for this purpose, the IRS borrows from Treas. Reg. § 1.263(a)-3(d)—which you examined in Chapter 4 and which distinguishes between an "improvement" and a mere "repair"—and takes the position that an improvement is substantial if it significantly adds to the value of the home, prolongs the home's useful life, or adapts it to a new use. Repairs that merely maintain the home in good condition, such as repainting the home, are not substantial improvements. If, however, painting is part of a renovation that substantially improves the home, the painting costs can be considered part of the cost of the improvements.[20] Because home equity indebtedness has no use test, it can also be used to construct or acquire a home, as well, meaning that the effective limit on the aggregate amount of purchase debt that can generate deductible interest is actually $1.1 million (rather than $1 million).[21]

In *Voss v. Commissioner*,[22] the co-owners of the couple's two residences were members of a California Registered Domestic Partnership. Recall from Chapter 8 that such partners are not currently considered married for Federal income tax purposes and must file separate returns. On their individual returns, each deducted the interest paid on $1.1 million of indebtedness (a total of $2.2 million of debt) used to purchase the homes, but the IRS claimed that the $1.1 million cap applied on a per-residence basis (not per taxpayer). While the Tax Court agreed with the government, the 9th Circuit Court of Appeals reversed, noting that the statute reduced the $1 million and $100,000 caps to $500,000 and $50,000, respectively, for married couples filing separate returns, which would have been unnecessary if the $1 million and $100,000 caps applied per residence rather than per taxpayer. In addition the § 36 first-time home buyer credit (now expired) of $8,000 was similarly reduced to $4,000 for married couples filing separately, but § 36 went on to provide that unmarried co-owners must allocate the $8,000 between them on their separate returns. No such similar language appears for unmarried co-owners in § 163(h)(3).

To illustrate the mechanics of the cap in the context of a married couple filing jointly, assume that Sara and Jonathan are married and purchase a home in which they will live on January 1 of Year 1 for $1.5 million, paying $200,000 in cash and borrowing $1.3 million, which is secured by the home. They make 11 monthly payments in Year 1 (consisting in part of principal repayment

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[19] *See* § 163(h)(4)(A)(i).
[20] *See* www.irs.gov/publications/p936/ar02.html#en_US_2011_publink1000229991.
[21] Chief Counsel Advice 200940030 (Aug. 7, 2009).
[22] 796 F.3d 1051 (9th Cir. 2015).

and in part of interest), reducing their principal balance to $1.2 million by the end of Year 1. Because no more than $1.1 million can qualify as indebtedness creating "qualified residence interest," Jonathan and Sara cannot deduct the small portion of their aggregate interest payment allocable to the loan principal that exceeds $1.1 million. Thus, Sara and Jonathan must complete a worksheet provided by the IRS to determine this amount. In figuring out the loan amount that exceeds the $1.1 million cap, Jonathan and Sara can, if they wish to keep their calculations simple, use their loan's *highest* balance during the year ($1.3 million in their case), but they are also permitted to use their *average* balance, which will allow them to deduct more of their interest in Year 1 because each monthly payment reduces their principal balance in the most common form of level-payment loan.[23] Once their loan balance is reduced to $1.1 million, 100% of the interest will thereafter satisfy the definition of qualified residence interest, and Sara and Jonathan will be able to deduct 100% of the interest without the need to resort to a worksheet.

Finally, the last sentence of § 163(h)(3)(B)(i) adds that debt incurred to refinance acquisition indebtedness is itself "acquisition indebtedness" to the extent of the principal balance of the refinanced loan. Thus, if interest rates decrease in a later year, and Jonathan and Sara refinance their remaining acquisition indebtedness in order to take advantage of the lower interest rate at a time when their loan balance is, say, $700,000, the new debt is "acquisition indebtedness" to the extent of $700,000. If they borrow $800,000 at the time of refinancing (instead of $700,000) in order to use the extra $100,000 cash to substantially improve their home, the entire $800,000 would qualify as acquisition indebtedness: the first $700,000 would qualify under the refinancing provision, and the remaining $100,000 would qualify because the proceeds satisfy the use test. If, instead, the extra $100,000 is used to purchase a car, pay down credit card debt, and take a trip to Rome, the extra $100,000 could not qualify as "acquisition indebtedness" but could nevertheless qualify as "home equity indebtedness" if Jonathan's and Sara's home is worth at least $800,000 (so that the equity limit is not exceeded).

Because of the generous $1.1 million ceiling for acquisition indebtedness, the ability to use the deduction for two homes, and the ability to use the home equity indebtedness provision to deduct personal consumption interest unrelated to the home, the qualified residence interest deduction is not aimed particularly at the middle class, which is why (as described above) 80% of the benefits of § 163(h)(3) is enjoyed by the top 20% of taxpayers, with only 5% enjoyed by the bottom 60%.

## Problems

**1.** Late last year Joyce and Jane, who are married, purchased a one-bedroom condo in Manhattan for $1.4 million, paying $600,000 in cash and borrowing $800,000, secured by a mortgage on the condo. This year, they pay $40,000 in aggregate interest on this loan. On April 1 of this year, they purchase a second, small home in the Hamptons (on Long Island) for $700,000, paying $400,000 in cash and borrowing $300,000, secured by a mortgage on the home. They pay $10,000 in aggregate interest for the 9 full months that they own the property this year. How much of the $40,000 interest paid on their Manhattan condo mortgage and the $10,000 interest paid on their Hampton home mortgage can they deduct this year under § 163(h)(3)?

[23] On our facts, the worksheet would show that their average balance for Year 1 was $1.25 million, which is lower than the original $1.3 million borrowed, equal to the sum of their $1.3 million balance at the beginning of the year and their $1.2 million balance at the end of the year ($2.5 million) divided by 2. The IRS worksheet takes taxpayers through the process fairly painlessly.

**2.** Same as **1.**, except that Joyce and Jane purchase only the Hampton home, not the Manhattan condo. (They rent their Manhattan condo, instead.) After purchasing the Hampton home in March, they had no plans to renovate the home, as they liked its gently worn appearance. At least, they thought they did. By September, they are tired of the look and decide that it needs substantial improvements, after all. Thus, they hire an architect, designer, and contractor to design and construct a substantial addition to the home, as well as to renovate the old kitchen and bathrooms. The entire project cost is $400,000, all of which is funded by a second mortgage on the home, secured by the home. Thus, in addition to the $10,000 that they pay on the first mortgage this year, they also pay $6,000 in interest for the 4 months of payments on the second mortgage this year. How much of the these interest payments can they deduct this year under § 163(h)(3)?

**3.** Boyce and Bonnie have owned their home, now worth $300,000, for 15 years, and they are proud of the fact that they just recently paid off the original 15-year mortgage. Bonnie was a stay-at-home mom, but Boyce lost his job two years ago and is still looking for a new job. Bonnie found a part-time job to supplement Boyce's unemployment insurance payments, but Bonnie's job does not provide health insurance coverage for the family. While he and Bonnie were able to stay on the health insurance policy of Boyce's old employer for the first year and a half after his layoff, they were uninsured when their 16-year-old daughter Bridget was diagnosed with a devastating kidney disease earlier this year. The doctors gave Boyce and Bonnie little hope that Bridget would survive without a kidney transplant. Fortunately, a donor kidney became available, Bridget underwent the transplant and follow-up care, and she is doing well. The bad news is that the hospital and other bills for her care—even after being very substantially reduced by the hospital after many months of negotiation and providing documentation of their financial situation—totaled $200,000, and Boyce and Bonnie pay these bills by taking out a new mortgage on their home in June, secured by the home. They pay $5,000 in interest on the mortgage for the last 6 months of this year. How much of the this $5,000 can they deduct under § 163(h)(3)?

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As noted above, most economists deeply dislike the qualified residence interest deduction on efficiency grounds, and our exploration above also notes fairness concerns, with the bulk of the tax benefits disproportionately enjoyed by high-income taxpayers. The Urban Institute recently studied the anticipated effects of three possible reforms: (1) eliminating the deduction entirely, (2) capping the amount of debt eligible to produce deductible qualified residence interest at $500,000, and (3) fully replacing the deduction with a refundable 15% tax credit, subject to a $25,000 cap regarding the amount of interest that would be eligible for the 15% credit. Under the last reform, a dollar of interest would provide the same 15 cents of tax savings for taxpayers in the 28% and 39.6% brackets, for example. Thus, the maximum tax savings for taxpayers paying at least $25,000 in mortgage interest in a year would be $3,750 ($25,000 x .15). With respect to each proposed reform, the study simulated the change in tax liability for the bottom quintile, middle quintile, 80$^{th}$ to 99$^{th}$ percentile, and the top 1%. The reform that would produce the least change in tax burdens would be the second: merely capping the amount of eligible debt at $500,000. The most progressive change would be replacing the deduction with a 15% credit, capped at $25,000 of interest, which would actually *reduce* the tax burden of the bottom and middle quintiles while increasing the tax burden for the top 20%—the quintile that benefits the most under the current-

law deduction (instead of credit) approach.[24]

How would these proposed changes affect prices in the housing market? The study concludes that "[t]he current turbulence in housing markets simply makes it extremely difficult to predict the effects of changes" in completely eliminating the qualified residence interest deduction, though there is reason to believe that any short-term drop in prices would stabilize and "may have little effect on housing prices over the longer term." But even those short-term decreases in prices may not occur outside the high-end housing market in the case of the proposed third reform (replacing the deduction with a 15% refundable tax credit), which "could actually stabilize and increase prices of lower-priced homes, whose values continue to lag."[25]

***The exclusion of gain on the sale or exchange of a principal residence under § 121***

Prior to 1997, the Code contained two, separate provisions under which § 1001 gain realized on the sale or exchange of a principal residence could go unrecognized. Under old § 1034 (now repealed), realized gain on the sale of a principal residence could go unrecognized so long as the taxpayer reinvested the entire sale proceeds in a new principal residence of equal or higher price within a specified period of time. If the taxpayer spent less than the entire sale proceeds of the first house when purchasing the second, the realized gain had to be recognized to the extent of the retained cash. Moreover, the basis of the newly purchased residence had to be reduced by any unrecognized gain, preserving it for possible future reckoning. In other words, repealed § 1034 was a rollover provision that operated very much like § 1033 (pertaining to involuntary conversion gain), studied in Chapter 13.

Because many retirees could not take advantage of old § 1034 when they sold the big, family home and either rented or purchased a much smaller (and less expensive) retirement home, old § 121 (prior to its amendment in 1997) provided a one-time, elective exclusion of no more than $125,000 of § 1001 gain realized on the sale of a principal residence if the sellers were at least 55 years old—regardless of whether the taxpayer purchased a new home. If they did purchase a new home, their basis in the new home was not reduced by the unrecognized gain. In other words, old § 121 was a complete forgiveness provision (unlike old § 1034).

In 1997, Congress repealed § 1034 and greatly expanded § 121. No longer is it a one-time election, no longer is its use restricted to those aged 55 or older, and no longer is the amount excluded capped at $125,000. Like old § 121, however, the excluded gain on the sale of house 1 is completely forgiven rather than merely deferred through a basis reduction in newly purchased house 2. Indeed, the seller need not purchase a house 2 but can choose to rent without losing the gain exclusion.

Thus, while old § 1034 (like current § 1033) was a consumption tax provision of the cash-flow consumption tax variety (allowing deferral of income until withdrawn from investment and consumed), § 121 is a consumption tax provision of the wage tax variety (explicitly excluding the capital return)—both of which were described in Chapter 2.

Section 121 generally exempts $250,000 of § 1001 realized gain ($500,000 for married taxpayers filing jointly) on the sale, exchange, or destruction by casualty of a residence if the taxpayer has both owned and lived in the residence as his "principal" residence for at least two of

[24] Those interested in viewing these results in chart form can see them at URBAN INSTITUTE, *supra* note 18.
[25] *Id*.

the five years prior to sale.[26] Thus, while § 163(h)(3) allows interest allocable to *two* homes to satisfy the definition of deductible "qualified residence interest," the exclusion for home sale gain is limited to the sale of the taxpayer's "principal" residence.

To the extent that the gain is realized by casualty and exceeds the $250,000 (or $500,000) limit that can be excluded under § 121, the remaining gain can be deferred (though not forgiven) under § 1033 if the taxpayer otherwise satisfies its terms. Under § 121(d)(5)(B), for purposes of applying § 1033, the "amount realized" is reduced by the amount excluded under § 121.

For example, assume that Lois, who is unmarried and lives in New Jersey, suffered a complete destruction of her fully insured principal residence by Superstorm Sandy. Because Lois had purchased the home 20 years ago, the destroyed house had a $200,000 basis but was worth $600,000 when destroyed. Lois realizes a $400,000 gain under § 1001 when she receives $600,000 in insurance proceeds, $250,000 of which she can exclude under §§ 121(a), (b)(1), and (d)(5)(A). If she decides to rent, Lois must include the remaining $150,000 of realized gain in her Gross Income under § 61(a)(3). If, however, she uses a portion of the insurance proceeds to purchase a principal residence for, say, $400,000 and makes a timely election under § 1033, the remaining $150,000 gain can go unrecognized, as well. Her § 1001 "amount realized" *for purposes of the § 1033 analysis only* is $350,000, equal to the $600,000 in insurance proceeds received *less* the $250,000 that she properly excluded under § 121.[27] Because she rolled over this entire $350,000 deemed "amount realized" into the purchase of her new home (costing $400,000), none of the remaining $150,000 of her realized gain must now be recognized, but she must reduce her $400,000 cost basis in the new home by this unrecognized gain (to $250,000) under § 1033(b)(2).

In general, taxpayers cannot take advantage of § 121 more than once in any 24-month period.[28] If, however, a taxpayer sells a principal residence within 24 months of a prior sale (when gain was excluded under § 121) because of a change in employment, certain health reasons, or certain "unforeseen circumstances,"[29] the taxpayer may be able to exclude some or all of the gain under § 121 on the later sale. In that case, the relevant ceiling ($250,000 or $500,000) will be reduced by a fraction, the numerator of which is the number of months of qualifying use since the last § 121 sale and the denominator of which is 24 months.[30]

For example, assume that Becky, who is unmarried, sells a home, properly excludes her realized gain under § 121, and immediately moves into her newly purchased home. Twelve months later, Becky's employer unexpectedly requires her to move to a new office in another state and purchases her home from her as part of the relocation package. If Becky realizes a gain on this second sale, her § 121 exclusion ceiling is reduced by 50% because she owned and lived in the most recently sold home for only 12 months of the usually required 24 months. Thus, Becky could exclude no more than $125,000 of realized gain (rather than $250,000).

If a taxpayer converts (depreciable) rental property to his personal residence (or properly depreciates a portion of the home's basis under the § 280A home office deduction, studied in Chapter 20), § 121(d)(6) has long provided that the portion of realized gain (on a later sale) equal

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[26] *See* §§ 121(a), (b)(1) & (2), and (d)(5)(A).
[27] *See* § 121(d)(5)(B).
[28] *See* § 121(b)(3)(A).
[29] The list of unforeseen circumstances includes, for example, divorce, death, or multiple births from the same pregnancy, among other circumstances. *See* Treas. Reg. § 1.121-3(e).
[30] *See* §§ 121(c)(1) and (2).

to the prior depreciation deductions is not eligible for exclusion. In addition, Congress amended § 121 in 2008 by adding § 121(b)(5) in an effort to prevent taxpayers with multiple residences from serially moving into each for two-year periods prior to each sale, making each their "principal" residence. Prior to this amendment, taxpayers could easily convert a second vacation home into a "principal residence" simply by moving into it full time for two years prior to sale.

Section 121(b)(5) now requires inclusion of gain attributable to periods of "nonqualified use," not counting periods of nonqualified use prior to January 1, 2009. In general, "nonqualified use" is any use of the home other than as the principal residence of the taxpayer or the taxpayer's spouse or former spouse but does not include periods *after* vacating the home as a principal residence. The amount that fails to qualify for exclusion is the same proportion of the total realized gain as the period of nonqualified use (not counting the period after moving out) bears to the total ownership period (counting the period after moving out). The legislative history provides two examples:[31]

> Example 1: Assume that an individual buys a property on January 1, 2009, for $400,000 and uses it as rental property for two years, claiming $20,000 of depreciation deductions. On January 1, 2011, the taxpayer converts the property to his principal residence. On January 1, 2013, the taxpayer moves out, and the taxpayer sells the property for $700,000 on January 1, 2014. As under present law, $20,000 of gain attributable to the depreciation deductions is included in income. Of the remaining $300,000 gain, 40% of the gain (2 years divided by 5 years), or $120,000, is allocated to nonqualified use and is not eligible for exclusion. Since the remaining gain of $180,000 is less than the maximum gain of $250,000 that may be excluded, gain of $180,000 is excluded from Gross Income.
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> Example 2: Assume that an individual buys a principal residence on January 1, 2009, for $400,000, moves out on January 1, 2019, and on December 1, 2021, sells the property for $600,000. The entire $200,000 gain is excluded from Gross Income, as under present law, because periods after the last qualified use do not constitute nonqualified use.

Even though the period *after* vacating the home is not counted as "nonqualified use," remember that the seller must nevertheless satisfy the threshold requirement that she live in the home as her principal residence for at least two of the five years prior to sale to be eligible for *any* exclusion under § 121(a). For example, assume that Mona, after three years of living in her home, moves out and rents the house to tenants. Four years later, she sells the house. Although Mona owned the home for seven years, and although no part of the period after she moved out of the home is counted as "nonqualified use," Mona cannot exclude any part of her gain under § 121(a) because she did not live in the home as her principal residence for at least two of the five years prior to sale.

## Problem

Charles and Claire are married and both work in Manhattan as a lawyer and investment banker, respectively. They purchase a condo in Manhattan, their principal residence, in 2011 for $2 million

[31] JOINT COMMITTEE ON TAXATION, TECHNICAL EXPLANATION OF DIVISION C OF H.R. 3221, THE "HOUSING ASSISTANCE TAX ACT OF 2008," 63-64, at www.thetaxbook.com/updates/thetaxauthority_update_service/pdf/govdocs/tech_pl110-289.pdf.

and their weekend home in the Hamptons on April 1, 2012, for $1 million. After purchasing the Hamptons home, they spend $300,000 on a large addition and major renovations. When Charles and Claire both retire in 2015, they sell their Manhattan condo for $2.5 million and move into their Hamptons home full time on April 1, 2015. In the winter of 2018, they decide that the cold winters up north are just too much, and they put their Hamptons home on the market. They vacate their home on February 1, 2018, move to Florida, and sell the home on April 1 for $1.9 million. What are the couple's tax consequences under the assumption that § 121 remains unamended for the relevant years?

## B. Personal casualty and theft losses

You have learned that a pure SHS tax base is generally intended to reach amounts spent on personal consumption via deduction disallowance. Thus, you have learned that personal-use property is not depreciable under § 167(a) and that § 1001 losses arising on the sale or exchange of personal-use property are generally not deductible under § 165(c)(3), as those realized value losses represent personal consumption rather than income-production costs. Under SHS principles, you have learned that only costs incurred to produce *includable Gross Income* should be deductible in order to prevent the same dollars from being doubly taxed to the same taxpayer.

Nevertheless, § 165(c)(3) permits certain realized losses with respect to personal-use property to be deducted (subject to severe restrictions found in § 165(h)) *if and only if* the loss arises from "fire, storm, shipwreck, or other casualty, or from theft," rather than from sale or exchange. Why?

The keys to ascertaining the purpose underlying the allowance for personal casualty and theft losses are the floors found in §§ 165(h)(1) and (h)(2)(A). First, under § 165(h)(1), each personal casualty or theft loss can be taken into account only to the extent that it exceeds $100. Second—and more important—the aggregate of personal casualty and theft losses that exceed $100 can generally be deducted only to the extent of (1) realized and recognized personal casualty gains[32] (if any), and (2) the portion of the remainder that exceeds 10% of the taxpayer's AGI. Because of these floors (particularly the steep 10% floor), only personal casualty and theft losses that are relatively extraordinary in amount (compared to the taxpayer's AGI) are effectively deductible under § 165(c)(3). Thus, the deduction for personal casualty and theft losses under § 165(c)(3) is best understood as resting on ability to pay policy grounds rather than on normative tax theory (the definition of "income" under SHS principles). Routine personal casualty and theft losses reflect the expected vicissitudes of everyday life, which require no deviation from SHS principles. An extraordinary loss, however, reflects a reduced ability to contribute to the fisc in that year—even though the loss represents what would otherwise be nondeductible personal consumption.

***Determining whether the loss arises from "theft" or "casualty"***

You wear your expensive (but unfortunately uninsured) diamond brooch to a charity event, and it is gone from your lapel when you arrive home. Have you realized a possible personal "theft" loss to deduct? Or have you merely lost it because of, say, a loose clasp? Revenue Ruling 72-112[33] provides: "To qualify as a 'theft' loss within the meaning of § 165(c)(3), the taxpayer needs only

[32] Recall from Chapter 13 that taxpayers can elect under § 1033 to avoid recognizing realized personal casualty gains to the extent that they roll over the amount realized on the casualty into property "similar or related in service or use" within a certain time period.
[33] 1972-1 C.B. 60.

to prove that his loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent." The burden of proof that the property was stolen under these standards rests with the taxpayer.

How do we distinguish between a "casualty" loss (potentially deductible) and a loss arising from mere use or deterioration over time? Remember that personal-use property is not depreciable, so § 165(c)(3) should not be implemented in a way that would effectively allow deductions for routine loss in value through the backdoor. Under the statutory interpretation canon of construction *noscitur a sociis* (Latin for "it is known from its associates"), the meaning of one word in a list of similar words should be informed by the common features among the words. Thus, the IRS interprets the word "casualty" to require that the damage occur with the suddenness typical of "fire, storm, or shipwreck"—the words accompanying "casualty" in § 165(c)(3). Termite damage to personal-use property does not arise from a "casualty" within the meaning of § 165(c)(3), for example, because the damage occurs slowly, over many years, rather than from "an identifiable event of a sudden, unusual, or unexpected nature."[34]

The mere loss of property, while not deductible as a "theft" loss, can possibly be deductible as a "casualty" loss—on the right facts. For example, in Revenue Ruling 72-592,[35] the IRS acquiesced in the Tax Court's holding in *White v. Commissioner*.[36] In so doing, it elaborated the meaning of "sudden, unusual, or unexpected," quoted just above.

> In the *White* case, the taxpayer-husband accidentally slammed the car door on his wife's hand after helping her alight from the car. Her diamond engagement ring absorbed the full impact of the blow, which broke two flanges of the setting holding the diamond in place. His wife quickly withdrew her injured hand, shaking it vigorously, and the diamond dropped or flew out of the broken setting. The uninsured diamond was never found, and the taxpayer claimed a casualty loss deduction for its value in the year it was lost.
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> The Tax Court, convinced that the diamond was irrevocably and irretrievably lost, sustained the taxpayer's claim, indicating that the diamond was completely removed from the enjoyment of its owner and that it had no value to the owner after the loss. The Service, in acquiescing in the decision, agreed that property that is accidentally and irretrievably lost can be the basis for a casualty loss deduction under section 165 (c) (3) of the Code if it otherwise qualifies as a casualty loss.
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> In other words, the Service position [that property that is merely lost cannot generate a deduction under § 165(c)(3)] is altered only to the extent that the accidental loss of property can now qualify as a casualty. Such losses must, of course, qualify under the same rules as must any other casualty; namely, the loss must result from some event that is (1) identifiable, (2) damaging to property, and (3) sudden, unexpected, and unusual in nature. The meaning of the terms "sudden, unexpected, and unusual," as developed in court decisions, is set forth below.
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> To be "sudden" the event must be one that is swift and precipitous and not gradual or progressive.

[34] Rev. Rul. 63-232, 1972-2 C.B. 101.
[35] 1972-2 C.B. 101.
[36] 48 T.C. 430 (1967).

> To be "unexpected" the event must be one that is ordinarily unanticipated that occurs without the intent of the one who suffers the loss.
>
> To be "unusual" the event must be one that is extraordinary and nonrecurring, one that does not commonly occur during the activity in which the taxpayer was engaged when the destruction or damage occurred, and one that does not commonly occur in the ordinary course of day-to-day living of the taxpayer.

The taxpayer's intentional destruction of property (*e.g.*, arson) is "sudden" but is nevertheless not deductible as a casualty loss, as discussed more thoroughly in Chapter 20. Damage arising from mere "negligence" by the taxpayer, however, can result in a deductible loss.[37]

***Determining the amount and character of a personal casualty or theft loss and whether it is an Itemized Deduction or Above-the-Line Deduction***

Suppose that Claire purchases a rare vase dating from the Ming Dynasty for $600,000, which she places on the mantel in her living room to enjoy. Claire is not a dealer in Ming Dynasty vases, so she holds the vase as a capital asset. Many years later, the vase is appraised at $1 million, shortly after which Claire's grandson accidentally knocks it off the mantel, shattering it into hundreds of pieces (beyond repair). Unfortunately, Claire's insurance for the vase has lapsed. Before applying the floors in § 165(h), what is the amount of Claire's § 165(c)(3) deduction?

The $400,000 increase in the vase's value since Claire's purchase was never included in Claire's Gross Income because of the realization requirement. In order to avoid a double tax benefit (both exclusion and deduction) for the same dollars, you know by now that Claire's loss should therefore be limited to no more than her $600,000 basis, and § 165(b) confirms this result. (Only if Claire were forced to include in Gross Income that increase in value each year under a mark-to-market system would she thereby create additional basis to deduct on the vase's eventual destruction).

Suppose, instead, that the damage is less severe. Instead of hundreds of pieces, the vase is broken into three large segments, and an art restorer is able to painstakingly repair the piece at a cost of $100,000. After the damage but before the restoration, the pieces are appraised at only $200,000 (down from $1 million), and the appraiser determines that this $800,000 loss in value is attributable entirely to the casualty, rather than to a general market decline in the value of Ming Dynasty vases.[38] After the restoration, the piece is appraised at $400,000. Two questions arise. First, what is the amount of Claire's personal casualty loss? Second, how must Claire treat the $100,000 cost incurred to restore the piece?

Because 80% of the property's value was destroyed by reason of the casualty, the conceptually correct answer to the first question would start with a deduction (before applying § 165(h)) of only 80% of her $600,000 basis ($480,000). In this way, the destruction would be deemed to come *proportionately* from each of the unrealized appreciation (not deductible) and her basis (deductible). Claire is treated more favorably, however, under Treas. Reg. § 1.165-7(b), which provides that the measure of Claire's loss is equal to the *lesser* of (i) the reduction in FMV arising from the casualty or (ii) the property's basis. The reduction in value arising from a casualty must generally be obtained by "competent appraisal," though repair costs can serve as a proxy in certain

[37] *See, e.g.*, Treas. Reg. § 1.165-7(a)(3) (allowing deduction of automobile damage arising from faulty driving so long as the damage "is not due to the willful act or willful negligence" of the taxpayer).
[38] *See* Treas. Reg. § 1.165-7(b)(2)(i).

circumstances.[39] On these facts, Claire would use the appraisals, as they show a larger loss in value than was incurred in repair costs. Thus, the amount described in (i) is $800,000 ($1 million FMV immediately before the casualty *less* the $200,000 FMV immediately afterward), and the amount described in (ii) is $600,000 (the vase's basis). Claire's deduction (before applying § 165(h)) is equal to her *entire* $600,000 basis, just as though the property were completely (instead of only partially) destroyed. How fortunate for Claire!

Let's suppose that Claire's AGI is $400,000 (without regard to the personal casualty loss itself) and that Claire realizes no personal casualty gains for the year. Under § 165(h)(1), Claire's $600,000 deduction is first reduced to $599,900. Claire's allowable loss deduction under § 165(h) is an Itemized Deduction rather than one taken above the line under § 62(a)(3) in reaching AGI because § 62(a)(3) applies only if the loss is realized by "sale or exchange." Thus, Claire's AGI remains $400,000 for purposes of applying § 165(h)(2), under which her deduction is further reduced by 10% of her $400,000 AGI ($40,000) to $559,900. Even though Claire holds the vase as a capital asset, her Itemized Deduction is an ordinary one because the loss does not arise from the "sale or exchange" of a capital asset but rather arises from a casualty event. Thus, Claire avoids the § 1211(b) capital loss limitation rule.

Claire clearly will itemize her deductions this year (rather than take the Standard Deduction) because her personal casualty loss deduction alone exceeds her Standard Deduction. Thus, Claire will benefit from this deduction. Because Claire is permitted to deduct $559,900 of her basis, she must reduce her $600,000 basis by this amount (to $40,100) to prevent her from using this basis a second time as an offset against amount realized on any future sale or exchange (to avoid a double tax benefit for the same dollars). Under Treas. Reg. § 1.263(a)-3(k)(1)(iii), Claire must then capitalize the $100,000 restoration cost, increasing her basis to $140,100.

How would these results change if Claire also realizes and recognizes a personal casualty *gain* in the same year? Suppose, for example, that Claire has two Ming Dynasty vases (instead of one), both of which are knocked off the mantel by her grandson. The first (Vase 1), which is uninsured, is the one described above, producing a $600,000 loss before applying § 165(h). The second (Vase 2) was purchased for $400,000, was appraised at $700,000 immediately before the casualty, and is completely destroyed in the accident. Unlike Vase 1, however, Vase 2 is fully insured, and Claire receives an insurance check for $700,000 after filing a claim, producing a $300,000 personal casualty gain under § 1001 ($700,000 A/R *less* $400,000 A/B). Because Claire does not purchase a new Ming Dynasty vase with the insurance proceeds, she is unable to avoid recognizing this $300,000 realized gain under § 1033, which increases her AGI (for the moment) from $400,000 to $700,000 for the year. How much of her $600,000 personal casualty loss arising on the damage to Vase 1 can Claire deduct under § 165(h)?

As in the prior case, Claire's $600,000 personal casualty loss with respect to Vase 1 is first reduced by $100 to $599,900 under § 165(h)(1). The amount of this $599,900 loss that is deductible under § 165(h)(2) is determined in two steps. First, under § 165(h)(2)(A)(i), Claire can deduct $300,000 (equal to her personal casualty gain), and this portion of the deductible loss is taken above the line in reaching AGI (notwithstanding that this loss does not arise on "sale or exchange" within the meaning of § 62(a)(3)) under the authority of § 165(h)(5)(A)—just enough to perfectly offset her includable $300,000 personal casualty gain. Thus, her AGI for purposes of applying § 165(h)(2)(A)(ii) is, as in the prior case, only $400,000 (instead of $700,000). Second,

[39] *See* Treas. Reg. § 1.165-7(2)(ii).

under § 165(h)(2)(A)(ii), Claire can deduct $259,900 (equal to the excess of the remaining $299,900 loss over 10% of her $400,000 AGI) as an Itemized Deduction.

In sum, Claire (1) fully includes her $300,000 personal casualty gain in Gross Income, (2) deducts $300,000 of her $599,900 personal casualty loss above the line (effectively offsetting the $300,000 Gross Income inclusion), and (3) deducts $259,900 of the remaining loss as an Itemized Deduction. Once again, none of the gains and losses are capital (notwithstanding that Claire holds the vases as capital assets) because the "sale or exchange" requirement under § 1222 is failed.

Rarely does a taxpayer realize more personal casualty gains than losses. For the sake of illustration, however, suppose that Claire realizes a $600,000 personal casualty loss with respect to Vase 1 and a $700,000 personal casualty gain (instead of $300,000) with respect to Vase 2. First, the 10% floor in § 165(h)(2)(A)(ii) is not applicable, as § 165(h)(2)(A) expressly applies *only* in the more usual case in which personal casualty losses exceed personal casualty gains. Thus, Claire can fully deduct the $599,900 personal casualty loss remaining after applying § 165(h)(1). Second, both the gains and losses are "treated" as capital gains and losses under the authority of § 165(h)(2)(B), notwithstanding that they do not arise from a "sale or exchange." Because the gains exceed the losses, § 1211(b)'s capital loss limitation rule should not be a hindrance in this case, unless Claire has significant capital losses from other sources, as well. If Claire realizes no other capital gains and losses for the year, and if she held both vases for more than one year before the casualty event, the net casualty gain is, in effect, treated as preferentially taxed "net capital gain" within the meaning of § 1222(11), as described in Chapter 15.

Finally, § 165(i) allows a taxpayer suffering a casualty in Year 2 to elect to take the allowable loss deduction in the year preceding the casualty (Year 1) by filing an amended return *if and only if* the loss is attributable to a Federally declared disaster and occurs in the disaster area. By filing an amended return for the prior year that contains the new casualty loss deduction, the taxpayer can obtain a refund of tax just when it can best be used (in the year of the disaster). Absent this rule, the taxpayer would have to wait until the filing season commences for the disaster year (Year 3) to file a tax return that obtains the benefit of the deduction.

**Problem**

Scott and Sally own a boat, which they purchased several years ago for $60,000 and use for recreational purposes. They had it appraised earlier this year for insurance purposes at $40,000, but they had not yet obtained coverage when a severe storm damages the boat. After the storm, Scott and Sally have the boat appraised at $30,000. They pay $7,000 to repair the storm damage. Without regard to any possible casualty loss deduction, Scott's and Sally's AGI is $70,000.

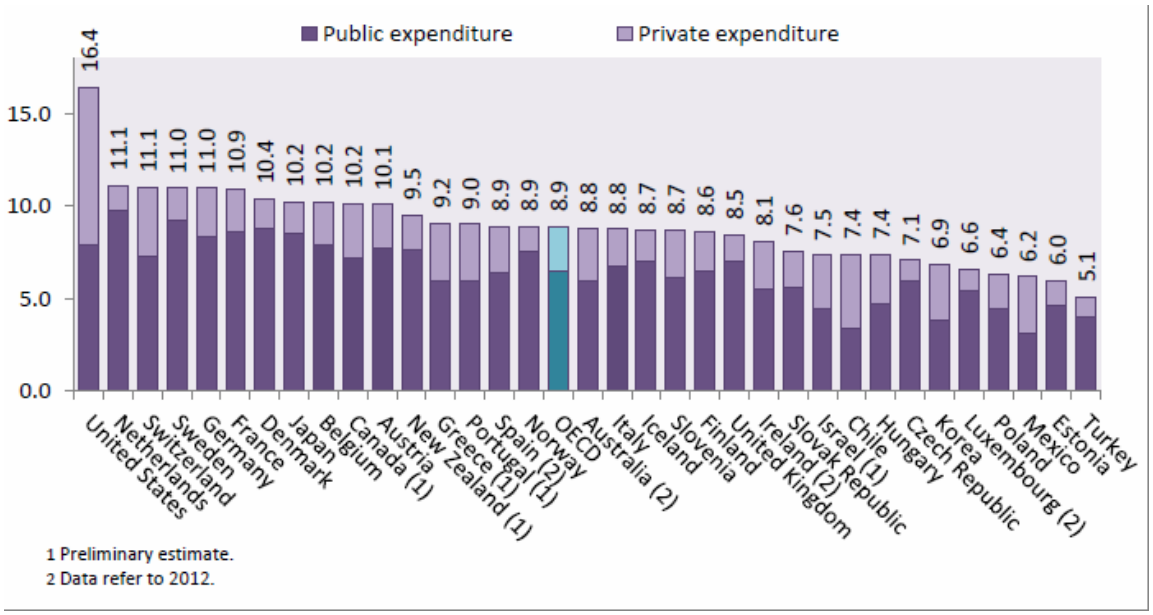
**a.** How much, if any, can Scott and Sally deduct under §§ 165(c)(3) and (h)?

**b.** How would your answer change if they also receive an insurance check in the same year for $8,000 to compensate them for the theft of Sally's insured diamond engagement ring, which Scott had purchased years ago for $6,000? They decide not to purchase another diamond ring with the insurance payment but rather to use the money for a romantic trip to Paris.

## C. Health care

Americans spend far more—at least 5 percentage points of GDP more—on health care than do

citizens of most other developed nations, with approximately 53% spent in the private sector and 47% in the public sector (primarily Medicare and Medicaid). The chart below shows spending as a percentage of GDP in 2012 or the nearest year for which data is available. [40] The United States is at the far left in the chart.




Though we spend significantly more, we do not necessarily get more bang for our buck, with data showing that our "actual quality of health is no better than in countries that spend a fraction of what we spend on healthcare. A major reason for that is that we simply spend more for the same procedures and drugs and have far higher administrative overhead than countries with single-payer systems."[41] For example, one study revealed that the average price of a hip replacement is $40,364 in the U.S. and $7,731 in Spain; the average price of an M.R.I. scan is $1,121 in the U.S. and $319 in the Netherlands; the average price of a Lipitor supply is $124 in the U.S. and $6 in New Zealand.[42] In addition, the American method of providing care to pregnant women and the item-by-item method of charging for that care results in Americans paying more for childbirth than those in any other industrialized nation. "Despite its lavish spending, the United States has one of the highest rates of both infant and maternal death among industrialized nations, although the fact that poor and uninsured women and those whose insurance does not cover childbirth have trouble getting or paying for prenatal care contributes to those figures."[43] Of course, these price differentials are captured as income by various health-care market participants (doctors and other health-care providers; insurance companies; medical device manufacturers, owners, and operators; pharmaceutical companies; *etc.*), creating strong and powerful interests that resist change. In a competitive market, providers would compete on price, bringing down overall costs, but the U.S.

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[40] *OECD Health Statistics 2015, Focus on Health Spending*, at www.oecd.org/els/health-systems/health-data.htm. Reprinted with permission.

[41] Bruce Bartlett, *U.S. Taxes and Government Benefits in an International Context*, 127 TAX NOTES 1429, 1430 (2012).

[42] *See* Elisabeth Rosenthal, *The $2.7 Trillion Medical Bill*, at www.nytimes.com/2013/06/02/health/colonoscopies-explain-why-us-leads-the-world-in-health-expenditures.html?_r=0.

[43] Elisabeth Rosenthal, *American Way of Birth Costliest in the World*, N.Y. TIMES , Jul. 1, 2013, at A1, at www.nytimes.com/2013/07/01/health/american-way-of-birth-costliest-in-the-world.html?pagewanted=all&_r=0.

health-care market does not operate like other U.S. consumer markets for, say, TV sets.

> "In the U.S., we like to consider health care a free market," said Dr. David Blumenthal …. " but it is a very weird market, riddled with market failures." …. If the American health care system were a true market, the increased volume of colonoscopies—the numbers rose 50 percent from 2003 to 2009 for those with commercial insurance—might have brought down the costs because of economies of scale and more competition. Instead, it became a new business opportunity.[44]

Why bring these matters up in a textbook on the individual income tax? The exclusions from Gross Income for employer-provided health care under §§ 105(b) and 106 have long been identified as significant contributing factors in these market failures, and the Internal Revenue Code has been more recently used as a tool in the "consumer-driven movement" toward health-care cost containment with the introduction of health savings accounts coupled with high-deductible insurance plans. Before we discuss these provisions, however, let's first consider the § 213 deduction for certain medical expenses, which stands on a different footing.

***The § 213 deduction for certain medical costs***

Section 213(a) provides that the uncompensated costs for medical care of the taxpayer, as well as of his or her spouse and dependents, can be deducted to the extent that the aggregate exceeds 10% of the taxpayer's AGI, increased from 7.5% of AGI for years prior to 2013. As explored in Chapters 8 and 9, members of a civil union or registered domestic partnership are not considered married for Federal income tax purposes, so medical expenses paid by Mary for health care provided to her civil partner Monica could be deducted by Mary (to the extent exceeding 10% of Mary's AGI) only if Monica qualified as Mary's dependent within the meaning of §§ 151 and 152.

The 10% floor serves the same purpose here as in the case of personal casualty and theft losses, described in Part B. That is to say, the § 213 deduction for uncompensated medical expenses is best understood as resting on ability to pay policy grounds rather than on normative tax theory (the definition of "income" under SHS principles). Routine medical expenses reflect the expected vicissitudes of everyday life. An extraordinary amount of medical expenses relative to income, however, reflects a reduced ability to contribute to the fisc in that year—even though the costs represent what would otherwise be nondeductible personal consumption.

The § 213 deduction is an Itemized Deduction but is not a § 67 MID (because § 213 has its own floor). Recall that only about 30% of taxpayers itemize, with the remainder taking the Standard Deduction. Thus, even before the recent increase in the AGI floor from 7.5% to 10%, relatively few tax returns showed a § 213 deduction. Nevertheless, let's spend a few moments considering the broad outline of the sorts of costs that are potentially deductible under § 213.

"Medical care" is defined in § 213(d)(1)(A) as encompassing costs paid "for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body." Additional subsections explicitly list health and dental insurance premiums, including qualified long-term care insurance (subject to certain age-related limits), certain transportation costs (including lodging) incurred to travel to the place of treatment, and prescription drugs. While cosmetic surgery literally affects a "structure" of the body, Congress added § 213(d)(9) in 1990 to deny deduction in such cases unless the surgery is necessary to "ameliorate a deformity arising from … a congenital abnormality, a personal injury resulting from

[44] *Id.*

an accident or trauma, or disfiguring disease." For example, the IRS states that the cost of breast reconstruction surgery after a mastectomy for breast cancer is deductible but that the cost of breast augmentation surgery merely to improve personal appearance is not.[45]

The disease need not be physical. Treas. Reg. § 1.213-1(d)(1)(ii) specifically mentions costs incurred to ameliorate a "mental defect or illness," including costs paid to a psychiatrist or psychologist. In *O'Donnahbain v. Commissioner*, [46] the Tax Court held in a reviewed decision (with 8 judges in the majority, 5 judges concurring, and 3 judges dissenting) that gender identity disorder is a "disease" within the meaning of § 213(d)(1)(A), that the costs for Ms. O'Donnahbain's hormone therapy and male-to-female sex reassignment surgery were incurred for the treatment of the disease and thus were generally deductible, but that her breast augmentation surgery was cosmetic surgery within the meaning of § 213(d)(9), the cost of which was nondeductible because the surgery was directed at improving her appearance rather than meaningfully treating the disease.

Notice that § 213(a) uses the word "expenses," which you have learned is a tax term of art to mean current wealth decreases, *i.e.*, the opposite of "capital expenditures" (a mere change in the form in which wealth is held rather than a current wealth decrease). Treas. Reg. § 1.213-1(e)(iii) recognizes that "[c]apital expenditures are generally not deductible for Federal income tax purposes." Nevertheless, the regulation further provides that an outlay that otherwise satisfies the definition of medical care "shall not be disqualified merely because it is a capital expenditure." Examples provided in the regulation include eye glasses, a seeing-eye dog, artificial teeth and limbs, and a wheelchair. The reason for this rule is that the long-lived asset would not otherwise be depreciable under §§ 167 and 168 because it is a personal-use asset. Thus, they are, in effect, *treated* as though they were "expenses" (rather than capital expenditures) for purposes of § 213.

Moreover, a medical capital expenditure that permanently improves other property, such as a personal residence, may be deductible as a medical "expense"—if it otherwise satisfies the definition of medical care—but only to the extent that the cost exceeds the increase in value to the underlying property. Here is the example provided in the same regulation.

> Such a situation could arise, for example, where a taxpayer is advised by a physician to install an elevator in his residence so that the taxpayer's wife who is afflicted with heart disease will not be required to climb stairs. If the cost of installing the elevator is $1,000 [the low cost reflecting this 1960s vintage regulation] and the increase in the value of the residence is determined to be only $700, the difference of $300 … is deductible as a medical expense.

The regulation also confirms that the cost of maintaining and repairing such improvements are generally 100% deductible, even if less than 100% of the original installation cost was deductible.

***The §§ 105(b) and 106 exclusions for employer-provided health care (and the § 162(l) deduction for the self-employed)***

Absent §§ 105(b) and 106, amounts paid by an employer for employee health care would be treated under the *Old Colony Trust* two-step as (1) received by the employee (includable in Gross Income under § 61(a)(1) as compensation for services rendered) and (2) paid by the employee to the insurance company or other health care provider (deductible under § 213 only to the extent

[45] *See* IRS Publication 502 at www.irs.gov/pub/irs-pdf/p502.pdf.
[46] 134 T.C. 34 (2010).

exceeding 10% of AGI). Sections 105(b) and 106, however, provide authority for employees to exclude 100% of health care purchased or provided by their employers, with no floor or ceiling.[47]

As indicated in the chart at the beginning of this chapter, the §§ 105(b) and 106 exclusions for employer-provided health care are huge revenue losers. Moreover, self-employed individuals are permitted to deduct 100% of the cost of health insurance premiums as a business expense under § 162(*l*) (and to exclude benefits received under the plan under § 104(a)(3)), unhampered by the 10% floor otherwise applicable under § 213 to other individuals who must purchase health insurance in the individual market because they are either (1) employees (rather than self-employed individuals) whose employers do not offer health insurance or (2) unemployed.[48]

Some say that the exclusion for employer-provided health coverage is an historical accident dating to WWII. The Stabilization Act of 1942 imposed strict wage and price controls to tamp down rampant inflation as employers competed for suddenly scarce workers while many men were fighting overseas. Remember Rosie the Riveter? The Act made "raises difficult during a time of acute labor shortages."[49] But the Act did not limit employer competition over insurance and pension benefits. Health insurance was relatively inexpensive in this era of low-tech health care (penicillin was just recently discovered in 1928), so more employers began to offer group coverage for employees as a way to attract them away from other employers (though some employers had offered such group coverage even before 1939). "'It was just a way to allow employers to evade the wage and price controls of World War II,' MIT health economist Jonathan Gruber told NPR…. 'And it's sort of grown exponentially since, and there really isn't a single healthcare expert who would design a system from scratch which would include this feature.'"[50]

Without precise statutory authority, the IRS (critically) ruled that this insurance coverage would be excludable from Gross Income, notwithstanding the predecessor to § 61(a)(1). In addition, the National Labor Relations Board ruled in 1948 that fringe benefits could be the subject of collective bargaining, which furthered the growth of employer-provided health insurance as part of union collective bargaining agreements. In 1953, "the IRS issued a revenue ruling that effectively reversed its previous stance, declaring employer contributions to employee health insurance plans to be taxable income for the employee."[51] Congress reacted in 1954 by adding §§ 105(b) and 106, effectively codifying the earlier IRS ruling. And we were off to the races!

Fully three-fifths of the population under age 65 benefit from the exclusions under §§ 105(b) and 106.[52] Group insurance (which typically has lower rates than insurance purchased on the individual market) need not be confined to groups defined by employment; geographic or other groups could work just as well. But the current statutory scheme encourages employers to provide group health insurance instead of paying the equivalent cash wages to their employees and allowing them to purchase group health insurance directly (because the employees would then be saddled with

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[47] Section 106 permits exclusion of employer-paid *coverage* under a health insurance plan, whether self-funded by the employer or purchased from a third-party insurance carrier, for the employee taxpayer, his or her spouse, and dependents. Section 105(b) permits the same taxpayers to exclude the *benefits received* (including reimbursement from an employer of costs incurred) for medical care described in § 213.

[48] Because the health costs are treated as business expenses under § 162, the self-employed can take these deductions above the line in reaching AGI under § 62(a)(1).

[49] Joseph J. Thorndike, *The Deliberate Creation of the Most Expensive Tax Preference*, 137 TAX NOTES 1141 (2012).

[50] *Id.*

[51] *Id.*

[52] Bob Lyke, CONGRESSIONAL RESEARCH SERVICE, *The Tax Exclusion for Employer-Provided Health Insurance: Policy Issues Regarding the Repeal Debate*, at www.allhealth.org/briefingmaterials/rl34767-1359.pdf.

the 10% floor in § 213).

On the face of the statute, the *employee* appears to be the target of this tax benefit. Recall, however, that the more broadly available the tax expenditure, the more likely it is to be captured (at least in part) by other actors in the marketplace through the price mechanism. One set of actors capturing part of the economic benefit of the exclusion is likely employers.

To illustrate, let's keep the math simple by assuming a flat 25% tax rate with no Standard Deduction or Personal Exemption Deduction. Carl is an unmarried employee. Compare two scenarios for Carl. In Scenario 1, Carl's employer pays to him $80,000 in cash wages and provides no employer-paid health care plan. Carl uses $7,500 of his wages to purchase health insurance directly for the year (in a group market defined by, say, geography rather than employment). In Scenario 2: Carl's employer pays to him $70,000 in cash wages and provides coverage under a group health care plan, paying 100% of the $7,500 premium that Carl would otherwise have to pay.

Notice that Carl enjoys health-care coverage in both scenarios and is in precisely the same *after-tax* cash position in both. In Scenario 1, no portion of the premium is deductible by Carl under § 213 because no part exceeds the 10%-of-AGI floor. Thus, Carl would owe a $20,000 tax on his unreduced $80,000 wages ($80,000 x .25) and would have $52,500 of cash left in hand ($80,000 wages *less* $20,000 tax *less* $7,500 nondeductible insurance premium). In Scenario 2, Carl would exclude the $7,500 value of the employer-provided health insurance coverage under § 106 and would owe a $17,500 tax on his $70,000 cash wages ($70,000 x .25), leaving precisely the same $52,500 of cash in hand. Thus, Carl would be indifferent between these two employment packages. But is the *employer* indifferent?

Carl's employer can deduct the compensation paid to Carl as a business expense under § 162(a)(1), whether paid entirely in cash directly to Carl or partly to an insurance company in the form of health-care coverage for Carl (and without regard to whether Carl can exclude the coverage from his Gross Income). Thus, while Carl is indifferent between the two employment packages, Carl's *employer* is better off by $2,500 under Scenario 2, paying only $77,500 in before-tax compensation, compared to $80,000 in Scenario 1. In short, Carl's *employer* was able to capture part of the economic benefit of the § 106 exclusion in the form of depressed cash wages. When the Patient Protection and Affordable Care Act (Obamacare) was being debated, big business (employers) lobbied heavily against reducing the § 106 exclusion.

Other actors that capture part of this benefit include doctors, hospitals, insurance companies, and other health-care providers, who benefit from the increased demand that comes from consumers when they purchase more and more of what looks like "free" health care to them. Prices rise and the number of procedures rise, contributing to the escalating rate of health-care cost inflation. Thus, between 1999 and 2009 (before the Patient Protection and Affordable Care Act was signed into law in 2010), the economy grew by about 20%, but health care costs increased by about 50%.[53]

Both liberal and conservative economists agree that the most straightforward way to reduce health-care spending would be to repeal or reduce the § 106 exclusion.

There is near universal agreement among economists that the exclusion should be

[53] David Leonhardt, *Health Care Reform and the Unpopular T-Word*, at www.nytimes.com/2009/07/29/business/economy/29leonhardt.html [hereinafter Leonhardt, *The Unpopular T-Word*].

> eliminated or curtailed. It creates an unwarranted bias in favor of employer-provided over self-financed health insurance. It creates a bias for compensation to be paid out in the form of health insurance instead of wages. It contributes to spiraling healthcare costs. And as an exclusion from taxable income, it favors the wealthy over the poor.[54]

"Yet many politicians are loath to come out against the exclusion, for the obvious reason that it makes them sound pro-tax."[55]

Employee cognitive perceptions play a part, as well. Some taxpayers recognize that the economic burden of a positive tax nominally imposed on one party can be shifted (to a greater or lesser extent) to other actors in the marketplace. For example, when policy analysts discuss the possible adoption of a carbon tax imposed on energy companies, taxpayers often recognize that the economic pain of that tax is likely to be shifted to consumers (at least in part) in the form of higher energy prices. Yet, those same taxpayers are often resistant to the notion that tax *benefits* ostensibly directed at them can be captured by others through the price mechanism, as well. Most employees *think* that the tax exclusion for employer-provided health care benefits them entirely, and their union representatives are vocal against its repeal or reduction. John Q. Public often does not understand that his cash wages are being artificially depressed and that health care costs are higher than they otherwise would be—in short that the exclusion is, at least to some extent, captured by others. This cognitive bias makes it very difficult for policymakers to discuss limiting the § 106 exclusion calmly.

An example of this phenomenon can be seen in a feature adopted in the Patient Protection and Affordable Care Act. While economists argued for a limit in the amount that can be excluded under § 106 (a reduction of *the tax benefit*), Congress instead adopted the so-called Cadillac tax—*a positive tax*—to reach (essentially) the same economic end result but perhaps in a more politically palatable manner. Originally scheduled to begin 2018 but now deferred until 2020 under the Protecting Americans from Tax Hikes Act of 2015, a nondeductible 40% excise tax will be imposed on the "excess benefit" provided to any employee in 2020 and later years under an employer-provided health care plan. The "excess benefit" is generally defined as the amount exceeding $10,200 for an individual and $27,500 for families, increased each year by the Urban Consumer Price Index. The notable feature for purposes of this discussion is that the tax is imposed on the *insurance provider* (the insurance company providing the plan or the administrator of the plan in the case of an employer that self-insures).

> The tax doesn't fall directly on workers. It doesn't even fall on employers. It falls on everyone's favorite villain: health insurance companies…. Presumably, insurers would pass the cost of the tax onto companies, which would then become less willing to offer expensive plans. They would instead shift some of the money they are now spending on health insurance into cash compensation, which would, of course, be taxed, raising more revenue.[56]

In other words, the so-called Cadillac Tax is really just one means of effectively limiting the § 106 exclusion at the top end, though in a more convoluted manner, which should help to ameliorate the distortions caused in the marketplace by the exclusion. The main reason why this attempt to limit

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[54] Martin A. Sullivan, *The Employer Healthcare Exclusion's Role in Tax Reform*, 137 TAX NOTES 462 (2012).
[55] Leonhardt, *The Unpopular T-Word*, *supra* note 57.
[56] *Id.*

the § 106 exclusion had to be "dressed up with a whole lot of lipstick"[57] is, in part, attributable to how we are wired cognitively.

Policy analysts continue to argue, however, for capping the § 106 exclusion directly. For example, the Urban Institute published a study in May 2013 advocating limiting the exclusion for income and payroll tax purposes at the 75th percentile of 2013 premiums, indexed thereafter by GDP growth. "The policy would produce $264.0 billion in new tax revenues over the coming decade while preserving 93 percent of the tax subsidies available under the current policy."[58]

***The consumer-driven, health-care movement: HSAs and high-deductible plans***

Even before Obamacare, Congress has used the Internal Revenue Code as a tool in battling the intransigent market failures that contribute to health-care cost inflation. For example, Congress created Health Savings Accounts (HSAs), which require an accompanying high-deductible health insurance plan, by enacting § 223 in 2003 (with a later companion provision for employer-provided HSA plans). To appreciate the extraordinary tax treatment of HSAs in § 223, recall that amounts added to savings accounts would be nondeductible (as capital expenditures) under SHS income tax principles and that the earnings in the account (in excess of basis) would be taxed as accrued. You learned in Chapter 2 that some savings accounts are afforded preferential cash-flow consumption tax treatment, such as savings in Individual Retirement Accounts (IRAs) and § 401(k) plans, under which contributions are *deducted* (or excluded if made by an employer), earnings are not taxed as accrued, but withdrawals are *fully included*, as the taxpayer would have no basis in the account. You saw in Chapter 2 how investors generally enjoy a higher after-tax return over time under cash-flow consumption tax treatment than under SHS income tax treatment. The extraordinary achievement of the HSA is that it produces even *better* than consumption tax treatment! **Under § 223, (1) contributions to the HSA are deductible (or excludable if made by the insured's employer), (2) the earnings on the account are not taxed as they accrue, and (3) withdrawals are excludable to the extent spent on medical care within the meaning of § 213.**[59] The catch is that, for a savings account to be eligible for this extraordinarily favorable treatment, the taxpayer must have a high-deductible health insurance plan.[60] The HSA is intended to help the taxpayer save for the out-of-pocket costs required under the high-deductible plan.

Withdrawals from an HSA that are not spent on medical care are includable in Gross Income (as they would be under a cash-flow consumption tax) and subject to an additional 20% penalty, but the penalty is avoided if the taxpayer has reached the Medicare retirement age. In other words, HSAs can be seen more crassly as nothing more than, in effect, an increase in the contribution limits that otherwise apply to IRAs and § 401(k) plans for the "healthy, wealthy, and wise." If the taxpayer merely waits until retirement, the withdrawn funds are treated no worse than they would be treated under an IRA or § 401(k) plan if not spent on medical care (and treated better if spent

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[57] *Id.*

[58] Lisa Clemons-Cope, Stephen Zuckerman & Dean Resnick, *Limiting the Tax Exclusion of Employer-Sponsored Health Insurance Premiums: Revenue Potential and Distributional Consequences*, at www.urban.org/UploadedPDF/412816-Limiting-the-Tax-Exclusion-of-Employer-Sponsored-Health-Insurance-Premiums.pdf.

[59] The § 223 deduction is taken above the line in reaching AGI under § 62(a)(19).

[60] For 2017, § 223 requires a health plan with an annual deductible of at least $1,300 for an individual ($2,600 for family coverage) and maximum out-of-pocket expenses of $6,550 for individual coverage ($13,100 for family coverage). The 2017 maximum contribution to an HSA is $3,400 for self-only coverage under a high-deductible plan and $6,750 for family coverage. *See* Rev. Proc. 2016-28, 2016-20 I.R.B. 852.

on medical care).

Why did Congress wish to encourage high-deductible health care insurance plans to such an extent that it created savings accounts that afford *better* than consumption tax treatment? The enactment was in furtherance of what has come to be called the consumer-driven, health-care movement. Supporters of this movement believe that the chief culprit behind the high rate of U.S. health-care cost inflation is "moral hazard," the risk that consumers overuse services for which they do not personally bear the economic cost. The idea is that if patients bear more of the out-of-pocket cost of health care, they will become more discerning consumers—shopping around for the best price for a needed procedure or drug and avoiding unnecessary care—which would unleash competitive forces in the market that will drive down health-care costs and expand access.

Critics of the consumer-driven, health-care movement[61] argue, among other things, that studies show that consumers facing high deductibles avoid preventive and necessary treatment in about the same proportion as unnecessary treatment. In addition, consumers cannot easily obtain information that would enable them to effectively "comparison shop" regarding the costs of, say, a hip replacement, as they would for a TV.

> "I can get the price for a car, for a can of oil, for a gallon of milk. But health care? That's not so easy." Dr. Peter Cram, an associate professor of internal medicine at the University of Iowa and co-writer of a paper describing efforts to procure price estimates for a hip replacement from more than 100 hospitals. Only half the hospitals could provide any kind of estimate, and those that did quoted figures that ranged from $11,100 to $125,798.[62]

In addition, some argue that consumer-driven health care comes at the price of greater inequality. High-deductible insurance policies are attractive to the young and healthy. As they opt out of traditional insurance pools, however, the risk pool in traditional insurance plans will worsen and premiums will rise even faster. Insurance works best when the risk pool contains a broad swath of randomly assigned people. The real losers will be poorer workers with chronic illnesses.

***The § 36B premium health care credit***

Under § 36B, which was enacted as part of the Affordable Care Act, taxpayers with AGI between 100% and 400% of the poverty level (based on household size) are eligible for tax credits to help pay for health care premiums purchased over their state's health insurance marketplace. These credits are paid directly to the insurance company providing their coverage each month, thus reducing the taxpayer's monthly out-of-pocket premium costs, unless the taxpayer prefers to wait and take the tax credit on her annual tax return.

The amount of the credit is equal to the lesser of (1) the taxpayer's premium for the chosen plan and (2) the cost of the state's second-lowest "silver" plan (the benchmark plan) *less* the taxpayer's expected contribution for coverage, which is based on a sliding scale. For example,

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[61] *See, e.g.*, TIMOTHY S. JOST, HEALTH CARE AT RISK: A CRITIQUE OF THE CONSUMER-DRIVEN MOVEMENT (Duke University Press 2007).

[62] Elisabeth Rosenthal, *Price for a New Hip? Many Hospitals are Stumped*, at http://well.blogs.nytimes.com/2013/02/11/price-for-a-new-hip-many-hospitals-are-stumped/. *See also* Gina Kolata, *What Does Birth Cost? Hard to Tell*, at http://well.blogs.nytimes.com/2013/07/08/what-does-birth-cost-hard-to-tell/ (describing an uninsured pregnant woman's attempts to comparison shop the price of an uncomplicated birth at various hospitals).

self-only coverage for a taxpayer with income equal to 200% of the poverty line must contribute 6.3% of his income toward coverage. Here is an example:

> John is 24 years old and has an annual income of $23,340, which equals 200% of the poverty line for purposes of the 2015 tax credit. His expected contribution is 6.3 percent of his income, or $1,470 a year. The benchmark plan available to John is priced at $5,000; John is eligible for a credit amount of no more than $3,530 ($5,000 *less* $1,470).[63]

**Problems**

**1.** Mary is an employee at Multinational, Inc., who earns a cash salary of $200,000 per year. Multinational also provides group health insurance coverage to its employees, their spouses, and dependents. This year, International pays 100% of the $20,000 health insurance premium for Mary, her spouse Monica, and their minor children. What are Mary's tax consequences?

**2.** Caleb is an unmarried, self-employed carpenter who earns $75,000 this year and pays $5,000 for self-only health insurance coverage in the individual market. Caleb does not own a home or make significant charitable contributions. What are Caleb's tax consequences?

**3.** Barbara is unmarried, 26 years old, and employed full-time at a local hair and nail salon that employs 40 people and does not provide its employees with health care coverage. Working as much overtime as she can, Barbara earns $25,000 this year and pays $5,000 for self-only health insurance coverage in the individual market. Barbara does not own a home or make significant charitable contributions. What were Barbara's tax consequences prior to enactment of the Affordable Care Act? How has the ACA affected Barbara's tax consequences?

## D. Charitable contributions

A deduction for charitable contributions was first enacted in 1917. Today, § 170(a)(1) provides authority to deduct "any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year." Subsection (c) defines "charitable contribution" as a "contribution or gift to or for the use of" certain listed beneficiaries. The first, under (c)(1), is a state or local government, the Federal government, the District of Columbia, or a U.S. possession "but only if the contribution or gift is made for exclusively public purposes." For example, the Federal government reports each year the number and aggregate amount of donations received by it to reduce the Federal debt. More than $5.1 million was contributed for this purpose in 2015.[64]

Subsections (c)(2), (3), (4), and (5) list nongovernmental organizations that are eligible to receive deductible contributions. Each of these organizations are themselves exempt from Federal income tax, but *not all tax-exempt organizations qualify for deductible contributions under § 170*—our focus.

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[63] *See* www.healthreformbeyondthebasics.org/premium-tax-credits-answers-to-frequently-asked-questions/; http://aspe.hhs.gov/poverty/14poverty.cfm. If the taxpayer chooses to claim the credit with her annual tax return rather than having it paid monthly directly to the insurance company providing coverage, Form 8962 leads the taxpayer through the credit computation.

[64] *See* www.treasurydirect.gov/govt/reports/pd/gift/gift.htm.

***Tax-exempt organizations***

Section 501(c) lists 29 separate types of organizations that are eligible for an exemption from Federal income tax under either § 1(e) (applying to trusts) or § 11 (applying to corporations) if they satisfy certain stringent criteria. For example, §§ 501(c)(8) and (10) provide exemption to certain fraternal societies operating under the lodge system, and § 501(c)(6) provides exemption to "business leagues, chambers of commerce, real estate boards, boards of trade, or professional football leagues … not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual." The National Football League, which was a tax-exempt organization for decades, abandoned its tax-exempt status in 2015.[65]

Even these otherwise tax-exempt organizations, however, can owe Federal income tax under the unrelated business income tax (UBIT) found in §§ 511 to 515, which Congress enacted in 1950 after New York University famously acquired ownership of the Mueller Macaroni company. The UBIT reaches business income that is not related (aside from funding needs) to the organization's exempt purpose in order to prevent these organizations from enjoying an unwarranted competitive price advantage over non-exempt businesses selling similar goods or services.[66]

For our purposes, the most important category in § 501(c)'s list of tax-exempt organizations is § 501(c)(3) because it dovetails with the types of organization that can receive deductible contributions under § 170. Notice that *both* §§ 501(c)(3) and 170(c)(2)(B) refer to organizations operated exclusively for religious, charitable, scientific, literary, or educational purposes. For this reason, you will often hear the § 170 deduction described as applying primarily to contributions made to § 501(c)(3) organizations, even though a citation to § 501(c)(3) does not literally appear in § 170. Moreover, donations to churches, synagogues, and mosques are deductible under § 170 (and churches, synagogues, and mosques are generally exempt from tax) even if they do not formally organize a trust or corporation or formally apply for § 501(c)(3) tax exemption. Of the approximately 1.49 million § 501(c) organizations in 2011, approximately 1.08 million were § 501(c)(3) organizations eligible to receive deductible donations under § 170. This figure, however, includes only about half of the 300,000 estimated religious congregations, with the remaining half not registering with the IRS.[67] For ease of reference, we can call all of these simply "public charities," and this group is big, encompassing most of the charities with which you are familiar—everything from large, national charities (such as the American Red Cross, the American Cancer Society, and the Corporation for Public Broadcasting) to your local church or synagogue, orchestra, and soon-to-be *alma mater* law school.

Private foundations constitute a subset of § 501(c)(3) organizations that can receive tax-deductible contributions under § 170. While the statutory definition of a private foundation has many working parts,[68] they are typically created by donations from a small group of people (often a single family) and do not solicit funds from the public. They are subject to certain excise taxes

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[65] Jonathan Clegg, *NFL to End Tax-Exempt Status*, at www.wsj.com/articles/nfl-to-end-tax-exempt-status-1430241845.

[66] *But see* Ethan Stone, *Adhering to the Old Line: Uncovering the History and Political Function of the Unrelated Business Income Tax*, 34 EMORY L.J. 1475 (2005) (questioning the unfair competition rationale).

[67] JOINT COMMITTEE ON TAXATION, PRESENT LAW AND BACKGROUND RELATING TO THE FEDERAL TAX TREATMENT OF CHARITABLE CONTRIBUTIONS, JCX-4-13 (Feb. 11, 2013), at www.jct.gov/publications.html?func=showdown&id=4506.

[68] An unusual feature of the definition is that it is described in the negative. All § 501(c)(3) organizations are presumed to be private foundations unless they establish that they are not. *See* § 509.

under §§ 4940 through 4945 and deduction restrictions under § 170 that do not apply to donations to public charities. Examples of private foundations[69] that you may have heard about are the Bill and Melinda Gates Foundation, the Robert Wood Johnson Foundation, the John S. and James K. Knight Foundation, the William and Flora Hewitt Foundation, and the Rockefeller Foundation. The material below on the deductibility of § 170 contributions focuses solely on the much more common contributions to public charities; it does not explore the limitations that apply to contributions to private foundations.

Those interested in learning more about this complex area are encouraged to take the separate course exploring Tax-Exempt Organizations.

***Who benefits from the § 170 deduction and where do our charitable dollars go?***

The § 170 deduction is an Itemized Deduction (because not listed in § 62) but is not a MID subject to the 2% floor (because listed in § 67(b)(4)). As with all Itemized Deductions, it can be reduced for high-income taxpayers under § 68, the so-called Pease limitation described in Chapter 1, Part B. Also recall that approximately 70% of taxpayers take the Standard Deduction instead of the aggregate of their Itemized Deductions. Most of those who itemize (and thus most of those who benefit from the charitable contribution deduction) are homeowners living in relatively high-tax states because of the combination of the deductions for qualified residence interest (under § 163(h)(3)) and state and local income and property taxes (under § 164(a))—Itemized Deductions all. Renters in low-tax states are far less likely to obtain a tax benefit from § 170. Is that a rational way to determine who should benefit from § 170?

Congress has considered transforming a portion of the charitable contribution deduction into an above-the-line deduction, but others argue that this approach would provide a double tax benefit for the same dollars because the Standard Deduction amount already encompasses a presumed amount of charitable giving. Another reform option would transform the deduction into a credit (say, at 15% or 25%) for amounts contributed above a floor (*e.g.*, 2% of AGI) so that all taxpayers would save the same $150 or $250 in tax for a $1,000 contribution exceeding whatever floor is adopted.[70]

Still others respond that the tax benefit should remain in the form of a deduction in order to best target the intended audience: the wealthy. That is to say, supporters of the *status quo* argue that those whose behavior we are most intent on changing (to give more to charity) are more responsive to the tax incentive than are low- and moderate-income taxpayers, and the wealthy might reduce their giving if they save only $280 in tax for a $1,000 contribution (under a 28% credit) instead of $396 for that same $1,000 contribution (under a deduction for a contribution otherwise falling

[69] There are actually two types of private foundations: private non-operating foundations (the much more common type) and private operating foundations. Private non-operating foundations make grants to other nonprofit organizations, while private operating foundations use the bulk of their resources in furtherance of their own charitable programs, instead of making grants to other nonprofit organizations. The Getty Museum in Los Angeles is a private operating foundation. The § 170 deduction restrictions mentioned in the text do not apply to private operating foundations, which will not be further discussed here.

[70] Under the Gift Aid program in England, for example, every £1 donated to a qualified charity by English citizens certifying that they will pay income tax at least equal to their aggregate Gift Aid donations for the year generates a direct payment of 25 pence from the U.K. government to the charity. Such an approach is economically equivalent to a 20% tax credit. In the U.S., direct payments to charities by the Federal government might not be possible with respect to donations to churches, synagogues, and mosques (the largest recipients of donations) without violating the First Amendment Establishment Clause.

within the 39.6% bracket).[71] Whether or not that is true, of course, is an empirical question. In addition, the income tax is not the only relevant tax to consider in this regard. The estate tax, discussed in Chapter 7, also affects charitable giving, as such contributions reduce the estate tax base, as well. With only the very wealthy subject to the estate tax, the estate tax deduction for charitable contributions is much better targeted.

Some argue that the deduction should be entirely repealed, as the evidence is mixed regarding whether the deduction encourages greater giving. "In 2006 [American] taxpayers with incomes over $100,000 received 76% of the total $40.9 billion tax subsidy due to the charitable deduction, although they made only 57% of all donations; those with incomes of less than $50,000 received a mere 5% of the subsidy, despite making one-fifth [20%] of all charitable donations."[72] "In 2001, Independent Sector … found that households earning less than $25,000 a year gave [to charity] an average of 4.2 percent of their incomes; those with earnings of more than $75,000 gave away 2.7 percent."[73] In other words, those who do not benefit much, if at all, from § 170 tend to give a larger share of their income to charity than those who do benefit from § 170. In addition, overall giving has consistently hovered around 2% of GDP even as the tax benefit available to the wealthy has varied widely with changes in the top tax rate over time.[74] Many studies confirm a "warm glow" effect accompanying substantial charitable giving, which implies that such giving might continue unabated even absent a tax benefit. If giving is substantially unresponsive to the deduction, then the deduction is nothing more than an inefficient windfall benefit for upper-bracket taxpayers at a loss to the Treasury each year that requires tax rates to be higher than they would otherwise need to be to collect *$X*.

Some support a tax benefit on the argument that it reduces the size of government by replacing government spending with private spending by charities on community services and the poor. The empirical data is mixed in this regard, however. A 2007 study, for example, showed that "only a small percentage of charitable giving by the wealthy was actually going to the needs of the poor; instead it was mostly directed to other causes—cultural institutions, for example, or their *alma maters*—which often came with the not-inconsequential payoff of enhancing the donor's status among his or her peers."[75] That 2007 study revealed that only 4% of the donations made by upper-income taxpayers are made to organizations devoted to helping the disadvantaged.[76] Thus, some argue that tax benefits ought to be limited to—or augmented in the case of—such donations.[77]

Religion is perennially the number one charitable choice of lower-income Americans (those who more likely take the Standard Deduction and thus do not benefit from § 170) and is perennially the number one recipient overall of charitable contributions—nearly a third of the total each year. While most charities must submit a Form 990 annually that describes how they spend their

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[71] Similarly, President Obama's budget proposals perennially advocated limiting the tax benefit for all Itemized Deductions, including the charitable contribution deduction, to no more than 28% for taxpayers in higher tax brackets, and those who oppose the proposal argue that it would reduce the incentive for the wealthy to give to charity.

[72] *Sweetened Charity*, THE ECONOMIST, June 9, 2012, at 29, 32.

[73] Judith Warner, *Helping Hand? Why Giving the Rich a Break Doesn't Necessarily Do Anything for the Poor*, N.Y. TIMES, Aug. 22, 2010, Sunday Magazine, at 11.

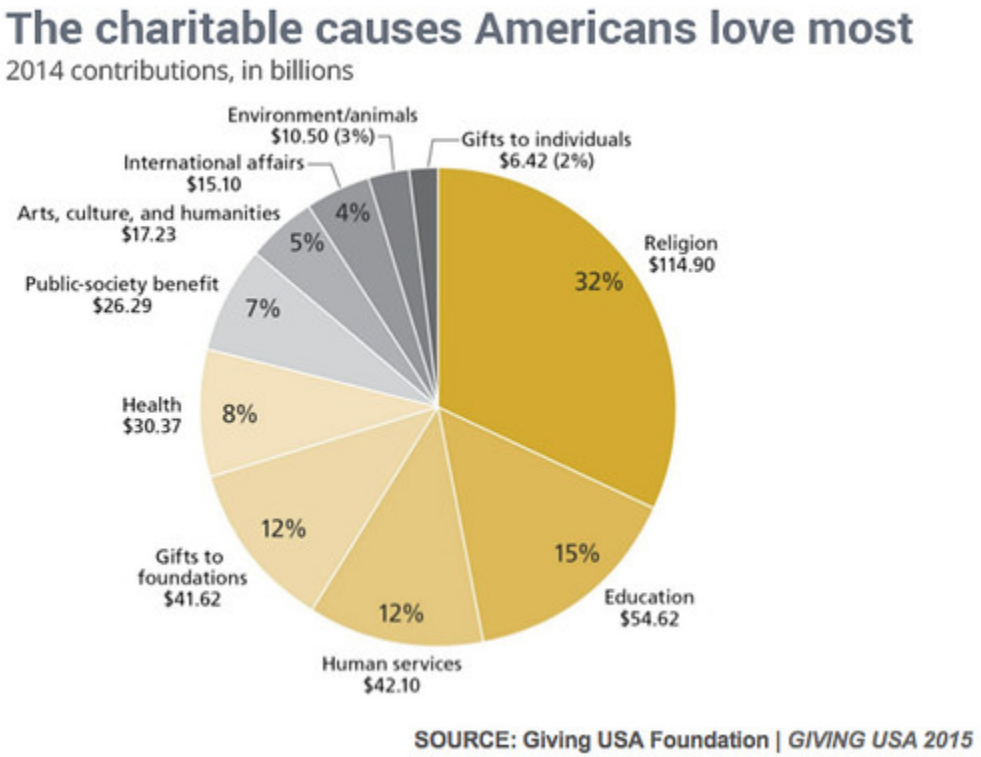
[74] *See, e.g.*, Daniel J. Mitchell, *Should We End the Tax Deduction for Charitable Donations? Yes: It Doesn't Increase Giving*, WALL ST. J., Dec. 17, 2012, at R1.

[75] Warner, *supra* note 77, at 12.

[76] *See* Miranda Perry Fleischer, *It's the Charitable Deduction, not the "Things We Like" Deduction*, 142 TAX NOTES 1229, 1230 (2014).

[77] *Id.*

contributed money, churches are exempt from filing this form, making it difficult to know how much of their aggregate donations are spent on buildings, salary, *etc.*, and how much is spent on community services. The chart below, showing the share that each recipient type received in 2014 of aggregate charitable donations (with individuals providing more than 70% of donations), is similar to other years.[78]




***What is a "contribution or gift" within the meaning of § 170(c)?***

Recall from Chapter 7 the *Duberstein* definition of a "gift" for purposes of the § 102 *exclusion* from § 61 Gross Income by the gift recipient: a transfer made by the donor out of "detached and disinterested generosity … out of affection, respect, admiration, charity or like impulses," as opposed to one proceeding primarily from "the constraining force of any moral or legal duty" or from "the incentive of anticipated benefit of an economic nature."[79] The *Duberstein* Court also said that the intention of the donor controls this inquiry.[80] Are the words "contribution or gift" in § 170(c) interpreted similarly? Prior to the Supreme Court's 1986 decision in *United States v. American Bar Endowment*,[81] lower courts had disagreed about whether § 170 contained an "intent" test similar to § 102.

In *American Bar Endowment*, taxpayers purchased life, health, accident and disability insurance

[78] THE CENTER ON PHILANTHROPY AT INDIANA UNIVERSITY, GIVING USA 2015: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2014 (Report Highlights), at http://givingusa.org/product/giving-usa-2015-report-highlights//. Reprinted with permission. In 2014, 72% of charitable contributions were made by individuals, 15% were made by foundations, 8% came from bequests, and 5% were made by corporations. *See id.*
[79] Comm'r v. Duberstein, 363 U.S. 278, 285 (1960).
[80] *Id.* at 286.
[81] 477 U.S. 105 (1986).

policies through insurance companies contracting with the American Bar Endowment (ABE), a § 501(c)(3) organization eligible to receive contributions that are deductible under § 170. Because of the favorable mortality and morbidity profiles of the member-contributors, premiums in excess of those necessary to provide insurance coverage were, in effect, refunded each year by the insurance companies to ABE. As a condition of participating in the program, the members purchasing insurance through ABE were required to agree that the organization could retain these refunds for use in its charitable programs, and ABE informed these members that their shares of these refunds were deductible under § 170. The IRS disagreed and challenged the deduction by four taxpayers, and the Supreme Court agreed with the IRS's deduction denial, adopting a two-part test in determining whether a transfer is a "dual payment," a portion of which is a "contribution or gift" within the meaning of § 170(c).

> A payment of money generally cannot constitute a charitable contribution if the contributor expects a substantial benefit in return. S. Rep. No. 1622, 83d Cong., 2d Sess., 196 (1954). However, as the Claims Court [predecessor to the current U.S. Court of Federal Claims] recognized, a taxpayer may sometimes receive only a nominal benefit in return for his contribution. Where the size of the payment is clearly out of proportion to the benefit received, it would not serve the purposes of § 170 to deny a deduction altogether. A taxpayer may therefore claim a deduction for the difference between a payment to a charitable organization and the market value of the benefit received in return, on the theory that the payment has the "dual character" of a purchase and a contribution. *See, e.g.*, Rev. Rul. 67-246, 1967-2 C.B. 104 (price of ticket to charity ball deductible to extent it exceeds market value of admission); Rev. Rul. 68-432, 1968-2 C.B. 104, 105 (noting possibility that payment to charitable organization may have "dual character").
>
> In Rev. Rul. 67-246, *supra*, the IRS set up a two-part test for determining when part of a "dual payment" is deductible. First, the payment is deductible only if and to the extent it exceeds the market value of the benefit received. Second, the excess payment must be "made with the intention of making a gift." 1967-2 C.B., at 105. The Tax Court has adopted this test, see *Murphy* v. *Comm'r*, 54 T.C. 249, 254 (1970); *Arceneaux* v. *Comm'r*, 36 TCM 1461, 1464 (1977); but see *Oppewal* v. *Comm'r*, 468 F.2d 1000, 1002 (CA1 1972) (expressing "dissatisfaction with such subjective tests as the taxpayer's motives in making a purported charitable contribution" and relying solely on differential between amount of payment and value of benefit).
>
> The Claims Court applied that test in this case, and held that respondents Broadfoot, Boynton, and Turner had not established that they could have purchased comparable insurance for less money. Therefore, the court held, they had failed to establish that the value of ABE's insurance to them was less than the premiums paid. Respondent Sherwood demonstrated that there did exist a group insurance program for which he was eligible and which offered lower premiums than ABE's insurance. However, Sherwood failed to establish that he was aware of that competing program during the years at issue. Sherwood therefore had failed to demonstrate that he met the second part of the above test—that he had intentionally paid more than the market value for ABE's insurance because he wished to make a

gift. We hold that the Claims Court applied the proper standard.[82]

Treas. Reg. § 1.170A-1(h) now incorporates this two-part test by providing that the taxpayer bears the burden of proving that he or she both (1) intends to make a payment exceeding the fair market value of any goods or services received in return from the charity and (2) actually makes such a payment. Thus, university tuition paid by the parent of a child attending the university (a § 501(c)(3) organization that can receive deductible contributions) is not deductible because the payment purchases educational services of (at least) equivalent value. If, however, a parent *intentionally* pays more than the required tuition, the excess can be a "contribution or gift" within the meaning of § 170(c).

The fair market value of the insurance in *American Bar Foundation* was easily determined because insurance is commonly bought and sold in the commercial world. How should we measure the value of intangible services received from a § 501(c)(3) organization that are *not* commonly bought and sold in the marketplace?

## HERNANDEZ v. COMMISSIONER

490 U.S. 680 (1989)

MR. JUSTICE MARSHALL delivered the opinion of the Court.

Section 170 of the Internal Revenue Code permits a taxpayer to deduct from Gross Income the amount of a "charitable contribution." The Code defines that term as a "contribution or gift" to certain eligible donees, including entities organized and operated exclusively for religious purposes. We granted certiorari to determine whether taxpayers may deduct as charitable contributions payments made to branch churches of the Church of Scientology (Church) in order to receive services known as "auditing" and "training." We hold that such payments are not deductible.

I

Scientology was founded in the 1950s by L. Ron Hubbard. It is propagated today by a "mother church" in California and by numerous branch churches around the world. The mother Church instructs laity, trains and ordains ministers, and creates new congregations. Branch churches, known as "franchises" or "missions," provide Scientology services at the local level, under the supervision of the mother Church.

Scientologists believe that an immortal spiritual being exists in every person. A person becomes aware of this spiritual dimension through a process known as "auditing." Auditing involves a one-to-one encounter between a participant (known as a "preclear") and a Church official (known as an "auditor"). An electronic device, the E-meter, helps the auditor identify the preclear's areas of spiritual difficulty by measuring skin responses during a question and answer session. Although auditing sessions are conducted one on one, the content of each session is not individually tailored. The preclear gains spiritual awareness by progressing through sequential levels of auditing, provided in short blocks of time known as "intensives."

The Church also offers members doctrinal courses known as "training." Participants in these sessions study the tenets of Scientology and seek to attain the qualifications necessary to serve as

[82] *Id.* at 116-18.

auditors. Training courses, like auditing sessions, are provided in sequential levels. Scientologists are taught that spiritual gains result from participation in such courses.

The Church charges a "fixed donation," also known as a "price" or a "fixed contribution," for participants to gain access to auditing and training sessions. These charges are set forth in schedules, and prices vary with a session's length and level of sophistication. In 1972, for example, the general rates for auditing ranged from $625 for a 12 1/2-hour auditing intensive, the shortest available, to $4,250 for a 100-hour intensive, the longest available. Specialized types of auditing required higher fixed donations: a 12 1/2-hour "Integrity Processing" auditing intensive cost $750; a 12 1/2-hour "Expanded Dianetics" auditing intensive cost $950. This system of mandatory fixed charges is based on a central tenet of Scientology known as the "doctrine of exchange," according to which any time a person receives something he must pay something back. In so doing, a Scientologist maintains "inflow" and "outflow" and avoids spiritual decline.

The proceeds generated from auditing and training sessions are the Church's primary source of income. The Church promotes these sessions not only through newspaper, magazine, and radio advertisements, but also through free lectures, free personality tests, and leaflets. The Church also encourages, and indeed rewards with a 5% discount, advance payment for these sessions. The Church often refunds unused portions of prepaid auditing or training fees, less an administrative charge.

Petitioners in these consolidated cases each made payments to a branch church for auditing or training sessions. They sought to deduct these payments on their federal income tax returns as charitable contributions under § 170. Respondent Commissioner disallowed these deductions, finding that the payments were not charitable contributions within the meaning of § 170.

Petitioners sought review of these determinations in the Tax Court. Before trial, the Commissioner stipulated that the branch churches of Scientology are religious organizations entitled to receive tax-deductible charitable contributions under the relevant sections of the Code. This stipulation isolated as the sole statutory issue whether payments for auditing or training sessions constitute "contribution[s] or gift[s]" under § 170.

The Tax Court held a 3-day bench trial during which the taxpayers and others testified and submitted documentary exhibits describing the terms under which the Church promotes and provides auditing and training sessions. Based on this record, the court upheld the Commissioner's decision. 83 T.C. 575 (1984). It observed first that the term "charitable contribution" in § 170 is synonymous with the word "gift," which case law had defined "as a *voluntary transfer* of property by the owner to another *without consideration* therefor." *Id.*, at 580, quoting *DeJong* v. *Comm'r*, 36 T.C. 896, 899 (1961) (emphasis in original), aff'd, 309 F.2d 373 (CA9 1962). It then determined that petitioners had received consideration for their payments, namely, "the benefit of various religious services provided by the Church of Scientology." 83 T.C., at 580. The Tax Court also rejected the taxpayers' constitutional challenges based on the Establishment and Free Exercise Clauses of the First Amendment.

The Courts of Appeals for the First Circuit in petitioner Hernandez's case, and for the Ninth Circuit in Graham, Hermann, and Maynard's case, affirmed. The First Circuit rejected Hernandez's argument that under § 170, the IRS's ordinary inquiry into whether the taxpayer received consideration for his payment should not apply to "the return of a commensurate *religious* benefit, as opposed to an *economic or financial* benefit." 819 F.2d, at 1217 (emphasis in original). The court found "no indication that Congress intended to distinguish the religious benefits sought

by Hernandez from the medical, educational, scientific, literary, or other benefits that could likewise provide the *quid* for the *quo* of a nondeductible payment to a charitable organization." *Ibid.* The court also rejected Hernandez's argument that it was impracticable to put a value on the services he had purchased, noting that the Church itself had "established and advertised monetary prices" for auditing and training sessions, and that Hernandez had not claimed that these prices misstated the cost of providing these sessions. *Id.*, at 1218.

Hernandez's constitutional claims also failed. Because § 170 created no denominational preference on its face, Hernandez had shown no Establishment Clause violation. *Id.*, at 1218-1221. As for the Free Exercise Clause challenge, the court determined that denying the deduction did not prevent Hernandez from paying for auditing and training sessions and thereby observing Scientology's doctrine of exchange. Moreover, granting a tax exemption would compromise the integrity and fairness of the tax system. *Id.*, at 1221-1225.

The Ninth Circuit also found that the taxpayers had received a "measurable, specific return … as a *quid pro quo* for the donation" they had made to the branch churches. 822 F.2d, at 848. The court reached this result by focusing on "the external features" of the auditing and training transactions, an analytic technique which "serves as an expedient for any more intrusive inquiry into the motives of the payor." *Ibid.* Whether a particular exchange generated secular or religious benefits to the taxpayer was irrelevant, for under § 170 "[i]t is the structure of the transaction, and not the type of benefit received, that controls." *Id.*, at 849.

The Ninth Circuit also rejected the taxpayers' constitutional arguments. The tax deduction provision did not violate the Establishment Clause because § 170 is "neutral in its design" and reflects no intent "to visit a disability on a particular religion." *Id.*, at 853. Furthermore, that the taxpayers would "have less money to pay to the Church, or that the Church [would] receive less money, [did] not rise to the level of a burden on appellants' ability to exercise their religious beliefs." *Id.*, at 851. Indeed, because the taxpayers could still make charitable donations to the branch church, they were "not put to the choice of abandoning the doctrine of exchange or losing the government benefit, for they may have both." *Ibid.* We granted certiorari to resolve a Circuit conflict concerning the validity of charitable deductions for auditing and training payments.[5] We now affirm.

II

For over 70 years, federal taxpayers have been allowed to deduct the amount of contributions or gifts to charitable, religious, and other eleemosynary institutions. *See* 2 B. Bittker, Federal Taxation of Income, Estates and Gifts para. 35.1.1 (1981) (tracing history of charitable deduction). The legislative history of the "contribution or gift" limitation, though sparse, reveals that Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services. Only the former were deemed deductible. The House and Senate Reports on the 1954 tax bill, for example, both define "gifts" as payments "made with no expectation of a financial return commensurate with the amount of the gift." S. Rep. No. 1622, 83d Cong., 2d Sess., 196 (1954); H. R. Rep. No. 1337, 83d Cong., 2d Sess., A44 (1954).

[5] Compare Christiansen v. Comm'r, 843 F. 2d 418 (CA10 1988) (holding payments not deductible), cert. pending, No. 87-2023; Miller v. IRS, 829 F. 2d 500 (CA4 1987) (same), cert. pending, No. 87-1449, with Neher v. Comm'r, 852 F. 2d 848 (CA6 1988) (holding payments deductible); Foley v. Comm'r, 844 F. 2d 94 (CA2 1988) (same), cert. pending, No. 88-102; Staples v. Comm'r, 821 F. 2d 1324 (CA8 1987) (same), cert. pending, No. 87-1382. The rulings for the taxpayer in the Neher, Foley, and Staples cases rested on statutory, not constitutional, grounds.

Using payments to hospitals as an example, both Reports state that the gift characterization should not apply to "a payment by an individual to a hospital *in consideration of* a binding obligation to provide medical treatment for the individual's employees. It would apply only if there were no expectation of any *quid pro quo* from the hospital." S. Rep. No. 1622, *supra*, at 196 (emphasis added); H. Rep. No. 1337, *supra*, at A44 (emphasis added).

In ascertaining whether a given payment was made with "the expectation of any *quid pro quo*," the IRS has customarily examined the external features of the transaction in question. This practice has the advantage of obviating the need for the IRS to conduct imprecise inquiries into the motivations of individual taxpayers. The lower courts have generally embraced this structural analysis. *See, e.g.*, *Singer Co.* v. *U.S.*, 449 F.2d 413, 422-423 (Ct. Cl. 1971) (applying this approach and collecting cases), cited in *U.S.* v. *American Bar Endowment*, 477 U.S. 105, 117 (1986); *see also* 2 B. Bittker, *supra*, at para. 35.1.3 (collecting cases). We likewise focused on external features in *U.S.* v. *American Bar Endowment*, *supra*, to resolve the taxpayers' claims that they were entitled to partial deductions for premiums paid to a charitable organization for insurance coverage; the taxpayers contended that they had paid unusually high premiums in an effort to make a contribution along with their purchase of insurance. We upheld the Commissioner's disallowance of the partial deductions because the taxpayers had failed to demonstrate, at a minimum, the existence of comparable insurance policies with prices lower than those of the policy they had each purchased. In so doing, we stressed that "[t]he *sine qua non* of a charitable contribution is a transfer of money or property *without adequate consideration*." *Id.*, at 118 (emphasis added in part).

In light of this understanding of § 170, it is readily apparent that petitioners' payments to the Church do not qualify as "contribution[s] or gift[s]." As the Tax Court found, these payments were part of a quintessential *quid pro quo* exchange: in return for their money, petitioners received an identifiable benefit, namely, auditing and training sessions. The Church established fixed price schedules for auditing and training sessions in each branch church; it calibrated particular prices to auditing or training sessions of particular lengths and levels of sophistication; it returned a refund if auditing and training services went unperformed; it distributed "account cards" on which persons who had paid money to the Church could monitor what prepaid services they had not yet claimed; and it categorically barred provision of auditing or training sessions for free. Each of these practices reveals the inherently reciprocal nature of the exchange.

Petitioners do not argue that such a structural analysis is inappropriate under § 170, or that the external features of the auditing and training transactions do not strongly suggest a *quid pro quo* exchange. Indeed, the petitioners in the consolidated *Graham* case conceded at trial that they expected to receive specific amounts of auditing and training in return for their payments. 822 F.2d, at 850. Petitioners argue instead that they are entitled to deductions because a *quid pro quo* analysis is inappropriate under § 170 when the benefit a taxpayer receives is purely religious in nature. Along the same lines, petitioners claim that payments made for the right to participate in a religious service should be automatically deductible under § 170.

We cannot accept this statutory argument for several reasons. First, it finds no support in the language of § 170. Whether or not Congress could, consistent with the Establishment Clause, provide for the automatic deductibility of a payment made to a church that either generates religious benefits or guarantees access to a religious service, that is a choice Congress has thus far declined to make. Instead, Congress has specified that a payment to an organization operated exclusively for religious (or other eleemosynary) purposes is deductible *only* if such a payment is

a "contribution or gift." The Code makes no special preference for payments made in the expectation of gaining religious benefits or access to a religious service. The House and Senate Reports on § 170, and the other legislative history of that provision, offer no indication that Congress' failure to enact such a preference was an oversight.

Second, petitioners' deductibility proposal would expand the charitable contribution deduction far beyond what Congress has provided. Numerous forms of payments to eligible donees plausibly could be categorized as providing a religious benefit or as securing access to a religious service. For example, some taxpayers might regard their tuition payments to parochial schools as generating a religious benefit or as securing access to a religious service; such payments, however, have long been held not to be charitable contributions under § 170. *Winters* v. *Comm'r*, 468 F.2d 778 (CA2 1972); see *id.*, at 781 (noting Congress' refusal to enact legislation permitting taxpayers to deduct parochial school tuition payments). Taxpayers might make similar claims about payments for church-sponsored counseling sessions or for medical care at church-affiliated hospitals that otherwise might not be deductible. Given that, under the First Amendment, the IRS can reject otherwise valid claims of religious benefit only on the ground that a taxpayers' alleged beliefs are not sincerely held, but not on the ground that such beliefs are inherently irreligious, see *U.S.* v. *Ballard*, 322 U.S. 78 (1944), the resulting tax deductions would likely expand the charitable contribution provision far beyond its present size. We are loath to effect this result in the absence of supportive congressional intent. Cf. *U.S.* v. *Lee*, 455 U.S. 252, 259-261 (1982).

Finally, the deduction petitioners seek might raise problems of entanglement between church and state. If framed as a deduction for those payments generating benefits of a religious nature for the payor, petitioners' proposal would inexorably force the IRS and reviewing courts to differentiate "religious" benefits from "secular" ones. We need pass no judgment now on the constitutionality of such hypothetical inquiries, but we do note that "pervasive monitoring" for "the subtle or overt presence of religious matter" is a central danger against which we have held the Establishment Clause guards. *Aguilar* v. *Felton*, 473 U.S. 402, 413 (1985); *see also Widmar* v. *Vincent*, 454 U.S. 263, 272, n. 11 (1981) ("[T]he University would risk greater 'entanglement' by attempting to enforce its exclusion of 'religious worship' and 'religious speech'" than by opening its forum to religious as well as nonreligious speakers); cf. *Thomas* v. *Review Bd. of Indiana Employment Security Div.*, 450 U.S. 707, 716 (1981).

Accordingly, we conclude that petitioners' payments to the Church for auditing and training sessions are not "contribution[s] or gift[s]" within the meaning of that statutory expression.[10]

[Part III omitted.]

IV

We turn, finally, to petitioners' assertion that disallowing their claimed deduction is at odds with the IRS's longstanding practice of permitting taxpayers to deduct payments made to other religious institutions in connection with certain religious practices. Through the appellate stages of this litigation, this claim was framed essentially as one of selective prosecution. The Courts of Appeals for the First and Ninth Circuits summarily rejected this claim, finding no evidence of the intentional governmental discrimination necessary to support such a claim. 822 F.2d, at 853 (no

[10] Petitioners have not argued here that their payments qualify as "dual payments" under IRS regulations and that they are therefore entitled to a partial deduction to the extent their payments exceeded the value of the benefit received. See American Bar Endowment, 477 U.S., at 117 (citing Rev. Rul. 67-246, 1967-2 C.B. 104). We thus have no occasion to decide this issue.

showing of "the type of hostility to a target of law enforcement that would support a claim of selective enforcement"); 819 F.2d, at 1223 (no "discriminatory intent" proved).

In their arguments to this Court, petitioners have shifted emphasis. They now make two closely related claims. First, the IRS has accorded payments for auditing and training disparately harsh treatment compared to payments to other churches and synagogues for their religious services: Recognition of a comparable deduction for auditing and training payments is necessary to cure this administrative inconsistency. Second, Congress, in modifying § 170 over the years, has impliedly acquiesced in the deductibility of payments to these other faiths; because payments for auditing and training are indistinguishable from these other payments, they fall within the principle acquiesced in by Congress that payments for religious services are deductible under § 170.

Although the Commissioner demurred at oral argument as to whether the IRS, in fact, permits taxpayers to deduct payments made to purchase services from other churches and synagogues, the Commissioner's periodic revenue rulings have stated the IRS's position rather clearly. A 1971 ruling, still in effect, states: "Pew rents, building fund assessments, and periodic dues paid to a church … are all methods of making contributions to the church, and such payments are deductible as charitable contributions within the limitations set out in section 170 of the Code." Rev. Rul. 70-47, 1970-1 C.B. 49 (superseding A.R.M. 2, C.B. 150 (1919)). We also assume for purposes of argument that the IRS also allows taxpayers to deduct "specified payments for attendance at High Holy Day services, for tithes, for torah readings and for memorial plaques." *Foley* v. *Comm'r*, 844 F.2d, at 94, 96.

The development of the present litigation, however, makes it impossible for us to resolve petitioners' claim that they have received unjustifiably harsh treatment compared to adherents of other religions. The relevant inquiry in determining whether a payment is a "contribution or gift" under § 170 is, as we have noted, not whether the payment secures religious benefits or access to religious services, but whether the transaction in which the payment is involved is structured as a *quid pro quo* exchange. To make such a determination in this case, the Tax Court heard testimony and received documentary proof as to the terms and structure of the auditing and training transactions; from this evidence it made factual findings upon which it based its conclusion of nondeductibility, a conclusion we have held consonant with § 170 and with the First Amendment.

Perhaps because the theory of administrative inconsistency emerged only on appeal, petitioners did not endeavor at trial to adduce from the IRS or other sources any specific evidence about other religious faiths' transactions. The IRS' revenue rulings, which merely state the agency's conclusions as to deductibility and which have apparently never been reviewed by the Tax Court or any other judicial body, also provide no specific facts about the nature of these other faiths' transactions. In the absence of such facts, we simply have no way (other than the wholly illegitimate one of relying on our personal experiences and observations) to appraise accurately whether the IRS's revenue rulings have correctly applied a *quid pro quo* analysis with respect to any or all of the religious practices in question. We do not know, for example, whether payments for other faiths' services are truly obligatory or whether any or all of these services are generally provided whether or not the encouraged "mandatory" payment is made.

The IRS's application of the "contribution or gift" standard may be right or wrong with respect to these other faiths, or it may be right with respect to some religious practices and wrong with respect to others. It may also be that some of these payments are appropriately classified as partially deductible "dual payments." With respect to those religions where the structure of

transactions involving religious services is established not centrally but by individual congregations, the proper point of reference for a *quid pro quo* analysis might be the individual congregation, not the religion as a whole. Only upon a proper factual record could we make these determinations. Absent such a record, we must reject petitioners' administrative consistency argument.[13]

Petitioners' congressional acquiescence claim fails for similar reasons. Even if one assumes that Congress has acquiesced in the IRS's ruling with respect to "[p]ew rents, building fund assessments, and periodic dues," Rev. Rul. 70-47, 1970-1 C.B. 49, the fact is that the IRS's 1971 ruling articulates no broad principle of deductibility, but instead merely identifies as deductible three discrete types of payments. Having before us no information about the nature or structure of these three payments, we have no way of discerning any possible unifying principle, let alone whether such a principle would embrace payments for auditing and training sessions.

For the reasons stated herein, the judgments of the Courts of Appeals are hereby

*Affirmed*.

JUSTICE O'CONNOR, with whom JUSTICE SCALIA joins, dissenting.

The Court today acquiesces in the decision of the Internal Revenue Service (IRS) to manufacture a singular exception to its 70-year practice of allowing fixed payments indistinguishable from those made by petitioners to be deducted as charitable contributions. Because the IRS cannot constitutionally be allowed to select which religions will receive the benefit of its past rulings, I respectfully dissent.

The cases before the Court have an air of artificiality about them that is due to the IRS's dual litigation strategy against the Church of Scientology (Church). The IRS has successfully argued that the mother Church of Scientology was not a tax-exempt organization from 1970 to 1972 because it had diverted profits to the founder of Scientology and others, conspired to impede collection of its taxes, and conducted almost all of its activities for a commercial purpose. *See Church of Scientology of California* v. *Comm'r*, 83 T.C. 381 (1984), aff'd, 823 F.2d 1310 (CA9 1987), cert. denied, 486 U.S. 1015 (1988). In the cases before the Court today, however, the IRS decided to contest the payments made to Scientology under 26 U. S. C. § 170 rather than challenge the tax-exempt status of the various branches of the Church to which the payments were made. According to the Deputy Solicitor General, the IRS challenged the payments themselves in order to expedite matters. As part of its litigation strategy in these cases, the IRS agreed to several stipulations which, in my view, necessarily determine the proper approach to the questions presented by petitioners.

The stipulations, relegated to a single sentence by the Court, established that Scientology was at all relevant times a religion; that each Scientology branch to which payments were made was at

[13] Petitioners argue that an unofficial "question and answer guidance package" recently issued by an IRS official requires deductibility of payments for auditing and training sessions. Referring to the revenue ruling on pew rents, the brochure states that "fixed payments for similar religious services" are fully deductible. *See* IRS Official Explains New Examination-Education Program on Charitable Contributions to Tax-Exempt Organizations, BNA Daily Report for Executives, Special Report No. 186, J-1, J-3 (Sept. 26, 1988) (cited in Reply Brief for Petitioners 6). In ascertaining the IRS's justifications for its administrative practice, however, our practice is to rely on the agency's official rulings, not on the unofficial interpretations of particular IRS officials. In any event, the brochure on which petitioners rely was not included in the record before the Tax Court or the Courts of Appeals in these cases, and, in fact, was issued months after we granted certiorari.

all relevant times a "church" within the meaning of § 170(b)(1)(A)(i); and that Scientology was at all times a "corporation" within the meaning of § 170(c)(2) and exempt from general income taxation under 26 U. S. C. § 501(a). As the Solicitor General recognizes, it follows from these stipulations that Scientology operates for "'charitable purposes'" and puts the "public interest above the private interest." Brief for Respondent 30. *See also Neher, supra*, at 855. Moreover, the stipulations establish that the payments made by petitioners are fixed donations made by individuals to a tax-exempt religious organization in order to participate in religious services, and are not based on "market prices set to reap the profits of a commercial moneymaking venture." *Staples* v. *Comm'r*, 821 F.2d 1324, 1328 (CA8 1987), cert. pending, No. 87-1382. The Tax Court, however, appears to have ignored the stipulations. It concluded, perhaps relying on its previous opinion in *Church of Scientology*, that "Scientology operates in a commercial manner in providing [auditing and training]. In fact, one of its articulated goals is to make money." 83 T.C., at 578. The Solicitor General has duplicated the error here, referring on numerous occasions to the commercial nature of Scientology in an attempt to negate the effect of the stipulations. *See* Brief for Respondent 13-14, 23, 25, 44.

It must be emphasized that the IRS's position here is *not* based upon the contention that a portion of the knowledge received from auditing or training is of secular, commercial, nonreligious value. Thus, the denial of a deduction in these cases bears no resemblance to the denial of a deduction for religious-school tuition up to the market value of the secularly useful education received. *See Oppewal* v. *Comm'r*, 468 F.2d 1000 (CA1 1972); *Winters* v. *Comm'r*, 468 F.2d 778 (CA2 1972); *DeJong* v. *Comm'r*, 309 F.2d 373 (CA9 1962). Here the IRS denies deductibility solely on the basis that the exchange is a *quid pro quo*, even though the *quid* is exclusively of spiritual or religious worth. Respondent cites no instances in which this has been done before, and there are good reasons why.

When a taxpayer claims as a charitable deduction part of a fixed amount given to a charitable organization in exchange for benefits that have a commercial value, the allowable portion of that claim is computed by subtracting from the total amount paid the value of the physical benefit received. If at a charity sale one purchases for $1,000 a painting whose market value is demonstrably no more than $50, there has been a contribution of $950. The same would be true if one purchases a $1,000 seat at a charitable dinner where the food is worth $50. An identical calculation can be made where the *quid* received is not a painting or a meal, but an intangible such as entertainment, so long as that intangible has some market value established in a noncontributory context. Hence, one who purchases a ticket to a concert, at the going rate for concerts by the particular performers, makes a charitable contribution of zero even if it is announced in advance that all proceeds from the ticket sales will go to charity. The performers may have made a charitable contribution, but the audience has paid the going rate for a show.

It becomes impossible, however, to compute the "contribution" portion of a payment to a charity where what is received in return is not merely an intangible, but an intangible (or, for that matter a tangible) that is not bought and sold except in donative contexts so that the only "market" price against which it can be evaluated is a market price that always includes donations. Suppose, for example, that the charitable organization that traditionally solicits donations on Veterans Day, in exchange for which it gives the donor an imitation poppy bearing its name, were to establish a flat rule that no one gets a poppy without a donation of at least $10. One would have to say that the "market" rate for such poppies was $10, but it would assuredly not be true that everyone who "bought" a poppy for $10 made no contribution. Similarly, if one buys a $100 seat at a prayer

breakfast—receiving as the *quid pro quo* food for both body and soul—it would make no sense to say that no charitable contribution whatever has occurred simply because the "going rate" for all prayer breakfasts (with equivalent bodily food) is $100. The latter may well be true, but that "going rate" *includes* a contribution.

Confronted with this difficulty, and with the constitutional necessity of not making irrational distinctions among taxpayers, and with the even higher standard of equality of treatment among *religions* that the First Amendment imposes, the Government has only two practicable options with regard to distinctively religious *quids pro quo:* to disregard them all, or to tax them all. Over the years it has chosen the former course.

Congress enacted the first charitable contribution exception to income taxation in 1917. War Revenue Act of 1917, ch. 63, § 1201(2), 40 Stat. 330. A mere two years later, in A.R.M. 2, 1 C.B. 150 (1919), the IRS gave its first blessing to the deductions of fixed payments to religious organizations as charitable contributions:

> [T]he distinction of pew rents, assessments, church dues, and the like from basket collections is hardly warranted by the act. The act reads "contributions" and "gifts." It is felt that all of these come within the two terms.
>
> In substance it is believed that these are simply methods of contributing although in form they may vary. Is a basket collection given involuntarily to be distinguished from an envelope system, the latter being regarded as "dues"? From a technical angle, the pew rents may be differentiated, but in practice the so-called "personal accommodation" they may afford is conjectural. It is believed that the real intent is to contribute and not to hire a seat or pew for personal accommodation. In fact, basket contributors sometimes receive the same accommodation informally.

The IRS reaffirmed its position in 1970, ruling that "[p]ew rents, building fund assessments and periodic dues paid to a church … are all methods of making contributions to the church and such payments are deductible as charitable contributions." Rev. Rul. 70-47, 1970-1 C.B. 49. Similarly, notwithstanding the "form" of Mass stipends as fixed payments for specific religious services, the IRS has allowed charitable deductions of such payments. See Rev. Rul. 78-366, 1978-2 C.B. 241.

These rulings, which are "official interpretation[s] of [the tax laws] by the [IRS]," Rev. Proc. 78-24, 1978-2 C.B. 503, 504, flatly contradict the Solicitor General's claim that there "is no administrative practice recognizing that payments made in exchange for religious benefits are tax deductible." Brief for Respondent 16. Indeed, an Assistant Commissioner of the IRS recently explained in a "question and answer guidance package" to tax-exempt organizations that "[i]n contrast to tuition payments, religious observances generally are not regarded as yielding private benefits to the donor, who is viewed as receiving only incidental benefits when attending the observances. The primary beneficiaries are viewed as being the general public and members of the faith. Thus, payments for saying masses, pew rents, tithes, and other payments involving fixed donations for similar religious services, are fully deductible contributions." IRS Official Explains New Examination-Education Program on Charitable Contributions to Tax-Exempt Organizations, BNA Daily Report for Executives, Special Report No. 186, J-1, J-3 (Sept. 26, 1988). Although this guidance package may not be as authoritative as IRS rulings, in the absence of any contrary indications it does reflect the continuing adherence of the IRS to its practice of allowing deductions for fixed payments for religious services.

There can be no doubt that at least some of the fixed payments which the IRS has treated as charitable deductions, or which the Court assumes the IRS would allow taxpayers to deduct are as "inherently reciprocal" as the payments for auditing at issue here. In exchange for their payment of pew rents, Christians receive particular seats during worship services. *See* Encyclopedic Dictionary of Religion 2760 (1979). Similarly, in some synagogues attendance at the worship services for Jewish High Holy Days is often predicated upon the purchase of a general admission ticket or a reserved seat ticket. *See* J. Feldman, H. Fruhauf, & M. Schoen, Temple Management Manual, ch. 4, p. 10 (1984). Religious honors such as publicly reading from Scripture are purchased or auctioned periodically in some synagogues of Jews from Morocco and Syria. *See* H. Dobrinsky, A Treasury of Sephardic Laws and Customs 164, 175-177 (1986). Mormons must tithe their income as a necessary but not sufficient condition to obtaining a "temple recommend," *i.e.*, the right to be admitted into the temple. *See* The Book of Mormon, 3 Nephi 24:7-12 (1921); Reorganized Church of Jesus Christ of Latter-day Saints, Book of Doctrine and Covenants § 106:1b (1978); *Corporation of Presiding Bishop of Church of Jesus Christ of Latter-day Saints* v. *Amos*, 483 U.S. 327, 330, n. 4 (1987). A Mass stipend—a fixed payment given to a Catholic priest, in consideration of which he is obliged to apply the fruits of the Mass for the intention of the donor—has similar overtones of exchange. According to some Catholic theologians, the nature of the pact between a priest and a donor who pays a Mass stipend is "a bilateral contract known as *do ut facias*. One person agrees to give while the other party agrees to do something in return." 13 New Catholic Encyclopedia, Mass Stipend, p. 715 (1967). A finer example of a *quid pro quo* exchange would be hard to formulate.

This is not a situation where the IRS has explicitly and affirmatively reevaluated its longstanding interpretation of § 170 and decided to analyze *all* fixed religious contributions under a *quid pro quo* standard. There is no indication whatever that the IRS has abandoned its 70-year practice with respect to payments made by those other than Scientologists. In 1978, when it ruled that payments for auditing and training were not charitable contributions under § 170, the IRS did not cite—much less try to reconcile—its previous rulings concerning the deductibility of other forms of fixed payments for religious services or practices. *See* Rev. Rul. 78-189, 1978-1 C.B. 68 (equating payments for auditing with tuition paid to religious schools).

Nevertheless, respondent now attempts to reconcile his previous rulings with his decision in these cases by relying on a distinction between direct and incidental benefits in exchange for payments made to a charitable organization. This distinction, adumbrated as early as the IRS's 1919 ruling, recognizes that even a deductible charitable contribution may generate certain benefits for the donor. As long as the benefits remain "incidental" and do not indicate that the payment was actually made for the "personal accommodation" of the donor, the payment will be deductible. It is respondent's view that the payments made by petitioners should not be deductible under § 170 because the "unusual facts in these cases … demonstrate that the payments were made primarily for 'personal accommodation.'" Brief for Respondent 41. Specifically, the Solicitor General asserts that "the rigid connection between the provision of auditing and training services and payment of the fixed price" indicates a *quid pro quo* relationship and "reflect[s] the value that petitioners expected to receive for their money." *Id.*, at 16.

There is no discernible reason why there is a more rigid connection between payment and services in the religious practices of Scientology than in the religious practices of the faiths described above. Neither has respondent explained why the benefit received by a Christian who obtains the pew of his or her choice by paying a rental fee, a Jew who gains entrance to High Holy

Day services by purchasing a ticket, a Mormon who makes the fixed payment necessary for a temple recommend, or a Catholic who pays a Mass stipend is incidental to the real benefit conferred on the "general public and members of the faith," BNA Daily Report, at J-3, while the benefit received by a Scientologist from auditing is a personal accommodation. If the perceived difference lies in the fact that Christians and Jews worship in congregations, whereas Scientologists, in a manner reminiscent of Eastern religions, see App. 78-83 (testimony of Dr. Thomas Love), gain awareness of the "immortal spiritual being" within them in one-to-one sessions with auditors, *ante*, at 684-685, such a distinction would raise serious Establishment Clause problems. *See Wallace* v. *Jaffree*, 472 U.S. 38, 69-70 (1985) (O'Connor, J., concurring in judgment); *Lynch* v. *Donnelly*, 465 U.S. 668, 687-689 (1984) (concurring opinion). The distinction is no more legitimate if it is based on the fact that congregational worship services "would be said anyway," Brief for Respondent 43, without the payment of a pew rental or stipend or tithe by a particular adherent. The relevant comparison between Scientology and other religions must be between the Scientologist undergoing auditing or training on one hand and the congregation on the other. For some religions the central importance of the congregation achieves legal dimensions. In Orthodox Judaism, for example, certain worship services cannot be performed and Scripture cannot be read publicly without the presence of at least 10 men. 12 Encyclopaedia Judaica, Minyan, p. 68 (1972). If payments for participation occurred in such a setting, would the benefit to the 10th man be only incidental while for the personal accommodation of the 11th? In the same vein, will the deductibility of a Mass stipend turn on whether there are other congregants to hear the Mass? And conversely, does the fact that the payment of a tithe by a Mormon is an absolute prerequisite to admission to the temple make that payment for admission a personal accommodation regardless of the size of the congregation?

Given the IRS's stance in these cases, it is an understatement to say that with respect to fixed payments for religious services "the line between the taxable and the immune has been drawn by an unsteady hand." *U. S.* v. *Allegheny County*, 322 U.S. 174, 176 (1944) (Jackson, J.). This is not a situation in which a governmental regulation "happens to coincide or harmonize with the tenets of some or all religions," *McGowan* v. *Maryland*, 366 U.S. 420, 442 (1961), but does not violate the Establishment Clause because it is founded on a neutral, secular basis. *See Bob Jones University* v. *U.S.*, 461 U.S. 574, 604, n. 30 (1983). Rather, it involves the differential application of a standard based on constitutionally impermissible differences drawn by the Government among religions. As such, it is best characterized as a case of the Government "put[ting] an imprimatur on [all but] one religion." *Gillette* v. *U.S.*, 401 U.S. 437, 450 (1971). That the Government may not do.

In my view, the IRS has misapplied its longstanding practice of allowing charitable contributions under § 170 in a way that violates the Establishment Clause. It has unconstitutionally refused to allow payments for the religious service of auditing to be deducted as charitable contributions in the same way it has allowed fixed payments to other religions to be deducted. Just as the Minnesota statute at issue in *Larson* v. *Valente*, 456 U.S. 228 (1982), discriminated against the Unification Church, the IRS's application of the *quid pro quo* standard here—and only here—discriminates against the Church of Scientology. I would reverse the decisions below.

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Notice that at least two distinct issues presented themselves in *Hernandez*: a statutory construction issue (the scope of "contribution or gift" within the meaning of § 170(c)) and a constitutional issue under the First Amendment Establishment Clause. With respect to the first

issue, the Court determined that Mr. Hernandez's payments failed to qualify as gifts because the "external features" of the transaction—as structured by the parties themselves—entailed an explicit *quid pro quo*, negating the presence of a gift. The Church would not have provided the auditing and training religious services without payments of the specified amounts.

The Court then addressed the Establishment Clause issue. Can the government forbid deduction of fixed *quid pro quo* payments paid by members of the Church of Scientology in exchange for a religious benefit while allowing deduction of fixed *quid pro quo* payments paid by "a Christian who obtains the pew of his or her choice by paying a rental fee, a Jew who gains entrance to High Holy Day services by purchasing a ticket, a Mormon who makes the fixed payment necessary for a temple recommend, or a Catholic who pays a Mass stipend," in the words of Justice O'Connor? While she concluded that it could not, the majority skirted the issue by arguing essentially that the administrative inconsistency issue was not fully developed at the trial and appellate levels and thus was unripe for Supreme Court review.

Members of the Church of Scientology thereafter initiated new litigation in order to better develop the record at trial on this issue. In *Powell v. United States*,[83] the government's motion to dismiss for failure to state a claim on which relief could be granted under Fed. R. Civ. P. 12(b)(6) was granted at the trial level, with the court citing *Hernandez*, but the Eleventh Circuit Court of Appeals reversed and remanded for further development, saying: "The Supreme Court rejected Hernandez's administrative inconsistency argument, not because it wasn't viable, but because there wasn't a proper factual record to establish the IRS's discordant treatment of religious contributions. Hence, if anything, *Hernandez* alerts us to the fact that there is a claim for administrative inconsistency."[84]

As the *Powell* litigation continued, Congress enacted § 170(f)(8) in 1993, which disallows deduction of $250 or more unless the donor obtains a "contemporaneous written acknowledgement" from the donee organization that contains a good faith estimate of the value of any goods or services" received "or, if such goods or services consist solely of intangible religious benefits, a statement to that effect." Notice that this provision does not alter the definition of "contribution or gift" within the meaning of § 170(c) or the result in *Hernandez*. Rather, it only excuses religious organizations from providing documentation of the value of "intangible religious benefits" provided. Nevertheless, three months later, the IRS withdrew without explanation the 1978 Revenue Ruling denying deductions for payments made by Scientologists for auditing and training services that it had successfully defended in *Hernandez* after entering into a closing agreement with the Church of Scientology that settled all outstanding litigation.[85] Thus, even though it spent considerable time and resources litigating *Hernandez* all the way up to the Supreme Court—and won—the IRS announced in 1993 that it would no longer challenge deduction of such auditing and training payments.

Is the IRS's failure to enforce *Hernandez* lawful? Does it affect the deductibility of religious school tuition? In *Sklar*, below, the taxpayers attempted to deduct 55% of the tuition paid to send their children to a private Jewish school, equal to the portion allocable by time to the children's religion classes. Although such tuition fails as a "contribution or gift" under the *Hernandez* test,[86]

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[83] 945 F.2d 374 (11th Cir. 1991).
[84] *Id*. at 377.
[85] *See* Rev. Rul. 93-73, 1993-2 C.B. 75.
[86] *See also* Rev. Rul. 83-104, 1983-2 C.B. 46.

the Sklars relied upon the very "administrative inconsistency" grounds once invoked by Scientologists. If Scientology members are permitted to deduct payments for auditing and training, they argued, so should they be permitted to deduct payments for religious instruction in the Jewish faith. But the Ninth Circuit Court of Appeals disagreed.

## SKLAR v. COMMISSIONER

282 F.3d 610 (9th Cir. 2002)

Before PREGERSON, REINHARDT, and SILVERMAN, CIRCUIT JUDGES.

REINHARDT, CIRCUIT JUDGE: The Sklars contend that because "the IRS has admitted that it permits members of the Church of Scientology to deduct their payments for religious instruction … in order to avoid violating the First Amendment, [the] IRS must permit adherents of other faiths to deduct their payments for religious instruction." To the extent that the Sklars claim that the Establishment Clause requires that we extend the Scientology deduction to all religious organizations, they are in error for three reasons: First, we would be reluctant ever to presume that Congress or any agency of the government would intend that a general religious preference be adopted, by extension or otherwise, as such preferences raise the highly sensitive issue of state sponsorship of religion. In the absence of a clear expression of such intent, we would be unlikely to consider extending a policy favoring one religion where the effect of our action would be to create a policy favoring all. Second, the Supreme Court has previously stated that a policy such as the Sklars wish us to create would be of questionable constitutional validity under *Lemon*, because the administration of the policy could require excessive government entanglement with religion. *Hernandez*, 490 U.S. at 694; *see Lemon*, 403 U.S. at 612-13. Third, the policy the Sklars seek would appear to violate section § 170. *See Hernandez*, 490 U.S. at 692-93.

To the extent that the Sklars are also making an administrative inconsistency claim, we reject that claim on two grounds. First, in order to make an administrative inconsistency claim, a party must show that it is similarly situated to the group being treated differently by the agency. We seriously doubt that the Sklars are similarly situated to the persons who benefit from the Scientology closing agreement because the religious education of the Sklars' children does not appear to be similar to the "auditing", "training" or other "qualified religious services" conducted by the Church of Scientology. Second, even if they were so situated, because the treatment they seek is of questionable statutory and constitutional validity under § 170 of the IRC, under *Lemon*, and under *Hernandez*, we would not hold that the unlawful policy set forth in the closing agreement must be extended to all religious organizations.

In the end, however, we need not decide the Establishment Clause claim or the administrative inconsistency claim as the Sklars have failed to show that their tuition payments constitute a partially deductible "dual payment" under the Tax Code. The Sklars assert that because 45% of their children's school day was spent on secular education, and 55% on religious education, they should receive a deduction for 55% of their tuition payments. On the record before this court, the Sklars failed to satisfy the requirements for deducting part of a "dual payment" under the Tax Code. The Supreme Court discussed the deductibility of such payments in *United States v. American Bar Endowment*, 477 U.S. 105 (1986), and held that the taxpayer must establish that the dual payment exceeds the market value of the goods received in return.

[T]he Sklars have not shown that any dual tuition payments they may have made exceeded the

market value of the secular education their children received. They urge that the market value of the secular portion of their children's education is the cost of a public school education. That cost, of course, is nothing. The Sklars are in error. The market value is the cost of a comparable secular education offered by private schools. The Sklars do not present any evidence even suggesting that their total payments exceeded that cost. There is no evidence in the record of the tuition private schools charge for a comparable secular education, and thus no evidence showing that the Sklars made an "excess payment" that might qualify for a tax deduction. This appears to be not simply an inadvertent evidentiary omission, but rather a reflection of the practical realities of the high costs of private education. The Sklars also failed to show that they intended to make a *gift* by contributing any such "excess payment." Therefore, under the clear holding of *American Bar Endowment*, the Sklars cannot prevail on this appeal.

SILVERMAN, CIRCUIT JUDGE, concurring: The majority states that the Church of Scientology's closing agreement is not relevant because "the Sklars are not similarly situated to the members of the Church of Scientology …." That may or may not be true, but it has no bearing on whether the tax code permits the Sklars to deduct the costs of their children's religious education as a charitable contribution. Section 170 states that *quid pro quo* donations, for which a taxpayer receives something in return, are not deductible. *Hernandez* holds that § 170 applies to religious *quid pro quo* donations. *American Bar Endowment* holds that charitable donations are deductible only to the extent that they exceed the fair market value of what is received in exchange. The Sklars receive something in return for their tuition payments—the education of their children. Thus, they are not entitled to a charitable deduction under § 170. *Hernandez* clearly forecloses the argument that § 170 should not apply because the tuition payments are for religious education. Finally, the Sklars have not demonstrated that what they pay for their children's education exceeds the fair market value of what they receive in return; therefore, they have not shown that they are entitled to a deduction under *American Bar Endowment*. It is as simple as that.

If the IRS does, in fact, give preferential treatment to members of the Church of Scientology—allowing them a special right to claim deductions that are contrary to law and rightly disallowed to everybody else—then the proper course of action is a lawsuit to stop *that* policy.[1] The remedy is not to require the IRS to let others claim the improper deduction, too.

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Who could initiate the lawsuit alluded to in Judge Silverman's concurrence? As described by Professor Lawrence Zelenak, "the law of standing does not permit self-appointed guardians of the public interest to challenge the IRS's unduly lenient treatment of other taxpayers."[87] An exception perhaps exists in the case of possible Establishment Clause violations, indicated by the two 1980s cases cited by Judge Silverman, though Professor Zelenak expresses doubt that Supreme Court decisions in 2007 and 2011 leave this exception intact.[88]

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[1] *See* Bowen v. Kendrick, 487 U.S. 589 (1988) (allowing a taxpayer group to challenge the constitutionality of the Adolescent Family Life Act under the Establishment Clause); School Dist. of City of Grand Rapids v. Ball, 473 U.S. 373, 380 n. 5 (1985) (noting and affirming "the numerous cases in which we have adjudicated Establishment Clause challenges by state taxpayers to programs for aiding nonpublic schools."), rev'd on other grounds, Agostini v. Felton, 521 U.S. 203 1997).

[87] Lawrence Zelenak, *Custom and the Rule of Law in the Administration of the Income Tax*, 62 DUKE L.J. 829, 847 (2012).

[88] Professor Zelenak believes that Hein v. Freedom From Religion Foundation, 551 U.S. 587 (2007), and Arizona Christian School Tuition Organization v. Winn, 131 S. Ct. 1436 (2011), are "sufficient to deny standing to taxpayers

Let's return to the topic of dual payments, in which a portion of a payment made to a § 501(c)(3) organization is nondeductible consideration for the purchase of goods or services and the remainder is a deductible if made with the intention of making a gift. In the case of services received from a charity that are not commonly bought and sold in the marketplace, *Hernandez* instructs that the "external features" of the transaction—as structured by the parties themselves—should govern whether a dual payment is present. Absent an objective marketplace reference for value, this focus on the "external features" of the transaction prohibits Mr. Hernandez from arguing that the auditing and training services had a lower value (or no value) to him, allowing him to deduct all or a portion of the payment as a gift. Only if Mr. Hernandez had paid more than the church's listed price would he have made a dual payment, with the excess constituting a gift.

How does this analysis affect the receipt of naming rights? For example, John Smith makes a $15 million "donation" to his *alma mater* law school, and the school renames itself the "John Smith School of Law." Can Mr. Smith deduct the entire $15 million payment, nothing, or an amount between $0 and $15 million? Does it matter whether Mr. Smith's payment is expressly made conditional on the decision of the school's Board of Trustees to rename the school in his honor? That the Board insisted on a payment of at least $15 million for the privilege, a term that is contractually enforceable? While the sale of naming rights by charities has exploded in the last two decades, the IRS currently values naming rights at $0, concluding that any benefit received is "incidental" and not made as a "personal accommodation" to the donor.[89] Thus, Mr. Smith can deduct the entire $15 million. Is this result consistent with *Hernandez*? If not, would anyone have standing to litigate the issue?

In the case of dual payments that involve goods or services that *are* commonly bought and sold in the marketplace, § 6115(a) requires charities receiving a "*quid pro quo* contribution in excess of $75" to make a "good faith estimate" of the fair market value received by the taxpayer and to inform him or her that only the excess is deductible. Section 6115(b) defines "*quid pro quo* contribution" to exclude payments made to charities "organized exclusively for religious purposes, in return for which the taxpayer receives solely an intangible religious benefit that generally is not sold in a commercial transaction outside the donative context." Section 6115 was enacted in the same legislation adopting § 170(f)(8), described above.

To illustrate, assume that Deborah receives an invitation in the mail from the Cleveland Orchestra to purchase a ticket for a gala at lovely Severance Hall to celebrate the 75th anniversary of the Cleveland Orchestra, consisting of cocktails, a dinner, and a concert. The invitation states that the ticket price is $1,500, of which $1,300 is deductible. In this case, the Cleveland Orchestra's "good faith estimate" of the value of the food and concert is $200, with the excess deductible as a gift under § 170.

Finally, how should we value the *opportunity to purchase* (at full face value) hard-to-get tickets to the Ohio State/Michigan football game? We have an answer to this one in the statute itself. Section 170(*l*) is reportedly the result of the lobbying efforts of a Baton Rouge lawyer who held season tickets on the 43-yard-line at Tiger stadium, home of the football team at Louisiana State

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challenging the constitutionality of favorable IRS treatment of other taxpayers. Thus, the sort of third-party standing hinted at in … First Amendment cases now appears to be doubly foreclosed." Zelenak, *supra* note 91 at 847 n.84.

[89] *See generally* William A. Drennan, *Where Generosity and Pride Abide: Charitable Naming Rights*, 80 U. CIN. L. REV. 53 (2011); John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction*, 36 WAKE FOREST L. REV. 657 (2001).

University.[90]

> Some U.S. colleges with the most popular teams in football, basketball and hockey take advantage of the provision to market higher prices to season-ticket buyers. They set the face value, then demand additional hundreds or thousands of dollars in what are designated contributions as a condition of sale. The pitch is that under U.S. law, the fans can write off 80 percent of the mandatory donations when they itemize deductions. Other schools don't set specific donation levels. Instead, they award seat locations using point systems in which giving may be one element.[91]

***Determining the deductible amount when property is contributed in kind***

Absent the receipt of goods or services in return, the deductible amount when cash is contributed to a public charity or private foundation is the amount of cash. In the same circumstances, what is the measure of the deductible amount if tangible property (*e.g.*, Blackacre or equipment) or intangible property (*e.g.*, shares of corporate stock or a patent) is contributed? For example, how much should Jane be permitted to deduct if she contributes property that she previously purchased for $1,000 to a charity at a time when its fair market value (FMV) is $5,000?

Under SHS principles, Jane should be permitted to deduct no more than her $1,000 basis if we are to avoid allowing to Jane a double tax benefit for the same dollars, as the $4,000 appreciation in value since her purchase has not yet been included in her Gross Income under the realization requirement, and the making of the gift is not itself a realization event, as you learned in Chapter 7. Stated another way, if we are trying to measure "income" properly as a normative matter, Jane's deduction must be limited to her basis (after-tax dollars) for the same reason that § 165 loss deductions (under § 165(b)), § 166 bad-debt deductions (under § 166(b)), and depreciation deductions (under § 167(c)) are limited to basis, not FMV.

"But wait," you say. "Section 170 is a tax expenditure. It represents an intentional deviation from SHS principles by allowing deduction of a personal expense." How bright you are! Because § 170 is thought by most to be a tax expenditure, SHS's definition of income is irrelevant. Rather, tax expenditures require the sort of nontax, cost-benefit analysis recounted at the beginning of this chapter and Chapter 17. What is the goal sought to be accomplished? Is that goal better accomplished inside or outside the tax system? If the tax system is to be used, is the provision crafted well to avoid windfall losses, *i.e.*, the deduction of more than is necessary to achieve the desired level of giving? Is the distribution of the tax expenditure's benefits among income groups fair, remembering always that these provisions, because they are not costless, mean that tax *rates* are higher than they otherwise would be to raise *$X* in revenue? Under such an analysis, when (if ever) are double tax benefits necessary to reach the nontax goal sought to be accomplished under § 170 in an efficient manner that loses as little revenue as possible? With the possible exception of art museums, which might desire the donation of a particular painting or sculpture in kind, most charities are frank that they prefer cash donations, which increases their flexibility in furthering their exempt purposes.

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[90] *See* Curtis Eichelberger & Charles R. Babcock, *Football Ticket Tax Break Helps Colleges Get Millions*, at www.bloomberg.com/news/2012-10-25/got-college-football-tickets-take-a-tax-break.html. The article describes how the law, which originally applied *only* to Louisiana State and the University of Texas at Austin, was enacted in 1986 and expanded in 1988 to all colleges and universities when they complained. The authors believe that the Ohio State University benefited the most from this provision in 2011.

[91] *Id.*

The starting point in determining the amount of Jane's deduction is Treas. Reg. § 1.170A-1(c)(1), which provides that "the amount of the contribution is the fair market value of the property at the time of the contribution, reduced as provided in section 170(e)(1)." As implied in this regulation, § 170(e)(1) can operate to reduce the deduction below FMV (usually, though not always, to the property's basis) in the case of *appreciated* property (property with a built-in gain). Thus, with respect to property with a *built-in loss*, the taxpayer is clearly limited to a deduction equal to the property's FMV, not the property's higher basis. For example, if Jane purchases property for $7,000 and contributes it to charity at a time when its FMV has fallen to $5,000, she can deduct no more than its $5,000 FMV. If the built-in loss property is business or investment property (as opposed to personal-use property), what should Jane do, in light of §§ 165(c)(1) and (2)? She should *sell* the property for its $5,000 FMV to a third party, deduct the realized and recognized $2,000 loss under § 165(c), and contribute the $5,000 cash obtained on the sale to the charity (instead of the property in kind)! Whether she contributes the property in kind or sells it and contributes the cash to the charity, her § 170 deduction will be $5,000 in any event. But if she contributes the property in kind to the charity, she will lose her $2,000 § 165(c) loss deduction because the gift (unlike the sale) is not a realization event.

In the early days of the income tax, a full FMV deduction for charitable contributions of *appreciated* property in kind was likely the reflexive result of the same thinking that early on resulted in the recipient of an *inter vivos* gift taking a FMV basis instead of a carryover basis (before the enactment of § 1015), as described in Chapter 7, Part A., or the exclusion as a "capital return" of personal injury damages, as described in Chapter 17, Part B. By 1962, after the concept of "basis" (capital) was better understood as a running record of previously taxed dollars, Congress enacted § 170(e) to limit a FMV deduction for appreciated property to those situations that Congress thought required it to achieve the policy goals of § 170, and § 170(e) has been amended many time since then. As you work your way through § 170(e)(1), consider whether Congress has drawn the lines well in determining which contexts (if any) justifiably require a full FMV deduction (and thus a double tax benefit for the same dollars) under a cost-benefit analysis.

**In order to apply the rules in § 170(e)(1), which may reduce the FMV deduction otherwise allowable under Treas. Reg. § 1.170A-1(c)(1) on a contribution of appreciated property, you must *first* determine the character of the gain (long-term capital gain, short-term capital gain, § 1231 gain, or ordinary gain) that the taxpayer would realize if, contrary to fact, the taxpayer sold the property to a third party for its FMV instead of contributed it in kind to the charity. That is to say, you must determine the *character of the property's built-in gain* at the time of the contribution.**

As noted earlier, this discussion is limited to (the much more common) contributions to public charities. It does not discuss the additional limitations that apply to contributions to private foundations. In addition, contributions of fractional interests, future interests, and partial interests in property are subject to complex rules beyond the scope of this introductory course.[92] Ditto for the special rules applying to the contribution of real property as a "qualified conservation contribution" within the meaning of § 170(h).

*Situation 1:* Returning to Jane, let's assume that the property with a basis of $1,000 and FMV of $5,000 that she contributes to a public charity is a widget and that Jane sells widgets to customers in the ordinary course of her business. If Jane were to sell this inventory for its $5,000

[92] *See, e.g.*, §§ 170(a)(3), (f)(2)-(4), and (o).

FMV instead of contributing it, she would realize a $4,000 gain under § 1001 ($5,000 A/R *less* $1,000 A/B), and this gain would be ordinary in character. *See* § 1221(a)(1). With this information in hand, carefully read the introductory clause in § 170(e)(1) and then subparagraph (A). This language requires that Jane must reduce her $5,000 FMV deduction by the gain that would *not* have been long-term capital gain had she sold it (instead of contributed it to charity). Thus, Jane must reduce her deduction to the widget's $1,000 basis ($5,000 FMV *less* $4,000 ordinary built-in gain) when she contributes the property in kind to a public charity.

*Situation 2*: Assume that the property that Jane contributes to a public charity is a widget-making machine, which she uses in her business to produce the widgets that she sells to customers as inventory. She bought the machine for $10,000 several years ago and properly deducted $4,000 in depreciation (reducing its basis to $6,000 under § 1016(a)(2)) before contributing it to a public charity when its FMV is $8,000. If Jane were to sell this machine for its $8,000 FMV, she would realize a $2,000 gain under § 1001 ($8,000 A/R *less* $6,000 A/B), and this gain would be entirely ordinary under § 1245(a) as depreciation recapture, which you studied in Chapter 15, Part D. Because the property's built-in gain is ordinary in character rather than long-term capital gain, § 170(e)(1)(A) again requires Jane to reduce her deduction to the property's basis ($8,000 FMV *less* $2,000 ordinary built-in gain) when she contributes the machine to a public charity.

*Situation 3*: Assume the same facts as in Situation 2, except that the widget-making machine that Jane purchased for $10,000 increased in value to $11,000 before she contributed it to a public charity, notwithstanding that she properly deducted $4,000 in depreciation (reducing its basis to $6,000) during her ownership. If Jane were to sell this machine for its $11,000 FMV, she would realize a $5,000 gain under § 1001 ($11,000 A/R *less* $6,000 A/B). Of this $5,000 gain, $4,000 would be ordinary under § 1245 as depreciation recapture, and the remaining $1,000 would be § 1231 gain under § 1231(b). Recall from Chapter 15, Part D., that Jane's realized and recognized § 1231 gains and losses are "treated" as though they are long-term capital gains and losses, respectively, *only* if her § 1231 gains exceed her § 1231 losses from all dispositions of § 1231 property for the year. How much can Jane deduct on her contribution of this machine to charity?

Carefully read the penultimate sentence in § 170(e)(1). It effectively provides that built-in gain representing § 1231 gain is always "treated" as long-term capital gain for purposes of both §§ 170(e)(1)(A) and (B) (discussed below). Under § 170(e)(1)(A), Jane need not reduce her $11,000 FMV deduction by the amount of built-in gain representing § 1231 gain, but she must reduce her deduction by the $4,000 of built-in gain representing ordinary depreciation recapture under § 1245. Thus, Jane can deduct only $7,000 ($11,000 FMV *less* $4,000 ordinary built-in gain) when she contributes the machine, which is neither the property's $11,000 FMV nor its $6,000 A/B. If either §§ 170(e)(1)(A) or (B) is triggered, the taxpayer's deduction in the vast majority of cases is reduced to the property's basis, but this Situation 3 is the rare case that illustrates that a reduction to basis does not always result.

*Situation 4*: Jane contributes shares of corporate stock that she holds as an investment to a public charity. She purchased the stock for $6,000 three years ago and its FMV is $10,000 at the time of contribution. If Jane were to sell the stock, she would realize a $4,000 gain under § 1001 ($10,000 A/R *less* $6,000 A/B), and this gain would be long-term capital gain because (1) the stock is not described in § 1221 and (2) Jane held this capital asset for more than one year. Thus, Jane's contribution survives § 170(e)(1)(A), but we have not yet examined § 170(e)(1)(B).

**Whereas § 170(e)(1)(A) always reduces a FMV deduction by the amount of built-in gain**

**that does *not* represent either long-term capital gain or § 1231 gain, § 170(e)(1)(B) may reduce a FMV deduction by the amount of built-in gain that *does* represent either long-term capital gain or § 1231 gain—but only in certain circumstances**. Read carefully the last clause of § 170(e)(1)(B), referring to gain that *would* have been long-term capital gain if the property were sold. The penultimate sentence of § 170(e)(1) again applies for this purpose, as well, referring to § 1231 gain. Because the built-in gain in Jane's stock *is* long-term capital gain, her FMV deduction is at risk under § 170(e)(1)(B), but her deduction will be reduced by such gain *only* if the property is otherwise described in subsection (i) through (iv) of § 170(e)(1)(B). We shall focus only on (i) and (iii).[93] Jane's stock is not described in (i) because stock is not "tangible" property but rather is *intangible* property, and it is not described in (iii) because corporate stock is not a patent, copyright, or other property described there.

Because neither §§ 170(e)(1)(A) nor (B) apply, Jane can deduct the stock's full $10,000 FMV, resulting in a double tax benefit for the $4,000 built-in gain, which she can both exclude (because gifts are not realization events) and deduct (under § 170) as part of her $10,000 deduction. Nirvana! This analysis explains why appreciated corporate stock held for more than one year is one of the most common forms of in-kind charitable contributions by the wealthy. Even better, the future dividends on this stock, as well as any gain realized when the public charity sells the stock (after taking a § 1015 carryover basis), are generally not taxed to the charity under the UBIT rules.[94] In other words, the built-in gain disappears from the tax system, just as occurs under § 1014 when appreciated property is passed at death, discussed in Chapter 7.

*Situation 5*: Assume the same facts as in Situation 4, except that Jane has held the stock for only 11 months before contributing it to the public charity. Very bad tax planning on Jane's part! Section 170(e)(1)(A) reduces her deduction to the stock's $6,000 basis because the built-in gain is *not* long-term capital gain (but rather is *short-term capital gain*). She should have waited one more month and a day before contributing the stock!

*Situation 6*: Assume the same facts as in Situation 4, except that the contributed property is undeveloped land that Jane does not use in her business. Because the $4,000 built-in gain is long-term capital gain, the contribution avoids § 170(e)(1)(A). Does it avoid § 170(e)(1)(B)? Yes! She avoids (iii) because land is not a patent, copyright, *etc.* She also avoids (i). Unlike corporate stock, land is tangible property, but it is tangible *real* property rather than tangible *personal* property (in the property law sense). Regardless of how the public charity uses the land, therefore, Jane is entitled to a $10,000 FMV deduction. Once again, nirvana for Jane!

*Situation 7*: Jane, who is not an art dealer, purchased a painting 20 years ago for $500,000 that experts attributed to one of Rembrandt's students. Jane's lucky day arrived, however, when it was recently confirmed, using new technology, that it was painted by the master himself, after which a new appraisal placed its value at $30.5 million.[95] Without regard to the painting contribution,

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[93] We shall ignore (iv), relating to certain "taxidermy property," which was added in 2006 after an exposé by the Washington Post and congressional hearings revealed that big game hunters were donating their stuffed trophies to niche museums that would accept them and deducting inflated values that included the cost of their safari trips. You can't make this stuff up! *See* Marc Kaufman, *Big-Game Hunting Brings Big Tax Breaks*, at www.washingtonpost.com/wp-dyn/articles/A26324-2005Apr4.html.

[94] *See* § 512(b).

[95] *See, e.g.*, *Mystery Painting is Revealed to be a Rembrandt Worth £20 million*, at www.telegraph.co.uk/culture/art/art-news/9936875/Mystery-painting-is-revealed-to-be-a-Rembrandt-worth-20-million.html.

Jane has an AGI of $70 million this year. Should she sell the painting to a buyer or contribute it in kind to an art museum? If she could enjoy a double tax benefit for the $30 million built-in gain (both exclusion of the $30 million built-in gain and deduction of the $30.5 FMV of the painting under § 170), she would clearly be better off contributing the property in kind.

Because the built-in gain represents long-term capital gain, § 170(e)(1)(A) clearly does not apply to reduce Jane's deduction, but § 170(e)(1)(B)(i)(I) could possibly apply, reducing Jane's deduction to its $500,000 basis, but only if the museum's *use* of the painting is unrelated to it its tax-exempt purpose. What does this language mean? The legislative history accompanying this provision indicated that "a clear example of where property is not being used for an organization's exempt purpose is where it is intended at the time of the donation that the exempt organization will sell the property," an example of unrelated use that is now found in the regulations.[96] An example of unrelated use not involving a sale by the charity is found in a Private Letter Ruling involving a contribution of an antique automobile to a college. The college did not offer courses in antique car restoration, and the car was stored in a professor's garage. The IRS ruled that the car was not being used in connection with the college's exempt purpose, reducing the donor's contribution to the car's basis.[97]

If the museum informs Jane that it will place the Rembrandt in its galleries for viewing by the public, the use of the donated property is clearly related to the museum's exempt purpose. If, however, the museum knows at the time of the donation that it has a sufficient number of Old Master paintings and thus will sell the Rembrandt and use the cash to then purchase a painting that would augment its modern collection, Jane's deduction would be reduced to $500,000 under § 170(e)(1)(B)(I).

You can imagine that it was not uncommon for public charities to accept donations of tangible personal property in kind with the promise to use it in a manner that furthers its exempt purpose (allowing the donor to take a FMV deduction), only to find that a sale for cash is necessary, after all, a short time later. Congress reacted by adding §§ 170(e)(1)(B)(i)(II) and (e)(7) in 2006. If the museum sells within the same year of donation, Jane's deduction will be reduced to $500,000 under § 170(e)(1)(B)(II), unless the museum certifies, under penalties of perjury, either that (i) the museum's use of the property prior to sale was "substantial" and describes how the property was used and how its use furthered the museum's exempt purpose or (ii) the museum intended to use the property in furtherance of its exempt purpose but that the intended use "has become impossible or infeasible to implement." If the sale occurs after the year of donation but before the end of three years, Jane does not go back and file an amended return for the donation year (deducting only the property's basis instead of FMV) but rather includes in Gross Income (in the year of the charity's sale of the property) the property's built-in gain at the time of the donation.

Taxpayers contributing their old personal-use cars to public charities, who sell them in order to raise cash, need not worry about § 170(e)(1)(B)(i)'s related-use test because these vehicles reflect a built-in *loss*, not a built-in gain. Nevertheless, taxpayers commonly used inflated FMVs to measure their deductions before Congress added §§ 170(f)(12) and 6720 in 2004, which combine, in general, to limit the donor's deduction to the gross proceeds obtained by the charity on the vehicle's sale without any significant intervening use or material improvement and to impose penalties on charities that fail to furnish the proper acknowledgement to the donor, which the donor

[96] *See* Treas. Reg. § 1.170A-4(b)(3)(i).
[97] PLR 8009027 (Nov. 29, 1979).

must include with his tax return.[98]

***Contributions of services in kind***

Treas. Reg. § 1.170A-1(g) prohibits the deduction of the FMV of services donated in kind, thus preventing a double tax benefit (both exclusion and deduction) for the same dollars, notwithstanding the double tax benefits allowed with respect to contributions of appreciated property that avoid reduction under § 170(e)(1). Unreimbursed expenses incurred in rendering the services are generally deductible, however, such as transportation, travel, and uniform costs. With respect to the deduction of travel costs as charitable contributions beware § 170(j), added in 1986.

***Substantiation requirements***

To be entitled to *any* deduction, the taxpayer must maintain a record of the donation, including a "written communication from the donee organization" showing the date and amount of the contribution.[99] As noted earlier, § 170(f)(8) requires the taxpayer to obtain a "contemporaneous written acknowledgement" from the donee organization for contributions of $250 or more that states whether any goods or services were obtained in return (and the FMV of any *quid pro quo*). With respect to contributions of property in kind worth more than $500, § 170(f)(11) further requires the taxpayer to attach Form 8283 to her return, with a description of the property, and § 170(f)(11) requires the taxpayer to obtain (and attach to her return) a qualified appraisal for property worth more than $5,000. Finally, also as noted earlier, § 170(f)(12) imposes special substantiation requirements with respect to the donation of used vehicles.

***AGI percentage contribution limits***

In no case can more than 50% of AGI (disregarding any § 172 net operating loss carryback) be offset by the aggregate of the taxpayer's charitable contributions for the year.[100] In the case of any individual contribution, however, the percentage limit can be lower. Contributions exceeding the relevant contribution limit can be carried forward for five years for possible deduction, though any carryover is deducted *last* in the carryover year, after applying the percentage limits to any contributions actually made in the carryover year. Below are the three most important percentage limits for contributions to public charities (not private foundations).[101]

- Cash contributions to most public charities and religious organizations are subject to the highest 50%-of-AGI limit.
- Contributions of property in kind to such charities are also subject to the highest 50%-of-AGI limit *but only if* § 170(e)(1) applies to reduce the contribution amount below FMV.
- A 30%-of-AGI limit applies to contributions of property in kind to such charities if § 170(e)(1) does *not* apply, allowing the donor to deduct the property's FMV. A taxpayer can revive the higher 50%-of-AGI limit by electing to deduct only the lesser amount that would have been allowable if § 170(e)(1) had applied to reduce the deduction below FMV.[102] The

[98] Congress also enacted § 170(f)(16) in 2006, which denies deduction for clothing and household items unless they are in "good used condition or better."
[99] *See* § 170(f)(17).
[100] *See* §§ 170(b)(1)(A) and (G).
[101] More restrictive limits, which are beyond the scope of this introduction, apply to contributions *for the use of* the charity (generally meaning property contributed *in trust for* the charity).
[102] *See* § 170(b)(1)(C)(iii).

election applies to all such property contributions for the year.

In what order are these limits applied? In general, the taxpayer's maximum 50%-of-AGI cap is used up in the same order listed above: (1) cash contributions, (2) contributions of property in kind subject to the 50%-of-AGI limit, and (3) contributions of property in kind subject to the 30%-of-AGI limit.[103]

> **Example 1**: Mark's AGI is $50,000 this year when he contributes to the church that he attends both $2,000 in cash and land that he had purchased several years ago for $22,000 and held for investment. Mark obtains a qualified appraisal of the land this year confirming that it is now worth $28,000. Because the land is not described in § 170(e)(1),[104] Mark is entitled to deduct the $28,000 FMV of the land, and he does not elect to reduce his deduction under § 170(b)(1)(C)(iii) to the land's $22,000 A/B. Thus, the 30%-of-AGI limit applies to the land contribution.
>
> The $2,000 cash donated to his church is considered first and is fully deductible because it does not exceed Mark's $25,000 cap (equal to 50% of his $50,000 AGI).
>
> With respect to the land contribution, Mark's $28,000 deduction is limited to $15,000, which is the *lesser* of the 30%-of-AGI limit and the $23,000 amount remaining of his $25,000 cap ($25,000 cap *less* $2,000 allowable cash donation).
>
> Mark deducts $17,000 this year and carries forward $13,000 of the land deduction ($28,000 *less* $15,000 allowable this year) to Year 2, when the percentage limits will again apply. Mark's Year-2 contributions are deducted first under the percentage limits before his Year-1 carryover is analyzed. Any undeducted carryover expires after five years.
>
> **Example 2**: Same as Example 1, except that Mark makes the § 170(b)(1)(C)(iii) election to reduce his land deduction from its $28,000 FMV to its $22,000 A/B (as though the land were described in § 170(e)(1)) in order to use the 50%-of-AGI limit (instead of the 30%-of-AGI limit) for this contribution.
>
> The $2,000 cash donated to his church is considered first and is fully deductible because it does not exceed the $25,000 cap (equal to 50% of Mark's $50,000 AGI).
>
> With respect to the land contribution, Mark's $22,000 deduction is fully allowable as it, together with his $2,000 cash contribution, does not exceed his $25,000 cap.
>
> Mark deducts $24,000 this year and has no carryover.

## Problems

Doug and Lindsey are married and file a joint return. Without considering the items noted below, their AGI is $300,000. To what extent can Doug and Lindsey deduct as charitable contributions the items noted below for the current tax year? Assume that each of the organizations

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[103] *See generally* IRS Publication 526 at www.irs.gov/publications/p526/ar02.html#en_US_2012_publink1000229802.

[104] It is not described in § 170(e)(1)(A) because the land's built-in gain *is* long-term capital gain. Moreover, it is not described in § 170(e)(1)(B)(i) because land is real property rather than personal property and is not described in § 170(e)(1)(B)(iii) because land is not a patent, copyright, or similar property.

noted below is a public charity, contributions to which are eligible for deductions under § 170, and that Doug and Lindsey will itemize their deductions instead of taking the Standard Deduction.

**1.** Doug and Lindsey purchased two tickets to attend a Cleveland Orchestra concert for $50 each (a total of $100), and they attended the concert. What if they did not attend the concert after purchasing the tickets because Doug was not feeling well? What if, because they knew that they could not attend, they called the box office on the morning of the concert and donated their tickets back to the box office so that they could be resold?

**2.** Doug and Lindsey, both of whom graduated from Ohio State University, jointly contribute $5,000 to the Ohio State University annual fund each year. Those who make a minimum contribution of at least $5,000 are entitled to purchase tickets to the Ohio State/Michigan football game (very hot tickets that sell out quickly) before they go on sale to the general public. They purchase two tickets to the game for $50 each ($100 total), which is their face amount. *See* § 170(*l*).

**3.** Doug and Lindsey have decided that they will contribute shares of corporate stock to the American Red Cross. They are deciding among three blocks of stock, each of which has an FMV of $20,000. Which of the three blocks of stock should they contribute in kind and why?

**a.** Shares purchased 2 years ago for $25,000?

**b.** Shares purchased earlier this year for $18,000?

**c.** Shares purchased 5 years ago for $5,000?

**4.** Doug owns an art gallery where he sells paintings and sculptures (which he buys at wholesale from the artists) to customers. Doug contributes a painting of a book to his local library, which will hang on the wall behind the library's front desk. Doug purchased the painting 2 years ago for $500, but it was just appraised at $2,000.

**5.** Same as **4.**, except that Doug does not own an art gallery but, rather, is a lawyer. He contributes the same painting to his local library, which will hang on the wall behind the library's front desk. Doug purchased the painting 2 years ago from an art gallery for $500, but it was just appraised at $2,000.

**6.** Same as **5.**, except that both Doug and the library's Board of Trustees know that the library would rather have the cash than the painting. Thus, the library Board sells the painting for $2,000 shortly after Doug's contribution.

**7.** Lindsey is a dentist who contributes 8 hours of her time each month at a free clinic performing free dental work to low-income residents. In her own office, Lindsey would earn approximately $1,600 of net profit for 8 hours of work. *See* Treas. Reg. § 1.170A-1(g). Does this Regulation suggest that Lindsey should perform additional paid work for $1,600 and contribute the cash instead of her time? What about taxpayers, unlike Doug and Lindsey, who will take the Standard Deduction instead of itemizing their deductions? What about taxpayers, unlike Doug and Lindsey, who contribute more than 50% of their AGI to charity, rendering additional cash donations nondeductible in the current year (though creating a carryover for five years)?

## E. State and local taxes

Federal taxes are generally nondeductible under § 275. The state, local, and foreign taxes listed in §§ 164(a)(1) through (5) are deductible, whether or not connected with a trade or business or investment. The most important are (1) and (3): real property taxes and income taxes. The deduction helps to ameliorate, though of course not eliminate, the differential in local tax burdens between citizens of high tax states, such as New York, and low-tax states, such as Mississippi. This view of Federalism looks at the relationship of the states *vis-a-vis* one another and the United States. It tends to have a bit of a leveling effect across the states.

Noticeably absent after 1986 are sales taxes. The elimination of the deduction for state sales taxes was one of the base-broadening measures that paid for the dramatic reduction in ordinary income tax rates (from a top tax rate of 50% to 28%). From a Federalism perspective, is it a good idea to pick and choose among state taxes when deciding their deductibility for Federal income tax purposes? *If* we view Federalism as the relationship between the Federal government and the autonomy of each state, then it would seem that the Federal government ought to allow deduction of *all* state and local taxes or deny deduction of *all* state and local taxes. Allowing the deduction of *some* taxes (income and property taxes) but not others (sales taxes) intrudes on the states' choices regarding which taxes to adopt, increase, eliminate, *etc*., because a tax that is deductible for Federal income tax purposes becomes more palatable than one that is not.

On the other hand, states did not retreat from sales taxes in favor of income and property taxes after 1986. Indeed, since 1986 states have tended to *decrease* their income taxes and *increase* their consumption taxes. These moves have had a doubly regressive effect. Sales taxes, as consumption taxes, both hit the poor and lower middle class more heavily than the relatively wealthy (as described in Chapters 2 and 3) and are also mostly nondeductible for Federal income tax purposes. Thus, the pain of these regressive state taxes is not ameliorated on the Federal income tax return. At the same time, state income taxes, which hit the relatively wealthy more heavily than do sales taxes, have not only been proportionately reduced by many states but also remain deductible for Federal income tax purposes, reducing their pain. These trends remind us that many factors—including perceptions about different kinds of taxes—affect their acceptability to state electorates.

States that do not have state income taxes complained heavily about the 1986 amendments that rendered sales taxes nondeductible, eventually resulting in a series of temporary provisions that allowed residents to elect to deduct *either* income or sales taxes (but not both). Finally, the Protecting Americans from Tax Hikes Act of 2015 made this election permanent in § 164(b)(5).

Taxes that are not listed in § 164 but are connected with a trade or business or investment, including sales taxes, are potentially deductible under the second sentence in § 164(a).[105] For example, a business that pays a state sales tax on the purchase of short-lived office supplies can deduct that sales tax under this language.

Can a sole proprietor that purchases a delivery truck for use in her business and pays a state sales tax deduct it under this sentence? No. The third sentence in § 164(a) reminds us that taxes incurred in the course of acquiring or selling a long-lived asset must be capitalized. The sales tax

[105] Is this language redundant, *i.e.*, would §§ 162 and 212 provide the authority for those deductions in any event? No. This language is necessary because § 164 carves out the domain of taxes from other expenses, just as § 163 carves out interest from other expenses. As a general rule of statutory interpretation, the specific takes precedence over the general.

incurred by the sole proprietor becomes part of the cost basis of the delivery truck and is deducted under § 179 or as depreciation deductions over time under §§ 167 and 168, as you learned in Chapter 14. The outlays for the short-lived office supplies described above would be current expenses, rather than capital expenditures, so the sales taxes on those purchases would be deductible immediately.

## F. Expenses for the determination, collection, or refund of any tax

Your obligation to pay Federal taxes is a personal one, even though the obligation arises because of business and investment income that you earn. Therefore, amounts that you spend in connection with satisfying your personal obligation to pay your Federal income tax are personal expenses, normally nondeductible under § 262. The taxpayer in *Lykes v. United States*[106] contested a Federal gift tax assessment and incurred attorney fees in that contest. He attempted to deduct those fees by squeezing within § 212(2). How? He argued that the fees came within the language of § 212(2) because the gift tax assessment pertained to gifts that Mr. Lykes made *of investment property*. The Supreme Court disagreed, and Congress reacted by enacting § 212(3), which would clearly allow a taxpayer in his position today to deduct the costs incurred in actually defending against a gift tax or income tax assessment. Read § 212(3).

What other kinds of expenses come within this language? The question is how broadly to construe "the determination, collection, or refund of any tax." The legislative history shows that it would clearly cover expenses incurred in completing tax returns and dealing with actual tax controversies with the IRS. The regulations, however, go farther. Treas. Reg. § 1.212-1z(*l*) provides that "expenses paid or incurred by a taxpayer *for tax counsel or* expenses paid or incurred in connection with the preparation of his tax returns or in connection with any proceedings involved in determining the extent of tax liability or in contesting his tax liability are deductible." (Emphasis added.) Thus, not only expenses incurred to defend against a tax controversy (as in the case of Mr. Lykes) or to comply with the law (as in the case of paying a tax return preparer) but also amounts paid *for tax planning* are deductible. For example, though the costs of obtaining a divorce are nondeductible personal expenses, the costs incurred for tax advice in negotiating tax-efficient arrangements for child support, alimony, and a property settlement are deductible.

Who really benefits from § 212(3)? Capture, anyone? Capture effects may be reduced because the § 212(3) deduction is an Itemized Deduction (because not listed in § 62) and a MID (because not listed in § 67(b)). Thus, not many taxpayers may actually benefit from the § 212(3) deduction. Recall that the price mechanism can be exploited to capture tax benefits most readily when the tax benefit is widely available.

[106] 343 U.S. 118 (1952).

# Chapter 19: Gambling and Hobby Losses

You learned in Chapter 1 that current expenses incurred to purchase personal consumption are nondeductible under § 262(a)—even though they represent a wealth decrease—to ensure that purchased personal consumption remains in the tax base. For the same reason, you learned in Chapters 1 and 14 that the basis created by a nondeductible capital expenditure to acquire personal-use property (whether tangible or intangible) is not depreciable or amortizable, even if the property has an ascertainable useful life and wastes away in a predictable manner. Finally, you learned in Chapter 18 that § 165(c)(3) personal losses are not deductible except in the case of certain casualty and theft losses, subject to severe restrictions under § 165(h). Thus, you cannot deduct the cost of an entertaining night out at the movies with friends (a current expense), depreciate the cost basis of woodworking equipment that you use to create furniture only for your home (a nondeductible capital expenditure), or deduct the § 1001 loss on the sale of a personal-use car for an amount realized less than basis.

Should entertainment and hobby costs remain entirely nondeductible, however, if they *also* happen to generate includable § 61 Gross Income, as well, unlike the above examples? Instead of going to the cinema for entertainment, suppose that you visit a casino, instead, and win a few jackpots on your placed bets. Or suppose that you sell furniture that you enjoy making at local summer art fairs. Should Congress tax earnings from fun—rather than from business or investment—in a *gross receipts* manner, without any deduction allowances, rather than in the usual net profit manner inherent in an SHS income tax? After all, you also learned in Chapter 1 that a tax conforming to SHS income tax principles should not doubly tax the same dollars to the same taxpayer, which generally requires that the costs of producing *includable Gross Income* be deductible. The §§ 162 and 212 business and investment expense provisions, the ability to depreciate the basis of business and investment property with an ascertainable useful life under §§ 167 and 168 and related provisions, and the ability to deduct unrecovered basis in excess of amount realized on the sale, exchange, destruction, or theft of business or investment property under §§ 165(c)(1) or (2) are all premised on this bedrock principle.

The next chapter will address allocating costs between clearly personal consumption activities and clearly profit-oriented activities. The subtly different issue addressed in this chapter is how to determine, in the first instance, whether an activity is a business or other profit-oriented activity or only a personal consumption activity. Moreover, if the activity is determined to reside solely in the personal consumption sphere, does current law avoid doubly taxing the same dollars to the same taxpayer under the income tax when the activity generates includable Gross Income (unlike most personal consumption activities), or are such earnings taxed in a gross receipts manner?

## A. Gambling losses: § 165(d)

Connor is a lawyer who never entered a casino before a visit to Las Vegas with friends for a weekend holiday, where he decides to try his luck at the roulette table for fun. On the first day of his trip, he places seven bets for $10 each (a total of $70). One of the $10 bets wins a payout of $100, but the remaining six bets are lost. On the second day, he places ten bets of $20 each (a total of $200). One $20 bet wins a payout of $30, and another wins a payout of $50. The remaining

eight bets are lost. Connor engages in no other gambling activity for the year. What are Connor's tax consequences with respect to these wagers?

Before looking at § 165(d), you might have concluded that (1) Connor must include the $180 in cash payouts in his § 61 Gross Income under the residual clause as clearly realized wealth accessions and that (2) no part of his $270 in total bets is deductible, as the outlays constitute personal entertainment "expenses" under § 262(a), just as the cost of an entertaining night out at the movies with friends is not deductible. Or you might have concluded that—even though Connor's activity resides in the personal consumption sphere—the $270 in aggregate bets create "basis" in the opportunity to gamble that can fully offset the entire $180 gross payout won by Connor, resulting in no § 61 Gross Income inclusion, just as the $20,000 original cost basis of a personal-use car can fully offset the $8,000 amount realized on its later sale to prevent the same dollars from being doubly taxed to the same person under the fundamental precept that you studied in Chapter 1 (with the remaining $12,000 of unrecovered basis representing a nondeductible personal consumption loss under § 165(c)(3)). Or perhaps you might even have concluded that gambling is inherently a "transaction entered into for profit" within the meaning of § 165(c)(2)—even for a casual gambler like Connor—permitting him not only to deduct $180 of his bets against the $180 of Gross Income but also to deduct the remaining $90 gambling net loss (the excess of his $270 in aggregate bets over his $180 winnings) against his law practice earnings.

Section 165(d) occupies the field with respect to gambling losses, and it instructs that "[l]osses from wagering transactions shall be allowed only to the extent of the gains from such transactions."

In a superficial way, § 165(d) may appear to operate very similarly to §§ 469 and 163(d), both of which you studied in Chapter 16, but § 165(d) is a fundamentally different provision. Recall that § 469 allows current deduction of expenses, depreciation, and § 165(c)(1) or (2) losses incurred in passive activities *only* to the extent of aggregate passive Gross Income for the year, and § 163(d) permits current deduction of investment interest *only* to the extent of net investment income for the year. In this manner, the excess deductions cannot be used to "shelter" unrelated income, just as Connor's gambling net loss cannot be used to offset income from his law practice under § 165(d). Sections 469(b) and 163(d)(2), however, permit unused (excess) deductions to be carried forward for use in future years, but § 165(d) does not permit Connor to carry forward any unused (excess) gambling losses. This important distinction arises because passive activity losses and excess investment interest clearly represent business/investment deductions,[1]—only the sheltering effect is problematic—whereas Connor's gambling weekend activity represents personal consumption. In other words, unlike §§ 469 and 163(d), § 165(d) is no mere timing rule for what are truly business or investment deductions. Rather, § 165(d) illustrates that the fundamental precept described in Chapter 1 that the same dollars should not be taxed to the same taxpayer more than once under an SHS income tax is so strong that Connor is permitted to deduct his gambling losses—even though he is gambling merely for its entertainment value—*but only to the extent of his gains* (to avoid doubly taxing him on the same dollars). The excess is pure (nondeductible) personal consumption.

How are "losses" and "gains" measured for purposes of § 165(d), however? Does Connor realize a $90 gambling gain on Day 1 (the excess of the $100 payout over the $10 bet for that

[1] Section 469 applies only to true business or investment activities, not personal consumption activities. *See* §§ 469(c)(1)(A) and (c)(6). As you will learn in Part B. of this chapter, whether an activity is a true business or investment activity is determined by the presence of a profit motive under § 183.

particular wager) and $10 and $20 gambling gains, respectively, for each of his two winning bets on Day 2? That is to say, do we measure gains and losses bet-by-bet, or is there another way to figure his gains and losses from wagering transactions this year?

## GENERIC LEGAL ADVICE MEMORANDA 2008-011

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ISSUE

How does a casual gambler determine wagering gains and losses from slot machine play?

FACTS

The taxpayer (Mrs. X) is a casual gambler. The taxpayer uses the cash receipts and disbursements method of accounting and files her returns on a calendar year basis. The taxpayer properly substantiates all gains and losses incurred in the wagering transactions pursuant to § 6001 of the Internal Revenue Code and Rev. Proc. 77-29, 1977-2 C.B. 538.

The taxpayer is retired on a modest, fixed income. Therefore, she carefully limits the amount of money she gambles. Her practice is to commit only $100 to slot machine play on any visit to a casino. She wagers until she loses the original $100 committed to gambling or until she stops gambling and "cashes out." Upon cashing out, the taxpayer may have $100 (the basis of her wagers), less than $100 (a wagering loss), or more than $100 (a wagering gain).

The taxpayer went to a casino to play the slot machines on ten separate occasions throughout the year. On each visit to the casino, the taxpayer exchanged $100 of cash for $100 in slot machine tokens and used the tokens to gamble. Taxpayer did not use cash, credit or "player's cards" to gamble. On five occasions, the taxpayer lost her entire $100 in tokens before terminating play. On the other five occasions, the taxpayer redeemed her remaining tokens for the following amounts of cash: $20, $70, $150, $200 and $300.

ANALYSIS

Section 61 provides that Gross Income means all income from whatever source derived. Rev. Rul. 54-339, 1954-2 C.B. 89, holds that wagering gains are included in Gross Income. *See Umstead v. Comm'r*, T.C. Memo. 1982-573, 44 TCM 1294, 1295 (1982).

Section 165 (a) allows a deduction for any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(d) provides that losses from wagering transactions are allowed only to the extent of the gains from such transactions.

Section 1.165-10 of the Income Tax Regulations provides that losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions.

*Wagering Gains and Wagering Losses*

Section 165(d) uses the words "gains" and "losses" from wagering transactions without

ascribing a technical meaning to the terms. In the absence of a stated definition to the contrary, the literal language of the statute should control. If the language of a statute is plain, clear, and unambiguous, the statutory language is to be applied according to its terms, unless a literal interpretation of the statutory language would lead to absurd results. *U.S. v. Ron Pair Enterprises, Inc.*, 489 U.S. 235 (1989); *Burke v. Comm'r*, 105 T.C. 41, 59 (1995). In ordinary parlance, a wagering "gain" means the amount won in excess of the amount bet (basis). *See* Rev. Rul. 83-130, 1983-2 C.B. 148, at 149, holding that in calculating wagering gains, the cost (or basis) of the wager is excluded. That is, the wagering gain is the total winnings less the amount of the wager. The term wagering "loss" means the amount of the wager (basis) lost.

Casual gamblers may deduct their wagering losses only to the extent of their wagering gains; gamblers may not carry over excess wagering losses to offset wagering gains in another taxable year or offset non-wagering income. *Skeeles v. U.S.*, 95 F. Supp. 242, 118 Ct. Cl. 362 (1951), *cert. denied*, 341 U.S. 948 (1951). Casual gamblers may not net their gains and losses from slot machine play throughout the year and report only the net amount for the year. *See U.S. v. Scholl*, 166 F.3d 964 (9th Cir. 1999).[1]

A key question in interpreting § 165(d) is the significance of the term "transactions." The statute refers to gains and losses in terms of wagering transactions. Some would contend that transaction means every single play in a game of chance or every wager made. Under that reading, a taxpayer would have to calculate the gain or loss on every transaction separately and treat every play or wager as a taxable event. The gambler would also have to trace and recompute the basis through all transactions to calculate the result of each play or wager. Courts considering that reading have found it unduly burdensome and unreasonable. *See Green v. Comm'r*, 66 T.C. 538 (1976); *Szkircsak v. Comm'r*, T.C. Memo 1980-129. Moreover, the statute uses the plural term "transactions" implying that gain or loss may be calculated over a series of separate plays or wagers.

The better view is that a casual gambler, such as the taxpayer who plays the slot machines, recognizes a wagering gain or loss at the time she redeems her tokens. We think that the fluctuating wins and losses left in play are not accessions to wealth until the taxpayer redeems her tokens and can definitively calculate the amount above or below basis (the wager) realized. *See Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). For example, a casual gambler who enters a casino with $100 and redeems his or her tokens for $300 after playing the slot machines has a wagering gain of $200 ($300 - $100). This is true even though the taxpayer may have had $1,000 in winning spins and $700 in losing spins during the course of play. Likewise, a casual gambler who enters a casino with $100 and loses the entire amount after playing the slot machines has a wagering loss of $100, even though the casual gambler may have had winning spins of $1,000 and losing spins of $1,100 during the course of play.[2]

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[1] Gamblers must report wagering gains, even though their losses over a tax year exceed their gains. That increases a casual gambler's AGI and has a significant tax impact (especially on low income taxpayers), because many tax benefits phase out as AGI increases, *e.g.*, exclusion of social security payments.

[2] We note that § 6041 requires gambling businesses to report payments over certain dollar amounts, "gross receipts" reporting. The amount reported as gross receipts from many types of gambling is not reduced by the amount (basis) of the wager. *See* Rev. Proc. 77-29, 1977-2 C. B. 538. However, such reported payments are not necessarily taxable wagering gains. A gambling business may issue an information return for a casual gambler's winning spin, but the gambler continues play and wagers and loses that amount during slot machine play. Wagering gain or loss is determined at the time the casual gambler redeems his or her tokens at the end of slot machine play.

*Calculating the Taxpayer's Gains and Losses*

Under the facts presented, the taxpayer purchased and subsequently lost $100 worth of tokens on five separate occasions. As a result, the taxpayer sustained $500 of wagering losses ($100 × 5). The taxpayer also sustained losses on two other occasions, when the taxpayer redeemed tokens in an amount less than the $100 (basis) of tokens originally purchased. The loss is the basis of the bet ($100 in tokens) minus the amount of the tokens eventually redeemed. Therefore, on the day the taxpayer redeemed $20 worth of tokens, the taxpayer incurred an $80 wagering loss ($100-$20). On the day the taxpayer redeemed $70 worth of tokens, the taxpayer incurred a $30 wagering loss ($100-$70).

On three occasions, the taxpayer redeemed tokens in an amount greater than the $100 of tokens originally purchased. The amount redeemed less the $100 basis of the wager constitutes a wagering gain. *See* Rev. Rul. 83-130, *supra*. On the day the taxpayer redeemed $150 worth of tokens, the taxpayer had a $50 wagering gain ($150-$100). On the day the taxpayer redeemed $200 worth of tokens, the taxpayer had a $100 wagering gain ($200-$100). And on the day the taxpayer redeemed $300 worth of tokens, the taxpayer had a $200 wagering gain ($300-$100).

For the year, the taxpayer had total wagering gains of $350 ($50 + $100 + $200) and total wagering losses of $610, ($500 from losing the entire basis of $100 on five occasions + $80 and $30 from two other occasions). The taxpayer's wagering losses exceeded her wagering gains for the taxable year by $260 ($610 - $350). The taxpayer must report the $350 of wagering gains as Gross Income under § 61. *Scholl*, *supra*. However, under §165(d), the taxpayer may deduct only $350 of the $610 wagering losses. The taxpayer may not carry over the excess wagering losses to offset wagering gains in another taxable year or offset non-wagering income. *Skeeles*, *supra*.

A casual gambler who elects to itemize deductions may deduct wagering losses, up to wagering gains, on Form 1040, Schedule A. In this case, the taxpayer may deduct only $350 of her $610 of wagering losses as an itemized deduction. A casual gambler who takes the standard deduction rather than electing to itemize may not deduct any wagering losses. *See* Rev. Rul. 54-339, 1954-2 C.B. 89.

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As indicated in the GLAM, the § 165(d) deduction is an Itemized Deduction for casual gamblers like Connor, but it is not a § 67 MID subject to the 2% floor (because listed in § 67(b)(3)). By its terms, however, § 165(d) is not limited to the casual gambler who gambles for the activity's entertainment value; it also applies to professional gamblers who have a clear profit motive and make their living by games of chance. While a carryover of unused (excess) deductions may appear to be required in theory for the professional gambler for the same reason that §§ 469 and 163(d) provide for a carryover (*i.e.*, the excess represents true business costs), perhaps Congress believes that gambling is inherently a personal consumption activity, that distinguishing between casual and professional gamblers would be a difficult task to accomplish on any consistent basis, or that discouraging folks from choosing gambling as their livelihood is a worthwhile goal. In any event, the gambler who can satisfy his burden of proof that he is a professional (rather than casual) gambler can take the § 165(d) deduction above the line under § 62(a)(1), rather than as an Itemized Deduction, ensuring that the every dollar of allowable § 165(d) deduction actually reduces the tax base.[2] As you learned in Chapter 1, Part B., an Itemized Deduction, in contrast, is taken below the

[2] *See, e.g.*, Comm'r v. Groetzinger, 480 U.S. 23 (1987) (holding that a full-time gambler may be engaged in a "trade

line and cannot be deducted by those who take the Standard Deduction, instead. Thus, the § 165(d) deduction for the casual gambler reduces the tax base only to the extent it, along with other Itemized Deductions, exceed the Standard Deduction.

What about the travel and other associated costs incurred by the professional gambler? By its terms, § 165(d) applies only to wagering "loss." You learned in Chapter 1 that "loss" is a term of art in tax that refers to unrecovered *basis*—in this context, created by the bets placed. Nevertheless, a few Code sections define "loss" in a special way *for purposes of that particular Code section only*, which can sometimes be confusing for students. For example, you have learned that § 469 specially defines a passive activity "loss" as the excess of passive deductions over passive Gross Income. In Chapter 21, you will learn that a net operating "loss" is generally defined in §§ 172(c) and (d) as the excess of currently allowable business and investment deductions over business and investment Gross Income. But § 165(d) does not contain any special definition of "loss" unique to wagering transactions, which means that there is a strong argument that § 165(d) should apply only to the *basis* created by placing wagers, not the associated § 162 business "expenses" incurred by a professional gambler. This interpretation is even stronger because the provision resides in § 165, which otherwise uses "loss" in its general tax-term-of-art sense of unrecovered basis.

Nevertheless, until recently the Tax Court (and at least one Circuit Court of Appeals) had held that the associated costs incurred by the professional gambler are also limited to wagering gains under § 165(d).[3] The Tax Court has now abandoned this position in *Mayo v. Commissioner*,[4] however, and the government has acquiesced in this decision.[5] Thus, otherwise allowable § 162 business expenses of the professional gambler (such as travel costs) are not limited by § 165(d).

**Problem**

Describe Connor's tax consequences from his gambling weekend in Las Vegas using the numbers described at the beginning of this Part A. How much must Connor include in his § 61 Gross Income? How much can he deduct under § 165(d)? What if he takes the Standard Deduction?

## B. Hobby losses: § 183

Our lawyer Connor earns $100,000 each year from his full-time law practice. He also enjoys woodworking in his spare time; his specialties are coffee tables and bookcases. His basement is filled with lathes, band saws, and other expensive woodworking equipment (that he purchased with borrowed money), as well as a supply of wood that he uses to create his pieces. His home is filled to the brim with his work, and his friends and family have also been the recipients of his pieces as gifts over the years. Connor decides to rent a space at the local summer art fair in the hope of selling a few of his pieces, and he succeeds in selling a coffee table with a $100 basis (equal to the cost of the wood) for $500. None of his other pieces sell.

Connor's $400 realized and recognized § 1001 gain is clearly includable in his Gross Income

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or business").

[3] *See* Offutt v. Comm'r, 16 T.C. 1214 (1951); Estate of Todisco v. Comm'r, 757 F.2d 1 (1st Cir. 1985), *aff'g*, T.C. Memo. 1983-247; Kochevar v. Comm'r, T.C. Memo. 1995-607; Praytor v. Comm'r, T.C. Memo. 2000-282 (each characterizing certain business "expenses" of the professional gambler as wagering "losses" subject to § 165(d)).

[4] 136 T.C. 81 (2011).

[5] Action on Decision (AOD) 2012-3.

under § 61(a)(3). Can he deduct depreciation with respect to his woodworking equipment under §§ 167 and 168, expenses in the form of supplies, equipment repairs, and the rental fee that he paid for his space at the fair under either §§ 162 or 212, and the interest incurred on the loans used to purchase the woodworking equipment under § 163(a)—which you should assume is a grand total of $1,000 this year? If he can, $600 of those deductions would shelter income from his law practice. On the other hand, if he is denied deduction of the entire $1,000 of costs incurred, his $400 of Gross Income would be taxed in a gross receipts manner, violating the fundamental precept that the same dollars should not be taxed to the same taxpayer more than once if Congress seeks to honor "income" tax principles.

Prior to 1969, the only authority for a taxpayer like Connor to take *any* deductions was the business and investment provisions, such as those cited above, and under those the taxpayer was denied all deductions if he engaged in the activity "primarily" as a "sport, hobby, or recreation."[6] Under this "primary purpose" test, taxpayers like Connor were permitted to deduct 100% of their costs (under the business and investment Code sections) or nothing (as personal consumption costs). In other words, Connor would have been denied all deductions prior to 1969 if he engages in his woodworking activity primarily as a hobby rather than in an attempt to earn a profit.

One of the chief reasons that Congress enacted § 183 in 1969—which fully replaces the old "primary purpose" test—was to create a deduction (in § 183(b)(2)) that did not previously exist for taxpayers like Connor. As described below, § 183(b)(2) essentially provides authority for a taxpayer who lacks a profit motive to nevertheless deduct the depreciation and expenses incurred in the activity but *only* to the extent of the Gross Income earned in the activity, with no carryover of excess deductions to future years. In other words, §§ 183 and 165(d) operate very much alike. Congress need not go further than allowing Connor to deduct just enough to offset the $400 of Gross Income earned in the activity to avoid doubly taxing the same dollars to the same taxpayer under the income tax. The excess $600 represents pure (nondeductible) personal consumption if he lacks a profit motive and thus should not offset earnings from his law practice.

An important ancillary consequence of enacting § 183, however, is that it effectively imports the "profit motive" test into every single Code section that otherwise allows deductions for business and investment costs, whether §§ 167, 168 (deprecation), §§ 162 and 212 (expenses), § 165(c)(1) & (2) (losses), § 163 (interest), *etc.* To be specific, by providing that "no deduction … shall be allowed *under this chapter* except as provided in this section" with respect to any activity that is "not engaged in for profit," § 183(a) implicitly requires that a taxpayer invoking deduction authority under, say, §§ 162 or 212 must establish a profit motive. Nevertheless, the only taxpayers who actually need to worry about establishing a profit motive in order to take deductions directly under the business and investment provisions are those whose activity is operating at a loss in the sense that deductions generated by the activity (if they were allowed without limit) exceed the Gross Income generated by the activity for the year. Connor's woodworking activity, for example, generates more depreciation and expense deductions ($1,000) than Gross Income ($400 of § 1001 gain) for the year. If Connor wishes to fully deduct the $1,000 in aggregate depreciation and expenses directly under §§ 179, 167, 168, 162 or 212, and 163, he must establish a profit motive. Absent a profit motive, Connor is limited to the deduction authorized in § 183(b). Notice that § 183(b) contains those magic words "there shall be allowed a deduction …."

Applied literally, § 183(a) denies even the personal consumption deductions that (by their

[6] Treas. Reg. § 1.212-1(c).

nature) do not require a profit motive in the first place, such as the deduction for qualified residence interest and the deduction for personal casualty losses. Thus, § 183(b)(1) first revives these sorts of deductions without limit. For example, assume that one of Connor's expensive woodworking machines is stolen by a thief who breaks into his home while he is away for that weekend in Las Vegas and that Connor's properly computed personal casualty loss deduction under §§ 165(c)(3) and (h) (studied in Chapter 18) is $500. Under § 183(b)(1), Connor is permitted to fully deduct this $500 personal casualty loss, regardless of his lack of profit motive and regardless of the Gross Income earned in his woodworking activity.

Section 183(b)(2) then allows Connor to deduct so much of his $1,000 of depreciation and expenses as does not exceed his Gross Income from the activity ($400) *less* the amount allowed under § 183(b)(1) ($500). On these facts, Connor is not permitted to deduct any of his $1,000 in depreciation and expenses. In other words, the allowable personal consumption deductions incurred in Connor's hobby without regard to profit motive (the § 165(c)(3) personal casualty loss) eat up the woodworking Gross Income *first*. Only if woodworking Gross Income remains after accounting for the § 183(b)(1) amount can he deduct his depreciation and expenses under § 183(b)(2). If Connor had not suffered the theft, which means that he incurred no deductions described in § 183(b)(1) (the more usual case), he would be permitted to deduct $400 of his $1,000 in total depreciation and expenses under § 183(b)(2)—just enough to offset his woodworking Gross Income.[7] How do we know the extent to which the $400 of allowable deductions comes from the depreciation (which reduces the woodworking equipment's basis) and how much comes from the expense deductions (which do not affect basis)? Connor may need to know that information if he later sells a piece of equipment. Treas. Reg. § 1.183-1(b)(1) provides that deductions that affect property basis come *last*, which means that the $400 first consists of expense deductions (to the extent thereof) and only then depreciation.

In short, Connor cannot use the excess $600 of deductions (the net loss) arising in his woodworking activity to offset any earnings from his law practice *unless* he can establish a profit motive with respect to his woodworking activity. If Connor can establish a profit motive, his deductions are not taken under § 183(b) but rather are taken directly under §§ 179, 167, 168, 162 or 212, and 163, under which he would be permitted to fully deduct the entire $1,000 without limit,[8] $600 of which would necessarily offset income from his law practice.[9] If he cannot establish

[7] Actually, that statement is not quite accurate today. Because § 183(b) is not listed in § 62, it is an Itemized Deduction, which means that Connor may not be able to benefit from it if he takes the Standard Deduction. Moreover, even if Connor itemizes his deductions, the § 183(b) deduction is also a MID subject to the 2% floor because § 183(b) is also not listed in § 67(b). Thus, it is not quite accurate to say today that Connor's $400 of Gross Income from his coffee table sale will, in fact, necessarily be fully offset by his § 183(b) deduction, though that clearly was its original purpose.

[8] As business or income-production deductions not incurred by an employee (rather than a §183(b) deduction), Connor would be permitted to take these § 167, 168, *etc.*, deductions above the line under § 62(a)(1).

[9] Notice that § 469 is irrelevant to Connor's analysis because he "materially participates" in both his law practice and the woodworking activity within the meaning of § 469(h). He is not a passive investor in either activity. On other facts, however, the § 183 analysis would apply *first*, under which no carryover is permitted for the net loss, before § 469, which would provide a carryover for the net loss. *See, e.g.*, Lee A. Shepherd, *Is the Tax Law Subsidizing Ann Romney's Horse?*, 136 TAX NOTES 627 (2012) (describing how the substantial net losses arising on Ann Romney's investment in Rafalca, a horse participating in Olympics dressage competition and ridden by another rider, would be permitted to be carried forward as a § 469 PAL only if she invested with a profit motive within the meaning of § 183). This order is necessary because § 469 applies only to activities for which deductions are allowed under the business and investment provisions under §§ 469(c)(1)(A) and (c)(6), and you now know that § 183 effectively requires a profit motive in order for deductions to be taken under the authority of the business and investment provisions.

a profit motive for his woodworking activity, his only deduction is provided by § 183(b); the sheltering effect is disallowed. How can Connor establish a profit motive?

***Establishing a profit motive***

Section 183(c), which provides that an activity not engaged in for profit is one for which business and investment expense deductions are disallowed, is obviously circular. It is one of those subsections that does not provide positive law but rather effectively punts to Treasury to issue regulations, which is where you must look for guidance regarding the profit motive test.

Treas. Reg. § 1.183-2(a) provides that profit motive is determined "by reference to objective standards, taking into account all of the facts and circumstances of each case." The taxpayer must show that he "entered into the activity, or continued the activity, with the objective of making a profit." A profit motive may exist even if there is only a "small chance of making a large profit," such as with a wildcat oil well. Finally, this regulation provides that "greater weight is given to objective facts than to the taxpayer's mere statement of his intent."

Treas. Reg. § 1.183-2(b) then lists and discusses nine relevant factors to consider in measuring profit motive (among unnamed others), including the manner in which the taxpayer carries on the activity, the expertise of the taxpayer or his advisors, the time and effort expended, the expectation that assets used in the activity will appreciate in value (eventually offsetting year-to-year operating losses when the assets are sold at a gain that exceeds the prior operating losses), the taxpayer's success in similar activities, the history of profits and losses, the financial status of the taxpayer, and the presence of personal pleasure or recreation. The regulations clarify that the existence of a profit motive is not to be determined "on the basis that the number of factors (whether or not listed in this paragraph) indicating a lack of profit motive exceeds the number of factors indicating a profit motive, or vice versa." The analysis is intended to be a more holistic one. I urge you to read these paragraphs, as well as the examples that follow in Treas. Reg. § 1.183-2(c).

Notice that each of the first three examples, which conclude that the taxpayer may not be engaging in the activity with a profit motive, stresses that the taxpayer enjoys substantial outside income (which would be sheltered by the activity operating losses if not limited under § 183(b)). It is in this context that factfinders most commonly surmise that the taxpayer is engaging in the loss activity for enjoyment, recreation, or other reasons because (1) he does not need the activity to provide a livelihood and (2) the outside income can be sheltered by the activity losses if allowed. The combination of pleasure plus wealth appears to be particularly difficult to overcome. In *Bessenyey v. Commissioner*,[10] a pre-§ 183 case decided under the "primary purpose" test, a rich Hungarian heiress wished to replenish in America a rare horse breed she knew from her childhood in Hungary. She incurred heavy operating losses in the activity, the Tax Court determined that she lacked a profit motive, and the Second Circuit Court of Appeals affirmed. It is better to be rather middle class if the taxpayer enjoys the activity. For example, the taxpayer in *Churchman v. Commissioner*[11] was an artist who suffered net losses from her art activities for 20 straight years. Nevertheless, she was held to have a profit motive, which allowed her excess deductions to offset her husband's salary income as a University professor on their joint return. She had art training, marketed her work in a professional manner, and periodically taught art classes. I often wonder, however, if Ms. Churchman would have won with her 20 straight years of operating losses had her

[10] 379 F.2d 252 (2d Cir. 1967).
[11] 68 T.C. 696 (1977).

husband earned millions in investment banking each year….

Also worthy of note is the factor that considers whether assets used in the activity are expected to appreciate in value, thus eventually not only offsetting the year-to-year operating losses but producing an overall profit in the long run. This factor appears to provide a leg up to those (unlike Connor) whose activities involve land, such as farmers. For example, the taxpayer in *Fields v. Commissioner*[12] was a full-time lawyer who raised cattle on his 73-acre farm on the weekends. Even though he suffered consistent operating losses from his cattle activity, he was held to have a profit motive, and one factor in his favor was that he expected the land to appreciate in value.

Nevertheless, even taxpayers with relatively modest outside income who engage in an activity that involves land do not always win.

## ZARINS v. COMMISSIONER

T.C. Memo. 2001-68, *aff'd*, 2002-1 U.S.T.C. (CCH) ¶ 50,471 (6th Cir. 2002)

COLVIN, JUDGE: Respondent determined deficiencies in petitioners' Federal income taxes of $7,952 for 1994 and $4,788 for 1995. The issue for decision is whether petitioners operated their tree farm activity for profit in 1994 and 1995. We hold that they did not.

Petitioners were married and filed joint returns for 1994 and 1995. They lived in Ostrander, Ohio, during the years in issue and when they filed their petition. Petitioners' parents owned a farm on which they raised cattle. They also grew trees, of which they sold about 100-200 per year for 3 or 4 years. Petitioner worked on the farm when he was young, and he attended several farm seminars with his father over the years. Petitioner took business and economics courses in college and received an engineering degree before the years in issue. Petitioners worked for the State of Ohio during the years in issue. Petitioner was an engineer and his wife, Zigrida Zarins, was a computer manager. Petitioner retired in 1997.

*Starting the Tree Farm*

Sometime before 1979, petitioners bought an 85-acre farm for $78,300. Much of the farm was covered with trees, including hawthorns, walnuts, and oaks. Petitioners lived in a trailer while they built a house on the farm. They began living in the house around 1984. Petitioner removed large amounts of brush and thorns and cultivated about 40 acres of the land by himself.

Around 1990, petitioners began to plant evergreen trees on their land. Petitioner had planted about 2,000 seedlings by the end of 1993. He planted about 1,000 trees in 1993, but most of them died in a severe drought that year.

Petitioner spent about 15 to 20 hours per week on this activity in 1994 and 1995. He spent most of that time in 1994 building an irrigation pond and dam, for which he paid contractors $10,403 in 1994. The pond provided water for a pumping system that could reach about 1,000 feet from the pond. He did not plant many trees in 1994 because he built the irrigation pond. He was involved in time-consuming litigation over the pond with the Ohio Department of Natural Resources and a neighboring hunting club in 1995 and 1996.

In 1994 and 1995, petitioner bought gravel to build an access road on the farm. Petitioners used their own equipment to build the road. Petitioner bought equipment such as a compressor and

[12] T.C. Memo. 1981-550.

pump, mulch sweeper, generator, and chain saw in 1994 and 1995. However, petitioners had no equipment to ball the roots of and remove large trees.

Petitioners did not sell many trees in 1994 and 1995. Petitioners promoted tree sales in 1994 and 1995 by word of mouth, mostly to their relatives. In 1994 and 1995, petitioners sold trees to relatives (who helped dig the trees) and to three other customers for $20 per tree. In 1997, petitioners sold a number of trees not specified in the record for which they received payment in 1998. Petitioners' farm was visible from the road, but they did not have a sign for it.

Petitioner had planted about 3,000 to 3,500 trees by the end of 1995, and about 5,000 by March 2000. He did not keep records of the number of trees he planted.

*Petitioner's Business Records and Business Plan*

Petitioners did not have a separate bank account for their tree farm. Petitioner kept records of expenses and income for income tax purposes. He put expense receipts in separate files by category. He did not maintain any other books and records for their tree farm during the years in issue. Petitioners did not have a budget, did not make income or profit projections, and did not prepare a cost analysis for the tree farm. At a time not specified in the record, petitioners projected that they would sell 200 to 300 trees per year by around 1998 or 1999.

Petitioner did not seek expert advice about how to operate a tree farm for profit. Sometime before 1990, he asked neighbors who had botany degrees for advice on how to grow trees. Petitioner attended several agricultural seminars: a fish raising seminar in 1992, evergreen seminars in 1995 and 1997, a tree pruning seminar in 1997, and a nursery short course at Ohio State University in 1998.

Petitioners earned an unspecified amount of income from 1984 or 1985 to 1990 by allowing people to use their land to hunt and to practice for competitions with their dogs. Petitioners also tried to grow strawberries and grapes on their land and to raise fish.

*Petitioners' Tax Returns*

Petitioners reported on Schedules F, Profit or Loss From Farming, attached to their tax returns for 1993 to 1998 that they operated a tree farm. Petitioners reported the following amounts of nonfarm income (*i.e.*, wages, pension, interest, and taxable income tax refunds) on their income tax returns filed for 1993 through 1998:

| Year | Wages | Pension | Nonfarm Income |
|---|---|---|---|
| 1993 | $ 95,578 | | $ 96,065 |
| 1994 | 101,750 | | 102,222 |
| 1995 | 108,877 | | 110,432 |
| 1996 | 118,377 | | 119,374 |
| 1997 | 102,510 | $ 22,836 | 125,954 |
| 1998 | 63,783 | 39,810 | 102,587 |

Petitioners deducted the following amounts of farm expenses for tax years 1993 to 1998:

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|
| Seeds and plants | 132 | 354 | 423 | 1,320 | 638 | -- |

| | | | | | | |
|---|---|---|---|---|---|---|
| Fertilizers | 352 | -- | -- | 19 | 2 | -- |
| Labor | -- | 80 | 150 | -- | -- | -- |
| Custom hire (machine work) | 613 | 10,721 | 1,107 | -- | -- | -- |
| Advertising | -- | -- | -- | -- | -- | 688 |
| Depreciation[1] | 3,331 | 3,550 | 3,243 | 2,268 | 718 | 483 |
| Car and truck | 896 | 870 | 1,200 | 1,307 | 1,242 | 383 |
| Mortgage interest | -- | 3,955 | 3,556 | 3,533 | 4,030 | -- |
| Gasoline | 1,456 | 2,595 | 1,844 | 1,781 | 1,359 | 709 |
| Repairs and maintenance | -- | 3,325 | 963 | 133 | 215 | 1,532 |
| Insurance | 362 | 388 | 429 | 451 | 916 | -- |
| Supplies | 1,531 | 1,756 | 3,235 | 1,149 | 4,427 | 274 |
| Taxes | 433 | 351 | 390 | 459 | 487 | -- |
| Utilities | 400 | 450 | 520 | 560 | 560 | -- |
| Machine parts | -- | -- | -- | 905 | -- | -- |
| Legal fee | -- | -- | -- | 40 | -- | -- |

*Opinion*

*A. Whether Petitioners Operated Their Tree Farm For Profit*

The first issue for decision is whether petitioners operated their tree farm for profit in 1994 and 1995. A taxpayer conducts an activity for profit if he or she does so with an actual and honest profit objective. *See Osteen v. Comm'r*, 62 F.3d 356, 358 (11th Cir. 1995), affg. in part and revg. on other issues T.C. Memo 1993-519; *Surloff v. Comm'r*, 81 T.C. 210, 233 (1983); *Dreicer v. Comm'r*, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983). In deciding whether petitioners operated their tree farm for profit, we consider the following nine nonexclusive factors: (1) The manner in which the taxpayer carried on the activity; (2) the expertise of the taxpayer or his or her advisers; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved. *See* sec. 1.183-2(b), Income Tax Reg. No single factor controls. *See Osteen v. Comm'r*, *supra* at 358; *Brannen v. Comm'r*, 722 F.2d 695, 704 (11th Cir. 1984), affg. 78 T.C. 471 (1982); sec. 1.183-2(b), Income Tax Regs.

*B. Application of the Factors*

*1. Manner in which the taxpayer conducts the activity.* Maintaining complete and accurate books and records, conducting the activity in a manner substantially similar to comparable businesses which are profitable, and making changes in operations to adopt new techniques or abandon unprofitable methods suggest that a taxpayer conducted an activity for profit. *See Engdahl v. Comm'r*, 72 T.C. 659, 666-667 (1979); sec. 1.183-2(b)(1), Income Tax Regs.

There is no evidence establishing that petitioner had a business plan. Petitioner wanted to sell

[1] Petitioners depreciated a truck, a mulch sweeper, a generator, a compressor, a pump, and chain saws.

evergreen trees and some of the trees that were growing indigenously on the land to nurseries and to individuals, and he knew that he could not sell the trees he planted for 10 years. However, the fact that he planted trees without keeping records of the number planted and that he had no specific concept for operating a profitable tree farm shows that he did not have a business plan.

Petitioners contend in their brief that they planned to plant about 500-1000 seedlings each year and to sell 300-1000 trees for $9,000-$30,000 per year around years 10 to 12. However, statements in a brief are not evidence. *See* Rule 143(b); *Niedringhaus v. Comm'r*, 99 T.C. 202, 214 n.7 (1992); *Viehweg v. Comm'r*, 90 T.C. 1248, 1255 (1988).

Petitioners contend that petitioner made income projections for the tree farm. However, we have not so found because petitioners offered no evidence to support that contention. Petitioner kept records of income and expenses for his tree farm to substantiate the deductions petitioners claimed on their 1994 and 1995 returns. These records do not establish that their tree farm had profit potential.

Petitioners contend that they tried to make their tree farm profitable without spending large amounts of money other than for the pond. However, they offered no evidence of the amount of expenses or sales they expected to have. There is no evidence in the record showing that enough of petitioners' trees will be available for sale to enable them to make a profit. Petitioners contend that they made numerous changes in their operations to improve their profit potential. We disagree. Petitioners offered no evidence that they changed their operations.

This factor favors respondent.

*2. The expertise of the taxpayers or their advisors.* Efforts to gain experience, a willingness to follow expert advice, and preparation for an activity by extensive study of its practices may indicate that a taxpayer has a profit objective. *See* sec. 1.183-2(b)(2), Income Tax Regs. A taxpayer's failure to obtain expertise in the economics of an activity indicates that he or she lacks a profit objective. *See Burger v. Comm'r*, 809 F.2d 355, 359 (7th Cir. 1987), affg. T.C. Memo 1985-523; *Golanty v. Comm'r*, 72 T.C. 411, 432 (1979).

Petitioner contends that he had the necessary expertise to operate a profitable tree farm and that he learned the basics from his parents. However, petitioner did not specify how he was involved in his parents' tree farming activity. Petitioner contends that he sometimes sought advice from his botanist neighbors about growing trees and that he attended an evergreen seminar in 1995. However, petitioners did not show that they had expertise relating to the tree farming business, or seek expert advice on how to operate their farm for profit.

This factor favors respondent.

*3. Taxpayer's time and effort.* The fact that a taxpayer devotes much time and effort to an activity may indicate that he or she has a profit objective. *See* sec. 1.183-2(b)(3), Income Tax Regs. Petitioner was employed full-time as an engineer in 1994 and 1995. He worked 15 to 20 hours a week in 1994 and 1995 on the tree farm. However, much of the time petitioner spent working on the tree farm in those years was not directly related to raising or selling trees. He built a pond in 1994, he built an access road in 1994 and 1995, and he was engaged in litigation relating to the pond in 1995. Petitioner failed to show to what extent the pond and road were directly related to the tree farm. Petitioner testified that the pond supported irrigation up to about 1,000 feet from the pond, but he did not show how many of his trees were within 1,000 feet of the pond. This factor favors respondent.

*4. Expectation that property used in the activity will appreciate in value.* A taxpayer may intend to make an overall profit when appreciation in the value of assets used in the activity is realized. *See* sec. 1.183-2(b)(4), Income Tax Regs. There is an overall profit if net earnings and appreciation are enough to recoup losses sustained in prior years. *See Bessenyey v. Comm'r*, 45 T.C. 261, 274 (1965), affd. 379 F.2d 252 (2d Cir. 1967).

Petitioners contend that their land is well located for future development. They contend that, at the time of trial, the farm was worth more than $ 750,000. Petitioner testified that sometime in the future he probably would sell some of the farm land for commercial development to realize the appreciation that has occurred in the 20 years petitioners have owned it. His testimony did not convince us that, either when he started the tree farm or during the years in issue, he considered or expected that future appreciation of the farm land would offset the cumulative losses from the farm.

The record is silent as to the fair market value of petitioners' land when they started the tree farm. Thus, we can only compare the fair market value of petitioners' 85 acres in 2000 to the $78,300 petitioners paid for it sometime before 1979. Such a comparison improperly includes appreciation in the value of petitioners' farm that occurred before petitioners began their tree farm activity in 1990. *See Pearson v. Comm'r*, T.C. Memo 1996-66.

Petitioners contend that their trees will increase in value. However, petitioners did not show how much the value of their trees will appreciate or when tree appreciation plus other tree income will exceed their accumulated losses.

This factor favors respondent.

*5. Taxpayer's success in other activities.* The fact that a taxpayer previously engaged in similar activities and made them profitable may show that the taxpayer has a profit objective. *See* sec. 1.183-2(b)(5), Income Tax Regs. The record does not show how petitioner was involved in his parents' tree farm or if they operated it successfully. Thus, petitioner has not established that he successfully engaged in any other activity similar to the tree farm. This factor favors respondent.

*6. Taxpayer's history of income or losses.* A history of substantial losses may indicate that the taxpayer did not conduct the activity for profit. *See Golanty v. Comm'r, supra* at 427; sec. 1.183-2(b)(6), Income Tax Regs. A taxpayer may have a profit objective even when the activity has a history of losses, *see Bessenyey v. Comm'r, supra* 45 T.C. at 274, because losses during the initial stage of an activity do not necessarily indicate that the activity was not conducted for profit, *see Engdahl v. Comm'r*, 72 T.C. at 669; sec. 1.183-2(b)(6), Income Tax Regs.

Petitioners contend that it will take 10-14 years for the tree farm to be profitable. The years at issue are years 5 and 6 of petitioners' activity. Because petitioners' losses were incurred during the startup period of their activity, this factor is neutral. *See Strickland v. Comm'r*, T.C. Memo 2000-309; *Davis v. Comm'r*, T.C. Memo 2000-101.

*7. Amount of occasional profits, if any*. The amount of any occasional profits the taxpayer earned from the activity may show that the taxpayer had a profit objective. *See* sec. 1.183-2(b)(7), Income Tax Regs. Petitioners' tree farm generated no profit during the years in issue and showed a small profit in 1998. This factor is neutral.

*8. Financial status of the taxpayer*. The receipt of a substantial amount of income from sources other than the activity, especially if the losses from the activity generate large tax benefits, may indicate that the taxpayer does not intend to conduct the activity for profit. *See* sec. 1.183-2(b)(8),

Income Tax Regs.

Petitioners had $102,222 in unrelated Gross Income for 1994 and $ 110,432 for 1995, and claimed Schedule F losses of $28,080 and $16,699, respectively. Although petitioners had income against which they deducted their losses, they did not realize substantial tax benefits from the tree farm activity. Of their losses, depreciation accounted for only 12.6 percent in 1994 and 19.4 percent in 1995; most of their losses were from cash outlays. *See Davis v. Comm'r*, supra (the fact that the taxpayers spent 40-50 percent of their income on the activity and that depreciation accounted for only 9-17.5 percent of their losses indicated that the activity was not a hobby). Petitioners' financial status does not affect our analysis. *See Callahan v. Comm'r*, T.C. Memo 1996-65, affd. 111 F.3d 892 (5th Cir. 1997). Consequently, this factor is neutral.

*9. Elements of personal pleasure*. The presence of recreational or personal motives in conducting an activity may indicate that the taxpayer is not conducting the activity for profit. *See* sec. 1.183-2(b)(9), Income Tax Regs. Petitioner worked hard planting trees, removing thorns and brush, and building the pond and access road. We do not know whether he enjoyed doing that work. Petitioners' residence is located on their land, and they have not shown that their tree farm activity did not benefit their residence and their enjoyment of their property. *See Estate of Dickerson v. Comm'r*, T.C. Memo 1997-165 (Christmas tree farm activity not conducted for profit; the trees provided personal pleasure because they were located near the taxpayers' residence). Petitioners have not shown that they lacked recreational or personal motives for engaging in the tree activity. This factor is neutral.

*10. Conclusion*. We conclude that petitioners did not operate their tree farm for profit in 1994 and 1995.

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Finally, one of the more amorphous unlisted factors that factfinders will consciously or unconsciously consider is the credibility of the taxpayer's testimony. Perhaps Mr. Zarins made a less convincing witness on the stand than did Mr. Fields (the full-time lawyer who raised cattle on his 73-acre farm on the weekends). The Tax Court's final paragraph in *Fields* indicates as much.

> Finally, and importantly, we found petitioners to be credible and forthright in their testimony. It is clear to this Court that petitioners did not enter into the activities herein lightly. We find that they had a sincere intention to reap a profit both from their cattle-raising operation and from the appreciation of their property. It naturally follows that petitioners do not fall within the grasp of section 183. In so holding, we do not intend to give the petitioners a "blank check" for the future; at some point, if the losses continue unabated, petitioners could be deemed foolhardy to the extent of having abandoned any possible profit motive.[13]

In other words, look sincere!

***The § 183(d) presumption and § 183(e) election***

Suppose that Connor has participated in the summer art fair for many years and has actually earned a modest operating profit (Gross Income in excess of depreciation and expense deductions) in three of the five years prior to this year. In that case, the burden of proof shifts from Connor (in establishing a profit motive) to the IRS (in establishing a *lack* of profit motive) under § 183(d),

[13] *Fields*, T.C. Memo. 1981-550.

which the IRS never attempts. Failure to earn a profit in three of the prior five years, however, does not mean that Connor suffers a presumption *against* a profit motive, as Treas. Reg. § 1.183-1(c)(1)(ii) provides that "no inference that the activity is not engaged in for profit shall arise" in that case. Thanks to the Kentucky lobby, the § 183(d) presumption is triggered if the taxpayer enjoys an operating profit in only two of seven years if the activity consists of "the breeding, training, showing, or racing of horses."

Let's return to our original facts, in which this Year 1 is the first in which Connor participates in the summer art fair, and he suffers a $600 operating loss for the year ($400 of Gross Income and $1,000 in aggregate depreciation and expense deductions). Nevertheless, he is an optimist (as are all good entrepreneurs), and he believes that he will be able to satisfy the § 183(d) presumption by the end of Year 5. If Connor wishes both to (1) avoid having to meet his burden of establishing a profit motive in this Year 1 under the facts-and-circumstances test and (2) fully deduct his $1,000 in aggregate depreciation and expense deductions (thereby offsetting $600 of his law practice earnings) instead of deducting only $400 under § 183(b)(2), he can choose to make the election provided under § 183(e). The election allows him to fully deduct the $1,000 in Year 1 *without establishing a profit motive* at the cost of *extending the statute of limitations* beyond the usual three years to include the full § 183(d) period. Thus, if he fails to satisfy the § 183(d) presumption at the end of Year 5, the IRS can re-open his Year-1 and Year-2 returns and collect tax (and interest) if Connor fails to establish a profit motive for those years. If Connor does not make the § 183(e) election in Year 1, deducts the full $1,000 without IRS challenge in the good-faith belief that he would be able to establish a profit motive in Year 1 if challenged, but (alas) fails to show a profit in three of five years by the end of Year 5, Year 1 is a closed year under the usual three-year statute of limitations (absent fraud or a failure to file on Connor's part). In that case, the IRS would not be able to collect additional tax for those years.

***Defining the scope of "the activity"***

Recall from Chapter 16 that the § 469 passive activity loss (PAL) rules generally lump *all* passive Gross Income and *all* passive deductions from *all* passive activities together in determining whether the taxpayer has suffered a PAL. Similarly, § 163(d) generally lumps *all* investment interest and *all* net investment income together in determining how much of the taxpayer's investment interest can be deducted. Section 183(a), in contrast, refers to "an activity" and "such activity," meaning that § 183 applies in an activity-by-activity manner (as does § 465, pertaining to the at-risk rules). Gross Income from one activity not engaged in for profit cannot absorb deductions from a second activity not engaged in for profit under § 183(b)(2). Thus, it becomes important to define the scope of each activity.

Treas. Reg. § 1.183-1(d) does so by first requiring the taxpayer to identify each separate "undertaking." Whether one or more "undertakings" constitute a single "activity" for purposes of § 183 is a factual inquiry, and the most important facts to consider are "the degree of organizational and economic interrelationship of various undertakings, the business purpose which is (or might be) served by carrying on the various undertakings separately or together in a trade or business or in an investment setting, and the similarity of various undertakings." The regulations go on to state: "Generally, the Commissioner will accept the characterization by the taxpayer of several undertakings either as a single activity or as separate activities. The taxpayer's characterization will not be accepted, however, when it appears that his characterization is artificial and cannot be reasonably supported under the facts and circumstances of the case."

If you were the factfinder, would you have arrived at the Tax Court's conclusion on this issue in the case below?

**TOPPING v. COMMISSIONER**

T.C. Memo. 2007-92

GOEKE, JUDGE: After concessions, the issues for decision [for tax years 1999, 2000, and 2001] are: (1) Whether petitioner conducts her equestrian and related activities as part of her design business; and (2) whether these activities are for profit under section 183(a). We hold that: (1) Petitioner conducts her equestrian and related activities as part of her design business; and (2) petitioner's design and equestrian activities are conducted for profit.

FINDINGS OF FACT

Petitioner resided in Wellington, Florida, at the time of filing the petition. In 1998, petitioner was 46 years old and in the middle of a bitter divorce. She had no means of supporting herself. Petitioner held no job, had no college degree, and had not had any full-time employment for the past 25 years. Her significant assets consisted of a 16-year-old horse and a debt-encumbered condo in Wellington, Florida.

Forced to make a living to support herself, petitioner developed a plan to use her prominence in the equestrian world to build a business designing horse barns and homes. Her plan was to establish and maintain herself as a peer worthy of trust among the exceptionally wealthy families who participate in the upper realms of the equestrian circuit, own multiple residences, and use interior designers. Even though she had no written business plan, she discussed her plan for her business venture with her certified public accountant, Jeffrey Borofsky (C.P.A. Borofsky). She also discussed her plan with a longtime friend who had successfully started her own business. Petitioner did not conduct a formal market study, nor did she prepare any cash flow projections in anticipation of starting her new business. She did not have any experience in design other than taking a few design courses in college. However, petitioner possessed the artistic ability to draft structural designs freehand. Petitioner also was an experienced equestrian, having ridden horses and competed on an amateur level since she was 12 or 13 years old.

In 1999, petitioner formed a limited liability company, Topping White Design, L.L.C. (Topping White), in Florida. The address of Topping White is the petitioner's place of residence. [Ed. note: Limited Liability Companies are ignored as a separate entity for tax purposes. Thus, the activities of Topping White are treated as being conducted by the owner directly, and the Gross Income earned and deductions incurred by Topping White are treated as earned and incurred directly by Ms. Topping.] Petitioner uses her home office to handle all financial aspects of her design business. The assets of petitioner's activities include horses, a truck, a trailer, and an automobile. Petitioner uses the truck, trailer, and automobile for both the equestrian and design activities. In May of 1999, petitioner hired Deborah Martin (Ms. Martin). Ms. Martin's primary responsibilities include general administrative work, such as preparing invoices, dealing with clients, collecting money, ordering supplies, scheduling contractors, and entering information into a computer. Petitioner also relies upon trainers both to refer clients and improve her performance as a competitor. Moreover, petitioner works with architects, electricians, plumbers, furniture manufacturers, and other experts in their trades in order to run the interior design aspect of her business. Every one of the trainers that petitioner has worked with has referred at least one design client to petitioner. Petitioner also

engages C.P.A. Borofsky to handle her accounting matters.

Petitioner's business methodology consists of entering in and attending horse shows, and making contacts with prospective clients at the shows. Potential clients develop from horse show contacts, and then petitioner and Ms. Martin meet with the potential client. Early on in her business, petitioner tried to develop clients through her longtime experience playing golf. When golf failed to produce any clients, she dropped her golf club membership.

Petitioner develops her equestrian contact clients for Topping White while competing during the Winter Equestrian Festival, which takes place at the Jockey Club. The Jockey Club is an elite, private club, which is not open to the general public. The Jockey Club consists of a large concentration of extraordinarily wealthy people. Most of the attendees in the Jockey Club own horses, and all come to watch the equestrian competition on either side of the competing rings. The Jockey Club has up to 90 tables with six seats per table. These tables are reserved at the beginning of the season. During the period 1999 through 2001, the cost of a table reservation was $5,000 for the 7-week season. Since then, the price has climbed to $25,000. Petitioner originally owned a table at the Jockey Club, but when the cost of a table increased, she initially split the cost with one client, and then later split the cost with two clients.

At the Jockey Club there is a rectangular tent situated between two competing rings—the DeNemethy Ring, where petitioner sometimes competes, and the Grand Prix Ring, where petitioner frequently competes. The rings contain large leaderboards that are visible throughout the Jockey Club. The events are announced over the loudspeaker, which can be heard throughout the Jockey Club. When petitioner enters the Grand Prix Ring during competition, her name is flashed on the leaderboards and announced over the loudspeaker as the owner of the horse and once again as the rider. She rides her horses in the Grand Prix Ring where the amateur-owner classes are held. The Grand Prix Ring is a grass field where riders compete with jumps that can exceed 4 to 6 feet in height. Those who compete must finish within a prescribed period without any faults to be successful. Those who successfully complete the first round advance to the second round. When petitioner advances to the second round, upon entry into the ring, her name is once again flashed on the leaderboards and called over the loudspeaker. If she finishes in the ribbons class, her name is displayed yet again on the leaderboards and announced over the loudspeaker. Win or lose, petitioner returns to the Jockey Club among competitors and observers, where conversations take place over the just-completed competition. To continue to develop her design business, petitioner believes she cannot rest on her reputation and disappear from the scene, but she must continue her client development efforts on the equestrian circuit.

The membership requirements for the Jockey Club do not necessitate ownership of a horse or to be a competitor. However, petitioner believes that if she were to sell all of her horses or were to give up amateur riding, both current and prospective clients would perceive that she had failed financially, would not rely on her as a designer, and thus not trust her with the keys to their homes and their barns. Petitioner also testified that she has to maintain the reputation she has cultivated as a skilled competitor in order to keep her existing relationships and to cultivate new ones. We find petitioner's testimony plausible in this regard.

Petitioner does not advertise her interior design business through advertising media such as equestrian-related magazines, Web sites, or newspapers. In addition, she does not display banners or sponsor any events through Topping White. Petitioner intentionally rejects this type of advertising because the ethos of the Jockey Club and its members perceive that kind of generic

advertising of a personal service business as tacky or gauche. In addition, petitioner does not want to convey the impression that she is desperate for or needs the work. Rather, petitioner relies on her exposure and reputation as both a rider and owner, and also her popularity among the members of the Jockey Club. Instead of actively seeking new clients, petitioner adopts a more subtle approach to attracting prospective clients by making herself available at the Jockey Club during key times in order for prospective clients to find her. In addition, petitioner also relies on word of mouth and referrals by members of the Jockey Club.

The normal evolution of a design project involves a prospective client's contacting petitioner at a horse show. Normally, the Monday after the horse show, Ms. Martin arranges a meeting between petitioner and the prospective client. The meeting typically takes place at the design site with the potential client, petitioner, and Ms. Martin. In most meetings, approximately half of the discussion is design-related to the actual project, while the other half consists of discussion on equestrian-related subjects. For each of her clients, petitioner has designed at least one horse barn. Petitioner's clients, often very wealthy, entrust her with the keys to their home, even after the projects are completed.

Petitioner uses her general knowledge of horses and specifically her knowledge of the idiosyncracies of each of her client's horses to evolve her barn designs. For example, her knowledge of a horse's particular injury or temperament leads her to design a barn with stalls tailored to each horse's individual needs. Interior design of a client's home often requires knowledge related to horses. Though generally most families do not want an equestrian theme of decoration in their homes, the designing process requires petitioner to know the needs of the families who are essentially "horse people." Some of the designs incorporate mudrooms and expanded storage for boots, saddles, and other equipment. In addition, in the interior design process, petitioner has to consider bringing "the outside lifestyle as coming to the inside" by testing fabrics for durability, cleaning ability, and recovery relative to the client's everyday livability.

Petitioner keeps records for her horse barn/interior design activities. All of the files relating to client development and design implementation are kept together by year. Petitioner maintains records that keep an inventory of expenses related to both interior design and equestrian-related activities. Initially, petitioner used a manual accounting system, but then upgraded to Excel and then QuickBooks. Petitioner uses QuickBooks to keep records for both the equestrian and interior design activities on a consolidated basis. Petitioner does not keep records of training costs or costs associated exclusively with horse shows for the purposes of projecting a budget. Nor does she or C.P.A. Borofsky prepare monthly budgets or cash flow projections for either the interior design or equestrian activities. According to petitioner, that is because there is no way to predict what those costs will be from month to month, and that the equestrian circuit is not her business but is part of her overall plan to develop her interior design clientele. At trial, petitioner produced documentary evidence of a profit or loss statement prepared by C.P.A. Borofsky that tracked expenses for both her equestrian and interior design activities.

For the tax years 1999 through 2001, C.P.A. Borofsky filed separate Schedules C, Profit or Loss From Business, for the horse and design activities with petitioner's tax returns. Starting in 2002, C.P.A. Borofsky combined the activities on one Schedule C. Petitioner reported net losses from her horse activities and net income from Topping White as follows:

| | Net Loss of | Net Income of |
|---|---|---|

| Tax Year | Horse Activity | Topping White |
|---|---|---|
| 1998 | $47,123 | $200,908 |
| 1999 | 80,735 | 157,239 |
| 2000 | 206,080 | 499,908 |
| 2001 | 275,169 | 322,459 |

On a consolidated basis, however, petitioner's overall business enjoyed a net profit 6 of the first 7 years of the business:

| Year | Gross Income | Cash Expenses | Net Income |
|---|---|---|---|
| 1998 | $253,965 | $100,180 | $153,785 |
| 1999 | 276,453 | 199,949 | 76,504 |
| 2000 | 707,521 | 413,693 | 293,828 |
| 2001 | 542,183 | 494,893 | 47,290 |
| 2002 | 523,038 | 485,279 | 37,759 |
| 2003 | 841,564 | 495,422 | 346,142 |
| 2004 | 498,826 | 506,887 | (8,061) |

Petitioner is a beneficiary of the Daniel Topping Trust (the trust) from which she received taxable income from 1998 through 2004. For the years in question, that income consisted of $14,060 for 1999, $12,053 for 2000, and $11,882 for 2001. For all of the other years, the amount received from the trust was under $20,000.

On August 26, 2004, respondent mailed to petitioner a notice of deficiency asserting deficiencies for the taxable years 1999, 2000, and 2001. The notice contained no determination regarding the relationship between the horse circuit and the horse barn/interior design activities. The notice disallowed all of petitioner's Schedule C horse-related expenses, explaining:

> It has been determined that the amounts claimed as Schedule C horse racing expenses for the tax years ending 12/31/99, 12/31/2000 and 12/31/2001 are not allowable as such since said activity is deemed to be an activity not engaged in for profit. It has further been determined that said expenses are allowable as Schedule A expenses subject to the applicable Adjusted Gross Income limitations. Accordingly, your taxable income is increased by the disallowed expenses adjustment amounts.

Petitioner timely filed her petition with this Court. In her petition, petitioner assigned error to respondent's segregation of the equestrian and interior design activities and also for all other disallowed expenses related to her interior design and equestrian activities.

OPINION

Section 183 restricts taxpayers from deducting losses from an activity that is not "engaged in for profit." Sec. 183(a). An activity is engaged in for profit if the taxpayer entertained an actual and honest profit objective in engaging in the activity. *Dreicer v. Comm'r*, 78 T.C. 642, 645 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983); sec. 1.183-2(a), Income Tax Regs. The taxpayer's expectation of profit must be in good faith. *Allen v. Comm'r*, 72 T.C. 28, 33 (1979) (citing sec. 1.183-2(a), Income Tax Regs.).

*Application of § 183*

Before we address whether petitioner had the requisite profit motive based on the facts and circumstances, we first must address the threshold issue of whether petitioner's equestrian and design undertakings constitute a single activity for purposes of deciding whether petitioner had the requisite profit motive under section 183. We believe in this case that the resolution of this issue skews all of the remaining issues in favor of the party who prevails. Petitioner's arguments for profit motive all revolve around the assumption that the undertakings constitute one activity, while respondent's arguments isolate the equestrian undertaking and its losses to argue that petitioner did not have the requisite profit motive.

*Whether Petitioner's Undertakings May Be Treated as One Activity*

Multiple undertakings of a taxpayer may be treated as one activity if the undertakings are sufficiently interconnected. Sec. 1.183-1(d)(1), Income Tax Regs. The most important factors in making this determination are the degree of organizational and economic interrelationship of the undertakings, the business purpose served by carrying on the undertakings separately or together, and the similarity of the undertakings. *Id.* The Commissioner generally accepts the taxpayer's characterization of two or more undertakings as one activity unless the characterization is artificial or unreasonable. *Id.*

We have considered these and other factors in determining whether the taxpayer's characterization is unreasonable. The other factors so considered include: (a) Whether the undertakings are conducted at the same place; (b) whether the undertakings were part of the taxpayer's efforts to find sources of revenue from his or her land; (c) whether the undertakings were formed as separate activities; (d) whether one undertaking benefited from the other; (e) whether the taxpayer used one undertaking to advertise the other; (f) the degree to which the undertakings shared management; (g) the degree to which one caretaker oversaw the assets of both undertakings; (h) whether the taxpayer used the same accountant for the undertakings; and (i) the degree to which the undertakings shared books and records. *Mitchell v. Comm'r*, T.C. Memo 2006-145 (citing *Keanini v. Comm'r*, 94 T.C. 41, 46, (1990); *Tobin v. Comm'r*, T.C. Memo. 1999-328; *Estate of Brockenbrough v. Comm'r*, T.C. Memo. 1998-454; *Hoyle v. Comm'r*, T.C. Memo. 1994-592; *De Mendoza v. Comm'r*, T.C. Memo. 1994-314; *Scheidt v. Comm'r*, T.C. Memo. 1992-9)).

We find petitioner's characterization of the equestrian and design undertakings as a single activity for purposes of section 183 to be supported by the facts of this case. A close organizational and economic relationship exists between the equestrian and design undertakings. Petitioner's success as an equestrian competitor creates goodwill that benefits her design business. *See Keanini v. Comm'r*, *supra*. Petitioner formed the equestrian and design undertakings as a single integrated business. Petitioner had been a competitor for most of her adult life, and she transformed this sport experience into an avenue to establish goodwill as an interior designer of horse barns and second homes. She had a plan for an integrated equestrian-based design business. Petitioner and her assistant manage and oversee both undertakings and their assets and also use the same books and records to track both undertakings.

Further, petitioner's equestrian activities significantly benefit her design business, and we find a significant business purpose for the combination of these undertakings. Her prominence as a competitor has gained respect among her peers and causes them to seek her out when they are in need of a designer for their horse barns and recreational homes.

Respondent faults petitioner for not advertising in a conventional sense, such as putting up ads in equestrian magazines or banners at horse shows. Respondent argues that petitioner's failure to specifically advertise the name of Topping White through conventional media is indicative of the lack of an economic relationship between the two undertakings. However, petitioner testified and had witnesses corroborate that traditional advertising of a personal service business is not welcomed by the clientele petitioner sought. Thus, petitioner made a business decision not to advertise conventionally. The question is not whether a particular mode of doing business is wise, but whether the taxpayer honestly believed the method employed would turn a profit for him. In this case, petitioner's judgment has proven prophetic. In *Dreicer v. Commissioner*, 78 T.C. 642 (1982), affd. without opinion 702 F.2d 1205 (D.C. Cir. 1983), we elucidated that the purpose of section 183 is "to allow deductions where the evidence indicates that the activity is actually engaged in for profit even though it might be argued that there is not a reasonable expectation of profit. * * * This is the proper legal standard under section 183." *Id.* at 645.

Further, the evidence demonstrates that petitioner demonstrated good business judgment. Her equestrian contacts are responsible for more than 90 percent of her client base, and her overall business produced a sizable net profit for all of the years at issue. Therefore, petitioner has not only demonstrated that she honestly believed that her mode of advertising would turn a profit, but also has proven that it has been successful and that adopting respondent's suggestion would probably have backfired.

Respondent cites several cases where we held that the taxpayer's activities could not be aggregated and argues that those cases are analogous to the facts in this situation. In *De Mendoza v. Commissioner*, *supra*, the Court refused to aggregate the taxpayer's farming/polo activity and his real estate law practice, despite the taxpayer's position that one reason he began playing polo was to meet clients for his law firm. Based on the evidence, the Court concluded that the farm was formed and operated as a separate business, and the Court was not convinced that the taxpayer began the polo activity to generate legal business or that the activity materially benefited the taxpayer's law practice. In *Wilkinson v. Commissioner*, T.C. Memo. 1996-39, we held that a plastic surgeon's horse ranch activities and his medical practice were not interrelated business activities, despite the taxpayer's claim that the publicity he derived from playing polo and hosting social gatherings helped him get patients for his cosmetic surgery practice. *Id.* In *Zdun v. Commissioner*, T.C. Memo. 1998-296, affd. without published opinion 229 F.3d 1161 (9th Cir. 2000), we held that a dentist's organic apple orchard was not part of the same activity as his holistic dental practice even though the apples were sold to the dental practice's patients at the office.

We do not find any of the cases respondent relies on to be analogous to petitioner's situation. None of the activities in those cases have the same level of integration and interdependence that petitioner's equestrian and design activities did. We are persuaded that petitioner's equestrian activities are necessary to the success of her design business. In the equestrian-related cases that respondent cites, it is apparent that the recreational activities were an afterthought to the taxpayer's primary business, and were more of a social opportunity than an integrated part of a symbiotic business plan. In both *De Mendoza* and *Wilkinson*, the Court found that the benefit of the ranching activities was "incidental" to the taxpayers' law and medical practices, respectively. Similarly, in *De Mendoza*, we were not convinced that the taxpayer's polo activity materially benefited his business. In *Zdun v. Commissioner*, only 10 to 15 percent of the taxpayer dentist's patients actually took the apples he offered, even when he provided the apples to them for no cost.

Here, virtually all of petitioner's clients are equestrian-related contacts who depend on her

knowledge and expertise of horses in designing their barns and homes. In addition, the success of petitioner's interior design business is far from incidental to her equestrian contacts. The evidence shows, rather, that petitioner's interior design business materially benefits from her equestrian-related activities, which is consistent with the distinctions made between incidental and material benefit in *De Mendoza* and *Wilkinson*. The evidence demonstrates that petitioner's involvement in the equestrian world is the cornerstone of her cultivation of relationships with her clientele. Given the nature of petitioner's clientele, we find her testimony about the relationship between her equestrian-related activities and her design business to be credible and logical.

Respondent argues that petitioner did not start riding horses for the purpose of promoting her interior design business, citing the fact that petitioner had competed for sport since a young age. We recognize that petitioner's interest in horses and participation in competition preceded the formation of her equestrian-based design activity. Petitioner's business plan as executed abruptly converted her preexisting hobby into part of an integrated business venture after her divorce.

Respondent also relies on the existence of the LLC entitled "Topping White Design" to argue that petitioner's design business was separate from her equestrian activities. Respondent argues that petitioner should be held to the form of her structure, citing the fact that petitioner used the name of Topping White in dealing with third parties. However, there is no basis to restrict petitioner's overall activities to Topping White. Petitioner deals with clients and is known in the equestrian world as "Tracy Topping." Petitioner conducts both aspects of her business through Topping White, using the same assets, computer program, and files. The fact that petitioner is known on the basis of her name to her clients in the equestrian world does not somehow make her activities with her equestrian-related contacts separate from her design business, which also bears her name.

We also are aware that for the years at issue, C.P.A. Borofsky reported the activities on two separate Schedules C. Positions taken by a taxpayer in a tax return are treated as admissions and cannot be overcome without cogent proof that they are erroneous. *Mendes v. Comm'r*, 121 T.C. 308, 312 (2003); *Estate of Hall v. Comm'r*, 92 T.C. 312, 337-338 (1989). Based on the plethora of evidence that the two undertakings constitute a single activity, we find that petitioner has overcome that position.

We find that a close organizational and economic relationship exists between the equestrian and the design undertakings. Accordingly, we determine that for purposes of section 183, the equestrian undertaking and the design operation constitute a single activity. We need not consider whether petitioner engaged in the equestrian-based design business with the objective of making a profit because the combined activities were profitable in each of the years at issue.[4]

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[4] Petitioner argues that the presumption under sec. 183(d) applies. Under sec. 183(d), in the case of an activity consisting in major part of the breeding, training, showing, or racing of horses, if the Gross Income derived from the activity exceeds the deductions for any 2 of 7 consecutive taxable years, then the activity shall be presumed to be engaged in for profit unless the Commissioner establishes to the contrary. *See* Bunney v. Comm'r, T.C. Memo 2003-233 (citing Golanty v. Comm'r, 72 T.C. 411, 425 (1979), affd. without published opinion 647 F.2d 170 (9th Cir. 1981)). We find that petitioner's equestrian activities were secondary to her activities as a designer. Therefore, this part of the presumption does not apply. Sec. 183(d) presumes an activity is conducted for profit if the Gross Income exceeds the attributable deductions for 3 out of 5 consecutive years (the Gross Income test). The presumption applies only after the third profit year. Mitchell v. Comm'r, T.C. Memo 2006-145 (citing sec. 183(d)). Since we found that petitioner's equestrian and design activities constitute a single undertaking, the sec. 183(d) presumption applies for the years 2001 and 2002. However, we do not analyze the factors in terms of the presumption because we find that this case turns on the fact that the equestrian and design undertakings were an integrated business. Therefore, we find the

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Even if a taxpayer establishes a profit motive so that the activity is considered a true business or investment activity (with deductions taken directly under the business and investment deduction provisions rather than § 183(b)), the inquiry does not necessarily end there. The particular deductions at issue may not be properly *allocable* to the business, as occurred with Mr. Vitale.

**Hobby or Business: Brothel-Hopping Scrutinized by the IRS**[14]

Robert W. Wood

Most sophisticated businesspeople know that the IRS has long battled with taxpayers seeking to deduct as "business expenses" something that turns out to be motivated by pleasure more than profit. Most famous examples of these so-called "hobby loss" cases involve horse breeding, horse racing, car racing, and a variety of other pastimes. One clearly can have a legitimate business (and either make or lose money) in these fields. Yet, the IRS levels particular scrutiny in many such cases.

Not surprisingly, profits help. The IRC presumes that if you make a profit in three out of five consecutive years, then you may have a legitimate business. But if you fall short of this presumption, you'll have to find other ways of convincing the IRS that you are truly in business. If you are unlucky enough to have a loss every year for 20 years, you will have to do a very good job of convincing them, and few such taxpayers can do so.

*Steamy "Business"*

An amusing recent Tax Court case concerning this age-old business vs. pleasure dichotomy involves the world's oldest profession. In *Ralph Louis Vitale, Jr. v. Commissioner*, T.C. Memo. 1999-131, Mr. Vitale claimed that he was engaged in the trade or business of writing about prostitution. The story began back in 1992, when Mr. Vitale was still employed full-time. Anticipating his 1997 retirement, he began writing fiction. In 1993, he began researching a story about brothels in Nevada. How did he begin his research?

You guessed it: He visited numerous houses of ill repute. Although he paid prostitutes in cash (apparently a kind of industry standard), he kept a detailed journal of his numerous "research" visits. To the chagrin of the more prurient tax case reader, it's not clear exactly what appears in the journals. Ultimately, Vitale submitted the manuscript to a so-called joint venture publisher (sometimes known as a "vanity" publisher), paying $4,375 to publish and market 10,000 copies of the book.

Despite the shadowy nature of his publishing effort, Vitale actually received $2,600 in royalties on the book in 1996. Of course, he was still significantly in the red on his project (and I don't mean red garters). To make matters worse, the publisher filed for bankruptcy in 1996. Vitale filed a proof of claim for unpaid royalties and got his rights to the book back. He then began marketing the book to publishers and agents.

The IRS disallowed Mr. Vitale's deductions for 1993 and 1994 relating to the writing based on

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presumption to be unnecessary since the characterization of petitioner's design undertaking and equestrian undertaking as a single activity carries the day.

[14] 83 TAX NOTES 1941 (1999). Reprinted with permission of the author.

lack of profit motive. So Mr. Vitale went to the Tax Court, and the Tax Court apparently liked him (or at least his book). The Tax Court concluded that Vitale did have a profit motive after all. The court delicately noted that the "recreational" aspect of his writing weighed against his case. However, the court concluded that such factors were outweighed by the businesslike manner of his recordkeeping, the diligence of his marketing, and the not atypical start-up nature of his losses.

*The Pen Is Mightier Than the Sword?*

Although Mr. Vitale truly "scored" in this case (meaning, of course, that he beat the IRS on the tough "for profit" motive test), he ended up winning the battle but losing the war. The court denied virtually all of his claimed deductions for lack of substantiation. (I guess in the heat of his brothel visits he forgot to ask for a receipt.) Indeed, the court pointed out that Mr. Vitale's cash payments to prostitutes were "so personal in nature as to preclude their deductibility." (These weren't journalistic interviews then?) Still, the court declined to impose negligence or accuracy-related penalties, finding that Mr. Vitale made a reasonable attempt to comply with the tax laws.

As for me, I'm thinking of writing a book, preferably about what it is like to stay at all of the world's most fabulous and exotic (and expensive) resorts. I'm afraid there will be some dreary (and probably expensive) research. Well, somebody has to do it. . . .

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Similarly, the *Topping* court also addressed this additional issue (deleted from the excerpt above). Even if Ms. Topping succeeded in establishing that the equestrian and design undertakings were a single "activity" that showed a profit, the IRS argued that many of the equestrian costs were nevertheless not deductible as "ordinary" and "necessary" business expenses within the meaning of § 162, providing a great segue to the next chapter, which considers how to determine whether costs are properly allocable to a true business or investment.

## Problems

Rose is a dentist who earns $150,000 each year from her dental practice. She really enjoys traveling around the world during her scheduled vacation time, and she finds that her travels are more enjoyable if she undertakes them with the purpose of planning and putting together an unusual travel guide for each location that focuses (unlike other travel guides) on out-of-the way places that are off the beaten tourist path. She particularly likes to visit small farming villages, as they remind her of her happy childhood growing up on a farm. She produces the travel guides using elegant graphic software (including photos that she takes) and sells them online. In her first year (Year 1), she travels to remote locations in Asia and Africa, and she is excited when she earns $100 of Gross Income on sales of her travel guides online! Alas, the air fare, hotel, and other travel costs incurred to produce the guide totaled $20,000. That is to say, she incurred a loss (excess of potential deductions over Gross Income) of $19,900 for Year 1 with respect to this activity.

**a.** How much can Rose deduct—and under which Code section—if she succeeds in establishing a profit motive?

**b.** How much can Rose deduct—and under which Code section—if she fails to establish a profit motive?

**c.** Suppose that Rose has no profit motive in Years 1 through 4 and that her Gross Income and costs incurred to produce the travel guides are as follows for each year. After traveling to Asia

and Africa in Year 1, she visits less exotic locations that are less expensive to visit in Years 2, 3, and 4.

| | Gross Income | Potential Deductions |
|---|---|---|
| Year 1 | $ 100 | $20,000 |
| Year 2 | 6,000 | 5,500 |
| Year 3 | 10,000 | 9,000 |
| Year 4 | 8,000 | 6,600 |

At the beginning of Year 5, Rose steps back and considers that, in light of her unexpected profits, she might be able to make a business of her travel guide endeavor! She thus develops a profit motive before taking her Year-5 trip. Alas, she travels to the outback in Australia, incurring $15,000 in costs and generating only $2,000 in sales of her travel guide for Year 5. How much can Rose deduct?

**d.** Same as **c.**, except that Rose believes from the beginning of Year 1 that she will be the next Rick Steves. Although she knows that all new businesses generate losses (more deductions than Gross Income) at the beginning, she believes that she will be able to generate small profits after the first year that will grow larger as time goes on, eventually permitting her to quit her dentist practice and work full-time at her new business. What may Rose consider doing in Year 1?

**e.** Rose the dentist does not write travel guides. Instead, Rose the dentist lives on a small farm just outside the city limits and enjoys growing strawberries, blueberries, and hay during the spring and summer seasons. She sells the berries at a roadside stand on the weekends and uses the hay to feed her horses, which she also rides at equestrian events. This year (Year 1) Rose earns $10,000 of Gross Income and incurs only $5,000 of costs (expenses, depreciation of her farm equipment, *etc.*) with respect to her berry and hay crops; she earns $1,000 in prizes at her equestrian events but incurs $4,000 in costs. How much can Rose deduct—and under which Code sections?

# Chapter 20: Allocating Costs Between Income Production and Personal Consumption

The last chapter examined the issue of how to determine whether an activity is properly categorized as either (1) an income-producing activity, on the one hand, or (2) a personal consumption activity, on the other, and you learned that the defining test is the presence of a "profit motive" under § 183. This chapter, in contrast, *assumes* the presence of a true business or investment (*i.e.*, assumes a profit motive) and asks a different question: which outlays (both current expenses and capital expenditures that can generate depreciation and § 165 loss deductions) are properly *allocable* to the income-producing activity and which are properly allocable to the taxpayer's personal sphere? In other words, this chapter examines the *nexus* issue. In a minor key, Part E. considers the additional issue of whether an income-producing activity should be considered a trade or business, on the one hand, or investment activity, on the other, and what difference that distinction might make.

The material in this chapter is not exhaustive but rather is intended as an introductory and practical guide to the most significant primary tests (found in the statute, Treasury regulations, IRS guidance, and judicial decisions) that help to resolve these allocation issues. It runs the gamut from the meaning of the terms "ordinary" and "necessary" in §§ 162 and 212, to *Gilmore*'s origin-of-the-claim test, to the treatment of meal, transportation, travel, and entertainment costs, to the analysis of property converted from personal use to income production (including the so-called home office deduction), and more.

## A. The meaning of "ordinary" and "necessary"

Recall from Chapter 1 that the starting point in analyzing whether wealth reductions can be deducted is finding the Code section that contains the magic words "there shall be allowed a deduction" and satisfying each of its requirements. But the analysis sometimes cannot end there. Even if the Code section granting deduction authority is satisfied, you must then consider whether another Code section steps in to take away the otherwise allowable deduction. You have already studied §§ 1211, 469 and 465, for example, which can defer, respectively, otherwise allowable § 165 losses if they are "capital" losses or the net losses (excess of deductions over Gross Income) in connection with passive activities or activities without a sufficient amount "at risk." In addition, you will learn in this chapter that expenses that meet the deduction requirements of § 162 may nevertheless be reduced or denied deduction if they pertain to meals, travel, or entertainment and fail to satisfy the additional hurdles found in § 274, discussed below in Part C.

With respect to expenses, however, the *starting* point is § 162 (in the case of a business activity) or § 212 (in the case of investment activity), and each requires that the expense at issue be both "ordinary" and "necessary" to be deductible. What do those words mean? The Treasury regulations are silent, so we must look to judicial decisions that interpret the terms.

Mr. Welch's employer (a corporation for which he was an officer) went bankrupt, and Mr. Welch decided to start his own sole proprietorship in the same line of business. In order to court clients of the bankrupt corporation in his new endeavor, Mr. Welch voluntarily repaid some of the

corporation's debts that were discharged in the bankruptcy proceeding and for which he had no legal liability to repay. He attempted to deduct these costs as ordinary and necessary business expenses under the predecessor to § 162, but the Supreme Court, in a 1933 unanimous decision written by Justice Cardozo, agreed with the government that his outlays were not deductible.

The decision in *Welch v. Helvering*[1] is categorized today as one that turns on the distinction between a current "expense" (potentially deductible) and a nondeductible "capital expenditure." For example, the *INDOPCO* decision, a 1992 capital expenditure case that you read in Chapter 4, lists *Welch* as holding that "payments of [a] former employer's debts are capital expenditures."[2] The reason why Mr. Welch's payments were categorized as capital expenditures (creating basis in his new business) rather than current expenses is they created *new* goodwill in Mr. Welch's *new* business that had a life that extended substantially beyond the end of the payment year.[3] Although the decision ultimately turned on the "expense" requirement, Justice Cardozo's opinion in *Welch* is nevertheless more often quoted today for its (ultimately unnecessary) dicta in defining "ordinary" and "necessary."

Justice Cardozo found that Mr. Welch's payments satisfied the "necessary" requirement, stating: "We may assume that the payments to creditors of [Mr. Welch's former employer] were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch* v. *Maryland*. He certainly thought they were, and we should be slow to override his judgment."[4] Justice Cardozo did not explain why the meaning of the word "necessary" in § 162 should be informed by its interpretation in *McCulloch v. Maryland*,[5] the 1819 case that explored the meaning of the "necessary and proper" clause of Article 1, § 8, of the U.S. Constitution, which affects the scope of Congressional power. In any event, notice that Justice Cardozo's test for "necessary"—as requiring nothing more than that the payment be "appropriate and helpful" to the business—is a very easy threshold to meet.

Similarly, the "ordinary" test, while perhaps slightly more substantial, is also fairly easy to satisfy. Justice Cardozo stated:

> 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. 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.... 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

[1] 290 U.S. 111 (1933).
[2] INDOPCO v. Comm'r, 503 U.S. 79, 85 n.5 (1992).
[3] This basis of this new goodwill is not likely amortizable today under § 197, studied in Chapter 14, because it is self-created. *See* § 197(c)(2).
[4] 290 U.S. at 113.
[5] 17 U.S. 316 (1819).

> of life. Life in all its fullness must supply the answer to the riddle.[6]

In other words, even an infrequent outlay can be "ordinary" if it is not unusual according to industry norms.[7] Some lower courts have added the gloss that an outlay must be "reasonable," as well, to be ordinary and necessary.[8]

These thresholds for "ordinary and necessary" are so easy to meet that they have not played a substantial part in denying expense deductions. For example, the expenses incurred in operating a private Lear jet by the owner of a timber farm in Oregon are "ordinary and necessary."[9] In extreme cases, however, these standards can be used to deny truly idiosyncratic costs that are better allocated to the taxpayer's personal sphere. For example, a manufacturer of custom plywood products was denied deduction of the costs of a weekend trip for 120 people to the Super Bowl, including business clients, because the costs were not ordinary and necessary.[10] And the costs of legal bribes and kickbacks, while ordinary in that they were apparently common in the taxpayer's paving industry, were held to be not "appropriate and helpful," failing the necessary test.[11]

As noted above, Mr. Welch's repayment of debts not legally owed in the course of developing *new* goodwill for his new business venture failed the "expense" requirement in § 162. In contrast, the payment of obligations not legally owed in order to *repair* the business's previously existing goodwill *can* qualify as an "expense." Recall that this same distinction was made in both Chapter 4, exploring the line between expenses and capital expenditures generally, and Chapter 17, exploring the particular line between those education costs that can be deducted under Treas. Reg. § 1.162-5 as business expenses (because repairing previously existing human capital) and those

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[6] 290 U.S. at 114-15. Does the last phrase supply a helpful benchmark for lawyers attempting to advise their clients?

[7] One reason why it was initially difficult to discern whether *Welch* turned on the "expense" issue or "ordinary" issue is that Justice Cardozo characterized Welch's repayment of his former employer's debts as "extraordinary," stating:

> 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, 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.

290 U.S. at 114. Do you find Welch's voluntary repayment of his former employer's debts to be "extraordinary" or rather a savvy business move in regaining the trust of the old corporation's former clients in his new business venture? In any event, an additional reason why the basis of the decision was initially difficult to glean is that some early cases interpreted "ordinary" to mean a current expense, as opposed to a capital expenditure. As noted above, the modern Court clearly labels *Welch* as a capital expenditure case, not one turning on whether the payment was "ordinary" in industry practice or "extraordinary."

[8] *See, e.g.*, Kurzet v. Comm'r, 222 F.3d 830 (10th Cir. 2000).

[9] *Id.*

[10] Danville Plywood Corp. v. U.S., 899 F.2d 3 (Fed. Cir. 1990). The *Danville* case reminds us that, even though the costs at issue pertain to entertainment, the analysis does not begin with § 274(a)—which is a deduction disallowance rule—but rather with § 162. Only deductions that survive § 162 in the first instance, including the ordinary and necessary tests, must then satisfy the additional hurdles in § 274(a), discussed in Part C., to remain deductible.

[11] Car-Ron Asphalt Paving Co. v. Comm'r, 758 F.2d 1132 (6th Cir. 1985). *See also* Diggs v. Comm'r, 715 F.2d 245 (6th Cir. 1983) (Congressman's costs of traveling to his national party's political convention related to his own political goals rather than his business as a legislator) and Henry v. Comm'r, 36 T.C. 879 (1961) (tax lawyer's costs of owning and operating a yacht with a flag displaying "1040" not ordinary and necessary in his line of business).

that cannot (because creating new human capital).

In *Dunn & McCarthy, Inc. v. Commissioner*,[12] for example, the president of a corporation who was suffering personal financial difficulties borrowed money from several other employees of the corporation before committing suicide without repaying the loans. The decedent's estate had no assets with which to repay the amounts. Even though the corporation had no legal liability to pay the president's personal debts to his fellow employees, the Board of Directors approved the use of corporate cash to repay the other employees "for the purpose of protecting the goodwill of its business" and sought to deduct the repayments as § 162 ordinary and necessary business expenses. The Tax Court denied the deductions, but the 2nd Circuit reversed, stating:

> Although the corporation was under no legal obligation to make good to the salesmen the president's personal borrowings, it properly recognized a moral obligation to do so, for the lenders were necessarily influenced in some measure by the official position of the borrower [as] their immediate superior. The Tax Court made a finding that "There was no indication that if the loans were not paid the petitioner would lose either customers or its salesmen." If this means merely that no salesman threatened to resign and no customer threatened to withdraw his account if the loans were not paid, the finding is correct. But if it means that failure to pay would have had no effect upon the loyalty of the salesmen or the good will of the customers, we think that the finding is not supportable. It was the unanimous opinion of the directors that a failure by the corporation to recognize its moral obligation would not only impair the attitude of the salesmen toward the company but also would affect adversely the opinion of customers who learned of it. To us this seems a self-evident inference. It also finds support in the testimony. Immediately after the death of Mr. Jones, the salesmen asked Mr. Gorman, a director who succeeded Mr. Jones as sales manager, whether the company was planning to do anything about their loans, thus indicating their opinion that the company should do something…. Thus it seems clear that the outlay was made for the purpose of conserving the goodwill of salesmen and of customers and actually accomplished that purpose.
>
> Such an expenditure of corporation funds would seem to be an "ordinary and necessary" expense in carrying on the business. The opinion of the Tax Court does not question the judgment of the petitioner's directors in thinking that their action was an appropriate and helpful course to follow "and to that extent what was done might be regarded as necessary," but holds that it was not an "ordinary" expense. Reliance for this view is put upon *Welch v. Helvering*….. On the facts the case is plainly distinguishable from the case at bar. Welch made a capital outlay to acquire goodwill for a new business. In the present case the payment was an outlay to retain an existing goodwill, that is, to prevent loss of earnings that might result from destroying such goodwill by failing to recognize the company's moral obligation. Moreover, we do not think that under the circumstances of the present case the expenditure was "in a high degree extraordinary." It was the kind of outlay which we believe many corporations would make, and have made, under similar circumstances. As Mr. Justice Cardozo stated [in *Welch*]: "The standard set up by

[12] 139 F.2d 242 (2nd Cir. 1943).

> 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."[13]

The IRS now agrees with this distinction, as evidenced in Revenue Ruling 76-203.[14] In that ruling, the taxpayer's furniture and storage warehouse burned to the ground, totally destroying the household goods stored there by the taxpayer's customers, some of whom failed to purchase insurance. The ruling recites that "[s]ome of the taxpayer's customers were unhappy over their losses and complained that they were not sufficiently informed about their insurance options. To preserve its goodwill among its customers, and to protect its business reputation, the taxpayer plans to make at least partial monetary restitutions to the uninsured customers." Citing *Dunn & McCarthy*, the revenue ruling concludes that the payments could be deducted as ordinary and necessary business expenses.

The goodwill at issue, however, must pertain to the business at issue when the taxpayer has more than one business. For example, the country music singer Conway Twitty earned most of his income as an entertainer. Nevertheless, he and several of his friends decided to open a chain of fast food restaurants called "Twitty Burger" in the late 1960s. Dozens of investors, some of whom were friends though others were strangers, loaned money to the business. Alas, the venture failed. The corporation operating Twitty Burger had no assets, and Conway Twitty had no personal legal obligation to repay the investors. Nevertheless, Mr. Twitty decided to repay the investors more than $90,000 in the early 1970s out of his own pocket, which he sought to deduct under § 162 "to protect his reputation and earning capacity in his ongoing business of being a country music entertainer."[15] The government argued that there was no relationship between Twitty Burger and the singer's business of being a country music entertainer, but the Tax Court agreed with Mr. Twitty and allowed the deduction.

***Lobbying costs as business expenses***

The costs incurred to lobby legislators to act favorably toward the taxpayer's business interests might seem to satisfy the ordinary and necessary tests easily, as lobbying is quite common in business and can clearly be helpful to the business's profitability. Nevertheless, pre-1962 Treasury regulations provided that such costs failed to satisfy these tests, and the Supreme Court upheld the validity of the regulations in *Cammarano v. United States.*[16] Congress thereafter enacted § 162(e) in 1962, which permitted deduction of costs incurred to directly lobby legislators with respect to a matter directly affecting the business but prohibited deduction of costs incurred in "grassroots" lobbying that attempted merely to influence public opinion. The Clinton administration's 1993 budget proposals advocated repeal of the direct lobbying deduction in an attempt to level the playing field between ordinary citizens lobbying on social issues (who must lobby with after-tax dollars) and businesses (who could lobby with pre-tax dollars to the extent used to directly lobby within the meaning of former § 162(e)). Later that year, Congress amended § 162(e) to disallow the deduction of direct lobbying expenses at the Federal and state—but not local—levels. The amendments also newly prohibited deduction of costs incurred in contacting certain Federal officials. The costs of grassroots lobbying and intervening in a political campaign continue to be nondeductible as business expenses—even at the local level.[17]

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[13] *Id.* at 243-44.
[14] 1976-1 C.B. 45.
[15] *Jenkins v. Comm'r*, T.C. Memo. 1983-667.
[16] 358 U.S. 498 (1959).
[17] *See* §§ 162(e)(1)(B) & (C) and (e)(2)A).

## GEARY v. COMMISSIONER

235 F.3d 1207 (9th Cir. 2000)

Before FLETCHER, O'SCANNLAIN, and GOULD, CIRCUIT JUDGES.

O'SCANNLAIN, CIRCUIT JUDGE: We must decide whether a taxpayer is entitled to an income tax deduction for expenses incurred to place a proposition affecting his working conditions on a local ballot.

I

Robert Geary, a veteran officer of the San Francisco Police Department, appeals a judgment from the Tax Court upholding the Commissioner's determination of a deficiency in his income tax for the 1993 tax year and an assessment of an accuracy-related penalty. The Tax Court disallowed Geary's claimed deduction of $9,711.49 in purported "business expenses" incurred under the following circumstances.

In response to a 1992 San Francisco Police Department policy to encourage creative community policing strategies, Geary began patrolling his beat with a ventriloquist's dummy, whom he named Officer Brendan O'Smarty ("the dummy" or "Officer O'Smarty"). Geary patrolled San Francisco's ethnically diverse North Beach neighborhood and used the dummy to assist him in breaking down language and cultural barriers with neighborhood residents. Geary's unusual approach to community policing attracted national and international media attention, from Turkish television coverage to the front page of the New York Times. Geary realized income as a result of this media attention. Geary signed an option contract with Golden Door Productions to develop a story concept for a film and received over $14,000 when his concept was sold to Interscope Communications. Geary also earned income as a hand model.

When Geary's supervisors became aware of his community policing technique, they told him to "get rid of the puppet because it makes the department look stupid." Geary protested and insisted on meeting with department officials about Officer O'Smarty. At the meeting, it was decided that Geary would need prior written departmental approval before taking Officer O'Smarty on future patrols. The plight of Officer O'Smarty stirred the San Francisco Board of Supervisors to pass a resolution urging the mayor to instruct the chief of police to allow Geary to continue patrolling with the dummy. The mayor resisted the Board's entreaty and the resolution was ignored.

At this point, it occurred to Geary that he should let the San Francisco voters decide whether he should be permitted to use the dummy as he saw fit. He formed the Committee to Save Puppet Officer Brendan O'Smarty and circulated a petition to place the issue before the voters. As required by California law, the San Francisco City Attorney certified that the ballot title appearing on the petition was "presented as a true and impartial statement of the proposed measure." The proposed text of the declaration of policy as it appeared on the petition recited that the measure would allow Geary to decide when to team up with Officer O'Smarty in order "to develop greater trust between the community and the Police Department, improve communications between the department and the general public, and help remove barriers which hamper the goals of the department."

Geary secured sufficient signatures to place the measure on the ballot as "Proposition BB" and the public approved the proposition the following November. Geary incurred $11,465 in petition circulation and promotion expenses and deducted this amount from his 1993 income taxes as

Schedule C advertising expenses. Of this amount, Geary paid $9,088.60 to a professional petition signature collector to obtain the nearly 10,000 signatures required for his proposition to be placed on the ballot. Geary paid an additional $622.89 in connection with the circulation of the ballot petition for a total of $9,711.49 in expenses related to the circulation of the petition and collection of signatures. The remaining $1,753.51 was spent for slate card mailings, paid argument in the ballot pamphlet, and other expenses designed to promote the proposition.

The IRS disallowed Geary's entire Schedule C deduction, issued a notice of deficiency in the amount of $3,499, and assessed an accuracy-related penalty under 26 U.S.C. § 6662(a) and (b)(1) in the amount of $700. Geary petitioned for a redetermination of the deficiency and penalty in Tax Court. He contended that these expenses were "ordinary and necessary expenses" of his business [income attributable to the puppet activity earned outside of his police salary] or, in the alternative, unreimbursed employee business expenses, and hence deductible under 26 U.S.C. § 162(a). Geary was the sole witness to testify at trial. On April 5, 1999, the Tax Court entered judgment for the Commissioner, holding that such expenses were nondeductible under 26 U.S.C. § 162(e)(2)(B), which disallows business deductions for expenses incurred "in connection with any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums." The court rejected Geary's contention that his primary purpose in placing the measure on the ballot was to inform the voters of his creative community policing efforts and to let them decide whether he should continue to patrol with Officer O'Smarty. The court concluded that "taken as a whole, petitioner's actions show a clear intent to influence the general public." The court also determined that Geary was subject to an accuracy-related penalty under 26 U.S.C. § 6662(b)(1) because he negligently claimed a deduction for such expenses.

On appeal, Geary claims that the Tax Court erred in characterizing his effort to place his puppet proposition on the ballot as an attempt to influence the public. He insists that he merely wished to inform the voters in neutral terms about the issue and let them decide for themselves. Geary has conceded that $1,753.51 of his total claimed advertising deduction, not related to petition circulation or signature collection, was incurred in an attempt to influence the public. Thus, only the $9,711.49 in petition-related expenses are at issue in this appeal.

II

Since 1918, regulations promulgated by the Treasury have provided that expenses incurred for the promotion or defeat of legislation are not deductible as business expenses. *See Cammarano v. U.S.*, 358 U.S. 498 (1959). In *Cammarano*, the Supreme Court held that these regulations applied equally to referenda; hence, expenses incurred by liquor retailers and distributors in an effort to encourage voters to vote against a state prohibition initiative were not deductible as ordinary and necessary business expenses. *Id.* at 505-12. In the Revenue Act of 1962, Congress codified this portion of the *Cammarano* decision, adding § 162(e) to the Internal Revenue Code. Revenue Act of 1962, Pub. L. 87-834 § 3(a). Section 162(e)[(1)(C)] provided that there would be no deduction for "any amount paid or incurred … in connection with any attempt to influence the general public, or segments thereof, with respect to elections, legislative matters, or referendums." This provision was meant to disallow deductions "for expenses incurred in connection with what is usually called "grassroot" campaigns intended to develop a point of view among the public generally …." S. REP. NO. 87-1881, 1962 U.S.C.C.A.N. 3297, 3326.

Geary contends that his petition circulation and signature collection expenses were not incurred in an attempt to "influence the public" under § 162(e)[(1)(C)]. He insists that his efforts to place

Proposition BB on the ballot were borne solely from a desire to inform the public about the police puppet issue and to let the voters decide whether he should continue to patrol with Officer O'Smarty. He relies heavily on the fact that the San Francisco City Attorney certified that the ballot title appearing on the ballot petition was a "true and impartial statement of the purpose of the proposed measure." He also insists that the signature collectors did not tell anyone to vote for or against the measure.

We disagree. The plain language of § 162(e)[(1)(C)] renders nondeductible "any amount paid or incurred … in connection with any attempt to influence the general public …." The expenses at issue here were clearly "in connection with" Geary's attempt to influence the public with respect to the puppet proposition. The circulation of the petition and collection of signatures were necessary first steps in Geary's overall promotion of the proposition.

In *Washburn v. Commissioner*, 283 F.2d 839 (8th Cir. 1960), the Eighth Circuit squarely rejected arguments virtually identical to Geary's. In *Washburn*, the taxpayer claimed a deduction for signature collection expenses he incurred in an effort to place a referendum on the ballot that would repeal a certain legislative act. The taxpayer claimed that he did not incur these expenses in order to influence the public, but merely to place the referendum on the ballot. The court rejected this argument:

> The facts in the instant case come within the purview of *Strauss* and *Cammarano*. Here the taxpayer expended money for the purpose of obtaining sufficient signatures to make possible the referendum of an existing state statute to the people under the same state constitutional provision involved in *Strauss*…. The taxpayer here argues that he expended these funds only for the purpose of securing signatures to make possible the referendum, and not for the promotion or defeat of legislation. But obviously he was doing it for the purpose of annulling the existing legislation. Having found this purpose as a fact, the Tax Court necessarily held the expenditures nondeductible under the specific provisions of the Treasury Regulations.

Here, too, the Tax Court found that Geary incurred the petition circulation and signature collection expenses for the purpose of influencing the public. This finding is not clearly erroneous. Geary began his efforts to place Proposition BB on the ballot in response to the police department's restrictions on his use of Officer O'Smarty. He paid for the expenses at issue through his "Committee to Save Puppet Officer Brendan O'Smarty," which he formed, according to his own testimony, for the express purpose of getting the proposition passed. The petition he circulated contained the text of the proposed declaration of policy in addition to a "true and impartial" ballot title certified by the City Attorney as required by the California Election Code. After securing Proposition BB's place on the ballot, Geary incurred additional expenses to promote the measure and to ensure its passage. Thus, there can be little doubt that Geary incurred the disputed petition circulation expenses in connection with—and, in fact, as an integral part of—his overall attempt to persuade the public.

In the words of Judge Learned Hand, "political agitation as such is outside the statute, however innocent the aim …. Controversies of that sort must be conducted without public subvention; the Treasury stands aside from them." *Slee v. Comm'r*, 42 F.2d 184, 185 (2d Cir. 1930), quoted in *Cammarano*, 358 U.S. at 512. Accordingly, we reject Geary's attempt to receive "public subvention" for his campaign on behalf of Officer O'Smarty.

III

26 U.S.C. § 6662(a) provides for an accuracy-related penalty equal to 20 percent of any underpayment attributable to, among other things, "negligence or disregard of rules or regulations." 26 U.S.C. § 6662(b)(1). The Tax Court upheld the Commissioner's assessment of a penalty against Geary pursuant to this section.

26 U.S.C. § 6664(c)(1) provides that no penalty shall be imposed under § 6662 "if it is shown that there was a reasonable cause for such [underpayment] and that the taxpayer acted in good faith …." 26 U.S.C. § 6664(c)(1). According to the Treasury regulations, "circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances, including the experience, knowledge, and education of the taxpayer." 26 C.F.R. § 1.6661-6(b). Given the unusual facts of this case, Geary's relative lack of experience, and the absence of case law on point from this circuit, we conclude that Geary's underpayment was not attributable to negligence but rather amounted to no more than an honest misunderstanding of law that was reasonable in light of all the facts and circumstances. *See Stanford v. Comm'r*, 152 F.3d 450, 460-61 (5th Cir. 1998) (vacating penalty where taxpayer's underpayment was reasonable under the circumstances). We accordingly reverse the Tax Court's affirmance of Geary's accuracy-related penalty.

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***Bribes and kickbacks, fines and penalties, treble damages under the antitrust laws, and the end of the common law public policy exception (or is it?)***

Prior to 1969, some courts attempted to disallow the deduction of business expenses that they found to be contrary to "public policy," even though the costs otherwise satisfied the ordinary and necessary tests and even though the Supreme Court typically (though not always) reversed. For example, the lower courts denied deductions for rent and wages paid by the operators of an illegal gambling enterprise, but the Supreme Court reversed in *Commissioner v. Sullivan*,[18] stating that such a rule "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."[19] Similarly, the lower courts denied deduction as business expenses of legal defense costs incurred by a securities dealer criminally convicted for violation of the Federal securities laws, but the Supreme Court again reversed in *Commissioner v. Tellier*.[20] Nevertheless, the Supreme Court did see some room for deduction disallowance on public policy grounds. In *Tank Truck Rentals v. Commissioner*,[21] for example, the Court agreed that business expense deductions for government fines and penalties incurred by the business for violation of state criminal laws were properly disallowed because deduction "would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof."[22] The Court noted that "[d]eduction of fines and penalties uniformly has been held to frustrate state policy in severe and direct fashion by reducing the 'sting' of the penalty prescribed by the state legislature."[23]

Is augmenting the pain of the punishment the goal of denying normative deductions, *i.e.*, those

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[18] 356 U.S. 27 (1958).
[19] *Id.* at 29.
[20] 383 U.S. 687 (1966).
[21] 356 U.S. 30 (1958).
[22] *Id.* at 33-34.
[23] *Id.* at 35-36.

necessary to measure SHS income properly? If it is, notice that the punishment would vary by the happenstance of the taxpayer's tax bracket. A taxpayer with little Gross Income would not suffer any punishment from deduction denial, a taxpayer whose marginal dollars fall within the 28% bracket would suffer a punishment of 28 cents for each dollar denied deduction, and a taxpayer whose marginal dollars fall within the 39.6% bracket would suffer a punishment of 39.6 cents for the same dollar denied deduction. Moreover, you have learned that denying normative deductions otherwise required in measuring SHS income properly can result in doubly taxing the same dollars to the same taxpayer. In other words, the policy issues arising under the old public policy exception to business expense deductions are of the same ilk (though on the flip side of the coin) as those arising in connection with tax expenditures, which *reduce* tax in a way that is inconsistent with SHS principles. Is the tax law the best tool to use to further such nontax policy goals?

Because of the ambiguity and inconsistency in application of the public policy doctrine, Congress both codified and explicitly limited the doctrine in 1969 by enacting §§ 162(c), (f), and (g) and implying in the legislative history that the common law doctrine for denying business expense deductions on public policy grounds is nearly (if not entirely) dead. To be specific, the Senate Report stated: "The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be all inclusive. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions."[24]

Under § 162(f), the payment must (1) constitute a "fine or penalty" (encompassing both civil and criminal fines and penalties but not civil damages), (2) be paid "to a government," and (3) be incurred because of "the violation of any law." Indeed, Treas. Reg. § 1.162-21(b)(2) specifically states that "[c]ompensatory damages paid to a government do not constitute a fine or penalty." Even though an amount is called a government "fine," it may nevertheless be deductible if it can be shown that the payment is *remedial* in nature rather than *punitive* in nature. Examples include British Petroleum's fines in connection with the Deepwater Horizon oil spill and several bank fines in connection with the financial crisis.[25] You can be sure that much negotiation goes into the drafting of these settlement agreements.[26]

Treble damages that can be imposed under the antitrust laws—which are denied deduction under § 162(g)—represent punitive damages. Notice, therefore, that *compensatory* antitrust damages are not disallowed deduction. Nor are punitive damages *other* than treble damages under the antitrust laws rendered nondeductible.[27]

As quoted above, the *Sullivan* Court said that only Congress—not the courts under a common law doctrine—ought to decide the extent to which illegal businesses should be denied all deductions and thus be taxed on Gross Income. In 1982, Congress enacted § 280E, which provides

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[24] S. REP. NO. 552, 91st Cong., 1st Sess., at 274 (1969), *reprinted in* 1969-3 C.B. 423, 597. Congress further expanded § 162(c) in 1971 by adding paragraph (3), pertaining to kickbacks, rebates, and bribes under the Medicare and Medicaid programs. Treasury also added a regulation that effectively extended these proscriptions to § 212, as well. *See* Treas. Reg. § 1.212-1(p).

[25] *See* Liz Moyer, *Tax Deductions Blunt Impact of Large Corporate Settlements, Report Says*, at www.nytimes.com/2015/12/03/business/dealbook/tax-deductions-blunt-impact-of-large-corporate-settlements-report-says.html.

[26] *See generally* Robert W. Wood, *No-Admit Settlements and Deducting Bad Conduct*, 140 TAX NOTES 733 (2013) (exploring tax characterization language in settlement agreements entered into with the government

[27] *See* Robert W. Wood, *BP, Oil, and Deducting Punitive Damages*, 128 TAX NOTES 663, 663 (2010).

that "no deduction or credit" shall be allowed with respect to a business consisting of trafficking in controlled substances. A basis offset (or an offset for Cost of Goods Sold under inventory accounting, described in Chapter 13), however, is not mechanically a "deduction." Rather, basis offsets "amount realized" in arriving at *Gross Income* under §§ 1001 and 61(a)(3), and the Cost of Goods Sold offsets Gross Receipts under inventory accounting in arriving at *Gross Income* under § 61(a)(2).

Assume, for example, that a drug dealer employs three confederates, purchases heroin for $10,000, resells it on the street for $100,000, and incurs wage costs of $30,000 for the year. Although § 280E denies deduction from Gross Income of the wage costs under § 162, it does not deny the basis offset in arriving at Gross Income. Thus, the drug dealer's Taxable Income equals his $90,000 Gross Income ($100,000 A/R *less* $10,000 A/B). If the dealer had sold shoes instead of narcotics, his Taxable Income would have equaled $60,000 ($90,000 Gross Income *less* $30,000 in § 162 deductions).

Can § 165 *loss* deductions (which you know by now are deductions of unrecovered basis) be disallowed under the common law public policy doctrine? The Tax Court has held that the doctrine survives to deny § 165 loss deductions in certain circumstances. In *Mazzei v. Commissioner*,[28] a reviewed opinion heard by the entire Tax Court, the taxpayer suffered a theft of $20,000, which he sought to deduct under §§ 165(c)(3) and (h) (studied in Chapter 18). The thieves were con men who convinced gullible Mr. Mazzei that they could create a perfect $100 counterfeit bill for every real $100 bill that he could provide with a little black box plugged into an electrical socket. Of course, as soon as Mr. Mazzei handed over $20,000 in real bills, confederates of the fraudsters stormed the apartment dressed as policemen, and everyone ran—including the fraudsters with Mr. Mazzei's real cash. The Tax Court denied his theft loss deduction on public policy grounds because, even though he was a victim, Mr. Mazzei intended to participate in illegal counterfeiting activity. The majority opinion never mentions the 1969 and 1971 amendments to § 162 or their legislative histories.

In contrast, Judges Sterrett (in dissent) and Tannenwald (in his concurrence) both do address the legislative history, with each stressing (through italics) different parts of it. After recounting *Tellier* and *Sullivan*, Judge Sterrett wrote:

> Against this background, Congress as part of the Tax Reform Acts of 1969 and 1971 attempted to set forth categories of expenditures within the purview of section 162 which were to be denied on the grounds of public policy. The Senate Finance Committee report for the 1969 Tax Reform Act states, "The provision for the denial of the deduction for payments in these situations which are deemed to violate public policy is intended to be *all inclusive*. Public policy, in other circumstances, generally is not sufficiently clearly defined to justify the disallowance of deductions." (Emphasis added.) S. Rept. No. 91-552, 91st Cong., 1st Sess. (1969). In expanding the category of nondeductible expenditures, the legislative history of the 1971 Tax Reform Act states, "The committee continues to believe that the determination of when a *deduction* should be *denied* should remain under the *control* of *Congress*." (Emphasis added.) S. Rept. No. 92-437, 92d Cong., 1st Sess. (1971).[29]

[28] 61 T.C. 497 (1974) (reviewed).
[29] *Id.* at 506.

Judge Tannenwald responded:

> Clearly, *Tellier* did not preclude the application of public policy considerations under any and all circumstances. Similarly, in enacting the amendments to section 162, dealing with the deduction of various items involving such considerations, Congress left the door open by recognizing that "public policy, in other circumstances, *generally* is not sufficiently clearly defined to justify the disallowance of deductions." *See* S. Rept. No. 91-552, 91st Cong., 1st Sess., p. 274 (1969) (emphasis added). The reference to legislative retention of control over deductions in the Senate committee report accompanying the Revenue Act of 1971 was limited to situations involving bribes and kickbacks. *See* S. Rept. No. 92-437, 92d Cong., 1st Sess., p. 72 (1971).[30]

Favorably citing *Mazzei*, Revenue Ruling 81-24[31] denies a § 165 loss deduction to an arsonist who purposely set fire to his own property, stating: "[A]lthough Congress codified and limited the public policy doctrine in the case of ordinary and necessary business expenses by amending section 162(c) and enacting sections 162(f) and (g), the rules for disallowing a deduction under section 165 on the grounds of public policy are not so limited."

***Excess compensation***

Section 162(a)(1) explicitly lists "a reasonable allowance for salaries or other compensation for personal services actually rendered" as an example of a deductible ordinary and necessary business expense. This provision, enacted in 1918, appears to have been a codification of a 1917 Treasury Regulation that allowed corporations that did not pay their owner-employees a salary (in favor of plowing back all of the profits into the business) to nevertheless deduct a "reasonable" phantom salary for purposes of computing (and reducing) their liability for an Excess Profits Tax that was added to corporations' income tax liability during WWI.[32] After the repeal of the Excess Profits Tax, however, the provision remained. Over time, it has come to be interpreted primarily as a *limit* on how much of an employee's salary can be deducted as a business expense—usually in the context of the closely held corporation that attempts to disguise nondeductible dividends as deductible salary paid to its owner-employees. Thus, Treas. Reg. § 1.162-7(b)(1) provides that "[a]n ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries."[33]

Outside the closely held corporation context, the vast majority of shareholders are not also employees. Thus, the distinction between salary, on the one hand, and a dividend, on the other, is not the primary policy concern. Rather, the deduction for escalating executive salaries over the last several decades raises an economic efficiency concern. While the deductibility of executive pay

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[30] *Id.* at 504.

[31] 1981-1 C.B. 79. *See also* Rev. Rul. 77-126, 1977-1 C.B. 47, and Rev. Rul. 82-74, 1982-1 C.B. 110.

[32] *See* Erwin N. Griswold, Note, *New Light on a "Reasonable Allowance for Salaries,"* 59 HARV. L. REV. 286 (1945) (yes—*the* Erwin Griswold, mentioned in this textbook's Introduction).

[33] Prior to 2003, dividends were taxed at the same rate as other ordinary income, such as salary. Thus, the incentive was high to disguise a cash transfer to employee-shareholders as compensation (rather than a dividend) in order to create a deduction at the corporate level for a payment that was includable at ordinary income tax rates at the shareholder-employee level in any event. This incentive to disguise dividends as salary in the closely held corporation context was reduced in 2003 when the tax rate applicable to "qualified dividends" was generally reduced to equal that imposed on "net capital gain" under § 1(h)(11).

by a publicly traded corporation does not fit comfortably in a course devoted primarily to examining the income taxation of individuals, this issue can provide another timely example of the problem of economic rents and the tax system's possible reaction to it. Recall from Chapter 3 that "rent-seeking" can be described as the mere shifting of wealth from one to another without any increase in aggregate wealth—in this case, a shift in the allocation of the corporation's profits (if any) from other workers and shareholders of the corporation to the corporation's executives.

> In 1965, C.E.O.s at big companies earned, on average, about twenty times as much as their typical employee. These days, C.E.O.s earn about two hundred and seventy times as much…. That huge gap between the top and the middle is the result of a boom in executive compensation, which rose eight hundred and seventy-six per cent between 1978 and 2011, according to a study by the liberal Economic Policy Institute.[34]

If the escalated pace of salary increases results not from market forces but a market *failure* amounting to rent-seeking behavior on the part of executives and the compensation committees of corporate boards of directors,[35] imposing a deduction limit on the "excess" salary could actually increase the economy's overall efficiency.

Because the "reasonable" standard in § 162(a)(1) looks in part to similar compensation packages paid by similar companies, § 162(a)(1) has not proved effective at limiting deduction of executive pay, as it has ballooned across the board. Thus, Congress enacted § 162(m) in 1993. While the original bill would have denied deduction for almost all executive compensation in excess of $1 million, the enacted provision added a hugely important exception for "performance-based compensation," which frees from the deduction limit compensation paid on meeting certain performance goals identified by a compensation committee of the board of directors "comprised solely of 2 or more outside directors."[36] In practice, this exception has swallowed the rule.[37]

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[34] James Surowiecki, *Open Season*, at www.newyorker.com/talk/financial/2013/10/21/131021ta_talk_surowiecki?printable=true&currentPage=all.

[35] *See, e.g.*, Lucian Bebchuk, Jesse Fried, and David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 U. CHI. L. REV. 751 (2002).

[36] *See* § 162(m)(4)(C).

[37] For an article with many illuminating examples, see Elliott Blair Smith, *Companies Use IRS to Raise Bonuses with Earnings Goals*, at www.businessweek.com/news/2013-09-13/six-cents-help-net-bonus-millions-as-ceos-get-lower-goals.The latest rule designed to curb inflation in executive pay, announced by the Securities and Exchange Commission (SEC) in September 2013, is to require "companies to disclose the ratio of the C.E.O.'s pay to that of the median worker. The idea is that, once the disparity is made public, companies will be less likely to award outsized pay packages." Surowiecki, *supra* note 34. Ironically, this new rule may do just the opposite.

> [T]he drive for transparency has actually helped fuel the spiralling salaries. For one thing, it gives executives a good idea of how much they can get away with asking for. A more crucial reason, though, has to do with the way boards of directors set salaries. As the corporate-governance experts Charles Elson and Craig Ferrere write in a recent paper, boards at most companies use what's called "peer benchmarking." They look at the C.E.O. salaries at peer-group firms, and then peg their C.E.O.'s pay to the fiftieth, seventy-fifth, or ninetieth percentile of the peer group—never lower. This leads to the so-called Lake Wobegon effect: every C.E.O. gets treated as above average. With all the other companies following the same process, salaries ratchet inexorably higher. "Relying on peer-group comparisons, the way boards do, mathematically guarantees that pay is going to go up," Elson told me. "Higher pay becomes a kind of self-fulfilling prophecy."

*Id. See also* Andrew Ross Sorkin, *More Transparency, More Pay for CEOs*, at http://dealbook.nytimes.com/2014/11/10/more-transparency-more-pay-for-c-e-o-s/?_r=0.

## B. The origin-of-the-claim test

*Gilmore*'s origin-of-the-claim test is often recited when trying to determine whether a particular outlay should be traced back to the taxpayer's personal sphere or to his business or investment activities or property. (Those interested in reading about the salacious facts in this incredibly dysfunctional marriage can read Professor Joel S. Newman's fun piece in *Tax Notes*.[38])

**UNITED STATES v. GILMORE**

372 U.S. 39 (1963)

JUSTICE HARLAN delivered the opinion of the court.

In 1955 the California Supreme Court confirmed the award to the respondent taxpayer of a decree of absolute divorce, without alimony, against his wife Dixie Gilmore. The case before us involves the deductibility for federal income tax purposes of that part of the husband's legal expense incurred in such proceedings as is attributable to his successful resistance of his wife's claims to certain of his assets asserted by her to be community property under California law. The claim to such deduction, which has been upheld by the Court of Claims, is founded on [the predecessor to § 212(2)], which allows as deductions from gross income "ordinary and necessary expenses … incurred during the taxable year … for the … conservation … of property held for the production of income."

Because of a conflict of views among the Court of Claims, the Courts of Appeals, and the Tax Court regarding the proper application of this provision, and the continuing importance of the question in the administration of the federal income tax laws, we granted certiorari on the Government's petition.

At the time of the divorce proceedings, instituted by the wife but in which the husband also cross-claimed for divorce, respondent's property consisted primarily of controlling stock interests in three corporations, each of which was a franchised General Motors automobile dealer.[5] As president and principal managing officer of the three corporations, he received salaries from them aggregating about $66,800 annually, and in recent years his total annual dividends had averaged about $83,000. His total annual income derived from the corporations was thus approximately $150,000. His income from other sources was negligible.

As found by the Court of Claims, the husband's overriding concern in the divorce litigation was to protect these assets against the claims of his wife. Those claims had two aspects: *first*, that the earnings accumulated and retained by these three corporations during the Gilmores' marriage (representing an aggregate increase in corporate net worth of some $600,000) were the product of respondent's personal services, and not the result of accretion in capital values, thus rendering respondent's stockholdings in the enterprises *pro tanto* community property under California law; *second*, that to the extent that such stockholdings were community property, the wife, allegedly the innocent party in the divorce proceeding, was entitled under California law to more than a one-

[38] Joel S. Newman, *Gilmore v. United States: The Divorce*, 116 TAX NOTES 493 (2007).

[5] He owned 100% of the outstanding stock of Don Gilmore-San Francisco, 73 1/3% of the outstanding stock of Don Gilmore-Hayward, and 60% of the outstanding stock of Don Gilmore-Riverside.

half interest in such property.[6]

The respondent wished to defeat those claims for two important reasons. *First*, the loss of his controlling stock interests, particularly in the event of their transfer in substantial part to his hostile wife, might well cost him the loss of his corporate positions, his principal means of livelihood. *Second*, there was also danger that if he were found guilty of his wife's sensational and reputation-damaging charges of marital infidelity, General Motors Corporation might find it expedient to exercise its right to cancel these dealer franchises.

The end result of this bitterly fought divorce case was a complete victory for the husband. He, not the wife, was granted a divorce on his cross-claim; the wife's community property claims were denied in their entirety; and she was held entitled to no alimony.

Respondent's legal expenses in connection with this litigation amounted to $32,537.15 in 1953 and $8,074.21 in 1954—a total of $40,611.36 for the two taxable years in question. The Commissioner of Internal Revenue found all of these expenditures "personal" or "family" expenses and as such none of them deductible. [§ 262(a).] In the ensuing refund suit, however, the Court of Claims held that 80% of such expense (some $32,500) was attributable to respondent's defense against his wife's community property claims respecting his stockholdings and hence deductible under [§ 212(2)] as an expense "incurred … for the … conservation … of property held for the production of income." In so holding the Court of Claims stated:

> Of course it is true that in every divorce case a certain amount of the legal expenses are incurred for the purpose of obtaining the divorce and a certain amount are incurred in an effort to conserve the estate and are not necessarily deductible under [the predecessor to § 212(2)], but when the facts of a particular case clearly indicate [as here] that the property, around which the controversy evolves, is held for the production of income and without this property the litigant might be denied not only the property itself but the means of earning a livelihood, then it must come under the provisions of [the predecessor to § 212(2)]…. The only question then is the allocation of the expenses to this phase of the proceedings.

The Government does not question the amount or formula for the expense allocation made by the Court of Claims. Its sole contention here is that the court below misconceived the test governing [§ 212(2)] deductions, in that the deductibility of these expenses turns, so it is argued, 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. So viewing Dixie Gilmore's claims, whether relating to the existence or division of community property, it is contended that the expense of resisting them must be deemed nondeductible "personal" or "family" expense under [§ 262(a)], not deductible expense under [§ 212(2)]. For reasons given hereafter we think the Government's position is sound and that it must be sustained.

I

For income tax purposes Congress has seen fit to regard an individual as having two personalities: "one is [as] a seeker after profit who can deduct the expenses incurred in that search;

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[6] Under California law a party granted a divorce on grounds of extreme cruelty or adultery may, in the court's discretion, be awarded up to all of the community property of the marriage. Cal. Civ. Code § 146. *See* Barham v. Barham, 33 Cal. 2d 416, 202 P. 2d 289; Wilson v. Wilson, 159 Cal. App. 2d 330, 323 P. 2d 1017. Such grounds for divorce were alleged by each of these spouses against the other.

the other is [as] a creature satisfying his needs as a human and those of his family but who cannot deduct such consumption and related expenditures."[11] The Government regards [§ 212(2)] as embodying a category of the expenses embraced in the first of these roles.

Initially, it may be observed that the wording of [§ 212(2)] more readily fits the Government's view of the provision than that of the Court of Claims. For in context "conservation of property" seems to refer to operations performed with respect to the property itself, such as safeguarding or upkeep, rather than to a taxpayer's retention of ownership in it. But more illuminating than the mere language of [§ 212(2)] is the history of the provision.

Prior to 1942 § 23 allowed deductions only for expenses incurred "in carrying on any trade or business," the deduction presently authorized by [§ 162(a)]. In *Higgins* v. *Commissioner*, 312 U.S. 212, this Court gave that provision a narrow construction, holding that the activities of an individual in supervising his own securities investments did not constitute the "carrying on of a trade or business," and hence that expenses incurred in connection with such activities were not tax deductible. The Revenue Act of 1942, by adding what is now [§ 212(1) and (2)], sought to remedy the inequity inherent in the disallowance of expense deductions in respect of such profit-seeking activities, the income from which was nonetheless taxable.

As noted in *McDonald* v. *Commissioner*, 323 U.S. 57, 62, the purpose of the 1942 amendment was merely to enlarge "the category of incomes with reference to which expenses were deductible." And committee reports make clear that deductions under the new section were subject to the same limitations and restrictions that are applicable to those allowable under [§ 162(a)]. Further, this Court has said that [§ 212] "is comparable and *in pari materia* with [§ 162(a)]," providing for a class of deductions "coextensive with the business deductions allowed by [§ 162(a)], except for" the requirement that the income-producing activity qualify as a trade or business. *Trust of Bingham* v. *Commissioner*, 325 U.S. 365, 373, 374.

A basic restriction upon the availability of a [§ 162(a)] deduction is that the expense item involved must be one that has a business origin. That restriction not only inheres in the language of [§ 162(a)] itself, confining such deductions to "expenses … incurred … in carrying on any trade or business," but also follows from [§ 262(a)], expressly rendering nondeductible "in any case … personal, living, or family expenses." In light of what has already been said with respect to the advent and thrust of [§ 212], it is clear that the "personal … or family expenses" restriction of [§ 262(a)] must impose the same limitation upon the reach of [§ 212(2)—in other words that the only kind of expenses deductible under [§ 212(2)] are those that relate to a "business," that is, profit-seeking, purpose. The pivotal issue in this case then becomes: was this part of respondent's litigation costs a "business" rather than a "personal" or "family" expense?

The answer to this question has already been indicated in prior cases. In *Lykes* v. *United States*, 343 U.S. 118, the Court rejected the contention that legal expenses incurred in contesting the assessment of a gift tax liability were deductible. The taxpayer argued that if he had been required to pay the original deficiency he would have been forced to liquidate his stockholdings, which were his main source of income, and that his legal expenses were therefore incurred in the "conservation" of income-producing property and hence deductible under [§ 212(2)]. The Court first noted that the "deductibility [of the expenses] turns wholly upon the nature of the activities to which they relate" (343 U.S., at 123), and then stated:

[11] SURREY & WARREN, CASES ON FEDERAL INCOME TAXATION 272 (1960).

> Legal expenses do not become deductible merely because they are paid for services which relieve a taxpayer of liability. That argument would carry us too far. It would mean that the expense of defending almost any claim would be deductible by a taxpayer on the ground that such defense was made to help him keep clear of liens whatever income-producing property he might have. For example, it suggests that the expense of defending an action based upon personal injuries caused by a taxpayer's negligence while driving an automobile for pleasure should be deductible. [Section 212] has never has been so interpreted by us….
>
> While the threatened deficiency assessment … added urgency to petitioner's resistance of it, neither its size nor its urgency determined its character. It related to the tax payable on petitioner's gifts …. The expense of contesting the amount of the deficiency was thus at all times attributable to the gifts, as such, and accordingly was not deductible.
>
> If, as suggested, the relative size of each claim, in proportion to the income-producing resources of a defendant, were to be a touchstone of the deductibility of the expense of resisting the claim, substantial uncertainty and inequity would inhere in the rule…. It is not a ground for … [deduction] that the claim, if justified, will consume income-producing property of the defendant." 343 U.S., at 125-126.

In *Kornhauser* v. *United States*, 276 U.S. 145, this Court considered the deductibility of legal expenses incurred by a taxpayer in defending against a claim by a former business partner that fees paid to the taxpayer were for services rendered during the existence of the partnership. In holding that these expenses were deductible even though the taxpayer was no longer a partner at the time of suit, the Court formulated the rule that "where a suit or action against a taxpayer is directly connected with, or … proximately resulted from, his business, the expense incurred is a business expense…." 276 U.S., at 153. Similarly, in a case involving an expense incurred in satisfying an obligation (though not a litigation expense), it was said that "it is the origin of the liability out of which the expense accrues" or "the kind of transaction out of which the obligation arose … which [is] crucial and controlling." *Deputy* v. *du Pont*, 308 U.S. 488, 494, 496.

The principle we derive from these cases is that the 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, for, as *Lykes* teaches, that "would carry us too far"[15] and would not be compatible with the basic lines of expense deductibility drawn by Congress.[16] Moreover, such a rule would lead to capricious results. If two taxpayers are each sued for an automobile accident while driving for pleasure, deductibility of their litigation costs would turn on the mere circumstance of the character of the assets each happened to possess, that is, whether the judgments against them stood to be satisfied out of income- or nonincome-producing property. We should be slow to attribute to Congress a

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[15] The Treasury Regulations have long provided: "An expense (not otherwise deductible) paid or incurred by an individual in determining or contesting a liability asserted against him does not become deductible by reason of the fact that property held by him for the production of income may be required to be used or sold for the purpose of satisfying such liability." Treas. Reg. (1954 Code) § 1.212-1(m); *see* Treas. Reg. 118 (1939 Code) § 39.23(a)-15 (k).

[16] Expenses of contesting tax liabilities are now deductible under § 212(3) of the 1954 Code. This provision merely represents a policy judgment as to a particular class of expenditures otherwise nondeductible, like extraordinary medical expenses, and does not cast any doubt on the basic tax structure set up by Congress.

purpose producing such unequal treatment among taxpayers, resting on no rational foundation.

Confirmation of these conclusions is found in the incongruities that would follow from acceptance of the Court of Claims' reasoning in this case. Had this respondent taxpayer conducted his automobile-dealer business as a sole proprietorship, rather than in corporate form, and claimed a deduction under [§ 162(a)],[17] the potential impact of his wife's claims would have been no different than in the present situation. Yet it cannot well be supposed that [§ 162(a)] would have afforded him a deduction, since his expenditures, made in connection with a marital litigation, could hardly be deemed "expenses … incurred … in carrying on any trade or business." Thus, under the Court of Claims' view expenses may be even less deductible if the taxpayer is carrying on a trade or business instead of some other income-producing activity. But it was manifestly Congress's purpose with respect to deductibility to place all income-producing activities on an equal footing. And it would surely be a surprising result were it now to turn out that a change designed to achieve equality of treatment in fact had served only to reverse the inequality of treatment.

For these reasons, we resolve the conflict among the lower courts on the question before us in favor of the view 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" and hence whether it is deductible or not under [§ 212(2)]. We find the reasoning underlying the cases taking the "consequences" view unpersuasive.

We turn then to the determinative question in this case: did the wife's claims respecting respondent's stockholdings arise in connection with his profit-seeking activities?

II

In classifying respondent's legal expenses the court below did not distinguish between those relating to the claims of the wife with respect to the *existence* of community property and those involving the *division* of any such property. Nor is such a breakdown necessary for a disposition of the present case. It is enough to say that in both aspects the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity. This is obviously so as regards the claim to more than an equal division of any community property found to exist. For any such right depended entirely on the wife's making good her charges of marital infidelity on the part of the husband. The same conclusion is no less true respecting the claim relating to the existence of community property. For no such property could have existed but for the marriage relationship. Thus none of respondent's expenditures in resisting these claims can be deemed "business" expenses, and they are therefore not deductible under [§ 212(2)].

In view of this conclusion it is unnecessary to consider the further question suggested by the Government: whether that portion of respondent's payments attributable to litigating the issue of the existence of community property was a capital expenditure or a personal expense. In neither event would these payments be deductible from gross income.

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Mr. Gilmore made two arguments in support of deducting at least a portion of his divorce

[17] We find no indication that Congress intended [the predecessor to § 212(1)] to include such expenses.

litigation costs. First, he relied on the predecessor to § 212(2) by arguing that the community property claims of his wife could cause him to lose income-producing property (the stock in his three corporations) and that this potential consequence caused the cost to be incurred "for the management, conservation, or maintenance of property held for the production of income." Second, he relied on the predecessor to § 162(a) by arguing that the sensational charges made by his wife could cause General Motors to invoke a clause in his car dealer franchise contract that would permit cancellation for conduct that could damage G.M.'s reputation if the court found the claims to be credible. (While this contract clause might sound preposterous to 21st century ears, remember that the Gilmores divorced in 1955.) Because losing his car dealer franchise contracts would eviscerate his ability to earn a living, he argued that the costs incurred to defend against these charges could be deducted as business expenses. The *Gilmore* Court rejected both arguments when it stated that the proper focus in determining deductibility under either §§ 162 or 212 is on the *origin* of the cost rather than on the potential *consequences* to the taxpayer's income-producing property or business interests. Because the origin of Mr. Gilmore's lawyer fees could be traced back to the dissolution of his marriage, they were § 262 personal expenses, not §§ 162 or 212 business or investment expenses. Today, the first sentence of Treas. Reg. § 1.262-1(b) "generally" (using that word) confirms this characterization.

Treas. Reg. § 1.262-1(b) goes on to state, however, that the costs incurred by a recipient of tax alimony to negotiate the tax alimony terms or to enforce payment are deductible under § 212(1) as expenses incurred "for the production or collection of income." While this rule may appear to be inconsistent with the origin-of-the-claim test (because alimony negotiation and enforcement have their origins in the alimony recipient's personal life), this rule is necessary in order to honor SHS normative principles. Recall from Chapter 9 that tax alimony is includable in Gross Income. Thus, SHS principles require that the costs directly connected to producing this stream of includable Gross Income should be deductible to avoid doubly taxing the same dollars to the same taxpayer—even though the includable Gross Income arises in the taxpayer's personal sphere and not out of a profit motive. In other words, this rule is consistent with the deduction allowances in §§ 165(d) and 183(b), studied in the last chapter, which essentially allow deductions to the extent of the Gross Income earned in the personal activity.

In addition, do not forget the § 212(3) tax expenditure (which has nothing to do with measuring SHS income properly), allowing deduction of expenses incurred "in connection with the determination, collection, or refund of any tax." As you learned in Chapter 18, Treas. Reg. § 1.212-1(*l*) interprets this language generously to apply to costs incurred "for tax counsel," *i.e.*, tax-planning expenses. Thus, the costs incurred by *both* parties to a divorce are deductible to the extent properly allocable to costs incurred for tax advice in structuring the alimony, child support, and property settlements with an eye on their tax consequences. All of these § 212 deductions are MIDs, however, subject to the 2% floor in § 67.

***Gilmore II***

In Chapter 4, you learned that costs incurred to defend or perfect title to property (including intangible property, such as stock) are not current "expenses" but rather nondeductible "capital expenditures" that must be capitalized into the property's basis.[39] Assume, for example, that Mark purchases Blackacre (a farm rented to tenant farmers) from Sara in Year 1. In Year 2, Caleb sues Mark for Blackacre, arguing that he owned it and that Sara never had Blackacre title to sell to

[39] *See* Treas. Reg. § 1.263(a)-4(d)(9).

Mark. Mark incurs lawyer and court costs in defending his Blackacre title and wins in Year 2. Even though the tenant farm is clearly property held for the production of income, Mark cannot deduct his lawyer and court costs under § 212(2) as current "expenses" but rather must capitalize the costs under § 263, increasing his Blackacre basis under § 1016(a)(1).[40]

Perhaps in reaction to the *Gilmore* Court's last paragraph reprinted above, Mr. Gilmore later sought to increase his stock basis by his litigation costs in computing his gain on sale of the stock. The Federal District Court permitted him to do so, reasoning that the divorce litigation costs were incurred to protect his title to the stock.[41] In view of the Supreme Court's earlier decision, however, was that result correct? Did not the Supreme Court conclude that these costs were current expenses incurred to dissolve the marital relationship and *not* in defending or perfecting title to the stock? The government did not appeal the decision—perhaps because it was afraid that the appellate court would make the same mistake. A District Court decision has less precedential value than appellate court decisions.

***How far back do we go in looking for the "origin" of a cost?***

The "origin" test is easy to state but not always easy to apply, as it raises another question: how far back should we go in locating a cost's origins? To put this issue in perspective, recall Mr. Vitale, whose case was described in the short article at the end of the last chapter.[42] The Tax Court concluded that Mr. Vitale's efforts in publishing (at his own expense) a book about prostitution were undertaken with the requisite "profit motive" to make it a true business, even though Mr. Vitale incurred costs that exceeded his realized Gross Income from book sales. With that finding, Mr. Vitale avoided the § 183(b)(2) deduction limit (which, absent a profit motive, would have limited his deductions to the amount of Gross Income generated by the book sales for the year). The Tax Court nevertheless did accept the government's argument that the particular expenses incurred by Mr. Vitale in visiting prostitutes were nevertheless nondeductible as inherently personal expenses. Stated another way, the Tax Court traced these costs back beyond his business need to do book research to his personal (sexual) life.

How close to the business must the nexus be for an expense to have its origin in the business? How would you have decided the following cases if you were the judge applying the origin test?

**Harden v. Commissioner.**[43] A woman with whom a prominent NFL football player had a "personal relationship" filed criminal sexual assault charges with the police department against the player. The football club learned of the complaint and informed the player that he would be traded or released "if the matter became public knowledge." The player paid the woman $25,000 in exchange for dropping the charges and keeping the matter confidential, and the football club extended the player's contract. The player deducted the $25,000 under § 162. If you were the judge, would you decide that the origin of this cost lay in the taxpayer's business?

**Peckham v. Commissioner.**[44] A medical doctor performed an elective abortion in 1954. At the time (before *Roe v. Wade*), all abortions were illegal under the state law at issue unless "necessary for the preservation of the mother's life or health." The physician was criminally indicted and

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[40] The same result arises even if the property at issue is personal-use property (rather than business or investment property). Review Problem 8 at the end of Chapter 1, Part A.
[41] *See* Gilmore v. U.S., 245 F. Supp. 383 (N.D. Cal. 1975) (often referred to as *Gilmore II*).
[42] Vitale v. Comm'r, T.C. Memo. 1999-131.
[43] T.C. Memo. 1991-454.
[44] 327 F.2d 855 (4th Cir. 1964).

found guilty. In addition, his license to practice medicine was revoked. He deducted his legal defense costs under § 162, arguing that "his primary reason for expending the sum of $10,959.50 in his defense against the indictment was to protect his license to practice medicine." Recall the *Tellier* case (described in Part A.), in which the Supreme Court held that the defense costs incurred by a securities dealer criminally convicted for violation of the Federal securities laws were deductible as ordinary and necessary business expenses, rejecting deduction denial on public policy grounds. While *Tellier* was decided two years after *Peckham* and thus was not available as precedent for the Fourth Circuit Court of Appeals to consult, it did not invoke the old public policy exception in any event but rather decided the case entirely on the nexus question regarding whether the behavior for which the physician was indicted was connected to his medical practice. If you were the judge, would you decide that the origin of this cost lay in the taxpayer's business?

To save you time in looking up the cited cases, I'll spill the beans. Both were denied their deductions under the origin test.[45]

***The origin of commuting, clothing, and meal costs unconnected to travel or entertainment***

The origin test can require *more* than showing a "but-for" relationship. For example, a taxpayer who lives in the suburbs would not incur costs to commute to work in the city center but for his job there. Nevertheless, commuting costs are traced back to the taxpayer's decision to live in the suburbs—a personal choice. Thus, Treas. Reg. § 1.262-1(b)(5) provides: "The taxpayer's costs of commuting to his place of business or employment are personal expenses…." In an excess of caution, perhaps, Treas. Reg. § 1.162-2(e) confirms: "Commuters' fares are not considered as business expenses and are not deductible." In short, the cost of traveling from the taxpayer's personal residence to her place of employment or a job site is usually nondeductible.[46] Similarly, a parent might not incur childcare costs but for the need to work, but childcare costs are not deductible as business expenses; they are traced back to the personal decision to have the child.[47]

How are these concepts applied in the case of work clothing? A lawyer might *hate* wearing suits and never wears them outside a court appearance. Can the lawyer deduct the suit costs as business expenses under § 162?

**PEVSNER v. COMMISSIONER**

628 F.2d 467 (5th Cir. 1980)

JUDGE JOHNSON: This is an appeal by the Commissioner of Internal Revenue from a decision of the United States Tax Court. The tax court upheld taxpayer's business expense deduction for clothing expenditures in the amount of $1,621.91 for the taxable year 1975. We reverse.

Since June 1973 Sandra J. Pevsner has been employed as the manager of the Sakowitz Yves St.

[45] Could Mr. Harden nevertheless capitalize the costs into his renewed player contract under *Gilmore II* and amortize that basis as a "section 197 intangible," which would effectively offset a portion of his contract earnings in reaching Taxable Income? Is his player contract described in § 197(d)? Or, as implied earlier, was *Gilmore II* wrongly decided? That is to say, is the *Harden* court's holding that the origin of these costs lay in his personal life rather than his player contract prevent him from capitalizing these costs into the contract?

[46] A narrow exception can apply if the taxpayer has a so-called home office that satisfies the tests of § 280A and travels to other work sites. *See infra* n. 91.

[47] Even though not deductible as business expenses, childcare costs can sometimes generate a tax credit under § 21. Section 21 is a tax expenditure, however, not a normative provision intended to measure SHS income accurately, as is § 162.

Laurent Rive Gauche Boutique located in Dallas, Texas. The boutique sells only women's clothes and accessories designed by Yves St. Laurent (YSL), one of the leading designers of women's apparel. Although the clothing is ready to wear, it is highly fashionable and expensively priced. Some customers of the boutique purchase and wear the YSL apparel for their daily activities and spend as much as $20,000 per year for such apparel.

As manager of the boutique, the taxpayer is expected by her employer to wear YSL clothes while at work. In her appearance, she is expected to project the image of an exclusive lifestyle and to demonstrate to her customers that she is aware of the YSL current fashion trends as well as trends generally. Because the boutique sells YSL clothes exclusively, taxpayer must be able, when a customer compliments her on her clothes, to say that they are designed by YSL. In addition to wearing YSL apparel while at the boutique, she wears them while commuting to and from work, to fashion shows sponsored by the boutique, and to business luncheons at which she represents the boutique. During 1975, the taxpayer bought, at an employee's discount, the following items: four blouses, three skirts, one pair of slacks, one trench coat, two sweaters, one jacket, one tunic, five scarves, six belts, two pairs of shoes and four necklaces. The total cost of this apparel was $1,381.91. In addition, the sum of $240 was expended for maintenance of these items.

Although the clothing and accessories purchased by the taxpayer were the type used for general purposes by the regular customers of the boutique, the taxpayer is not a normal purchaser of these clothes. The taxpayer and her husband, who is partially disabled because of a severe heart attack suffered in 1971, lead a simple life and their social activities are very limited and informal. Although taxpayer's employer has no objection to her wearing the apparel away from work, taxpayer stated that she did not wear the clothes during off-work hours because she felt that they were too expensive for her simple everyday lifestyle. Another reason why she did not wear the YSL clothes apart from work was to make them last longer. Taxpayer did admit at trial, however, that a number of the articles were things she could have worn off the job and in which she would have looked "nice."

The Tax Court allowed the taxpayer to deduct the total amount of $1,621.91. The Tax Court reasoned that the apparel was not suitable to the private lifestyle maintained by the taxpayer. This appeal by the Commissioner followed.

The principal issue on appeal is whether the taxpayer is entitled to deduct as an ordinary and necessary business expense the cost of purchasing and maintaining the YSL clothes and accessories worn by the taxpayer in her employment as the manager of the boutique. This determination requires an examination of the relationship between Section 162(a), which allows a deduction for ordinary and necessary expenses incurred in the conduct of a trade or business, and Section 262 of the Code, which bars a deduction for all "personal, living, or family expenses." Although many expenses are helpful or essential to one's business activities—such as commuting expenses and the cost of meals while at work—these expenditures are considered inherently personal and are disallowed under Section 262. *See, e.g., U.S. v. Correll*, 389 U.S. 299 (1967); *Comm'r v. Flowers*, 326 U.S. 465 (1946).

The generally accepted rule governing the deductibility of clothing expenses is that the cost of clothing is deductible as a business expense only if: (1) the clothing is of a type specifically required as a condition of employment, (2) it is not adaptable to general usage as ordinary clothing,

and (3) it is not so worn. *Donnelly v. Comm'r*, 262 F.2d 411, 412 (2d Cir. 1959).[3]

In the present case, the Commissioner stipulated that the taxpayer was required by her employer to wear YSL clothing and that she did not wear such apparel apart from work. The Commissioner maintained, however, that a deduction should be denied because the YSL clothes and accessories purchased by the taxpayer were adaptable for general usage as ordinary clothing and she was not prohibited from using them as such. The Tax Court, in rejecting the Commissioner's argument for the application of an objective test, recognized that the test for deductibility was whether the clothing was "suitable for general or personal wear" but determined that the matter of suitability was to be judged subjectively, in light of the taxpayer's lifestyle. Although the court recognized that the YSL apparel "might be used by some members of society for general purposes," it felt that because the "wearing of YSL apparel outside work would be inconsistent with … (taxpayer's) lifestyle," sufficient reason was shown for allowing a deduction for the clothing expenditures.

In reaching its decision, the Tax Court relied heavily upon *Yeomans v. Commissioner*, 30 T.C. 757 (1958). In *Yeomans*, the taxpayer was employed as fashion coordinator for a shoe manufacturing company. Her employment necessitated her attendance at meetings of fashion experts and at fashion shows sponsored by her employer. On these occasions, she was expected to wear clothing that was new, highly styled, and such as "might be sought after and worn for personal use by women who make it a practice to dress according to the most advanced or extreme fashions." 30 T.C. at 768. However, for her personal wear, Ms. Yeomans preferred a plainer and more conservative style of dress. As a consequence, some of the items she purchased were not suitable for her private and personal wear and were not so worn. The Tax Court allowed a deduction for the cost of the items that were not suitable for her personal wear. Although the basis for the decision in *Yeomans* is not clearly stated, the Tax Court in the case *sub judice* determined that

> (a) careful reading of *Yeomans* shows that, without a doubt, the Court based its decision on a determination of Ms. Yeomans' lifestyle and that the clothes were not suitable for her use in such lifestyle. Furthermore, the Court recognized that the clothes Ms. Yeomans purchased were suitable for wear by women who customarily wore such highly styled apparel, but such fact did not cause the court to decide the issue against her. Thus, Yeomans clearly decides the issue before us in favor of the petitioner.

T.C. Memo 1979-311 at 9-10.

Notwithstanding the tax court's decision in *Yeomans*, the Circuits that have addressed the issue have taken an objective, rather than subjective, approach. *Stiner v. U.S.*, 524 F.2d 640, 641 (10th Cir. 1975); *Donnelly v. Comm'r*, 262 F.2d 411, 412 (2d Cir. 1959). An objective approach was also taken by the tax court in *Drill v. Commissioner*, 8 T.C. 902 (1947). Under an objective test, no reference is made to the individual taxpayer's lifestyle or personal taste. Instead, adaptability for personal or general use depends upon what is generally accepted for ordinary street wear.

The principal argument in support of an objective test is, of course, administrative necessity. The Commissioner argues that, as a practical matter, it is virtually impossible to determine at what

[3] When the taxpayer is prohibited from wearing the clothing away from work a deduction is normally allowed. *See* Harsaghy v. Comm'r, 2 T.C. 484 (1943). However, in the present case no such restriction was placed upon the taxpayer's use of the clothing.

point either price or style makes clothing inconsistent with or inappropriate to a taxpayer's lifestyle. Moreover, the Commissioner argues that the price one pays and the styles one selects are inherently personal choices governed by taste, fashion, and other unmeasurable values. Indeed, the Tax Court has rejected the argument that a taxpayer's personal taste can dictate whether clothing is appropriate for general use. *See Drill v. Comm'r*, 8 T.C. 902 (1947). An objective test, although not perfect, provides a practical administrative approach that allows a taxpayer or revenue agent to look only to objective facts in determining whether clothing required as a condition of employment is adaptable to general use as ordinary streetwear. Conversely, the Tax Court's reliance on subjective factors provides no concrete guidelines in determining the deductibility of clothing purchased as a condition of employment.

In addition to achieving a practical administrative result, an objective test also tends to promote substantial fairness among the greatest number of taxpayers. As the Commissioner suggests, it apparently would be the Tax Court's position that two similarly situated YSL boutique managers with identical wardrobes would be subject to disparate tax consequences depending upon the particular manager's lifestyle and "socio-economic level." This result, however, is not consonant with a reasonable interpretation of Sections 162 and 262.

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Several cases have similarly denied deduction by television news anchors of the cost of their on-air clothing and accessories, even if they would not otherwise wear them outside of their work environment.[48] An easy example of deducible clothing costs would be the cost of a clown outfit worn by a professional clown. Interesting tidbit: Sweden's income tax rules contain a similar rule pertaining to the deductibility of clothing costs as a business expense, and the 1970s pop group Abba admitted that the only reason that they wore such outlandish clothing was so that they could deduct the cost.[49]

The *Pevsner* court adopted an objective test (rather than subjective test) for purposes of determining whether the clothing at issue is suitable for use outside of the work environment out of concerns for both administrative ease and "substantial fairness among the greatest number of taxpayers." Near the end of the case below, does Judge Richard Posner (one of the pioneers of the law and economics movement) imply that someone who subjectively gains less "utility" from a meal than its price (*i.e.*, subjectively values the meal less than the money paid for it) can deduct the portion of the cost in excess of that subjective value if the meal is consumed in a business setting? Would such a rule be administrable?

## MOSS v. COMMISSIONER

758 F.2d 211 (7th Cir. 1985)

Before CUMMINGS, CHIEF JUDGE, BAUER and POSNER, CIRCUIT JUDGES.

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

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[48] *See, e.g.*, Hynes v. Comm'r, 74 T.C. 1266 (1980); Hamper v. Comm'r, T.C. Summary Op. 2011-17.
[49] *See* Simon Bowers, *Abba Admits Outrageous Outfits Were Worn to Avoid Tax*, at http://www.theguardian.com/music/2014/feb/16/abba-outfits-tax-deduction-bjorn-ulvaeus.

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." [S]ection 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 … away from home (that is, on an overnight trip away from his place of work, see *United States v. Correll*, 389 U.S. 299, 19 L. Ed. 2d 537, 88 S. Ct. 445 (1967)), section 162(a)(2) [does not apply] to this case. The Internal Revenue Service concedes, however, that meals are deductible under section 162(a) when they are ordinary and necessary business expenses (provided the expense is substantiated with adequate records, see section 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. Treas. Reg. § 1.262-1(b)(5).

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, section 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 section 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 soufflé 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. Comm'r*, 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. Comm'r*, T.C. Memo 1977-419, 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*, T.C. Memo 1984-200, 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.

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Up until now, we have seen that costs are placed in the taxpayer's income-producing sphere or personal sphere generally in an all-or-nothing manner. The costs of commuting, work clothing suitable for general use, and childcare, for example, are placed wholly within the personal sphere instead of being apportioned partially to each sphere—even though at least a portion of such costs may not have been incurred but for business reasons. On the flip side of the coin, work clothing satisfying the three *Pevsner* tests (*e.g.*, the clown suit) is placed wholly within the business sphere, even though the taxpayer must generally wear clothing of some sort even in the absence of work.

What about the cost of a taxpayer's own meal during the workday, say, during a business lunch with a client prior to closing a corporate merger? Judge Posner observes that "most people would eat lunch even if they didn't work." Does that mean that the cost of the taxpayer's own meal should *always* be placed wholly within her personals sphere? Even if she spent more (because of the business context) than she otherwise would have spent eating alone at home?

Prior to 1921, the cost of a taxpayer's own meal that otherwise satisfied the threshold requirements for a business expense deduction was only partially deductible, equal to the portion exceeding the cost of what the taxpayer *would have spent* absent the business context. While Judge Posner describes this approach as "the economically correct solution," this rule, as you can imagine, was so difficult to administer that Congress repealed it. Thus, Judge Posner observed that otherwise deductible business meals became fully deductible after 1921, "providing the expense is 'different from or in excess of that which would have been made for the taxpayer's personal purposes,'" citing *Sutter v. Commissioner* (commonly referred to as the *Sutter* rule).

At the time that *Moss* was decided, therefore, the cost of the taxpayer's own meal was either 100% deductible under § 162 (and the *Sutter* rule) or entirely nondeductible under § 262. One of the base-broadening measures enacted in the Tax Reform Act of 1986 to pay for the substantial tax rate reductions in that Act (described in Chapter 3) was § 274(n). Section 274(n)(1) now provides that otherwise deductible meal costs under § 162 are generally reduced by 50%. In other words, 50% of the cost is deemed to be nondeductible personal consumption *even if the meal is otherwise deductible under § 162*. For example, Judge Posner notes that § 162(a)(2) specifically allows deduction of the taxpayer's own meal costs incurred while traveling "away from home in pursuit of a trade or business," discussed in Part C., below. Today, § 274(n)(1) reduces the deductible amount of travel meal expenses by 50%. The taxpayer staying at a hotel on a 3-day business trip likely spends more on her hotel breakfast, lunch, and dinner than she would have spent at home, and the 50% rule essentially accounts for this incremental (extra) cost.

Even if the taxpayer is not in travel status within the meaning of § 162(a)(2), Judge Posner

agrees that a taxpayer can sometimes deduct the cost of his own meals (today, 50%) under the introductory clause in § 162(a) (before the first comma). This was the language that Mr. Moss relied on, but he lost his case. Why? Was it solely because he was not entertaining a client but rather eating only with his co-workers? No. Judge Posner cites *Wells v. Commissioner* for the proposition that a monthly lunch among a firm's lawyers (without clients present) "to allow partners to get to know associates" might well be deductible. At bottom, Judge Posner concludes that *daily* lunches with business colleagues—even if clients *are* present—are beyond the pale.

Judge Posner cites a Ninth Circuit Court of Appeals case, however, in which co-workers were permitted to deduct their meal costs (today, 50%) even though they ate together every day, but the facts were unusual. The taxpayers in *Sibla v. Commissioner* were Los Angeles firefighters.

> In the late 1950's a desegregation plan was implemented by the Fire Department. Previously segregated posts were consolidated in order to eliminate segregation within a post. The Board of Fire Commissioners adopted rules requiring all firemen at each fire station to participate in a nonexclusionary organized mess at the station house, unless officially excused. The only recognized ground for nonparticipation was a physical ailment verified by the city's own examining physician.
>
> The Fire Department provided kitchen facilities, but the firemen themselves generally organized the activities themselves. They provided dishes and pots, purchased and prepared the food, assessed members for the cost of the meals and collected the assessments. Meal expenses averaged about $3.00 per man for each 24-hour shift, which the taxpayers were required to pay even though they were at times away from the station on fire department business during the mess period.
>
> The Commissioner argues that an expense is "personal" rather than "business" if it is personal in character and could be incurred whether or not the taxpayer engaged in business activity. An expense for meals or groceries is generally considered a nondeductible personal expense. Here the taxpayer would have incurred a similar expense whether or not he ate at work. Consequently, the Commissioner contends the fact that the taxpayer incurred the expense while at work does not change the personal character of the expenditure.
>
> As the Tax Court has indicated, that which may be a personal expense under some circumstances can, when circumscribed by company regulations, directives, and conditions, lose its character as a personal expense and take on the color of a business expense. Recognizing the "unusual nature of petitioner's employment, the involuntary nature of the expense incurred, petitioner's limited ability to physically participate in the mess, and his employer's lack of intent to compensate or otherwise benefit petitioner for enacting the requirement," the Tax Court said, "upon consideration of the entire record, … we find that the amounts in issue constitute business expenses rather than personal expenses."[50]

Citing *Sibla*, the Eighth Circuit Court of Appeals in *Christey v. United States* similarly permitted members of the Minnesota Highway Patrol to deduct under the introductory language in § 162(a) the cost of the restaurant meals eaten while on duty.

> As a requirement of their job, troopers must comply with the rules and regulations

[50] 611 F.2d 1260, 1261-62 (9th Cir. 1980).

contained in the General Orders of the Patrol. These orders address in detail the conduct required of troopers while on duty. General Order R 77-20-008 ("the General Order") provides troopers with specific instructions concerning meal breaks while on duty. The General Order requires that troopers "eat their meals in a public restaurant adjacent to the highway whenever practical" and "report by radio when they eat and … advise the telephone number or the code number of the restaurant where they are eating." The restaurant must be open to the public and may not serve liquor. The Order prohibits troopers from eating meals at home during working hours and has been interpreted to prohibit troopers from bringing meals from home and eating in their patrol cars. The Order also details the time at which troopers may eat, the time allowed for a meal, and the number of troopers who may eat together. Failure to adhere to these instructions renders troopers subject to reprimand.

As set forth in the General Order, the principal purpose of these requirements "is to promote public safety and obedience to the law through the physical presence of troopers in uniform and to facilitate, through availability to the public, the reporting of accidents and the dissemination of information with reference to the traffic and motor vehicle laws of the state." …

There was testimony that during meals troopers are subject to calls for emergencies and other Patrol business to which they must respond immediately. Troopers are also subject to interruptions from the general public who are seeking information about road conditions, weather, traffic laws, and other subjects relating to trooper responsibilities. Thus, troopers are frequently interrupted during their meals and are often unable to finish meals for which they have paid.[4]

The government contends that the restrictions on the manner in which the taxpayers could take their meals while on duty were not so significant that they transformed an essentially personal expense into a business expense. They reason that the restrictions are no different from those placed upon other taxpayers who have to work during meals and are subject to interruptions. Further, the happenstance that the Patrol may derive incidental benefit from troopers' public visibility and their accessibility during meals does not operate to exclude taxpayers' meal expenses from personal or living expenses.

The District Court, however, reasoned that the number of duty-related restrictions and requirements concerning their meals "effectively extended the performance of the troopers' duties from patrol cars on highways to tables in restaurants." Under these circumstances, the court concluded that the troopers' meal expenses were "ordinary and necessary" expenses. We do not believe this conclusion is clearly erroneous. This is not a case in which the taxpayers are attempting to deduct the cost of their meals merely because they are working overtime, *Coombs v. Comm'r*, 608 F.2d 1269 (9th Cir. 1979), or working through their meal break, *see Antos v. Comm'r*, 1976 T.C. Memo. 89, 35 T.C.M. (CCH) 387 (1976), *aff'd* 570 F.2d 350

[4] In fact, after review of his radio log, Officer Pillsbury testified that he had been called out from meal breaks during 42 percent of his shifts in 1981 and during 50 percent thereof in 1982. Officer Christey testified that he has never consumed a meal while on duty without interruption.

> (9th Cir. 1978) (unpublished opinion), or where business activities make meals at home inconvenient. *Fife v. Comm'r*, 73 T.C. 621 (1980). Nor is this a case in which the sole restriction on the taxpayer is where he may eat his meal. *See, e.g.*, *Walsh v. Comm'r*, 1987 T.C. Memo. 18; *Moscini v. Comm'r*, 1977 T.C. Memo. 245; *Kammerer v. Comm'r*, 1976 T.C. Memo. 11. The restrictions here and their cumulative effect are substantial. The troopers must eat at certain times and places. The troopers remain on duty throughout their meals. They may not bring a meal from home or return home to eat their meal. As part of their job the troopers are required during their meal break to be available to the public not only to respond to emergencies but to provide any information the public may seek. Thus, they are frequently interrupted during meals and are subject to being called away from a meal for an emergency, whether they have eaten what they have paid for or not.
>
> In light of the circumstances of this case, we believe the district court's conclusion that the meal expenses which the taxpayers incurred while on duty in 1981 and 1982 were deductible as ordinary and necessary expenses under § 162(a) is not clearly erroneous.[51]

The number of distinguished cases that are cited provides an effective warning that *Sibla* and *Christey* cannot likely be extended too far beyond their facts. In both cases, the substantial requirements imposed by the employees' superiors—taken together collectively—convinced the courts that these meals were not analogous to the daily restaurant meals eaten by Mr. Moss and his co-workers. In addition, the status of the taxpayers as public servants frankly may have affected, if not consciously, the judges' evaluation of the facts.

## Problems

**1.** Return to *Amos v. Commissioner* in Chapter 17, Part B. Can Mr. Rodman deduct as a § 162 ordinary and necessary business expense the $200,000 that he paid to Mr. Amos arising out of his behavior during an NBA game?

**2.** Melanie and Mortimer divorced last year. Melanie paid her lawyer $2,000 for her services in connection with negotiating the settlement agreement with Mortimor's lawyer. Melanie asked her lawyer to break down the bill precisely because she suspects that some of the costs may be deductible for tax purposes. Her lawyer listed the following amounts:

- $300 for time negotiating the child support payments that she will receive from Mort;
- $200 for time negotiating alimony payments that she will receive from Mort;
- $500 for time negotiating their property settlement involving their investment portfolio; and
- $1,000 for time spent on other matters.

Mortimer paid his lawyer $3,000 and made the same request, and his lawyer responded with the following itemization:

- $400 for time negotiating the child support payments;
- $500 for time negotiating alimony payments;
- $700 for time negotiating their property settlement; and

[51] 841 F.2d 809, 810-13 (8th Cir. 1988).

- $1,400 for time spent on other matters.

**a.** What amount, if any, can each deduct?

**b.** During the first year after the divorce, Mortimer failed to pay either the required child support payments ($15,000) or alimony payment ($5,000) to which he agreed in their settlement agreement. Melanie again employed her lawyer to bring a civil action to collect the amounts owed, and Mortimer finally paid without litigation. Melanie paid her lawyer $1,000 for her time spent on the matter. What amount, if any, can Melanie deduct?

**3.** Mernie Baidoff is a securities broker whose behavior caused the U.S. Securities & Exchange Commission (SEC) to bring a criminal action for securities fraud. Baidoff was convicted and sentenced to 10 years in prison. In addition, the court ordered him to pay to the government a criminal fine of $20 million, as well as a civil fine of $50 million in the nature of restitution, with the latter being disbursed by the government to victims who were harmed by his actions. In addition, Baidoff paid his defense lawyer $3 million.

**a.** What amount, if any, can Mernie deduct?

**b.** How would your answer change, if at all, if Mernie were convicted of insider trading instead (a fraud on the market with no identifiable individual victims), and the $50 million civil fine was retained by the government rather than disbursed as restitution?

## C. Travel and entertainment costs

Section 162(a)(2) specifically authorizes deduction of "traveling expenses (including amounts expended for meals and lodging other than amounts that are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business." While meal costs are reduced by 50% under § 274(n)(1), other travel costs are 100% deductible, such as the cost of transportation, hotels, and tips. Section 274(d) now imposes strict substantiation requirements for the deduction of business travel costs (as well as entertainment costs), but the penultimate sentence excuses some recordkeeping "in the case of an expense which does not exceed an amount prescribed pursuant to regulations." Under the authority of Treas. Reg. §§ 1.274-5(g) and (j), the IRS periodically issues a Notice (supplanting prior annual Revenue Procedures) that allows taxpayers to deduct (1) a set amount for each mile of automobile travel in lieu of keeping track of actual gasoline, depreciation, and other costs incurred in using the taxpayer's personal automobile to drive, say, to another state for a business meeting and (2) a set *per diem* amount for meals in lieu of retaining receipts.[52] They adopt the mileage rates issued by the General Services Administration (GSA), as well as the *per diem* meal rates issued by the GSA for different localities.[53] Taxpayers can keep and use actual receipts, instead, but the set mileage and *per diem* meal rates are simple and widely used. As usual, only 50% of the meal *per diem* is deductible because of the § 274(n)(1) limit.

***"Away from home in pursuit of a trade or business"***

When is a taxpayer "away from home in pursuit of a trade or business" within the meaning of § 162(a)(2)? Two Supreme Court cases most often cited with respect to this issue are *United States*

[52] *See, e.g.*, Rev. Proc. 2011-47, 2011-2 C.B. 520; Notice 2015-63, 2015-4 I.R.B. 461.
[53] You can find the *per diem* rates at www.gsa.gov.

*v. Correll* and *Commissioner v. Flowers*. To put them into context, recall from Part B. that commuting costs are generally not deductible. Thus, mileage costs incurred to drive from your home in the suburbs to your office downtown are not deductible. Also note that certain transportation costs are deductible under the introductory clause in § 162 even when *not* in travel status under § 162(a)(2). For example, the cost incurred to take a taxi from your downtown office to the courthouse for a court session with your client is deductible, even though you are not in travel status. Because you are not in travel status, however, the cost of your lunch alone at the courthouse cafeteria is not deductible. *See Moss*, *supra*.

The taxpayer in *United States v. Correll*[54] was a traveling salesman who left home early each workday, ate breakfast and lunch on the road, and returned home in time for dinner. He traveled many miles over a large sales territory (crossing state lines), but he always made it home for dinner. His automobile expenses were deductible under the introductory language in § 162(a), without regard to § 162(a)(2), but his breakfast and lunch costs would be deductible only if he were "away from home in pursuit of a trade or business" within the meaning of § 162(a)(2). The government argued that a taxpayer cannot be in travel status unless away from home long enough to require sleep or rest (sometimes referred to as the "overnight" rule), and the Supreme Court confirmed the reasonableness of the rule in this case. Thus, Mr. Correll could not deduct his breakfast and lunch costs. In effect, Mr. Correll was like Mr. Moss. The Court said:

> 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. Rather than requiring "every meal-purchasing taxpayer to take pot luck in the courts," the Commissioner has consistently construed travel "away from home" to exclude all trips requiring neither sleep nor rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed. 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.
>
> Any rule in this area must make some rather arbitrary distinctions, 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. 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.
>
> 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

[54] 389 U.S. 299 (1967).

> Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well. 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 his business travel, and Congress might well have thought that only taxpayers in that category should be permitted to deduct their living expenses while on the road.[55]

The taxpayer in *Flowers* was a lawyer living in Jackson, Mississippi, when he accepted a job as General Counsel for a railroad. The railroad's business headquarters was located in Mobile, Alabama, where the railroad provided an office to Mr. Flowers. Nevertheless, he preferred to live in Jackson, and the railroad and Mr. Flowers came to an agreement that he could continue to live in Jackson, Mississippi, so long as he traveled to Mobile (at his own expense) periodically. His old law firm in Jackson permitted him to work out of an office there, which Mr. Flowers furnished at his own cost. "The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary's expenses while in Jackson."[56] Mr. Flowers traveled to Mobile when necessary, but he worked more than twice as many days at his office in Jackson on railroad business than he did in Mobile. Mr. Flowers sought to deduct under § 162(a)(2) the transportation costs (mileage costs) that he incurred in traveling back and forth between Mobile and Jackson, as well as his hotel and meal costs while in Mobile.

The lower courts and the government disagreed regarding the location of what has come to be called the taxpayer's "tax home"—the place from which he had to be "away" to be entitled to deduct travel expenses under § 162(a)(2). The government and Tax Court (at the trial level) took the position that his "tax home" was Mobile, Alabama, where the railroad's headquarters (and the office provided to Mr. Flowers by his employer) was located. Thus, they contended that Mr. Flowers was not traveling "away from home" within the meaning of § 162 when he was traveling *to* Mobile from Jackson. The 5th Circuit, in contrast, determined that his "tax home" was where his personal residence was located in Jackson, Mississippi, and permitted him to deduct his costs under § 162(a)(2) when he traveled to Mobile. Because the Fifth Circuit Court of Appeals stance (which was consistent with the position taken by the Second Circuit Court of Appeals) differed from that in the Tax Court and the Fourth Circuit Court of Appeals, the Supreme Court granted *certiorari* to resolve the conflict. Many commentators believed that the Supreme Court would settle the issue of "tax home"—business headquarters or hearth as "home"—but the Supreme Court skirted the issue by focusing instead on the last phrase in § 162(a)(2): "in pursuit of a trade or business."

## COMMISSIONER v. FLOWERS

326 U.S. 465 (1946).

[The facts are described above.] 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.

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[55] *Id*. at 302-05.

[56] Flowers v. Comm'r, 326 U.S. 465, 486 (1946).

(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.

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 court below held that 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 and the administrative rulings[5] have consistently defined it as the equivalent of the taxpayer's place of business. *See Barnhill* v. *Comm'r*, 148 F.2d 913 (C.C.A. 4). On the other hand, the decision below and *Wallace* v. *Commissioner*, 144 F.2d 407 (C.C.A. 9), have flatly rejected that view and have confined the term to the taxpayer's actual residence. *See also Coburn* v. *Comm'r*, 138 F.2d 763 (C.C.A. 2).

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. There is no claim that the Tax Court misconstrued this condition or used improper standards in applying it. And it is

[5] Treasury Regulations do 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 C.B. 174 (1921); I.T. 1264, I-1 C.B. 122 (1922); I.T. 3314, 1939-2 C.B. 152; G.C.M. 23672, 1943 C.B. 66.

readily apparent from the facts that its inferences were supported by evidence and that its conclusion that the expenditures in issue were nondeductible living and personal expenses was fully justified.

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.

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*Flowers* is consistent with the rule described earlier that expenses incurred in commuting from home to work are nondeductible personal expenses. Mr. Flowers simply chose to have a very long commute! Moreover, this rule applies even in cases, unlike *Flowers*, where the taxpayer did not impose the long commute on himself for personal reasons. For example, commuters who must travel as much as 200 miles from their homes in Nevada residential communities to reach their jobs at remote test sites in the Nevada dessert cannot deduct their commuting expenses, even though their long commute is necessary.[57]

Though the Court said that it was not deciding the issue, the last paragraph implies that it agrees with the government and Tax Court that a taxpayer's "tax home" is generally the place of his "business headquarters." A taxpayer traveling away from his business headquarters for a *temporary* job has long been allowed § 162(a)(2) deductions. For example, if the railroad needed

[57] *See, e.g.,* Cor v. Comm'r, T.C. Memo. 2013-240.

Mr. Flowers to travel to and live in, say, Tallahassee, Florida, during the pendency of a six-month legal action being prosecuted against the railroad in Florida, his transportation costs, Florida rent, and (50% of) meal costs would be deductible under § 162(a)(2). If a job placement is *too long*, however, the new location becomes his business headquarters, and the taxpayer is no longer in travel status but rather is expected to move his residence to his new business headquarters (rather than have his living expenses subsidized by other taxpayers). If he chooses not to move, the extra expenses are similar to those incurred by Mr. Flowers, who chose to have a long commute rather than move to his new job's location.

But how long is "temporary"? Once again, the lower courts disagreed on this issue, and Congress eventually amended § 162(a) in 1982 by adding the penultimate sentence, which provides that "the taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year." The Revenue Ruling below interprets this provision and, in so doing, reviews the government's position regarding the location of the taxpayer's "tax home." Notice that the government concedes that a taxpayer's personal residence *can* be his "tax home" under certain circumstances. What are they?

**REVENUE RULING 93-86**

1993-2 C.B. 71

ISSUE

What effect does the 1-year limitation on temporary travel, as added by section 1938 of the Energy Policy Act of 1992, Pub. L. No. 102-486, have on the deductibility of away from home travel expenses under section 162(a)(2) of the Internal Revenue Code?

FACTS

*Situation 1*. Taxpayer *A* is regularly employed in city *Cl-1*. In 1993, *A* accepted work in city *Cl-2*, which is 250 miles from *Cl-1*. *A* realistically expected the work in *Cl-2* to be completed in 6 months and planned to return to *Cl-1* at that time. In fact, the employment lasted 10 months, after which time *A* returned to *Cl-1*.

*Situation 2*. The facts are the same as in *Situation 1*, except that Taxpayer *B* realistically expected the work in *Cl-2* to be completed in 18 months, but in fact it was completed in 10 months.

*Situation 3*. The facts are the same as in *Situation 1*, except that Taxpayer *C* realistically expected the work in *Cl-2* to be completed in 9 months. After 8 months, however, *C* was asked to remain for 7 more months (for a total actual stay of 15 months).

LAW AND ANALYSIS

Section 162(a)(2) of the Code allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business, including travel expenses (including amounts expended for meals and lodging other than amounts that are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business. Under section 262(a), no deduction is allowed for personal, living, or family expenses, unless expressly provided by law.

For travel expenses to be deductible under section 162(a)(2) of the Code, they must satisfy the following three conditions: (1) they must be ordinary and necessary, (2) they must be incurred

while away from home, and (3) they must be incurred in pursuit of a trade or business. *See Comm'r v. Flowers,* 326 U.S. 465 (1946), and Rev. Rul. 60-189, 1960-1 C.B. 60.

A taxpayer's "home" for purposes of section 162(a)(2) of the Code is generally considered to be located at (1) the taxpayer's regular or principal (if more than one regular) place of business, or (2) if the taxpayer has no regular or principal place of business, then at the taxpayer's regular place of abode in a real and substantial sense. If a taxpayer comes within neither category (1) nor category (2), the taxpayer is considered to be an itinerant whose "home" is wherever the taxpayer happens to work. Rev. Rul. 73-529, 1973-2 C.B. 37, and Rev. Rul. 60-189. Travel expenses paid or incurred in connection with an indefinite or permanent work assignment are generally nondeductible.

Travel expenses paid or incurred in connection with a temporary work assignment away from home are deductible under section 162(a)(2) of the Code. *See Peurifoy v. Comm'r,* 358 U.S. 59 (1958). The courts and the Service have held that employment is temporary for this purpose only if its termination can be foreseen within a reasonably short period of time. *See Albert v. Comm'r,* 13 T.C. 129 (1949), and Rev. Rul. 75-432, 1975-2 C.B. 60.

Employment that is initially temporary may become indefinite due to changed circumstances. *See Norwood v. Comm'r,* 66 T.C. 467 (1976), *Bark v. Comm'r,* 6 T.C. 851 (1946), Rev. Rul. 73-578, 1973-2 C.B. 39, and Rev. Rul. 60-189, 1960-1 C.B. 60. In Rev. Rul. 73-578, 1973-2 C.B. 39, a citizen of a foreign country comes to the U.S. under a 6-month nonimmigrant visa to work for a U.S. employer, intending to resume regular employment in the foreign country after this period. After 4 months, however, the individual agrees to continue the employment for an additional 14 months. Rev. Rul. 73-578, 1973-2 C.B. 39 holds that the individual may deduct ordinary and necessary travel expenses paid or incurred during the first 4 months of the employment. However, the individual may not deduct travel expenses paid or incurred thereafter, unless the expenses are paid or incurred in connection with temporary employment away from the location of the individual's regular employment with the U.S. employer.

Revenue Ruling 83-82, 1983-1 C.B. 45, provides that, for purposes of the deduction for travel expenses under section 162(a)(2) of the Code, if the taxpayer anticipates employment away from home to last less than 1 year, then all the facts and circumstances are considered to determine whether such employment is temporary. If the taxpayer anticipates employment to last (and it does in fact last) between 1 and 2 years, Rev. Rul. 83-82, 1983-1 C.B. 45 provides a rebuttable presumption that the employment is indefinite. The taxpayer may rebut the presumption by demonstrating certain objective factors set forth in the revenue ruling. For employment with an anticipated or actual stay of 2 years or more. Rev. Rul. 83-82, 1983-1 C.B. 45 holds that such employment is indefinite, regardless of any other facts or circumstances. All the factual situations in Rev. Rul. 83-82, 1983-1 C.B. 45 involve employment in a single location for more than 1 year.

Section 1938 of the Energy Policy Act of 1992, Pub. L. No. 102-486, amended section 162(a)(2) of the Code to provide that a taxpayer shall not be treated as being temporarily away from home during any period of employment if such period exceeds 1 year. This amendment applies to any period of employment in a single location if such period exceeds 1 year. *See* H.R. Conf. Rep. No. 102-1018, 102d Cong., 2d Sess. 429, 430 (1992). Thus, section 162(a)(2), as amended, eliminates the rebuttable presumption category under Rev. Rul. 83-82, 1983-1 C.B. 45 for employment lasting between 1 and 2 years, and shortens the 2-year limit under that ruling to 1 year. The amendment is effective for costs paid or incurred after December 31, 1992.

Accordingly, if employment away from home in a single location is realistically expected to last (and does in fact last) for 1 year or less, the employment will be treated as temporary in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment will be treated as indefinite, regardless of whether it actually exceeds 1 year. If employment away from home in a single location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes.

In *Situation 1*, *A* realistically expected that the work in *Cl-2* would last only 6 months, and it did in fact last less than 1 year. Because *A* had always intended to return to *Cl-1* at the end of *A*'s employment in *Cl-2*, the *Cl-2* employment is temporary. Thus, *A*'s travel expenses paid or incurred in *Cl-2* are deductible.

In *Situation 2*, *B's* employment in *Cl-2* is indefinite because *B* realistically expected that the work in *Cl-2* would last longer than 1 year, even though it actually lasted less than 1 year. Thus, B's travel expenses paid or incurred in *Cl-2* are nondeductible.

In *Situation 3*, *C* at first realistically expected that the work in *Cl-2* would last only 9 months. However, due to changed circumstances occurring after 8 months, it was no longer realistic for *C* to expect that the employment in *Cl-2* would last for 1 year or less. Therefore, *C*'s employment in *Cl-2* is temporary for 8 months and indefinite for the remaining 7 months. Thus, *C*'s travel expenses paid or incurred in *Cl-2* during the first 8 months are deductible, but *C*'s travel expenses paid or incurred thereafter are nondeductible.

HOLDING

Under section 162(a)(2) of the Code, as amended by the Energy Policy Act of 1992, if employment away from home in a single location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment away from home in a single location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is indefinite, regardless of whether it actually exceeds 1 year. If employment away from home in a single location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes.

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Is the Ruling's resolution of *Situation 2* consistent with the statutory language? If your client with facts identical to those in Situation 2 decides to incur the costs of litigation to challenge this interpretation, what are her chances of winning? Review both the Introduction material and footnote 2 of Judge Kozinski's dissent in *Henderson* (below) regarding the level of judicial deference accorded to IRS guidance.

Notice that the ruling concedes that a taxpayer's "regular place of abode in a real and substantial sense" can be considered his "tax home" for purposes of § 162(a)(2)—if and only if the taxpayer has no regular or principal place of business. If the taxpayer has *neither* a regular or principal place

of business *nor* a regular place of abode "in a real and substantial sense," he is considered to be an itinerant tax turtle, who takes his tax home with him (as a turtle takes his shell) wherever he travels. Think of the traveling salesman whose only home is a recreational vehicle that he uses to travel around the country while selling his wares. Tax turtles are denied all § 162(a)(2) deductions because they are never "away from home." How do we differentiate between a tax turtle, on the one hand, and a taxpayer who has no regular or principal place of business but nevertheless has a "regular place of abode in a real and substantial sense," on the other? What does that quoted language—which is not in the statute itself—mean?

## HENDERSON v. COMMISSIONER

143 F.3d 497 (9th Cir.), *cert. denied*, 525 U.S. 877 (1998)

Before NELSON, WIGGINS, and KOZINSKI, CIRCUIT JUDGES.

WIGGINS, CIRCUIT JUDGE: We must decide whether a taxpayer may claim Boise, Idaho, as his "tax home" for the 1990 tax year even though virtually all of his work that year was for a traveling ice show. James Henderson claimed deductions under Internal Revenue Code § 162(a)(2) for living expenses incurred "away from home" while on the tours. The Commissioner disallowed the deductions, concluding that Henderson had no legal tax home for purposes of § 162(a)(2) because he lacked the requisite business reasons for living in Boise between ice show tours. As a result of the disallowance, Henderson had a deficiency in his 1990 federal income tax of $1,791. The Tax Court upheld the Commissioner's decision. We have jurisdiction under 26 U.S.C. § 7482(a), and we affirm.

Henderson's parents lived in Boise, where they had reared him. Even after graduating from the University of Idaho in 1989, he maintained many personal contacts with Boise. For instance, he received mail at his parents' residence, lived there between work assignments, and kept many belongings and his dog there. He also was registered to vote in Idaho, paid Idaho state income tax, maintained an Idaho driver's license, and maintained his bank account in Idaho. During 1990, he spent about two to three months in Boise, staying at his parents' residence. While he was there, he performed a few minor jobs to maintain or improve the family residence.

In 1990, Henderson worked as a stage hand for Walt Disney's World of Ice, a traveling show. His employers' corporate offices were in Vienna, Virginia. Henderson was employed on a tour-by-tour basis. He testified that at the end of one tour, he would be contacted about participating in the next one. Following the completion of a tour, he returned to his parents' home in Boise. He worked on three different Disney tours that year. The first lasted from January 1 to May 13, the second from July to November, and the third from December 5 to December 31. He traveled on tour to thirteen states and Japan. The tours stopped in each city for a few days or weeks. While traveling, he received [a cash *per diem* from his employer] to cover expenses.

Henderson claims that he looked periodically for employment in Boise between the tours, but the evidence showed that he worked as a stage hand only for a single ZZ Top concert. The Tax Court found that while he returned to Boise in his "idle time," his source of employment during the tax year had no connection to Boise. On appeal, Henderson contends that his 1990 tax home was Boise, primarily based on his extensive personal contacts there.

Internal Revenue Code § 162(a)(2) allows a deduction for all ordinary and necessary "traveling expenses … while away from home in the pursuit of a trade or business." This section embodies

"a fundamental principle of taxation"—that the cost of producing income is deductible from a person's taxable income. *Hantzis v. Comm'r,* 638 F.2d 248, 249 (1st Cir. 1981). To qualify for the "away from home" deduction, the Supreme Court has held that the taxpayer's expenses must (1) be reasonable and necessary expenses, (2) be incurred while away from home, and (3) be incurred while in the pursuit of a trade or business. *Flowers v. Comm'r,* 326 U.S. 465, 470 (1946).

The first and third criteria are not at issue. The subject of this appeal is whether the expenses Henderson claims as deductions were incurred while "away from home." If Henderson establishes that his home was Boise, his reasonable traveling expenses on the Disney tours are deductible. The Tax Court concluded that Boise was not Henderson's tax home because his choice to live there had nothing to do with the needs of his work; thus, the Tax Court held that Henderson could not claim the deduction for traveling expenses incurred while away from Boise. It held that Henderson had no tax home because he continuously traveled for work. We agree.

Henderson builds a strong case that he treated Boise as his home in the usual sense of the word, but "for purposes of [section] 162, 'home' does not have its usual and ordinary meaning." *Putnam v. U.S.,* 32 F.3d 911, 917 (5th Cir. 1994) ("In fact, 'home'—in the usual case—means 'work.'"). We have held that the term "home" means "the taxpayer's abode at his or her principal place of employment." *Folkman v. U.S.,* 615 F.2d 493, 495 (9th Cir. 1980); *see also Coombs v. Comm'r,* 608 F.2d 1269, 1275 (9th Cir. 1979) (stating that "tax home" is generally, but not always, exact locale of principal place of employment). If a taxpayer has no regular or principal place of business, he may be able to claim his place of abode as his tax home. *See Holdreith v. Comm'r,* 1989 T.C. Memo 449 (1989).

A taxpayer may have no tax home, however, if he continuously travels and thus does not duplicate substantial, continuous living expenses for a permanent home maintained for some business reason. *James v. U.S.,* 308 F.2d 204, 207 (9th Cir. 1962); *Cerny v. Comm'r,* 1991 T.C. Memo 526 (1991), *aff'd by unpublished opinion,* 2 F.3d 1156 (9th Cir. 1993). Clearly, if a taxpayer has no "home" for tax purposes, then he cannot deduct under § 162(a)(2) for expenses incurred "away from home." This is for good reason. In *James,* we examined the statutory precursor to the present version of § 162(a) and explained that the deduction was designed to mitigate the burden on taxpayers who travel on business. 308 F.2d at 207. The burden exists "only when the taxpayer has a 'home,' the maintenance of which involves substantial continuing expenses which will be duplicated by the expenditures which the taxpayer must make when required to travel elsewhere for business purposes." *Id.*; *see also Andrews,* 931 F.2d 132 at 135 (emphasizing that the deduction's purpose was to mitigate duplicative expenses); *Hantzis,* 638 F.2d at 253. Thus, a taxpayer only has a tax home—and can claim a deduction for being away from that home—when it appears that he or she incurs substantial, continuous living expenses at a permanent place of residence. *James,* 308 F.2d at 207-08.

Revenue Ruling 73-539, 1973-2 C.B. 37, outlines three factors to consider in determining whether a taxpayer has a tax home or is an itinerant. Essentially, they are (i) the business connection to the locale of the claimed home; (ii) the duplicative nature of the taxpayer's living expenses while traveling and at the claimed home; and (iii) personal attachments to the claimed home. While subjective intent can be considered in determining whether he has a tax home, objective financial criteria are usually more significant. *Barone,* 85 T.C. at 465.

The location of Henderson's tax home is a determination of fact reviewed for clear error. *Frank v. U.S.,* 577 F.2d 93, 97 (9th Cir. 1978). Similarly, we believe the determination of whether a

taxpayer has a tax home or is an itinerant depends on the facts of each case and should be reviewed for clear error. Considering these factors, the Tax Court did not clearly err when it concluded that Henderson is an itinerant taxpayer.

First, Henderson had virtually no business reason for his tax home to be in any location—he constantly traveled in 1990 as part of his work with the World on Ice tours. His personal choice to return to Boise was not dictated by business reasons. Except for brief intervals, he was employed for the tours. He worked only one night in Boise. While he testified he looked for other work in Boise between tours, he also testified that at the end of each tour he would have a contract talk with the company manager about the next tour. The Tax Court determined that Henderson merely returned to Boise during his "idle time" between tours. While his reasons for returning may be entirely understandable, we cannot say the Tax Court clearly erred in concluding they were personal, not business, reasons. His minimal employment efforts in Boise do not change this analysis.

The importance of the business reason for residing in a certain place is illustrated in *Hantzis*. In that case, the First Circuit disallowed the "away from home" deduction for a law student from Boston who took a summer job in New York. The court held that she did not have a tax home in Boston, even though her husband lived in Boston and she lived there during the school year, because she had no business reason to maintain a home in Boston during the summer while she worked in New York. The court explained why the deduction did not apply in those circumstances:

> 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…. [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 section 162(a)(2).

*Hantzis*, 638 F.2d at 255.

Second, Henderson did not have substantial, continuing living expenses in Boise that were duplicated by his expenses on the road. The evidence showed that he lived with his parents when he stayed in Boise. The Tax Court found that he paid no rent and had no ownership interest in his parents' home. His financial contributions in Boise were limited. He contributed some labor to maintenance and improvement of the home while he was there, and he paid about $500 for supplies. While his parents may have expended money that benefited Henderson as well—*i.e.*, maintaining a mortgage, paying utilities, and so forth—this is not a substantial living expense incurred by Henderson. Further, any minor expense he may have incurred while living with his parents was not continuing during the periods while he traveled on tour. That is, there is no evidence he had any expenses in Boise while he traveled on the Disney tours.

The fact that Henderson may have incurred higher expenses while traveling with Disney than he would have if he had obtained a full-time job in Boise is not dispositive. The issue presented is whether his claimed expenses were incurred while he was away from his tax home. To assume that Henderson is entitled to the deduction simply because Henderson incurred higher expenses than he would have had he worked in Boise ignores the important question of whether Boise was his tax home at all. Only if Boise is his tax home can Henderson claim deductions for expenses incurred while away from Boise.

Because these two factors weigh against finding that he had a tax home in Boise, the Tax Court

did not clearly err when it discounted his evidence on the third factor: personal attachment to Boise. Henderson cites cases, *e.g. Horton v. Comm'r,* 86 T.C. 589, 593 (1986), which hold that a taxpayer may treat a personal residence as his tax home even if it is not the same as the place of his temporary employment with a certain employer. This principle does not help Henderson, however, because he cannot establish any (non-*de minimis*) business connection to Boise to justify the position that it was his permanent tax home. *See Hantzis,* 638 F.2d at 254-55. Thus, travel away from Boise while on tour with Disney was not travel "away from home" as that term is understood for income tax purposes.

AFFIRMED.

KOZINSKI, CIRCUIT JUDGE, dissenting: The Tax Code provides that travel expenses are fully deductible, so long as they are incurred while "away from home" in the pursuit of business. I.R.C. § 162(a)(2). Henderson fits comfortably within this language. He lived with his parents in Boise, which made their home his home under any reasonable definition of the term. And he incurred travel expenses in pursuing a job that moved from town to town. Given the itinerant nature of his employment, Henderson could not have avoided these travel expenses by moving his home closer to work. He is thus easily distinguished from the taxpayer in *Hantzis* v. *Comm'r,* 638 F.2d 248 (1st Cir. 1981), who could have avoided the travel expenses altogether by moving closer to her work. *Hantzis*'s extra-statutory requirement that a home is not a "tax home" unless dictated by business necessity has no application when the job itself has no fixed location.

The other reasons offered by the IRS for denying Henderson his traveling expense deduction are not supported by the Code or the regulations, nor do they make any sense. That Henderson's parents did not charge him room and board is of no consequence. Neither the Code nor common experience requires that a taxpayer pay for his home, else all minors and many in-laws would be deemed homeless. "Home" is not a term of art; it is a common English word meaning a permanent place where a person lives, keeps his belongings, receives his mail, houses his dog—just as Henderson did. Indeed, a grown son living in his parents' house is said to be living "at home." Whether he compensates his parents in cash, by doing chores or through filial affection is none of the Commissioner's business. What matters is that, by going on the road in pursuit of his job, Henderson had to pay for food and lodging that he would not have had to buy had he stayed home.

*James* v. *United States,* 308 F.2d 204 (9th Cir. 1962), cuts against the government. Despite some imprecise language in the opinion, the facts there were very different. George James was on the road 365 days a year and had *no* permanent home; he spent his entire life traveling from hotel to motel. Wherever a weekend or holiday found him, he would stay there until it came time to go to his next location. James thus was, indeed, a tax turtle—someone with no fixed residence. Henderson is very different: He had a home in Boise, a place where he returned when he wasn't working. He was no more a tax turtle than anyone else who travels a lot for business. That his home happens to be owned by his parents makes it no less his home.[1]

Fast planes and automobiles have turned us into a nation of itinerants. The tradition of families living together in one city, even under one roof, is sadly disappearing. Yet there is virtue in keeping

[1] *James*'s emphasis on duplication of expenses is unnecessary to the holding, and mistaken to boot. Duplication is one possible method of sifting out business expenses from personal ones, but not the method chosen by Congress. Section 162(a)(2) requires only that the taxpayer be away from home in pursuit of business; meals, for example, are fully deductible [editor's note: actually, only 50% deductible under § 274(n)(1)] even though the expense is not duplicated back at home.

families together, in parents who welcome their adult children under their roof. Leave it to the IRS to turn a family reunion into a taxable event. Henderson is being hit with extra taxes because his lifestyle doesn't conform to the IRS's idea of normalcy. But why should the government get extra money because the Hendersons chose to let their son live at home? Had they given him $600 a month to rent an apartment next door, Henderson surely would have gotten the travel deduction. I see no reason why the Henderson family ought to be penalized because the parents gave their son a gift of housing rather than cash—or why the Commissioner should be the beneficiary of this parental generosity. If Congress had said it must be so, I would bow to its wisdom. But Congress said no such thing and I do not feel bound to give the same deference to the Commissioner's litigating position.[2] Given the dearth of authority or common sense supporting the Commissioner's view, we are free to encourage happy family arrangements like those between Henderson and his mom and dad. In the name of family values, I respectfully dissent.

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To understand the procedural posture of *Henderson*, we need to review the mechanical rules that determine *when* an otherwise allowable deduction is taken in the computation process from Gross Income to Taxable Income. You learned in Chapter 1, Part B., that otherwise allowable § 162 *unreimbursed* employee business expenses are not only Itemized Deductions (unavailable to those who take the Standard Deduction) but also Miscellaneous Itemized Deductions (MIDs) that are subject to the 2% floor in § 67. In other words, you learned that the deduction of unreimbursed employee business expenses is severely constrained. In contrast, otherwise allowable § 162 *reimbursed* employee business expenses are deducted above the line (directly from Gross Income in reaching AGI) if the reimbursement is made under "a reimbursement or other expense allowance arrangement with his employer" that satisfies the requirements of an accountable plan under § 62(c).[58] Because the above-the-line deduction would perfectly offset the § 61(a)(1) Gross Income inclusion of the reimbursement itself, Treas. Reg. § 1.62-2(c)(4) permits the employee to ignore both (forgoing the deduction and excluding the reimbursement) for administrative ease (which can also reduce payroll taxes). Thus, an employee receiving reimbursement from her employer under an accountable plan for the air fare and hotel costs incurred with respect to otherwise deductible business travel can simply ignore both. In essence, the Gross Income inclusion and deduction, taken together, are a wash that is permitted to be netted together off the employee's tax return (usually a no-no, as you learned in Chapter 1).

How does the employer and employee account for a reimbursement of otherwise deductible *meal or entertainment costs* (with the latter considered below) in light of the 50% reduction rule for such costs in § 274(n)(1)? Unlike transportation costs (such as air fare or mileage) and hotel costs, it might appear that the includable reimbursement and deductible meal or entertainment costs are *not* a wash because the employee would include 100% of the reimbursement under §

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[2] Revenue Ruling 73-529 is entitled to some deference—exactly how much is unclear—but certainly far less than the statuesque deference we give regulations. *See* Estate of McLendon v. Comm'r, 135 F.3d 1017, 1023-24 (5th Cir. 1998); First Chicago NBD Corp. v. Comm'r, 135 F.3d 457, 459-460 (7th Cir. 1998). Because the Service cannot easily recant a position after a ruling is published, it has reason to be overly stingy in drafting. Institutional pressures may also drive the Service to stretch the language of the Code; it's easier for the Executive Branch to have the Service milk more revenue out of the existing Code than to persuade Congress to amend it. Moreover, unlike most regulations, Revenue Rulings are not subject to the notice-and-comment procedures of the Administrative Procedure Act. Ruling 73-529 sweeps too broadly to be persuasive here: Under the Ruling, Henderson would get no deduction even if he spent ten months a year at home instead of ten weeks, simply because he paid no rent.

[58] *See* § 62(a)(2)(A).

61(a)(1) but would be permitted to deduct only 50% of the meal cost under §§ 162 and 274(n)(1). Notice, however, that § 274(n)(2) lists several exceptions to the § 274(n)(1) 50% reduction rule. The very first exception cross-references several subsections of § 274(e), including § 274(e)(3). Under § 274(e)(3), the *employee's* deduction is freed from the 50% reduction rule because the *employer's* deduction will be subject to the § 274(n)(1) 50% reduction when it takes its own § 162 deductions for the reimbursed costs. (This relationship is one reason why the employee must substantiate such costs to the employer under § 62(c)(1) for the reimbursement to qualify as being made under an accountable plan, as the employer needs the information to substantiate its own deduction of the reimbursement.)

Rather than reimburse actual travel costs, Mr. Henderson's employer, like many employers, paid to him a cash *per diem* to cover these expenses. So long as (1) the *per diem* amount, as described at the beginning of this section, was correct and (2) Mr. Henderson could lawfully deduct his travel expenses under § 162(a)(2), he could exclude the *per diem* from his Gross Income (and forgo the § 162(a)(2) deductions) under Treas. Reg. § 1.62-2(c)(2). If, however, Mr. Henderson's facts fail to satisfy the requirements of § 162(a)(2), he must include the *per diem* reimbursement in his Gross Income, with no offsetting deduction. This analysis explains why the case analyzed whether he was entitled to take § 162(a)(2) deductions, even though the litigation arose because he failed to include the *per diem* payments in his Gross Income. Whether he properly excluded the reimbursement turns on whether he could properly deduct his travel expenses under § 162(a)(2).

While Judge Kozinski's last paragraph was a bit over the top (dissenting "[i]n the name of family values"?), does he have a point when he asserts that whether Mr. Henderson incurred duplicative costs (such as rent) should be irrelevant to whether he should be entitled to deduct his travel expenses on the road? Where do you think the "duplicative cost" idea arose? Mr. Henderson would not have incurred these travel costs on the road but for his temporary jobs with Disney, but we have seen that the deductibility of business expenses does not turn solely on a "but for" test. We have seen, for example, that commuting and childcare costs are not deductible as business expenses, even if they would not have been incurred but for the job. Nevertheless, the *incremental* (or extra) costs incurred solely because of a business can be legitimate business costs in some contexts, and the best example of this analysis is the deduction for travel costs while away from home in pursuit of a trade or business. Indeed, we saw that the incremental cost idea best explains the § 274(n)(1) 50% rule for travel and other business meals. Even though a taxpayer must eat lunch in any event, she may spend more than she otherwise would on the road, and the 50% rule allows her, in effect, to deduct the extra (or incremental) cost as a business expense.

The existence of duplicative expenses (such as when a taxpayer both rents a permanent residence in Boise and rents a hotel room in Denver on a business trip) is the *best example* of an incremental cost incurred because of business. But should proving duplicative costs be the *sole* method of establishing that incremental costs were incurred? Could he have performed the job duties required of him by his employer if he had refused to travel? Obviously not. Did not Mr. Henderson therefore clearly incur incremental costs because of business travel—such as hotel and meal costs on the road that exceeded what he would have spent at home with his parents ($0)—unlike a true itinerant? Or is the majority's approach the only administratively feasible way to avoid opening the door to abuse? (Keep this incremental cost idea in mind when we arrive at the § 280A(c) so-called home office deduction in Part D.)

***Mixed trips***

Suppose that Pat travels by plane from Los Angeles to New York City for business meetings scheduled for Tuesday, Wednesday, Thursday, and Friday. She arrives on Monday evening, and she would have left on Saturday morning if she did not wish to spend some time in New York for pleasure. She leaves on Tuesday evening after enjoying the city's sights on Saturday, Sunday, Monday, and Tuesday morning. How much of her air fare, lodging, meal (50%), and incidental costs are deductible as business expenses?

Treas. Reg. § 1.162-2(a) first provides that travel expenses must be "reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it" to be deductible. Thus, her meal (50%), lodging, and incidental costs (such as taxi fares) for Monday evening through Saturday morning are clearly deductible. Her Saturday lunch, dinner, and lodging costs, as well as her meal, lodging, and incidental costs for Sunday through Tuesday are nondeductible personal expenses because not "directly attributable" to her business. One exception would be the taxi or subway fare to reach the airport on Tuesday evening, as she would have incurred that cost even if she had not extended her stay for personal reasons but rather flew home on Saturday morning.

What about the air fare? In the wholly domestic context, Treas. Reg. § 1.162-2(b)(1) once again takes an all-or-nothing approach by concluding that 100% of Pat's air fare is deductible if the trip is "related primarily" to her business, and 0% is deductible if not. In the latter case, "expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible." Treas. Reg. § 1.162-2(b)(2) adds that whether the trip is "related primarily" to business "depends on the facts and circumstances in each case" but that the relative time spent on business and personal pursuits "is an important factor" in making that determination. In an example, the regulation provides that a trip during which the taxpayer spends one week on business and five weeks on vacation "will be considered primarily personal in nature in the absence of a clear showing to the contrary." In the case of foreign travel, however, more stringent allocation rules replace the all-or-nothing rule for the air fare unless the travel does not exceed one week or is devoted to personal pursuits for less than 25% of the time.[59]

***§ 274: entertainment***

Like meals, entertainment—even if undertaken for business reasons—typically provides personal consumption benefits, which makes the deductibility of entertainment costs as business expenses particularly ripe for abuse. In one notorious 1955 case, the Tax Court allowed the owners of a Dairy to deduct the costs of an African safari because the owners used the hunt extensively in promotional materials, even though the Tax Court observed: "The cost of a big game hunt in Africa does not sound like an ordinary and necessary expense of a dairy business in Erie, Pennsylvania, but the evidence in this case shows clearly that it was and was so intended."[60] Because business entertainment can be "appropriate and helpful" to the business and is a common practice, entertainment costs can often satisfy the § 162 "ordinary" and "necessary" tests rather easily, though not always. Recall the plywood manufacturer described earlier in this chapter, who was denied § 162 deductions for the costs to take 120 people, many of whom were business clients, to the Super Bowl because the costs were not "ordinary and necessary."

In 1961, President Kennedy first advocated substantially reducing or disallowing the deduction of meal and entertainment costs as business expenses, such as the "three martini lunch" (common

[59] *See* § 274(c); Treas. Reg. § 1.274-4.
[60] Sanitary Farms Dairy, Inc. v. Comm'r, 25 T.C. 463, 467 (1955).

in those Mad Men days). While modest restrictions were added in 1962, 1978, 1986, and 1992, entertainment costs that otherwise satisfy the low "ordinary" and "necessary" thresholds of § 162 continue to be deductible so long as they satisfy the additional restrictions now found in § 274, including the 50% reduction rule in § 274(n)(1) and the § 274(d) substantiation rules mentioned earlier, notwithstanding periodic additional calls to restrict the deductibility of entertainment costs as business expenses.[61] Notice that § 274 does not grant the authority to take deductions, as it does not contain the magic words "there shall be allowed a deduction." Rather, § 274 is a Code section that takes away *otherwise allowable* deductions, *i.e.*, deductions that satisfy each of the terms of a Code section that does contain those magic words, including the "ordinary and necessary" tests in §§ 162 or 212.

Under § 274(a)(1)(A), business entertainment activity expenses that satisfy § 162 are nevertheless disallowed unless they also meet either the "directly related" test or the "associated with" test. The Treasury Regulations fill in the content of those tests.

**"Directly related" test.** The most common means of satisfying the "directly related" test is to meet the four requirements in Treas. Reg. § 1.274-2(c):

- The taxpayer must have more than a "general expectation" that future income will arise from the entertainment. Thus, the nurturing of general goodwill is not sufficient to satisfy this requirement, though the taxpayer need not "show that income or other business benefit actually resulted from each and every expenditure for which a deduction is claimed."[62]
- During the "entertainment period," the taxpayer "actively engaged in a business meeting, negotiation, discussion, or other bona fide business transaction."[63]
- The "principal character … of the combined business and entertainment … was the active conduct of the taxpayer's trade or business." The regulation clarifies that this test is failed with respect to "hunting or fishing trips or on yachts and other pleasure boats unless the taxpayer clearly establishes to the contrary."[64]
- Only those actively engaged in the conduct of the trade or business during the entertainment are present (with an exception for spouses found in Treas. Reg. § 1.274-2(d)(4)).[65]

Alternatively, the directly related test is satisfied if the entertainment occurs "in a clear business setting directly in furtherance of the taxpayer's trade or business," such as the sponsorship of a hospitality room at a business convention. Another example provided is "entertainment of business representatives and civic leaders at the opening of a new hotel or theatrical production, where the clear purpose of the taxpayer is to obtain business publicity rather than to create or maintain the goodwill of the recipients of the entertainment …."[66]

Providing entertainment that will be included in the income of another as a prize or compensation can also satisfy the directly related test. "For example, if a manufacturer of products

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[61] *See, e.g.*, Richard Schmalbeck & Jay A. Soled, *Elimination of the Deduction for Business Entertainment Expenses*, 123 TAX NOTES 757 (2009); Richard Schmalbeck & Jay A. Soled, *The Cultural Symbolism of the Deductible Skybox*, 126 TAX NOTES 1524 (2010).
[62] Treas. Reg. § 1.274-2(c)(3)(i).
[63] Treas. Reg. § 1.274-2(c)(3)(ii).
[64] Treas. Reg. § 1.274-2(c)(3)(iii).
[65] Treas. Reg. § 1.274-2(c)(3)(iv).
[66] Treas. Reg. § 1.274-2(c)(4).

provides a vacation trip for retailers of his products who exceed sales quotas, as a prize or award includable in gross income, the expenditure will be considered directly related to the active conduct of the taxpayer's trade or business."[67]

Finally, the directly related test is failed if it occurs "under circumstances where there [is] little or no possibility of engaging in the active conduct of trade or business" because the "distractions are substantial," such as business meetings "at night clubs, theaters, and sporting events, or during essentially social gatherings such as cocktail parties." Similarly, the directly related test is failed if the entertainment includes "persons other than business associates at places such as cocktail lounges, country clubs, golf and athletic clubs, or at vacation resorts."[68]

Thus, if Sandra takes current business clients to a theater production simply to maintain a good business relationship (goodwill) with them, her costs are not deductible as business expenses because the entertainment fails the directly related test. Suppose, however, that Sandra takes those same clients to the theater to celebrate the successful completion of a business negotiation with them earlier that afternoon. On these changed facts, the entertainment may satisfy the "associated with" test under Treas. Reg. § 1.274-2(d).

**"Associated with" test.** Entertainment that fails the directly related test can nevertheless satisfy the associated with test if it both (1) is associated with the active conduct of a trade or business and (2) directly precedes or follows a "substantial and bona fide business discussion."[69] To satisfy the first requirement, the taxpayer must establish that he "had a clear business purpose in making the expenditure, such as to obtain new business or to encourage the continuation of an existing business relationship."[70] Under the latter phrase, entertainment costs incurred merely to create or maintain goodwill can satisfy the associated with test even though it fails the directly related test—so long as the second requirement is also satisfied. The bona fide business discussion must be "substantial in relation to the entertainment" though it is "not necessary that more time be devoted to business than to entertainment to meet this requirement."[71] Rather, the taxpayer must show only that "the principal character of the combined entertainment and business activity [is] the active conduct of business."[72] The requirement that the bona fide business discussion directly precede or follow the entertainment can be satisfied even if they do not occur on the same day in some cases. "For example, if a group of business associates comes from out of town to the taxpayer's place of business to hold a substantial business discussion, the entertainment of such business guests and their wives on the evening prior to, or on the evening of the day following, the business discussion would generally be regarded as directly preceding or following such discussion."[73]

With respect to entertainment conducted by employees and reimbursed by the employer, these rules (including the need to satisfy either the directly related test or associated with test and to reduce the deduction by 50% under § 274(n)(1)) apply only once—either to the employer or to the employee. They apply to the employer (and not the employee) *unless* the employer includes the reimbursement in the employee's wages as additional compensation. In that (unusual) case, the

[67] Treas. Reg. § 1.274-2(c)(5).
[68] Treas. Reg. § 1.274-2(c)(7).
[69] Treas. Reg. § 1.274-2(d)(1).
[70] Treas. Reg. § 1.274-2(d)(2).
[71] Treas. Reg. § 1.274-2(d)(3)(i)(*a*).
[72] *Id.*
[73] Treas. Reg. § 1.274-2(d)(3)(ii). Note the assumption underlying use of the word "wives." This regulation was promulgated in 1963.

employee is stuck with satisfying one of the § 274(a) tests and suffering the 50% deduction reduction.[74] Moreover, because the expense would then be considered an *unreimbursed* business expense, it would also be a § 67 MID for the employee, as described in Chapter 1, Part B.

### *§ 274: business meals*

Prior to 1986, business meals unconnected to business travel could be deducted so long as the meal occurred in a setting conducive to business discussion, even if no business was actually discussed before, during, or after the meal. After 1986, such meals must satisfy the same "directly related" or "associated with" tests that apply to entertainment costs generally.[75]

In addition, § 274(k) was added in 1986, which provides that business meals are deductible only to the extent "not lavish or extravagant under the circumstances" (whether or not in travel status) and only if the taxpayer or her employee is present (except when the taxpayer or her employee is in travel status, when she might dine alone at the hotel). While the language in § 274(k) could be read to disallow *all* deduction in the case of a lavish meal, the 1986 legislative history provides an example that allows the nonlavish portion to be deducted, with only the excess rendered nondeductible, and it also clarifies that the § 274(n)(1) percentage reduction rule applies after § 274(k) (rather than before).[76] Thus, if a business meal that costs $800 is considered lavish to the extent that it exceeds, say, $500, the taxpayer can deduct $250 (50% of the $500 nonlavish portion). There is very little guidance regarding standards to apply in determining whether a meal is "lavish or extravagant under the circumstances." IRS Publication 463, for example, states only that the amount must be "reasonable under the circumstances" and that "[e]xpenses will not be disallowed just because they are more than a fixed dollar amount or take place at deluxe restaurants, hotels, nightclubs, or resorts."[77] In practice, § 274(k) has not often been invoked by the IRS to reduce deductions.

### *Substantiation of costs*

The § 274(d) substantiation rules for business entertainment, travel, and meal costs supplant what had come to be known as the "Cohan rule" after *Cohan v. Commissioner*.[78] In that case, Judge Learned Hand held that the Broadway impresario George M. Cohan (who composed such classics as *Yankee Doodle Dandy*, *Over There*, and *You're a Grand Old Flag*) could deduct estimated entertainment and travel expenses even though he failed to keep receipts and otherwise record the business reason for the travel and entertainment costs.[79] Section 274(d) and the

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[74] *See* §§ 274(e)(2) and (3); Treas. Reg. §§ 1.274-2(f)(2)(iv)(*a*) and (*b*).
[75] *See* CONF. NO. 99-841, 1986-3 C.B. Vol. 4 at 25.
[76] *Id*.
[77] PUBLICATION 468 (2012): TRAVEL, ENTERTAINMENT, GIFT, AND CAR EXPENSES at www.irs.gov/publications/p463/index.html.
[78] Indeed, Treas. Reg. § 1.274-5T(a) refers to the case by name: "This limitation supersedes the doctrine found in *Cohan v. Commissioner*, 39 F.2d 540 (2d Cir. 1930)."
[79] Judge hand wrote:

> In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board [of Tax Appeals, predecessor to the Tax Court] refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of

regulations thereunder now forbid this kind of guesswork with respect to travel and entertainment expenses.[80] Today, the taxpayer must retain receipts and record the time and place of the entertainment, the business purpose of the meeting, and the business relationship of the attendees.[81]

This brief introduction to § 274 is not exhaustive. Other provisions address conventions and seminars outside North America or on cruise ships (§ 274(h)), entertainment tickets (§ 274(*l*)), certain travel expenses (§ 274(m)), and more.

## Problems

Saul is the sole owner of Informatech LLC, a small information technology company in Palo Alto, California. Informatech is considering the acquisition of Ideabot, a Colorado company that owns a valuable patent that would benefit Informatech's business. Saul flies to Denver on Sunday evening of Week 1 and returns to Palo Alto on Saturday evening of Week 3. Saul's meetings with Ideabot executives occur daily (except for the intervening weekend) from Monday of Week 1 through Thursday afternoon of Week 2, when they finally reach agreement on all negotiating points and execute an acquisition contract for closing in several months. On Friday evening of Week 2, Saul and two Ideabot executives (and the executives' spouses) celebrate with dinner and a show at the local playhouse (at Saul's expense). Saul spends Saturday through Friday on vacation skiing before returning to Palo Alto on Saturday evening of Week 3.

Saul incurs the following costs with respect to his trip:

- round trip air fare: $500
- lodging: $250 each night
- breakfast each day: $15
- lunch each day: $20
- dinner each day: $60 (except Friday of Week 2)
- dinner on Friday of Week 2 for Saul, the two executives, and their spouses: $900
- five tickets to the play: the tickets had a face amount of $100 each, but Saul had to purchase them through the hotel concierge for $120 each ($600) because the play was otherwise sold out and the concierge had to access the secondary market to find them
- local transportation (taxis to and from the airport and around town): $300 from Sunday of

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> any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computation, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence.

39 F.2d at 543-44.

[80] With respect to expenses *other* than entertainment, travel, and meal costs, the *Cohan* rule may still apply today. *See, e.g.*, Merians v. Comm'r, 60 T.C. 187, 189-90 (1973) (permitting the portion of a lawyer's overall fee that is allocable to tax planning for purposes of § 212(3) deduction to be estimated under the *Cohan* rule).

[81] *See* Treas. Reg. § 1.274-5T(b)(3) and (4) and -5T(c).

Week 1 through Friday of Week 2, $100 from Saturday through Saturday of Week 3 (including $20 for the trip to the airport)

- ski lift tickets: $100 each day from Saturday of Week 2 through Friday of Week 3 ($700)

**a.** What are Saul's tax consequences with respect to this trip?

**b.** Same as **a.**, except that Ideabot is a Swiss company, and Saul flies to Lucerne instead of Denver (and skis the Alps instead of the Rockies during Week 3) with round trip air fare of $1,500 (instead of $500). *See* § 274(c).

**c.** Same as **b.**, except that Saul returns home on Wednesday evening (instead of Saturday evening) after skiing on Saturday, Sunday, Monday, and Tuesday.

**d.** Same as **a.**, except that Saul does not travel but rather sends one of Informatech's employees, Susan, on the trip because she has been the one spearheading the acquisition. Susan incurs the same costs described in **a.**, and Informatech reimburses (under an accountable plan) all but her personal expenses. How do each of Saul and Susan treat these payments for tax purposes?

## D. Use of a personal residence for income production

A personal residence can be converted wholly from personal use to income production or used only partly (or for only part of the year) for income production.

***Converting a former personal residence wholly to income production***

A taxpayer who vacates her personal residence and converts it entirely to income production (*e.g.*, by renting the home to tenants) for all or part of a year must generally include the § 61 Gross Income generated and can generally begin depreciating the property's basis under §§ 167 and 168 (studied in Chapter 14). If the property's basis at the time of conversion exceeds the property's fair market value (FMV), however, only the portion of the basis equal to the lower FMV can be depreciated under Treas. Reg. § 1.167(g)-1.

For example, assume that Joan purchases her home for $200,000 in Year 1. During the next five years, Joan lives in the home and thus cannot depreciate any part of her $200,000 basis. In Year 6, however, Joan moves out of the home and rents it to a tenant. If the home's FMV is $250,000 at the time of conversion, Joan can begin to depreciate her entire $200,000 basis in the property. If, however, the property's FMV is only $160,000 at the time of conversion, she can begin to depreciate only $160,000 of her $200,000 basis; the $40,000 of value that was lost during the period that she was living in the home represents nondeductible personal consumption, which means that no part of the $40,000 basis attributable to that value loss should be deductible.

Neither can basis attributable to periods of personal use be the subject of a loss deduction under § 165(c)(2) when the property is sold. For purposes of computing the portion of a § 1001 realized loss that is "allowable" under § 165, Treas. Reg. § 1.165-9(b) requires the taxpayer to subtract from the amount realized the lesser of (1) the property's FMV at the time of the conversion, reduced by any depreciation deductions taken, or (2) the property's actual adjusted basis.

Let's return to Joan's example. Assume that Joan begins depreciating $160,000 of her $200,000 basis when she converts her personal residence to rental property because the property's FMV is only $160,000 at the time of conversion. After renting the property to tenants for several years, during which she properly deducts $20,000 in depreciation, Joan sells the property for $130,000.

Joan's § 1001 *realized loss* is $50,000: the excess of her actual $180,000 adjusted basis ($200,000 original cost basis *less* $20,000 depreciation deductions) over the $130,000 amount realized. The portion of this $50,000 realized loss that is *allowable as a § 165 deduction*, however, is only $10,000. In computing her allowable loss deduction under Treas. Reg. § 1.165-9(b), Joan must use the lesser of (1) $140,000 (the property's $160,000 FMV at the time of the conversion *less* $20,000 depreciation deductions) or (2) the property's actual $180,000 adjusted basis. Using the lesser $140,000 figure, Joan's deductible loss is limited to $10,000. The remaining $40,000 of her $50,000 § 1001 realized loss represents a nondeductible personal consumption loss under § 165(c)(3) because attributable to the period during which she lived in the home.[82]

After conversion, a taxpayer can not only begin depreciating basis but can also begin deducting maintenance and repair expenses (and similar expenses, such as utility and insurance costs paid by the owner) under either §§ 212 or 162. In addition, mortgage interest previously deducted as an Itemized Deduction under § 163(h)(3) while the home was used as a personal residence (or rendered nondeductible to the extent in excess of the limits provided in § 163(h)(3)) would become deductible as business or investment interest to the extent allowable under §§ 163(a) or (d) (and not disallowed under another provision, such as the § 469 passive activity loss rules). All of these deductions would be taken above the line under either § 62(a)(1) (if not pertaining to rental property) or § 62(a)(4) (if pertaining to rental property).

A notable exception to this usual paradigm pertains to homes that are rented for fewer than 15 days in a calendar year. In that case, § 280A(g) provides that (1) no deductions are allowed for the rental period (either depreciation or expenses) and (2) the gross rental income, otherwise includable in Gross Income under § 61(a)(5), is excludable. As the Wall Street Journal reported, "The tax-free perk is often called the 'Masters' provision,' because homeowners use it during the famed golf tournament in August, Ga. 'Even people with modest homes get a boost,' often earning between 15% and 25% of a year's mortgage payments, says Bill Woodward, a CPA at the Elliott Davis firm in Augusta. Many homeowners pocket from $6,000 to $30,000, he adds."[83]

***The so-called home office deduction***

Assume that Larry Lawyer, an associate (employee) with a local law firm, takes some work home to do on the weekends in his study and that the study represents 10% of his personal residence's square footage. If Larry owns his home, can he depreciate 10% of his basis under §§

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[82] If Joan sold for, say, $150,000, she would realize a § 1001 loss of $30,000 ($180,000 adjusted basis *less* $150,000 amount realized). None of this loss would be allowable as a deduction under § 165(c)(2), however, because using the lesser $140,000 figure required by Treas. Reg. § 1.165-9(b) does not produce a loss when compared to the $150,000 amount realized. Do not be fooled into thinking that Joan must include a $10,000 *gain* on these changed facts, however, as she did not realize a § 1001 gain to include; she realized a § 1001 *loss* of $30,000, though none of it is deductible. In effect, her entire $30,000 realized loss is attributable to her prior period of personal use, during which the property lost $40,000 of value.

[83] Laura Saunders, *High-Impact Tax Breaks*, at http://online.wsj.com/news/articles/SB10001424127887324251504578581902057217408. Taxpayers who rent their personal residence for periods exceeding 15 days must include in Gross Income the rent received and can deduct depreciation and expenses only for the portion of the year during which the residence is rented to others. *See* § 280A(e). The portion allocable to the rental period is "that amount which bears the same relationship to the total amount of the item as the number of days on which the unit is rented at a fair rental during the taxable year bears to the number of days on which the unit is used for any purpose … during the taxable year." Prop.Treas. Reg. § 1.280A-3(d)(3). These deductions are subject, however, to the overall § 280A(c)(5) limitation described in the next subsection of the textbook. When property otherwise satisfying the requirements of § 121 is sold, the portion of realized gain that represents prior depreciation deductions is not eligible for exclusion. *See* § 121(d)(6).

167 and 168? If Larry rents (rather than owns) his home, can he deduct 10% of his rent? Can he deduct 10% of his monthly gas heat and electricity bills and 10% of his homeowner's or renter's insurance policy (the portion attributable to his study)? With respect to business "expenses" at least, recall Justice Cardozo's take on the meaning of "ordinary" and "necessary" in § 162(a), considered in Part A. Because "necessary" means nothing more than "appropriate and helpful" and "ordinary" means nothing more than commonplace in the business, taxpayers like Larry easily deducted such "home office" costs before 1976. But was that the correct normative result, *i.e.*, a result consistent with a proper measurement of "income" as a matter of tax theory?

We know that business deductions are necessary in an income tax to prevent the same dollars from being doubly taxed to the same taxpayer, but which costs should properly be allocable to the taxpayer's business sphere (rather than to his personal sphere)? We have earlier seen that satisfying a "but for" test may not be *sufficient* to shift an outlay from the nondeductible personal consumption sphere to the deductible business sphere (recall the working parent's nondeductible childcare costs), but satisfying the but for test should nevertheless always be a *primary* threshold or floor—a necessary first step—before any business deduction is possible. Only outlays that would not have been incurred but for the business can plausibly be characterized as incremental (extra) costs incurred *because of* business needs. Perhaps even more should be required than a "but for" test, but never less. If an outlay would have been incurred for personal reasons in any event, *i.e.*, even absent the presence of a business, the outlay should not be attributable to the taxpayer's business sphere but rather to his personal sphere. In short, no double taxation of the same dollars to the same taxpayer is plausible absent (at least) satisfaction of the "but for" test.

With respect to home office deductions, therefore, the theoretically correct question to ask is whether the taxpayer bought a bigger house (or rented a larger apartment or house) than he otherwise would have bought or rented absent the business use of the home. If the taxpayer would have bought the same-sized house (or rented the same-sized apartment) even absent the business use of the home, no deductions are normatively justified, as no incremental (extra) cost is incurred *because of* the business use of the home. Of course, you can immediately appreciate how such a test would not be administratively workable in the real world. Thus, when Congress enacted § 280A in 1976 with the express desire to limit such deductions, it created more administratively workable proxy tests to engage in the same inquiry indirectly.

Section 280A(a) first disallows *all* deductions pertaining to "a dwelling unit which is used by the taxpayer during the taxable year as a residence." Subsection (b) then immediately revives the tax expenditure personal deductions pertaining to the home, such as qualified residence interest (§ 163(h)(3)), real estate taxes (§ 164(a)(1)), and personal casualty losses (§ 165(c)(3) & (h)). If any additional deductions allocable to the home are to be allowed (*e.g.*, business deductions under §§ 162, 167, 168, *etc.*), § 280A(c) must be satisfied.[84] With respect to home offices, the relevant subsection would be (c)(1), which allows such deductions only if the portion of the dwelling unit under consideration satisfies three tests.

- *First*, the space must be used *exclusively* for business. A space that is also used for personal purposes does not qualify.
- *Second*, the space must be used on a *regular* basis in business. Using the exclusively

[84] Rental use, described in §§ 280A(c)(3) and (e), was discussed in the prior subsection. Sections 280A(c)(2), pertaining to certain business storage use, and (c)(4), pertaining to use of the home in providing day care services, are not further described here.

dedicated space, say, only once each year for business is clearly not sufficient.

- *Third*, the space must be used (exclusively and regularly) in one of the three manners listed:

  (A) it is the "principal place of business" with respect to "any" of the taxpayer's businesses (if the taxpayer has more than one business),

  (B) it is the place where the taxpayer meets with clients, patients, or customers "in the normal course of his trade or business," or

  (C) if the space is a separate structure that is not attached to the dwelling, it is used "in connection with" the taxpayer's business.

For fans of classic television, a good example of (B) would be Dr. Huxtable's ground floor office space in The Cosby Show. Bill Cosby's character was on obstetrician whose family lived in a Brooklyn Heights townhouse, the basement level of which was used as his obstetrician office, where he met with his patients. A classic example of (C) is the author's writing shed. Authors such as Mark Twain, Roald Dahl, George Bernard Shaw, Henry David Thorough, Michael Pollan, and Virginia Wolf, though not all American and not all writing after adoption of the income tax, wrote in separate sheds constructed on their property.[85]

These tests serve effectively as proxies in attempting to determine the likelihood that the taxpayer incurred extra, incremental costs because of business use of his home. Thus, for example, Congress believed that if a portion of the taxpayer's home is set aside *exclusively* for business use, is so used on a *regular basis*, and is, as one example, the *principal place of business* for the taxpayer's business, the likelihood is high that the taxpayer bought (or rented) a larger abode than he would have absent the business use.

How "exclusive" must the use be?

## RAYDEN v. COMMISSIONER

T.C. Memo. 2011-1

WHERRY, JUDGE: Respondent determined that petitioners are liable for a Federal income tax deficiency of $19,740 for the 2004 tax year. After concessions, the only issue remaining is to determine the portion of petitioners' residence which was used exclusively on a regular basis as a principal place of business by Mr. Rayden during the 2004 tax year.[2]

FINDINGS OF FACT

Some of the facts have been stipulated, and the stipulation of facts, the supplemental stipulation of facts, and the accompanying exhibits are hereby incorporated by this reference. Petitioner husband (petitioner) is the sole proprietor of InfoGen and Resource Direct. Before 1997 petitioner conducted his business out of 8,000 square feet of commercial space until financial difficulties and family issues required petitioner to terminate the lease and move the business into his home. Petitioner's home consists of 7,272 square feet of living space, which includes the garage. During the tax year at issue, petitioner resided in this residence with his wife and daughter. Petitioner also

[85] *See* http://www.apartmenttherapy.com/famous-small-offthegrid-worksp-140587.

[2] At trial respondent conceded that 43 percent of petitioners' house was used exclusively for business. Petitioner contended at trial that the applicable figure is 71 percent and on brief that it is 70 percent.

has two sons who, during this period, attended college and lived away from home.

Petitioners' two-story residence consists of 12 rooms. There is additional space in the area of the vestibule, hall, and staircase. There is also an attached three-car garage. Petitioner's family put the master bedroom and master bathroom to personal use. Petitioners' daughter used the room designated on Exhibit 15-P as bedroom 2, including the sitting area, bathroom, and closet, for personal purposes. Petitioners asserted at the trial that 10 percent of the use of bedroom 2 was for business. The room designated as the guest room consists of 283 square feet and was used by petitioner wife in connection with her travel agency business.

Petitioner and his family frequently ate out but used the kitchen some each week for eating meals and occasional cooking. The subcontractors who worked for petitioner's business in petitioner's home also used the kitchen for breaks and lunches. Petitioner's family used the service room for laundry. Petitioner explained that he used the den, with the adjoining bar and vestibule, to entertain family members one to two times a year. About three times a year petitioner and his family used the dining room for family dinners. Petitioner and petitioners' daughter occasionally had meals in the breakfast area, as its name would imply.

Petitioner and his family did not use the living room for personal purposes. On a rare occasion, someone other than a business associate might walk through the room. Otherwise, it was used only for business. The maid's room was used for staging and preparing projects for petitioner's business and not for personal purposes. Bedroom 3 was used as a graphic and video studio, and bedroom 4 was used as a programming and survey office. Both of these bedrooms were used solely for business. The 186-square-foot hall area led only to bedrooms 3 and 4 and thus also was used only for business. The garage comprised approximately 1,103 square feet of the first floor. It was used primarily for storage and as a shop and studio.

Petitioners filed a Form 1040, U.S. Individual Income Tax Return, for the 2004 tax year. The tax return included a Schedule C for petitioner's marketing consultant business with respect to which he claimed a rent expense of $90,646. It also included a Schedule C for petitioner's Infogen computer software business with respect to which he claimed a rent expense of $84,515. Petitioners also reported rental income of $175,161 on Schedule E, Supplemental Income and Loss, and claimed expenses of $131,739.

Respondent issued a notice of deficiency on December 31, 2007, determining a $19,740 deficiency in petitioners' income tax for 2004. Petitioners filed a timely petition with this Court on March 28, 2008, denying liability for the deficiency. A trial was held on June 17, 2009, in Los Angeles, California.

OPINION

Deductions are a matter of "legislative grace," and "a taxpayer seeking a deduction must be able to point to an applicable statute and show that he comes within its terms." *New Colonial Ice Co. v. Helvering*, 292 U.S. 435 (1934); see also Rule 142(a). As a general rule, section 162(a) authorizes a deduction for "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." An expense is ordinary for purposes of this section if it is normal or customary within a particular trade, business, or industry. *Deputy v. du Pont*, 308 U.S. 488, 495 (1940). An expense is necessary if it is appropriate and helpful for the development of the business. Comm'r v. Heininger, 320 U.S. 467, 471 (1943). Section 262, in contrast, precludes deduction of "personal, living, or family expenses."

Where the expense in question relates to property that is occupied by the taxpayer as a residence, section 280A(a) lays down the following general rule: "in the case of a taxpayer who is an individual or an S corporation, no deduction otherwise allowable under this chapter shall be allowed with respect to the use of a dwelling unit which is used by the taxpayer during the taxable year as a residence." However, an exception to this general ban is found in section 280A(c)(1), which provides that section 280A(a) does not apply to an item of expense to the extent allocable to a portion of the taxpayer's residence which "is exclusively used on a regular basis" as the taxpayer's principal place of business.

There is no dispute that a portion of petitioners' home was used on a regular basis as the principal place of petitioner's business. We are, however, confronted with the fact-specific inquiry of whether certain rooms in petitioners' house were used exclusively for the business. The legislative history of section 280A dealing with exclusive use explains:

> Exclusive use of a portion of a taxpayer's dwelling unit means that the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business. The use of a portion of a dwelling unit for both personal purposes and for the carrying on of a trade or business does not meet the exclusive use test. * * * [S. Rept. 94-938, at 148 (1976), 1976-3 C.B. (Vol. 3) 49, 186; H. Rept. 94-658, at 161 (1975), 1976-3 C.B. (Vol. 2) 695, 853.]

The Court in *Hefti v. Commissioner*, T.C. Memo. 1988-22, discussed this legislative history and observed that "[a]ny personal use of a room or segregated area will preclude its use in computing depreciation or other allocable expenditures, unless some or all of the use of the room was for the storage of inventory."

Petitioner contends that 70-71 percent of his home was used exclusively and regularly for business during the 2004 tax year. As the Court did in *Hefti*, we find it implausible that the taxpayer and his family "had no social or personal life in any portion of the residence other than a few bedrooms and the kitchen." *Id.* During his testimony petitioner acknowledged a few occasional uses of other rooms for personal purposes during 2004. Nevertheless, because personal use was allegedly minimal compared with business use, petitioners contend that they should be allowed the claimed expense deduction. We appreciate petitioners' contention, but Congress has made it clear that this is not the law.

Respondent conceded that petitioner used the library and the garage exclusively for business. We also find that petitioner used the living room exclusively for business. Although petitioner's own exhibit claimed that the business used the living room only 95 percent of the time, at trial he credibly explained that "[t]he only reason I put down 95 percent is that somebody who would be visiting could have possibly walked in [or through] that area and walked out."

This Court has previously held that the mere nonbusiness passage from one room to the next can be classified as a *de minimis* personal use of the room and will not disqualify the room from the exclusivity requirement of section 280A(c) (1). *See Lind v. Comm'r*, T.C. Memo. 1985-490 ("That petitioners and their family members may have occasionally walked through the garage does not violate the exclusive business use rule."); *Hughes v. Comm'r*, T.C. Memo. 1981-140 ("Petitioner's incidental use of the closet to walk to and from his bathroom was *de minimis*.").

We also find credible petitioner's testimony that the maid's room and bedrooms 3 and 4 were used exclusively for business. *See Thalacker v. Comm'r*, T.C. Memo. 1984-488 (upholding a home

business deduction on the basis of a taxpayer's credible testimony). Petitioner explained that the maid's room was 100 percent used "in the business for staging and preparing projects." He also explained that bedroom 3 was used for graphic design and as a video design studio and that bedroom 4 was used for programming, customer service, and surveys. Petitioner also proffered photographs of bedrooms 3 and 4 depicting their business use. Although, as respondent pointed out at trial, these photographs, necessarily limited to two dimensions, depict only one side of the room, we find them to be reliable evidence corroborating petitioner's testimony regarding the business use of these two rooms.

Because we find that bedrooms 3 and 4 were used exclusively for business, we also find that the hall area, which leads only to those two rooms, was also used exclusively for business. The table below summarizes the rooms in petitioners' residence that were used exclusively and regularly for petitioner's business in 2004 and their total area in square feet.

| **Room** | **Square Feet** |
|---|---|
| Library | 328.5 |
| Garage | 1,102.5 |
| Living room | 405.0 |
| Maid's room | 364.0 |
| Bedroom 3 | 444.0 |
| Bedroom 4 | 392.0 |
| Hallway to 3 & 4 | 186.0 |
| Total | 3,222.0 |

Using these figures it appears that petitioner used 3,222 square feet for his business in 2004, which is 44.3 percent of the total area of petitioners' house. We note that this percentage was determined using the stipulated 7,272 total square feet; had we used the total square footage from petitioners' Exhibit 15-P of 8,321.625, the percentage of his business use would have been 38.7 percent of petitioners' home. Respondent has done an excellent job of applying the law to the facts. Indeed, respondent was more generous then this Court would have been had we, as we would be inclined to do, used the total square footage from petitioners' Exhibit 15-P. We therefore find that, as contended by respondent, petitioner used 43 percent of the home exclusively for business. As we explain below, the remaining rooms were not exclusively used for business and the expenses apportionable to their use do not qualify as deductible under section 280A(c)(1).

Although petitioner first explained that he did not eat in the breakfast room, in response to a question by the Court he conceded that on occasion he or his family may have eaten in the breakfast area. Petitioner also did not use the den, vestibule, and adjoining bar exclusively for business. Petitioner explained that "maybe one or two times a year, [the area] was used sometimes by family that were visiting". We do not regard as *de minimis* this personal use of the room by visiting family. "Exclusive use" is narrowly construed, as discussed in the legislative history of section 280A above. This means that "'the taxpayer must use a specific part of a dwelling unit solely for the purpose of carrying on his trade or business.'" *Culp v. Comm'r*, T.C. Memo 1993-270 (quoting *Sam Goldberger, Inc. v. Comm'r*, 88 T.C. 1532, 1557 (1987)).

Petitioner also did not use the dining room exclusively for business when his family was visiting. Petitioner testified that "one or two nights a year" when his sons were in town they would

have a family dinner in the dining room. Petitioner is not entitled to a deduction for items of expense apportionable to these rooms. By his own admission, normal household activities took place in those rooms. *See Langer v. Comm'r*, 980 F.2d 1198, 1199 (8th Cir. 1992) (disallowing a business expense deduction for a portion of the home in which household activities also took place), affg. T.C. Memo. 1990-268.

In conclusion, petitioner used 43 percent of the house's total area exclusively for business and may claim business expense deductions prorated accordingly. He is not entitled to a Schedule C deduction in connection with the remaining 57 percent of the house's total area.

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The most difficult interpretive category is found in § 280A(c)(1)(A). What is the taxpayer's "principal place of business" (for "any" of his businesses if she has more than one)? Prior to the Supreme Court's decision in *Commissioner v. Soliman*,[86] some courts appeared to substitute, in effect, the word "essential" for "principal." For example, a professional musician employed by the Metropolitan Opera in New York City attended rehearsals and performances at Lincoln Center (for which he was paid) but also practiced alone in his apartment for many more hours each week (30 to 32 hours) than he spent performing at Lincoln Center.[87] Which location was his "principal" place of business: the opera house or his apartment? The Second Circuit determined that it was his apartment because his practice at home was an essential element of his job with the Metropolitan Opera, entitling the musician to deduct a portion of the rent and other expenses allocable to the portion of his apartment used "exclusively" and on a "regular basis" for practicing.

The taxpayer in *Soliman* was a self-employed anesthesiologist (an independent contractor rather than an employee) who performed services in three different hospitals, where he spent the majority of his time (30 to 35 hours each week) caring for patients. Eighty percent of his hospital time was spent at one hospital. None of the hospitals provided office space to him, so he spent two to three hours each day in his home office (a spare bedroom in his condominium) doing professional reading and performing necessary administrative tasks, such as managing his patient logs and billing patients. He sought to deduct a portion of his condominium fees, depreciation, utilities, and commuting expenses from his home to and from the hospitals under the "principal place of business" prong of § 280A(c)(1)(A). There was no dispute that he satisfied the "exclusive use" and "regular basis" tests. The only issue was whether his study was his "principal place of business" for his anesthesiology practice. In a reviewed decision with dissents, the Tax Court determined that the home office was his principal place of business, as did a divided Fourth Circuit Court of Appeals.[88] The Supreme Court heard the case because of the variety of outcomes in similar cases in the Courts of Appeals.

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[86] 506 U.S. 168 (1993).

[87] *See* Drucker v. Comm'r, 715 F.2d 67 (2d Cir. 1983).

[88] An important side effect of the lower courts' determinations that Dr. Soliman's "principal place of business" was his home was to transform his otherwise nondeductible commuting expenses (incurred in traveling from his home to the hospitals) into deductible business expenses of going from one place of business to another, just as a lawyer can deduct the cost of taxi fare to travel from his downtown office to the courthouse to appear with a client before a judge. Though not mentioned in the Supreme Court decision, the Tax Court decision makes clear that Dr. Soliman's home office deduction was approximately $1,259, while his car deductions totaled $3,758. A portion of the latter would, no doubt, have been deductible in any event to the extent the costs reflected travel among the three hospitals, but a good portion may have been deductible *only* if Dr. Soliman's condominium was held to be his "principal place of business." *See* 94 T.C. 20, 22 (1990).

Reversing the lower court decision, the Supreme Court observed:

> Before [§ 280A's] adoption, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. *See, e. g., Newi v. Comm'r*, 432 F.2d 998 (CA2 1970). This generous standard allowed many taxpayers to treat what otherwise would have been nondeductible living and family expenses as business expenses, even though the limited business tasks performed in the dwelling resulted in few, if any, additional or incremental costs to the taxpayer. H.R. Rep. No. 94-658, p. 160 (1975); S. Rep. No. 94-938, p. 147 (1976)….
>
> In deciding whether a location is "the principal place of business," the commonsense meaning of "principal" suggests that a comparison of locations must be undertaken. This view is confirmed by the definition of "principal," which means "most important, consequential, or influential." Webster's Third New International Dictionary 1802 (1971). Courts cannot assess whether any one business location is the "most important, consequential, or influential" one without comparing it to all the other places where business is transacted….
>
> Contrary to the Court of Appeals' suggestion, the statute does not allow for a deduction whenever a home office may be characterized as legitimate. That approach is not far removed from the "appropriate and helpful" test that led to the adoption of § 280A. Under the Court of Appeals' test, a home office may qualify as the principal place of business whenever the office is essential to the taxpayer's business, no alternative office space is available, and the taxpayer spends a substantial amount of time there. *See* 935 F.2d, at 54. This approach ignores the question whether the home office is more significant in the taxpayer's business than every other place of business.[89]

In comparing each location, the Court instructed the fact finder to consider (1) the relative importance of the activities undertaken at each location, with "the point where goods and services are delivered" given "great weight"[90] in making this determination, and (2) the time spent at the home office compared to the time spent at other business locations. Because both parts of this two-part test pointed away from Dr. Soliman's home office, the Court easily concluded that his home office was not Dr. Soliman's "principal place of business."

> [T]he actual treatment was the most significant event in the professional transaction. The home office activities, from an objective standpoint, must be regarded as less important to the business of the taxpayer than the tasks he performed at the hospital. A comparison of the time spent by the taxpayer further supports a determination that the home office was not the principal place of business. The 10 to 15 hours per week spent in the home office measured against the 30 to 35 hours per week at the three hospitals are insufficient to render the home office the principal place of business in light of all the circumstances of this case. That the office may have been essential is not controlling.[91]

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[89] *Soliman*, 506 U.S. at 173-74.
[90] *Id*. at 175.
[91] *Id*. at 178.

How would our Metropolitan Opera musician fare under this two part test? Unlike Dr. Soliman, the musician spent more time in his home office on essential activities than he did delivering the services for which he was paid at another location (the opera house).

Congress reacted to *Soliman* by amending the statute in one important respect for those taxpayers, like Dr. Soliman but unlike Larry Lawyer described at the beginning of this subsection, who are independent contractors rather than employees. The last sentence in § 280A(c)(1) now provides:

> For purposes of subparagraph (A), the term "principal place of business" includes a place of business which is used by the taxpayer for the administrative or management activities of any trade or business of the taxpayer if there is no other fixed location of such trade or business where the taxpayer conducts substantial administrative or management activities of such trade or business.

Notice that the statutory language does not require that no other business location be available for such administrative tasks; it requires only that the independent contractor does not actually *conduct* "substantial" business elsewhere. So long as a taxpayer in Dr. Soliman's position today does not perform any "substantial" administrative activities at the hospitals, his home office can constitute the "principal place of business" for his medical practice—even if one or more of the hospitals actually provides an office to him for these activities (which he chooses not to use). This largesse is not likely available to Larry Lawyer, an employee, because the immediately preceding sentence provides that the "exclusive use" test will be satisfied with respect to an employee only if the home space is used "for the convenience of the employer." Thus, if an employer provides work space to the employee in which to perform tasks, the "exclusive use" test is failed when the employee chooses to perform work tasks at home, instead.

Even if all of these hurdles are surmounted and the taxpayer is clearly entitled to deduct depreciation and expenses allocable to business use of his personal residence, Congress was concerned about a sheltering effect if the business Gross Income is relatively trivial compared to the home office (and other business) deductions. Absent a limiting rule, the excess deductions (the net loss) would shelter unrelated investment income or income from an unrelated business of the taxpayer (or the taxpayer's spouse, with whom he files a joint return). Thus, § 280A(c)(5) generally limits the amount of allowable home office deductions in any year to the amount of Gross Income generated by the business in that year remaining after *first* deducting the allocable portion of the tax expenditure home deductions, as well as business deductions not related to the home. In other words, the home office deductions are taken *last*—after (1) qualified residence interest, real estate property taxes, and personal casualty losses[92] and (2) advertising, supplies, professional fees, depreciation of business equipment, and any other non-home-related deductions allocable to the business.[93] Only if sufficient Gross Income from the business remains after taking these deductions can the home office deductions be taken. Any nondeductible net loss can be carried forward indefinitely and deducted when sufficient Gross Income is generated to permit deduction.

For example, assume that George is an employee of another (*e.g.*, a schoolteacher) but also has a second business as an independent contractor (*e.g.*, a tree trimmer on the weekends and during the summer), which he manages from his home. His home, which he purchased for $100,000, contains 3,500 square feet, 350 of which (10%) satisfies the requirements of § 280A(c)(1) in

[92] *See* § 280A(c)(5)(B)(i).
[93] *See* § 280A(c)(5)(B)(ii).

connection with George's tree-trimming business. He places the 350 square feet into service in his business on January 10 of this year. The portion of George's aggregate $100,000 basis allocable to the 350 square feet is $10,000 (10%). Because George's use satisfies the requirements of § 280A(c)(1), he can depreciate this $10,000 basis under §§ 167 and 168 over 39 years, using the straight-line method and the mid-month convention that you studied in Chapter 14.[94] Because George is an independent contractor to his customers, his deduction would be taken above the line under § 62(a)(1), directly from Gross Income. An allocable portion of his § 163 mortgage interest is transformed from "qualified residence interest" under § 163(h)(3) (an Itemized Deduction) into business interest under § 163(a), deductible above the line under § 62(a)(1). A similar approach applies to his § 164 real property tax deduction. The remaining mortgage interest and real property tax (allocable to the 90% of his home that is not his home office) remain Itemized Deductions, allowable only to the extent that George itemizes. In addition, George can deduct under § 162 (above the line under § 62(a)(1)) the portion of his utility bills, home repairs, and homeowners insurance (otherwise nondeductible personal expenses) that is properly allocable to his home office, which we shall assume is 10%.[95]

Applying the § 280A(c)(5) limit, how much of George's home office depreciation and expenses can he actually deduct this year under the following assumptions?

- Gross Income generated by George's tree-trimming business is $9,000,
- George pays $10,000 in interest on his home loan ($1,000 of which is allocable to his home office) and $6,000 in real property taxes ($600 of which is allocable to his home office),
- George's depreciation and § 179 deductions for his truck, saws, stump-grinder, and other equipment (all used exclusively in his tree-trimming business) and business expenses unrelated to his home (such as advertising costs) are $6,000,
- the first-year depreciation for the $10,000 basis allocable to his home office is $246 (2.461% of $10,000), and
- George's aggregate cost for homeowners insurance, utilities, and repair bills is $20,000 ($2,000 of which is allocable to his home office).

Of the deductions listed above, only the $2,246 listed in the final two bullets—the home office depreciation, insurance, utility, and repair costs, which would be entirely nondeductible absent § 280A—are potentially limited by the § 280A(c)(5) ceiling. His mortgage interest, real property tax, and business deductions for his tree-trimming business that are unrelated to use of the home are fully allowable under other Code sections without regard to § 280A. Nevertheless, the $2,246 home office deductions are allowed only to the extent of the excess (if any) of the $9,000 Gross Income generated by George's tree-trimming business over the deductions (listed in the second and third bullets) that are allowable without regard to § 280A. Thus, of George's aggregate $2,246 home office deduction, only $1,400 is allowed this year: $9,000 Gross Income *less* $7,600 ($1,600 mortgage interest and real property tax allocable to the home office and $6,000 in business

[94] Because George is not renting this 350 square feet to a tenant, this depreciable property is not classified as "residential rental property," which uses a 27.5-recovery period, but rather is classified as "nonresidential real property," which uses a 39-year recovery period. Review §§ 168(e)(2), (c), (d)(2), and (b)(3).

[95] Any repair that pertains to a specific part of the house outside the home office would not be deductible. For example, no part of the cost of repairing the kitchen faucet would be deductible under § 280A because it is not properly allocable to the home office.

deductions unrelated to the home). George must carry forward the remaining $846 (rather than use it this year to shelter income from his teacher salary) and hope that his tree-trimming business generates sufficient additional Gross Income (or that his mortgage interest, real property tax, or business deductions unrelated to the home decrease by a sufficient amount) to allow George to deduct the carryover after applying the § 280A(c)(5) ceiling in a future year. Moreover, of the $2,246 in aggregate home office deductions, depreciation deductions (which must reduce basis) are taken last, which means that none of George's $246 depreciation deduction is allowed this year, and his home basis is not yet reduced under § 1016(a)(2).

Whew! George has to go to a lot of trouble to deduct a relatively trivial amount ($1,400). Moreover, he must bifurcate his home mortgage interest and real property tax into their two components parts, with the portion allocable to his home office removed from his Itemized Deductions and taken above the line, instead. The reduction, if large enough, could render George unable to itemize. More to the point, these portions eat up his tree-trimming Gross Income *first* under § 280A(c)(5), reducing his allowable home office deduction. In addition, George must maintain precise records of his total insurance, utility, and repair costs in order to both substantiate the home office deduction and to determine how much of the total amount is properly allocable to his home office. Finally, George must remember to reduce his home basis by any depreciation allowed or allowable in a future year under his carryover, and the portion of any gain realized on a later sale equal to prior depreciation deductions is not eligible for exclusion under § 121(d)(5).

In an effort to simplify life for taxpayers like George, the IRS issued Revenue Procedure 2013-13 in 2013,[96] which allows certain taxpayers otherwise satisfying the requirements of § 280A(c) to elect, if they wish, to use an optional safe harbor method in determining the home office deduction. If George elects to use this safe harbor method:

- No depreciation deduction can be taken (thus avoiding the concomitant basis reduction).
- None of George's qualified residence interest, real property tax, and personal casualty loss (if any) is apportioned to the home office, which means, in effect, that none of these deductions eats up his tree-trimming Gross Income in applying the § 280A(c)(5) ceiling to his home office deduction. They remain Itemized Deductions in full, taken in addition to George's above-the-line home office deduction.
- The allowable home office deduction is calculated by formula and is deemed to be substantiated (freeing George from maintaining insurance, utility, and repair cost records). The formula provides a deduction equal to $5.00 (subject to adjustment in future years) multiplied by the square footage of the home office (determined on an average monthly basis), not to exceed 300 square feet.
- George is free to use the optional safe harbor method in some years and not others, though depreciation deductions calculated in years in which the safe harbor method is not used must take into account the intervening years. Thus, if George uses the optional safe harbor method in Year 1 (forgoing the Year-1 depreciation deduction) but not in Year 2, the depreciation deduction calculated for Year 2 must use the percentage otherwise applicable to Year 2, even though this is the "first" year in which George is actually attempting to deduct depreciation.

[96] 2013-1 C.B. 478.

If George elects to use the optional safe harbor method, his home office deduction would be $1,500 this year (instead of $2,246), equal to $5.00 multiplied by 300 square feet. The remaining 50 square feet of his 350 square foot home office is not taken into account. In applying the § 280A(c)(5) ceiling, none of his $10,000 qualified residence interest or $6,000 real property tax is allocable to the home office. Thus, he retains $16,000 in Itemized Deductions (in addition to his above-the-line home office deduction) and, more important, preserves more Gross Income for his home office deduction under the § 280A(c)(5) ceiling. Thus, the $1,500 home office deduction is fully allowable (with no carryover) under George's new $3,000 ceiling under § 280A(c)(5): $9,000 Gross Income *less* $6,000 in business deductions unrelated to the home. In short, George can choose between deducting $1,400 this year (with an $846 carryover) or deducting $1,500 this year (with no carryover). If he chooses the former, however, he must maintain good records to substantiate his deduction.[97]

## E. Distinguishing between "business" and "investment"

Throughout this course and textbook, you have learned that the most significant divide lies between income-producing activities on the one hand (both business and investment activities) and personal consumption activities on the other. Income-producing activities—both business and investment—can generate deductions; personal-consumption activities generally do not (except for the personal tax expenditure deductions).

While both business and investment activities can generate deductions, some differences in treatment can nevertheless render the line between the two spheres important. The most significant context in which this occurs is beyond the scope of this textbook, but those of you who enroll in the class entitled "The Federal Income Taxation of International Transactions" will study it. A nonresident alien (a noncitizen who does not reside in the U.S.) or a foreign corporation that earns income that is "effectively connected" to a "U.S. trade or business" (terms of art) is subject to U.S. tax (absent a bilateral tax treaty providing otherwise) under the same graduated rates, after allowable deductions are taken, that apply to U.S. citizens, residents, and corporations under §§ 1 and 11.[98] If, on the other hand, the income earned by a nonresident alien or foreign corporation consists of interest, dividends, royalties, and other forms of investment income, it may be subject to a gross 30% tax, with no deductions permitted.[99] That is quite a significant difference!

A few less significant differences between "business" and "investment" are worth considering (or reviewing) here. First, recall from Chapter 11 that nonbusiness bad debts are treated as short-term capital losses under § 166(d), whereas business bad debts are deductible as ordinary losses, unhampered by the § 1211(b) capital loss limitation rule. Moreover, as a sneak preview of the next chapter, to the extent business bad debts (and other business deductions) of an individual exceed Gross Income (including both business and investment Gross Income income) in the year realized, the excess (unusable) business deduction can be carried back or forward to other tax years under § 172 to reduce tax, whereas nonbusiness deductions (including § 166(d) bad-debt deductions) in excess of nonbusiness (investment) Gross Income cannot be carried to other years.

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[97] This optional safe harbor method is not available for use by taxpayers who rent a portion of their personal residence to a tenant or who rent to a tenant their entire personal residence for only part of the year. Such taxpayers must calculate their allowable deductions the old-fashioned way.

[98] *See* §§ 871(b) and 882.

[99] *See* §§ 871(a) and 881.

## UNITED STATES v. GENERES

405 U.S. 93 (1971)

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 Internal Revenue Code of 1954, as amended, and of the implementing Regulations § 1.166-5.[2]

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 taxpayer, Allen H. Generes, prevailed in a jury trial in the District Court. On the Government's appeal, the Fifth Circuit affirmed by a divided vote. 427 F.2d 279 (CA5 1970). Certiorari was granted to resolve a conflict among the circuits.

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.

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[2] Treas. Reg. § 1.166-5(b)(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. . . .

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. 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 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. The court refused the Government's request for an instruction that the applicable standard was that of *dominant* rather than significant motivation.

After twice returning to the court for clarification of the instruction given, the 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 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. *Trent* v. *Comm'r*, 291 F.2d 669 (CA2 1961); *Jaffe* v. *Comm'r*, T.C. Memo para. 67,215; *Estate of Saperstein* v. *Comm'r*, T.C. Memo para. 70,209; *Faucher* v. *Comm'r*, T.C. Memo para. 70,217;*Rosati* v. *Comm'r*, T.C. Memo para. 70,343; Rev. Rul. 71-561, 1971-50 I.R.B. 13.

*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 in 1948 under § 23(e)(2) of the 1939 Code. The standard prescribed by that statute was incurrence of the loss "in any transaction entered into for profit, though not connected with the trade or business." The Court rejected this approach and held that the loss was a nonbusiness bad debt subject to short-term capital loss treatment under § 23(k)(4). The loss was deductible as a bad debt or not at all. *See* Rev. Rul. 60-48, 1960-1 C.B. 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 "devoting 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.

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 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, § 5(a), 39 Stat. 759, provided differently for trade or business losses than it did for losses sustained in another transaction entered into for profit. And it has been the specific policy with respect to bad debts since the Revenue Act of 1942 incorporated into § 23(k) of the 1939 Code the distinction between business and nonbusiness bad debts. 56 Stat. 820.

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. *Comm'r*, 361 F.2d 640, 644 (CA3 1966), and in § 165(c)(2), see *Austin* v. *Comm'r*, 298 F.2d 583, 584 (CA2 1962). In these related areas, consistency is desirable. *See also Comm'r* v. *Duberstein*, 363 U.S. 278, 286 (1960).

…

*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."

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 taxpaid. 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.

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.

[The separate concurrences by Justices Marshall, White, and Brennan and the dissent by Justice Douglas are omitted.]

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Recall the significant difference between business interest and investment interest, discussed in Chapter 16. Section 163 does not limit the amount of business interest that can be deducted in any one year (though other Code sections may step in to limit the deduction of business interest, such as § 469). In comparison, § 163(d) limits the deduction of investment interest in any year to the amount of net investment income included in the same year, with the remainder carried forward for possible deduction in future years.

Also recall from Chapter 1, Part B., that many investment deductions are Itemized Deductions because not listed in § 62, while the business deductions of a non-employee (and even some employees of certain types or to the extent that the amounts are reimbursed by the employer under an accountable plan) are taken above the line.[100] Furthermore, many of these investment Itemized Deductions (though not all) are subject to reduction under the 2% floor described in § 67 for regular tax purposes and are completely disallowed under the Alternative Minimum Tax.[101] In a similar vein, the allowable gambling losses (under § 165(d)) deducted by the non-professional gambler are Itemized Deductions, worthless to the non-Itemizer, though they are protected from both reduction under § 67 and disallowance under § 56(b)(1)(A)(i).[102] The professional gambler who can establish that he engages in gambling as a business, in contrast, can deduct his allowable gambling losses (under § 165(d)) above the line under § 62(a)(1). In addition, the professional gambler may be able to deduct related business travel expenses under § 162(a)(2), which the casual gambler cannot deduct, as discussed in Chapter 19, Part A.

Finally, consider the difference between a "trader" in stock and securities and a mere investor. A "trader," who is considered to be engaged in a trade or business, seeks to benefit from short-term fluctuations in market prices—an artifact of the market itself—rather than from long-term growth or profitability in the underlying business. Another important effect of "trader" status is the ability to elect mark-to-market accounting under § 475(f), under which the owner includes the appreciation in the security's value at year's end (or deducts the loss in value), adjusting basis, accordingly. The benefit obtained thereby is that these gains and losses are transformed from capital to ordinary. As traders, by definition, rarely realize long-term gain (and thus do not benefit from the reduced tax rate for net capital gain if this gain is considered capital gain), transforming their trading (short term) capital gains and losses into ordinary gains and losses has only the beneficial effect of avoiding the § 1211(b) capital loss limitation rule. The threshold for reaching "trader" status is quite steep, however.

In *Assaderaghi v. Commissioner*,[103] for example, the taxpayer had a full-time job earning $230,000 when he began buying and selling securities in 1994 and began trading options in 1995. After a decade, these activities increased significantly. For tax years 2008 and 2009, he claimed trader status.

His trading increased from fewer than 100 trades in 2005 to 535 trades in 2008. He

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[100] *See* § 62(a)(1).
[101] *See* § 56(b)(1)(A)(i).
[102] *See* § 67(b)(3).
[103] T.C. Memo. 2014-33.

> made 180 trades in 2009. Of those trades, 214 in 2008 and 34 in 2009 were trades of the same security during the same market day (same-day trades).[7] Thus, 40% of Mr. Assaderaghi's trades were same-day trades in 2008 and 19% were same-day trades in 2009.
>
> Mr. Assaderaghi executed trades on 154 days in 2008 and 94 days in 2009. More than half of the 535 trades made in 2008 were executed in January, June, and July. He traded on fewer than 10 days in the months of February, August, and October 2008 and on fewer than 10 days in each month from January through June 2009. Mr. Assaderaghi made zero trades in February 2009.
>
> …
>
> A taxpayer's trading activities constitute a trade or business within the meaning of section 162(a) where both of the following requirements are satisfied: (1) the taxpayer's trading is substantial, and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from those short-term changes rather than to profit from the long-term holding of investments. *See, e.g., Mayer v. Comm'r*, T.C. Memo. 1994-209. In determining whether a taxpayer's trading activity is substantial, we consider the number of trades executed in a year, the amount of money involved in those trades, and the number of days on which trades were executed. *See Nelson v. Comm'r*, T.C. Memo. 2013-259; *Endicott v. Comm'r*, T.C. Memo. 2013-199.

Applying these tests, the Tax Court concluded that Mr. Assaderaghi did not trade with sufficient frequency to qualify as a trader.

> "In the cases in which taxpayers have been held to be traders in securities, the number and frequency of transactions indicated that they were engaged in market transactions almost daily for a substantial and continuous period, generally exceeding a single taxable year; and those activities constituted the taxpayers' sole or primary income-producing activity." *Chen v. Comm'r*, T.C. Memo. 2004-132, 2004 WL 1194625, at *4 (citing *Levin v. U.S.*, 597 F.2d 760 (Ct. Cl. 1979), and *Fuld v. Comm'r*, 139 F.2d 465 (2d Cir. 1943), aff'g 44 B.T.A. 1268 (1941)). Conversely, where the taxpayer's daily trading activities covered only a portion of the year and securities trading was not the sole or even primary income-producing activity, trader status was denied. *See id.* (citing *Paoli v. Comm'r*, T.C. Memo. 1991-351). Indeed, daily trading in securities for a portion of the taxable year may be reasonably characterized as "sporadic" rather than "frequent, regular, and continuous", and therefore insufficient to achieve trader status. *Id.* (citing *Boatner v. Comm'r*, T.C. Memo. 1997-237, and *Comm'r v. Groetzinger*, 480 U.S. 23, 35 (1987)).
>
> We conclude that the number of days on which and the frequency with which Mr. Assaderaghi executed trades do not evidence the frequency, continuity, and regularity necessary to constitute a trade or business.[18]

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[7] The purchase and sale of the same security during the same market day is also known as a "round trip" day trade. Mr. Assaderaghi's 214 same-day trades in 2008 and 34 same-day trades in 2009 are the equivalent of 107 and 17 round trip trades in 2008 and 2009, respectively.

[18] Mr. Assaderaghi's employment—and substantial income unrelated to his securities activity—during the years at

For a taxpayer to be a trader he also must seek to catch the swings in the daily market movements and profit from these short-term changes. *Kay v. Comm'r*, T.C. Memo. 2011-159 (citing *Mayer v. Comm'r*, T.C. Memo. 1994-209). To determine whether a taxpayer seeks to catch the swings in the daily market the Court reviews the holding period of the securities. *See Estate of Yaeger v. Comm'r*, 889 F.2d at 33; *Mayer v. Comm'r*, T.C. Memo. 1994-209. In *Holsinger*, we held that the taxpayer did not seek to catch the swings in the daily market because a significant amount of his stock was held for more than 31 days. Similarly, in *Kay*, we held that the taxpayer was not a trader because most of his stocks were held for over 30 days.

In 2008 Mr. Assaderaghi executed 214, or 40%, of his trades as same-day trades. In 2009 he executed 34, or 19%, of his trades as same-day trades. The parties disagree on the holding periods for Mr. Assaderaghi's remaining 321 trades in 2008 and 146 trades in 2009. On the record before us, we find that petitioners have failed to carry their burden of establishing, see Rule 142(a), and the record does not otherwise establish, the holding periods for the remaining securities traded by Mr. Assaderaghi. As a result, we cannot conclude that Mr. Assaderaghi sought to profit from the swings in the daily market.[20]

On the basis of the foregoing, we conclude that Mr. Assaderaghi's trading activity did not constitute a trade or business in 2008 or 2009. Petitioners are therefore limited to a $3,000 deduction of losses from the purchase and sale of securities under section 1211(b) for each year in issue.

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issue as the vice president of engineering at SiTime also supports a finding that he was not a trader in securities. *See* Paoli v. Comm'r, T.C. Memo. 1991-351 (finding the taxpayer's management services and substantial service income relevant in concluding that the taxpayer was not a trader in securities).

[20] Assuming arguendo that petitioners did establish that Mr. Assaderaghi sought to catch the swings in the daily market movements and to profit from those short-term changes, we would still conclude that he was not in the trade or business of being a securities trader. *See* Mayer v. Comm'r, T.C. Memo. 1994-209 (holding that a taxpayer's trading activities constitute a trade or business within the meaning of sec. 162(a) where both of the following requirements are satisfied: (1) the taxpayer's trading is substantial and (2) the taxpayer seeks to catch the swings in the daily market movements and to profit from those short-term changes rather than to profit from the long-term holding of investments).

# Unit VII:

# The Taxable Year and Methods of Accounting

## Introduction to Chapters 21 and 22

In this final unit, we shall examine the taxable year concept and the two major methods of accounting for Gross Income and expense items.

A tax on income could theoretically be imposed only at the end of a taxpayer's life, when we can know for certain the precise net profit earned throughout his or her lifetime. Because of the obvious administrative difficulties such an approach would impose, however, the law must artificially segregate the taxpayer's life into arbitrary accounting periods, measure the tax base during each period, and require the payment of tax shortly after the end of that measuring period. For the sake of convenience, the Internal Revenue Code typically adopts periods of one year, shortly after the end of which the taxpayer's Taxable Income is measured and tax is paid. We have referred to this rule of convenience as "the annual accounting principle," and we have already observed violations of it, most notably the realization requirement, which delays reckoning of gains and losses in property value until a realization event occurs, such as with sale, exchange, casualty, or theft. Chapter 21 shall revisit the annual accounting tax principle and consider two additional provisions.

Chapter 22 will explore the two most common methods of accounting that govern the timing of Gross Income inclusions and expense deductions: the cash method of accounting and the accrual method of accounting. While you were introduced to the basic rules in Chapter 10, Part C., here we delve more deeply into the history and development of the law, as well as examine the operative rules in more detail.

# Chapter 21: The Taxable Year

As a theoretical matter, Congress could delay the payment of income tax until the end of a taxpayer's life and the determination of the taxpayer's aggregate realized income (or loss) over his entire lifetime. As such an approach would be impractical, however, Congress requires that tax be figured and paid after the end of each "taxable year," defined in § 441 as either the calendar year or a fiscal year, with the latter further defined in § 441(e) as a 12-month period "ending on the last day of any month other than December." A taxable year is usually determined by the way in which the taxpayer keeps his books and records and is effectively adopted by the filing of the first tax return using a particular taxable year.[1] Thereafter, a taxpayer generally must obtain permission to change its taxable year under § 443 in order that income does not slip through the cracks in the change year. The taxable year of most individuals is the calendar year. Some taxpayers, particularly corporations, may use a fiscal year to better conform to, say, a seasonal business.

While clearly necessary as an administrative matter, artificially segmenting our lives into yearly periods creates some tensions regarding how events and expectations in one year should (or should not) affect tax consequences in another. This chapter first reviews the "annual accounting principle" and topics that we have considered throughout this textbook that implicate it. Two additional facets of the annual accounting principle that we have not yet discussed is the tax benefit rule, considered in Part B., and the net operating loss deduction, explored in Part C.

## A. The annual accounting principle in general

The "annual accounting principle" was first introduced in Chapter 1 and has been revisited many times since then. In general, the annual accounting principle requires that Gross Income (wealth accessions) and deductions (wealth reductions) be determined based upon facts (and expectations) known as of each current year. The most significant deviation from the annual accounting principle is the realization requirement, under which wealth increases and decreases in the form of changes in property value are ignored until a realization event, such as a sale or exchange of the property. But we have considered other aspects of the annual accounting principle, as well, several of which are briefly reviewed below.

***The borrowing exclusion***

The borrowing exclusion (studied in Chapter 10) is another significant deviation from the annual accounting principle in that cash in hand that is not basis recovery is nevertheless permitted to be excluded from the tax base solely because of what we believe will happen in a *future* year: repayment with after-tax (undeducted) dollars. This deviation permits tax-free dollars to be invested and to earn a return. Though the return is nominally included in the tax base, it is effectively free from tax (as under a consumption tax of the wage tax variety) between the time the return is received and the underlying principal is repaid with after-tax dollars. More important, while basis generally consists of previously taxed dollars to implement the precept that the same dollars should not provide a double tax benefit for the same taxpayer, pre-tax borrowed dollars can immediately create basis under *Crane*, which can be immediately deducted under § 179 or

[1] *See* §§ 441(a) through (c); Treas. Reg. § 1.441-1(c)(1).

depreciated under §§ 167, 168, and 197.

The borrowing exclusion privilege was likely borrowed (pun intended) in the early days of the income tax in a reflexive manner from financial accounting (under which borrowed funds are also excluded from the "income" statement of businesses) before the differences between income taxation and consumption taxation (and the E. Cary Brown yield-exemption phenomenon discussed in Chapter 2) were well understood. It continues today, no doubt, because of the ease of administration that the borrowing exclusion presents: the routine borrowing and repayment of principal typically has no tax effects for either the borrower or lender. Nevertheless, this favorable treatment, while perhaps necessary as an administrative matter, produces many well-known distortions and opportunities for tax shelter activity, including those described above.

***§ 61(a)(12) debt-discharge income***

If borrowed cash were included in the tax base on receipt (contrary to current law), repayment of principal would be deductible (also contrary to current law). In that pretend world, a borrower who failed to repay principal would simply lose her repayment deduction, and we would need no special tax rule to account for the failure to repay. Under real-world current law, however, the failure to repay principal must generally create a Gross Income inclusion to prevent the complete forgiveness of tax on the earlier "borrowed" amount (which would have been taxed indirectly when repaid with undeducted, after-tax dollars), as you learned in Chapter 11. That is to say, the obligation to repay was the *only* fact that prevented the earlier cash receipt from being included in Gross Income upon receipt. Once the obligation to repay disappears, the justification for the earlier exclusion also disappears. Under the annual accounting principle, however, the borrower is not permitted to file an amended return for the earlier year (even if the statute of limitations remains open) because exclusion was *proper* based on the facts known in that year (the expectation that the amount would be repaid with after-tax dollars). Rather, we account for the changed expectations by creating a Gross Income inclusion in that later year under § 61(a)(12) and the annual accounting principle, which may, under certain circumstances, be excluded under § 108(a), with reduction of tax attributes under § 108(b).

***Receipts subject to a contingent obligation to repay***

Because the borrowing exclusion is an extraordinary privilege, you learned in Chapter 10 that taxpayers have attempted to exclude all sorts of cash receipts under it, such as embezzled and extorted funds. *James*[2] and *North American Oil*,[3] however, combine to limit the borrowing exclusion to those receipts accompanied by an *unconditional* obligation to repay that is recognized by the parties at the time of transfer and receipt. Thus, even though an embezzler has a legal obligation to repay embezzled funds if caught, embezzled funds are not excludable under the borrowing exclusion. Repayment in a later year can raise a deduction issue in that later year under the annual accounting principle.

*North American Oil* confirms that a receipt subject only to a *contingent* obligation to repay (should certain facts arise) is usually includable immediately (in the year of receipt) under the annual accounting principle. If the contingency ripens, resulting in repayment in a later year, the changed circumstances will once again be dealt with in that later year, usually in the form of either a § 165 deduction or § 1341 credit, under the annual accounting principle. You learned in Chapter

[2] James v. U.S., 366 U.S. 213 (1961).
[3] North Am. Oil Consol. v. Burnet, 286 U.S. 417 (1932).

5, however, that a major exception to this approach is found in § 83. The value of property received as compensation for services rendered that may have to be repaid if certain contingencies ripen is *not* included in Gross Income in the year of the property's receipt. Rather, inclusion is delayed until the substantial risk of forfeiture lapses, absent election under § 83(b). If the taxpayer makes the § 83(b) election, which results in inclusion in the year of receipt under the usual approach that receipts subject only to a contingent obligation to repay are immediately includable, the taxpayer loses his deduction if the contingency ripens and repayment occurs (even though she wouldn't lose her deduction if the matter were analyzed under the common law rule rather than under the statute).

***Depreciation recapture and the Arrowsmith doctrine***

You learned in Chapter 14 that depreciation and amortization (under §§ 167, 168, and 197) and § 179 deductions are ordinary, offsetting high-taxed income. Because such deductions are intentionally accelerated in many instances, depreciated assets can often be sold at a gain under § 1001 because of the § 1016(a)(2) basis reduction that accompanies such accelerated deductions. Absent special rules, the resulting gain could often qualify as low-taxed capital gain because the asset is often a capital asset or § 1231 property, resulting in tax arbitrage of the rate differential. Thus, you learned in Chapter 15 that § 1245 (which would not be necessary absent the rate reduction for net capital gain) recaptures the gain realized on the sale of non-real estate as ordinary gain to the extent of prior depreciation. The depreciation recapture rule found in § 1250, however, which applies to real property, is essentially a dead letter today.[4]

The *Arrowsmith* doctrine,[5] also discussed in Chapter 15, operates under similar reasoning. A current-year inclusion or deduction is capital to the extent that it effectively reverses the effect of a prior-year capital gain inclusion or capital loss deduction. Mr. Arrowsmith paid a liability as the successor in interest to a corporation that liquidated in an earlier year. If the corporation had paid the liability in a timely manner before liquidation, Mr. Arrowsmith would have realized less capital gain (or a larger capital loss) on the liquidation distribution that retired his stock. Thus, the Mr. Arrowsmith's transactionally related later payment must be characterized as a capital loss.

## B. The tax benefit rule

The tax benefit rule is closely related to the analysis underlying depreciation recapture and the *Arrowsmith* doctrine. While those rules address how to *characterize* a gain or payment (as ordinary, capital, or § 1231 gain or loss) when it is transactionally related to an earlier inclusion or deduction, the tax benefit rule generally addresses whether a current-year receipt must be *included* in Gross Income at all in light of its transactional connection to an earlier payment or loss.

The tax benefit rule had its origins in the common law, as reflected in *Dobson v. Commissioner*,[6] though it was later codified in § 111. Mr. Dobson purchased stock in 1929 in a public offering by the corporation. Bad timing! After the crash, he sold the stock at substantial losses in 1930 and 1931. Even though the losses were listed as deductions on his tax returns, he enjoyed no tax benefit

[4] The gain recaptured as ordinary income under § 1250 is the excess of actual depreciation taken over the amount that would have been deducted using the straight-line method of depreciation. By requiring all real property put into service after 1986 to be depreciated using the straight-line method, the Tax Reform Act of 1986 essentially rendered § 1250 impotent. Nevertheless, § 1(h) applies a maximum net capital gain rate of 25% (rather than 15% or 20%) to such gain to the extent that it would have been recaptured as ordinary gain if § 1245 had applied. *See* Chapter 15, Part E.
[5] This doctrine is named for the case that produced it: Commissioner v. Arrowsmith, 193 F.2d 734 (2d Cir. 1952).
[6] 320 U.S. 489 (1943).

from the deductions because his Taxable Income was already at zero (from other deductions) without regard to these particular stock loss deductions. In other words, even absent the additional stock loss deductions, the taxpayer's remaining deductions would nonetheless have exceeded his Gross Income in 1930 and 1931. Thus, he realized no tax benefit from these stock loss deductions.

In 1936, the taxpayer learned that the company had not complied with state laws governing the stock issuance. In addition, he "learned of facts indicating that he had been induced to purchase by fraudulent representations."[7] He sued the company and recovered more than $45,000 in a 1939 settlement, none of which he included on his 1939 return. When the government argued that the entire amount was includable in 1939 as ordinary income, the taxpayer litigated in the Tax Court, arguing in the alternative that (1) none of the recovery was includable or (2) any includable portion would properly be characterized as capital gain and not ordinary income. Notice how the second argument is based on what we would today call the *Arrowsmith* doctrine, though *Dobson* predated *Arrowsmith*: if he had to include a recovery of a portion of his prior losses, the inclusion should be capital because effectively representing a recovery of his prior capital losses.

The Tax Court agreed with the taxpayer's first argument, however, that *none* of the recovery was includable because he realized no tax benefit from the prior loss deductions. The Supreme Court described the Tax Court holding as follows:

> The recovery upon the shares sold was not, however, sufficient to make good the taxpayer's original investment in them. And if the amounts recovered had been added to the proceeds received in 1930 and 1931 they would not have altered [the taxpayer's] income tax liability for those years, for even if the entire deductions claimed on account of these losses had been disallowed, the returns would still have shown net losses.[8]

The Circuit Court of Appeals reversed, arguing that "the Tax Court's decision 'evaded or ignored' the statute of limitation, the provision of the Regulations that 'expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year,' and the principle that recognition of a capital loss presupposes some event of 'realization' which closes the transaction for good."[9]

The Supreme Court, in turn, disagreed with the Circuit Court of Appeals:

> We do not agree. The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital.[10]

Section 111(a) now codifies the exclusionary aspect of the tax benefit rule. The flip side, of course, is the *inclusionary* aspect of the tax benefit rule. If a taxpayer recovers an amount in Year

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[7] *Id.* at 491.
[8] *Id.*
[9] *Id.* at 492.
[10] *Id.* at 493.

2 that *did* reduce positive Taxable Income in Year 1 (producing a Year-1 tax benefit), he must include the Year-2 recovery if we are to honor the maxim that the same dollars should not provide a double tax benefit to the same taxpayer. If the Year-1 deduction was a capital loss, the Year-2 inclusion would be capital gain under the *Arrowsmith* doctrine.

How does § 111 apply when the Year-1 deduction is an Itemized Deduction, which you learned in Chapter 1, Part B., provides a tax benefit *only* to the extent that the aggregate of Itemized Deductions exceeds the Standard Deduction?

**REVENUE RULING 92-91**

1992-2 C.B. 49

ISSUES

(1) Is an interest overcharge, which a homeowner paid as the result of a financial institution's miscalculation of interest on an adjustable rate mortgage (ARM), deductible by the homeowner in the year of payment as qualified residence interest under section 163(h)(3) of the Internal Revenue Code?

(2) Is the homeowner's recovery of the interest overcharge in a subsequent year includible in the homeowner's gross income in the year of recovery if the homeowner's deduction of the interest overcharge reduced the homeowner's federal income tax in a prior tax year?

FACTS

In 1990, *BK*, a financial institution that services and owns home mortgages, notified *A*, an individual homeowner, that *A* was required to pay interest in the amount of $10,000 on an ARM for 1990. *A*, who is a calendar year taxpayer, uses the cash receipts and disbursements method of accounting, and files a joint federal income tax return, paid *BK* $10,000 as interest due on the ARM in 1990. BK included the $10,000 as interest on the Form 1098, Mortgage Interest Statement, that it filed with the Internal Revenue Service for the 1990 calendar year and on the copy of the Form 1098 that it sent to *A* for that year.

The ARM obtained by *A* from *BK* at all times qualified as either acquisition indebtedness or home equity indebtedness with respect to a qualified residence of *A*, so that the interest *A* paid to *BK* on the ARM would be qualified residence interest under section 163(h)(3) of the Code. Thus, *A* deducted the $10,000 *A* paid to *BK* as qualified residence interest on *A's* 1990 federal income tax return that *A* timely filed in April of 1991. *A's* total itemized deductions for 1990 were $15,000 (including the $10,000 A paid to *BK*). The standard deduction that *A* could have claimed in 1990 was $5,450.

In June of 1991, *BK* discovered a $700 overcharge of the interest due on *A's* ARM in 1990. BK immediately paid *A* $750, an amount that represented a refund of the $700 interest overcharge and $50 in interest on that overcharge. *A* included the $700 interest overcharge and the $50 in interest in gross income for 1991.

LAW AND ANALYSIS

*Issue 1: Interest Deduction*

Section 163(a) of the Code generally allows a deduction for all interest paid or accrued within the taxable year on indebtedness.

Although section 163(h)(l) of the Code provides that no deduction for personal interest is allowed to noncorporate taxpayers, section 163(h)(2)(D) provides that personal interest does not include qualified residence interest.

Under section 163(h)(3)(A) of the Code, "qualified residence interest" generally is defined as any interest that is paid or accrued on acquisition indebtedness or home equity indebtedness with respect to any qualified residence of the taxpayer. Under section 163(h)(3)(B), "acquisition indebtedness" is any indebtedness that is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer and is secured by such residence. Under section 163(h)(3)(C), "home equity indebtedness" is any indebtedness (other than acquisition indebtedness) secured by a qualified residence. In general, acquisition indebtedness may not exceed $1,000,000, and home equity indebtedness may not exceed $100,000.

Section 461 of the Code provides that the amount of any deduction or credit allowed by subtitle A of the Code shall be taken for the taxable year that is the proper taxable year under the method of accounting used in computing taxable income.

Section 1.461-1 of the Income Tax Regulations provides that under the cash receipts and disbursements method of accounting, amounts representing allowable deductions generally must be taken into account for the taxable year in which they are paid.

As a general rule, a taxpayer is not allowed a deduction for a payment for which no liability exists or reasonably appears to exist. *See Kenyon Instrument Co. v. Comm'r*, 16 T.C. 732 (1951) (court denied a deduction for state franchise taxes to the extent the taxpayer knew it was not liable for the taxes).

However, when a taxpayer is notified that payment of a liability is due, and the taxpayer in good faith pays the liability, the taxpayer may properly deduct the payment (if a deduction is otherwise allowable) in the taxable year it is made, even though the payment is determined to be erroneous in a subsequent taxable year. *See Baltimore Transfer Co. v. Commissioner*, 8 T.C. 1 (1947), acq., 1947-2 C.B. 1, in which the court allowed a taxpayer to deduct overpayments made to a state unemployment compensation fund in one year that were based on an erroneous notification to the taxpayer by the fund that was not corrected until the following tax year. The court concluded that the taxpayer acted reasonably in accepting as correct the fund's administrative determination of the amount owed by the taxpayer.

In this case, *BK* notified *A* of the interest due on the ARM for 1990 and *A*, in good faith, paid this amount in 1990. *BK* did not inform *A* until June of 1991 that *BK* had erroneously determined (and billed *A* for) the amount of interest due on the ARM. Therefore, on *A'* 1990 Federal income tax return, *A* properly deducted the $700 overpayment *A* made to *BK* in 1990 as qualified residence interest under section 163 of the Code.

*Issue 2: Income Inclusion*

Section 61 (a) of the Code provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Section 61(a)(4) provides that interest is an item of gross income.

Section 111 of the Code excludes from gross income amounts attributable to the recovery during the taxable year of any amount deducted in any prior year to the extent that the amount did not reduce the amount of tax imposed by chapter 1 of subtitle A of the Code.

Section 111 of the Code is a partial codification of the tax benefit rule, which generally requires the inclusion in income of amounts that were deducted by a taxpayer in a prior tax year to the extent those amounts generated a tax benefit to the taxpayer through a reduction in the amount of tax liability in the prior tax year. *See generally, Estate of Block v. Comm'r*, 39 B.T.A. 338 (1939), *aff'd sub nom. Union Trust Co. v. Comm'r*, 111 F.2d 60 (7th Cir. 1940), *cert, denied*, 311 U.S. 658 (1940). The tax benefit rule is applied when a subsequent event occurs which is fundamentally inconsistent with the premise on which an earlier deduction was based. The purpose of the rule is to achieve rough transactional parity within the framework of a tax system requiring annual calculations. *See Hillsboro National Bank v. Comm'r*, 460 U.S. 370 (1983).

The amount of an interest over-charge reimbursement that is includible in gross income under the tax benefit rule is the lesser of (1) the reimbursement, or (2) the amount by which the taxpayer's itemized deductions in the year of the interest over-charge exceeded the standard deduction.

In this case, *A* received a $700 reimbursement in 1991 attributable to *A's* 1990 mortgage interest deduction. The $700 reimbursement is less than $9,550, the amount by which *A's* total itemized deductions in 1990 ($15,000) exceeded the standard deduction ($5,450) that A could have claimed for that year. Therefore, the tax benefit rule requires that *A* include the $700 reimbursement in *A's* gross income in 1991. In addition, the $50 in interest on the $700 reimbursement that *A* received must be included in *A's* gross interest in 1991 under section 61 (a) (4) of the Code.

HOLDINGS

(1) An interest overcharge, which a homeowner paid as the result of a financial institution's miscalculation of interest on an adjustable rate mortgage (ARM), is deductible by the homeowner in the year of payment as qualified residence interest under section 163(h)(3) of the Code.

(2) The homeowner's recovery of the interest overcharge in a subsequent year is includible in the homeowner's gross income in the year of recovery to the extent that the homeowner's deduction of the interest overcharge reduced the homeowner's federal income tax in a prior tax year. This result requiring income inclusion in the year of recovery is the same whether the financial institution refunds the interest overcharge to the homeowner or reduces the outstanding principal on the homeowner's mortgage by the amount of the interest overcharge.

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The tax benefit rule can be triggered even if no actual cash refund or recovery is received of an amount previously deducted. Note the reference in the above ruling to *Hillsboro National Bank* and the ruling's statement of the holding in that case: "The tax benefit rule is applied when a subsequent event occurs which is fundamentally inconsistent with the premise on which an earlier deduction was based." An actual cash refund or recovery of an outlay or loss, as occurred in both *Dobson* and the ruling, is merely the most common example of an event that is "fundamentally inconsistent with the premise on which earlier deduction was based."

Suppose, for example, that Ann properly deducts in Year 1 under § 162 the cost of office supplies, fully expecting the supplies to be used in her sole proprietor business.[11] In Year 4, however, the taxpayer converts the supplies to personal use by taking them home for use by her children in doing their homework and creating craft projects. While Ann realized no "recovery"

[11] Recall from Chapter 4 that the cost of materials and supplies of low value are categorized as a current "expense" rather than as a nondeductible "capital expenditure."

of the amount that she paid to the office supply store in purchasing the supplies, converting the supplies to her personal use is an event that is "fundamentally inconsistent" with the premise of her earlier § 162 deduction—that the supplies would be used in her business. Thus, Ann must include in her Year-4 Gross Income the amount deducted in Year 1 with respect to the supplies that she took home.

In *Hillsboro National Bank*, Justice O'Connor gave another example, explored the rationale supporting extension of the tax benefit rule beyond actual recoveries, and provided a test to determine whether the event is one that is "fundamentally inconsistent" with the prior deduction.[12]

> An examination of the purpose and accepted applications of the tax benefit rule reveals that a "recovery" will not always be necessary to invoke the tax benefit rule. The purpose of the rule is not simply to tax "recoveries." On the contrary, it is to approximate the results produced by a tax system based on transactional rather than annual accounting…. It has long been accepted that a taxpayer using accrual accounting who accrues and deducts an expense in a tax year before it becomes payable and who for some reason eventually does not have to pay the liability must then take into income the amount of the expense earlier deducted. *See, e. g., Mayfair Minerals, Inc. v. Comm'r*, 456 F.2d 622 (CA5 1972) (per curiam); *Bear Manufacturing Co. v. U.S.*, 430 F.2d 152 (CA7 1970), cert. denied, 400 U.S. 1021 (1971); *Haynsworth v. Comm'r*, 68 T.C. 703 (1977), affirmance order, *609 F.2d 1007 (CA5 1979); G.M. Standifer Construction Corp. v. Comm'r*, 30 B.T.A. 184, 186-187 (1934), petition for review dism'd, 78 F.2d 285 (CA9 1935)….
>
> The basic purpose of the tax benefit rule is to achieve rough transactional parity in tax and to protect the Government and the taxpayer from the adverse effects of reporting a transaction on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, *if that event had occurred within the same taxable year, it would have foreclosed the deduction*. In some cases, a subsequent recovery by the taxpayer will be the only event that would be fundamentally inconsistent with the provision granting the deduction.[13]

If Ann had brought the office supplies home for her children's use in the same year in which she bought them, she would not have been permitted to deduct the cost of the supplies as a business expense under § 162. Thus, taking the supplies home to her children in a year subsequent to their purchase (and deduction) is an event that is "fundamentally inconsistent" with the § 162 deduction and requires Ann to include in Gross Income the amount previously deducted.

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[12] The facts of the case dealt with corporate tax provisions that are beyond the scope of this course (and have been amended since the case was decided in any event).

[13] Hillsboro Nat'l Bank v. Comm'r, 460 U.S. 370, 381-84 (1983) (emphasis added).

**Problem**

Assume that the Standard Deduction for Year 1 is $7,000. In Year 1, Leo deducts $7,600 in Itemized Deductions, which reduces his Taxable Income, though he still owes tax for the year. Among his Itemized Deductions is the payment of a local real property tax imposed on his personal residence, which is deductible under § 164(a). In Year 3, the local tax assessor determines that it had miscalculated the real property tax owed by Leo in Year 1 by $1,000, which it sends to him in Year 3. How much, if any, of the $1,000 receipt must Leo include in his Gross Income in Year 3?

## C. Net operating losses

Notice how the taxpayer in the case below made an argument similar to the one that carried the day in *Dobson*, decided in 1943, though the case below predates *Dobson*.

**BURNET v. SANFORD & BROOKS COMPANY**

282 U.S. 359 (1931)

MR. JUSTICE Stone delivered the opinion of the Court.

In this case certiorari was granted to review a judgment of the Court of Appeals for the Fourth Circuit, 35 F.2d 312, reversing an order of the Board of Tax Appeals, 11 B.T.A. 452, 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, 53 Ct. Cls. 490, was affirmed by this Court in 1920. *U.S.* 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 §§ 230, 232 and 234(a) of 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. By §§ 233(a) and 213(a) gross income "includes . . . income derived from … businesses … 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 U.S.* v. *Anderson*, 269 U.S. 422; *Aluminum Castings Co*. v. *Routzahn*, *ante*, p. 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*, p. 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. *See Pollock* v. *Farmers' Loan & Trust Co*., 158 U.S. 601, 630. 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 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 under § 212(b), 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 U.S.* v. *Anderson*, and *Aluminum Castings Co*. v. *Routzahn, supra*. The other was under Treasury Regulations (Art. 121 of Reg. 33 of Jan. 2, 1918, under the Revenue Acts of 1916 and 1917; Art. 36 of Reg. 45, Apr. 19, 1919, under the Revenue Act of 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.

The Court of Appeals said that the case of the respondent here fell within the spirit of these regulations. But the court did not hold, nor does respondent assert, that it ever filed returns in compliance either with these regulations, or § 212(b), 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. *U.S.*, 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.

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The Court noted regulations pertaining to "income derived from certain long-term contracts," under which "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." The first of these methods of accounting for long-term contracts is called the "completed-contract method of accounting," and the second is referred to as the "percentage-of-completion method." If the Sanford & Brooks Company had been able to use the completed-contract method, it appears that it might effectively have obtained its desired result, as the earlier contract litigation stipulated that the award was "made upon the contract." Nevertheless, the Court implied that the taxpayer failed to file its returns in compliance with the Treasury regulation at issue. Today, these complex rules are found in § 460 and Treas. Reg. § 1.460-4 and are not further considered here.

Was not Sanford & Brooks in a very similar position to the taxpayer in *Dobson*? Both taxpayers realized more deductions than Gross Income in Year 1 (with the excess thus providing no tax benefit) and subsequently recovered (via law suits) a portion of their earlier losses in Year 2. Mr. Dobson succeeded in avoiding inclusion of his recovery in 1939, but Sanford & Brooks was not so fortunate in 1931. The Supreme Court appeared to hold that the annual accounting principle prevented the taxpayer's desired result and, in the final paragraph, punted to Congress for relief.

Congress obliged by enacting the predecessor to § 172. **Sections 172(c) and (d) generally define a "net operating loss" (NOL) for any year as the excess of the taxpayer's business deductions (and any personal casualty or theft loss allowed under § 165(c)(3)) over the sum of business Gross Income and any remaining investment Gross Income not absorbed by nonbusiness deductions**.[14] Under §§ 172(b)(1) and (2), an NOL for any particular year is first carried back to the second preceding taxable year, then to the immediately preceding taxable year, and finally forward for the next 20 taxable years until it is either used or expires unused. To the extent that the NOL can be carried back (because the taxpayer had positive Taxable Income in either or both of the years preceding the NOL year), the taxpayer files an amended return (as those years are still open years under the general three-year statute of limitations), taking the § 172 NOL deduction and thereby obtaining a tax refund.

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[14] Section 172(c) initially appears to allow *all* deductions and *all* Gross Income to be taken into account in determining the taxpayer's NOL, but §§ 172(d)(3) and (4) quickly disabuse us of this notion. Combined, they provide that (1) the § 151 Personal Exemption and Dependent Deductions are not taken into account and (2) the remaining nonbusiness deductions (*e.g.*, alimony, the Standard Deduction for those who do not itemize, the personal deductions, investment expenses deductible under § 212, *etc.*) are taken into account only to the extent of investment Gross Income, although a personal casualty or theft loss is treated as a business deduction for this purpose. Thus, the personal and investment deductions in excess of investment Gross Income cannot create or increase an NOL, with the exception of personal casualty or theft losses. When the smoke clears, § 172 creates an NOL, in broad description, only to the extent that *business deductions* (and any personal casualty or theft loss) exceeds the sum of business Gross Income and any remaining investment Gross Income not absorbed by nonbusiness deductions. Of course, any NOL carryover or carryback from another year is also not taken into account in determining a particular year's NOL. *See* § 172(d)(1).

A taxpayer can waive the carryback period under § 172(b)(3) and carry the NOL only forward. Why would a taxpayer consider making that election in view of the time value of money? What if the taxpayer believes that the business is about to take off and that future Taxable Income will fall in a significantly higher tax bracket than that applicable in the prior years?

Notice that § 172 provides broader relief than does the tax benefit rule (except for the 20-year time limit under the former). Section 111 can apply only if the cash received in the current year is transactionally related to the prior-year deductions (to the extent that the deductions provided no tax benefit). In contrast, a § 172 NOL can effectively reduce future Gross Income even though the future Gross Income has no factual connection to the prior-year deductions creating the NOL. Indeed, the taxpayer may have ended the business that created the NOL by the time the taxpayer can use the NOL to offset profits from an entirely different business in a later year.

In Chapter 16 (pertaining to tax shelters), you studied Code sections that can disallow certain net losses in Year 1 but permit the unused deductions to be carried forward indefinitely for possible use in a future year. For example, § 469 disallows the net loss arising in passive activities to be currently deducted, § 465 disallows net losses in excess of amounts "at risk" in the activity to be currently deducted, and § 163(d) disallows the deduction of investment interest in excess of net investment income in any year. In each of these cases, the disallowed net loss is permitted to be carried forward indefinitely for possible use in future years. In contrast to § 172, these provisions apply only to a segment or portion of the taxpayer's overall Gross Income and deductions and disallow the *sheltering* effect, *i.e.,* they prevent the net loss from offsetting other Gross Income realized by the taxpayer *in the same year*. Section 172, in contrast, arises only when a taxpayer's allowable business deductions from *all* sources (after applying provisions like §§ 469, 465, and 163(d)) exceeds Gross Income for the year, negating any tax liability. Section 172 permits the taxpayer's *overall* net loss for the year to be carried to other taxable years.

Recall that the Court rejected the taxpayer's tax benefit argument in 1931 in *Sanford & Brooks* but accepted it in 1943 in *Dobson*. Would § 111 apply today (with *Dobson* on the books) to permit a taxpayer in the position of Sanford & Brooks to exclude the lawsuit recovery? No. *See* § 111(c). Because § 172 is now in effect, a company like Sanford & Brooks would have a § 172 NOL for each of the earlier years in which its deductions exceeded Gross Income. So long as the company receives the lawsuit recovery in a year prior to the expiration of the 20-year carryover period, the company could not invoke § 111 to exclude the cash because the creation of the NOL under § 172 in the earlier years is presumed to save tax (thus providing a tax benefit) in some year. Indeed, the inclusion in Gross Income of the lawsuit recovery (because § 111 does not apply) could possibly allow the taxpayer to now use all or a portion of its § 172 NOL carryovers created in the earlier loss years (unless the taxpayer is overwhelmed with other deductions in the recovery year that exceeds all Gross Income, generating yet another NOL to carry forward).

## Problem

The Home Improvement Company realizes the following Taxable Income or net loss (deductions exceeding Gross Income) in each of the years indicated. Net losses are indicated by parentheses. How does § 172 apply to the Home Improvement Company?

| | | | |
|---|---|---|---|
| Year 1: $500,000 | Year 4: ($350,000) | Year 7: $100,000 | Year 10: $250,000 |
| Year 2: $250,000 | Year 5: $50,000 | Year 8: $150,000 | |
| Year 3: $25,000 | Year 6: ($10,000) | Year 9: ($25,000) | |

# Chapter 22: Methods of Accounting

A taxpayer's method of accounting governs *only* the timing of (1) Gross Income inclusions under § 61 and (2) expense deductions under those Code sections authorizing deduction of current expenses. The two primary methods of accounting are the cash method of accounting, considered in Part A., and the accrual method of accounting, explored in Part B. These discussions expand upon the brief introduction to these methods found in Chapter 10, Part C.

The taxpayer's method of accounting is irrelevant to other significant timing issues, such as the realization requirement and depreciation. The taxpayer's method of accounting also has no impact on the threshold issue (on the deduction side) regarding whether an outlay is properly categorized as a nondeductible capital expenditure or current expense or (on the income side) regarding whether a receipt constitutes Gross Income at all.

Section 448(a) requires use of the accrual method by C corporations (corporations taxed under the provisions of Subchapter C of the Internal Revenue Code instead of Subchapter S) and by partnerships or LLCs with a C corporation as a partner or owner. Three taxpayers are excused from mandatory use of the accrual method under § 448(b): farming businesses, qualified personal service corporations, and entities with average annual gross receipts of $5 million or less.

Some Code provisions and Treasury Regulations specifically describe how and when certain Gross Income items are to be reported. With respect to gains from property sales, for example, dealers selling inventory must generally use inventory accounting, which you studied in Chapter 13, Part A.[1] To the extent allowed under § 453, also studied in Chapter 13, Part A., eligible taxpayers receiving installment payments with respect to the sale of property may be able to report the § 1001 gain using the installment method. Finally, § 83 (studied in Chapter 5) controls the inclusion timing of § 61(a)(1) compensation received in the form of property subject to a substantial risk of forfeiture, a provision that will have relevance in connection with deferred compensation, considered below in connection with the cash method.

Taxpayers not required to use the accrual method can use either method under § 446(a), depending "on the basis of which the taxpayer regularly computes his income in keeping his books." The "books" of most individual taxpayers would be their checkbooks and credit/debit card statements, which record receipts and payments when made. Thus, most individuals who are employees or owners of a sole proprietorship (or wholly owned LLC) that sell services typically use the cash method of accounting.

A very important gloss on the determination of which method of accounting must be used (and how that method is to be interpreted) is found in § 446(b), which invests in the government broad power to challenge a taxpayer's method of accounting (either overall or for a particular item) if it "does not clearly reflect income." This broad power has been most important in the context of accrual accounting.

## A. The cash method of accounting

The cash method of accounting is fairly simple, except in the case of certain deferred

[1] *See* Treas. Reg. § 1.446-1(c)(2).

compensation arrangements governed by special Code provisions.

Under Treas. Reg. § 1.446-1(c)(1)(i), Gross Income is included when actually or constructively received, and expense deductions are taken when actually paid. Checks are generally considered cash equivalents for purposes of both inclusion and deduction. Thus, an employee with a calendar year as his taxable year who receives a paycheck on December 31 of Year 1 must include the Gross Income in Year 1, notwithstanding his failure to cash the check until January 2 of Year 2.[2]

The date of a payment made through the postal system will generally be governed by the postmark date. Thus, mailing a charitable contribution check to your favorite charity on December 30 of Year 1 would generally allow a Year-1 deduction, even though the charity does not receive the check in the mail until January of Year 2.

Suppose that Rachel, a calendar year taxpayer, charges to her credit card an otherwise deductible $200 charitable contribution on December 31 of Year 1 and pays her credit card balance by check in January of Year 2. In which year can Rachel deduct the $200 contribution under § 170? We can answer this question by first considering a closely related one. If Rachel uses a bank credit line to obtain $200 in cash that she uses to purchase office supplies for her business on December 31 of Year 1, her § 162 deduction is not delayed until she repays the bank under her line of credit in Year 2. Rather, the business expense is deductible when paid in Year 1, and her repayment of the borrowed cash used to purchase the supplies has no tax consequences (though the payment of interest on the borrowed cash would likely be deductible under § 163 as business interest). Rachel's charge to her credit card of a charitable contribution is analogized to a bank loan, which means that Rachel can deduct her charitable contribution in Year 1 (the year in which the charge is made).[3]

Notice that each of the above contexts (checks, a bank line of credit, and a credit card payment) involves three parties: the payor, the payee, and a third party bank or other financial institution as an intermediary. If, in contrast, Rachel simply promises on December 30 of Year 1 to pay $200 to the charity in Year 2 or promises on December 31 to pay the office supply vendor in Year 2, in each case transferring a note to that effect ("I.O.U. $200"), she is denied her expense deduction until Year 2 when paid.[4] A two-party note is too far away from a cash equivalent to constitute payment by a cash method payor. This remains true even if the note is secured or otherwise trades in an active market.[5]

Nevertheless, the cash method *recipient* of the two-party note may have to include the § 61 Gross Income represented by the note's fair market value (FMV) immediately *if* the note is made by a solvent obligor, is unconditional, is assignable, and is of a type frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium

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[2] Because tax returns need not be filed, generally speaking, until April 15 of the year following the taxable year (for a calendar year taxpayer), the recipient will know by the time the return is filed whether the check received on December 31 is not honored. In that case, no Year-1 inclusion is necessary.

[3] *See* Rev. Rul. 78-38, 1978-1 C.B. 68.

[4] *See* Rev. Rul. 76-135, 1976-1 C.B. 114.

[5] Notice that this rule—which denies *expense* deductions for the cash method payor until payments are made under the two-party note—differs significantly from the *Crane* rule (explored in Chapter 12) pertaining to the use of debt (even two-party debt) in purchasing property. Under *Crane*, the purchase debt creates valuable *basis* immediately, which can immediately begin to generate depreciation deductions, although the two-party debt must be *bona fide* if it is to create *Crane* basis. Review, for example, the *Knetsch* and *Estate of Franklin* cases in Chapter 16, Part A.

for the use of money.[6] In this case, the note is considered to be a cash equivalent by the payee, though not the payor. Thus, a lawyer that is paid for his services with a note of a type commonly sold to a bank or other buyer at a small discount from the face amount must include the FMV of the note on receipt, though the client who paid for those legal services with the note is denied deduction until payment is made under the note.[7] The note's value is typically a bit less than its face amount, as the note's buyer will discount the price that it pays for the note (to reflect both the time value of money and the risk of nonpayment).

***The constructive receipt doctrine***

Originally created in the common law, the constructive receipt doctrine is now memorialized in regulations. Treas. Reg. § 1.451-2(a) provides:

> 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.

For example, interest on a bank account balance is includable in the year credited, even if the taxpayer fails to withdraw the interest. If a depositor would forfeit substantial interest on early withdrawal under a contract (*e.g.*, a certificate of deposit), the interest will not be considered constructively received before the maturity date.[8] A taxpayer who purposefully fails to pick up a year-end bonus check on December 31 of Year 1 cannot defer inclusion until Year 2. The Tax Court held that a taxpayer was not in constructive receipt of a $1,000 lottery prize won on December 29 of Year 1 because he had to drive 136 miles round trip to pick up the check, which he did not do until Year 2, saying, "We will not confront taxpayers with the choice of traveling long distances to claim funds or face application of the constructive receipt doctrine."[9] The most interesting case of this type is *Hornung v. Commissioner*,[10] in which Paul Hornung was selected as the most valuable player in the N.F.L. championship game played on December 31, 1961, in Green Bay, Wisconsin. He learned at approximately 4:30 p.m. on that day that he won a Corvette automobile worth more than $3,300 (remember, this was 1961), which was waiting for him at a New York dealership. He actually received the car three days later at a luncheon in New York City. The Tax Court rejected the government's argument that Mr. Hornung had to include the car's fair market value in 1961 (rather than 1962) under the constructive receipt doctrine.

***Deferred compensation, the economic benefit doctrine, rabbi trusts, and § 409A***

Subchapter D of the Internal Revenue Code—§§ 401 through 436—contains the provisions that govern deferred compensation. This area of the law is highly complex, with the related Treasury

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[6] *See, e.g.*, Ennis v. Comm'r, 17 T.C. 465 (1951); Cowden v. Comm'r, 289 F.2d 20 (5th Cir. 1961). This rule on the payee side is reminiscent of the rule in § 453(f)(4) and (5) (studied in Chapter 13) that the payee's receipt of a two-party note that is payable on demand or is readily tradable is considered a cash equivalent that denies the payee the ability to defer § 1001 gain under the installment sale reporting rules.

[7] Rev. Rul. 76-135, 1976-1 C.B. 114.

[8] *See* Treas. Reg. § 1.451-2(a)(2). The example in this regulation illustrates that forfeiture of three months interest on a certificate of deposit of one year or less would be "substantial."

[9] Paul v. Comm'r, T.C. Memo. 1992-582.

[10] 47 T.C. 428 (1967).

Regulations spanning hundreds of pages. Indeed, employee deferred compensation is a specialized area of tax practice. While the details are beyond the scope of this textbook, an introduction to the big picture is necessary to discuss the intersection of deferred compensation with the cash method of accounting. The topic also provides an opportunity to revisit consumption taxation and how it differs from income taxation, a subject first introduced in Chapter 2.

Two of the more important deferred compensation arrangements that receive favorable tax treatment are qualified defined benefit plans and qualified defined contribution plans.[11] Under a qualified defined benefit plan (which are increasingly rare in the private sector though not uncommon in the public sector at the state and local level), the employer and employee pay amounts to a trust during the employee's working life sufficient to pay retirement benefits (usually keyed to length of service and final average salary) for the rest of the employee's life. Because employee retirement payments are formula-based, market risk with respect to the trust's investment returns lies with the employer.

Under a qualified defined contribution plan, in contrast, the employer, the employee, or both contribute a stipulated amount to a trust, which the employee can withdraw (along with the investment return earned on the contributions) during retirement. The so-called § 401(k) plan (named for the Code section authorizing it) is of this nature. The amount paid out during retirement will depend on the success of the trust's investments, which means that market risk with respect to the trust's investment returns lies with the employee.

Under both types of qualified plan, the employee enjoys cash-flow consumption tax treatment (rather than income tax treatment) with respect to these compensation arrangements, as the salary paid to the trust is not includable by the employee in the year earned (and paid to the trust) but rather is included only upon later distribution from the trust.[12] In addition, the qualified trust is itself exempt from tax on its investment earnings, and the employer's § 162 deduction for any salary paid by it to the trust is taken in the year of payment[13] (rather than in the later year of employee inclusion)—an extraordinary combination of rules that essentially means that the investment income earned by the trust slips through the cracks between the employer and employee and is not effectively taxed to *anyone* during the interim. To obtain these extraordinary results, therefore, the eligibility requirements (many of which were created by the Employee Retirement Income Security Act of 1974, or ERISA) are many, including that benefits not discriminate in favor of highly compensated employees and that the plan satisfy minimum participation, vesting, and funding standards.

Are there any possibilities for employee deferral *outside* the qualified plan provisions, *i.e.*, are there any *nonqualified* deferred compensation arrangements that succeed? If deferred compensation is not funded on a current basis (set aside by the employer on behalf of the employee), deferral is typically achieved because the taxpayer has received no current property interest. That is to say, a mere unfunded and unsecured promise to pay future compensation is not a transfer of "property" within the meaning of § 83 under Treas. Reg. § 1.83-3(d). If the promise of future payment is currently funded, however, the stakes are changed, as § 83 property can

[11] There are also profit-sharing plans, stock bonus plans, employee stock ownership plans (ESOPs), multi-employer plans, and more.

[12] You also learned in Chapter 2 that eligible workers can create Individual Retirement Accounts (or IRAs), which also enjoy cash-flow consumption tax treatment but do not typically involve the worker's employer.

[13] *See* §§ 404(a)(1) through (3).

encompass a beneficial interest in assets set aside for the employee. The employer and employee in the *Sproull* case, below, attempted to achieve both funding security and deferral for the employee. The attempt failed, however, and Mr. Sproull had to include the compensation that was set aside for him in a trust in his Gross Income prior to actual or constructive receipt under the "economic benefit doctrine." Attempts to avoid this doctrine with respect to funded, nonqualified deferred compensation led to the so-called rabbi trust and eventually to the enactment of a complex provision (§ 409A) to both codify these rules and combat abuse.

## SPROULL v. COMMISSIONER

16 T.C. 244 (1951)

Tietjens, Judge: Respondent determined a deficiency of $11,550.61 in the petitioner's income tax for 1945. The sole question is whether respondent was correct in including in petitioner's taxable income for 1945 the amount of $10,500 transferred in trust for petitioner in that year by petitioner's employer, but which was thereafter paid by the trustee to the petitioner in installments in 1946 and 1947 as required by the trust agreement.

FINDINGS OF FACT

The stipulated facts are found as facts. Those of the stipulated facts together with such facts found from oral testimony as are necessary for the decision are set forth below.

Petitioner E.T. Sproull is an individual residing in Bristolville, Ohio. His 1945 income tax return was filed on a calendar year basis with the collector of internal revenue for the 18th district of Ohio, Cleveland Division.

In 1929 petitioner became a large stockholder in and president of the Brainard Steel Corporation (hereinafter sometimes called the corporation). He held the office of president until the business was sold January 1, 1948.

Petitioner's salary was originally established at $12,000 per year, but shortly after 1929 the corporation ran into financial difficulties and petitioner voluntarily decreased his compensation over the depression years. He never made any claim on the corporation for the amount of the decrease, but at one time stated to the directors that he thought they owed him about $80,000.

The year 1945 was a good one financially for the corporation and on December 26, 1945, the corporation, following authorization of its board of directors, entered into a trust agreement with the Union Savings and Trust Company of Warren, Ohio, as trustee. Pursuant to the agreement, the corporation on December 31, 1945, paid over to the trustee the sum of $10,500 in consideration of services theretofore performed for the corporation by petitioner and the inadequacy of salary paid for such services. The trustee was empowered to invest and reinvest the money and was directed to pay out of principal to petitioner the sum of $5,250 on December 26, 1946, and the balance, including income, on December 26, 1947. In the event of petitioner's prior death, the amounts were to be paid to his administrator, executor, or heirs.

The trustee, pursuant to the agreement, paid to petitioner by check the sum of $5,250 on December 26, 1946, and a like sum on December 26, 1947. The petitioner in his 1946 calendar year return included as income the first $5,250 received from the trustee and in his 1947 calendar year return included as income the $5,250 received from the trustee in 1947.

At the time the trust agreement was authorized by the corporation's board of directors, petitioner was president of the board and held 1,375 shares of the corporate stock. At the same time petitioner's wife held 1,000 shares, and his three daughters 5,919 each. Petitioner thus controlled 20,132 shares, or 25.1 per cent, of an outstanding total of 78,916 shares. This situation continued to exist during the years 1945 to January 1, 1948. The action in setting up the trust was neither initiated by the petitioner nor taken pursuant to his direction.

On December 31, 1945, the corporation deducted, as an expense for salaries, the sum of $10,500 paid to the trustee, both in its records and in its calendar year income tax return for the year 1945.

OPINION

The Commissioner included in petitioner's 1945 taxable income as bonus income the sum of $10,500 paid by Brainard Steel Corporation to the Union Savings and Trust Company of Warren, Ohio, trustee under the agreement of December 26, 1945. Petitioner contends the respondent taxed him in the wrong year and that instead of being taxable on the full $10,500 in 1945 he was properly taxable in 1946 and 1947 on the amounts paid him by the trustee in those years.

Neither the stipulated facts nor the oral testimony establish whether petitioner made his returns on a cash basis. However, since that is the most common method of reporting income and since the trial apparently proceeded on that basis we assume the cash method was used.

Superficially the issue looks simple. Petitioner actually received no cash until the years 1946 and 1947. Why, then, should he be taxed in 1945? And what was the basis for respondent's action in so doing?

A possible basis is the application of the doctrine of constructive receipt and petitioner in his main argument assumes that to be the fact. He sets out to demonstrate the doctrine's inapplicability, pointing out (1) that although the sum was fixed and paid by his employer as compensation for services, he actually received no part of the money in 1945; (2) that he could not have reduced any part of the money to possession in that year because of the time limitations on payment to him set in the trust instrument, and (3) that he had no control of the corporate action in establishing the trust, nor was such action taken at his suggestion or pursuant to his direction.

This Court has rather fully discussed the doctrine of constructive receipt in *Richard R. Deupree*, 1 T.C. 113, and *J.D. Amend*, 13 T.C. 178. Although it be conceded that if we apply the tests described in those cases to the situation here we must agree with petitioner's argument that this is not a true case for application of the doctrine, agreeing with petitioner on that point does not dispose of the case. Respondent argues that if constructive receipt does not apply, then the doctrine of cash equivalent does. He cites the broad language of section 22(a) of the Internal Revenue Code which reads, in part, as follows:

SEC. 22. GROSS INCOME.

> General Definition. -- "Gross Income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, * * *.

Reliance is placed on *Renton K. Brodie*, 1 T.C. 275, and *J.H. McEwen*, 6 T.C. 1018. We

paraphrase the language used in *Brodie, supra*. Even if the doctrine of constructive receipt as it is commonly understood cannot here be correctly applied, 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, albeit not at his direction, in setting up the trust of which petitioner, or, in the event of his death then his estate, was the sole beneficiary and that the whole arrangement was part of a plan for his additional remuneration.

The question then becomes, as in *McEwen*, *supra*, 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. While this factor alone is not controlling, it does serve to distinguish this case from those in which the exact amount of compensation is subject to some future contingency or subject to the possibility of return to the employer. *See* Mertens, Law of Federal Income Taxation, Volume 2, Sections 10.13, 12.42, and 12.44.

It is true, as petitioner argues in trying to pull free from *Brodie* and *McEwen*, *supra*, that the arrangement gave petitioner only an equitable interest in the trust fund and that he had no vested interest in an annuity contract delivered into his possession as in *Brodie*, *supra*. But, that does not determine the issue whether the establishment of a trust such as was here established does not itself constitute taxable income to petitioner. This is especially true when it is considered that one of the arguments of petitioner in *Brodie*, *supra*, was that the annuity had no cash value and could not be assigned. Yet we held the amount expended for the annuity in *Brodie* taxable in the year expended. We think the case at hand is a stronger one for taxability than *Brodie*. Here, we think it must be held that the expenditure of the $10,500 in setting up the trust conferred an economic or financial benefit on petitioner properly taxable to him in 1945. The fund was ascertained and paid over by petitioner's employer for his benefit in that year. Petitioner had to do nothing further to earn it or establish his rights therein. The only duties of the trustee were to hold, invest, accumulate, and very shortly pay over the fund and its increase to petitioner or his estate in the event of his prior death. No one else had any interest in or control over the monies. The trust agreement contained no restriction whatever on petitioner's right to assign or otherwise dispose of the interest thus created in him. On the facts here there is no doubt that such an interest had a value equivalent to the amount paid over for his benefit, and that this beneficial interest could have been assigned or otherwise alienated requires the citation of only the most general authority. *See* Bogert, Trusts and Trustees, § 188. Respondent contends that the circumstances of the creation of this interest in petitioner was tantamount to paying over to him the cash in 1945.

Of course, petitioner argues that *Brodie* and *McEwen*, *supra*, are distinguishable on their facts. They involved annuity contracts purchased with funds furnished by petitioners' employers, in *Brodie* without the petitioner's direction or control but on his signing a written application, and in *McEwen* pursuant to a contract of employment to which petitioner was party. We think those differences are not significant here in view of petitioner's acquisition of a vested valuable interest in the trust fund here in question in the taxable year under consideration.

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Mr. Sproull preferred to defer the compensation inclusion to 1946 and 1947 (from 1945) for two likely reasons: (1) the ever-important time value of money and (2) the fact that marginal rates decreased (very) slightly after 1945 and the end of WWII. He lost, however, and the factors cited

in *Sproull* as significant to its holding included the following: (1) Mr. Sproull was under no obligation to perform future services before being entitled to payment, (2) the amounts were irrevocably paid by the employer in 1945 to the trust, (3) no other party had any interest in or control over the amounts contributed to the trust, and (4) the trust instrument did not prohibit Mr. Sproull from assigning his trust interest to another. While not stated clearly, the irrevocable payment by the employer to the trust likely protected the amounts from the employer's creditors if the company encountered financial difficulties between the time the trust was funded and the amounts were paid to Mr. Sproull. In addition, the trust income was not likely taxed to the company (the trust's grantor or funder) under the common law predecessors to the "grantor trust" rules studied in Chapter 8. Rather, the trust's income (earned on the initial endowment) would likely have been taxed either to the trust (absent distributions to Mr. Sproull) or to Mr. Sproull (with distributions).

In the years following *Sproull*, taxpayers (particularly corporate executives) attempted to avoid current taxation of nonqualified funded arrangements under the economic benefit doctrine by avoiding one or more of the factors listed by the *Sproull* court as important to its holding. Eventually, a rabbi's congregation obtained a favorable private letter ruling, which confirmed that its funded nonqualified deferred compensation arrangement with its rabbi succeeded in avoiding the economic benefit doctrine and thus succeeded in garnering deferral for the rabbi until trust distributions were made to him in a later year, even though the plan was not a qualified plan.

**PRIVATE LETTER RULING 8113107 (Dec. 31, 1980)**

This is in reply to the letter of April 21, 1980, submitted by your authorized representative, in which, for federal income tax purposes, a ruling is requested as to whether *N*, a rabbi, will be in receipt of income by virtue of the funding of a trust for his benefit by congregation *M*.

*M* proposes to fund the trust with *r* dollars. Under the terms of the trust agreement, the trustees will manage, invest, and reinvest the trust estate, and pay the net income derived therefrom to *N* at least quarter annually. Upon the death, disability, retirement, or termination of services of *N*, the trustees will make distributions of principal and income to *N* as provided for in the trust agreement.

Although *M* may not alter, amend, revoke, change, or annual any provisions of the trust agreement, the assets of the trust estate shall be subject to the claims of *M*'s creditors as if the assets were the general assets of *M*. Furthermore, *N*'s interest in the trust is not subject to the assignment, alienation, pledge, attachment, or claims of creditors, and may not be otherwise alienated or encumbered by *N*.

Section 61 of the Internal Revenue Code of 1954 defines gross income as all income from whatever source derived, except as specifically excluded by some other provision of law.

The principal generally known as the "economic benefit" doctrine provides one method for determining when amounts must be included in gross income. Pursuant to this theory, the creation by an obligor of a fund in which the taxpayer has vested rights will result in immediate inclusion by the taxpayer of the amount funded. A "fund" is created when an amount is irrevocably placed with a third party, and a taxpayer's interest in the fund is "vested" if it is nonforfeitable.

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Because the assets of the trust estate are subject to the claims of *M*'s creditors and are not paid

or made available within the meaning of section 451 of the Code, we conclude that the funding of the trust will not constitute a taxable event for *N*. Thus, payments of income or principal under the terms of the trust agreement will be includible in *N*'s gross income in the taxable year in which they are actually received or otherwise made available, whichever is earlier.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

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In essence, nonqualified deferred compensation payable from general employer funds that are subject to the claims of general creditors are treated as unfunded and unsecured promises to pay money in the future. For that reason, the promise does not rise to the level of "property" within the meaning of § 83 that could result in current inclusion under Treas. Reg. § 1.83-3(e).

Because this ruling happened to involve a rabbi, trusts structured to avoid the economic benefit doctrine have come to be called "rabbi trusts," and hundreds (if not thousands) of employers immediately jumped on the bandwagon and created so-called rabbi trusts for its corporate executives (only). While the timing of the § 162 deduction by the employer was irrelevant in this particular ruling (because this employer happened to be a tax-exempt entity), note that the employer deduction for other (non-tax-exempt) employers would not occur at the time of contribution to the trust, as it does with qualified plans. Rather, the employer deduction for the compensation paid to the rabbi trust is not taken until the year in which the compensation is included by the employee.[14] In addition, recall that a qualified plan trust is tax-exempt. Rabbi trusts, which fail to satisfy the complex qualified plan rules, are not tax-exempt trusts. Indeed, as explored below, a successful rabbi trust must be a grantor trust within the meaning of §§ 671 to 677 (studied in Chapter 8). Thus, the investment return earned on the trust principal will be included on the employer's tax return each year, just as though it never created the trust in the first place. When the smoke clears, you can appreciate that the only benefit of a rabbi trust is to provide deferral for the employee executive.

Because so many employers requested private letter rulings after the rabbi trust private letter ruling, confirming that their trust would be similarly treated, the government finally responded in 1992 by issuing Revenue Procedure 92-64,[15] which contains (1) a safe harbor method to avoid the economic benefit doctrine if certain requirements are satisfied and (2) a model rabbi trust document. Among the more important requirements that must be satisfied under the safe harbor are the following:

- The trust must be a valid trust under state law and must be a grantor trust for Federal income tax purposes under §§ 671-677, which means that the trust's income will (unless the employer is a tax-exempt entity) be included on the employer's tax return as earned.
- The trust's assets must be subject to the claims of general creditors of the employer. This requirement prevents the employee from having a "vested" or current interest in the trust, unlike in the case of qualified plans.
- Participants must be prohibited from assigning their interests in the trust.

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[14] *See* § 404(a)(5).
[15] 1992-2 C.B. 422.

- In the event of insolvency, the trustee must be prohibited from making distributions to participants, and the employer must provide notice to the trustee of the insolvency.
- Payments must be made according to a payment schedule included in the trust agreement. Typically, payments are scheduled to be made on the occurrence of specified events, such as retirement, death, disability, or separation from employment, though there can be a hardship exception.
- If the trust lacks sufficient assets to make scheduled payments, the employer must be obligated to make up the shortfall.
- The participant must elect to defer inclusion of the compensation prior to the year in which the related services are rendered (to avoid constructive receipt).

In the years following 1992, aggressive taxpayers sought to engineer increased certainty of payment. One strategy was to move the trust assets offshore, where it might be more difficult for the employer's creditors to discover and reach the assets. Another strategy was to include payout triggers in the trust document keyed to the employer's financial condition. The goal was to trigger a payout just prior to an employer becoming insolvent, when payouts must stop and general creditors would likely claim the trust assets.

Congress finally reacted to all of this activity by enacting § 409A in 2004, which (1) essentially codifies and modifies the rabbi trust safe harbor ruling requirements, (2) closes some loopholes, and (3) imposes a 20% penalty on nonqualified deferred compensation amounts if the deferral privilege is lost under § 409A in addition to augmented interest (adding one percentage point to the usual interest rate imposed on tax underpayments). In general terms, § 409A requires current inclusion of funded nonqualified deferred compensation arrangements not subject to a substantial risk of forfeiture unless certain requirements are met. Section 409A(a)(2) limits the types of events that can trigger a payout. Section 409A(a)(4) codifies the requirement that the election to defer must be made prior to the year in which the related services are performed. Section 409A(b)(1) directly addresses the offshore rabbi trust. Amounts transferred offshore are now immediately included by the plan participant unless the related services are also performed offshore in the same country, which effectively ended the general use of offshore rabbi trusts. In addition, § 409A(b)(2) requires immediate inclusion if the plan contains a payout trigger related to "the employer's financial health." In short, § 409A is a far-reaching provision that all advisors regarding funded, nonqualified deferred compensation arrangements must study closely.

## Problem

Hallie, who is the chief financial officer of Worldco, is an employee who uses the cash method of accounting and the calendar year as her taxable year. When does she include or deduct each of the items described below?

**a.** Hallie's annual salary is $30,000 per month ($360,000 for the year), but she automatically has $5,000 per month ($60,000 for the year) withheld and paid to a § 401(k) plan maintained by her employer and open to participation by all Worldco employees. She is on vacation in Mexico from December 28 of Year 1 to January 10 of Year 2. Thus, she does not pick up her December paycheck until Year 2.

**b.** In addition to her § 401(k) plan, Hallie and Worldco have a contract under which $5,000 is

set aside each month (in addition to her $360,000 salary) in a trust for her benefit and the benefit of other Worldco officers (only) with similar contracts. The trust is not part of a qualified plan but satisfies the requirements of a rabbi trust. The trust amounts will be paid to Hallie after her termination with Worldco.

**c.** In early December, Hallie responds to a PBS fund drive on television by calling and making a pledge to donate $10,000, which is deductible under § 170. She mails the check before she leaves for Mexico, but the PBS station does not receive and cash the check until January of Year 2. How would your answer change, if at all, if Hallie charges the $10,000 contribution to her credit card before leaving for Mexico and pays her credit card balance containing the charge in January of Year 2?

**d.** Hallie purchases a lottery ticket on December 10 but fails to check to see whether her numbers won until she returns from Mexico in January, when she discovers that she won $1,000. She drives to the nearby local lottery office and claims her $1,000 prize.

## B. The accrual method of accounting

The Federal income tax enacted in 1913 required use of the cash method of accounting by all taxpayers. Businesses—particularly corporations using the accrual method of accounting *for financial accounting purposes*—complained about the need to keep two sets of books, and Congress amended the law in 1916 to take account of these complaints by adding to the statute the following language:

> A corporation … keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as returned.[16]

It was this language that first effectively allowed certain taxpayers to use the accrual method of accounting for *tax* purposes if they used that method for financial accounting purposes in general. Thus, before we further immerse ourselves in accrual accounting for tax purposes, we need to segue to a brief, general discussion of what accrual accounting means and requires in the financial accounting world and how the underlying values that inform accrual accounting in that world can diverge from income tax values. This discussion will set the stage for considering how and why accrual accounting for income tax purposes differs from "generally accepted accounting principles" (GAPP) in the financial accounting world—a divergence that can frustrate accountants in the class but which is very important if we seek to tax "income" rather than only "consumption" (or, stated differently, if we are to protect the tax on capital returns). Congress has shown that it knows well how to enact more favorable consumption tax provisions when it wants to do so (such as the qualified plan rules described in Part A.). Judges and administrators of the statute should, therefore, be wary of effectively allowing consumption tax treatment through the backdoor (in a context not contemplated by Congress) via the manipulation of accounting doctrine. This concern is irrelevant to financial accounting, under which no payment obligations arise and which,

[16] Revenue Act of 1916, § 13(d), 39 Stat. 756, 770, quoted in U.S. v. Anderson, 269 U.S. 422, 435 (1926).

therefore, can downplay the time value of money and the ability to earn a return on funds not yet included on the "income" statement for (nontax) financial reporting purposes.

***Accrual accounting in financial reporting and the divergence of financial accounting and income tax values***

Even without an income tax, businesses would need to generate "income" statements in order to provide useful information about the economic health of the business to share with potential investors (contemplating investment in the business) and potential lenders (considering making a loan to the business). The Securities and Exchange Commission (SEC), which regulates the issuance and trading of securities over the public markets to both maintain an efficient market and protect investors, also requires that publicly traded corporations submit regular financial statements. The creation of these income statements must accord with GAAP, but GAAP (unlike the Internal Revenue Code) does not consist of a single set of rules, applicable to all businesses, regarding the timing of revenue inclusions and deductions of costs. Rather, GAAP permits a broad range of reasonable alternatives, based on the individual facts and circumstances of each business, regarding how and when revenue is to be included on the income statement and when costs are to be deducted against that revenue in arriving at "income." Moreover, the income statement is generated at first by the company; only then do accountants review and certify that the information presented by the business is consistent with GAAP. This approach permits quite a bit of latitude in how profits are reported even for very similar businesses.

For example, as far back as 1958, the Managing Partner of Arthur Anderson (the now-defunct accounting firm) and a leading figure in the accounting world argued for the creation of an "accounting court," saying:

> [N]owhere does [the auditor's certification that the income statement is consistent with GAAP] say that for the same transaction there are acceptable alternative principles which produce widely different results and which destroy comparability with other companies, or sometimes make impossible a realistic appraisal of the company itself. On this point we should ask ourselves this question, which is an important moral one: Do the readers know that in giving the standard certificate we have a choice of principles, practices or conventions applicable to the same transactions, and that such choice can be certified without qualification even though the profits reported would vary widely, depending on which principle of accounting was chosen? … In fact [the accountant] will often certify statements which reflect identical transactions in different companies, recorded in widely different ways and with material differences in the results obtained. The only defense for this latitude of choice is that alternative principles which produce such widely varying results are all classified as "generally accepted."[17]

His call led to the creation of the Accounting Principles Board (currently known as the Financial Accounting Standards Board or FASB), but the tractability of GAAP remains. For example, a 1997 article describing a Goldman Sachs report on the veracity of earnings reports states:

> Executives don't have to risk committing fraud to play with earnings. The Goldman study notes somewhat archly that accounting rules still give financial officers plenty of "opportunities"—all quite legal—to massage income statements. Using different

[17] Leonard Spacek, *The Need for an Accounting Court*, ACCOUNTING REV. 368 (July 1958).

> approaches, financial officers can shift earnings from the present to the future, paving the way for steady earnings growth. They can also take tomorrow's earnings and place them on today's income statements, pleasing impatient investors. And if the auditors do not object, these executives can get away with reporting earnings well before their time.[18]

Similarly, another article drily noted:

> Companies strive to meet three supposed thresholds [when reporting earnings]: (1) positive earnings, (2) prior-year results and (3) analyst expectations. Most of them will do so, though often by only a whisker. A few, on the other hand, will miss by a mile. This is not due to chance, nor smiling fates. Companies manipulate their earnings to make it come out that way. Those that are going to fall short or that are comfortably ahead "save up" earnings for next time. Those who expect to come close will "borrow" earnings from the future.[19]

After the financial accounting debacles of Enron and other corporations at the turn of the 21st century, Congress enacted the Sarbanes-Oxley Act in 2002 in an attempt to shore up the credibility of financial statements of companies using the public markets, but some observe that the malleability of GAAP is simply inherent in the beast.

> Contrary to what Congress seemed to believe, there is no such thing as a statement of income under GAAP that is inherently "correct," or can be made inherently "correct" by an effective audit. All such statements—quite legitimately and necessarily—are the consequence of management's opinion about a vast number of events and circumstances that may or may not arise in the future. Thus, while better and more expensive auditing—which is surely coming—may improve the chances of catching actual fraud, it will not improve the "accuracy" of financial statements.
> …
>
> Auditors do not prepare the financial statements and are not capable of making the judgments that management must make in the course of doing so. The most auditors can do is question management estimates of such things as reserves or depreciation rates—items that can have major effects on reported earnings—if they seem so grossly out of line as to be unreasonable. These cases will be unusual. The notion that better regulation of accountants and more thorough audits will produce substantially more accurate financial statements is wrong.[20]

In 2009, FASB issued Statement of Financial Accounting Standards No. 168, which brought all of the GAAP standards into a single source.[21] "Finding an applicable rule, however, may continue to be a challenging process for both compliance and enforcement efforts because GAAP

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[18] Jon E. Hilsenrath, *On the Books, More Fact and Less Fiction*, at http://www.nytimes.com/1997/02/16/business/on-the-books-more-fact-and-less-fiction.html.
[19] Roger Lowenstein, *How to Be a Winner in the Profits Game*, WALL ST. J., Apr. 3, 1997, at C1.
[20] Peter J. Wallison, *The Error at the Heart of the Sarbanes-Oxley Act*, at http://www.aei.org/article/economics/financial-services/poor-diagnosis-poor-prescription/.
[21] *See* Arthur Acevedo, *The Fox and the Ostrich: Is GAAP a Game of Winks and Nods?*, 12 TRANSACTIONS: TENN. J. OF BUS. LAW 63, 76 (2010).

itself continues to be susceptible to multiple interpretations and applications."[22]

One example of how GAAP does not provide a single "correct" outcome is that it invests broad latitude in the company's managers to estimate the value of its inventory. *Thor Power Tool*, below, not only evidences the malleability provided to company managers under GAAP (note in particular footnotes 5 and 17) but also evidences the broad discretion provided to the Commissioner under § 446(b) to challenge accounting methods (for tax purposes) that, in his or her opinion, fails to reflect income clearly, even though they satisfy GAAP for financial accounting purposes.

## THOR POWER TOOL COMPANY v. COMMISSIONER

439 U.S. 522 (1979)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

In 1964, petitioner Thor Power Tool Co. (hereinafter sometimes referred to as the taxpayer), in accord with "generally accepted accounting principles," wrote down what it regarded as excess inventory to Thor's own estimate of the net realizable value of the excess goods. Despite this write-down, Thor continued to hold the goods for sale at original prices. It offset the write-down against 1964 sales and thereby produced a net operating loss for that year; it then asserted that loss as a carryback to 1963 under § 172 of the Internal Revenue Code of 1954. The Commissioner of Internal Revenue, maintaining that the write-down did not serve to reflect income clearly for tax purposes, disallowed the offset and the carryback. On the taxpayer's petition for redetermination, the Tax Court, in an unreviewed decision by Judge Goffe, upheld the Commissioner's exercise of discretion. The United States Court of Appeals for the Seventh Circuit affirmed. We granted certiorari to consider these important and recurring income tax accounting issues.

A.

Taxpayer manufactures hand-held power tools, parts and accessories, and rubber products. At its various plants and service branches, Thor maintains inventories of raw materials, work-in-process, finished parts and accessories, and completed tools. At all times relevant, Thor has used, both for financial accounting and for income tax purposes, the "lower of cost or market" method of valuing inventories. *See* Treas. Reg. § 1.471-2(c).

Thor's tools typically contain from 50 to 200 parts, each of which taxpayer stocks to meet demand for replacements. Because of the difficulty, at the time of manufacture, of predicting the future demand for various parts, taxpayer produced liberal quantities of each part to avoid subsequent production runs. Additional runs entail costly retooling and result in delays in filling orders.

In 1960, Thor instituted a procedure for writing down the inventory value of replacement parts and accessories for tool models it no longer produced. It created an inventory contra-account and credited that account with 10% of each part's cost for each year since production of the parent model had ceased. The effect of the procedure was to amortize the cost of these parts over a 10-year period. For the first nine months of 1964, this produced a write-down of $22,090.

In late 1964, new management took control and promptly concluded that Thor's inventory in general was overvalued. After "a physical inventory taken at all locations" of the tool and rubber

[22] *Id.*

divisions, management wrote off approximately $2.75 million of obsolete parts, damaged or defective tools, demonstration or sales samples, and similar items. The Commissioner allowed this writeoff because Thor scrapped most of the articles shortly after their removal from the 1964 closing inventory. Management also wrote down $245,000 of parts stocked for three unsuccessful products. The Commissioner allowed this write-down, too, since Thor sold these items at reduced prices shortly after the close of 1964.

This left some 44,000 assorted items, the status of which is the inventory issue here. Management concluded that many of these articles, mostly spare parts, were "excess" inventory, that is, that they were held in excess of any reasonably foreseeable future demand. It was decided that this inventory should be written down to its "net realizable value," which, in most cases, was scrap value.

Two methods were used to ascertain the quantity of excess inventory. Where accurate data were available, Thor forecast future demand for each item on the basis of actual 1964 usage, that is, actual sales for tools and service parts, and actual usage for raw materials, work-in-process, and production parts. Management assumed that future demand for each item would be the same as it was in 1964. Thor then applied the following aging schedule: the quantity of each item corresponding to less than one year's estimated demand was kept at cost; the quantity of each item in excess of two years' estimated demand was written off entirely; and the quantity of each item corresponding to from one to two years' estimated demand was written down by 50% or 75%. Thor presented no statistical evidence to rationalize these percentages or this time frame. In the Tax Court, Thor's president justified the formula by citing general business experience, and opined that it was "somewhat in between" possible alternative solutions.[5] This first method yielded a total write-down of $744,030.

At two plants where 1964 data were inadequate to permit forecasts of future demand, Thor used its second method for valuing inventories. At these plants, the company employed flat percentage write-downs of 5%, 10%, and 50% for various types of inventory. Thor presented no sales or other data to support these percentages. Its president observed that "this is not a precise way of doing it," but said that the company "felt some adjustment of this nature was in order, and these figures represented our best estimate of what was required to reduce the inventory to net realizable value." This second method yielded a total write-down of $160,832.

Although Thor wrote down all its "excess" inventory at once, it did not immediately scrap the articles or sell them at reduced prices, as it had done with the $3 million of obsolete and damaged inventory, the write-down of which the Commissioner permitted. Rather, Thor retained the "excess" items physically in inventory and continued to sell them at original prices. The company found that, owing to the peculiar nature of the articles involved, price reductions were of no avail in moving this "excess" inventory. As time went on, however, Thor gradually disposed of some

[5] "So here is where I fell back on my experience of 20 years in manufacturing of trying to determine a reasonable basis for evaluating this inventory. In my previous association, we had generally written off inventory that was in excess of one year. In this case, we felt that that would be overly conservative, and it might understate the value of the inventory. On the other hand, we felt that two years … would be too optimistic and that we would overvalue the inventory [in view of] the factors which affect inventory, such as technological change, market changes, and the like, that two years, in our opinion, was too long a period of time. So what we did is we came up with a formula which was somewhat in between … writing off, say, everything over one year as compared to writing everything [off] over two years, and we came up with this formula that has been referred to in this Court today." App. 57.

of these items as scrap; the record is unclear as to when these dispositions took place.

Thor's total write-down of "excess" inventory in 1964 therefore was $926,952. Thor credited this sum to its inventory contra-account, thereby decreasing closing inventory, increasing cost of goods sold, and decreasing taxable income for the year by that amount.[9] The company contended that, by writing down excess inventory to scrap value, and by thus carrying all inventory at "net realizable value," it had reduced its inventory to "market" in accord with its "lower of cost or market" method of accounting. On audit, the Commissioner disallowed the write-down in its entirety, asserting that it did not serve clearly to reflect Thor's 1964 income for tax purposes.

The Tax Court, in upholding the Commissioner's determination, found as a fact that Thor's write-down of excess inventory did conform to "generally accepted accounting principles"; indeed, the court was "thoroughly convinced … that such was the case." The court found that if Thor had failed to write down its inventory on some reasonable basis, its accountants would have been unable to give its financial statements the desired certification. The court held, however, that conformance with "generally accepted accounting principles" is not enough; § 446(b), and § 471 as well, prescribe, as an independent requirement, that inventory accounting methods must "clearly reflect income." The Tax Court rejected Thor's argument that its write-down of "excess" inventory was authorized by Treasury Regulations and held that the Commissioner had not abused his discretion in determining that the write-down failed to reflect 1964 income clearly.

B.

Inventory accounting is governed by §§ 446 and 471 of the Code. Section 446(a) states the general rule for methods of accounting: "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." Section 446(b) provides, however, that if the method used by the taxpayer "does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income." Regulations promulgated under § 446, and in effect for the taxable year 1964, state that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income." Treas. Reg. § 1.446-1(a)(2).[10]

Section 471 prescribes the general rule for inventories. It states: "Whenever in the opinion of the [Commissioner] the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventory shall be taken by such taxpayer on such basis as the [Commissioner] may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

As the Regulations point out, § 471 obviously establishes two distinct tests to which an inventory must conform. First, it must conform "as nearly as may be" to the "best accounting practice," a phrase that is synonymous with "generally accepted accounting principles." Second, it "must clearly reflect the income." Treas. Reg. § 1.471-2(a)(2).

It is obvious that on their face, §§ 446 and 471, with their accompanying Regulations, vest the

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[9] For a manufacturing concern like Thor, Gross Profit basically equals Sales minus Cost of Goods Sold. Cost of Goods Sold equals Opening Inventory, plus Cost of Inventory Acquired, minus Closing Inventory. A reduction of Closing Inventory, therefore, increases Cost of Goods Sold and decreases Gross Profit accordingly.

[10] The Regulations define "method of accounting" to include "not only the over-all method of accounting of the taxpayer but also the accounting treatment of any item." Treas. Reg. § 1.446-1(a)(1).

Commissioner with wide discretion in determining whether a particular method of inventory accounting should be disallowed as not clearly reflective of income. This Court's cases confirm the breadth of this discretion. In construing § 446 and its predecessors, the Court has held that "[the] Commissioner has broad powers in determining whether accounting methods used by a taxpayer clearly reflect income." *Comm'r v. Hansen*, 360 U.S. 446, 467 (1959). Since the Commissioner has "[much] latitude for discretion," his interpretation of the statute's clear-reflection standard "should not be interfered with unless clearly unlawful." *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930). To the same effect are *United States v. Catto*, 384 U.S. 102, 114 (1966); *Schlude v. Commissioner*, 372 U.S. 128, 133-134 (1963); *American Automobile Assn. v. United States*, 367 U.S. 687, 697-698 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, 189-190 (1957); *Brown v. Helvering*, 291 U.S. 193, 203 (1934). In construing § 203 of the Revenue Act of 1918, 40 Stat. 1060, a predecessor of § 471, the Court held that the taxpayer bears a "heavy burden of [proof]," and that the Commissioner's disallowance of an inventory accounting method is not to be set aside unless shown to be "plainly arbitrary." *Lucas v. Structural Steel Co.*, 281 U.S. 264, 271 (1930).

As has been noted, the Tax Court found as a fact in this case that Thor's write-down of "excess" inventory conformed to "generally accepted accounting principles" and was "within the term, 'best accounting practice,' as that term is used in section 471 of the Code and the regulations promulgated under that section." Since the Commissioner has not challenged this finding, there is no dispute that Thor satisfied the first part of § 471's two-pronged test. The only question, then, is whether the Commissioner abused his discretion in determining that the write-down did not satisfy the test's second prong in that it failed to reflect Thor's 1964 income clearly. Although the Commissioner's discretion is not unbridled and may not be arbitrary, we sustain his exercise of discretion here, for in this case the write-down was plainly inconsistent with the governing Regulations which the taxpayer, on its part, has not challenged.

It has been noted above that Thor at all pertinent times used the "lower of cost or market" method of inventory accounting. The rules governing this method are set out in Treas. Reg. § 1.471-4. That Regulation defines "market" to mean, ordinarily, "the current bid price prevailing at the date of the inventory for the particular merchandise in the volume in which usually purchased by the taxpayer." § 1.471-4(a). The courts have uniformly interpreted "bid price" to mean replacement cost, that is, the price the taxpayer would have to pay on the open market to purchase or reproduce the inventory items. Where no open market exists, the Regulations require the taxpayer to ascertain "bid price" by using "such evidence of a fair market price at the date or dates nearest the inventory as may be available, such as specific purchases or sales by the taxpayer or others in reasonable volume and made in good faith, or compensation paid for cancellation of contracts for purchase commitments." § 1.471-4(b).

The Regulations specify two situations in which a taxpayer is permitted to value inventory below "market" as so defined. The first is where the taxpayer in the normal course of business has actually offered merchandise for sale at prices lower than replacement cost. Inventories of such merchandise may be valued at those prices less direct cost of disposition, "and the correctness of such prices will be determined by reference to the actual sales of the taxpayer for a reasonable period before and after the date of the inventory." The Regulations warn that prices "which vary materially from the actual prices so ascertained will not be accepted as reflecting the market."

The second situation in which a taxpayer may value inventory below replacement cost is where

the merchandise itself is defective. If goods are "unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes," the taxpayer is permitted to value the goods "at bona fide selling prices less direct cost of disposition." § 1.471-2(c). The Regulations define "bona fide selling price" to mean an "actual offering of goods during a period ending not later than 30 days after inventory date." The taxpayer bears the burden of proving that "such exceptional goods as are valued upon such selling basis come within the classifications indicated," and is required to "maintain such records of the disposition of the goods as will enable a verification of the inventory to be made."

From this language, the regulatory scheme is clear. The taxpayer must value inventory for tax purposes at cost unless the "market" is lower. "Market" is defined as "replacement cost," and the taxpayer is permitted to depart from replacement cost only in specified situations. When it makes any such departure, the taxpayer must substantiate its lower inventory valuation by providing evidence of actual offerings, actual sales, or actual contract cancellations. In the absence of objective evidence of this kind, a taxpayer's assertions as to the "market value" of its inventory are not cognizable in computing its income tax.

It is clear to us that Thor's procedures for writing down the value of its "excess" inventory were inconsistent with this regulatory scheme. Although Thor conceded that "an active market prevailed "on the inventory date," it "made no effort to determine the purchase or reproduction cost" of its "excess" inventory. Thor thus failed to ascertain "market" in accord with the general rule of the Regulations. In seeking to depart from replacement cost, Thor failed to bring itself within either of the authorized exceptions. Thor is not able to take advantage of § 1.471-4(b) since, as the Tax Court found, the company failed to sell its excess inventory or offer it for sale at prices below replacement cost. Indeed, Thor concedes that it continued to sell its "excess" inventory at original prices. Thor also is not able to take advantage of § 1.471-2(c) since, as the Tax Court and the Court of Appeals both held, it failed to bear the burden of proving that its excess inventory came within the specified classifications. Actually, Thor's "excess" inventory was normal and unexceptional, and was indistinguishable from and intermingled with the inventory that was not written down.

More importantly, Thor failed to provide any objective evidence whatever that the "excess" inventory had the "market value" management ascribed to it. The Regulations demand hard evidence of actual sales and further demand that records of actual dispositions be kept. The Tax Court found, however, that Thor made no sales and kept no records. Thor's management simply wrote down its closing inventory on the basis of a well-educated guess that some of it would never be sold. The formulae governing this write-down were derived from management's collective "business experience"; the percentages contained in those formulae seemingly were chosen for no reason other than that they were multiples of five and embodied some kind of anagogical symmetry. The Regulations do not permit this kind of evidence. If a taxpayer could write down its inventories on the basis of management's subjective estimates of the goods' ultimate salability, the taxpayer would be able, as the Tax Court observed, "to determine how much tax it wanted to pay for a given year."

For these reasons, we agree with the Tax Court and with the Seventh Circuit that the Commissioner acted within his discretion in deciding that Thor's write-down of "excess" inventory failed to reflect income clearly. In the light of the well-known potential for tax avoidance that is inherent in inventory accounting, the Commissioner in his discretion may insist on a high evidentiary standard before allowing write-downs of inventory to "market." Because Thor

provided no objective evidence of the reduced market value of its "excess" inventory, its write-down was plainly inconsistent with the Regulations, and the Commissioner properly disallowed it.

C.

The taxpayer's major argument against this conclusion is based on the Tax Court's clear finding that the write-down conformed to "generally accepted accounting principles." Thor points to language in Treas. Reg. § 1.446-1(a)(2), to the effect that "[a] method of accounting which reflects the consistent application of generally accepted accounting principles … will ordinarily be regarded as clearly reflecting income" (emphasis added). Section 1.471-2(b), of the Regulations likewise stated that an inventory taken in conformity with best accounting practice "can, as a general rule, be regarded as clearly reflecting … income" (emphasis added). These provisions, Thor contends, created a presumption that an inventory practice conformable to "generally accepted accounting principles" is valid for income tax purposes. Once a taxpayer has established this conformity, the argument runs, the burden shifts to the Commissioner affirmatively to demonstrate that the taxpayer's method does not reflect income clearly. Unless the Commissioner can show that a generally accepted method "demonstrably distorts income," Brief for Chamber of Commerce of the United States as Amicus Curiae 3, or that the taxpayer's adoption of such method was "motivated by tax avoidance," Brief for Petitioner 25, the presumption in the taxpayer's favor will carry the day. The Commissioner, Thor concludes, failed to rebut that presumption here.

If the Code and Regulations did embody the presumption petitioner postulates, it would be of little use to the taxpayer in this case. As we have noted, Thor's write-down of "excess" inventory was inconsistent with the Regulations; any general presumption obviously must yield in the face of such particular inconsistency. We believe, however, that no such presumption is present. Its existence is insupportable in light of the statute, the Court's past decisions, and the differing objectives of tax and financial accounting.

First, as has been stated above, the Code and Regulations establish two distinct tests to which an inventory must conform. The Code and Regulations, moreover, leave little doubt as to which test is paramount. While § 471 of the Code requires only that an accounting practice conform "as nearly as may be" to best accounting practice, § 1.446-1(a)(2) of the Regulations states categorically that "no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income" (emphasis added). Most importantly, the Code and Regulations give the Commissioner broad discretion to set aside the taxpayer's method if, "in [his] opinion," it does not reflect income clearly. This language is completely at odds with the notion of a "presumption" in the taxpayer's favor. The Regulations embody no presumption; they say merely that, in most cases, generally accepted accounting practices will pass muster for tax purposes. And in most cases they will. But if the Commissioner, in the exercise of his discretion, determines that they do not, he may prescribe a different practice without having to rebut any presumption running against the Treasury.

Second, the presumption petitioner postulates finds no support in this Court's prior decisions. It was early noted that the general rule specifying use of the taxpayer's method of accounting "is expressly limited to cases where the Commissioner believes that the accounts clearly reflect the net income." *Lucas v. Am. Code Co.*, 280 U.S., at 449. More recently, it was held in *American Automobile Assn. v. United States* that a taxpayer must recognize prepaid income when received, even though this would mismatch expenses and revenues in contravention of "generally accepted

commercial accounting principles." 367 U.S., at 690. "[To] say that in performing the function of business accounting the method employed by the Association 'is in accord with generally accepted commercial accounting principles and practices,'" the Court concluded, "is not to hold that for income tax purposes it so clearly reflects income as to be binding on the Treasury." *Id.*, at 693. "[We] are mindful that the characterization of a transaction for financial accounting purposes, on the one hand, and for tax purposes, on the other, need not necessarily be the same." *Frank Lyon Co. v. U.S.*, 435 U.S. 561, 577 (1978). *See Comm'r v. Idaho Power Co.*, 418 U.S. 1, 15 (1974). Indeed, the Court's cases demonstrate that divergence between tax and financial accounting is especially common when a taxpayer seeks a current deduction for estimated future expenses or losses. *E.g., Comm'r v. Hansen*, 360 U.S. 446 (1959) (reserve to cover contingent liability in event of nonperformance of guarantee); *Brown v. Helvering*, 291 U.S. 193 (1934) (reserve to cover expected liability for unearned commissions on anticipated insurance policy cancellations); *Lucas v. Am. Code Co., supra* (reserve to cover expected liability on contested lawsuit). The rationale of these cases amply encompasses Thor's aim. By its president's concession, the company's write-down of "excess" inventory was founded on the belief that many of the articles inevitably would become useless due to breakage, technological change, fluctuations in market demand, and the like.[17] Thor, in other words, sought a current "deduction" for an estimated future loss. Under the decided cases, a taxpayer so circumstanced finds no shelter beneath an accountancy presumption.

Third, the presumption petitioner postulates is insupportable in light of the vastly different objectives that financial and tax accounting have. The primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and others properly interested; the major responsibility of the accountant is to protect these parties from being misled. The primary goal of the income tax system, in contrast, is the equitable collection of revenue; the major responsibility of the Internal Revenue Service is to protect the public fisc. Consistently with its goals and responsibilities, financial accounting has as its foundation the principle of conservatism, with its corollary that "possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets."[18] In view of the Treasury's markedly different goals and responsibilities, understatement of income is not destined to be its guiding light. Given this diversity, even contrariety, of objectives, any presumptive equivalency between tax and financial accounting would be unacceptable.[19]

This difference in objectives is mirrored in numerous differences of treatment. Where the tax law requires that a deduction be deferred until "all the events" have occurred that will make it fixed

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[17] "I think it is pretty obvious that [inventory representing a 10-year supply] has inherently less value [than inventory representing a 1-year supply] because of the things that can happen to the inventory. Some of it will be lost. Some of it may become damaged. Some of it will become obsolete because of the technological change. Some won't be sold because of the fact that you have market changes. So we were confronted with the problem, as anybody in the manufacturing field [would be], of trying to develop a relationship between inventory quantity and anticipated usage." App. 56-57 (testimony of Thor's president).

[18] AICPA Accounting Principles Board, Statement No. 4, Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises para. 171 (1970), *reprinted in* 2 APB ACCOUNTING PRINCIPLES 9089 (1973). *See* Sterling, *Conservatism: The Fundamental Principle of Valuation in Traditional Accounting*, 3 ABACUS 109-113 (1967).

[19] *Accord*, Raby & Richter, *Conformity of Tax and Financial Accounting*, 139 J. ACCOUNTANCY 42, 44, 48 (Mar. 1975); Arnett, *Taxable Income vs. Financial Income: How Much Uniformity Can We Stand?*, 44 ACCOUNTING REV. 482, 485-487, 492-493 (July 1969); Cannon, *Tax Pressures on Accounting Principles and Accountants' Independence*, 27 ACCOUNTING REV. 419, 419-422 (1952).

and certain, *U.S. v. Anderson*, 269 U.S. 422, 441 (1926), accounting principles typically require that a liability be accrued as soon as it can reasonably be estimated.[20] Conversely, where the tax law requires that income be recognized currently under "claim of right," "ability to pay," and "control" rationales, accounting principles may defer accrual until a later year so that revenues and expenses may be better matched.[21] Financial accounting, in short, is hospitable to estimates, probabilities, and reasonable certainties; the tax law, with its mandate to preserve the revenue, can give no quarter to uncertainty. This is as it should be. Reasonable estimates may be useful, even essential, in giving shareholders and creditors an accurate picture of a firm's overall financial health; but the accountant's conservatism cannot bind the Commissioner in his efforts to collect taxes. "Only a few reserves voluntarily established as a matter of conservative accounting," Mr. Justice Brandeis wrote for the Court, "are authorized by the Revenue Acts." *Brown v. Helvering*, 291 U.S., at 201-202.

Finally, a presumptive equivalency between tax and financial accounting would create insurmountable difficulties of tax administration. Accountants long have recognized that "generally accepted accounting principles" are far from being a canonical set of rules that will ensure identical accounting treatment of identical transactions.[22] "Generally accepted accounting principles," rather, tolerate a range of "reasonable" treatments, leaving the choice among alternatives to management. Such, indeed, is precisely the case here. [23] Variances of this sort may be tolerable in financial reporting, but they are questionable in a tax system designed to ensure as far as possible that similarly situated taxpayers pay the same tax. If management's election among "acceptable" options were dispositive for tax purposes, a firm, indeed, could decide unilaterally—within limits dictated only by its accountants—the tax it wished to pay. Such unilateral decisions would not just make the Code inequitable; they would make it unenforceable.

D.

Thor complains that a decision adverse to it poses a dilemma. According to the taxpayer, it would be virtually impossible for it to offer objective evidence of its "excess" inventory's lower value, since the goods cannot be sold at reduced prices; even if they could be sold, says Thor, their reduced-price sale would just "pull the rug out" from under the identical "non-excess" inventory Thor is trying to sell simultaneously. The only way Thor could establish the inventory's value by a "closed transaction" would be to scrap the articles at once. Yet immediate scrapping would be

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[20] *See, e.g.*, McClure, *Diverse Tax Interpretations of Accounting Concepts*, 142 J. ACCOUNTANCY 67, 68-69 (Oct. 1976); Kupfer, *The Financial Accounting Disclosure of Tax Matters; Conflicts With Tax Accounting Technical Requirements*, 33 N.Y.U. INST. ON FED. TAX. 1121, 1122 (1975); Healy, *Narrowing the Gap Between Tax and Financial Accounting*, 22 TULANE TAX INST. 407, 417 (1973); *A Challenge: Can the Accounting Profession Lead the Tax System?*, 126 J. ACCOUNTANCY 66, 68-69 (Sept. 1968).

[21] *E.g.*, Raby & Richter, *supra*, at 44; Arnett, *supra*, at 486; 126 J. ACCOUNTANCY, *supra*, at 68.

[22] Arnett, *supra*, at 492 (noting that there are "many and diverse 'acceptable' practices in valuing inventories, depreciating assets, amortizing or not amortizing goodwill," and the like); 126 J. ACCOUNTANCY, *supra*, at 69 (noting that "methods of determining inventory costs vary widely and various methods, if consistently applied, will be acceptable for accounting purposes"); Eaton, *Financial Reporting in a Changing Society*, 104 J. ACCOUNTANCY 25, 26 (Aug. 1957); Cox, *Conflicting Concepts of Income for Managerial and Federal Income Tax Purposes*, 33 ACCOUNTING REV. 242 (1958); Cannon, *supra*, at 421 (suggesting that accountants "are quite prone to define 'generally accepted' as 'somebody tried it'").

[23] Thor's experts did not testify that the company's write-down procedures were the only "generally accepted accounting practice." They testified merely that Thor's inventory needed to be written down, and that the formulae Thor used constituted a "reasonable" way of doing this. App. 166, 184, 196.

undesirable, for demand for the parts ultimately might prove greater than anticipated. The taxpayer thus sees itself presented with "an unattractive Hobson's choice: either the unsalable inventory must be carried for years at its cost instead of net realizable value, thereby overstating taxable income by such overvaluation until it is scrapped, or the excess inventory must be scrapped prematurely to the detriment of the manufacturer and its customers." Brief for Petitioner 25.

If this is indeed the dilemma that confronts Thor, it is in reality the same choice that every taxpayer who has a paper loss must face. It can realize its loss now and garner its tax benefit, or it can defer realization, and its deduction, hoping for better luck later. Thor, quite simply, has suffered no present loss. It deliberately manufactured its "excess" spare parts because it judged that the marginal cost of unsalable inventory would be lower than the cost of retooling machinery should demand surpass expectations. This was a rational business judgment and, not unpredictably, Thor now has inventory it believes it cannot sell. Thor, of course, is not so confident of its prediction as to be willing to scrap the "excess" parts now; it wants to keep them on hand, just in case. This, too, is a rational judgment, but there is no reason why the Treasury should subsidize Thor's hedging of its bets. There is also no reason why Thor should be entitled, for tax purposes, to have its cake and to eat it too.

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*Thor Power Tool* contains quite a lot to digest. It is most often cited for its discussion about the different purposes and goals of financial and tax accounting. The purpose of financial accounting is to provide *reliable information* about the economic health of the business to those who may make important decisions (to invest or to lend) based on the information. Thus, it tends toward conservatism in measuring profits, where "estimates, probabilities, and reasonable certainties," in the words of the Court, are acceptable in order to avoid misleading potential investors and lenders. The goal of measuring "income" in order to collect a tax payment, in contrast, requires more certainty with respect to realized wealth accessions (and reductions) in order to ensure both that similarly situated taxpayers are taxed the same and that wealth accessions and reductions are realized before taken into account.

You also saw a reference to the "matching principle" in *Thor Power Tool*. Notwithstanding the flexibility of GAAP, as a broad, general statement, GAAP usually requires that revenue be included in the year in which goods or services are sold (regardless of when payment for those goods or services is received), with "costs and expenses" (both depreciation and expenses) then "matched" with its related revenue and deducted in the same year (again, regardless of when payment is made). Thus, the "matching principle" is an example of *transactional accounting* (including the revenue and deductions from a transaction in the same year, regardless of when realized or incurred), which differs from the income tax's *annual accounting principle*. Transactional accounting can downplay the time value of money, for example. The matching principle is nevertheless a deeply important and foundational principle of accrual accounting under GAAP. The purpose of the "matching principle" is to avoid a misleading picture of the financial health of the business. Including revenue when received and costs when paid could, for example, create the appearance of roller-coaster profits and losses when the business is actually stable and steadily expanding.

But the so-called matching principle under GAAP can undermine income tax values[23]—values that go beyond those identified by Justice Blackmun in *Thor Power Tool*. You already read in Chapter 14, for example, how depreciation *for financial accounting purposes* is premised on the matching principle, under which the cost of long-lived property is deducted in the same years and at the same rate as expected revenues generated by that asset are included. Thus, depreciation rates for financial accounting purposes can vary (within limits) from company to company, based on reasonable estimates of management regarding the rate at which those assets are contributing to yearly revenue. In an income tax that incorporates a realization requirement, in contrast, the rate of depreciation should (absent a deliberate tax expenditure component) reflect the declining-balance method evidenced in a level-payment debt instrument, as only those amounts reflect a permanent and irretrievable (and thus realized) wealth reduction. Too-fast depreciation (or the allowance of any depreciation with respect to an asset that does not waste away in a predictable manner solely because of the passage of time) can result in the capital return generated by the asset effectively escaping taxation, as under a cash-flow consumption tax (or its wage tax equivalent).

Similarly, reflexive application of the matching principle from financial accounting can permit deferral of cash in hand or can permit a deduction of an amount not yet paid. If respected for income tax purposes, as well, such timing results would effectively permit the capital return earned on the cash in hand effectively to escape taxation for the period between the year in which the cash is received and the year included (or the year in which the deduction is taken and the year the amount is actually spent). In other words, applying the matching principle from financial accounting can transform the income tax base into a consumption tax base—an irrelevant factor in financial accounting, under which no payment obligation arises. If the time span is long enough between accrual and actual payment or receipt, it can even result in better-than-consumption tax treatment in the form of "rent" (as described in Chapter 3 and revisited many times since then)—a "profit" representing mere shifts in wealth from other taxpayers to the party at issue. These ideas are developed further below in the sections that examine when deductions pertaining to future expenses should be accrued and when prepaid income (also called advance payments) should be accrued (included) under the accrual method. But first, we need to examine the building block: the all-events test for accruing income and deductions.

***The all-events test and its use as a tool for diverging from GAAP***

Accrual accounting has been defined for *financial accounting purposes* as:

> an accounting method that measures the performance and position of a company by recognizing economic events regardless of when cash transactions occur. The general idea is that economic events are recognized by *matching revenues to expenses (the matching principle) at the time in which the transaction occurs rather than when payment is made (or received).* This method allows the current cash inflows/outflows to be combined with future expected cash inflows/outflows to give a more accurate picture of a company's current financial condition.[24]

Shortly after Congress first permitted use of accrual accounting for tax purposes in 1916, the Supreme Court decided *United States v. Anderson*,[25] in which the Yale & Towne Manufacturing

[23] *See generally* Deborah A. Geier, *The Myth of the Matching Principle as a Tax Value*, 15 AM. J. OF TAX POL'Y 17 (1998); Alan Gunn, *Matching of Costs and Revenues as a Goal of Tax Accounting*, 4 VA. TAX REV. 1 (1984).
[24] www.investopedia.com/terms/a/accrualaccounting.asp (emphasis added).
[25] 269 U.S. 422 (1926).

Company used the accrual method of accounting for both financial accounting purposes and in filing its income tax returns for 1916 and 1917, the years at issue. The taxpayer, which was engaged in the manufacture of munitions, was required to pay a Federal munitions tax on its 1916 profits, and the munitions tax was deductible for Federal income tax purposes. On its books Yale & Towne created an account entitled "reserves for taxes," listing various taxes for which it became liable by reason of its 1916 operations, including the munitions tax at issue. The taxpayer deducted these taxes on its books (for financial reporting purposes) in 1916 but did not deduct the munitions tax for income tax purposes until 1917, the year in which the tax was actually assessed and paid.

The Commissioner argued that Yale & Towne must deduct the munitions tax under the accrual method for tax purposes in 1916, the same year in which it accrued the tax for financial accounting purposes. (The 1917 spike in income tax rates that accompanied America's entrance into WWI explains both the taxpayer's desire to delay the deduction and the Commissioner's desire to accelerate it, notwithstanding conventional wisdom under time-value-of-money principles that deductions are more valuable to the taxpayer if taken earlier.) The taxpayer argued that a tax cannot be considered accrued until it is due and payable, which occurred in 1917, but the Supreme Court disagreed. In rejecting the taxpayer's argument, the Court enunciated language that was later seized upon as the accrual test in tax accounting: the all-events test.

> In a technical legal sense it may be argued that a tax does not accrue until it has been assessed and becomes due; but it is also true that in advance of the assessment of a tax, all the events may occur which fix the amount of the tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee's books. In the economic and bookkeeping sense with which the statute and Treasury decision were concerned, the taxes had accrued.[26]

While it seems clear that the Court was merely attempting to capture the standard for accrual of an expense from within the financial accounting perspective that it was importing, the so-called all-events test (language not used in financial accounting) has taken on a life of its own in the tax arena. Later cases adopted it as the test controlling when expenses should be accrued, and Treasury regulations now use it as the standard for determining not only when expenses must be deducted but also when Gross Income must be included under the accrual method.

That evolution was not inevitable. The Court appears to have been merely trying to articulate the essence of what financial accountants captured in the accrual idea—the matching principle. Because the profit on which the munitions tax was computed was included in 1916, the tax due on that profit must be matched to the same period. The all-events language was descriptive only. The Court could just as easily have said that if an item is accrued for financial accounting purposes, then it must be accrued for tax purposes under the accrual method, avoiding the all-events language entirely. But, as will be seen, the elevation of this language to an exalted talisman has proved to be fortunate, for it provided the means by which accrual accounting under the income tax could evolve in a manner that accorded with tax values that are ignored in financial accounting.

Today, Treas. Reg. § 1.446-1(c)(1)(ii)(A) provides:

> Generally, under an accrual method, income is to be included for the taxable year

[26] *Id.* at 441.

> 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 into account for Federal income tax purposes, in the taxable year in which all the events have occurred that established 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…. [S]ee [§ 461(h) and] §§ 1.461-4 through 1.461-6 for rules relating to economic performance.

***The accrual (deduction) of expenses not yet paid***

In *Anderson*, the taxpayer accrued (deducted) the tax in 1916 for financial reporting purposes, and the Court's decision required 1916 deduction for tax purposes, as well. But it did not take long for the Commissioner and the Court to begin using the all-events test to *delay* deductions for tax purposes (particularly with respect to contingent liabilities) that were permitted for financial reporting purposes in an earlier year.

For example, the taxpayer in *Lucas v. American Code Company*[27] fired an employee in 1919 who was under contract to work for 18 more years and who was to be paid by commissions on sales. The employee brought suit for breach of contract, which resulted in a judgment in his favor of $21,000 in 1921. The company appealed, but the appellate court affirmed and the company paid the damages to the employee in 1923. After the employee filed suit in 1919, the company immediately created on its books a "reserve" (resulting in a deduction for financial accounting purposes) equal to $14,700, which equaled the amount of unpaid commissions for the year (commissions that would have been paid to the employee if he had not been fired). The company increased the reserve by nearly $33,000 in 1920. The 1921 books were not yet closed when the 1923 trial resulted in the $21,000 judgment, and the company adjusted (reduced) its reserve account for 1921 to equal the $21,000 damage award. For tax purposes, it sought to deduct this $21,000 payment in 1919 (the year in which the employee was fired), as that year was still open under the statute of limitations, rather than in 1923 (the payment year) by arguing that

> all the facts which gave rise to the liability were fixed in that year; that damages must be assessed as of the date of the breach; that the loss therefore occurred in that year; and that it is immaterial that the amount of the damages was not determined or paid until later.[28]

The Court upheld the Commissioner's exercise of discretion under the predecessor to § 446(b)'s "clear reflection" language in denying the deduction until 1923, reasoning that because the company contested the liability the payment obligation was still uncertain in 1919. The Court contrasted the *Anderson* facts, under which the munitions tax, though not paid until 1917, was not contingent on any future events as of the end of 1916. Four years later, the Court confirmed that "a liability does not accrue as long as it remains contingent."[29] The all-events test came in handy in these cases, as one can easily argue that *all* the events have not yet occurred to establish the fact of liability if the liability is contingent, *i.e.*, if it depends on future events.

Although the Court in these cases disallowed current accrual (deduction) of future payments if

[27] 280 U.S. 445 (1930).
[28] *Id.* at 448.
[29] Brown v. Helvering, 291 U.S. 193, 200 (1934).

the payments were contingent, the contingency of the liability is not really the problem—or at least not solely the problem—from the vantage point of income tax values. The real problem from the vantage point of income tax values is that they were to be paid *in the future*—full stop. Thus, the cash is still on hand and can earn a return during the period before the payment obligation ripens.

Return, for example, to the *Anderson* case, in which the taxpayer was permitted (indeed, required) to accrue (deduct) the munitions tax one year before the tax was actually paid. Thus, the taxpayer retained the cash in hand for one more year *after it was deducted for income tax purposes*, which means that the deducted cash still in hand could be invested and earn a return for the taxpayer for that one-year period before the munitions tax was paid.

Recall from Chapter 2 that, for capital returns to be taxed under income tax principles, two ingredients must be satisfied: (1) the investment must be made with after-tax dollars and (2) the investment's return must be included in the tax base. If an investment can be made with pre-tax dollars, requirement (1) is failed, and the investment is treated to more favorable consumption tax treatment, as under a cash-flow consumption tax. Thus, even though the investment's return is included in the tax base (as it would be under a cash-flow consumption tax), the economic effect can be the same, under the E. Cary Brown yield-exemption phenomenon, as if the investment were made with after-tax dollars (if deduction had been disallowed in 1916) but the investment return (for the one-year period between 1916 and 1917) was permitted to be excluded from the tax base.

While this favorable treatment lasted for only one year in the facts of the *Anderson* case, you can imagine other facts in which a deduction could occur many years before actual payment. Indeed, with many years between the time of deduction and the time of actual payment, a taxpayer could even earn a "profit" (in the form of economic rent) funded with tax dollars from the Treasury, as discussed in the *Ford Motor Company* case (below)! The reason for this is that no provision in the Code requires deductions to be discounted to present value if the amounts are to be paid in the future. Deductions are accrued at face amount. Thus, even satisfaction of the all-events test should not permit premature deduction of a future liability in all cases. In recognizing this, Congress amended the Code in 1984 by adding § 461(h), which, in effect, delays deduction of future payments, even though they satisfy the all-events test, until "economic performance" occurs. Note the nature of the statutory interpretation argument made by Ford Motor Company regarding what this enactment implied about the state of the law in years prior to 1984.

## FORD MOTOR COMPANY v. COMMISSIONER

71 F.3d 209 (6th Cir. 1995)

Before ENGEL, MILBURN, and NORRIS, Circuit Judges.

MILBURN, CIRCUIT JUDGE: Petitioner Ford Motor Company ("Ford") appeals the decision of the United States Tax Court upholding respondent Commissioner of Internal Revenue's ("Commissioner") reduction of petitioner's deductions for its obligations under agreements it entered into in settlement of tort lawsuits against it. On appeal, the issue is whether respondent Commissioner abused her discretion in determining that petitioner's method of accounting for its structured settlements was not a clear reflection of income under 26 U.S.C. § 446(b) and in ordering petitioner to limit its deduction in 1980 to the cost of the annuity contracts it purchased to fund the settlements. For the reasons that follow, we affirm.

I.

A.

Petitioner Ford Motor Company is engaged in a number of businesses, including the manufacture of cars and trucks, and it maintains its books and records and files its income taxes using the accrual method of accounting. In the years preceding 1980, some of Ford's cars and trucks were involved in automobile accidents, and in 1980, Ford entered into 20 structured settlement agreements in settlement of personal injury or accidental death claims with persons who were injured in the accidents and with survivors of persons who died as a result of the accidents. In these structured settlement agreements, Ford agreed to make periodic payments of tort damages, yearly or monthly, in exchange for a release of all claims against it. The payments were to be made over various periods of time, the longest of which was 58 years. All but three of the settlements provided for payments over a period of 40 years or more. The agreements were of three types: (I) those that required petitioner to make periodic payments for a period certain ("Type I settlements"); (II) those that required petitioner to make periodic payments for the remainder of a claimant's life ("Type II settlements"); and (III) those that required petitioner to make periodic payments for the longer of a period certain or the remainder of a claimant's life ("Type III settlements"). In total, the structured settlement agreements provided for payments of $24,477,699.

To provide it with funds to cover the periodic payments, Ford purchased single premium annuity contracts at a cost of $4,424,587. The annuity contracts were structured so that the yearly annuity payments would equal the yearly amount owed to the claimants under the structured settlement agreements. None of the settlement agreements released petitioner from liability following the purchase of the annuity contract, and, in the event of a default on an annuity, petitioner would be required to pay the remaining balance owed to the tort claimants. The parties stipulated that the present value of the deferred payments that petitioner agreed to make to the claimants did not exceed the cost of the annuity contracts.

On its 1980 tax return, petitioner claimed deductions for the various types of structured settlements as follows: for the Type I settlements, it claimed the total amount of all periodic payments due; for the Type II settlements, it claimed the amounts it actually paid during 1980; and for the Type III settlements, it claimed the total amount of all payments due for the period certain portion of the settlement. These deductions totaled $10,636,994, which petitioner … carried back to its 1970 taxable year pursuant to 26 U.S.C. § 172(b)(1)(I). It also reported the annuity income on its 1980 federal income tax return under 26 U.S.C. § 72. For financial accounting purposes, petitioner reported the 1980 structured settlements by expensing the cost of the annuity in the year of the settlement. For other settlements not funded by annuities, of which there were none in 1980, petitioner expensed the present value of the payments to be made to the claimants in the year of the settlement.

Respondent Commissioner determined that Ford's method of accounting for its structured settlements did not clearly reflect income under 26 U.S.C. § 446(b) and disallowed the deductions petitioner claimed in excess of the cost of the annuities petitioner purchased. Respondent also excluded from petitioner's income the amounts required to be reported as income from annuity contracts, which was $323,340 in 1980. As a result, respondent determined a deficiency in petitioner's 1970 federal income tax liability of $3,300,151.

B.

Petitioner Ford challenged this deficiency determination by filing a petition in the United States Tax Court. In its amended petition, Ford claimed that it was entitled to deduct in 1980 the full amount of all payments to be made under the structured settlements, basing its valuation of the life settlements on the life expectancies of the claimants. The total deduction Ford claimed was $24,477,699.

The parties submitted the case to the United States Tax Court with all facts fully stipulated. A divided court upheld the Commissioner's position. Based on the Tax Court's opinion, the parties agreed on a deficiency determination of $2,833,860 under Rule 155 of the Tax Court Rules, and the Tax Court entered its decision in that amount. This timely appeal followed.

II.

A.

Section 446 of the Internal Revenue Code provides the general rule governing use of methods of accounting by taxpayers. Section 446(b) provides that, if the method of accounting used by the taxpayer to compute income does not clearly reflect income, "the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income." 26 U.S.C. § 446(b). The Commissioner has broad discretion under § 446(b) to determine whether a particular method of accounting clearly reflects income. *Thor Power Tool Co. v. Comm'r*, 439 U.S. 522, 533 (1979) (citing *Comm'r v. Hansen*, 360 U.S. 446, 467 (1959)). "Since the Commissioner has 'much latitude for discretion,' his interpretation of the statute's clear-reflection standard 'should not be interfered with unless clearly unlawful.'" 439 U.S. at 532 (quoting *Lucas v. Am. Code Co.*, 280 U.S. 445, 449 (1930)). Once the Commissioner has determined that a method of accounting does not clearly reflect income, she may substitute a method that, in her opinion, does clearly reflect income.

Petitioner appeals the Tax Court's holding that respondent correctly determined that petitioner's accrual method of accounting for its tort obligations did not clearly reflect income and its resulting disallowance of a portion of petitioner's deductions for such obligations by imposing a different accounting method on petitioner. All facts in this case were stipulated, and the issue before us is a question of ultimate fact, which we review de novo. *See Walter v. Comm'r, 753 F.2d 35, 38 (6th Cir. 1985)*; *see also RCA Corp. v. U.S.*, 664 F.2d 881, 888 (2d Cir. 1981), *cert. denied*, 457 U.S. 1133 (1982).

B.

There are three stages to our analysis in this case: first, we decide whether the application of § 446(b) was appropriate; second, we decide whether the Tax Court correctly determined that petitioner's method of accounting did not clearly reflect income; and third, we address the appropriateness of the method of accounting that the Commissioner imposed in its place.

First, petitioner argues that the Tax Court erred in allowing the Commissioner to require Ford to change its method of accounting because, in the absence of abuse or manipulation, an accrual method taxpayer clearly reflects its income when its reporting satisfies the "all events" test. Therefore, it argues that, because its accrual of deductions satisfied the all events test, the Commissioner had no authority to invoke § 446(b).

Ford Motor Company is an accrual method taxpayer. The accrual method of accounting takes income into account when the right to payment is earned, even if payment is not received until

later, and expenses into account when they are incurred, even if payment is not made until a later time. Financial accounting systems differ regarding the time that an expense is "incurred" and therefore should be accrued, but, under the tax law, the standard for determining when an expense is "incurred" is the "all events" test. Treas. Reg. § 1.466-1(c)(1)(ii); *U.S. v. Hughes Properties, Inc.*, 476 U.S. 593, 600 (1986). This test provides that an accrual method taxpayer must deduct an expense in the taxable year when all the events have occurred that establish the fact of liability giving rise to the deduction and the amount of the liability can be determined with reasonable accuracy. *Id.* The Tax Court assumed for purposes of discussion that Ford's deductions satisfied the all events test, and for purposes of our review, we will make this assumption as well.

It is a well-established principle that the Commissioner may not invoke her authority under § 446(b) to require a taxpayer to change from an accounting method that clearly reflects income, even if she believes that a second method might more clearly reflect income. *Louisville & Nashville R.R. v. Comm'r*, 641 F.2d 435, 438 (6th Cir. 1981). However, we hold that satisfaction of the all events test by an accrual method taxpayer does not preempt the Commissioner's authority under § 446(b) to determine that a taxpayer's method of accounting does not clearly reflect income.

Section 446(c) of the Internal Revenue Code provides that, subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under the accrual method of accounting. 26 U.S.C. § 446(c)(2). The all events test, which is merely a means devised to define the years in which income and deductions accrue, clearly is subordinate to the clear reflection standard contained in subsection (b). The Tax Court stated:

> The provisions of section 446 make it clear that a taxpayer's ability to use one or more of the methods of accounting listed in 446(c) is contingent upon the satisfaction of subsections 446(a) and (b). The statute does not limit the Commissioner's discretion under section 446(b) by the taxpayer's mere compliance with the methods of accounting generally permitted under section 446(c) …. In short, the statute clearly provides that the taxpayers may use an accrual method so long as it clearly reflects income.

The language of § 446 is clear on its face, and we agree with the Tax Court's interpretation of the statute. *See Mooney Aircraft, Inc. v. U.S.*, 420 F.2d 400, 406 (5th Cir. 1969) ("The 'all events test,' however, is not the only basis upon which the Commissioner can disallow a deduction. Under 446(b) he has discretion to disallow any accounting method which does not clearly reflect income.").

Petitioner argues that Congress acknowledged that the Commissioner's discretion under § 446(b) does not extend to situations such as the present case when it changed the Internal Revenue Code, effective in 1984, to provide in § 461(h)(2)(c) that accrual method taxpayers cannot deduct tort liabilities until the year in which payment is made. Ford points to the legislative history of § 461, which states that "the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money." Brief of Petitioner at 22 (citing H.R. Rep. No. 432, 98th Cong., 2d Sess., pt. II, at 1254 (1984)) (emphasis added). It argues that this statement indicates a recognition by Congress that the Commissioner was not authorized to deny the sort of accrual that Ford is attempting prior to 1984.

The Tax Court held that the change in prior law to which the legislative history refers is the all events test contained in the Income Tax Regulations and that Congress did not intend "to limit

respondent's authority under section 446(b) in any way by enacting section 461(h) in 1984." We agree that the change that this passage references is a modification of the all events test and conclude that nothing in the legislative history of § 461(h) limits the Commissioner's authority under § 446(b). Section 461(h) was a Congressional effort to remedy an accounting distortion by placing all accrual method taxpayers on the cash method of accounting for tort liabilities, regardless of the length of the payout period and without any consideration of whether accrual of an expense in an earlier year would distort income. Its enactment does not preclude the Commissioner from applying the clear reflection standard of § 446(b) on a case-by-case basis to taxpayers in tax years prior to 1984.

C.

Having determined that expenses that satisfy the all events test can be disallowed when accrual would not result in a clear reflection of income, we now examine the correctness of the Commissioner's determination that Ford's method of accounting for its tort obligations did not clearly reflect income. In its opinion, the Tax Court used an example to "highlight the distortion [of petitioner's income] about which respondent complains." It utilized the numbers from one settlement agreement under which Ford agreed to pay the claimant $504,000 in 42 equal, annual installments of $12,000. The annuity contract that Ford purchased to fund the payments cost $141,124, demonstrating an implicit rate of return of 8.19 percent. Ford claimed a deduction in 1980 in the amount of $504,000 for this obligation. The Tax Court used these numbers to create three scenarios, assuming that but for the settlement agreement in question, petitioner would have had taxable income in 1980 of at least $504,000.

In the first scenario, the Tax Court assumed that the accident in question did not occur and that, as a result, petitioner received an additional $504,000 of currently taxable income. The Tax Court further assumed that petitioner would have been subject to a 40 percent marginal tax rate, leaving it with $302,400. The Tax Court then noted that, if the after tax proceeds were invested over 42 years at a rate of 8.19 percent, the $302,400 would grow to $8,249,751.

In the second scenario, the Tax Court assumed that the accident occurred but that Ford discharged its liability in full by paying and deducting $141,124 and investing the remainder over 42 years. Its current deduction of the $141,124 it paid for the annuity would leave it with $362,876 of taxable income on which it would pay tax of $145,150, leaving $217,726. If it invested the $217,726 over the 42 year period at a 8.19 percent rate of return, it would grow to $5,939,756.

In the third scenario, the Tax Court assumed that the events occurred as they did in the present case, with Ford deducting the full $504,000 it was required to pay the tort claimants and paying no tax. Investing the $504,000 at a rate of return of 8.19 percent and taking into account the annual payments of $12,000, the Tax Court found that petitioner would have $9,898,901 remaining after 42 years.

The Tax Court pointed out that Ford is claiming scenario three treatment and that comparing scenario three to scenario one demonstrates that petitioner is better off with the accidents than if they never occurred. The Tax Court held that fully deducting payments extending over a long period of time leads to a distortion of income and "the incongruous result that the greater a taxpayer's nominal liability for negligence, the more it benefits." It therefore concluded that petitioner's method of accounting did not clearly reflect income.

Petitioner challenges the Tax Court's approval of the Commissioner's determination that its

accounting method did not clearly reflect income on several grounds. First, it argues that the Tax Court's numerical example was flawed by its use of a 8.19 percent rate of return. It asserts that the 8.19 percent rate of return that the Tax Court found implicit in one of the annuity contracts is a pre-tax rate of return because Ford is required to pay tax on amounts received as an annuity under 26 U.S.C. § 72 and that the Tax Court instead should have used the after-tax rate of 4.91 percent. Recomputing the investment growth over 42 years using this rate of return in the three scenarios, petitioner asserts that in scenario one it would be $2,267,705; in scenario two it would be $1,632,729; and in scenario three it would be $2,192,446. Thus, petitioner argues: "Ford did not 'fare[] better than if the accident never occurred'; the Tax Court's apparent reason for invalidating Ford's tax treatment rests on a misconception." Brief of Petitioner at 35 (quoting Tax Court's opinion). In her brief, respondent acknowledges the flaw in the Tax Court's numerical example and presents an example of her own, arguing that Ford was in a 46 percent tax bracket rather than a 40 percent tax bracket. In respondent's example, petitioner again fares better under scenario three treatment than under scenario one.

Petitioner's brief suggests that the Tax Court's determination that its accounting method did not clearly reflect income was based solely on the fact that, in the Tax Court's example, petitioner fared better with the accident than without. We conclude, however, that this factor was not determinative, and that, even viewing petitioner's numerical example as correct, the gross distortion of income that it demonstrates between the economic and tax results persuades us that the Tax Court's decision was not improper. Given the length of the payment periods, allowing a deduction for the full amount of liability in 1980 could lead to the result that the tax benefit from the deduction would fund the full amounts due in future years and leave petitioner with a profit. Such a result extends the accrual method of accounting beyond its inherent limitations.

Our task on appeal is to determine whether there is an adequate basis in law for the Commissioner's conclusion that Ford's method of accounting did not clearly reflect income. *See RCA Corp.*, 664 F.2d at 886. We find several cases from other circuits that support our finding that the Commissioner's exercise of her discretion was proper. First, in *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400 (5th Cir. 1969), the Fifth Circuit upheld the Commissioner's denial of the taxpayer's use of an accounting method based on his § 446(b) authority. In that case, Mooney manufactured airplanes, and each purchaser of an airplane received a "Mooney Bond," redeemable for $1000 when the airplane was permanently retired from service. Retirement of the aircraft usually occurred 20 or more years from the date of purchase. Mooney, an accrual method taxpayer, argued that the sale of an aircraft and corresponding issuance of a bond satisfied the all events test for the liability, and, therefore, it attempted to deduct the $ 1000 redemption price of the bonds in the year of sale. Conversely, the government argued that the all events test was not satisfied until the aircraft was retired and that the deduction was improper prior to such time. The Fifth Circuit disagreed with the government, holding that the all events test was satisfied at the time of sale. *Id.* at 405-06. However, it concluded that the taxpayer's method of accounting did not clearly reflect income, emphasizing that the long time period between the deduction for the bonds and their date of redemption was problematic and caused a distortion of income. *Id.* at 409-10.

…

Petitioner also argues that the Tax Court's decision that petitioner's method of accounting did not clearly reflect income was improper because it "authorizes arbitrary and unprincipled use of the Commissioner's section 446(b) power." Reply Brief of Petitioner at 3. It asserts that the Tax Court failed to provide any principles "to delineate the scope of section 446(b)," *id.* at 4, and that,

in doing so, it created an "arbitrary system … that requires all accrual taxpayers to account for their liabilities when they become fixed, yet makes the validity of that reporting method subject to the unconstrained whim of the Commissioner," *id.* at 5-6.

We are not persuaded by this policy-based argument. The Tax Court concluded its opinion stating:

> Finally, we want to make clear that the mere fact that a deduction which accrues prior to the time payment is made (the timing factor) does not, by itself, cause the accrual to run afoul of the clear reflection of income requirement. Inherent in the use of an accrual method is the fact that a deduction may be allowed in advance of payment. Our holding in the instant case is not intended to draw a bright line that can be applied mechanically in other circumstances. We decide only the ultimate question of fact in the instant case; namely, whether, for tax purposes, petitioner's method of accounting for its obligations under the structured settlements clearly reflects income. We hold that it does not and that the Government did not abuse its discretion in making that determination.

As the Tax Court observed, "the issue of whether the taxpayer's method of accounting clearly reflects income is a question of fact to be determined on a case-by-case basis." *See Hamilton Indus., Inc. v. Comm'r*, 97 T.C. 120, 128-29 (1991) (citing *Peninsula Steel Prods. & Equip. Co. v. Comm'r*, 78 T.C. 1029, 1045 (1982)). We find the Tax Court's language sufficient to limit its holding to extreme cases such as this one in which the economic results are grossly different from the tax results and therefore conclude that the Tax Court's decision does not allow the Commissioner arbitrary or unprincipled discretion.

D.

Given that a change was necessary because Ford's accrual of its settlement obligations in 1980 did not clearly reflect income, Ford argues that the method of accounting that the Commissioner imposed in its place was improper. Ford asserts that the Commissioner lacked the authority to impose the method of accounting that she did because it is "inconsistent with the plain dictates of the Code and regulations and the undisputed facts of this case." Brief of Petitioner at 23.

The method of accounting that the Commissioner imposed was to allow Ford a deduction for the amount that it paid for the annuities with no further deductions for the future payments that Ford will make to the claimants. To offset her disallowance of future deductions, the Commissioner will permit Ford to exclude its income from the annuity contracts. Petitioner asserts that this scheme violates established tax law for several reasons and forces Ford to use a tax treatment that it could not have adopted on its own.

First, petitioner argues that the Commissioner is imposing on it a present value method of accounting which should only be imposed in the presence of a directive by Congress to do so. Ford additionally argues that this method impermissibly allows it only to deduct the approximately $4 million it paid for the annuities without ever allowing a deduction for the additional approximately $20 million it will pay to the claimants and that the Commissioner's method is arbitrary because it is not a method that Ford could have adopted on its own.

Respondent counters that its method of accounting is a modified cash basis method that allows Ford "a dollar for dollar deduction, albeit in the form of an offset against its annuity income, for the full face amount of its future payments of approximately $24 million." Brief of Respondent at

30. Respondent points out that, because she allowed Ford to deduct the full cost of the annuity contracts in 1980, it has no basis in the contracts and would be fully taxable on the annuity income of $24,477,699 as it is received. However, the payments Ford is required to make to the tort claimants, which correspond exactly to the amount of its annuity income, give rise to deductions that offset the income and create a wash. Respondent argues that, because she has relieved taxpayer of the obligation to report the annuity income as it is received, she should not allow Ford any deductions for the required payments.

We find no merit in petitioner's assertion that this methodology is improper because it reduces the amount of the deductions to the present value of the payments petitioner is obligated to make. The Commissioner reduced petitioner's deduction to the cost of the annuity contracts. The stipulated facts provided only that the present value of the payments petitioner is obligated to make did not exceed this amount. There is no indication that respondent was imposing a present value method of accounting on petitioner.

Furthermore, we find no authority that prohibits the tax accounting treatment that the Commissioner and the Tax Court imposed here. The Commissioner's discretion to impose an alternate method of accounting under § 446(b) is not limited to methods that Ford could have adopted on its own. While we recognize that to require Ford to account for its tort obligations on the cash method might have been a more logical alternative, we cannot find that the Commissioner's exercise of her discretion was arbitrary because it resulted in an accounting treatment more favorable to Ford that a straight cash method would be. The only difference between the Commissioner's method of accounting and the cash basis method is that petitioner receives an immediate deduction for the cost of its annuities rather than recovering that cost over the terms of the annuities under 26 U.S.C. § 72, and this difference inures to Ford's benefit. We therefore conclude that the Tax Court's decision regarding the accounting method the Commissioner imposed was proper.

III.

For the reasons stated, the judgment of the Tax Court is AFFIRMED.

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The *Mooney Aircraft* case cited by the court is another notorious one. The taxpayer sold airplanes to customers. With each sale, the company transferred a "Mooney bond" to the customer, which entitled the airplane buyer to a $1,000 payment in the year the aircraft was retired. The estimated useful life of each aircraft was 20 years. The taxpayer argued, and the Fifth Circuit Court of Appeals agreed, that the all-events test would permit a Year-1 deduction of the $1,000, even though the $1,000 would not be paid, on average, until Year 20, rejecting the government's argument that the liability was "contingent upon the happening of a future event—retirement of the related aircraft."[30] Because no plane lasts forever, the court responded: "There is no contingency in this case as to the *fact* of liability itself; the only contingency relates to *when* the liability will arise."[31] Nevertheless, the court ruled in favor of the Commissioner on the alternative ground that current accrual would not clearly reflect income and thus was within the Commissioner's § 446(b) discretion to deny.

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[30] Mooney Aircraft v. U.S., 420 F.2d 400, 405 (5th Cir. 1969).
[31] *Id*. at 406.

> The most salient feature in this case is the fact that many or possibly most of the expenses which taxpayer wishes to presently deduct will not actually be paid for 15, 20 or even 30 years (the taxpayer has not attempted to deny this). In no other case coming to our attention have we found anything even comparable to the time span involved in this case. For all practical purposes the revenue taxpayer received from the sale of the planes is his to use as he pleases. Rather than being set up as a reserve to pay an impending expense it is far more probable that the money will be used as capital to expand the business. In what sense, then, is it an accurate reflection of income to regard it as an expense of doing business in the current year? To so regard it is to let an accounting fiction obscure the business and fiscal realities that are the heart of this case. In exercising his discretion the Commissioner need not close his eyes to these realities. We feel that … to allow a present deduction in this case would distort rather than reflect income. We therefore find no difficulty in concluding that the Commissioner had a reasonable basis for disallowing the deduction as not clearly reflecting income.[32]

As noted above, the distortion caused by premature deductions of future payments otherwise satisfying the all-events test caused Congress to add a third requirement (in addition to the two parts of the all-events test) in 1984: satisfaction of the "economic performance" requirement under § 461(h). If the facts in *Ford Motor Company* had arisen after 1984 (rather than before), § 461(h) would have prevented Year-1 deduction of the entire face amount of future tort payments (without regard to the § 446(b) "clear reflection" standard) because economic performance with respect to payment of a tort liability does not occur until payment.[33]

With respect to the accrual (deduction) of expenses connected with providing property or services to customers, economic performance occurs as the property or service is delivered to the customer.[34] Assume, for example, that an accrual method seller of central air conditioning systems agrees, with each sale, to service the air conditioner at no cost (*e.g.*, replace the air filter or add coolant) at the end of the first and second ownership years. Prior to the enactment of § 461(h), the air conditioner seller might have been permitted to deduct in the sale year the anticipated costs of servicing the air conditioners under the service contract if those costs could be determined "with reasonable accuracy" in Year 1. After 1984, however, these service costs could not be accrued (deducted) any earlier than each of the two years in which the services are performed.

With respect to the accrual (deduction) of expenses connected with receiving property or services from another, accrual occurs as the property or services are received.[35] Assume, for example, that an accrual method taxpayer contracts in Year 1 for electricity to be provided to his

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[32] *Id*. at 409-10.

[33] *See* § 461(h)(2)(C). In the case itself, the Commissioner, under its § 446(b) discretion, required the company to deduct the full cost of the annuity contract in Year 1 and exclude the annuity's investment return, both of which are contrary to the rules in § 72 (studied in Chapter 10), and it was then denied any future deduction when the tort payments were actually made to the victim using the amounts received under the annuity. After the enactment of § 461(h), there is no longer any need to deny the application of § 72 to the annuity purchase and investment return. Today, a taxpayer in the position of Ford Motor company would not be permitted to deduct the entire purchase price of the annuity in Year 1 (a nondeductible capital expenditure) but would recover that basis tax-free as payments under the annuity are received by it, as described in § 72. In addition, the company's actual payments to the tort victims would be deductible only in the years paid because economic performance is not satisfied until then with respect to a tort payment.

[34] *See* § 461(h)(2)(B).

[35] *See* § 461(h)(2)(A).

business in Year 3 at a cost of $10,000. Even though the liability is fixed (under the contract) in Year 1 and the amount is known with precision, the taxpayer cannot deduct the costs until Year 3 when the electricity is received.

Congress added an exception in § 461(h)(3) that permits accrual of items in Year 1 if

- the all-events test is satisfied in Year 1,
- economic performance will occur within the shorter of a "reasonable period" or 8½ months after the close of Year 1,
- the item is recurring in nature and is consistently treated as accruing in the year that the all-events test is met, and
- either (1) the item is not a "material item" or (2) accrual in Year 1 results in a "more proper match" against related income than would accrual in Year 2, and financial statements are taken into account in this regard.

That last bullet indicates that even Congress could not completely let go of the "matching principle" when it addressed the problem of premature deduction for future payments. You can think of § 461(h)(3) as a species of *de minimis* rule.

There are two ways to fix the problem in accounting for future payments for income tax purposes (as opposed to financial accounting purposes). Year-1 deductions could be discounted to their true present cost. Alternatively, the deduction could be deferred until the payment year and deducted in full. These methods are economically equivalent, but the former would require a choice of discount rate, which means that the tax value of using the most easily administrable alternative of two equal choices favors the delayed-deduction alternative. Indeed, Congress rejected the Year-1 deduction for future liabilities at a discounted rate in 1984 as being too cumbersome. Why, then, did it not simply provide that future payments could *never* be accrued until paid in order to honor income tax values (and not allow capital returns to effectively escape taxation between the time deducted and the time paid) instead of creating the "economic performance" rules?

Such an approach would, in essence, require use of the cash method of accounting. Let's return to this idea after first considering the receipt of prepaid income by an accrual method taxpayer.

***The accrual (inclusion) of prepaid income (advance payments)***

For financial accounting purposes, gross receipts are not included in income, even though prepaid and thus in hand, until they are *earned* through the future delivery of goods or services. Thus, a business receiving payment in Year 1 for services that it will perform for the customer in Year 3 is not included until Year 3. Only when the business performs the services or delivers the goods can we be sure that the business will be permitted to retain the cash in most cases, so deferring the inclusion of the cash in hand is understandable in light of the conservative goals of financial accounting. In addition, the costs that the business will incur in providing those goods or services will likely be incurred in Year 3, as well, so deferring the prepaid income receipt makes sense under the matching principle of financial accounting. Including the gross receipts in Year 1 (when received) and then deducting the related costs incurred to provide the future goods or services in Year 3 could imply roller-coaster profits and losses when the business may be actually quite stable and steadily profitable over time. And the alternative of also deducting those future

costs in Year 1 under the matching principle is not feasible if those future costs are not known within reasonable certainty in Year 1.

When should the accrual method taxpayer include prepaid income *for income tax purposes* (as opposed to financial accounting puruposes) in view of (1) the fact that the taxpayer has the cash in hand to invest and (2) the difference between an income tax and consumption tax? Would not failure to include in the year of receipt violate income tax values by effectively exempting the capital return that can be earned with the cash in hand between the years received and included?

In a trilogy of prepaid income cases decided between 1956 and 1963, the Supreme Court ruled against the taxpayer's desire in each case to defer inclusion of prepaid income. While the differences between income taxation and consumption taxation were not well understood outside academia at this time, the Court appeared to recognize that something just didn't "feel right" about permitting accrual method taxpayers to defer Gross Income until earned—especially under the "annual accounting principle" explored in the last chapter and our consideration of the receipt of cash subject only to a contingent obligation to repay in connection with *North American Oil* in Chapter 10. After all, if the goods or services are not, in fact, delivered as expected in the future year and cash has to be refunded to customers, those changed facts could result in an offsetting deduction then. Nevertheless, the Court in each case continued to give lip service to the matching principle while, at the same time, finding a rationale to reject its application in the particular case based on a lack of good evidence regarding precisely *when* future costs (to be matched with the prepaid income) would be incurred.

In *Automobile Club of Michigan v. Commissioner*,[36] the taxpayer included in Gross Income for tax purposes only the portion of prepaid membership dues that it recorded on its books for financial accounting purposes as being earned in that year. Membership dues were prepaid for one year, and the taxpayer credited on its books 1/12th of the receipt at the end of each month of the 12-month contract. Thus, a calendar year taxpayer receiving a $120 payment on November 1 for a one-year membership beginning on that date would include only $20 in Year 1 (reflecting $10 inclusions for each of November and December) and $100 in Year 2. The Court deferred to the Commissioner, who argued that such deferral failed to clearly reflect income under § 446(b).

> The pro rata allocation of the membership dues in monthly amounts is purely artificial and bears no relation to the services which petitioner may in fact be called upon to render for the member. [The predecessor to § 446(b)] vests the Commissioner with discretion to determine whether the petitioner's method of accounting clearly reflects income. We cannot say, in the circumstances here, that the discretionary action of the Commissioner, sustained by both the Tax Court and the Court of Appeals, exceeded permissible limits.[37]

Implied, perhaps, in the Court's language regarding "purely artificial" allocations that bore no relation to any services that the taxpayer might have to perform is the notion that a taxpayer who cannot show when future expenses will be incurred cannot rely on the matching rationale to permit deferral of cash in hand to match such uncertain future expenses. In a loose sense, this analysis is simply the flip side of the coin of the contingent liability analysis that the Court seized upon with respect to the current deduction of future payments a decade earlier. Contingency of the future

[36] 353 U.S. 180 (1957).
[37] *Id*. at 189.

liability provided the justification to defer to the Commissioner's power (under the clear reflection standard) to reject the financial reporting treatment of the item (and the matching principle embodied there) on the deduction side. Here, the contingency of future expenses to be matched with the cash in hand provided the justification to defer to the Commissioner in rejecting the financial reporting of the item on the Gross Income side.

In *American Automobile Association v. United States*,[38] the American Automobile Association pressed its case again, this time with better statistical evidence regarding the rate at which future costs would be incurred, attempting to distinguish *Automobile Club of Michigan* by arguing:

> *Michigan* does not control this case because of a difference in proof, *i.e.*, … in this case the record contains expert accounting testimony indicating that the system used was in accord with generally accepted accounting principles; that its proof of cost of member service was detailed; and that the correlation between that cost and the period of time over which the dues were credited as income was shown and justified by proof of experience.[39]

The Court again held for the Commissioner in forbidding deferral of the prepaid income in the year of receipt under the § 446(b) clear reflection standard. The Court essentially concluded that no statistical evidence would be sufficient because the future services are performed solely at the demand of individual members. The Court rejected an approach that established the rate of future costs by looking to service demand from the members as a pool. Because both the time and extent of the future services to be performed for any individual member could not be established, deferring income to match future expenses that might never arise is not necessary to reflect income clearly under the matching principle, the Court apparently reasoned. "Not only did individually incurred expenses actually vary from month to month, but even the average expense varied—recognition of income nonetheless remaining ratably constant."[40] Thus, the exercise of the Commissioner's discretion under the clear reflection standard was not "unsound."[41]

The Supreme Court did not bend two years later in *Schlude v. Commissioner*.[42] The Schludes operated a dance studio. Pursuant to contracts entered into with their students, they received prepaid gross receipts for a specified number of dance lessons to be given in the future. The contracts varied from five lessons to 1,200 hours of instruction to two lessons per month for life. None of the lessons were scheduled for certain dates or times; the students arranged for the lessons at their future convenience. The contracts were nonrefundable. The Schludes, who used the accrual method in keeping the dance studio's books, reported the prepaid gross receipts for tax purposes over time as lessons were taught (or as contracts were canceled without lessons). "Three certified public accountants testified that in their opinion the accounting system employed truly reflected the net income in accordance with commercial accrual accounting standards."[43] The Commissioner once again argued that the prepaid gross receipts must be included in income upon receipt in order to reflect income clearly for income tax purposes, and the Court once again agreed. The Court decided that the Schludes' situation was essentially the same as in the two prior cases.

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[38] 367 U.S. 687 (1961).
[39] *Id.* at 691.
[40] *Id.* at 693.
[41] *Id.* at 698.
[42] 372 U.S. 128 (1963).
[43] *Id.* at 132.

The Schludes could not establish either the time or extent of future services to be rendered because the dance lessons were scheduled only on demand by the students.

> [T]he advance payments related to services which were to be performed only upon customers' demands without relation to fixed dates in the future. The system employed here suffers from that very same vice, for the studio sought to defer its cash receipts on the basis of contracts which did not provide for lessons on fixed dates after the taxable year, but left such dates to be arranged from time to time by the instructor and his student. Under the contracts, the student could arrange for some or all of the additional lessons or could simply allow their rights under the contracts to lapse…. Clearly, services were rendered solely on demand in the fashion of the *American Automobile Association* and *Automobile Club of Michigan* cases.[44]

The Court's language in the trilogy regarding the need to know the precise time and extent of future services if prepaid income is to be deferred until those future years under the matching rationale permitted taxpayer victories in *Artnell Company v. Commissioner*[45] and *Tampa Bay Devil Rays v. Commissioner*.[46] The Seventh Circuit Court of Appeals (in the former) and the Tax Court (in the latter) permitted prepaid income pertaining to ticket sales, broadcasting and television rights, parking, and private suite reservations in connection with baseball games played by the Chicago White Sox and Tampa Devil Rays, respectively, to be deferred until the year in which the scheduled games were played. In *Artnell*, the court stated:

> All three [of the Supreme Court cases] held, upon consideration of the particular facts, that the commissioner did not abuse his discretion in rejecting a deferral of income where the time and extent of performance of future services were uncertain…. The uncertainty stressed in those decisions is not present here. The deferred income was allocable to games which were to be played on a fixed schedule. Except for rain dates, there was certainty. We would have no difficulty distinguishing the instant case in this respect.[47]

Finally, the IRS exercised its discretion under § 446(b) to explicitly permit short deferrals of prepaid services income (no more than to the end of the next taxable year) in 1971. In 2004, it expanded that discretion beyond services income.

## REVENUE PROCEDURE 2004-34

2004-1 C.B. 991

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

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[44] *Id.* at 135-36.
[45] 400 F.2d 981 (7th Cir. 1968).
[46] T.C. Memo. 2002-248.
[47] *Id.* at 983-84. The Tax Court in *Tampa Bay Devil Rays* said: "We agree with petitioner that the facts before us in the instant case fall within the narrow fact pattern of *Artnell Co*."

(as defined in section 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.

…

.03 Rev. Proc. 71-21, 1971-2 C.B. 549, was published to implement an administrative decision of the Commissioner in the exercise of his discretion under § 446 to allow accrual method taxpayers in certain specified and limited circumstances to defer the inclusion in gross income for federal income tax purposes of payments received (or amounts due and payable) in one taxable year for services to be performed by the end of the next succeeding taxable year. Rev. Proc. 71-21 was designed to reconcile the federal income tax and financial accounting treatment of payments received for services to be performed by the end of the next succeeding taxable year without permitting extended deferral of the inclusion of those payments in gross income for federal income tax purposes.

.04 Considerable controversy exists about the scope of Rev. Proc; 71-21. In particular, advance payments for non-services. (and often, for combinations of services and non-services) do not qualify for deferral under Rev. Proc. 71-21, and taxpayers and the Internal Revenue Service frequently disagree about whether advance payments are, in fact, for "services." In addition to the issue of defining "services" for purposes of Rev. Proc. 71-21, questions also arise about whether advance payments received under a series of agreements, or under a renewable, agreement, are within the scope of Rev. Proc. 71-21. In the interest of reducing the controversy surrounding these issues, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments for certain non-services and combinations of services and non-services. Additionally, the Service has determined that it is appropriate to expand the scope of Rev. Proc. 71-21 to include advance payments received in connection with an agreement or series of agreements with a term or terms extending beyond the end of the next succeeding taxable year. The Service has determined, however, that for taxpayers deferring recognition of income under this revenue procedure it is appropriate to retain the limited one-year deferral of Rev. Proc. 71-21….

…

SECTION 4. DEFINITIONS.

The following definitions apply solely for purposes of this revenue procedure—

.01 *Advance Payment*. Except as provided in section 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 applicable financial statement (as defined in section 4.06 of this revenue procedure) for a subsequent taxable year (or, for taxpayers without an applicable financial statement as defined in section 4.06 of this revenue procedure, 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));

(c) the use (including by license or lease) of intellectual property as defined in section 4.03 of this revenue procedure;

(d) the occupancy or use of property if the occupancy or use is ancillary to the provision of services (for example, advance payments for the use of rooms or other quarters in a hotel, booth space at a trade show, campsite space at a mobile home park, and recreational or banquet facilities, or other uses of property, so long as the use is ancillary to the provision of services to the property user);

(e) the sale, lease, or license of computer software;

(f) guaranty or warranty contracts ancillary to an item or items described in subparagraph (a), (b), (c), (d), or (e) of this section 4.01(3);

(g) subscriptions (other than subscriptions for which an election under § 455 is in effect), whether or not provided in a tangible or intangible format;

(h) memberships in an organization (other than memberships for which an election under § 456 is in effect); or

(i) any combination of items described in subparagraphs (a) through (h) of this section 4.01(3).

.02 *Exclusions From Advance Payment*. The term "advance payment" does not include—

(1) rent (except for amounts paid with respect to an item or items described in subparagraph (c), (d), or (e) of section 4.01(3));

(2) insurance premiums, to the extent the recognition of those premiums is governed by Subchapter L;

(3) payments with respect to financial instruments (for example, debt instruments, deposits, letters of credit, notional principal contracts, options, forward contracts, futures contracts, foreign currency contracts, credit card agreements, financial derivatives, *etc.*), including purported prepayments of interest; …

.03 *Intellectual Property*. The term "intellectual property" includes copyrights, patents,

trademarks, service marks, trade names, and similar intangible property rights (such as franchise rights and arena naming rights).

…

.05 *Next Succeeding Taxable Year*. The term "next succeeding taxable year" means the taxable year immediately following the taxable year in which the advance payment is received by the taxpayer….

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 section 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 section 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 section 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 section 5.02(1)(a)(ii) of this revenue procedure.

(b) If the taxpayer does not have an applicable financial statement (as defined in section 4.06 of this revenue procedure), or if the taxpayer is unable to determine, as required by section 5.02(1)(b)(i) of this revenue procedure, the extent to which advance payments are recognized in revenues in its applicable financial statements for the taxable year of receipt … a taxpayer using the Deferral Method must include the advance payment in gross income for the taxable year of receipt … to the extent earned in that taxable year and include the remaining amount of the advance payment in gross income in accordance with section 5.02(1)(a)(ii) of this revenue procedure. The determination of whether an amount is earned in a taxable year must be made without regard to whether the taxpayer

may be required to refund the advance payment upon the occurrence of a condition subsequent. If the taxpayer is unable to determine the extent to which a payment (such as a payment for contingent goods or services) is earned in the taxable year of receipt (and, if applicable, in a short taxable year described in section 5.02(2)), the taxpayer may determine that amount—

(i) on a statistical basis if adequate data are available to the taxpayer;

(ii) on a straight line ratable basis over the term of the agreement if the taxpayer receives advance payments under a fixed term agreement and if it is not unreasonable to anticipate at the end of the taxable year of receipt that the advance payment will be earned ratably over the term of the agreement; or

(iii) by the use of any other basis that in the opinion of the Commissioner results in a clear reflection of income.

…

.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. Except as stated otherwise, the taxpayer in each example has an applicable financial statement as defined in section 4.06 of this revenue procedure.

*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 applicable 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 applicable 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 7*. *F*, a hair styling salon, receives advance payments for gift cards that may later be redeemed at the salon for hair styling services or hair care products at the face value of the gift card. The gift cards look like standard credit cards, and each gift card has a magnetic strip that, in connection with *F*'s computer system, identifies the available balance. The gift cards may not be redeemed for cash, and have no expiration date. In its applicable financial statement, *F* recognizes advance payments for gift cards in revenues when redeemed. *F* is not able to determine the extent to which advance payments are recognized in revenues in its applicable financial statement for the taxable year of receipt and therefore does not meet the requirement of section 5.02(1)(b)(i) of this revenue procedure. Further, *F* does not determine under a basis described in section 5.02(3)(b) of this revenue procedure the extent to which payments are earned for the taxable year of receipt. Therefore, *F* may not use the Deferral Method for these advance payments.

…

*Example 15*. *L*, a professional sports franchise, is a member of a sports league that enters into contracts with television networks for the right to broadcast games to be played between teams in the league. The money received by the sports league under the contracts is divided equally among the member teams. The league entered into a 3-year broadcasting contract beginning October 1, 2004. *L* receives three equal installment payments on October 1 of each contract year, beginning in 2004. In its applicable financial statement, *L* recognizes 1/4 of the first installment payment in revenues for 2004 and 3/4 in revenues for 2005; *L* recognizes 1/4 of the second installment in revenues for 2005 and 3/4 in revenues for 2006; *L* recognizes 1/4 of the third installment in revenues for 2006 and 3/4 in revenues for 2007. *L* uses the Deferral Method. Under section 4 of this revenue procedure, each installment payment constitutes an "advance payment." For federal income tax purposes, *L* must include 1/4 of the first installment payment in gross income for 2004 and 3/4 in gross income for 2005; 1/4 of the second installment in gross income for 2005 and 3/4 in gross income for 2006; and 1/4 of the third installment in gross income for 2006 and 3/4 in gross income for 2007.

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Whew! In addition, Congress has enacted special elective provisions in §§ 455 and 456 pertaining to certain prepaid subscription income and prepaid membership dues for certain organizations.

Is all of this complexity justified? Does the complexity further income tax values? Just as the contingency was not the real problem in the future payment context (but rather the time delay between deduction and payment), so the contingency or certainty of the future expenses to be matched with the prepaid receipt is not the real problem in the prepaid income context (but rather the time delay between receipt and inclusion). The cash in hand (but not yet included) can earn a return. For the period between the investment of pre-tax dollars and the inclusion of those dollars in the income tax base, the taxpayer's return enjoys consumption tax treatment, which is contrary to income tax values. If both income tax values are to be respected and deferral of cash in hand is to be permitted, the inclusion (in the future year) should be grossed up by an interest component for tax purposes. While such an approach is used in one corner of current law in the international context,[48] adopting this approach on a wholesale basis for all prepaid receipts of accrual method taxpayers would be administratively cumbersome. Alternatively, of course, deferral of prepaid income could simply be prohibited. This brings us back to the question asked earlier.

***Back to our roots and the elimination of accrual accounting for § 61 Gross Income and expenses for income tax purposes?***

Now that we better appreciate the time value of money and the differences between income taxation and consumption taxation, is it time to abandon accrual accounting altogether for purposes of § 61 Gross Income inclusions and "expense" deductions as not clearly reflecting income in the *income tax sense* (as opposed to the financial accounting sense)? Because no payment liability arises in the financial accounting world, deferring cash in hand or deducting

[48] Investors in passive foreign investment companies (PFICs) can generally defer inclusion of certain offshore passive investment income as it is earned by the foreign corporation. When they sell the stock (or receive an "extraordinary distribution"), however, the included gain or dividend must be increased by an interest charge based on the value of the tax deferral. *See* § 1291.

expenses not yet paid so that revenue and expenses can be matched together in the same period under transactional accounting (which is in opposition to the annual accounting principle) does no damage to the goal of providing reliable information to potential investors and lenders regarding the economic health of the business over time. Indeed, such matching avoids what may be a misleading picture of roller-coaster profits and losses. We have seen that such treatment, however, is inconsistent with a *tax* base consisting of income, under which investments must generally be made with after-tax dollars.[49] Moreover, while the matching principle is a fundamental and important one in financial accounting, it is premised on transactional accounting, which is antithetical to the annual accounting principle in tax, as described in the last chapter. At bottom, because no payment obligations arise on the determination of "income" for financial accounting purposes, it can underplay to a serious extent the time value of money and (understandably) ignores the difference between an income tax base and consumption tax base.

Forbidding use of accrual accounting for income tax purposes would not alter the reporting of depreciation and interest, including original issue discount, as Chapters 10 and 14 explored how these issues are not governed by the taxpayer's method of accounting but rather are rooted in the realization doctrine (reckoning final and irretrievable losses in property value or increases in wealth).[50]

As explored throughout this textbook, the realization requirement with respect to property (particularly publicly traded securities that are easily valued at year's end) can be seen as a weak spot in the income tax in that it permits wealth accessions to escape taxation for many years (and even disappear at death under § 1014) and permits tax shelter activity of the sort combatted by § 469 (in the sense that frontloaded deductions will eventually be offset in many cases by realized gain at the back end when the shelter is eventually sold). Some who bemoan the failure to tax such gains as they "accrue" often conflate the realization requirement and accrual accounting and argue that accrual accounting better serves tax values than cash accounting. But mark-to-market accounting for publicly traded stocks and securities (*i.e.*, repealing the realization requirement for such assets), should Congress adopt that change, would not be inconsistent with repeal of accrual accounting generally.

Indeed, repealing the realization requirement for publicly traded securities, which are quite liquid because of the public trading, would strengthen income tax values in the same way that disallowing the deduction of expenses not yet paid and requiring inclusion of prepaid income on receipt would. For example, the investment return in the form of dividends earned on low-basis, high-value stock (with substantial unrealized gain) is earned largely on pre-tax dollars. In a nontrivial sense publicly traded securities can be seen as cash equivalents for the same reason that readily tradable or demand notes received from a property buyer are considered cash equivalents that forbid use of installment sale reporting by the property seller under §§ 453(f)(4) and (5) and

[49] The ability to make investments with pre-tax dollars is possible with borrowed cash, of course, but we have seen that this extraordinary privilege, which we tolerate mostly because of the simplicity of excluding borrowed cash and not deducting repaid principal, has created its own problems. *See supra* Chapters 10 through 12 and 16. Indeed, as discussed in Chapter 10, the treatment of borrowed cash for tax purposes was likely reflexively borrowed from financial accounting in the early years of the income tax. Like accrual accounting for financial reporting purposes, the treatment of borrowed cash is inconsistent with the annual accounting principle in that it permits our expectation of events anticipated to occur in a future year to affect the tax consequences of the current-year receipt.

[50] A minor exception with respect to OID would be that cash method interest recipients may be able to avoid the OID rules with respect to loans of less than $10,000 made between individuals. *See* § 1272(a)(2)(E).

for the same reason that cash method taxpayers must include certain two-party (readily tradable) notes on receipt as a cash equivalent.[51]

Because there is little (no?) constituency for such radical changes, however, courts and the administrators of the statute will have to remain vigilant when the deferral of a prepaid receipt or the deduction of a future cost can undermine income tax values, even though consistent with financial reporting.

## Problem

Jacob, who uses the accrual method of accounting and the calendar year as his taxable year, owns his own business (through a 100%-owned LLC) writing and servicing software programs of various sorts for use by businesses. When must Jacob accrue (include or deduct, as the case may be) each of the items described below?

**a.** Jacob leases software for a three-year term to a corporate business to help the business track its inventory. Both Jacob and the user believe that Jacob will have written the next generation of the software by the end of the three-year term. On January 1 of Year 1, Jacob receives a lump-sum payment of $90,000 under the lease agreement. On Jacob's applicable financial statement, he includes $30,000 in each of Years 1 through 3 with respect to this contract.

**b.** Jacob hires Becky as an employee in early December, and she begins working on December 15 of Year 1. Becky's employment contract requires that Jacob pay her $5,000 on the 15th of each month, so Becky receives her first $5,000 paycheck on January 15 of Year 2.

**c.** On November 25 of Year 1, Jacob pays $4,000 to a radio station for a series of one-minute advertisements for his business. One-half of the airtime slots will play in December and one-half will air in January.

[51] As described in Chapter 15, such unrealized gain is heavily concentrated in the wealthiest of households, so requiring mark-to-market taxation of publicly traded securities would add to the progressivity of the tax burden in a way that better reflects wealth distribution.