



# **Basic Income Tax**

***2023-2024 Edition***

WILLIAM P. KRATZKE



# Basic Income Tax 2023-2024 Edition

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## **About the Author**

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

## Notices

This is the 2023-2024 Edition of this casebook, updated April 15, 2023 (following the revised Edition for 2022-2023) and incorporating the Tax Cuts and Jobs Act. Visit <http://elangdell.cali.org/> for the latest version and for revision history.



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## Preface

This book is a basic income tax text. I intend this text to be suitable for a three-hour course for a class comprised of law students with widely different backgrounds. Certain principles permeate all of tax law. I have found that certain axioms or principles will carry us a long way. For example, income is taxed once – or treated as if it has been taxed. Once it has been taxed, its investment gives the taxpayer basis – which I define not as cost but as money that will not be subject to tax again. Etc. The text returns to these principles throughout. I usually put these matters in text boxes.

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

At the end of every chapter, I have included a short section entitled “What have you learned?” This page may be examined before beginning the study of a chapter. I intend it to be a statement of learning objectives: a student should have a solid understanding of the items listed.

In some areas, I have relied heavily on the CALI drills by Professor James Edward Maule (Villanova University). These drills both review and, in some instances, teach a little substance. Each zeroes in on a specific topic and should take a student about twenty minutes to complete if she has adequately prepared to do the drill. Of course, students can work through such drills at their own speed. With the assistance of CALI’s [LessonLink](#), professors and students alike can monitor students’ understanding of the discrete topics of these drills.

I have tried to make this text very readable – so that students can easily understand. I have aimed at law students who “know” they have no interest in income tax – but who may find that they in fact have a considerable interest in tax law. With my political science background, I was such a student. I am proof that one does not have to have an accounting background to find income tax law both important and interesting. Additionally, Magdalene Smith and Jay Clifton III were two such



students; they assisted me greatly in making this text as accessible as possible to all law students. I thank them now for their work.

I have alternated from one chapter to the next my usage of singular indefinite pronouns. I have used the feminine forms for chapters 1, 3, 5, 7, and 9. I have used the masculine forms for chapters 2, 4, 6, 8, and 10.

WPK

Memphis, Tennessee, July 2013, May 2016, and May 2017.

In December 2017, Congress enacted the Tax Cuts and Jobs Act. This statute contains significant measures that alter several Code provisions important to this course. Some, but not all, of these measures are “temporary,” i.e., for calendar years 2018 to 2025. I anticipate that we will be in for a period of intense lobbying to make these changes permanent. I note and briefly describe the provisions that have been “suspended” – anticipating that many of these changes will be made permanent.

WPK

Memphis, Tennessee, May 2018 and May 2019

Beginning in spring 2020, Congress responded to the pandemic with various tax measures – most of them temporary. They are now lapsing or have lapsed. In several places, the text includes references to these measures, accompanied by a general description. The text employs certain short-hand abbreviations to reference the following statutes:

CARES Act: the Coronavirus Aid, Relied, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (2020).

CAA: the Consolidated Appropriations Act, Pub. L. No. 116-260, 134 Stat. 1182 (2020). This legislation includes the COVID-Related Tax Relief Act of 2020 (CRTRA), and it includes the Taxpayer Certainty and Disaster Tax Relief Act of 2020 (TCDTA).

ARPA: the American Rescue Plan Act of 2021, Pub. L. No. 117-2, 135 Stat 4.

WPK

Memphis, Tennessee 2021

In the Inflation Reduction Act, Congress enacted several credits to address the reality of climate change. I have not tried to include these matters in the text. I have observed elsewhere that the basic principles that I emphasize can be applied in ways that promote certain policies (or not) or to favor some taxpayers over others. These policies are subject to change, and the favoritism shown certain classes of taxpayers can be completely reversed. However, the principles that are fundamental to “tax intuition” remain intact.

WPK

Memphis, Tennessee, May 2023

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

## I. Introduction to Some Basic Concepts

The United States Government needs money to operate. There are many ways our Government may raise money, only one of which is to tax its own citizens on their income. A few examples follow:

**Tariffs:** The Government might impose tariffs (i.e., taxes) on imports or exports. To sell their wares in the United States, foreign merchants at one time had to pay very high tariffs. Tariffs protect domestic producers of competitive wares. This hardly helps domestic *consumers* of products subject to a tariff because they must either pay an artificially inflated price for an import or a noncompetitive price for a (lower-quality?) domestic product. Export duties could also have a pernicious effect. They encourage domestic producers to sell more goods at home, rather than in foreign markets where they might have made more profits. Article 1, § 9, cl. 5 of the Constitution provides: “No Tax or Duty shall be laid on Articles exported from any State.” Notice: import tariffs are a cost that mostly the buyers and sellers of the products subject to them alone pay. Furthermore, the economic interests of different regions of the country are hardly uniform. The cotton-exporting southern states early on preferred low tariffs while northeastern manufacturing interests preferred the protection that high import tariffs provided. *See generally*, DOUGLAS A. IRWIN, *CLASHING OVER COMMERCE: A HISTORY OF US TRADE POLICY* (2017) (recounting history of import tariffs in the United States). The burden of paying for Government is not spread very evenly if tariffs are the means of raising revenue to finance the Government. Nevertheless, tariffs were the most important source of revenue for our country’s government in its early days. Now tariffs figure prominently in trade wars and not as revenue-raisers.

**Government Monopoly:** The Government might choose to enter a business and limit competition in that business. Most states have lotteries that they run with no competition other than what they are willing to tolerate, e.g., low-stakes bingo games that charities operate. One argument favoring this means of financing government is that there is no compulsion to buy lottery tickets, i.e., willing buyers contribute to Government coffers. Many non-purchasers derive benefits from lottery proceeds at the expense of those willing to give up some of their wealth in the forlorn hope of hitting it big. Governments may also engage in other businesses.

For example, some states own the liquor stores that operate within its borders. Governments may charge for services that they provide (e.g., access to parks) with a view to making profits that are spent in pursuit of other government objectives. There is always the risk that the Government might not be very good at running a particular business. Government-operated airlines are notorious money-losers. And again, why should consumers of certain products or services be saddled with the burden of paying for a government that (should) benefit(s) all of us?

**Taxing Citizens:** Instead of trying to raise money only from consumers of particular goods or services, Government may endeavor to spread the burden more evenly by taxing (most of) its citizens or residents. It may perhaps try to tax non-citizens or non-residents as well. This raises the questions of whom and what government should tax – or more formally, what should be the “tax base.” There are various possibilities.

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

The notable exception was the poll tax that some southern states in the post-Civil War era imposed as a condition of exercising the right to vote. The very purpose of such a tax was to discourage recently emancipated and almost uniformly poor Black persons from exercising their constitutional right to vote. The unfairness of the relative tax burdens associated with this cost of voting led to adoption of the 24<sup>th</sup> Amendment to the Constitution, which made poll taxes unconstitutional.

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

*The Ramsey Principle:* Consumption taxes on items for which demand is inelastic can raise a lot of revenue for the state. See F.P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 47 (1927). For our purposes, “inelastic demand” means that the quantity that buyers buy does not change (much) as prices increase or decrease. A life-saving drug might be such an item. Taxes on items for which demand is inelastic almost by definition are unavoidable and so do not divert consumers’ purchases to or from those items, i.e., they do not *distort* markets as much as other taxes might. Unfortunately, the things for which demand is inelastic are often things that poorer people must buy. Strict adherence to the Ramsey principle might create an excessive burden for those least well-off.

*Sales Tax:* A sales tax is a tax on sales and is usually a fixed percentage of the amount of the purchase. Sales taxes are relatively easy to collect. Sellers usually collect sales taxes at the point of sale. Many states and localities rely on a sales tax for a substantial portion of their revenue needs. Sales taxes are collected on amounts that citizens or residents *spend*, not on what they *save*. Hence, such taxes are more burdensome to persons who must spend more (even all) of their income to purchase items subject to a sales tax. While such taxes are nominally an equal percentage of

all purchases, their *effect* is *regressive* (*infra*). Those who must spend all their income on items subject to a sales tax pay a higher percentage of their income in such a tax than those wealthy enough to save some of their income.

In states that have sales taxes applicable to all purchases, every citizen or resident who buys anything pays some sales tax.<sup>1</sup> Perhaps this is fairer than alternatives. Recent financial crises have made clear that a state heavily dependent on sales taxes is vulnerable to economic downturns. Unemployment causes citizens or residents to reduce their purchases and so the sales tax that they pay. Economic downturns are the very occasions when states need more funds to finance services for which their citizens stand in greater need.

*Excise Taxes:* An excise tax is a sales tax that applies only to certain classes of goods, e.g., luxury items. Excise taxes on luxury items may be politically popular, but those excise taxes do not raise much revenue because they are avoidable. The demand for luxury items is usually highly elastic (*see* text box, *The Ramsey Principle*). Excise taxes on certain high-demand (arguably) non-necessities, e.g.,

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<sup>1</sup> State legislatures may carve out exceptions. Purchases of food might be subject to a sales tax that is lower than for other goods. Purchases of services might not be subject to a sales tax.



cellular telephones, raise much more revenue. Tourist-destination states find excise taxes on services that out-of-state visitors typically purchase to be attractive, e.g., renting cars, staying in hotels, visiting tourist sites. There is nothing quite so politically attractive as making someone who cannot vote in state elections willingly fill the state's coffers.

Most states impose excise taxes on "sin" purchases, e.g., cigarettes, alcohol. The public health costs associated with activities such as smoking or drinking may be high, so states tax heavily the purchases of products that cause it to have to provide costly health services. Arguably, such taxes may discourage persons from making the purchase in the first place.<sup>2</sup>

*Value Added Tax:* This tax is imposed on all sale transactions, not solely the sale to the ultimate consumer, i.e., it is imposed at every stage of production of a product. The seller pays the VAT to the government minus whatever tax the seller was assessed upon acquiring the unfinished good. Thus, the tax base is only a purchaser's actual additions to the value of a product. The final consumer does not resell the product, and so pays a VAT on the full cost of the item. Many European countries favor a VAT, often in combination with an income tax.

*A Progressive Consumption Tax:* As we shall see *infra* from our discussion of the Schanz-Haig-Simons concept of income, it is quite possible for Government to collect a tax on consumption once per year instead of incrementally upon each and every purchase. The tax on such consumption could be made *progressive*, i.e., the rate of tax increases as the amount of a taxpayer's consumption increases (*infra*).

*Wealth Taxes:* We could tax wealth. There are two common wealth taxes: estate taxes and property taxes. The estate tax is a tax imposed on the estates of decedents and the amount of the tax depends on the size of the estate. Property taxes are taxes on property that taxpayers own. Municipalities often rely on property taxes

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<sup>2</sup> Heavy smokers or drinkers are not deterred from indulging in their habits by such taxes. Light smokers or drinkers are more responsive to such taxes. The persons whom we might wish to deter are in fact not likely to be deterred.

Internal Revenue Service Data Book, 2022, data from pages 3-4. 2022			
Type of Return	# of Returns	Gross Tax Collections	% of total
Individual Income Tax	160,571,367	2,818,638,806	57.5
Business Income Tax	12,427,465	475,871,099	9.7
Employment Taxes	31,180,674	1,404,615,026	28.7
Excise Taxes	1,166,197	70,679,117	1.4
Gift Tax	270,149	4,445,883	0.1
Estate Tax	27,088	28,909,393	0.6

to raise the revenues they need. Notice that in the case of property taxes, the taxing authority can tax the same “wealth” again and again, e.g., every year. This is quite unlike an income tax, *infra*. The burden of wealth taxes falls upon those who hold wealth in the form subject to tax. Both persons subject to the tax and those not subject to the wealth tax may reap its benefits.

*Wage Taxes:* We could impose a flat percentage tax on all wages – no matter how high or how low. This is sometimes called a “payroll” tax. Some states rely heavily on a payroll tax. Payroll taxes are collected from employers and are therefore cheaper to administer than an income tax. Social Security taxes and Medicare taxes are wage taxes. The Social Security tax is 6.2% of employee wages that both employer and employee must pay, §§ 3101, 3111), limited to an amount indexed to take account of inflation – about the first \$160,000 of wage income, § 3121(a)(1) (cross-referencing Social Security Act). The ceiling on the tax base of the Social Security tax creates a *regressive* effect (*infra*), i.e., those with incomes higher than the ceiling pay an *effective* rate that is lower than the *effective* rate that those whose income is below the ceiling must pay. The Medicare tax is 1.45% of employee wages that both employer and employee must pay. The Medicare tax is not subject to a limit. For high-income earners,<sup>3</sup> there is an additional 0.9% tax on wages or

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<sup>3</sup> Taxpayers who are married filing jointly are subject to this tax to the extent their wages or self-employment income exceed \$250,000. Taxpayers who are married filing separately are subject to this tax to the extent their wages exceed one-half that amount. All other taxpayers are subject to this tax to the extent their wages exceed \$200,000. I.R.C. §§ 3101(b)(2), 1401(b)(2). Moreover, an individual is subject to a 3.8% Medicare tax on her “net investment income” to the extent her modified AGI (adjusted gross income) exceeds a threshold amount. I.R.C. § 1411(a). The threshold amount is

self-employment income. §§ 3101(b)(2), 1401(b)(2). The Social Security and Medicare programs mainly benefit senior citizens – and both are funded by a flat tax on wages of those currently working. Contrary to the claims of some politicians and commentators, *everyone* who works for her income pays some federal tax. The flat tax on all wages of low- to middle-income persons (combined 7.65% plus a like amount paid by employers<sup>4</sup>) assures that many workers pay more in these flat taxes than they do in progressive income taxes. This point makes the total burden of paying federal taxes of whatever type much less progressive than the brackets established by § 1 of the Internal Revenue Code imply.

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

## II. Tax and Life

The United States taxes the income of its citizens and permanent residents. This personal income tax accounts for about 57.5% of the United States Government’s tax revenues.<sup>5</sup> The Government’s reliance on the personal income tax as a source of revenue has increased, and the proportion of its revenue from other taxes such as the corporate income tax or the estate and gift taxes has contracted. These facts alone provide some reason for law students to study the law of individual income tax.

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\$250,000 for taxpayers who are married filing jointly, one-half that amount for taxpayers who are married filing separately, and \$200,000 for all others. I.R.C. § 1411(b).

<sup>4</sup> Self-employed taxpayers must pay both halves of these taxes. *See* § 1401.

<sup>5</sup> Do the percentages from the Internal Revenue Service’s Data Book, *supra*, surprise you?

Beyond this, title 26 of the United States Code (the Internal Revenue Code), is perhaps the most comprehensive statement of policy in American law. It affects everyone with an income. It affects everyone with a job. It affects everyone who might die. Tax law is hardly the exclusive domain of accountants and number crunchers.<sup>6</sup> Tax law is one domain of anyone who cares about such matters as fairness, economic growth, and social policy. The Code defines broadly the income on which it imposes a tax. It provides exceptions to these rules for those taxpayers Congress deems deserving of exceptions. Legislative exemption from an otherwise universal tax implicitly states policies on many subjects.

Far more persons will be subject to the Code's rules year after year than will be tort victims or defendants, parties to a contract dispute, or victims of crime – although many persons reading these lines consider those topics much more important to their legal studies and eventually their legal careers. Such persons may be right, but they might be surprised at how much the individual income tax will affect their practices. Federal taxation is about *money*. Those who claim that they will avoid tax issues in their practices will find that they work for and with people who *do* care about money, and they will find that avoidance of tax issues can make for some less-than-satisfied clients and colleagues.

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<sup>6</sup> Your author had a double major as an undergraduate – Political Science and the Far Eastern & Russian Institute. His LL.M. is not in tax law. He learned income tax law the same way you are going to: by reading the Code, studying texts, and talking to people.

**Multiple-Choice:** In any law practice, there will be times when you can

- A. Practice a little tax law.
- B. Malpractice a little tax law.

There is no option C.

•Consider: P collected damages from D for injuries sustained in an automobile accident. Tax consequences? Does it matter if P recovers only for her emotional distress? Same tax consequences if P collects damages because her employer discriminated against her on the basis of sex?

•Consider: S is a law student. Her university awarded her a full tuition scholarship. Any tax issues?

•Consider: H and W are divorcing. They will divide their property (including their investments) and arrange for child support. Any tax issues?

•Consider: A sells Blackacre to B for \$30,000 more than A paid for it. Any tax issues? Do the tax issues change if B agrees to pay A in ten annual installments?

•Consider: A wants to save money for her pension. If she understands some tax law, can she save some money – or even enlarge her pension?

•Consider: The federal government established a program whereby homeowners who owe money on a mortgage can have the principal of their loan reduced. Any tax issues?

•Consider: E's employer permits E to purchase items that it sells for a discount. Tax consequences?

•Consider: R is an employer who mistakenly paid E, an employee, a bonus in December. After discovering the mistake, E repaid the bonus to R. Any tax issues?

•And so on. Do you really think that you can avoid issues such as these by ignoring them? See Robert W. Wood, 10 *Tax Rules All Lawyers and Clients Should Know*, 9 TAX NOTES 755 (Feb. 6, 2017).

### III. Some Definitions Relevant to Taxing Income

Tax practitioners and scholars are conversant with certain terminology, concepts, and policies. We break into the seamless web of tax by considering in no particular order some terms, concepts, and policies.

*Tax Base:* The tax base is what it is we tax. The tax base of the federal income tax is not all income, but rather *taxable income*. Section 63 defines “taxable income.”

“Taxable income” is “gross income” minus deductions named in § 62, minus either a standard deduction or itemized deductions, minus the deduction for “qualified business income.” § 63(a, b).<sup>7</sup> In the remaining chapters, we examine the elements of this tax formula. Only the amount remaining after these subtractions is subject to federal income tax.

*Gross Income and Adjusted Gross Income:* “Adjusted gross income” is “gross income,” i.e., all accessions to a taxpayer’s wealth minus what taxpayer spends on items listed in § 62. Notice that in the accompanying box (“The Tax Formula”), there is a line, i.e., “the line.” The figure immediately beneath the line is “adjusted gross income” (AGI). In a *very* rough sense, § 62 deductions are for obligatory expenditures or for deferring income that will be subject to income tax at a later time of consumption. Subtractions may be “above the line” or “below the line.” Taxpayer is entitled to § 62 deductions irrespective of and in addition to itemized deductions or the standard deduction.

When a subtraction is “below the line,” what happens above the line might be very relevant. The Code limits certain itemized deductions to the amount by which an expenditure exceeds a given percentage of a taxpayer’s AGI. For example, a taxpayer’s deduction for medical expenditures is only the amount by which such expenditures exceed 7.5% of a taxpayer’s AGI. Congress can use such a limitation to customize such deductions. A 7.5%-of-AGI-floor on deductibility of medical expenses provides some rough assurance that the amount of a medical expense deduction requires a common level of “pain” among high- and low-income taxpayers.

*Exclusions from Gross Income:* We (say that we) measure “gross income” by a taxpayer’s “accessions to wealth.” However, there are some clear accessions to wealth that Congress has declared taxpayers do not count in tallying up their “gross income,” e.g., employer-provided health insurance (§ 106), life insurance proceeds (§ 101), interest from state or local bonds (§ 103), various employee fringe benefits (e.g., §§ 132, 129, 119). Many exclusions are employment-based.<sup>8</sup> Congressional exclusion of clear accessions to wealth from the income tax base creates certain incentives for those able to realize such untaxed gain – *and* for those who profit

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<sup>7</sup> The personal exemption deduction has been suspended until 2026. § 151(d)(5).

<sup>8</sup> See William P. Kratzke, The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income, 60 THE TAX LAWYER 1 (2006).

from supplying the benefit (e.g., life insurance companies, providers of medical services<sup>9</sup>) in exchange for untaxed dollars.

**The Tax Formula:**

(gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)  
EQUALS (taxable income)

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

**Learn this formula.**

**Deductions from Taxable Income:**

Congress permits taxpayers who spend their after-tax income in certain prescribed ways to subtract the amount of such expenditures from their taxable income. A deduction reduces only income otherwise subject to income tax. Hence, the person who gives her time to work for a charity may not deduct the fair market value (fmv) of the time because taxpayer would not otherwise be taxed on the fmv of her time. In lieu of itemizing such expenditures, taxpayers may elect to reduce their taxable income by a standard deduction.

**Income Phaseouts and Deduction Caps:**

When Congress wants to reduce the income tax liability of a lower-income

taxpayer for having made a particular expenditure but not the income tax liability of a higher-income taxpayer who made the same expenditure, it may phase the benefit out as a taxpayer’s income increases. Congress may also limit (i.e., “cap”) the amount a taxpayer may deduct. An example of both a phaseout and a cap is § 221, the deduction for interest paid on “qualified education loans.” The maximum deduction for such interest is \$2500. § 221(b)(1). Section 221(b)(2) reduces the cap by a percentage that increases as a taxpayer’s “modified adjusted gross income” increases above an amount indexed for inflation. When the percentage reaches 100%, taxpayer may not deduct any amount for paying qualified education loan interest. Consider: what is the profile of a taxpayer who would benefit most from deductibility of student loan interest and what is the profile of a taxpayer that would benefit least?

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<sup>9</sup> See William P. Kratzke, *Tax Subsidies, Third-Party Payments, and Cross-Subsidization: America’s Distorted Health Care Markets*, 40 U. MEM. L. REV. 279, 311-12 (2009) (tax subsidized health insurance makes more money available to health care providers).

Congress can apply phaseouts and caps to both credits and deductions. The precise mechanics and income levels of various phaseouts and caps differ. Income phaseouts and caps increase the complexity of the Code and so also increase the cost of compliance and administration. They can make it very difficult for a taxpayer to know what her effective tax rate is – as *any* change in AGI or deductions effectively changes this rate. Income phaseouts are a tool of congressional compromise. Perhaps Congress is so willing to enact income phaseouts because there are many inexpensive tax preparation programs available to taxpayers that perform all necessary calculations.

**Assignment:** Go to IRS.Gov, then to “Find Forms and Instructions,” then go to “Form 1040.” Also click on “Schedules for Form 1040” and go to “Schedule A.” Print a copy of Form 1040 and Schedule A. Notice how they implement the “tax formula” described in the text box.

*Progressive Tax Brackets, Progressive Tax Rates, or Progressive Taxation:* Taxpayers do not attach the same importance to every dollar that they earn. To a person whose annual taxable income is \$10 million, one dollar more or less has far less value (as gain or loss) than the same dollar has to a person whose annual taxable income is less than \$1000.<sup>10</sup> Hence, the person with \$10 million of income who receives one more dollar might feel the same level of sacrifice if she must pay \$0.90 of it in federal income tax – and so keeps only \$0.10 of it – as the person with \$1000 of income who receives one more dollar of income might feel if she must pay \$0.05 of it in federal income tax and so keeps \$0.95 of it. The Tax Code endeavors to require equal sacrifice by establishing progressive tax rates. Look at § 1 of the Code – preferably the latest table that the IRS has promulgated in a Revenue Procedure that adjusts tax rates for inflation. An understanding of the tax formula should lead you to conclude that the first dollars of a taxpayer’s income are not taxed at all. The next dollars above that threshold – and only those dollars – are subject to a tax of 10%. The next dollars above the next threshold – and only those dollars – are subject to a tax of 12%. And so on – at rates of 22%, 24%, 32%, 35%, and 37%. Tax brackets that increase as taxable income increases are “progressive” tax brackets. The highest individual tax bracket is 37%, but no taxpayer pays 37% of her taxable income in federal income taxes; do you see why?

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<sup>10</sup> We refer to this phenomenon as the declining marginal utility of money.



*Progressive Rates and Income Redistribution:* An argument favoring progressive tax brackets – aside from the declining marginal utility of money – is that the effect of progressive tax brackets is to redistribute income in favor of those who have less. After all, Government has only to spend the many dollars contributed by higher-income taxpayers for the benefit of those less well-off – and there will be income redistribution. Any person who is even slightly aware of current social conditions knows that the Tax Code has not proved to be a particularly effective instrument of income redistribution. Inequality in wealth distribution is at near historically high levels. High-income taxpayers pay less in taxes and keep more of their incomes than serious efforts at redistribution require. We all like tax cuts, but they can starve the Government. There are candidates for public office who argue for a maximum marginal tax bracket much higher than the current maximum of 37%.

*Regressive Tax:* A “regressive tax” is one where the percentage that taxpayers pay *decreases* as their income increases. A *flat tax* is one where the percentage that taxpayers pay is equal at all income levels. Some flat taxes are *regressive in effect*, e.g., a flat sales tax imposed on the purchase of necessities, *supra*.

*Effective tax rate:* Because we have a progressive rate structure, not every

dollar of taxable income is taxed at the same rate. Moreover, income derived from some sources is taxed differently than income derived from other sources. For example, an individual taxpayer’s “net capital gain” (essentially long-term capital gains plus most dividends) is taxed at a lower rate than her ordinary income. It may be useful for policy-makers to know what certain taxpayers’ “effective tax rate” is, i.e., (amount of tax)/(total income).

*Marginal Tax Rate:* A taxpayer’s marginal tax rate is the rate at which the next (or last) dollar is taxed. Because we have a progressive rate structure, this rate will be greater than the taxpayer’s effective tax rate. Among the reasons that the marginal tax rate is important is that it is the rate that determines the cost or value of whatever taxable-income-affecting decision a taxpayer might make, e.g., to work more, to have a spouse work outside the home, to incur a deductible expense, to accept a benefit that is excluded from her gross income in lieu of salary from an employer.

*The Upside Down Nature of Deductions and Exclusions:* A taxpayer pays a certain marginal rate of tax on the next dollar that she derives in gross income. Hence, a high-income taxpayer who pays a 37% marginal tax rate gains \$0.63 of additional spending power by earning one more dollar. The *higher* a taxpayer's marginal tax bracket, the *less* an additional dollar of income will net the taxpayer. The same principle works in reverse with respect to deductions. The same taxpayer might be considering contributing \$1 to her public radio station for which she would be entitled to a charitable contribution deduction. The public radio station would receive \$1 while the taxpayer sacrifices only \$0.63. On the deduction side, the *higher* a taxpayer's marginal tax rate, the *more* an additional dollar of deduction will save the taxpayer in income tax liability. And the *lower* a taxpayer's marginal tax rate, the *less* an additional dollar of deduction will save the taxpayer in income tax liability. A taxpayer whose marginal rate of tax is 10% must sacrifice \$0.90 in order that her public radio station receives \$1. The same principle applies to exclusions from gross income. A high-income taxpayer saves more on her tax bill by accepting employment benefits excluded from gross income than a low-income taxpayer, *infra*. These results might be the opposite of what policy-makers desire, i.e., they are "upside-down." The magnitude of this "upside-downness" depends upon the degree of progressivity of tax rates. Raising tax rates on high income earners will *increase* the "upside-downness" of deductions and exclusions. On the other hand, flat credits against tax liability will *reduce* the "upside-downness" of these incentives.

*Tax Incidence:* "Tax incidence" is a phrase used to name the person on whom the burden of paying a tax falls. The phrase is used to identify occasions where the ostensible payor of a tax can shift the burden to another.<sup>11</sup> For example, a property owner may be responsible for payment of real property taxes, but if the landowner simply increases the rentals that her tenants must pay, the incidence of such a tax falls on the tenants of the property owner.

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<sup>11</sup> Constitutional scholars have observed that the phrase "direct taxes" (*see* Art. I, § 9, cl. 4 of U.S. Constitution) refers to taxes whose burden cannot be transferred to another, e.g., head taxes. Implicitly, "indirect taxes" are taxes whose burden *can* be transferred to another, e.g., excise taxes. The point at which a *transferee* is not willing to pay the "indirect tax" constitutes a practical limit on congressional power to increase such taxes.

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

A credit reduces the taxpayer's tax liability dollar-for-dollar. Some credits are "non-refundable." This means that they cannot reduce a taxpayer's tax liability to less than zero. Other tax credits are "refundable," i.e., they can reduce a taxpayer's tax liability to less than zero in which case the Government will pay the taxpayer the excess. You can see that a refundable credit functions as a Government benefit program because the taxpayer's right to payment does not depend on owing the Government any money.

*The Right Side Up Nature of Tax Credits:* The effect of a tax credit equal to a certain percentage of an expenditure is precisely the same as a deduction of the expenditure from taxable income for a taxpayer whose marginal tax rate is the same as the percentage of the expenditure allowed as a credit. Thus, if Congress wants to encourage certain expenditures *and* wants to provide a greater incentive to low-income persons than to high-income persons, it can establish the percentage of the expenditure allowed as a credit at a level higher than the marginal tax bracket of a low-income taxpayer but lower than the marginal tax bracket of a high-income taxpayer, e.g., 14%. Such a credit will benefit a lower-income bracket taxpayer more than a deduction would and a higher-income taxpayer less than a deduction would. If this is what Congress desires, the effect of a tax credit is "right side up."

*One Last Word about Employment Taxes:* "Employment taxes" are the Social Security tax and the Medicare tax that we all pay on wages we receive from employers.<sup>12</sup> Employers pay a like amount.<sup>13</sup> Self-employed persons must pay the equivalent amounts as "self-employment" taxes. The Government collects approximately one third of its tax revenues through these taxes – much more than it collects from corporate income taxes, gift taxes, estate taxes, and excise taxes

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<sup>12</sup> 26 U.S.C. § 3101(a) (for "Old-Age, Survivors, and Disability Insurance;" 6.2%); 26 U.S.C. § 3101(b) (for "Hospital Insurance;" 1.45% and 2.35% for amounts over a certain threshold).

<sup>13</sup> 26 U.S.C. § 3111(a) (for "Old-Age, Survivors, and Disability Insurance;" 6.2%); 26 U.S.C. § 3111(b) (for "Hospital Insurance;" 1.45%).

combined. Eligibility to be a beneficiary of the Social Security program or Medicare program does not turn on a person's lack of wealth or need. The federal government collects a lot of money from working people so that *all* persons – rich and poor – can benefit from these programs.

*Alternative Minimum Tax:* In response to news stories about certain wealthy people who managed their financial affairs in such a way that they paid little or nothing in federal income tax, Congress enacted the alternative minimum tax (AMT) scheme. I.R.C. §§ 55-59. The basic scheme of the AMT is to require all taxpayers to compute their “regular tax” liability and their “alternative minimum tax liability.” They compute their AMT liability under rules that adjust taxable income upward by eliminating or reducing the tax benefits of certain expenditures or of deriving income from certain sources. They reduce the alternative minimum taxable income by a flat standard deduction that is subject to indexing. A (nearly) flat rate of tax applies to the balance. Taxpayer must pay the greater of her regular tax or AMT. Congress aimed the AMT at high-income persons who did not pay as much income tax as Congress thought they should.<sup>14</sup>

#### IV. Layout of the Code

The Internal Revenue Code is at title 26 of the United States Code. It is the law that *Congress* passed and that the President signed (unless there was a veto over-ride). The first part of your statutory supplement includes *some* of these provisions. The second part of your statutory supplement includes *some* of the regulations that the *Department of the Treasury* has promulgated. These regulations construe the Code. The Code provisions appear in your supplement without any reference to title 26, e.g., “sec. 61.” Regulations are denoted “Reg.” Most of the regulations that we study begin with a “1,” followed by the Code section that they construe. Each regulation is numbered according to the sequence in which Treasury promulgated it. Reg. § 1.61-8 is the eighth regulation that Treasury promulgated that construes section 61.

We will be studying only certain portions of the Internal Revenue Code. You should learn the basic outline of Code provisions that establish the basic income tax. The table of contents to your statutory supplement provides such an outline. This will

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<sup>14</sup> We will not spend any more time on the AMT. You should be aware that it exists and of its basic approach to addressing a particular (perceived) problem.

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

- §§ 1 and 11 establish tax rates;
- §§ 21-53 provide credits against tax liability;
- §§ 55-59 establish the alternative minimum tax;
- §§ 61-65 provide some key definitions concerning “gross income,” “adjusted gross income,” and “taxable income;”
- §§ 67-68 provide rules limiting deductions;
- §§ 72-91 require inclusion of specific items (or portions of them) in gross income;
- §§ 101-139I state rules concerning exclusions from gross income;
- §§ 141-149 establish rules governing state and local bonds whose interest is exempt from gross income;
- § 152 defines who is a “dependent;”
- §§ 161-199A establish rules governing deductions available both to individuals and to corporations;
- §§ 211-223 establish rules governing deductions available only to individuals;
- §§ 241-250 establish rules governing deductions available only to corporations;
- §§ 261-280H deny or limit deductions that *might* otherwise be available;
- §§ 441-483 provide various rules of accounting, including timing of recognition of income and deductions;
- §§ 1001-1021 provide rules governing the recognition of gain or loss on the disposition of property;
- §§ 1031-1045 provide rules governing non-recognition of gain or loss upon the disposition of property, accompanied by a transfer and adjustment to basis;
- §§ 1202-1260 provide rules for defining and calculating capital gains/losses;
- §§ 1271-1288 provide rules for original issue discount.

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

## V. Not All Income Is Taxed and Not All Income Is Taxed Alike

*Three Levels of Tax Law:* Tax law will come at you at three levels. The emphasis on them in this course will hardly be equal. Nevertheless, you should be aware of them. They are –

- (1) Statute and regulation reading, discernment of precise rules and their limits, application of these rules to specific situations;
- (2) Discerning and evaluating the policies underlying various provisions of the Internal Revenue Code;
- (3) Consideration of the role of an income tax in our society. What does it say about *us* that our government raises so much of its revenue through a personal income tax? Other countries rely more heavily on other sources of revenue. A personal income tax raises a certain amount of revenue. Some countries raise less revenue and provide their citizens (rich and poor alike) fewer services. Other countries (notably Scandinavian ones) raise more revenue and provide their citizens (rich and poor alike) with more services. The tax share of national income in the United States is about 30%; in Great Britain, it is about 40%; in Sweden, it is about 55%. THOMAS PIKETTY, *CAPITAL IN THE TWENTY-FIRST CENTURY* 476 (2014). Moreover, the United States provides middle- and high-income persons with more services and benefits than most people realize.

The tax formula begins with a taxpayer's "gross income." Every ensuing mathematical operation is a subtraction. This means that if the Code should deem a particular accession to wealth not to be "gross income," that accession will not be part of a taxpayer's "taxable income." Congress has chosen to exclude certain accessions to a taxpayer's wealth from "gross income." See §§ 101 to 139I. Exclusions from "gross income" is the subject of Chapter 3.

Beyond exclusions from gross income, Congress has determined that not all taxable income

should be taxed the same. Notably, long-term capital gains<sup>15</sup> (or more accurately "net capital gain") plus most dividend income of an *individual* is taxed at a lower rate than wage or salary income. Interest income derived from the bonds of state and local governments is not subject to any federal income tax. Certain other income derived from particular sources is subject to a marginal tax rate that is less than the tax rate applicable to so-called ordinary income. This encourages some taxpayers to seek income from tax-favored sources rather than from other sources.

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<sup>15</sup> That is, gain on the sale of property that a taxpayer owns for more than one year.

## VI. Illustration of the Tax Formula and Working with Some Tax Terminology

Consider a hypothetical family that is not unusual – whether or not it is typical. The point here is to illustrate how the tax formula works and to work with some basic tax terminology that we already know. Take this illustration one step at a time. You may not grasp all its details early in the semester. You will notice some of the Code’s “moving parts” and their inter-relatedness. Two “moving parts” are the indexed tax rates that change every year and inflation-adjusted deduction limits that also change every year. At the very front of your Code, you will find the current rates and limits. We apply the rates for 2023.

Bill and Mary are husband and wife. They have two children, Thomas who is 14 and Stephen who is 10. Bill works as a manager for a large retailer. Last year, he earned a salary of \$90,000. His employer provided the family with health insurance that cost \$15,000. Mary is a school administrator who earned a salary of \$85,000. Her employer provided her a group term life insurance policy with a death benefit of \$50,000; her employer paid \$250 to provide her this benefit. Their respective employers deducted employment taxes from every paycheck and paid each of them the balance. In addition to the above items, Bill and Mary own stock in a large American corporation, and that corporation paid them a dividend of \$500. Bill and Mary later sold that stock for \$10,000; they had paid \$8000 for it several years ago. Bill and Mary have a joint bank account that paid interest of \$400. Bill and Mary paid \$4300 for daycare for Stephen. They also paid \$3000 of interest on a student loan that Bill took out when he was in college. They spent \$30,000 to rent the apartment they live in. We will determine Bill and Mary’s tax liability. Assume that they will file as married filing jointly.

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

•*Answer:* Employment taxes are 6.2% for “social security” and 1.45% for “Medicare.” The total is 7.65%. The tax base of employment taxes is wages. So:

•Bill: Bill’s wages were \$90,000.  $7.65\%$  of \$90,000 = \$6885.

•Mary: Mary’s wages were \$85,000.  $7.65\%$  of \$85,000 = \$6502.50.

How much is Bill and Mary’s “gross income?”<sup>16</sup> You should see that this is the first

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<sup>16</sup> “Gross income,” § 61, is a topic that we take up in chapter 2. It encompasses all “accessions to wealth.” However, there are some “accessions to wealth” that we do not include in a taxpayer’s “gross



line of the tax formula. We need to determine what *is* included in, and what is *excluded* from, “gross income.” See §§ 61, 79, and 106.

- Answer:* Since Bill and Mary will file jointly, we pool their relevant income figures. Employment taxes do not reduce Bill and Mary’s gross income. Thus, they must pay income taxes on at least some of the employment taxes that they have already paid.

- Bill and Mary must include the following in their gross income: Bill’s salary (§ 61(a)(1)) of \$90,000; Mary’s salary (§ 61(a)(1)) of \$85,000; dividend (§ 61(a)(7)) of \$500; capital gain (§ 61(a)(3)) of \$2000; interest income (§ 61(a)(4)) from the bank of \$400. TOTAL: \$177,900.

- Bill and Mary do *not* include the amount that Bill’s employer paid for the family’s health insurance (§ 106(a)), \$15,000, or the amount that Mary’s employer paid for her group term life insurance (§ 79(a)(1)), \$250. Bill and Mary certainly benefitted from the \$15,250 that their employers spent on their behalf, but §§ 106 and 79 provide that they do not have to count these amounts in their “gross income.”

How much is Bill and Mary’s adjusted gross income (AGI)? See §§ 221 and 62(a)(17).

- Section 221 entitles Bill and Mary to deduct interest on the repayment of a student loan. While the couple paid \$3000 in student loan interest, § 221(b)(1) limits the deduction to \$2500. [Can you infer anything about congressional sentiment towards students who incur high amounts of student debt? What options do such students have?]

- Section 221(b)(2) requires the computation of a phasedown. Section 221(b)(2)(A) provides that the deductible amount must be reduced by an amount determined as per the rules of § 221(b)(2)(B). Section 221(b)(2)(B) establishes a ratio. Section 221(f) requires that the IRS keep the ratio up-to-date by indexing. Every year, the IRS announces in a revenue procedure the values to be used when a relevant Code provision requires indexing. For tax year 2023, the § 221(b)(2)(B) amount for taxpayers married filing jointly is \$155,000. Rev. Proc. 2022-38, at § 3.30.

- Since Bill and Mary are married filing a joint return, § 221(a)(2)(B)(i) establishes a numerator of:  $\$177,900 - \$155,000 = \$22,900$ .

- Section 221(b)(2)(B)(ii) establishes a denominator of \$30,000.

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income.” We consider some of those in chapter 3. The Code defines these exclusions in §§ 101 to 139I. The Code also defines the scope of certain inclusions in §§ 72 to 91 – and implicitly excludes what is outside the scope of those inclusions.



- The ratio that § 221(b)(2)(B) prescribes is  $\$22,900/\$30,000$ , i.e., 0.7633.
- Section 221(b)(2)(B) requires that we multiply this ratio by the amount of the deduction otherwise allowable, i.e., \$2500 and then *reduce* \$2500 by the resulting amount.  $\$2500 \times 0.7633 = \$1908.25$ .  $\$2500 - \$1908.25 = \$591.75$ . For paying \$3000 in student loan interest, Bill and Mary may deduct only \$591.75.
- Section 62(a)(17) provides that this amount is *not* included in taxpayers' AGI.
- Thus: Bill and Mary's AGI =  $\$177,900 - \$591.75 = \underline{\$177,308.25}$ .

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

- Answer:* Section 63(a and b) defines "taxable income" as EITHER "gross income" minus allowable deductions OR AGI minus a standard deduction.<sup>17</sup>
- The rent they pay is not deductible, and we are told of no deductions that would be "itemized," i.e., "allowable," so Bill and Mary will "elect" to take the standard deduction. This is another figure indexed for inflation. For tax year 2023, the standard deduction for taxpayers who are married and filing jointly is \$27,700. Rev. Proc. 2022-38, at § 3.16.
- Do the math:  $\$177,308.25$  MINUS \$27,700 equals \$149,608.25 of "taxable income."

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

- Answer:* Remember, not all income is taxed alike. Long-term capital gain and many dividends are taxed at a maximum rate of 20%. § 1(h)(1)(D) and § 1(h)(11). Bill and Mary received \$2000 in long-term capital gain and \$500 in dividends. Bill and Mary's taxable income will be greater than \$89,250 and will not be greater than \$553,850, so this portion of their taxable income will be taxed at the rate of 15%, i.e., \$375. *See* Rev. Proc. 2022-38, at § 3.03.
- The tax on the balance of their taxable income will be computed using the tables at § 1(j) of the Code, indexed for inflation:<sup>18</sup>  $\$149,640.33$  MINUS

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<sup>17</sup> Section 63(b) provides for a reduction of taxable income by personal exemptions and of the deduction provided in § 199A. The personal exemption deduction has been suspended, and § 199A provides a deduction for certain pass-through entities. We leave these aside for purposes of this illustration.

<sup>18</sup> The latest tax brackets are in the front pages of your student edition of the Code and Regulations.

\$2500 equals \$138,908.33. Go to § 1(j)(2)(A). Bill and Mary's taxable income is more than \$89,450 and less than \$190,750. Hence their federal income tax liability on their ordinary income equals \$10,294 PLUS 22% of  $(\$149,608.33 - \$89,450) = \$10,294 + \$13,234.83 = \underline{\$23,528.83}$

- Do you see the progressiveness in the brackets?

- Total tax liability =  $\$375 + \$23,528.83 = \underline{\$23,903.83}$ .

Are Bill and Mary entitled to any credits? If so, what is the effect on their income tax liability? *See* §§ 21 and 24.

- Answer:* For 2023, § 21 provides a credit on a portion of up to \$3000 for the “dependent care” expenses for a “qualifying individual.” Stephen is a “qualifying individual,” § 21(b)(1)(A). Thomas is not a “qualifying individual,” but Bill and Mary did not spend any money for Thomas’s “dependent care.” The credit in 2023 was 35% of the amount that Bill and Mary spent on such care that is subject to a phasedown of 1 percentage point for each \$2000 of AGI by which Bill and Mary’s AGI exceeds \$15,000, down to a minimum credit of 20%. § 21(a)(2). Bill and Mary’s AGI of \$177,308.33 (in 2023) is \$162,308.33 more than \$15,000. This means that their dependent care credit will be reduced from 35% to 20%. And, 20% of \$3000 is \$600. Bill and Mary may claim a tax credit for dependent care expenses of \$600; they received no credit for the amount they spent in excess of \$3000.

- Congress increased the credit limit for dependent care expenses substantially during pandemic.

- Bill and Mary may also claim a “child tax credit” for each of their children. § 24(a). Both Thomas and Stephen are “qualifying” children. § 24(c)(1). For tax year 2023, § 24(h)(3) provides a \$2000 credit for each of the children. Total child tax credits = \$4000.

- The effect of a tax credit is to reduce taxpayers’ *tax liability* – *not* their AGI or “taxable income.”  $\$23,903.83$  minus \$600 minus \$4000 equals \$19,303.83.

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

- Answer:* Bill and Mary's federal *income tax* liability is \$19,303.83. Their effective tax rate computed with respect to their "adjusted gross income" is  $\$19,303.83/\$177,308.83$ , i.e., 10.89%.

- Notice that we could use a different income figure to determine their effective tax rate, e.g., "gross income," "gross income plus exclusions," "taxable income." We have included employment taxes in this determination.

What is Bill and Mary's marginal tax bracket?

- Answer:* 22%. You should recognize this as the multiplier that we obtained from the tax table.

- Question:* If Bill and Mary made a deductible contribution of \$1, how much would this save them in federal income tax liability (if they itemized their deductions)?

- 22% of the amount they contributed, i.e., \$0.22. The contribution would have only cost them \$0.78.

- Question:* If the neighbors offered to pay Bill \$1000 to paint their house, how much would Bill actually *net* if he took them up on the offer?

- $\$1000 - (22\% \text{ of } \$1000) = \$780$  (disregarding employment taxes).

## VII. Statements of Tax Law and the Role of Courts

The Tax Code is federal statutory law. There are several features concerning its interpretation and enforcement that require understanding a few more terms and their importance.

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

At the pinnacle of the pyramid is the *United States Constitution*. Every statement of tax law below the Constitution must be consistent with it. Immediately below the

Constitution is the *Internal Revenue Code*, enacted pursuant to the lawmaking authority of Congress. Courts may construe provisions of the Code. Depending on the level of the court and the geographic area (i.e., federal circuit) subject to its

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

1. Tax Court: The Tax Court is a specialized court comprised of nineteen judges. It sits in panels of three judges. There is no jury in Tax Court cases. Taxpayer does *not* have to pay the amount of tax in dispute to avail herself of court review in Tax Court. Appeals from Tax Court are to the United States Court of Appeals for the Circuit in which the taxpayer resides.

2. Court of Claims. The Court of Claims hears cases involving claims – other than tort claims – against the United States. It sits without a jury. Taxpayer must pay the disputed tax to avail herself of review by the Claims Court. Appeals from a decision of the Court of Claims are to the United States Court of Appeals for the Federal Circuit.

3. Federal District Court. Taxpayer may choose to pay the disputed tax and sue for a refund in the federal district court for the district in which she resides. Taxpayer is entitled to a jury, and this is often the main motivation for going to federal district court. Appeals are to the United States Court of Appeals for the federal circuit of which the federal district court is a part.

rulings, those decisions are binding constructions of the Code's provisions.<sup>19</sup> The IRS may announce that it does or does not acquiesce in the decision of any court lower than the Supreme Court. Outside of the Code with its highly specific and at times technical language and court and administrative construction of it, there is very little federal income tax law. After all, taxpayers should not be made to guess what rule of tax liability a court (or other enforcement body) may decide to prescribe and enforce.

Immediately below the Code on the pyramid are *regulations* that the Secretary of the Treasury promulgates. These regulations are usually interpretive in nature. So long as these regulations are consistent with the Code<sup>20</sup> and the Constitution, they are *law*. The same rules of court construction of the Code apply to construction of regulations.

A *revenue ruling* is a statement of what the IRS believes the law to be on a certain point and how it intends to enforce the law. Since the tax liability of a taxpayer is

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<sup>19</sup> See *Marbury v. Madison*, 5 U.S. 137, 177 (duty of courts to say what the law is and to expound and interpret it). In other countries, court constructions of a code are persuasive authority only. A code still prevails in such countries over court pronouncements insofar as they might guide persons other than parties to a case.

<sup>20</sup> In *Mayo Found. for Med. Educ. and Res. v. U.S.*, 562 U.S. 44 (2011) the Supreme Court held that reviewing courts should give *Chevron* deference when passing upon the validity of Treasury Department (i.e., IRS) regulations. 562 U.S. at 55-56 (upholding regulation providing that employee normally scheduled to work 40 or more hours per week does not perform such work incident to and pursuant to course of study; employer not exempt from paying employment taxes). *Chevron, U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) established a two-part framework by which courts determine whether to defer to administrative rulemaking: (1) Has Congress addressed the precise question at issue? If not: (2) Is the agency rule "arbitrary or capricious in substance, or manifestly contrary to the statute." If not, then the reviewing court is to defer to the agency rule. 562 U.S. at 52-53. In *King v. Burwell*, 576 U.S. 473, (2015), the Court refused to defer to the IRS on the question whether the tax credits of 26 U.S.C. § 36B were available to those who purchased health insurance through federal exchanges rather than through state exchanges. An IRS regulation said "yes." The Court nevertheless made its own determination because this was an extraordinary case.

The tax credits are among the Act's key reforms, involving billions of dollars in spending each year and affecting the price of health insurance for millions of people. Whether those credits are available on Federal Exchanges is thus a question of deep "economic and political significance" that is central to this statutory scheme; had Congress wished to assign that question to an agency, it surely would have done so expressly.

576 U.S. at 485-86.

(generally) the business of only the taxpayer and the IRS,<sup>21</sup> this can be very valuable information. A *revenue procedure* is an IRS statement of how it intends to proceed when certain issues are presented. The IRS saves everyone the expenses of litigating such questions as whether an expenditure is “reasonable,” “substantial,” or “de minimis” in amount by announcing bright line construction of such terms. Revenue rulings and revenue procedures are *not* law, and courts may choose to ignore them.

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

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

*Three Principles to Guide Us Through Every Question of Income Tax:* There are three principles (which are less than rules but close enough):

1. We tax income of a taxpayer once and only once.
2. There are exceptions to Principle #1, but we usually must find those exceptions explicitly defined in the Code itself. We define exceptions with precision.
3. If there is an exception to Principle #1, we treat the untaxed income *as if* it had been taxed and we accomplish this by making appropriate adjustments to “basis.”

**Learn** these principles.

## VIII. Some Income Tax Policy and Some Income Tax Principles

The United States has adopted an income tax code, and the discussion now zeroes in on the statute that Congress has adopted and some broad policy issues that the Code raises. The Code itself implicitly embodies certain principles (*see*

<sup>21</sup> *See* Simon v. Eastern Kentucky Welfare Rights Organization, 426 U.S. 26, 40-45 (1976) (taxpayer unable to show that tax benefit given to other taxpayers caused injury to itself that any court-ordered relief would remedy).

accompanying text box). A tax code that requires taxpayers to pay income tax on less than all of their accessions to wealth and to pay different rates on different types of income necessarily raises questions of policy, equity, and fairness.

**Tax Expenditures:** Congress may choose not to make citizens pay income tax on receipt of certain benefits or on purchase of certain items. For example, an employee who receives up to \$15,950 (inflation-adjusted amount for 2023) from an employer for “qualified adoption expenses” may exclude that amount – as adjusted for inflation and subject to a phaseout – from her “gross income.” § 137. A taxpayer who pays such expenses may claim a credit equal to the amount that she paid. § 36C. A taxpayer who benefits from either of these two provisions enjoys a reduction in the federal income tax that she otherwise would have to pay. We can view that reduction as a government expenditure. In fact, we call it a “tax expenditure.” These two tax expenditures were expected to be \$0.4B in tax year 2023. Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Years 2022-2026* (JCX-22-22) December 22, 2022, 40. The tax expenditure for employer contributions for employee health care was expected to be \$190.4B. *Id.* at 43. See EDWARD D. KLEINBARD, WE ARE BETTER THAN THIS: HOW GOVERNMENT SHOULD SPEND OUR MONEY 241-63 (2015) (“The hidden hand of government spending”).

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

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

1. Horizontal equity: Taxpayers with equal accessions to wealth should pay the same amount of income tax. Like taxpayers should be taxed alike. Of course, we can argue about which taxpayers are truly alike.
2. Vertical equity: Unlike taxpayers, i.e., taxpayers with different accessions to wealth, should not be taxed alike. Those with more income should pay more *and* pay a higher percentage of their income in taxes. Income tax rates should be progressive.



3. Administrative feasibility: The tax system only applies to persons who have incomes. The rules should be easy to understand and to apply – for both the taxpayer and the collection agency, the Internal Revenue Service.

The first two of these principles are corollaries, i.e., each is little more than a restatement of the other. Consider how closely we can come to defining “income” in a way that meets that meets the first two norms.<sup>22</sup>

## IX. What We Tax: What Is Income?

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

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.<sup>23</sup>

Derivation of the same formula is also attributed to Georg von Schanz and to Robert Murray Haig. We may refer to this formula as the Schanz-Haig-Simons formula, the Haig-Simons formula, or the SHS formula. The SHS formula reflects that a taxpayer who receives income can either save (invest) or spend it.

*If Algebra or Economics Scare You –*

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<sup>22</sup> See Boris I. Bittker, *A “Comprehensive Tax Base” as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 934 (1967) (arguing that many of the changes necessary to create truly comprehensive tax base would be unacceptable).

<sup>23</sup> Henry C. Simons, *Personal Income Taxation* 50 (1937).



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

The SHS definition is an (enormously convenient) “algebraic sum.” If it is true that:

$$(\text{Income}) = (\text{Consumption}) + (\text{Additions to the store of property rights})$$

then it is equally true that

$$(\text{Income}) - (\text{Additions to the store of property right}) = (\text{Consumption}).$$

This point is quite useful to those who (believe that they) want the government to tax consumption rather than income, perhaps because they believe that those who

save rather than spend deserve to and will pay less in taxes than they do under the current system. The algebraic quality of this definition assures that no matter what our tax base is, we would never have to bear the expense or endure the inconvenience of keeping track of what we individually spend on consumption. Anyone who has received a W-2 from an employer or a 1099-INT from a bank knows that we can expect an employer or a bank to provide the pertinent information about wages or savings with an acceptable degree of accuracy. From this information, a taxpayer can

*The Unit of Measurement of Income, Consumption, and Savings – USD:* Inflation in the United States or elsewhere affects the relative value of savings held in different currencies. We measure taxable income by the currency of the United States, i.e., dollars. Similarly, we measure basis in assets by dollars. We assume that the value of a dollar does not change because of inflation. (We might alter the ranges of income subject to particular tax rates – i.e., to index – but we do not alter the number of dollars subject to income tax.) We do not adjust the amount of income subject to tax because the value of a dollar fluctuates against other of the world’s currencies. Instead, we require that transactions carried out in other currencies be valued in terms of dollars at the time of the relevant income-determinant events, i.e., purchase and sale. This applies to transactions involving virtual currencies such as bitcoin. See Notice 2014-21, 2014-16 I.R.B. 938 (Q&A 3; “A taxpayer who receives virtual currency as payment for goods or services must, in counting gross income, include the fair market value of the virtual currency measured in U.S. dollars ...”).

determine what she spent on consumption by manipulating the SHS formula as above. When a(n odd) question arises outside the ambit of W-2s or 1099s, e.g., whether a taxpayer should include in her taxable income the value of a meal that she does not have to purchase for herself, we simply adjust an element of the formula, and adjustment will drive an adjustment of at least one other element of the formula. Income, consumption, and savings are functions of each other.

### *Some Obvious or Not-so-Obvious Implications of the SHS Definition of “Income”*

If we choose to tax what we spend and what we save during a particular time period, then we are taxing only *increments* to a taxpayer’s overall well-being. Our tax code demands an annual accounting and assessment even though this can be inconvenient – and even inaccurate – for some taxpayers. What happens during the year is treated as an increment to what happened before, e.g., we added to a savings account that we already had, we consumed only a portion of an asset we already own. We do not tax *accumulated* wealth – property taxes and estate taxes do that. A concept integral to our income tax is “basis,” and its function is to measure what happened before and to assure that our income tax does *not* tax accumulated wealth but only *increments* to it.

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

Focus now on additions to “the store of property rights” that a taxpayer may accumulate during a relevant period and not on the consumption element of the SHS definition. Taxing a taxpayer’s increments to savings and investment is equivalent to taxing additions to taxpayer’s *unexercised power* to consume. Taxation of income is therefore the taxation of consumption plus increments to the *power* to consume.

People save money only if they value future consumption more than current consumption *and* believe that they can spend their savings on future consumption. Congress may encourage taxpayers to save for later consumption by not taxing the income that taxpayers willingly – and provably – save for certain items of consumption, e.g., saving for retirement through individual retirement accounts (IRAs) or “401(k)s.”

*b. Income, Consumption, and Value: The Consequences of Foregoing Value*

The measure of value is what a person is willing to pay for something she does not have or the price at which a person is willing to sell something she does have. A person cannot value something more than what she is able to give in exchange. A person should pay no more than the value she places on an item she wants or sell an item for less than the value she places on it.<sup>24</sup>

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

*We assume that taxpayers who voluntarily enter transactions know best what will increase surplus value to themselves, and that the choices each taxpayer makes concerning what to buy and what to sell are no concern of any other taxpayer. We also assume that all taxpayers make purchasing choices with income that has already been subject to tax. Section 262(a) implements this assumption by denying*

*deductions to taxpayers for purchases of items for personal consumption, including expenditures for basic living expenses. The statement that an expenditure is “personal” implies a legal conclusion concerning deductibility. If the money used to purchase items for personal consumption is subject to income tax, as a matter of*

*Taxing Only the Creation of Value?* Exchanges often generate income that the Code subjects to income tax. Arguably, the Code should not subject to tax the payoff from exchanges that everyone understands (probably) *reduce* a taxpayer’s wealth, but this is not the case. For example, court-ordered damages that a plaintiff deems inadequate to compensate for the loss of an unpurchased intangible (e.g., emotional tranquility) may nevertheless be subject to income tax. See § 104(a).

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<sup>24</sup> A person tends to value what she already has more than what she does not have.

*An Observation about the Tax Cuts and Jobs Act:* In December 2017, Congress made significant changes to the Code. It eliminated some deductions altogether, e.g., the deduction for alimony paid. It suspended for eight years several deductions, e.g., the deductions for personal exemptions, for “miscellaneous deductions,” and for moving expenses. At the same time, it doubled the standard deduction. For example, the standard deduction for a married couple filing jointly doubled to \$24,000 for tax year 2018. It also decreased the income tax brackets. The effect of these provisions will be to make many more taxpayers “choose” the standard deduction over itemization. For them – irrespective of what their marginal tax bracket is – the income tax code has become more neutral. For example, the Code will no longer encourage them to give more to charity or to spend more on a more expensive house. Those who choose to itemize will be those with higher incomes who make sizable expenditures for items that remain deductible. To the extent that the Code influences *their* choices, *their* marketplace choices will have greater impact on the economy than the choices of those taxpayers who do not “choose” to itemize. Now, if Congress wishes to influence the purchasing choices of those who can claim only the standard deduction, it must either provide a credit or provide that an expenditure is an adjustment to gross income see § 62). See William P. Kratzke, *Musings: Itemized Deductions and the Changing Fabric of American Society Wrought by the Tax Cuts and Jobs Act – Observing Regressiveness Hidden in Plain Sight*, 76 THE TAX LAWYER 293 (2023).

*policy the choices of any taxpayer with respect to such purchases should be unfettered. This observation supports not taxing the money taxpayer spends to make purchases that she has no option not to purchase.*

On the seller’s side, we should not have a tax code that favors selling one type of good or service over another. Sellers should be encouraged to utilize their resources in whatever trade or business maximizes their own seller surplus, even illegal ones.<sup>25</sup> This is good for buyers because sellers should choose to produce those things whose sale will create buyer surplus. A seller’s choice of which good or service to offer

should not depend on the cost of producing or providing that good or service, but on the net profit she can derive from its sale. A necessary implication of this is that

<sup>25</sup> The only exception to this principle is the trade or business of trafficking in certain controlled substances. See § 280E.

we should tax only the *net* income of those engaged in a trade or business – not gross proceeds. Section 162 implements this policy by allowing a deduction for ordinary and necessary trade or business expenses. One engaged in a trade or business generates profits by consuming productive inputs, and the cost of those inputs should not be subject to tax. If a taxpayer’s trade or business consumes productive inputs only slowly, i.e., over the course of more than a year, principles of depreciation<sup>26</sup> require the taxpayer to spread those costs over the longer period during which such consumption occurs. *See, e.g.*, §§ 167 and 168. Those who engage in activities that cannot create value but which really amount to a zero-sum game, e.g., gambling, should not be permitted to reduce the income on which they pay income tax to less than zero. *See* § 165(d).<sup>27</sup>

If the choices of buyers and sellers concerning what to buy and what to sell are matters of self-determination, then their choices should theoretically generate as much after-tax value as possible. A “neutral” tax code will tax all income alike, irrespective of how it is earned or spent. In theory, such “tax neutrality” distorts the free market the least and causes the economy to create the most value possible. We recognize (or will soon recognize) that the tax code that the nation’s policy-makers, i.e. Congress, have created is *not* neutral. Rather, we reward certain choices regarding purchase and sale by not taxing the income necessary for their purchase or by taxing less the income resulting from certain sales. Such deviations from neutrality cost the U.S. Treasury because they represent congressional choices to forego revenue and/or to increase the tax burden of other taxpayers who do not make the same purchase and sale choices. Such deviations of course take us into the realm of tax policy.

Deviations from neutrality can ripple through the economy. They cause over-production of some things that do not increase the nation’s wealth as much as the production of other things would. We tolerate such sacrifices in overall value because we believe that there are other benefits that override such foregone value.

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<sup>26</sup> ... or amortization or cost recovery.

<sup>27</sup> *But see* Commissioner v. Groetzinger, 480 U.S. 23 (1987) (full-time gambler who makes wagers solely for his own account is engaged in a “trade or business” within meaning of § 162).

*The Essence of Basis:* Adjusted basis represents money that will not again be subject to income tax, usually because it is what remains after taxpayer already paid income tax on a greater sum of money. More pithily: basis is “money that has already been taxed” (and so can’t be taxed again).

If Congress chooses to allow a taxpayer to exclude the value of a benefit from her gross income, we must treat the benefit *as if taxpayer had purchased it with after-tax cash*. By doing so, we assure ourselves that the value of the benefit will not “again” be subject to tax. This means that taxpayer will include in her adjusted basis of any property received in such a manner the value of the benefit so excluded. If the amount excluded from gross income is not added to taxpayer’s basis, it will be subject to tax upon sale of the item. See, e.g., § 132(a)(2) (qualified employee discount). That is hardly an “exclusion.”

When deviations are limited to transactions between two parties who can negotiate the purchase and sale of an item or benefit only from each other, e.g., employer and employee, one party may be able to *capture* more of the cooperative surplus for itself than it otherwise might. An employer might provide a benefit (e.g., group health insurance) to its employees, reduce employee wages by what would be the before-income-tax cost of the benefit, and pocket all the tax savings. Such *capture* might be contrary to what Congress intended or anticipated.

### *Basis – Or Keeping Score with the Government*

We tax only increments to consumption and saving during a particular period – not what came before. The tool by which we assure that “what came before” is not again subject to income tax is “basis.” Section 1012(a) tells us that a taxpayer’s “basis” in something is its cost. Taxpayer will pay for the item with money that was already subject to tax upon its addition to her store of property rights. Section 1011(a) tells us that “adjusted basis” is basis after adjustment. Section 1016 tells us to adjust basis upwards or downwards according to whether taxpayer converts more assets from her store of property rights in connection with the property (§ 1016(a)(1)), i.e., improves it; or consumes some of it in connection with her trade or business, or in connection with an activity engaged in for profit (i.e., depreciation (cost recovery) or amortization) (§ 1016(a)(2))<sup>28</sup> derived from a dealing in property is the price at which taxpayer sells property minus the price that she paid for the property.

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<sup>28</sup> The deduction of “miscellaneous deductions” has been suspended until 2026. § 67(g).

*The Relationship Between Basis and Deductions from Taxable Income.* An important point concerning the fact that adjusted basis is income that has already been subject to tax is that deductions, i.e., reductions in taxable income allowed to the taxpayer because taxpayer spent income in some specified way, are only allowed if taxpayer has a tax basis in them. Section 170 permits a deduction of contributions made to charitable organizations.

But: a charitable deduction only reduces the taxable income in which taxpayer *has adjusted basis*. This explains why the taxpayer may deduct the costs of transportation to get herself to the place where she renders services to a charity, but not the value of her services for which the charity pays her nothing. Presumably taxpayer incurred the costs of transportation from after-tax income, but paid no income tax on income she did not receive from the charitable organization.

Section 61(a)(3) informs us that a taxpayer's "gross income" includes gains derived from dealings in property. Section 1001(a) instructs us how to measure gains derived from dealing in property. Subtract "adjusted basis" from the "amount realized," i.e., the amount of money and the fair market value of any property received in the transaction. The subtraction of "adjusted basis" assures that its amount is not (again) subject to income tax.

The purchase of something from a taxpayer's after-tax "store of property rights," *to the extent that it is not for consumption*, represents only a change in the form in which taxpayer holds her wealth. It does not represent an addition to wealth and so does not fall within the SHS definition of "income." It should never again be subject to income tax lest we violate the first of our guiding principles by taxing twice the income necessary to purchase the item.

While the Code specifically defines "basis" and "adjusted basis," the *concept* of "basis," as frequently used in this text, is that it is a means of keeping score with the government. A taxpayer's score is the amount of after-tax income a taxpayer has invested – or is credited with having invested – in an asset that *will not again be subject to income tax*. The upshot of all this is that adjusted basis represents the current score in the game between taxpayer and the Government of what wealth has already been subject to tax and so should not be subject to tax again.



### *SHS Accounting for Spending From Savings*

An implication of the SHS conception of income is that we might have to follow taxpayer's after-tax money into and later out of her store of property rights to spend on consumption. If a taxpayer takes money from savings and spends it on instant gratification so that she acquires no asset in which she has an adjusted basis, intuitively we know that she does not have any income on which she must pay income tax. The SHS definition of income accounts for this by an off-setting decrease to taxpayer's store of property rights and increase in rights exercised in consumption.

***Investment, Basis, Depreciation, and Adjustments to Basis.*** An investment in an income-producing asset represents merely a change in the form in which a taxpayer holds after-tax wealth. Changing the form in which taxpayer holds wealth is not a taxable event. We assure ourselves that the change is not taxed by assigning basis to the asset. When the investment is in an asset that will eventually but not immediately be used up in the production of other income, income-producing consumption and "de-investment" occur simultaneously. The cost of income-producing consumption is deductible and so reduces taxable income. The expense of generating income through the use of assets that are not immediately and completely consumed is separately accounted for in whatever name as depreciation, amortization, or cost recovery. The accompanying de-investment requires a *reduction* in the adjusted basis of the income-producing asset. § 1016(a)(2).

### *Borrowing Money*

A taxpayer who borrows money may use that money either to exercise a right of consumption or to increase her store of property rights. In either case, SHS might provide that taxpayer has realized income. However, an obligation to repay accompanies any loan. *This obligation counts as a decrease in taxpayer's store of property rights.* Hence, the addition to income is precisely offset by this decrease in the value of taxpayer's store of property rights.

Incidentally, the Code nowhere states that loan proceeds are not included in a taxpayer's gross income, but we all understand that to be the rule.

AND: taxpayer may use loan proceeds to purchase an item for which she is credited with basis, just as if she had paid tax on the income used to make the purchase. Doesn't this seem to violate the first principle of income taxation noted above? No. Taxpayer will repay the loan from future income that will be subject to tax.



Taxpayer pays for her basis with money to be earned *and taxed* in the future. Repayment of loan *principal* is never deductible. Sometimes the cost of borrowing, i.e., interest, is deductible.

In the pages ahead, we examine various topics concerning income tax. In all cases, try to fit them into the principles described in this chapter.

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

## Wrap-up Questions for Chapter 1

1. A major issue in recent presidential campaigns has been whether the income tax on high income earners should be increased or decreased. Can you think of any standard by which to determine the appropriate level of progressivity in the Code?
2. The more progressive the Code, the greater the “upside-downness” of deductions. How might this be a good thing? What would be the advantage of granting tax credits instead of deductions or exclusions?
3. What are phaseouts? Why would Congress enact them? How do they affect a taxpayer’s effective tax rate?
4. Taxpayer received a tax-free benefit, perhaps a gift from a company that wanted to increase its business. Why must taxpayer have a fmv basis in the item?
5. If taxpayer receives a benefit but has no choice regarding its consumption – the manager of a lighthouse *must* live with his family in the lighthouse – should taxpayer be taxed on the value of the benefit? Why or why not?
6. Taxpayer owned some commercial property. Taxpayer recorded the property on its corporate books at a certain value. Over the course of several years, the value of the property fluctuated up and down. Taxpayer did not pay income tax on the increase in the property’s value. Why should taxpayer not be permitted to deduct decreases in the property’s value?

*Tax law and the pandemic:* The Covid-19 pandemic caused economic hardships and dislocations that rippled through all the economies of the world. Congress responded with various income tax measures to ease the financial burdens that the pandemic caused, notably the \$1200, \$600, and \$1400 tax credits for most Americans. These credits took the form of cash payouts. Most of these tax measures were (are) temporary. Congress did not change the fundamental structure of the income tax code, although tax relief measures altered the tax burdens that taxpayers must bear. As we shall see, Congress has used the Internal Revenue Code as an instrument with which to address this crisis. It will take several years to unwind all these “temporary” measures. In this text, many (though not all) these measures will be noted, usually in a text box.

## What have you learned?

Can you explain or define –

- tax base, deductions, exclusions, income phaseouts
- tax formula, credit against tax
- progressive tax rates
- marginal tax rates
- upside-down nature of deductions and exclusion
- right-side up nature of tax credits
- employment taxes
- the Tax Code, regulations, revenue rulings, revenue procedures, private letter rulings
- tax disputes and the Tax Court, the Court of Claims, and the Federal District Court
- tax norms of horizontal equity, vertical equity, and administrative feasibility
- Schanz-Haig-Simons definition of income and its elements
- three guiding principles of the income tax

- tax expenditures
- income tax treatment of personal expenditures (§ 262)
- tax neutrality, distortion
- basis
- tax treatment of loans

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

### *The Tax Formula:*

→ (gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)  
  
EQUALS (taxable income)  
  
Compute income tax liability from tables in § 1(j) (indexed for inflation)  
MINUS (credits against tax)

We now consider elements of the tax formula. The tax formula appears in a text box on the first page of every chapter. The topic of the chapter is noted by an arrow (→). You should always be aware of what part of the “forest” and which “tree(s)” are being discussed.

This chapter introduces you to the concept of “gross income,” the very first item in the tax formula. We also consider the constitutional underpinning of the federal income tax because the constitutional basis

of the income tax has been intertwined with the concept of gross income itself.

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

### I. The Constitutional and Statutory Definitions of “Gross Income”

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

Article I, § 2, clause 3: Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers ...

Article I, § 7, clause 1: All Bills for raising Revenue shall originate in the

House of Representatives; but the Senate may propose or concur with Amendments as on other Bills.

Article I, § 8, clause 1: The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States[.]

Article I, § 9, clause 4: No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

The Constitution does not delegate to any other branch of the government any authority to impose taxes.

In Article I, § 9, cl. 4, the Constitution refers to “direct” taxes, and restricts congressional power to impose them to those taxes that are assessed proportionately to the states’ populations. The founding fathers regarded consumption taxes as “indirect taxes” and believed them to be superior to “direct taxes” in terms of fairness and for purposes of raising revenue. *See* Alexander Hamilton, FEDERALIST NO. 21.

An income tax is a “direct tax.” *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601, 630 (1895) (tax on income from property). Congress has never tried to assess an income tax state by state in proportion to their respective populations. Hence, imposition of an income tax required an amendment to the Constitution. That came in 1913:

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

Read § 61(a) of the Code. Notice that “gross income” encompasses “all” income “from whatever source derived.” The language of the Code tracks that of the Sixteenth Amendment, and it has been noted many times that in taxing income, Congress exercised all the constitutional power that it has to do so. However, that point left open the question of what exactly is “income[], from whatever source derived.” Taxpayers have argued many times that the “income” that Congress wants to tax is beyond the scope of “income” as the term is used in the Sixteenth

Amendment. See Ann K. Wooster, Annot., *Application of 16<sup>th</sup> Amendment to U.S. Constitution – Taxation of Specific Types of Income*, 40 A.L.R. FED.2d 301 (2010).

We consider here two cases in which the Supreme Court undertook to provide a definition of “gross income,” the phrase that Congress used in § 61(a). We then consider a case in which the United States Court of Appeals for the Seventh Circuit considered the scope of congressional authority to impose an income tax. In *Macomber*, notice the justices’ differing views on the internal accounting of a corporation.

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

**Eisner v. Macomber**, 252 U.S. 189 (1920).

MR. JUSTICE PITNEY delivered the opinion of the Court.

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

It arises under the Revenue Act of September 8, 1916, 39 Stat. 756 et seq., which, in our opinion ... plainly evinces the purpose of Congress to tax stock dividends as income.<sup>29</sup>

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<sup>29</sup> Title I. – Income Tax

Part I. – “On Individuals”

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

The facts, in outline, are as follows:

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

Defendant in error, being the owner of 2,200 shares of the old stock, received certificates for 1,100 additional shares, of which 18.07 percent, or 198.77 shares, par value \$19,877, were treated as representing surplus earned between March 1, 1913, and January 1, 1916. She was called upon to pay, and did pay under protest, a tax imposed under the Revenue Act of 1916, based upon a supposed income of \$19,877 because of the new shares, and, an appeal to the Commissioner of Internal Revenue having been disallowed, she brought action against the Collector to recover the tax. In her complaint, she alleged the above facts and contended that, in imposing such a tax the Revenue Act of 1916 violated article 1, § 2, cl. 3, and Article I, § 9, cl. 4, of the Constitution of the United States, requiring direct taxes to be apportioned according to population, and that the stock dividend was not income within the meaning of the Sixteenth Amendment. A general demurrer to the complaint was overruled upon the authority of *Towne v. Eisner*, 245 U. S. 418, and, defendant having failed to plead further, final judgment went against him. To review it, the present writ of error is prosecuted.

....

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

....

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hundred and thirteen, and payable to its shareholders, whether, in cash or in stock of the corporation, ... which stock dividend shall be considered income, to the amount of its cash value.”

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

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

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

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

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



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

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

The same fundamental conception is clearly set forth in the Sixteenth Amendment – "*incomes, from whatever source derived*" – the essential thought being expressed with a conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? To answer this, regard must be had to the nature of a corporation and the stockholder's relation to it. We refer, of course, to a corporation such as the one in the case at bar, organized for profit, and having a capital stock divided into shares to which a nominal or par value is attributed.

Certainly the interest of the stockholder is a capital interest, and his certificates of stock are but the evidence of it. They state the number of shares to which he is entitled and indicate their par value and how the stock may be transferred. They show that he or his assignors, immediate or remote, have contributed capital to the enterprise, that he is entitled to a corresponding interest proportionate to the whole, entitled to have the property and business of the company devoted during the corporate existence to attainment of the common objects, entitled to vote at

stockholders' meetings, to receive dividends out of the corporation's profits if and when declared, and, in the event of liquidation, to receive a proportionate share of the net assets, if any, remaining after paying creditors. Short of liquidation, or until dividend declared, he has no right to withdraw any part of either capital or profits from the common enterprise; on the contrary, his interest pertains not to any part, divisible or indivisible, but to the entire assets, business, and affairs of the company. Nor is it the interest of an owner in the assets themselves, since the corporation has full title, legal and equitable, to the whole. The stockholder has the right to have the assets employed in the enterprise, with the incidental rights mentioned; but, as stockholder, he has no right to withdraw, only the right to persist, subject to the risks of the enterprise, and looking only to dividends for his return. If he desires to dissociate himself from the company, he can do so only by disposing of his stock.

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

In the present case, the corporation had surplus and undivided profits invested in plant, property, and business, and required for the purposes of the corporation, amounting to about \$45,000,000, in addition to outstanding capital stock of \$50,000,000. In this, the case is not extraordinary. The profits of a corporation, as they appear upon the balance sheet at the end of the year, need not be in the form of money on hand in excess of what is required to meet current liabilities and finance current operations of the company. Often, especially in a growing business, only a part, sometimes a small part, of the year's profits is in property capable of division, the remainder having been absorbed in the acquisition of increased plant, equipment, stock in trade, or accounts receivable, or in decrease of outstanding

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

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

The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and

accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

....

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

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

....

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

....

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

....

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

Judgment affirmed.

Mr. Justice Holmes, dissenting. [omitted]

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

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

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

....

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

....

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

....

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

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

...

... [W]hether a dividend declared payable from profits shall be paid in cash or in some other medium is also wholly a matter of financial management. If some other medium is decided upon, it is also wholly a question of financial management



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

....

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



from that of his partners is had.

....

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

*Fourth.* ...

*Fifth.* ...

....

*Capital and Surplus:* The opinions in this case provide a primer on corporation law. A corporation's shareholders are its owners. They pay money (or transfer other property) to the corporation to purchase shares that represent ownership of the corporation's *productive capital*. This ownership gives them the rights to receive dividends, to vote, and to share in the proceeds of a liquidation (i.e., to share in the growth of the corporation).

- Once the corporation begins to operate, it earns *profits*. The corporation might choose not to retain these profits and to distribute them to its shareholders as dividends. Alternatively, the corporation might not distribute the profits. Instead, it might hold the profits for later distribution and/or use the profits to acquire still more productive capital assets. Corporation law required that the "capital stock account" and the "surplus account" be separately maintained.

- Sections 301 and 316 still implement this scheme. Dividends are taxable as income to a shareholder only if a corporation has "earnings and profits."

*Sixth.* If stock dividends representing profits are held exempt from taxation under the Sixteenth Amendment, the owners of the most successful businesses in America will, as the facts in this case illustrate, be able to escape taxation on a large part of what is actually their income. So far as their profits are represented by stock received as dividends, they will pay these taxes not upon their income, but only upon the income of their income. That such a result was intended by the people of the United States when adopting the Sixteenth Amendment is

inconceivable. Our sole duty is to ascertain their intent as therein expressed. In terse, comprehensive language befitting the Constitution, they empowered Congress "to lay and collect taxes on incomes from whatever source derived." They intended to include thereby everything which by reasonable understanding can fairly be regarded as income. That stock dividends representing profits are so regarded not only by the plain people, but by investors and financiers and by most of the courts of the country, is shown beyond peradventure by their acts and by their utterances. It seems to me clear, therefore, that Congress possesses the power which it exercised to make dividends representing profits taxable as income whether the medium in which the dividend is paid be cash or stock, and that it may define, as it has done, what dividends representing profits shall be deemed income. It surely is not clear that the enactment exceeds the power granted by the Sixteenth Amendment. ...

*Notes and Questions:*

1. In *Macomber*, consider the different views of the excerpted opinions of a corporation. Recall that under the SHS definition of income, an *increment* to an investment is the manifestation and measure of taxable income, but a mere *change in the form* in which wealth is held is not a taxable event. Consider how the two opinions implicitly<sup>30</sup> handle these points. Is one view better than the other? Why?

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

- Is it even possible to avoid merging the capital and profits accounts of a corporation when considering whether a shareholder has enjoyed an increment to his power to consume?

- Should each shareholder pay income tax on a share's increased fmv if the corporation does not distribute the profits?

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

- Moreover, the law of corporate tax does *not* treat equity interests (stock) and creditor interests (debt) as equivalent – and so treats distributions of stock and debt differently.

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

- Is a stock dividend an increment to taxpayer's store of rights of

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<sup>30</sup> There was no SHS definition of “income” in 1920.

consumption? We tax all income once. When (and how) is a stock dividend taxed?

4. What exactly is the holding of the majority with respect to the meaning of “income” under the Sixteenth Amendment? Which of the following are critical to the case’s outcome?

- That shareholder did not “realize” any income and that without realization, there is no “income?”
- That shareholder did not receive any property for his use and benefit and that in the absence of such receipt, there is no “income?”
- That a corporation’s undistributed accumulations do not constitute “income” to a shareholder?
- That if the corporation does not segregate particular assets for the shareholder, there is no “income?”
- That shareholder’s receipt of shares did not alter his underlying interest in the corporation or make him richer, so the receipt of such shares is not “income” within the Sixteenth Amendment?
- That if a corporation’s assets are not reduced by a distribution, there is no dividend?

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

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

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

7. Income is taxed only once. “Basis” is money that will not again be subject to income tax, *usually* because it has already been subject to tax. Thus, basis is the

means by which we keep score with the government. Mrs. Macomber owned 2200 shares of Standard Oil. Let's say that she paid \$220,000 for these shares, i.e., \$100/share. After receiving the stock dividend, she owned 3300 shares.

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

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

*Tax Basis:* We encountered "basis" in chapter 1 and note here its statutory definition in § 1012(a) as the cost of property. What if taxpayer does not actually "buy" anything and so incurs no "cost" to acquire it? For example, suppose a corporation distributes shares of stock to some of its shareholders and that the distribution was a taxable event to the shareholders. Taxpayer pays income tax on the *fmv* of the property he received. What should be taxpayer's basis in the stock he received in this manner? It will be the value on which taxpayer paid income tax. We call this "tax basis." We treat it the same as we treat the basis that taxpayer acquires by actually paying the cost of property. When taxpayer sells the property, he subtracts his "tax basis" from the amount realized to determine his taxable gain.

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

- How do you think partners are taxed on undistributed partnership profits?

- How should that change a partner's basis in his partnership interest?

- What should happen to the partner's basis in his partnership interest if he later withdraws cash or property from the partnership?

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

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

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

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

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

*Commissioner v. William Goldman Theatres, Inc.* – William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew's, Inc., alleging a violation of the federal antitrust laws and seeking treble damages. ... It was found that Goldman has suffered a loss of profits equal to \$125,000 and was entitled to treble damages in the sum of \$375,000. ... Goldman

reported only \$125,000 of the recovery as gross income and claimed that the \$250,000 balance constituted punitive damages and as such was not taxable. ...

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

The sweeping scope of the controverted statute is readily apparent: ...

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

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

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages

is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

....

Reversed.

Mr. Justice DOUGLAS dissents. ...

*Notes and Questions:*

1. Taxpayers acknowledged that Congress could constitutionally impose a tax on punitive damages. Interestingly, the Supreme Court has indeed observed many times that Congress exercised all the power granted it by the Sixteenth Amendment. How much room does this really leave for a taxpayer to argue that Congress *could* tax windfalls but had not? Taxpayer may still argue that it's not income, and there is no other tax on punitive damages.
2. Memorize the elements of "gross income" stated in the first sentence of the last paragraph of the case. You'll have to do this eventually, so save some time and do it now.
3. SHS holds that income includes all rights exercised in consumption plus changes in a taxpayer's wealth. Does the phrase "accessions to wealth" encompass more or less than that?
4. Is the receipt of any accession to wealth, e.g., receiving exemplary damages, what most people think of as "income?" If not, what objectives does the Tax Code implicitly pursue by including all accessions to wealth in a taxpayer's taxable income?
5. The following case provides a good primer (review) of Congress's constitutional power to tax. Read § 104(a)(2), including the carryout paragraph at the end of § 104(a).
6. In *Macomber*, Standard Oil spent *after-tax dollars* (i.e., "surplus and undivided profits") to purchase capital assets with which it would presumably earn more profits. If a negligent third person damaged some of those capital assets and paid



money to Standard Oil so that it could restore them to their original condition, how should Standard Oil be taxed on the money it received? *See Clark v. Commissioner, infra*. How many times should Standard Oil pay income tax to have basis in a productive asset?

Now consider the assets with which a taxpayer earns income through work. What should be a taxpayer's basis in his "human capital?" How should this affect the taxability of a restoration of such capital after it has been injured?

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

On Rehearing  
GINSBURG, Chief Judge:

....

#### I. Background

[After successfully complaining to the Department of Labor that her employer had blacklisted her in violation of various whistle-blower statutes, Murphy received an award of \$45,000 for past and future emotional distress and \$25,000 for damage to her vocational reputation. Murphy suffered both "somatic" and "emotional" injuries along with other "physical manifestations of stress," i.e., anxiety attacks, shortness of breath and dizziness. She also suffered from bruxism (teeth grinding), a condition often associated with stress that can cause permanent tooth damage. Murphy included the \$70,000 in her gross income, but later filed an amended return claiming that she was entitled to a refund because I.R.C. § 104(a)(2) excluded the \$70,000 from her gross income. The IRS rejected her claim for a refund because Murphy failed to prove that the compensatory damages were attributable to "physical injury" or "physical sickness." Hence § 104(a)(2) did not exclude such damages from her gross income. Murphy sued the IRS and the United States in federal district court.

Murphy argued: (1) I.R.C. § 104(a)(2) excluded the compensatory damages from her gross income because the award was for "physical personal injuries;" (2) taxing her award is unconstitutional because her damages were not "income" within the meaning of the Sixteenth Amendment. The district court rejected all of Murphy's claims. Murphy appealed. On appeal, the court, 460 F.3d 79 (CA DC 2006),

reversed the district court's decision, concluding that § 104(a)(2) did not exclude Murphy's award from her gross income, but that her award was not "income" within the Sixteenth Amendment. The Government petitioned for a rehearing and argued that even if Murphy's award was not "income" within the Sixteenth Amendment, there was no "constitutional impediment" to taxing Murphy's award because a tax on such an award is not a direct tax and the tax is imposed uniformly. On rehearing, the court held that Murphy could not sue the IRS but could sue the United States.]

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

## II. Analysis

....

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

Section 104(a) ("Compensation for injuries or sickness") provides that "gross income [under § 61 of the IRC] does not include the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." 26 U.S.C. § 104(a)(2). Since 1996 it has further provided that, for purposes of this exclusion, "emotional distress shall not be treated as a physical injury or physical sickness." *Id.* § 104(a). ...

....

... In *O'Gilvie v. United States*, 519 U.S. 79 (1996), the Supreme Court read [the phrase "on account of"] to require a "strong[ ] causal connection," thereby making § 104(a)(2) "applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries." The Court specifically rejected a "but-for" formulation in favor of a "stronger causal connection." ...

....

... Murphy no doubt suffered from certain physical manifestations of emotional distress, but the record clearly indicates the Board awarded her compensation only "for mental pain and anguish" and "for injury to professional reputation." ... [W]e

conclude Murphy's damages were not "awarded by reason of, or because of, ... [physical] personal injuries," *O'Gilvie*, 519 U.S. at 83. Therefore, § 104(a)(2) does not permit Murphy to exclude her award from gross income.<sup>31</sup>

### C. Section 61 of the IRC

Murphy and the Government agree that for Murphy's award to be taxable, it must be part of her "gross income" as defined by § 61(a) ..., which states in relevant part: "gross income means all income from whatever source derived." The Supreme Court has interpreted the section broadly to extend to "all economic gains not otherwise exempted." *Comm'r v. Banks*, 543 U.S. 426, 433 (2005); *see also, e.g.,* [citation omitted]; *Comm'r v. Glenshaw Glass Co.*, 348 U.S. 426, 430 ("the Court has given a liberal construction to ["gross income"] in recognition of the intention of Congress to tax all gains except those specifically exempted"). "Gross income" in § 61(a) is at least as broad as the meaning of "incomes" in the Sixteenth Amendment. [footnote omitted]. *See Glenshaw Glass*, 348 U.S. at 429, 432 n. 11 ...; [citation omitted].

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

....

Finally, Murphy argues her interpretation of § 61 is reflected in the common law of tort and the provisions in various environmental statutes and Title VII of the Civil Rights Act of 1964, all of which provide for "make whole" relief. *See, e.g.,* 42 U.S.C. § 1981a; 15 U.S.C. § 2622. If a recovery of damages designed to "make

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<sup>31</sup> Insofar as compensation for nonphysical personal injuries appears to be excludable from gross income under 26 C.F.R. § 1.104-1, the regulation conflicts with the plain text of § 104(a)(2); in these circumstances the statute clearly controls. *See Brown v. Gardner*, 513 U.S. 115, 122 (1994) (finding "no antidote to [a regulation's] clear inconsistency with a statute").

whole” the plaintiff is taxable, she reasons, then one who receives the award has not been made whole after tax. Section 61 should not be read to create a conflict between the tax code and the “make whole” purpose of the various statutes.

The Government disputes Murphy’s interpretation on all fronts. First, noting “the definition [of gross income in the IRC] extends broadly to all economic gains,” *Banks*, 543 U.S. at 433, the Government asserts Murphy “undeniably had economic gain because she was better off financially after receiving the damages award than she was prior to receiving it.” Second, the Government argues that the case law Murphy cites does not support the proposition that the Congress lacks the power to tax as income recoveries for personal injuries. ...

....

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

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

Although Murphy and the Government focus primarily upon whether Murphy’s award falls within the definition of income first used in *Glenshaw Glass* [footnote omitted], coming within that definition is not the only way in which § 61(a) could be held to encompass her award. Principles of statutory interpretation could show § 61(a) includes Murphy’s award in her gross income regardless whether it was an “accession to wealth,” as *Glenshaw Glass* requires. For example, if § 61(a) were amended specifically to include in gross income “\$100,000 in addition to all other gross income,” then that additional sum would be a part of gross income under § 61 even though no actual gain was associated with it. In other words, although the

“Congress cannot make a thing income which is not so in fact,” *Burk-Waggoner Oil Ass’n v. Hopkins*, 269 U.S. 110, 114 (1925), it can label a thing income and tax it, so long as it acts within its constitutional authority, which includes not only the Sixteenth Amendment but also Article I, Sections 8 and 9. *See Penn Mut. Indem. Co. v. Comm’r*, 277 F.2d 16, 20 (3d Cir.1960) (“Congress has the power to impose taxes generally, and if the particular imposition does not run afoul of any constitutional restrictions then the tax is lawful, call it what you will”) (footnote omitted). Accordingly, rather than ask whether Murphy’s award was an accession to her wealth, we go to the heart of the matter, which is whether her award is properly included within the definition of gross income in § 61(a), to wit, “all income from whatever source derived.”

Looking at § 61(a) by itself, one sees no indication that it covers Murphy’s award unless the award is “income” as defined by *Glenshaw Glass* and later cases. Damages received for emotional distress are not listed among the examples of income in § 61 and, as Murphy points out, an ambiguity in the meaning of a revenue-raising statute should be resolved in favor of the taxpayer. *See, e.g., Hassett v. Welch*, 303 U.S. 303, 314 (1938); *Gould v. Gould*, 245 U.S. 151, 153

(1917); [citations omitted]. A statute is to be read as a whole, however [citation omitted], and reading § 61 in combination with § 104(a)(2) ... presents a very different picture – a picture so clear that we have no occasion to apply the canon favoring the interpretation of ambiguous revenue-raising statutes in favor of the taxpayer.

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

....

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

#### *D. The Congress’s Power to Tax*

The taxing power of the Congress is established by Article I, Section 8 of the Constitution: “The Congress shall have power to lay and collect taxes, duties, imposts and excises.” There are two limitations on this power. First, as the same section goes on to provide, “all duties, imposts and excises shall be uniform throughout the United States.” Second, as provided in Section 9 of that same Article, “No capitation, or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.” *See also* U.S. Const. art. I, § 2, cl. 3 (“direct taxes shall be apportioned among the several states which may

be included within this union, according to their respective numbers”).<sup>32</sup> We now consider whether the tax laid upon Murphy’s award violates either of these two constraints.

### 1. A Direct Tax?

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

Only three taxes are definitely known to be direct: (1) a capitation, U.S. Const. art. I, § 9, (2) a tax upon real property, and (3) a tax upon personal property. See *Fernandez v. Wiener*, 326 U.S. 340, 352 (1945) (“Congress may tax real estate or chattels if the tax is apportioned”); *Pollock v. Farmers’ Loan & Trust Co.*, 158 U.S. 601, 637 (1895) (*Pollock II*).<sup>33</sup> Such direct taxes are laid upon one’s “general ownership of property,” *Bromley*, 280 U.S. at 136; see also *Flint v. Stone Tracy Co.*, 220 U.S. 107, 149 (1911), as contrasted with excise taxes laid “upon a particular use or enjoyment of property or the shifting from one to another of any power or privilege incidental to the ownership or enjoyment of property.” *Fernandez*, 326 U.S. at 352; see also *Thomas v. United States*, 192 U.S. 363, 370 (1904) (excises cover “duties imposed on importation, consumption, manufacture and sale of certain commodities, privileges, particular business transactions, vocations, occupations and the like”). More specifically, excise taxes include, in addition to taxes upon consumable items [citation omitted], taxes upon the sale of grain on an exchange, *Nicol v. Ames*, 173 U.S. 509, 519 (1899), the sale of corporate stock, *Thomas*, 192 U.S. at 371, doing business in corporate form, *Flint*, 220 U.S. at 151, gross receipts from the “business of refining sugar,” *Spreckels*, 192 U.S. at 411, the transfer of property at death, *Knowlton v. Moore*, 178 U.S. 41, 81-82 (1900), gifts, *Bromley*, 280 U.S. at 138, and income from employment, see *Pollock*

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<sup>32</sup> Though it is unclear whether an income tax is a direct tax, the Sixteenth Amendment definitively establishes that a tax upon income is not required to be apportioned. [citation omitted].

<sup>33</sup> *Pollock II* also held that a tax upon the income of real or personal property is a direct tax. 158 U.S. at 637. Whether that portion of *Pollock* remains good law is unclear. See *Graves v. New York ex rel. O’Keefe*, 306 U.S. 466, 480 (1939).



*v. Farmers' Loan & Trust Co.*, 157 U.S. 429, 579 (1895) (*Pollock I*) (citing *Springer v. United States*, 102 U.S. 586 (1881)).

Murphy and the amici supporting her argue the dividing line between direct and indirect taxes is based upon the ultimate incidence of the tax; if the tax cannot be shifted to someone else, as a capitation cannot, then it is a direct tax; but if the burden can be passed along through a higher price, as a sales tax upon a consumable good can be, then the tax is indirect. This, she argues, was the distinction drawn when the Constitution was ratified. See Albert Gallatin, *A Sketch of the Finances of the United States* (1796), reprinted in 3 THE WRITINGS OF ALBERT GALLATIN 74-75 (Henry Adams ed., Philadelphia, J.P. Lippincott & Co. 1879) (“The most generally received opinion ... is, that by direct taxes ... those are meant which are raised on the capital or revenue of the people; by indirect, such as are raised on their expense”); *The Federalist No. 36*, at 225 (Alexander Hamilton) (Jacob E. Cooke ed., 1961) (“internal taxes[ ] may be subdivided into those of the direct and those of the indirect kind ... by which must be understood duties and excises on articles of consumption”). But see Gallatin, *supra*, at 74 (“[Direct tax] is used, by different writers, and even by the same writers, in different parts of their writings, in a variety of senses, according to that view of the subject they were taking”); EDWIN R.A. SELIGMAN, *THE INCOME TAX* 540 (photo. reprint 1970) (2d ed.1914) (“there are almost as many classifications of direct and indirect taxes as there are authors”). Moreover, the amici argue, this understanding of the distinction explains the different restrictions imposed respectively upon the power of the Congress to tax directly (apportionment) and via excise (uniformity). Duties, imposts, and excise taxes, which were expected to constitute the bulk of the new federal government’s revenue, see Erik M. Jensen, *The Apportionment of “Direct Taxes”: Are Consumption Taxes Constitutional?*, 97 COLUM. L. REV. 2334, 2382 (1997), have a built-in safeguard against oppressively high rates: Higher taxes result in higher prices and therefore fewer sales and ultimately lower tax revenues. See *The Federalist No. 21*, *supra*, at 134-35 (Alexander Hamilton). Taxes that cannot be shifted, in contrast, lack this self-regulating feature, and were therefore constrained by the more stringent requirement of apportionment. See *id.* at 135 (“In a branch of taxation where no limits to the discretion of the government are to be found in the nature of things, the establishment of a fixed rule ... may be attended with fewer inconveniences than to leave that discretion altogether at large”); see also Jensen, *supra*, at 2382-84.

... As it is clear that Murphy cannot shift her tax burden to anyone else, per Murphy and the amici, it must be a direct tax.



....

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

....

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

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

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

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

(indicating pre-*Bromley* that tax upon “every sale made in any place ... is really and practically upon property”).

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

## 2. Uniformity

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

## III. Conclusion

For the foregoing reasons, we conclude (1) Murphy’s compensatory award was not received on account of personal physical injuries, and therefore is not exempt from taxation pursuant to § 104(a)(2) of the IRC; (2) the award is part of her “gross income,” as defined by § 61 of the IRC; and (3) the tax upon the award is an excise

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

and not a direct tax subject to the apportionment requirement of Article I, Section 9 of the Constitution. The tax is uniform throughout the United States and therefore passes constitutional muster. The judgment of the district court is accordingly

*Affirmed.*

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

*Notes and Questions:*

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

2. In the first paragraph of part IIC, the court states our second guiding principle (*see* chapter 1) of tax law: “There are exceptions to [the principle that we tax all of the income of a particular taxpayer once], but we usually must find those exceptions in the Code itself.”

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

3. What is a direct tax under the Constitution? What taxes do we know are direct taxes? What is the constitutional limitation upon Congress’s power to enact direct taxes?

•In *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), the Supreme Court held that

[a] tax on going without health insurance does not fall within any

recognized category of direct tax. It is not a capitation. ... The whole point of the shared responsibility payment is that it is triggered by specific circumstances – earning a certain amount of income but not obtaining health insurance. The payment is also plainly not a tax on the ownership of land or personal property. The shared responsibility payment is thus not a direct tax that must be apportioned among the several States.

*Id.* at 571.

4. What is an indirect tax under the Constitution? What taxes do we know are indirect taxes? What is the constitutional limitation upon Congress's power to enact indirect taxes?

5. The court provides a good review of the power of Congress to impose taxes *aside from* the income tax. The court acknowledged that a tax on tort damages for emotional distress might *not* be a tax on income in the constitutional sense (i.e., Sixteenth Amendment) of the word. How should this affect the fact that all items of gross income are added together and form the bases of other important elements of the income tax, e.g., AGI, tax brackets applicable to *all* income. Might a tax upon such damages therefore render the constitutionality of the income tax questionable with respect to taxpayers such as Marrita Murphy?

- Items subject to an indirect tax affect the amount of items subject to a direct tax.

*Tort law and emotional distress:* Tort law usually requires a physical manifestation of emotional distress for plaintiff to recover damages. However, that physical manifestation is not itself a "personal physical injury. H.R. REP. NO. 104-737 at 301 n.56 (1996), *reprinted at* 1996-3 C.B. 741, 1041.

6. Let's embellish our three guiding principles of tax law:

- Taxpayer gets basis by paying income tax on the value of something received.
- Corollary: Taxpayer does not get basis without paying income tax – or without being excused from paying income tax – on an accession to wealth.

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

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

8. The court cited the case of *Penn Mut. Indem. Co. v. Comm’r*, 277 F.2d 16, 20 (3d Cir. 1960) with this parenthetical: “Congress has the power to impose taxes generally, and if the particular imposition does not run afoul of any constitutional restrictions then the tax is lawful, call it what you will.”

In *National Federation of Independent Business v. Sebelius*, 567 U.S. 519 (2012), the Supreme Court “confirmed” a “functional approach” to whether an assessment is a tax. 567 U.S. at 563-66 (“shared responsibility payment” actually a “tax,” even though called a “penalty”).

•In *Eisner v. Macomber*, the Supreme Court said:

“Congress cannot by any definition [of “income”] it may adopt conclude the matter, since it cannot by legislation alter the Constitution, from which alone it derives its power to legislate, and within whose limitations alone that power can be lawfully exercised.”

•Are these positions inconsistent?

•Does this imply that Congress can enact a tax – assuming that the legislative proposal originates in the House of Representatives – and later search for its constitutional underpinning?

*Taxing Only the Creation of Value?* [reprise from chapter 1] Voluntary exchanges are often essential to the creation of the income that the Internal Revenue Code subjects to income tax. Arguably, the Code should not subject to tax “income” derived from involuntary exchanges that everyone understands (probably) *reduce* a taxpayer’s wealth. This is not the case. Court-ordered damages that a plaintiff deems inadequate to compensate for the loss of an unpurchased intangible (e.g., emotional tranquility) may nevertheless be subject to income tax. See § 104(a).

## II. The Constitutional and Statutory Definitions of “Gross Income:” Accessions to Wealth

### *A. Some Recurring Themes*

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

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

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

....

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

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

“Voted: That this company pay any and all income taxes, state and Federal, that may hereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood[,] ... to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income taxes, state or federal, which taxes are to be paid out of the treasury of this corporation.”

....

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

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

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

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

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

....

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

....



Nor can it be argued that the payment of the tax ... was a gift. The payment for services, even though entirely voluntary, was nevertheless compensation within the statute. ...

It is next argued against the payment of this tax that, if these payments by the employer constitute income to the employee, the employee will be called upon to pay the tax imposed upon this additional income, and that the payment of the additional tax will create further income which will in turn be subject to tax, with the result that there would be a tax upon a tax. This, it is urged, is the result of the government's theory, when carried to its logical conclusion, and results in an absurdity which Congress could not have contemplated.

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

Separate opinion of MR. JUSTICE McREYNOLDS [omitted].

*Notes and Questions:*

*A Little Algebra:* Is the argument that the Commissioner creates a never-ending upward spiral of taxes upon taxes true?

•No.

•If taxpayer is to have \$X remaining after payment of taxes and the tax rate is  $\lambda$ , then taxable income equal to  $\$X/(1 - \lambda)$  will produce \$X of after-tax income. Obviously, graduated tax rates would require some incremental computations.

•We call a computation of the amount of income necessary to produce a desired after-tax amount “grossing up.” It’s useful to know how to do this.

1. Taxpayers pay their federal income taxes from after-tax income. This was not always true. Act of Oct. 3, 1913, entitled “An act to reduce tariff duties and to provide revenue for the Government and for other purposes,” part IIB, granted a deduction for national taxes paid. After Congress repealed this deduction, the American Woolen Company began paying William Wood’s federal income taxes. Without a deduction, taxpayer pays income taxes from after-tax income.

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

3. A taxpayer’s wealth increases when someone else pays one of taxpayer’s obligations. We treat this as an accession to wealth. You will encounter this principle many times throughout this course. Thus, when taxpayer’s employer pays taxpayer’s federal income taxes, taxpayer should include the amount of taxes in his gross income. The principle is applicable in many contexts.

4. A key consideration is whether a third party makes a payment to satisfy an actual “obligation” of the taxpayer, or merely to “restore” to taxpayer “capital” wrongfully or erroneously taken from him. *See Clark infra*.

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

Opinion. LEECH.

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

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

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

....

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

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

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

required to pay on the joint return as filed. Petitioner accepted the \$19,941.10.

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

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

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

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

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

....

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

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

Decision will be entered for the petitioner.

*Notes and Questions:*

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

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

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

3. In *Murphy*, *supra*, taxpayer made a "return-of-capital" argument. Why did taxpayer in *Murphy* lose but the taxpayer in *Clark* win?

**Gotcher v. United States**, 401 F.2d 118 (5<sup>th</sup> Cir. 1968)

THORNBERRY, Circuit Judge.

In 1960, Mr. and Mrs. Gotcher took a twelve-day expense-paid trip to Germany to tour the Volkswagon facilities there. The trip cost \$1372.30. His employer, Economy Motors, paid \$348.73, and Volkswagon of Germany and Volkswagon of America shared the remaining \$1023.53. Upon returning, Mr. Gotcher bought a twenty-five percent interest in Economy Motors, the Sherman, Texas Volkswagon dealership, that had been offered to him before he left. Today he is President of Economy Motors in Sherman and owns fifty percent of the dealership. Mr. and Mrs. Gotcher did not include any part of the \$1372.30 in their 1960 income. The Commissioner determined that the taxpayers had realized income to the extent of the \$1372.30 for the expense-paid trip and asserted a tax deficiency of \$356.79, plus interest. Taxpayers paid the deficiency, plus \$82.29 in interest, and thereafter timely filed suit for a refund. The district court, sitting without a jury, held that the

cost of the trip was not income or, in the alternative, was income and deductible as an ordinary and necessary business expense. [citation omitted] We affirm the district court's determination that the cost of the trip was not income to Mr. Gotcher (\$686.15); however, Mrs. Gotcher's expenses (\$686.15) constituted income and were not deductible.

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

Sections 101-[139I] specifically exclude certain items from gross income. Appellant argues that the cost of the trip should be included in income since it is not specifically excluded by §§ 101-[139G], reasoning that § 61 was drafted broadly to subject all economic gains to tax and any exclusions should be narrowly limited to the specific exclusions. [footnote omitted] This analysis is too restrictive since it has been generally held that exclusions from gross income are not limited to the enumerated exceptions. [footnote omitted] ...

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

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

The trip was made in 1959 when VW was attempting to expand its local dealerships

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

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

Some of the days were not related to touring VW facilities, but that fact alone cannot be decisive. The dominant purpose of the trip is the critical inquiry and some pleasurable features will not negate the finding of an overall business purpose. [citation omitted] Since we are convinced that the agenda related primarily to business and that Mr. Gotcher’s attendance was prompted by business considerations, the so-called sightseeing complained of by the Government is inconsequential. [citation omitted] ... [E]ven this touring of the countryside had an indirect relation to the business since the tours were not typical sightseeing excursions but were connected to the desire of VW that the dealers be persuaded that the German economy was stable enough to justify investment in a German

product. ... 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. [footnote omitted] Thus it appears that the value of any trip that is paid by the employer or by a businessman primarily for his own benefit should be excluded from gross income of the payee on similar reasoning. [citations omitted]

In the recent case of *Allen J. McDonnell*, 26 T.C.M. 115, Tax Ct. Mem. 1967-68, a sales supervisor and his wife were chosen by lot to accompany a group of contest winners on an expense-paid trip to Hawaii. In holding that the taxpayer had received no income, the Tax Court noted that he was required by his employer to go and that he was serving a legitimate business purpose though he enjoyed the trip. The decision suggests that in analyzing the tax consequences of an expense-paid trip one important factor is whether the traveler had any choice but to go. Here, although the taxpayer was not forced to go, there is no doubt that in the reality of the business world he had no real choice. The trial judge reached the same conclusion. He found that the invitation did not specifically order 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 good business relations with VW. Besides having no choice but to go, he had no control over the schedule or the money spent. VW did all the planning. In cases involving noncompensatory economic gains, courts have emphasized that the taxpayer still had complete dominion and control over the money to use it as he wished to satisfy personal desires or needs. Indeed, the Supreme Court has defined income as accessions of wealth over which the taxpayer has complete control. *Commissioner of Internal Revenue v. Glenshaw Glass Co.*,



*supra*. Clearly, the lack of control works in the taxpayer's favor here.

*McDonnell* also suggests that one does not realize taxable income when he is serving a legitimate business purpose of the party paying the expenses. The cases involving corporate officials who have traveled or entertained clients at the company's expense are apposite. ... [W]hen it has been shown that the expenses were paid to effectuate a legitimate corporate end and not to benefit the officer personally, the officer has not been taxed though he enjoyed and benefited from the activity. [footnote omitted] Thus, the rule is that the economic benefit will be taxable to the recipient only when the payment of expenses serves no legitimate corporate purposes. [citation omitted] The decisions also indicate that the tax consequences are to be determined by looking to the primary purpose of the expenses and that the first consideration is the intention of the payor. The Government in argument before the district court agreed that whether the expenses were income to taxpayers is mainly a question of the motives of the people giving the trip. Since this is a matter of proof, the resolution of the tax question really depends on whether Gotcher showed that his presence served a legitimate corporate purpose and that no appreciable amount of time was spent for his personal benefit and enjoyment. [citation omitted]

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

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

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

Affirmed in part; reversed in part.

JOHN R. BROWN, Chief Judge (concurring): [omitted].

*Notes and Questions:*

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

- What happened to our second principle (*see* chapter 1) – that all income is taxed once unless an exception is specifically found in the Code?

2. What tests does the court state to determine whether the trip was "gross income?"

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

- Review: what is value? Do you think that taxpayer valued his trip as much as VW valued it? – as much as it cost VW? What about the value and cost of his wife's trip?

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

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

6. Back to windfalls, plus some dumb luck.

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

YOUNG, District Judge.

....

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

Plaintiffs make ... alternative contentions in support of their claim that the sum of \$836.51 should be refunded to them. First, that the \$4,467.00 found in the piano is not includable in gross income under § 61 of the Internal Revenue Code. (26 U.S.C. § 61) Secondly, even if the retention of the cash constitutes a realization of ordinary income under § 61, it was due and owing in the year the piano was purchased, 1957,

*Taxability of a Price Reduction:*  
What happens when taxpayer can purchase a computer that "normally" retails for \$1000 for \$800 during a "computer blowout sale?" Does our taxpayer enjoy a \$200 accession to wealth? Answer: No.

A "mere reduction in price" is not taxable income. A contrary rule would raise insurmountable problems of value determination. Recall the alternative definitions of "value" in chapter 1. Perhaps an insufficient number of persons were willing to pay \$1000 for the computer worth \$800 in the first place.

and by 1964, the statute of limitations provided by 26 U.S.C. § 6501 had elapsed. ... The Government, by its answer and its trial brief, asserts that the amount found in the piano is includable in gross income under § 61(a) of Title 26, U.S.C., that the money is taxable in the year it was actually found, 1964 ...

... [T]his Court has concluded that the taxpayers are not entitled to a refund of the amount requested ...

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

Subsections (1) through ([14]) of § 61(a) then go on to list [fourteen] items specifically included in the computation of the taxpayers’ gross income, and Part II of Subchapter B of the 1954 Code (§§ 71 et seq.) deals with other items expressly included in gross income. While neither of these listings expressly includes the type of income which is at issue in the case at bar, Part III of Subchapter B (§§ 101 et seq.) deals with items specifically excluded from gross income, and found money is not listed in those sections either. This absence of express mention in any code sections necessitates a return to the ‘all income from whatever source’ language of § 61(a) of the code, and the express statement there that gross income is ‘not limited to’ the following fifteen examples. ...

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

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

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

....

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

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

‘§ 1.61-14 Miscellaneous items of gross income.

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

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

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

In Ohio, there is no statute specifically dealing with the rights of owners and finders of treasure trove, and in the absence of such a statute the common-law rule of England applies, so that ‘title belongs to the finder as against all the world except the true owner.’ *Niederlehner v. Weatherly*, 78 Ohio App. 263, 29 N.E.2d 787 (1946), appeal dismissed, 146 Ohio St. 697, 67 N.E.2d 713 (1946). ... Under Ohio law, the plaintiffs must have actually found the money to have superior title over all but the true owner, and they did not discover the old currency until 1964. Unless there is present a specific state statute to the contrary, [footnote omitted] the majority of jurisdictions are in accord with the Ohio rule. [footnote omitted] Therefore, this Court finds that the \$4,467.00 in old currency was not ‘reduced to undisputed possession’ until its actual discovery in 1964, and thus the United States

was not barred by the statute of limitations from collecting the \$836.51 in tax during that year.

....

### *Notes and Questions:*

1. How did the court treat Rev. Rul. 1953-1? What does this tell you about the legal status of a revenue ruling?
2. What role did state law play in the resolution of this case? Why was it necessary to invoke it?

*Taxability of Manufacturers’ (and others’) Rebates:* In Rev. Rul. 76-96, 1976-1 C.B. 23, the IRS announced that it would treat automobile manufacturer rebates given to retail car buyers who negotiate with one of the manufacturer’s dealers at arm’s length to purchase one of its cars as purchase price reductions, not as gross income. The purchase price reduction results in a downward adjustment of the car buyer’s basis in the car. This would seem to be the appropriate treatment of rebates, especially when the rebate is actually a refund of part of the fee or purchase price that the taxpayer/purchaser pays. “Cash back” programs of credit card companies should not result in taxable income to the credit card holder/taxpayer.

But the use of American Express credit card “Reward Dollars” to purchase VISA gift cards that could be used to purchase money orders that taxpayers could deposit into their bank account caused taxpayers to realize gross income in *Anikeev v. Commissioner*, 121 T.C. Memo 2021-23. Money orders are not a product subject to a price adjustment. Note: taxpayers took a benefit over which they had limited discretion to control its disposition and converted it to an asset over which they had complete discretion to control its disposition.

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

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

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

The effect of subtracting "adjusted basis" is to exclude that amount from taxpayer's "gross income" and so from his income tax burden. That money of course had already been subject to income tax at the time the taxpayer put it into his "store of property rights" and so should not be subject to tax again.

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

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

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

MR. JUSTICE MURPHY delivered the opinion of the Court.

....

Petitioner acquired the property, a lot and ten-story office building, by devise from his father ... [T]he Irving Trust Co. and petitioner's father executed a contract in

which the latter agreed to lease the main floor and basement to the former for a term of fifteen years at an annual rental of \$25,000, the term to commence [in 1932. Shortly after agreeing to let such premises to Irving Trust Co., petitioner's father died.]

In 1933, the Irving Trust Co. found it unprofitable to maintain a branch in petitioner's building. After some negotiations, petitioner and the Trust Co. agreed to cancel the lease in consideration of a payment to petitioner of \$140,000.

Taxpayer argued that his damages should be computed thus: ((present value of contractually-required future rent payments) MINUS (fair rental value of property for remaining term of lease)) MINUS (amount realized) EQUALS (deductible loss).

Petitioner did not include this amount in gross income in his income tax return for 1933. On the contrary, he reported a loss of \$21,494.75 on the theory that the amount he received as consideration for the cancellation was \$21,494.75 less than the difference between the present value of the unmatured rental payments and the fair rental value of the main floor and basement for the unexpired term of the lease. ...

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

....  
The amount received by petitioner for cancellation of the lease must be included in his gross income in its entirety. Section [61] [footnote omitted] ... expressly defines gross income to include "gains, profits, and income derived from ... rent, ... or gains or profits and income from any source whatever." Plainly this definition reached the rent paid prior to cancellation, just as it would have embraced subsequent payments if the lease had never been canceled. It would have included a prepayment of the discounted value of unmatured rental payments whether received at the inception of the lease or at any time thereafter. Similarly, it would have extended to the proceeds of a suit to recover damages had the Irving Trust Co. breached the lease instead of concluding a settlement. [citations omitted] That the amount petitioner received resulted from negotiations ending in cancellation of the lease, rather than from a suit to enforce it, cannot alter the fact that basically the



payment was merely a substitute for the rent reserved in the lease. So far as the application of [§ 61(a)] is concerned, it is immaterial that petitioner chose to accept an amount less than the strict present value of the unmatured rental payments, rather than to engage in litigation, possibly uncertain and expensive.

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

....

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

The judgment of the Circuit Court of Appeals is affirmed.

*Notes and Questions:*

1. Taxpayer measured his gain/loss with the *benefit of the bargain* as his reference point. An economist would not value the buyout of the lease differently. If a lessor's interest has a certain value and the lessor sells it for less than that value, why can't the lessor recognize a *tax* loss? Cf. § 165 (deductibility of losses). The Court did not accept taxpayer's return-of-capital argument. Why was it correct in doing so?

2. The Tax Code taxes all income once unless specifically provided otherwise. Basis is the tool by which a taxpayer keeps score with the government concerning what accessions to wealth have already been subject to tax.

- How does the Court's opinion implement these principles?
- How did taxpayer's contentions fail to implement these principles?
- What exactly was taxpayer's basis in his lessor's interest in the stream of payments to be recognized under the lease? Where would his basis have come from?

3. Some employers offer employees a leave-based donation program. Under such programs, employees may forgo vacation, sick, or personal leave in exchange for which their employer makes charitable contributions deductible under § 170(a). The employer may claim a deduction for the payment, either as a charitable contribution (§ 170) or a business expense (§ 162). The employee does not pay income tax on the amount contributed, and is not entitled to deduct any payment made to the charity. Do you see why not?

- See IRS Notice 2020-46, 2020-47 I.R.B. 7 (employees not treated as constructively receiving gross income, wages, or compensation).

4. Read § 108(a)(1)(B).

**Lump sum payments:** On occasion, taxpayer may accept a lump sum payment in lieu of receiving periodic payments. The tax law characterizes the lump sum in the same manner as it would have characterized the periodic payments. We saw the Court apply this principle in *Glenshaw Glass* when it treated a lump sum payment in lieu of profits as if it were profit.

Sections 61(a) lists several forms that gross income may take. One such form is income from discharge of indebtedness. § 61(a)(11). The Code does not treat all forms of gross income the same. Different rates of tax may apply to different forms of gross income. Or, the Code might not tax some forms of

gross income at all. *See* chapter 3, *infra*. This was a key point in *Murphy v. IRS, supra*, which turned on the construction of § 104. In the following case, the court distinguishes between a gain that taxpayer derived from dealings in property and gains that taxpayer derived from a discharge of his debt. Determine what was at issue in *Gehl*, what the parties argued, and why it mattered.

**United States v. Gehl**, 50 F.3d 12 (unpublished), 1995 WL 115589 (8<sup>th</sup> Cir.), *cert. denied*, 516 U.S. 899 (1995)

NOTICE: THIS IS AN UNPUBLISHED OPINION.

....

BOGUE, Senior District Judge.

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

#### BACKGROUND

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

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

during 1988 or 1989, but were insolvent both before and after the transfers and discharge of indebtedness.

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

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

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

## DISCUSSION

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

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<sup>35</sup> Aside from being part of the restructuring agreement, the taxpayer’s transfer of \$6,123 cash to the PCA has little significance for the purposes of the present appeal.

Likewise, income is realized pursuant to I.R.C. § 61(a)(12) [now § 61(a)(11)] for “income from discharge of indebtedness.”

There can be little dispute with respect to Tax Court’s treatment of the \$29,412 portion of the debt forgiven subsequent to the transfers of land and cash. The Commissioner stipulated that under I.R.C. § 108(a)(1)(B),<sup>36</sup> the so-called “insolvency exception,” the taxpayers did not have to include as income any part of the indebtedness that the PCA forgave. The \$29,412 represented the amount by which the land and cash transfers fell short of satisfying the outstanding debt. The Tax Court properly found this amount to be excluded.

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

Taxpayers also appear to contend that under their circumstances, there was no “amount realized” under I.R.C. §§ 1001(a-b) and thus, no “gain” from the land transfers as the term is used in I.R.C. § 61(a)(3). Again, we must disagree. The amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Treas. Reg. § 1.1001-2(a)(1). Simply because the taxpayers did not actually receive any cash proceeds from the land transfers does not mean there was no amount realized. Via the land transfers, they were given credit toward an outstanding recourse loan to the extent of the land’s fair market value. This loan

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

had to be paid back. It is clear that the transfers of land employed to satisfy that end must be treated the same as receiving money from a sale. In this case the land transfers were properly considered “gains derived from dealings in property” to the extent the fair market value in the land exceeded the taxpayers’ basis in said land. I.R.C. §§ 61(a)(3), 1001(a).

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

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

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

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

(a) Inclusion in amount realized. - (1) \* \* \*

*Giving property as payment.* The exchange of appreciated (or depreciated) property to pay for something is a recognition event on the property exchanged. Why?  
•This is a very important principle.

Learn it.

(2) Discharge of indebtedness. The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section [61(a)(11)]. \* \* \*

(c) Examples \* \* \*

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 – \$6,000).

We believe the regulation is controlling and serves ... to provide support for the decision rendered by the Tax Court.<sup>37</sup>

### CONCLUSION

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

### *Notes and Questions:*

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

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<sup>37</sup> Despite the technical accuracy of the decision, one wonders about the propriety of the government’s exhaustive pursuit of this matter in view of the taxpayers’ dire financial situation and continued insolvency.

2. Suppose: Taxpayer owes money to another. Taxpayer might sell property that he owns. The gain derived from the sale would be subject to income tax. Taxpayer could then pay the cash he realized to the obligee or payee. Alternatively, taxpayer might simply transfer the property to his creditor so that the debt would be reduced by the fmv of the property. The tax consequences between these alternatives should not differ. The court recognized this when it stated:

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

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

4. Why is relief from a liability included in amount realized when applying the formula of § 1001?

### *C. Barter*

Now suppose that instead of accepting money in exchange for property or services, taxpayer accepts services for services, property for property, property for services, or services for property. Moreover, there is now another taxpayer who should receive reciprocal tax treatment.

### **Rev. Rul. 79-24, 1979-1 C.B. 60**

#### **GROSS INCOME; BARTER TRANSACTIONS**

....

#### **FACTS**

*Situation 1.* In return for personal legal services performed by a lawyer for a housepainter, the housepainter painted the lawyer’s personal residence. Both the lawyer and the housepainter are members of a barter club, an organization that annually furnishes its members a directory of members and the services they



provide. All the members of the club are professionals or trades persons. Members contact other members directly and negotiate the value of the services to be performed.

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

## LAW

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

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

## HOLDINGS

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

## Notes and Questions:

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

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

2. (continuing note 1): In situation 2, let's say that the fmV of the painting was \$6000. The fmV of the rent was \$7000. We say that we tax income once – but we

don't tax it more than once. In the following questions, keep track of what the taxpayer has and on how much income he has paid income tax.

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

3. Read Reg. § 1.61-2(d)(1 and 2(i)).

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

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

#### *D. Improvements to Leaseholds and the Time Value of Money*

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

MR. JUSTICE ROBERTS delivered the opinion of the Court.

....

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

The lease provided that the lessee might at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease

became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

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

“Unamortized cost” equals “adjusted basis.”
--

....

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

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

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

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

In 1935, the Circuit Court of Appeals for the Second Circuit decided, in *Hewitt Realty Co. v. Commissioner*, 76 F.2d 880, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the land, and, if removed, would be worthless except as bricks, iron, and mortar. It said, 76 F.2d 884: “The question, as we view it, is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.” This decision invalidated the regulations then in force. [footnote omitted]

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

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

The respondent insists that the realty – a capital asset at the date of the execution of the lease – remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or

treated as received in exchange for the improvements which were on the land at the date of the execution of the lease; that they are therefore in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner's disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment, and may not therefore be taxed without apportionment.

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

....

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

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

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

Judgment reversed.

....

*Notes and Questions:*

1. Aliquot: a fractional part that is contained a precise number of times in the whole.
2. *Bruun* of course undercuts the language of *Eisner v. Macomber* concerning the need to sever the improvement (increase in value) from the whole. You can see in taxpayer's (respondent's) contentions the elements of the *Macomber* Court's definition of "income" (i.e., this was not gain derived from capital). And of course, "realization" does not require receipt of cash.
3. Why did everyone who had anything to do with this case subtract the unamortized cost of the old building from the fmV of the new building in determining taxpayer's taxable income? After all, taxpayer does not own a building that no longer physically exists.
4. Sections 109/1019 reverse the holding of *Bruun*. Section 109 provides that a lessor of real taxpayer does not realize taxable gross income attributable to improvements that the lessee made to the real property upon termination of the lease. Section 1019 provides that taxpayer may not increase or decrease his adjusted basis in property because he received gross income that § 109 excludes.
  - Is § 1019 necessary?
  - What is conceptually wrong with §§ 109 and 1019? Isn't there some untaxed additions to taxpayer's storehouse of property rights? Where?
5. Section 109 does not apply to improvements that the lessee makes which the parties intend as rent. Reg. § 1.61-8(c) ("If a lessee places improvements on real estate which constitute, in whole or in part, a substitute for rent, such improvements constitute rental income to the lessor.")
  - Suppose that a retailer leases space for a period of one year in taxpayer/lessor's shopping mall. As part of the rental, lessee agrees to install various fixtures and to leave them to the lessor at the termination of the lease. The value of the fixtures is \$20,000.
    - What is lessor's basis in the fixtures?
    - Exactly what does the payment of rent purchase?
    - Exactly what does a lessor "sell" by accepting a rent payment?
6. Consider each of the rules the Court considered – as well as the rule that Congress created in §§ 109/1019. Identify each rule and consider this question: what difference does it make which rule is applied?

•Let's assume that the lessee did not remove a building, but simply erected a new building on vacant premises. Let's also put some numbers and dates into the problem for illustrative purposes. Assume that the fmV of the building in 2000 upon completion is \$400,000. The building will last 40 years. The building will lose \$10,000 of value every year, and this is the amount that taxpayer may claim as a depreciation/cost recovery deduction. Taxpayer must reduce his basis in the property (§ 1016) for depreciation deductions. The adjusted basis of the property equals its fmV. The lease upon completion of the building will run another 20 years until 2020. The lessee did not default thereby causing early termination of the lease. Immediately upon termination of the lease, taxpayer sells the property, and the portion of the selling price attributable to the building is \$200,000. Taxpayer's marginal tax bracket is 30%.

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

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

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

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

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

- How much is the income tax on this item of taxpayer’s gross income?

- What will taxpayer’s basis in the building be?

- What will taxpayer’s annual depreciation/cost recovery allowance be for each of the next twenty years?

- How much will the annual depreciation/cost recovery allowance reduce taxpayer’s income tax liability for each of the remaining years of the lease?

- What will be the total

reduction in taxpayer’s income tax liability resulting from depreciation/cost recovery allowances?

- What should happen to taxpayer’s basis in the building for each year that he claims a depreciation/cost recovery deduction?

- What will be taxpayer’s net income tax liability for having received the building?

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

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



- What is taxpayer's total tax bill?

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

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

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

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

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

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

building?

- What is taxpayer's total tax bill?

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

7. It is very expensive to litigate a case to a federal circuit court of appeals or all the way to the United States Supreme Court. If taxpayer's total net tax liability under any of the five approaches that the Court identified in *Bruun* is the same, *why* would parties spend serious money litigating a choice of rule question to the Supreme Court? For that matter, why would the Treasury Department use up so much ink promulgating and then changing regulations?

8. The answer (of course) lies in the fact that the right to have \$1 today is worth more than the right to have \$1 at some future time. The number of dollars involved in any of these transactions may not change, but their value certainly does. *Yet calculations of taxable income and income tax liability do not (often) change merely because \$1 today is worth more than \$1 tomorrow.* Taxpayers understand that principle very well and seek to reduce the *present value* of their tax liability as much as possible. They can do this by accelerating recognition of deductions and deferring recognition of income.

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

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

- You can Google “present value tables” to find a variety of such tables.
- Some tables appear in the pages immediately following this one. *Do not forget that these tables are here. You may wish to use them from time to time.*
- Table 1** shows what \$1 today will be worth at given interest rates (across the top of the table) after a given number of years (down the left-hand side of the table).
- Table 2** shows what \$1 at some given future date is worth today.
- Table 3** shows the present value of receiving \$1 at the end of every year for a given number of years, as is the case with an annuity. This table is

useful in determining the PV of any stream of payments that does not vary in amount, e.g., straight-line depreciation deductions.

•A useful approximation that you can verify by referring to table 1 is the so-called rule of 72. Simply divide 72 by the interest rate expressed as a whole number, e.g., 6 rather than 6%. The quotient is very close to the length of time it takes money to double in value at that interest rate.

**Table 1: Future value of \$1 at various interest rates, compounded annually:**

$$FV = 1(1 + r)^t$$

FV = future value; r = interest rate expressed as decimal; t = time, i.e., # of years.

In the left hand column is the number of years. In the top row is the interest rate.

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

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

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

**Table 3: Present Value of a \$1 Annuity Discounted by a Given Interest rate for a Certain Number of Annual Payments:  $PV = (-0.1) * (1 - 1/(1 + i)^{-t}) / i$**

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

10. Now: let's assume that the discount rate in our problems above is 8% and rework the answers. Compare the present value of taxpayer's \$60,000 tax liability on the very same transactions in 2000 under each of the five rules:

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

•In 2000, what is the present value of taxpayer's net tax liability?

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

•In 2000, what is the present value of taxpayer's net tax liability?

(3) New regulations that the Court referenced in *Bruun* that Treasury promulgated after *Miller*: the discounted PV of improvement's  $\text{fmv}$  at the termination of lease is included in taxpayer's taxable income at the time of completion of the building.

•In 2000, what is the present value of taxpayer's net tax liability?

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

•In 2000, what is the present value of taxpayer's net tax liability?

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

•In 2000, what is the present value of taxpayer's net tax liability?

11. The time value of money is one place where taxpayers and the Commissioner now play the tax game. Look for the ways in which it affects the contentions of parties, especially in chapter 9, *infra*. The higher the discount rate, the more taxpayer benefits from deferring payment of a tax and/or accelerating a deduction.

12. Congress can itself exploit the time value of money to pursue certain policy objectives that require taxpayers to save money for specified forms of consumption. For example, Congress may wish for taxpayers to save money throughout their working lives that they can spend in retirement. Sections 219/62(a)(7) permit taxpayers to reduce their adjusted gross income (AGI) by amounts that they save in an Individual Retirement Account (IRA). So also, Congress may wish for taxpayers to save money that they can spend on medical expenses at some future date. Sections 223/62(a)(19) permit taxpayers to reduce their (AGI) by amounts that they save in a Health Savings Account. The money that taxpayers deposit in these accounts at a young age can grow significantly, as the tables above attest.

### *E. Imputed Income*

Imputed income is the value a person derives by performing services for himself or by making use of property that he owns.

Consider the following:

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

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

Notice: John earned \$2000 per weekend. Mary “earned” \$1800 per weekend. Mary is not as productive or as efficient a painter as she is an attorney.

Nevertheless, Mary expended fewer resources to acquire a painted house than John did. How?

- The answer lies in the fact that John had to pay income tax on his

“consumption,” and Mary did not.

- Services that one performs for oneself give rise to “imputed income.”
- As a matter of administrative practice and convenience, we do not tax imputed income.
- As the facts of this hypothetical illustrate, not taxing imputed income causes inefficiency. Mary would create more value by practicing law on the weekends than by painting.
- Not taxing imputed income also causes distortions because from Mary’s point of view, not taxing her imputed income encourages her to perform more services for herself – so long as the cost of her inefficiency is less than the income taxes that she saves.
- In addition to these inefficiencies and distortions, not taxing imputed income derived from performing services for oneself costs the U.S. Treasury money. Obviously, we should not be concerned about de minimis amounts, e.g., mowing our own lawns. But one major source of lost revenue is the non-taxation of imputed income derived by the stay-at-home parent.

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

- Robert elects to take the \$20,000 return on his investments to pay the rent on a house valued at \$150,000. After paying \$5000 in income taxes, he will have \$15,000 with which to pay rent. His investment will not grow because he uses his entire return on investment to pay income tax plus rent.
- Eileen elects to change the form in which she holds some of her investment and to use \$150,000 to purchase a house. She will still have \$100,000 invested. Eileen can live in her house rent-free and will earn a 6% (i.e., 8% – (25% of 8%)) after-tax return on her investment, compounded annually. See table 1 in the discussion of *Bruun, supra*. In less than 16 years, Eileen will have \$250,000 PLUS she will own a \$150,000 home (assuming that it does not lose value; its value might even increase).

Notice: Obviously Eileen came out ahead of Robert. Both Eileen and Robert started with the same wealth and lived in the same type of house. How did Eileen do so much better than Robert?

- Again, Robert had to pay income tax on his consumption while Eileen did not.

- The fair rental value of property that a taxpayer owns is also imputed income, and it is not subject to income tax.
- As the facts of this hypothetical illustrate, not taxing imputed income causes inefficiency because it encourages taxpayers to invest in assets that

*Other statutory items of gross income:* Recall from chapter 1 that the Code specifically names some items of gross income in §§ 72-91. You should at least skim the table of contents to your Code to get an idea of what Congress has deemed worthy of specific inclusion. These Code sections often define the precise extent to which an item *is* (so implicitly the extent to which it *is not*) gross income.

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

they can use in preference to other investments.

- A house is something that a consumer can and wants to consume.

- Not taxing imputed income derived from ownership of property increases a taxpayer's return on investing in such property. Eileen received \$15,000 worth of rent annually on her \$150,000 investment – a tax-free return of 10%. A net after-tax return of 10% subject to 25% income tax would require a before-tax return of 13.33%.

- A major source of lost revenue to the Treasury through the non-taxation of the fair rental value of property that taxpayer owns results from Americans' widespread ownership of homes – and the ownership of homes that are more expensive than what many taxpayers would otherwise purchase.

- Perhaps the risk-adjusted return on Turkish apricot futures is greater than the 10% return Eileen so easily earned on her investment in a house, but Eileen will not choose to



maximize her investment return in this manner unless the return on such an investment is greater than 13.33%. The Tax Code assures that many taxpayers will prefer to purchase assets such as homes rather than make investments with higher before-tax returns.

- If excluding the fair rental value of a home from its owner's gross income is not sufficient motivation to buy a home –

- § 163(h) permits taxpayers who file married filing jointly to deduct mortgage interest on up to \$750,000 of indebtedness incurred to purchase a home.<sup>38</sup>

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

- § 164(a)(1) permits a deduction for state and local real property taxes.<sup>39</sup>

- Of course, these rules greatly increase demand for houses.<sup>40</sup> Without question, the Tax Code has distorted the market for houses and increased their prices.

### III. The Constitutional and Statutory Definitions of “Gross Income:” Realization

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

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

MR. JUSTICE STONE delivered the opinion of the Court.

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

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<sup>38</sup> This is the limit for 2018 to 2025. Then the limit will again be \$1,000,000. Moreover, § 163(h) will again allow a deduction for interest that taxpayer pays on \$100,000 of home equity indebtedness.

<sup>39</sup> For 2018 to 2025, taxpayer may deduct a total of \$10,000 for state and local property taxes, state and local personal property taxes, and state, local, and foreign income taxes. Foreign property taxes are not deductible. Beginning in 2026, all these taxes will be deductible without limit.

<sup>40</sup> The Tax Code makes a substantial contribution to urban sprawl.

year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935, respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son, who, in the same year, collected them at maturity. The Commissioner ruled that, under ... [§ 61], the interest payments were taxable, in the years when paid, to the respondent donor, who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. We granted certiorari because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of *Lucas v. Earl*, 281 U.S. 111, and with that of decisions by other circuit courts of appeals. See *Bishop v. Commissioner*, 54 F.2d 298; *Dickey v. Burnet*, 56 F.2d 917, 921; *Van Meter v. Commissioner*, 61 F.2d 817.

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

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

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning, the revenue laws have been interpreted as defining “realization” of income as the taxable event, rather than the acquisition of the right to receive it. And “realization” is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts

basis. Where the taxpayer does not receive payment of income in money or property, realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716; *Corliss v. Bowers*, 281 U.S. 376, 378. Cf. *Burnet v. Wells*, 289 U.S. 670.

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

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

Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself, he has nevertheless, by his act, procured

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

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

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

....

The dominant purpose of the revenue laws is the taxation of income to those who

earn or otherwise create the right to receive it and enjoy the benefit of it when paid. *See Corliss v. Bowers, supra*, 281 U.S. 376, 378; *Burnet v. Guggenheim*, 288 U.S. 280, 283. The tax laid by the 1934 Revenue Act upon income “derived from ... wages, or compensation for personal service, of whatever kind and in whatever form paid ... ; also from interest ...” therefore cannot fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received.

It is the statute which taxes the income to the donor although paid to his donee. *Lucas v. Earl, supra*; *Burnet v. Leininger, supra*. ...

... When, by the gift of the coupons, he has separated his right to interest payments from his investment and procured the payment of the interest to his donee, he has enjoyed the economic benefits of the income in the same manner and to the same extent as though the transfer were of earnings, and, in both cases, the import of the statute is that the fruit is not to be attributed to a different tree from that on which it grew. *See Lucas v. Earl, supra*, 281 U.S. at 115.

Reversed.

The separate opinion of MR. JUSTICE McREYNOLDS.

....

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

....

... The challenged judgment should be affirmed.

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

*Notes and Questions:*

1. Under the rules of § 102, donors make gifts with after-tax income, and the donee may exclude the value of the gift from his gross income. Taxpayer Horst of course tried to reverse this.
2. No doubt, taxpayer's son was in a lower tax bracket than taxpayer was. Hence, the bond interest would have been subject to a lower rate of tax if taxpayer had prevailed.
3. Did the Court hold that realization is no longer an element of gross income, or that taxpayer did in fact realize the bond interest income?
4. Consumption can take the form of directing income to another.
5. The Internal Revenue Code taxes "taxable income," §§ 1(a-e). [Section 1(j) rather than §§ 1(a-e) govern for 2018 to 2025.] The computation of "taxable income" begins with a summing up of all items of "gross income." The concept of "gross income" does not inherently embody a netting of gains and losses. A taxpayer may deduct losses only to the extent that the Code permits.<sup>41</sup> Sections 165(a and c) allow taxpayers to deduct trade or business losses and investment losses. A realization requirement applies to losses, just as it does to gross income. To be deductible, taxpayer must have "realized" the losses. Now read *Cottage Savings Association*.

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

JUSTICE MARSHALL delivered the opinion of the Court.

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

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<sup>41</sup> Many gamblers have learned the hard way that there is a limit to what they can deduct from their gambling winnings. § 165(d) (wagering losses deductible only to extent of gain from wagering transactions; until 2026, wagering "losses" include deductions otherwise allowable).

## I

Petitioner Cottage Savings Association (Cottage Savings) is a savings and loan association (S & L) formerly regulated by the Federal Home Loan Bank Board (FHLBB). [footnote omitted] Like many S & L's, Cottage Savings held numerous long-term, low-interest mortgages that declined in value when interest rates surged in the late 1970's. These institutions would have benefited from selling their devalued mortgages in order to realize tax-deductible losses. However, they were deterred from doing so by FHLBB accounting regulations, which required them to record the losses on their books. Reporting these losses consistent with the then-effective FHLBB accounting regulations would have placed many S & L's at risk of closure by the FHLBB.

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

This case involves a typical Memorandum R-49 transaction. On December 31, 1980, Cottage Savings sold "90% participation" in 252 mortgages to four S & L's. It simultaneously purchased "90% participation interests" in 305 mortgages held by these S & L's.<sup>42</sup> All of the loans involved in the transaction were secured by single-family homes, most in the Cincinnati area. The fair market value of the package of participation interests exchanged by each side was approximately \$4.5 million. The face value of the participation interests Cottage Savings relinquished in the transaction was approximately \$6.9 million.

On its 1980 federal income tax return, Cottage Savings claimed a deduction for \$2,447,091, which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation

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<sup>42</sup> By exchanging merely participation interests, rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S & L continued to service the loans on which it had transferred the participation interests and made monthly payments to the participation-interest holders.

interests that it received. As permitted by Memorandum R-49, Cottage Savings did not report these losses to the FHLBB. After the Commissioner of Internal Revenue disallowed Cottage Savings' claimed deduction, Cottage Savings sought a redetermination in the Tax Court. The Tax Court held that the deduction was permissible.

On appeal by the Commissioner, the Court of Appeals reversed. The Court of Appeals agreed with the Tax Court's determination that Cottage Savings had realized its losses through the transaction. ...

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

## II

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



Section 1001(a)'s language provides a straightforward test for realization: to realize

*Consistency between tax and financial accounting:*

The FHLBB obviously intended Memorandum R-49 to enable savings and loan associations to reduce their income tax liability and thereby come closer to solvency. This tax savings came at the expense of all other taxpayers who must "pick up the slack."

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

a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property." The parties agree that the exchange of participation interests in this case cannot be characterized as a "sale" under § 1001(a); the issue before us is whether the transaction constitutes a "disposition of property." The Commissioner argues that an exchange of property can be treated as a "disposition" under

§ 1001(a) only if the properties exchanged are materially different. The Commissioner further submits that, because the underlying mortgages were essentially economic substitutes, the participation interests exchanged by Cottage Savings were not materially different from those received from the other S & L's. Cottage Savings, on the other hand, maintains that any exchange of property is a "disposition of property" under § 1001(a), regardless of whether the property exchanged is materially different. Alternatively, Cottage Savings contends that the participation interests exchanged were materially different because the underlying loans were secured by different properties.

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

A

Neither the language nor the history of the Code indicates whether and to what extent property exchanged must differ to count as a "disposition of property" under § 1001(a). Nonetheless, we readily agree with the Commissioner that an exchange of property gives rise to a realization event under § 1001(a) only if the properties

exchanged are “materially different.” The Commissioner himself has, by regulation, construed § 1001(a) to embody a material difference requirement:

“Except as otherwise provided ... the gain or loss realized from the conversion of property into cash, *or from the exchange of property for other property differing materially either in kind or in extent*, is treated as income or as loss sustained.” Treas. Reg. § 1.1001-1, 26 CFR § 1.1001-1 (1990) (emphasis added).

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

We conclude that Treasury Regulation § 1.1001-1 is a reasonable interpretation of § 1001(a). Congress first employed the language that now comprises § 1001(a) of the Code in § 202(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 253; that language has remained essentially unchanged through various reenactments. [footnote omitted] And since 1934, the Commissioner has construed the statutory term “disposition of property” to include a “material difference” requirement. [footnote omitted] As we have recognized, “‘Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.’” *United States v. Correll*, 389 U.S. 299, 305-306 (1967), quoting *Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

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

Commissioner's construction of the statutory language to incorporate these principles certainly was reasonable.

## B

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

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

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

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

Delaware corporations, the original and successor corporations in *Weiss* both were incorporated in Ohio. In each case, following the reorganization, the stockholders of the old corporation received shares in the new corporation equal to their proportional interest in the old corporation.

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

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

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

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

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

“on the exchange of property held for productive use in a trade or business or for investment ... for property of like kind which is to be held either for productive use in a trade or business or for investment.” 26 U.S.C. § 1031(a)(1).

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

## C

Under our interpretation of § 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are “materially different” – that is, so long as they embody legally distinct entitlements. Cottage Savings’

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

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

### III

....

### IV

... [The decision of the Tax Court is affirmed.]

So ordered.

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

#### *Notes and Questions:*

1. As a practical matter, what was wrong with the Commissioner's arguments?
2. What is an “appreciation-based system” of taxation as opposed to a “realization-based system” of taxation?
  - The importance of this distinction as a matter of policy has increased significantly
  - The “cumbersome, abrasive, and unpredictable administrative task of

valuing' assets" annually passes under the phrase "mark-to-market."

3. What is the test of "realization" upon an exchange that the Court derived from *Phellis/Weiss/Marr*?

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

5. The Court's application of the realization requirement gives taxpayers considerable control over the timing of tax gains and losses.

6. As the Court indicated in part IIB of its opinion, § 1001(c) provides that "[e]xcept as otherwise provided, the amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized." In §§ 1031 to 1045 (among others), Congress "otherwise provided." We briefly consider here § 1031 and § 1033.

•§ 1031 (like-kind exchanges): § 1031(a) provides that "[n]o gain or loss shall be recognized on the exchange of *real property* held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." Tax-deferred exchange treatment does not apply to property that the taxpayer holds "primarily" for resale. § 1032(a)(2).



*Tax Cuts and Jobs Act:* Before 2018, § 1031's non-recognition treatment extended to like-kind exchanges of any property "held for productive use in a trade or business or for investment[.]" The Tax Cuts and Jobs Act now restricts such treatment to exchanges of real property. The Act denies tax-deferred treatment exchanges of real property held primarily for sale. § 1031(a)(2). The Act also denies tax-deferred treatment of exchanges of real property located outside of the United States. § 1031(h). The Act made obsolete many of § 1031's regulations.

The phrase "like kind" refers to the nature or character of the property, not its grade or quality. For example, improved and unimproved lands are of "like kind." Reg. § 1.1031(a)-1(b).

The transfers in a § 1031 transaction need not be simultaneous. Moreover, more than two parties may be involved. It would be rare that A and B own properties that they wish to exchange with each other.<sup>43</sup> More likely, B wishes to procure real property from A. A wishes to exchange his real property for other real property. B can then procure real property that A will accept and then exchange it for the property that A owns.

Since it would be rare for the properties involved in an exchange to be worth the same amount, one or more parties may throw in something "to boot." In such a case, the word "solely" in § 1031(a) does not require that the entire exchange be disqualified from § 1031 – only the assets that are not "like kind." In the exchange, taxpayer *realizes* gain/loss. When there is boot, taxpayer must *recognize* gain or boot received, whichever is less. § 1031(b). The assumption of a liability is treated as the payment of boot. Reg. § 1.1031-2.

To implement the principle that we tax all income once, the tax on gain is *deferred* through the transfer of basis. Section 1031(d) provides that the transferor's basis in the property he received is the same as the basis he had in the property that he transferred, decreased by the amount of boot received, and increased by the amount of boot subject to immediate recognition or decreased by the amount of loss recognized. Such transfer of basis from one property to another has the effect of deferring, not excluding, eventual recognition of gain. Tax deferral under § 1031 is not optional but mandatory, a point that works against a taxpayer who wishes to

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<sup>43</sup> Multi-party transfers of multiple pieces of real property will be (already are?) the domain of real estate specialists – and beyond the scope of this introduction to tax-deferral through basis transfers.



recognize loss in a completed transaction as the taxpayer in *Cottage Saving & Loan* did.

Problems:

- 1. A, who is not a dealer in real estate, in 2010 exchanges real estate held for investment, which he purchased in 1995 for \$50,000, for other real estate (to be held for productive use in trade or business) which has a fair market value of \$60,000, and \$20,000 in cash.
  - How much gain did A derive from this dealing in property?
  - How much gain must A recognize from this dealing in property?
  - What is A's adjusted basis in the property that he acquired in this transaction?

See Reg. § 1.1031(b)-1(b), Example 1.

- 1A. Suppose A exchanged the real property for other real estate which has a fmV of \$40,000 and \$40,000 of cash. How would your answers change?

- 2. B, an individual, owns an apartment house which has an adjusted basis in his hands of \$500,000, but which is subject to a mortgage of \$150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor \$50,000 in cash and another apartment house with a fair market value on that date of \$600,000. The transfer to C is made subject to the \$150,000 mortgage.

- How much gain did B derive from this dealing in property?
- How much gain must B recognize from this dealing in property?
- What is B's adjusted basis in the property that he acquired in this transaction?

See Reg. § 1.1031(d)-2, Example 1.

•§ 1033 (involuntary exchanges): A taxpayer whose property is destroyed, stolen, seized, requisitioned, or condemned may receive money for the property. The receipt of money would require taxpayer to treat such an "involuntary conversion" of property into money as a recognition event. If taxpayer uses the proceeds of the involuntary conversion to procure property "similar or related in service or use to the property so converted," taxpayer does not have to recognize gain except to the

extent the amount of money received exceeds the cost of the replacement property. § 1033(a)(2)(A). Again, the deferral of recognition is handled through a transfer of basis from the converted property to the replacement property, decreased by the money that taxpayer did not spend on the replacement property and increased by the amount of gain taxpayer recognized on the conversion (or decreased by the amount of loss taxpayer recognized on the conversion). § 1033(b)(1). In the case of an involuntary conversion, tax deferral is elective. § 1033(a)(2)(A).

Problem:

- A's vessel which has an adjusted basis of \$100,000 is destroyed in 2015, and A receives in 2016 an insurance payment of \$210,000. A invests \$150,000 of the insurance proceeds in a new vessel. A makes the election under § 1033(a)(2)(A).

- How much gain does A derive from this dealing in property?
- How much gain must A recognize from this dealing in property?
- What is A's basis in the replacement vessel?

*See Reg. § 1.1033(b)-1, Example.*

#### **IV. The Constitutional and Statutory Definitions of “Gross Income:” Dominion and Control**

Generally, taxpayer has dominion and control over a monetary accession to wealth if, as a practical matter, he may spend it without interference from others. The so-called “claim of right” doctrine – which the Court first announced in *North American Oil Consolidated v. Burnet*, 286 U.S. 417 (1932) – implements this principle.

**Gilbert v. Commissioner**, 552 F.2d 478 (2<sup>nd</sup> Cir. 1977)

LUMBARD, Circuit Judge:

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

Until June 12, 1962, Gilbert was president, principal stockholder, and a director of the E.L. Bruce Company, Inc., a New York corporation which was engaged in the lumber supply business. In 1961 and early 1962 Gilbert acquired on margin substantial personal and beneficial ownership of stock in another lumber supply company, the Celotex Corporation, intending ultimately to bring about a merger of Celotex into Bruce. To this end, he persuaded associates of his to purchase

*Claim of Right doctrine:* Taxpayer must include in his gross income an item when he has a “claim of right” to it. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932), the Supreme Court stated the doctrine thus:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

Celotex stock, guaranteeing them against loss, and also induced Bruce itself to purchase a substantial number of Celotex shares. In addition, on March 5, 1962, Gilbert granted Bruce an option to purchase his Celotex shares from him at cost. By the end of May 1962, 56% of Celotex was thus controlled by Gilbert and Bruce, and negotiations for the merger were proceeding; agreement had been reached that three of the directors of Bruce would be placed on the board of Celotex. It is undisputed that this merger would have been in Bruce’s interest.<sup>44</sup>

The stock market declined on May 28, 1962, however, and Gilbert was called upon to furnish additional margin for the Celotex shares purchased by him and his associates. Lacking sufficient cash of his own to meet this margin call, Gilbert

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<sup>44</sup> According to undisputed testimony in the tax court, it was the consensus of the Bruce board that the Celotex assets were selling at a bargain price and also that the dovetailing of the two companies’ sales operations would result in substantial economies.

instructed the secretary of Bruce to use corporate funds to supply the necessary margin. Between May 28 and June 6 a series of checks totalling \$1,958,000 were withdrawn from Bruce's accounts and used to meet the margin call. \$5,000 was repayed to Bruce on June 5. According to his testimony in the tax court, Gilbert from the outset intended to repay all the money and at all times thought he was acting in the corporation's best interests as well as his own.<sup>45</sup> He promptly informed several other Bruce officers and directors of the withdrawals; however, some were not notified until June 11 or 12.

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

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

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

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<sup>45</sup> Two years previously, Gilbert accomplished a merger with Bruce of another corporation controlled by him, Empire National Corporation, and in the process he had made some unauthorized withdrawals of Empire funds, all of which he paid back.

On June 22 the Internal Revenue Service filed tax liens against Gilbert based on a jeopardy assessment for \$3,340,000, of which \$1,620,000 was for 1958-1960 and \$1,720,000 was for 1962. [(footnote omitted)]. Bruce, having failed to file the assignment from Gilbert because of the real estate filing fee involved,<sup>46</sup> now found itself subordinate in priority to the IRS and, impeded by the tax lien, has never since been able to recover much of its \$1,953,000 from the assigned assets. [footnote omitted]. For the fiscal year ending June 30, 1962, Bruce claimed a loss deduction on the \$1,953,000 withdrawn by Gilbert. Several years later Gilbert pled guilty to federal and state charges of having unlawfully withdrawn the funds from Bruce.

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

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

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

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

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<sup>46</sup> When attempting to file in the New York County Clerk’s office on June 13 or 14, Bruce was told that it would have to pay a mortgage tax of at least \$10,000 because the assignment included real property. ...

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

This is not a typical embezzlement case, however, and we do not interpret *James* as requiring income realization in every case of unlawful withdrawals by a taxpayer. There are a number of facts that differentiate this case from *Buff* and *James*. When Gilbert withdrew the corporate funds, he recognized his obligation to repay and intended to do so. [(footnote omitted)]. The funds were to be used not only for his benefit but also for the benefit of the corporation; meeting the margin calls was necessary to maintain the possibility of the highly favorable merger. Although Gilbert undoubtedly realized that he lacked the necessary authorization, he thought he was serving the best interests of the corporation and he expected his decision to be ratified shortly thereafter. That Gilbert at no time intended to retain the corporation's funds is clear from his actions.<sup>47</sup> He immediately informed several of the corporation's officers and directors, and he made a complete accounting to all of them within two weeks. He also disclosed his actions to the corporation's outside counsel, a reputable law firm, and followed its instructions regarding repayment. In signing immediately payable promissory notes secured by most of his assets, Gilbert's clear intent was to ensure that Bruce would obtain full restitution. In addition, he attempted to sell his shares of Celotex stock in order to raise cash to pay Bruce back immediately.

When Gilbert executed the assignment to Bruce of his assets on June 8 and when this assignment for security was accepted by the Bruce board on June 12, the net market value of these assets was substantially more than the amount owed. The Bruce board did not release Gilbert from his underlying obligation to repay, but the assignment was nonetheless valid and Bruce's failure to make an appropriate filing to protect itself against the claims of third parties, such as the IRS, did not relieve

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

Gilbert of the binding effect of the assignment. Since the assignment secured an immediate payable note, Gilbert had as of June 12 granted Bruce full discretion to liquidate any of his assets in order to recoup on the \$1,953,000 withdrawal. Thus, Gilbert's net accretion in real wealth on the overall transaction was zero: he had for his own use withdrawn \$1,953,000 in corporate funds but he had now granted the corporation control over at least \$1,953,000 worth of his assets.

We conclude that where a taxpayer withdraws funds from a corporation which he fully intends to repay and which he expects with reasonable certainty he will be able to repay, where he believes that his withdrawals will be approved by the corporation, and where he makes a prompt assignment of assets sufficient to secure the amount owed, he does not realize income on the withdrawals under the *James* test. When Gilbert acquired the money, there was an express consensual recognition of his obligation to repay: the secretary of the corporation, who signed the checks, the officers and directors to whom Gilbert gave contemporaneous notification, and Gilbert himself were all aware that the transaction was in the nature of a loan. Moreover, the funds were certainly not received by Gilbert "without restriction as to their disposition" as is required for taxability under *James*; the money was to be used solely for the temporary purpose of meeting certain margin calls and it was so used. For these reasons, we reverse the decision of the tax court.

#### *Notes and Questions:*

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

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

As we held in *Buff v. Commissioner*, 496 F.2d 847 (2d Cir. 1974), if he spends the loot instead of repaying, he cannot avoid tax on his

embezzlement income simply by signing promissory notes later in the same year. *See also id.* at 849-50 (Oakes, J., concurring).

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

- The last paragraph of the opinion gives some idea of how little is required to show “consensual recognition of [an] obligation to repay.

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

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

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

7. *Security and damage deposits*: An electric utility company (IPL) requires customers with suspect credit to make a security deposit to assure prompt payment of utility bills. Customers are entitled to a refund of their deposit upon establishing good credit or making a sufficient number of timely payments. The electric company treated the deposits as a current liability. So long as the company refunded the deposits when customers were entitled to them, the company could spend the money as it chose. Should the utility include the deposits in its gross income? The answer to this question turns on whether the company had “complete dominion” over the funds.

IPL hardly enjoyed ‘complete dominion’ over the customer deposits entrusted to it. Rather, these deposits were acquired subject to an express ‘obligation to repay,’ either at the time service was terminated or at the time a customer established good credit. So long as the customer fulfills his legal obligation to make timely payments, his deposit ultimately is to be refunded, and both the timing and method of that refund are largely within the control of the customer.



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

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

8. For those who may hold some cryptocurrency, the IRS recently announced that:
- (1) A taxpayer does not have gross income under § 61 as a result of a hard fork of a cryptocurrency the taxpayer owns if the taxpayer does not receive units of a new cryptocurrency.
  - (2) A taxpayer has gross income, ordinary in character, under § 61 as a result of an airdrop of a new cryptocurrency following a hard fork if the taxpayer receives units of a new cryptocurrency.

Rev. Rul. 2019-24, 2019-44 I.R.B. 1004.



Do the CALI lesson, *Basic Income Taxation: Gross Income: Realization Concepts in Gross Income*.



Do the CALI lesson, *Basic Income Taxation: Gross Income: Indirect Transfers for Services*.

## Wrap-up Questions for Chapter 2

1. What policies does a broad definition of “gross income” implement and how?
2. What is the tax treatment of a return of capital? How does this treatment implement the principle that we tax income once?
3. In determining whether a taxpayer should include certain forms of consumption in his gross income, why should it matter that taxpayer has no discretion in what it is he must consume (for example, a trip to Germany to view Volkswagen facilities)?
4. The exchange of appreciated property to pay for something is a recognition event. How does this rule implement the principal that we tax all income once?
5. What economic distortions result from the Code’s failure to tax imputed income?

## What have you learned?

Can you explain or define –

- *Eisner v. Macomber*; definition of “gross income,” the significance of “realization”
- When and how a shareholder’s share of undistributed corporate income is taxed?
- This definitional characteristic of “basis:” money that will not be subject to tax (again)
  - Basis as the way taxpayer keeps score with the government
- *Glenshaw Glass*; definition of “gross income”
- Realization of income without actual receipt but through control of its disposition
- Constitutional importance of direct vs. indirect taxes
- Income tax treatment of –
  - receiving a windfall
  - receiving punitive damages
  - receiving compensatory damages
  - someone else paying taxpayer’s obligation
  - receiving a benefit over which taxpayer has no discretion to control
  - receiving a return of capital
  - receiving barter income
  - using appreciated (depreciated property) to pay for something
  - receiving imputed income from performing services

- receiving imputed income from owning property
- benefitting from a discharge (forgiveness) of indebtedness
- stealing money
- § 1001 formula for determining gain or loss; why is relief from a liability included in “amount realized”
- Time value of money; present value; future value
- Realization upon exchange of legal entitlements different in kind or extent
- Exchange of “materially different” properties that are “like-kind”
- Dominion and control
- Claim of right doctrine; test of *James v. United States*
- Difference in fact between a loan and stealing money
- Tax treatment of security deposits
- Tax treatment of like-kind exchanges and involuntary conversions
- How does Congress defer recognizing gain without forgiving it?

## Chapter 3: Exclusions from Gross Income

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

### *The Tax Formula:*

→(gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)

EQUALS (taxable income)

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

The availability of exclusions has several consequences:

- Taxpayers will seek wealth in forms that the Code excludes from their gross income. This point becomes more important as Congress curtails other means of reducing taxable income by suspending or repealing deductions.
- The fact that a taxpayer may acquire a form of wealth without bearing any tax burden will encourage others to “capture” some of the benefit.
- The fact that many taxpayers find a benefit to be attractive affects the market for that benefit, e.g., health care. Taxpayers acting as consumers will bid up the price of the benefit and so must spend more to acquire such forms of wealth (benefits) than they would if all taxpayers had to purchase the benefit with after-tax dollars. The price of acquiring the tax-favored benefit will increase. Entrepreneurs will enter businesses in which customers can purchase goods and services with untaxed dollars. Such entrepreneurs might have created more net after-tax societal value by selling other goods and services.

- The Treasury obviously must forego tax revenues simply because these accessions to wealth are not subject to income tax.

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

## I. The Society and Government that We Want

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

- Whether these are policies that the government should pursue;
- Whether tax benefits are the appropriate means of pursuing these policies. After all, those who choose to avail themselves of the benefits of these tax benefits do so at the expense of taxpayers who do not;
- Whether providing tax benefits to those who can avail themselves of those benefits is fair to those who lack the wherewithal to make the same choice? Does the exclusion perpetuate undesirable inequalities in our society?
- Whether the tax provisions by which Congress pursues these policies lead to unintended consequences and/or capture by those other than those Congress intended to benefit.

### *A. Gifts and Inheritances, § 102, and Related Basis Rules, §§ 1014, 1015*

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

- Is it possible that the exclusion may lead to a culture of gift-giving in

contexts other than the family – whose effects may not reflect generosity or affection?

- If so, is it possible that the costs of such gifts will escalate, and is it not certain that the donor will (at least try to) deduct the escalating costs of such gifts from her taxable income?

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

MR. JUSTICE BRENNAN delivered the opinion of the Court.

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

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

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

of the Cadillac as a business expense on its corporate income tax return.

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

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

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

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

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

And by another:

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

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

“resentment was expressed as to the ‘presumptuous’ suggestion that the action of the Board, taken after long deliberation, should be changed.”

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

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

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



Court of Appeals for the Second Circuit reversed.

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

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

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

The course of decision here makes it plain that the statute does not use the term "gift" in the common law sense, but in a more colloquial sense. This Court has indicated that a voluntarily executed transfer of his property by one to another, without any consideration or compensation therefor, though a common law gift, is not necessarily a "gift" within the meaning of the statute. For the Court has shown

that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730. And, importantly, if the payment proceeds primarily from “the constraining force of any moral or legal duty,” or from “the incentive of anticipated benefit” of an economic nature, *Bogardus v. Commissioner*, 302 U.S. 34, 41, it is not a gift. And, conversely, “[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.” *Robertson v. United States*, 343 U.S. 711, 714.<sup>48</sup> A gift in the statutory sense, on the other hand, proceeds from a “detached and disinterested generosity,” *Commissioner v. LoBue*, 351 U.S. 243, 246; “out of affection, respect, admiration, charity or like impulses.” *Robertson v. United States*, *supra*, at 343 U.S. 714. And, in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor’s “intention.” *Bogardus v. Commissioner*, 302 U.S. 34, 43. “What controls is the intention with which payment, however voluntary, has been made.” *Id.* at 302 U.S. 45 (dissenting opinion). [footnote omitted]

The Government says that this “intention” of the transferor cannot mean what the cases on the common law concept of gift call “donative intent.” With that we are in agreement, for our decisions fully support this. Moreover, the *Bogardus* case itself makes it plain that the donor’s characterization of his action is not determinative – that there must be an objective inquiry as to whether what is called a gift amounts to it in reality. 302 U.S. at 40. It scarcely needs adding that the parties’ expectations or hopes as to the tax treatment of their conduct, in themselves, have nothing to do with the matter.

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

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

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<sup>48</sup> The cases including “tips” in gross income are classic examples of this. *See, e.g.,* *Roberts v. Commissioner*, 176 F.2d 221.

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

Specifically, the trier of fact must be careful not to allow trial of the issue whether the receipt of a specific payment is a gift to turn into a trial of the tax liability, or of the propriety, as a matter of fiduciary or corporate law, attaching to the conduct of someone else. The major corollary to the Government's suggested "test" is that, as an ordinary matter, a payment by a corporation cannot be a gift, and, more specifically, there can be no such thing as a "gift" made by a corporation which would allow it to take a deduction for an ordinary and necessary business expense. As we have said, we find no basis for such a conclusion in the statute; and if it were applied as a determinative rule of "law," it would force the tribunals trying tax cases involving the donee's liability into elaborate inquiries into the local law of corporations or into the peripheral deductibility of payments as business expenses. The former issue might make the tax tribunals the most frequent investigators of an important and difficult issue of the laws of the several States, and the latter inquiry would summon one difficult and delicate problem of federal tax law as an aid to the solution of another. [footnote omitted] Or perhaps there would be required a

trial of the vexed issue whether there was a “constructive” distribution of corporate property, for income tax purposes, to the corporate agents who had sponsored the transfer. [footnote omitted] These considerations, also, reinforce us in our conclusion that, while the principles urged by the Government may, in nonabsolute form as crystallizations of experience, prove persuasive to the trier of facts in a particular case, neither they nor any more detailed statement than has been made can be laid down as a matter of law.

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

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

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. [citation omitted]. Where the trial has been by a judge

without a jury, the judge's findings must stand unless "clearly erroneous." Fed. Rules Civ. Proc. 52(a). ... The rule itself applies also to factual inferences from undisputed basic facts [citation omitted], as will on many occasions be presented in this area. [citation omitted]. And Congress has, in the most explicit terms, attached the identical weight to the findings of the Tax Court. I.R.C. § 7482(a). [footnote omitted]

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

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

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

It is so ordered.

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

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

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

MR. JUSTICE BLACK, concurring and dissenting.

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

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

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

....

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

... While we should normally suppose that a payment from father to son was a gift unless the contrary is shown, in the two situations now before us, the business

implications are so forceful that I would apply a presumptive rule placing the burden upon the beneficiary to prove the payment wholly unrelated to his services to the enterprise. The Court, however, has declined so to analyze the problem, and has concluded

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

....

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

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

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

...

#### *Notes and Questions:*

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



2. The Supreme Court stated:

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

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

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

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

- Employers of bakery workers* who wanted to stay on good terms with the local made deductible payments from their business accounts. Many employers had known taxpayer for many years and were on good terms with him. Most of this group’s journal insertions included a greeting such as “congratulations” and “best wishes.”
- Employer trade associations* made payments from assessments on employers, who in turn deducted payments that they made from their business accounts.
- Businesses who sold supplies* to the baking industry and treated payments for journal insertions as deductible advertising expenses.
- Other union locals* who made payments from funds accumulated from dues that they collected from members.
- Lawyers and doctors* who knew taxpayer personally and were in some manner associated with union activity in the baking industry. Some of these persons deducted their expenditure.
- Employees and other individuals*, many of whom purchased dinner tickets but only a few of whom purchased journal insertions. Many



in this group felt friendship, admiration, affection, and respect for taxpayer.

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

- What issues do these facts raise after *Duberstein*? Doesn't the opinion of *Duberstein* create some quite predictable problems?

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

4. A recurring fact pattern raises the question of whether “gifts” that a pastor receives from congregants are indeed gifts. Congregations’ governing bodies may develop the capacity to track donors’ desire (and/or mere willingness) to make non-deductible gifts to their pastor. e.g., special envelopes for contributions intended to be gifts. This is not equivalent to objective evidence of an intent to make a gift. The Tax Court has recently developed a 4-factor test for such cases: “[1] whether the donations are objectively provided in exchange for services; [2] whether the cleric (or other church authorities) requested personal donations; [3] whether the donations were part of a routinized, highly structured program, and given by individual church members or the congregation as a whole; and [4] whether the cleric receives a separate salary from the church and the amount of that salary in comparison to the personal donations.” *Felton v. Commissioner*, T.C. Memo. 2018-168, 116 T.C.M. (CCH) 365 (2018) (factors weighed in favor of salary rather than gifts); see *Brown v. Commissioner*, T.C. Memo. 2019-69, 117 T.C.M. (CCH) 1339 (2019) (same).

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

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

The Court combined two cases. How many possible outcomes for the two taxpayers were there? How many of them were espoused by at least one judge?

- No justice voted for *Duberstein* to win and *Stanton* to lose.

- Isn't the disparity of views pretty good evidence that Justice Frankfurter was absolutely right?

6. A business culture developed until the 1950s of giving very substantial business gifts in settings such as these. When the marginal tax bracket of the donor is very high, e.g., 70% and maybe higher, the cost of making a very substantial gift is quite low if its donor may deduct its cost. For example, if the donor's marginal tax bracket is 70%, the actual cost to the donor of making a deductible gift is only 30% of its price. Is it possible that Berman felt that if his gift was not sufficiently generous, Duberstein might pitch some of that business to others?

7. Subsequent to *Duberstein*, Congress added § 102(c)(1) and § 274(b)(1) to the Code. Read these sections.

- Would § 102(c)(1) change the result of either *Duberstein* or *Stanton*?
- Would § 274(b)(1) change the result of either *Duberstein* or *Stanton*?

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

- In the case of gifts, § 274(b) limits the deductibility of a gift(s) given to one individual to a total of \$25 if its cost is deducted under § 162 (trade or business expenses) or § 212 (expenses of producing or collecting profit or managing property held to produce income).

- In *Duberstein*, § 274(b) would have limited Mohawk Corporation's § 162 deduction to \$25. If Mohawk had nevertheless purchased a Cadillac for Duberstein, *Mohawk* would have paid income tax on the cost of the gift (less \$25). Mohawk would essentially have been a surrogate taxpayer for Duberstein's accession to wealth.

- Do you think that this cuts back on the number of Cadillacs given as business gifts?

- No matter what the merits of cases, isn't litigation of business gift issues likely to be much less frequent because of § 274(b)(1)?

- Is the congressional reaction to *Duberstein* better than the position that the Commissioner argued for in the case? Of course, the congressional solution was not one that the Commissioner would be in a position to advocate.

- The congressional solution leaves the remainder of the *Duberstein* analysis intact.

9. Section 102's exclusion also extends to bequests. Section 102(b)(2) provides that income *from* gifted property is not excluded from a taxpayer's gross income. In *Irwin v. Gavitt*, 268 U.S. 161 (1925), the Supreme Court held that the gift exclusion

extended to the gift of the corpus of a trust, but not to the income from it. *Id.* at 167. An income beneficiary for life must pay income tax on that income; the remainderman does not pay income tax on the property.

- Notice that the value of a remainderman's interest is less than the fmV of the property itself because she will not acquire it until the income beneficiary dies.
- If the donor had simply given the corpus outright without subjecting it to a life estate, the value of the exclusion would have been more. Where did this loss in value disappear to? Shouldn't *someone* benefit from it?
- Might these points ever be important in matters of estate planning? How so?

10. Taxpayer was an attorney who entered into a contract with a client whereby he agreed to provide whatever legal services she should require for the remainder of her life without billing her. The client agreed to bequeath to taxpayer certain stock. Eventually the client died, and taxpayer received the stock. Taxpayer argued that the fmV of the stock should be excluded from his gross income under § 102(a).

- Do you agree? See *Wolder v. Commissioner*, 493 F.2d 608 (2d Cir.), *cert. denied*, 419 U.S. 828 (1974).

11. Read §§ 74 and 274(j) carefully. Notice how the scope of the rule of § 74(a) is delineated by “exceptions” stated in § 74 (b, c, and d). The “exception” of § 74(c) is further refined by examining limitations and definitions of terms applicable to employer deductions in § 274(j).

- Congress frequently articulates precise tax rules through the statement of a broad rule followed by specific exceptions and definitions.
- When you see the word “qualified” in a Code section, e.g., “qualified plan award,” *look for* a definition of the phrase.



Do the CALI Lesson, *Basic Income Taxation: Gross Income: Gifts, Bequests, Prizes, and Donative Cancellations of Indebtedness*.

12. Recall from Chapter 1: *The Essence of Basis*: Adjusted basis represents money that will not again be subject to income tax, usually because it is what remains after taxpayer already paid income tax on a greater sum of money. More pithily: basis is “money that has already been taxed” (and so can’t be taxed again).

- Section 1015 states a special rule governing a donee’s basis in property

that she acquired by gift. Read the first sentence of § 1015(a). What rule(s) does it state?

13. Consider this hypothetical posed by the Supreme Court in *Taft v. Bowers*, 278 U.S. 470 (1929), where the Court held that the Code's adjusted basis rules applicable to gifts are constitutional:

"In 1916, A purchased 100 shares of stock for \$1000, which he held until 1923, when their fair market value had become \$2000. He then gave them to B, who sold them during the year 1923 for \$5000."

- (i) On how much gain must B pay income tax in 1923? *See* § 1015(a).
- (ii) Suppose that A had purchased the shares for \$5000 and gave them to B in 1923 when their fmV was \$2000. B sold the shares later in 1923 for \$1000. How much loss may B claim on her income tax return for 1923?
- (iii) Suppose that A had purchased the shares for \$2000 and gave them to B when their fmV was \$1000. B sold the shares in 1923 for \$1500. How much gain or loss must B claim on her income tax return?
- (iv) Suppose that A had purchased the shares for \$2000 and gave them to B when their fmV was \$1000. B sold them in 1923 for \$5000. On how much gain must B pay income tax in 1923?
- (v) Suppose that A had purchased the shares for \$2000 and gave them to B when their fmV was \$3000. B sold them in 1923 for \$1000. How much loss may B claim on her income tax return?

*Mixing taxes to increase basis:* When we say that "basis is money that has already been taxed (and so can't be taxed again)," we are referring to the *federal income tax*. The federal estate and gift taxes are *not in pari materia* with the federal income tax. Hence, payment of federal estate or gift tax does not affect liability for federal income tax, and vice versa. It follows that payment of federal estate or gift taxes should not affect a taxpayer's income tax basis in her property. *However*, § 1015(d) makes an exception to this (quite logical) rule. Read § 1015(d)(1 and 6). What rule(s) does this provision state?

14. The federal estate and gift taxes are *in pari materia* with each other. The federal income tax is *not in pari materia* with the federal estate and gift taxes.

- What does this mean?

15. Now consider the effect of § 1015(d)(1 and 6). Assume that the gift tax on any gift is 20% of the *fmv* of the gift. Assume also that the gift was made in 2022. How does this change your answers to the first question immediately above?

16. What should be the basis rules when property is acquired partly by gift and partly by sale, i.e., when donee pays less than the property's *fmv*? *See* Reg. § 1.1015-4.

17. What should be the basis rules when property is acquired from a decedent? Read § 1014. Identify the major loophole that the statute creates.

- What problem does § 1014(e) address?

- When taxpayer's basis in property is determined under § 1014, she is presumed to have held the property for more than one year, § 1223(9), a matter important to the computation of taxpayer's tax liability. *See* chapter 10, *infra*.

18. *Working with some tax rules*: Consider:

- “[E]nrichment through increase in value of capital investment is not income in any proper meaning of the term.” *Eisner v. Macomber*, 252 U.S. 189, 214-15 (1920).

- Borrowed money is not included in a taxpayer's gross income.

- § 1014(a).

Very wealthy taxpayers can adopt the strategy of “buy, borrow, die.” Explain what you think this strategy is and how it increases wealth inequality.



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Computation of Gain and Loss Realized*.

- This exercise brings together several principles you should have learned.

*B. Exclusion of Gain from Sale of Principal Residence: § 121*

**Tax Cuts and Jobs Act:** The Tax Cuts and Jobs Act limited the debt for which home mortgage interest is deductible for 2018 to 2025. These limits are lower than they had been. In 2026, the limit on the mortgage interest deduction will again be interest on up to \$1,000,000 of acquisition indebtedness and interest on up to \$100,000 of home equity indebtedness.

The Tax Cuts and Jobs Act provides for a similar seven-year suspension of unlimited deductibility of property taxes plus state and local income taxes or sales and local sales taxes. There is an overall limit of \$10,000 on the aggregate of all these taxes. § 164(b)(6)(B). Foreign real property taxes are not deductible during the same seven-year period. § 164(b)(6)(A).

The Tax Cuts and Jobs Act doubled the amount of the standard deduction. Doubling the standard deduction and limiting deductions for some of the more significant deductions for homeowners will inhibit pursuit of the goal of an “ownership society.”

In a politically-charged environment, it was not lost on politicians that coastal “blue” states are typically home to high-cost houses and high state and local taxes. Are the TCJA’s limits on deductions simply a matter of “politics?”

President George Bush II announced early in his presidency that he wanted America to be an “ownership society.” How would (does) widespread taxpayer ownership of private homes make America a better place? We have already examined imputed income derived from ownership of property – a significant matter when it comes to a taxpayer’s principal residence.

- Read § 121.
- What is the rule of § 121(a)?
- Does § 121 promote an “ownership society” – or something else? Don’t forget that –
- § 163(h) permits deduction of mortgage interest on up to \$750,000.
- § 164(a)(1) permits a deduction for state and local real property taxes. The deduction for these taxes plus state and local income or sales taxes is subject to an aggregate limit of \$10,000.

- Notice that § 121(b)(5) and

§ 121(c) employ pro-rating ratios so that at least some taxpayers who fail to meet *all* the requirements of § 121(a) and § 121(b)(3) can derive *some* benefit from home ownership.



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Exclusion of Gain on the Sale of a Principal Residence*.

- Notice: “ownership” and “use” are different concepts.

### *C. Interest on State and Local Bonds: § 103*

Read §§ 103 and 141.

Interest derived from a state or local bond is excluded from a taxpayer’s gross income. § 103(a). This exclusion does not extend to interest derived from some “private activity bonds,” § 103(b)(1), “arbitrage bonds,” § 103(b)(2), or bonds not in registered form, § 103(b)(3). This provision has always been a part of the Code because it was not always clear that Congress has the constitutional power to tax such income.

It might appear that § 103 would encourage investors to choose to purchase the bonds of state and local governments. After all, the interest income that such bonds generate is not subject to tax, whereas other investment income is subject to federal income tax. The investor should be able to keep more of her income. However, both borrowers (state and local governments) and investors know that the interest on such bonds is not subject to federal income tax. Hence, state and local governments can borrow money at less than prevailing interest rates, i.e., the rate that any other borrower would have to pay. If the market “bids down” the interest rate to the point that taxpayers in the highest tax bracket (37% until 2026, 39.6% after 2025) are no better off than they would be if they had purchased a corporate bond carrying equivalent risk and paid the income tax on the interest that they receive, the exclusion would function “only” as a means by which the U.S. Treasury transfers the tax revenue that it must forego to state and local governments. There are some (potential) economic distortions that this exclusion causes:

- If there are enough taxpayers in the highest tax bracket to “clear the market” for state and local bonds, the interest rate on such bonds should gravitate to  $(1 - \lambda) \times (\text{prevailing interest on corporate bonds})$ , where  $\lambda$  denotes the highest marginal tax rate. If this is the case, *all* the tax that the U.S. Treasury foregoes is transferred to state and local governments.

- *But if* there are *not* enough taxpayers in the highest tax bracket to “clear the market” for state and local bonds, state and local governments must offer an interest rate higher than  $(1 - \lambda) \times$  (prevailing interest on corporate bonds). Perhaps it will be necessary to entice some taxpayers in the second-to-highest or even third-to-highest bracket to purchase such bonds. The effect of this is to give taxpayers in the highest tax bracket a windfall, i.e., an after-tax return on state and local bonds that is higher than the after-tax return on corporate bonds. In *this* case, not all the foregone tax revenue is transferred from the U.S. Treasury to state and local governments; some of it is transferred to taxpayers in the highest tax bracket.
- How will this affect the market for corporate bonds?
- In effect, those who invest in state and local bonds have the power to “vote” to have some of their tax dollars go to state and local governments rather than to the federal government. Most of the (rational) voters will have high incomes.
- There is no limit to the amount of interest that a taxpayer may exclude under this provision.<sup>49</sup> Hence state and local governments may be encouraged to borrow more than they otherwise would. The laws of some states limit the amount that they can borrow.
- State and local governments may elect to finance “too many” capital projects – e.g., highways, schools, government buildings – by issuing bonds, as opposed either to foregoing such expenditures or procuring necessary funds in another manner, e.g., raising taxes.

#### *D. Scholarships: § 117*

Read § 117.

What justification do you see for the exclusion(s) provided by § 117? Some of you receive scholarship assistance on which you pay no federal income tax. Others do not receive such assistance and must work to be here. The wages that such students earn *are* subject to federal income tax.

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<sup>49</sup> However, such interest might be a “tax preference” item, § 57(a)(5) (private activity bonds), and so subject to the AMT. § 55(b)(2)(B).



Problem:

Moldaaur is the son of a professor at the Mega State University. Moldaur has enrolled at Mega State University. Tuition is \$20,000 at Mega State University. Moldaur is entitled to a 50% reduction in his tuition because he is the son of a professor. In addition, Moldaur qualified for a Hoffnung Scholarship under the state's lottery-to-education scholarship program. The state collects lottery revenues and divides them equally among those who qualify for scholarships. This year, each scholarship recipient was credited with \$14,000 towards tuition. The result for Moldaur is that he had a \$4000 account surplus, which the university refunded to him.

- Tax consequences to Moldaur? Read § 117(b)(1) and Prop. Reg. § 1.117-6(c)(1) carefully.
- Tax consequences to Moldaur's father? Read § 117(d) carefully.



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Scholarships*.

### *E. Rental Value of Parsonages: § 107*

Read §§ 107 and 265.

A “minister of the gospel” may exclude the housing allowance that a congregation pays to her. Such a taxpayer may spend some of this allowance on home mortgage interest (deductible under § 163(h)) or real estate taxes (deductible under § 164(a)(1)). Explain how this is a double dip. Section 265(a)(6) permits this double dip. How might a congregation, as payor of this allowance, capture some or all the benefit of the exclusion? The United States Court of Appeals for the Seventh Circuit held that § 107 does not violate the Establishment Clause of the First Amendment. *See Gaylor v. Mnuchin*, 919 F.3d 420, 437 (7<sup>th</sup> Cir. 2019).

## **II. Social Benefits**

The Code excludes from gross income payments for various benefits or the fmv of benefits taxpayer receives in kind. Who should administer government benefit programs, e.g., benefits for workplace injury? Who administers benefit “programs” when they are the product of exclusions from gross income?

*A. Life Insurance Death Benefits, § 101, and Annuities, § 72*

*A bit about insurance.* The basic idea of insurance, of course, is that individual persons purchase a policy that promises payment upon materialization of a specified risk. The policy is effective for a certain period, e.g., one year. The insurance company pools the premiums, and pays those for whom the risk materializes. Notice that policy-holders pay their premiums from after-tax money. Cf. § 264(a)(1) (no deduction for taxpayer-beneficiary for payment of premiums). We could treat the “winner” as if she has simply received a gift from those who contributed to the pool of money. Under such a rationale, the proceeds would be excluded from gross income by § 102.

Section 101(a)(1) excludes from gross income “amounts received (whether in a single sum or otherwise) under a life insurance contract, if such amounts are paid by reason of the death of the insured.” This provision has always been a part of the Code, and the desire to avoid taxing heirs has made repeal difficult. Many people purchase life insurance so that family members will receive money at a time when they no longer have the income of the deceased insured. It could be unseemly

to tax a grieving family under such circumstances. However, life insurance proceeds might become an investment of a beneficiary who does not collect them. So:

- “If any amount excluded from gross income ... is held under an agreement to pay interest thereon, the interest payments shall be included in gross income.” § 101(c).
- If life insurance proceeds are paid otherwise than as a lump sum, a portion of each payment is allocated pro rata to the amount excluded and the remaining return on investment *is* subject to income tax. § 101(d)(1).

Consider: H purchased a life insurance policy on his life with a face amount of \$200,000 and named W as the beneficiary. H died. W and the insurance company entered an agreement whereby the insurance company would hold \$200,000 and pay her \$250,000 in five years; W would have no claim of right to the funds during that time. After five years, instead of paying W \$250,000, the insurance company will pay W \$28,000 per year at a time when her life expectancy will be ten years.

- How would the payments to W be taxed during the first five years after H’s death, assuming W had no claim of right during that time?
- How would the payments to W during the succeeding ten years be taxed?

•See §§ 101(c and d); Reg. § 1.101-3(a); Reg. § 1.101-4(c); Reg. § 1.101-4(a)(1)(i); Reg. § 1.101-4(g) (Examples 1 and 3 (first two sentences only)<sup>50</sup>).

•The last provision might not be in your edition of the Regulations. Go to Westlaw or Lexis to find it.

Section 101(a)(2) provides that in the case of a transfer of a life insurance contract for valuable consideration, the exclusion is lost. The beneficiary in such a case may exclude only the amount she paid for the policy plus any subsequent premiums that she paid.

- An exception to this exception is made when the transferee takes for her basis the basis of the transferor. § 101(a)(2)(A).

- When might a transferee take for her basis the basis of the transferor?

- Another exception to the exception is made when the

transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer. § 101(a)(2)(B).

*A note about life insurance.* Life insurance comes in various forms, and tax benefits can extend well beyond excluding death benefits from gross income. “Life insurance contract” is defined in § 7702 so as to preclude an investment from being a “life insurance contract.” To be insurance, there must be a shifting of risk from the insured to the insurer.

- Term insurance is insurance that promises only for the term for which it is purchased to pay upon the occurrence of death. Upon expiration of the term, the policyholder has nothing.

- Permanent life insurance is life insurance that the insured maintains by paying a premium periodically. Premiums for permanent life insurance are higher than they are for term insurance; the insurance company invests the excess on behalf of the insured. The policy builds up cash value (“inside buildup”) – *tax-free*. Inside buildup can reduce premiums in future years, notably as premiums would otherwise increase because the insured is older and the risk of her death greater.

- Non-taxation of inside buildup permits permanent life insurance to function as a tax shelter.

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<sup>50</sup> Section 101(d)(1)(B) (repealed) provided a \$1000 exclusion from gross income for a surviving spouse beneficiary in addition to the exclusion provided by pro-rating a payment between recovery of basis and taxable income. This \$1000 additional exclusion has been repealed, but the regulations still incorporate it.

- When (why) would transfers such as those described in § 101(a)(2)(B) occur?

H purchased a permanent life insurance policy on his life with a face amount of \$300,000. He named W as the beneficiary. When H was 63 years old, and H and W's children no longer depended on them for support, W died. H saw no need to continue making premium payments so he sold the policy to his employer for \$100,000.

- How would you compute H's gross income from this sale?
- How would you compute H's gross income if instead H surrendered the policy to the insurance company for its cash value of \$100,000?
- Are there additional facts that you would need to know?
- Read on.

In Rev. Rul. 2009-13, 2009-21 I.R.B. 1029, the IRS took the position that a policy holder who *surrendered* a life insurance policy (Situation 1) should recognize as ordinary income gain equal to the cash surrender value received less the total of all premiums previously paid. The cash surrender value reflected cost-of-insurance charges. In contrast, a policy holder who *sold* a life insurance policy to an unrelated person (Situation 2) should reduce his basis by the cost-of-insurance and compute gain accordingly. Gain equal to inside buildup was subject to income tax as ordinary income; gain in excess of inside buildup was taxed as capital gain.

- In the case of *surrender* of a life insurance policy, inside buildup that had paid at least some of the premiums was *not* subject to tax. In the case of a *sale* of an insurance policy, inside buildup that had paid at least some of the premiums *was* subject to tax.<sup>51</sup>

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<sup>51</sup> Application of the rules for the commercial sale of a life insurance policy require access to information not always readily available. The Tax Cuts and Jobs Act added § 101(a)(3). Section 101(a)(3) defines a "reportable policy sale" to be an acquisition of an interest in a life insurance policy when the acquirer has no family, business, or financial interest with the insured other than an interest in the life insurance policy. Every person who acquires such an interest in a life insurance policy must report it to the IRS and to all persons, including the issuer, named in such notice. § 6050Y(a). The issuer of the policy is to notify the IRS and the seller(s) of the amount of investment in the insurance contract. § 6050Y(b). Payment of death benefits triggers a reporting requirement on the part of the payor of the gross amount of payments and an estimate of the buyer's investment in the contract. § 6050Y(c).

- The Tax Cuts and Jobs Act (2017) amended § 1016 to provide that no adjustment to the basis of an annuity or life insurance contract is to be made “for mortality, expense, or other reasonable charges incurred[.]” 1016(a)(1)(B).

- How does this amendment of § 1016 change the outcomes of Situations 1 and 2 of Rev. Rul. 2009-13? *See* Rev. Rul. 2020-5, 2020-9 I.R.B. 454.

*Notes and Questions:*

1. In Situation 2, assume that the face amount of the policy was \$400,000. B paid \$80,000 for the policy plus another \$500 per month in premiums for another six years. A died. B received \$400,000 from the life insurance company. How much must B include in her gross income?

2. Section 72 provides another opportunity to read a Code section replete with rules, exceptions, and definitions. The following paragraphs explain these rules, exceptions, and definitions. You must learn to read Code provisions for yourself.

3. Section 72 governs the tax treatment of payouts from an *annuity contract*. Section 72(a)(1) provides that gross income includes “any amount received as an annuity ... under an annuity, endowment, or life insurance contract.”

- Thus, annuity treatment can only apply to payments made under the named type of contracts.

- A taxpayer may invest after-tax dollars in an annuity contract. As with life insurance contracts, the inside buildup of an annuity contract is not subject to income tax. At a certain point in time, the taxpayer begins to receive a stream of payments from the investment and the income that the annuity has accumulated.

- You should see immediately that taxpayer will be receiving some of her own after-tax money and some not-yet-taxed investment income.

- There may be a fixed number of payments or the stream of payments may terminate only on the death of the taxpayer. Section 72 allocates a portion of each payment to taxpayer’s recovery of basis and a portion to not-yet-taxed inside buildup. § 72(b)(1).

- Section 72(c)(1) defines taxpayer’s “investment in the contract.”

- Section 72(c)(4) defines “annuity starting date” as “the first day of the first period for which an amount is received as an annuity under the contract[.]”

- Section 72(a)(1) provides that taxpayer must include in gross income “any amount received as an annuity[.]”
- Section 72(b)(1) excepts from “amounts received as an annuity” a prorated amount of taxpayer’s basis in the contract. This requires a determination of taxpayer’s “expected return under the contract.”
- If the “expected return” depends on the life expectancy of one or more individuals, taxpayer determines the “expected return” in accordance with actuarial tables that the Secretary of the Treasury has prescribed. These tables are in the regulations, *see* Reg. § 1.72-9.
  - Simply multiply the number of payments taxpayer can expect based on these actuarial tables by the amount of each payment. This product is the “expected return.”
  - Divide the taxpayer’s investment in the contract by the “expected return.” § 72(b)(1). Taxpayer multiplies this quotient by “any amount received as an annuity” to determine the amount that she excludes from gross income. *Id.*
- If taxpayer outlives what the actuaries predicted ...*: Once taxpayer has excluded her investment in the annuity contract from her gross income, taxpayer may no longer exclude any “amount received as an annuity” from her gross income. § 72(b)(2).
  - After all, receipt of such a payment would be an accession to wealth, i.e., income, which must be subject to income tax once.
- If taxpayer dies before the actuaries predicted she would ...*: On the other hand, should payments cease because taxpayer died prior to recovery of taxpayer’s investment in the contract, taxpayer may deduct the amount of the unrecovered investment for her last taxable year. § 72(b)(3)(A).

4. Section 72(e) states rules applicable to amounts received under an annuity, endowment, or life insurance contract that are *not* received as an annuity – *if* no other provision of this subtitle is applicable. § 72(e)(1).

- Section 1001 is a provision of “this subtitle” and applies when a life insurance policy is sold – and now without reduction of basis for mortality charges.

5. Section 101(g): Amounts that a “terminally ill” or “chronically ill” person receives under a life insurance contract may qualify for exclusion under § 101(a)(1). The same is true of the “amount realized” on the sale of a life insurance policy to a “viatical settlement provider.” § 101(g)(2).

- A “terminally ill” taxpayer is one who is certified by a physician as having

“an illness or physical condition which can reasonably be expected to result in death in 24 months or less after the date of the certification.” § 101(g)(4)(A).

- A “chronically ill” taxpayer is one who is not “terminally ill” and is unable to perform at least two activities of daily living (i.e., eating, toileting, transferring, bathing, dressing, and continence) or requires substantial supervision to protect herself “from threats to health and safety due to severe cognitive impairment.” § 101(g)(4)(B), referencing § 7702B(c)(2).

- A “chronically ill” taxpayer must use the payment for unreimbursed costs of long-term care. § 101(g)(3)(A).

Section 101(g) enables an insured taxpayer to get money out of a life insurance policy at a time when she has a substantial need for cash and the risk of death has nearly materialized.



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Annuities and Life Insurance Proceeds*. You may have to read some portions of the Code to answer all the questions. That would be a good thing. In a *tax-deferred* corporate reorganization, the basis of the transferee is determined by reference to the basis of the contract in the hands of the transferor.

### *B. Compensation for Injuries or Sickness: §§ 104, 105, 106*

Read § 104. Injured persons stand in need of compensation. Consider the precise extent to which the subsections of § 104 exclude compensation for injury from gross income.

- § 104(a)(2): Section 104(a)(2) seems to encourage taxpayers to search for a physical injury, much as a tort claim for negligent infliction of emotional distress impels a plaintiff to search for a physical manifestation. Review part IIB of CADC’s opinion in *Murphy v. Internal Revenue Service*, 493 F.3d 170 (CADC 2007), *supra*, chapter 2. The Government was correct in its reading of the “on account of” language in the statute. There must be a strong causal connection between the physical injury and the emotional distress – not the other way around – in order for § 104(a)(2) to exclude it from gross income by § 104(a)(2).

•§ 104(a)(3): What does § 104(a)(3) mean? What health or accident insurance payments does § 104(a)(3) reference?

- “Health and accident” insurance includes wage continuation policies. This is important for employees whose employers provide health insurance but not disability insurance.

- The exclusion applies to multiple payments from more than one self-purchased policy, even though the amount received exceeds the expense against which taxpayer procured the insurance.

•Read § 105. Notice the layout of § 105. Section 105(a) establishes a broad rule of inclusion in gross income. But use of the “except as otherwise provided in this section” language enables Congress to define the precise scope of an exclusion. What rule emerges from §§ 105(a and b)?

•The following two problems are derived from and answered by Rev. Rul. 69-154, 1969-1 C.B. 46. What is your intuition about how they should be solved? Feel free to look up that revenue ruling.

- C is covered by his employer’s health insurance policy. C’s employer pays the annual premium of \$10,000. This amount is excluded from C’s gross income. *See* § 106(a). In addition, C paid the entire premium of \$5000 for a personal health insurance policy.

- During the year, C had only one illness and incurred and paid total medical expenses, as defined in § 213 of the Code, of \$2700. In the same year, C was indemnified \$2100 by his employer’s insurance policy and \$1500 by his personal insurance policy.

- What is C’s gross income from the insurance companies’ reimbursements?

- D is covered by a health insurance policy. The annual premium is \$10,000. D’s employer pays \$4000; D excludes this amount from his gross income. D’s employer deducts the other \$6000 from D’s taxable wages. In addition, D paid the entire premium of \$5000 for a personal health insurance policy.

- During the year, D had only one illness and paid total medical expenses, as defined in § 213 of the Code, of \$2700. In the same year, D was indemnified \$2100 by his employer’s insurance policy and \$1500 by his personal insurance policy.

- What is D’s gross income from these reimbursements?



- Read § 106(a).



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Damages and Related Receipts*.

### *C. Payments to Wrongfully Incarcerated Individual: § 139F*

Section 139F provides: “In the case of any wrongfully incarcerated individual, gross income shall not include any civil damages, restitution, or other monetary award (including compensatory or statutory damages and restitution imposed in a criminal matter) relating to the incarceration of such individual for the ... offense for which such individual was convicted.”

### *D. Social Security: § 86*

Read § 86. It is not an easy read. Section 86 is among the Code provisions that require inclusion of certain items in gross income. Section 86 limits the amount of social security benefits that a taxpayer *must include* in gross income. Taxpayer *excludes the remainder*.

Exclusion by discretion: On occasion, the IRS may choose not to require taxpayers to include some benefit in their gross income. You may surmise the reasons why the IRS might take such a position. Examples of such discretionary exclusions include frequent flyer miles “earned” for business or official travel, see Announcement 2002-18 (so long as not converted to cash) and identity protection services provided to data breach victims, see Announcement 2015-35.

- Section 86 establishes three levels of taxable social security income that are subject to different rules of inclusion. We begin with an amount of income that § 86(b)(1)(A) defines.

- The amount of a taxpayer’s income determined under § 86(b)(1)(A) will either be –

- below the statutory “base amount.”

- above the statutory “base amount” but below the statutory “adjusted base amount.”

OR

- above the statutory “adjusted base amount.”

Again, notice that the Code uses definitions to delimit its rules. As you read the text that follows, examine the Code sections cited. Rather than try to state the computation rules, we will apply the rules through three problems involving the taxpayer “Joe the Pensioner.” He is single and receives social security benefits. Consider:

- Joe the Pensioner received \$20,000 of social security benefits payments last year. In addition, he received \$1000 in municipal bond interest that § 103 exempts from his gross income. Joe also did some work for his old employer for which he received \$6000. What is Joe’s gross income?
- Section 86(a) with deceptive simplicity sets forth rules governing taxpayer inclusion in gross income of social security benefits. Section 86(a) requires computations of various amounts and then comparing them. Hopefully, we can reduce this to a few straight-forward “if ... then” rules. It is best<sup>52</sup> to begin with § 86(b) – the provision that defines the “Taxpayers to Whom Subsection (a) applies.”
  - Section 86(b)(1)(A)(i) requires that we determine what Joe’s “modified agi” is. That phrase is defined in § 86(b)(2). Joe’s AGI at the moment, not counting his social security benefits or tax-exempt interest, is \$6000. To obtain Joe’s “modified agi,” we do not add his benefits (§ 86(b)(2)(A) (“determined without regard to this section”)) but we do add certain items, including his tax-exempt interest income, § 86(b)(2)(B), i.e., \$1000. *Joe’s modified adjusted gross income is \$7000.*
  - Section 86(b)(1)(A) requires us to add Joe’s *modified adjusted gross income plus one-half of his social security benefits*.  $\$7000 + \$10,000 = \$17,000$ . We will refer to this as the “(b)(1)(A) amount.”
  - Subtract the “base amount” from \$17,000. § 86(b)(1)(A and B).
    - “Base amount” is defined for Joe in § 86(c)(1)(A) as \$25,000.
    - According to § 86(a)(1), Joe must include in his gross income the lesser of one-half of the social security benefits that he received or one-half of the amount by which his “(b)(1)(A) amount” exceeds his “base amount.”
    - Joe’s “modified agi” does not exceed his “base amount,” so one-half of the excess described in § 86(b)(1) in our case will of course be \$0.
    - § 86(a)(1) requires a comparison:  $\$0 < \$10,000$ .
    - Joe must include the lesser of these figures, i.e., \$0, of his Social

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<sup>52</sup> ... in my view.

Security benefits in his gross income.

Notice that *if* the base amount exceeds taxpayer's "modified agi" plus one-half of her social security benefits, *then* there will be no "excess" – a term that appears in § 86(a)(1)(B). We can state the following straight-forward rule.

**1. If taxpayer's "modified agi" plus one-half of her social security benefits is less than the statutory "base amount," none of taxpayer's social security benefits will be subject to federal income tax.**

Now suppose that Joe the Pensioner received \$20,000 of social security benefit payments, \$1000 in tax exempt interest, and \$18,000 of payments for work he did for his old employer.

- Joe's "modified agi" plus one-half of his social security benefits (i.e., "(b)(1)(A)" amount) is \$29,000. This is \$4000 more than the statutory "base amount," i.e., \$25,000, § 86(c)(1)(A).

- Section 86(a)(2) describes a taxpayer whose "(b)(1)(A) amount" is more than an "adjusted base amount." For Joe, the "adjusted base amount" is \$34,000. § 86(c)(2)(A). Joe's "(b)(1)(A) amount" does not exceed his "adjusted base amount," so § 86(a)(1) applies to him.

- According to § 86(a)(1), Joe must include in his gross income the lesser of one-half of the social security benefits that he received or one-half of the amount by which his "(b)(1)(A)" amount exceeds his "base amount."

- The first amount is \$10,000. The second amount is \$2000.

- Joe must include \$2000 of social security benefits in his gross income.

We can now state the second of our straight-forward rules.

**2. If taxpayer's "modified agi" plus one-half of her social security benefits is more than the statutory "base amount" but less than the "adjusted base amount," taxpayer must include in her gross income the lesser of one-half of her social security benefits or one-half of the amount by which her "modified agi" exceeds the statutory base amount.**

Now suppose that Joe the Pensioner received \$20,000 of social security benefit payments, \$1000 in tax exempt interest, and \$30,000 of payments for work he did for his old employer.

- Joe's "(b)(1)(A)" amount is now \$41,000. This is \$7000 more than his "adjusted base amount," i.e., \$34,000, § 86(c)(2)(A). This means that § 86(a)(2) applies rather than § 86(a)(1).
- Section 86(a)(2) requires us to determine two different amounts and to include the lesser in Joe's gross income.
  - The first amount (§ 86(a)(2)(A)) is –
    - 85% of the "excess," i.e., 85% of \$7000, i.e., \$5950, PLUS
    - the lesser of
      - the amount that would be included in Joe's gross income if our second rule (i.e., § 86(a)(1)) did apply. The lesser of one-half of Joe's social security benefits (i.e., \$10,000) or one-half of the excess of Joe's "(b)(1)(A)" amount over his "base amount" (i.e.,  $\frac{1}{2}$  of  $(\$41,000 - \$25,000) = \$8000$ ) is \$8000.
      - or
      - one-half of the difference between Joe's "base amount" and "adjusted base amount." The difference between Joe's "base amount" and his "modified base amount" is  $\$34,000 - \$25,000$ . One-half of that amount is \$4500.
      - $\$4500 < \$8000$ .
  - $\$5950 + \$4500$  EQUALS \$10,450.
- The second amount (§ 86(a)(2)(B)) is –
  - 85% of Joe's social security benefit, i.e., 85% of \$20,000 = \$17,000.
- $\$10,450 < \$17,000$ . Joe must include \$10,450 in his gross income.

We state the third of our straight-forward rules.

**3. If taxpayer’s “modified agi” plus one-half of her social security benefits is more than the statutory “adjusted base amount,” taxpayer must include in her gross income the lesser of two amounts computed according to two more rules.**

*Pandemic Stimulus Checks:* Most of us are familiar with the stimulus payments made to American taxpayers to ameliorate the effects of the coronavirus pandemic in the amounts of \$1200, \$600, and \$1400. The Code treats these payments as refundable credits – not as exclusions. See 26 U.S.C. § 6428(b) (\$1200 in 2020); 26 U.S.C. § 6428A(b) (\$600 in 2020); 26 U.S.C. § 6428B(b) (\$1400 in 2021).

*E. Unemployment Benefits: § 85*

A taxpayer must include in her gross income unemployment compensation. § 85.

- The American Rescue Plan of 2021 included an amendment to § 85. For tax year 2020 only, the gross income of a taxpayer does not include \$10,200 of unemployment compensation. § 85(c). Pub. L. 117-2, tit. IX, § 9042(a), 135 Stat. 122. The limit applies individually to each spouse in the case of a joint return.

### III. Employment-Based Exclusions from Gross Income

The employment relationship is the seat of several exclusions from gross income. Sections 79, 106, 119, 127, 129, 132, and 137 exclude certain named benefits from the gross income of “an employee.” Employment-based exclusions from gross income can have a powerful influence in shaping employment relationships. Be alert to the possibility that the employer may capture the benefit of the exclusion simply by providing a benefit and then paying employees less than it otherwise would have. We should expect employees to deem employers who pay substandard wages in exchange for benefits that employees don’t really want to be not particularly desirable. The converse is true also: employees should seek out employers who provide benefits that they particularly value.

There is overlap between benefits provided in the employment setting that the Code excludes from gross income and social benefits that the Code excludes from gross income. An implicit message is that the employment setting is where employees *should* seek and employers should *provide* certain social benefits. See whether you

agree.

*A. Group Term Life Insurance: § 79*

Read § 79. What is the effect of restricting the exclusion to the purchase of group-term life insurance and not allowing discrimination in favor of a key employee? Why should there be a \$50,000 ceiling on the amount of group-term life insurance whose purchase is excluded from an employee's gross income?

The cost of group term life insurance with a death benefit that exceeds \$50,000 is gross income to the employee to the extent that such cost exceeds the cost of \$50,000 of group term life insurance plus the amount that the employee paid for such insurance. § 79(a). The regulations prescribe the monthly premium for such excess insurance. Reg. § 1.79-3(d).

*B. Educational Assistance Programs: § 127*

CARES Act, § 2206: added § 127(c)(1)(B) to provide that "educational assistance" includes payments of an employee's education loan. The provision was to sunset on December 31, 2020, but has been extended to the end of 2025 by the Taxpayer Certainty and Disaster Tax Relief Act of 2020, tit. I, subtit. B, § 120.

Read § 127. Why might a relatively low-cost private school charge more tuition per credit hour in its night or weekend MBA programs than it does for its full-time day program?

*C. Dependent Care Assistance Programs: § 129*

Read § 129. Why might a highly-paid employee prefer a dependent care assistance program to a 20% credit against income tax liability? What is the maximum

available exclusion if taxpayer has one child? Compare this figure with that of § 21.

•Consider: Taxpayers (married filing jointly) have three children, none of whom has reached the age of 13. They both work and earn substantial incomes. They are in the 35% income tax bracket, and their credit under § 21 is 20% of their dependent care expenses. They incur \$6000 of dependent care expenses during the year. Should they prefer an exclusion under § 129 or a tax credit under § 21?

ARPA, § 9632 amended § 129 to provide that in 2021, taxpayers could exclude \$10,500 (or half that amount for taxpayers married filing separately) for employer-provided dependent care assistance. This of course is more than twice the previous limit.

*D. Employer Contributions to Accident and Health Plans: § 106*

Read §§ 106 and 223.

During World War II, the nation lived under wage and price controls. Employers could circumvent wage controls by providing employees with certain benefits, notably pensions and health insurance. In 1954, Congress codified the employee exclusion of employer payments for accident or health plans in § 106(a). Recall that § 105(b) excludes the payments that such plans provide for care from gross income. Employers of course deduct whatever payments they make as employee compensation, § 162(a)(1). Most of the money that employees spend or employers spend on their behalf for health care is not subject to income tax at either the employer or employee level. In

ARPA, § 9631 amended § 21 to provide that in 2021, taxpayers could claim a credit for much more of their dependent care expenses. First, the credit is made refundable. Second, the dollar limit of employment-related expenses was increased to \$8000 for one qualifying individual, and \$16,000 for two or more qualifying individuals. Third, the “applicable percentage” is 50%, subject to the same phasedown rules. Fourth, the “applicable percentage” is reduced only as taxpayer’s agi exceeds \$125,000. Hence, 20% is the “applicable percentage” only for taxpayers whose agi exceeds \$185,000. Sixth, for taxpayers whose agi exceeds \$400,000 the “applicable percentage” phases out by 1 percentage point for each \$2000 (or fraction thereof) by which taxpayer’s agi exceeds \$400,000.

the United States health care is now a significant aspect of any employment relationship. Health care costs have spiraled upward. Payments for health plans have become the biggest expenditure that employers make for employee benefits. Highly distorted markets for health care services now prevail. *See* William P. Kratzke, *Tax Subsidies, Third-Party Payments, and Cross-Subsidization: America's Distorted Health Care Markets*, 40 U. MEM. L. REV. 279 (2009).

Health Savings Accounts (HSA) are savings accounts established for the benefit of an individual who has a high-deductible health plan. *See* § 223. An employee taxpayer may deduct the contributions she makes to such an account. § 223(a). An employee taxpayer may exclude employer contributions to such an account. § 106(d). Unspent funds in an HSA grow tax-free. § 223(e)(1). There is a monthly limit to the amount that taxpayer may save in such accounts. The savings in the account can be withdrawn without income tax to pay for medical expenses, presumably for the deductible portion that the health plan does not pay for. § 213(f)(1). Employer contributions to an HSA are not subject to employment taxes, § 106(d)(1), but employee contributions are subject to employment taxes.

*E. Meals or Lodging Furnished for the Convenience of the Employer: § 119*

Read § 119.

**Commissioner v. Kowalski**, 434 U.S. 77 (1977)

MR. JUSTICE BRENNAN delivered the opinion of the Court.

This case presents the question whether cash payments to state police troopers, designated as meal allowances, are included in gross income under § 61(a) of the Internal Revenue Code ..., 26 U.S.C. § 61(a), [footnote omitted] and, if so, are otherwise excludable under § 119 of the Code, 26 U.S.C. § 119. [footnote omitted]

I

... Respondent [footnote omitted] is a state police trooper employed by the Division of State Police of the Department of Law and Public Safety of the State of New Jersey. During 1970, the tax year in question, he received a base salary of \$8,739.38, and an additional \$1,697.54 [footnote omitted] designated as an



allowance for meals.

... Under [the State’s cash allowance] system, troopers remain on call in their assigned patrol areas during their midshift break. Otherwise, troopers are not restricted in any way with respect to where they may eat in the patrol area and, indeed, may eat at home if it is located within that area. Troopers may also bring their midshift meal to the job and eat it in or near their patrol cars.

The meal allowance is paid biweekly in advance and is included, although separately stated, with the trooper’s salary. The meal allowance money is also separately accounted for in the State’s accounting system. Funds are never commingled between the salary and meal allowance accounts. Because of these characteristics of the meal allowance system, the Tax Court concluded that the “meal allowance was not intended to represent additional compensation.”

Notwithstanding this conclusion, it is not disputed that the meal allowance has many features inconsistent with its characterization as a simple reimbursement for meals that would otherwise have been taken at a meal station. For example, troopers are not required to spend their meal allowances on their midshift meals, nor are they required to account for the manner in which the money is spent. ... [N]o reduction in the meal allowance is made for periods when a trooper is not on patrol because, for example, he is assigned to a headquarters building or is away from active duty on vacation, leave, or sick leave. In addition, the cash allowance for meals is described on a state police recruitment brochure as an item of salary to be received in addition to an officer’s base salary and the amount of the meal allowance is a subject of negotiations between the State and the police troopers’ union. Finally, the amount of an officer’s cash meal allowance varies with his rank, and is included in his gross pay for purposes of calculating pension benefits.

On his 1970 income tax return, respondent reported \$9066 in wages. That amount included his salary plus \$326.45 which represented cash meal allowances reported by the State on respondent’s Wage and Tax Statement (Form W-2). [footnote omitted]. The remaining amount of meal allowance, \$1,371.09, was not reported. On audit, the Commissioner determined that this amount should have been included in respondent’s 1970 income, and assessed a deficiency.

Respondent sought review in the United States Tax Court, arguing that the cash meal allowance was not compensatory, but was furnished for the convenience of the employer, and hence was not “income” within the meaning of § 61(a), and that,

in any case, the allowance could be excluded under § 119. ... [T]he Tax Court, with six dissents, [footnote omitted] held that the cash meal payments were income within the meaning of § 61 and, further, that such payments were not excludable under § 119. [footnote omitted]. The Court of Appeals for the Third Circuit, in a per curiam opinion, held that its earlier decision in *Saunders v. Commissioner*, 215 F.2d 768 (1954), which determined that cash payments under the New Jersey meal allowance program were not taxable, required reversal. We granted certiorari to resolve a conflict among the Courts of Appeals on the question. [footnote omitted]. We reverse.

## II

### A

The starting point in the determination of the scope of “gross income” is the cardinal principle that Congress in creating the income tax intended “to use the full measure of its taxing power.” [citations omitted]. ... In the absence of a specific exemption, therefore, respondent’s meal allowance payments are income within the meaning of § 61 since, like the payments involved in *Glenshaw Glass Co.*, the payments are “undeniabl[y] accessions to wealth, clearly realized, and over which the [respondent has] complete dominion.” *Commissioner v. Glenshaw Glass Co.*, [348 U.S. 426, 431 (1955)]. [citations omitted].

Respondent contends, however, that § 119 can be construed to be a specific exemption covering the meal allowance payments to New Jersey troopers. Alternatively, respondent argues that notwithstanding § 119, a specific exemption may be found in a line of lower court cases and administrative rulings which recognize that benefits conferred by an employer on an employee “for the convenience of the employer” – at least when such benefits are not “compensatory” – are not income within the meaning of the Internal Revenue Code. In responding to these contentions, we turn first to § 119. Since we hold that § 119 does not cover cash payments of any kind, we then trace the development over several decades of the “convenience of the employer” doctrine as a determinant of the tax status of meals and lodging, turning finally to the question whether the doctrine as applied to meals and lodging survives the enactment of the Internal Revenue Code of 1954.

### B

Section 119 provides that an employee may exclude from income “the value of any meals ... furnished to him by his employer for the convenience of the employer, but only if ... the meals are furnished on the business premises of the employer ...” By

its terms, § 119 covers meals furnished by the employer, and not cash reimbursements for meals. This is not a mere oversight. As we shall explain at greater length below, the form of § 119 which Congress enacted originated in the Senate and the Report accompanying the Senate bill is very clear: “Section 119 applies only to meals or lodging furnished in kind.” S. Rep. No. 1622, 83d Cong., 2d Sess., 190 (1954). *See also* Treas. Reg. § 1.119-1(c)(2) ... Accordingly, respondent’s meal allowance payments are not subject to exclusion under § 119.

## C

[The Court reviewed some early administrative determinations concerning the “convenience of the employer” doctrine. The phrase first appeared in O.D. 265. O.D. 514 provided that the “convenience of the employer” turned on the employer’s characterization of a (noncash, T.D. 2992) benefit as noncompensatory. Mim. 5023 provided that the “convenience of the employer” turned on the necessity of providing a benefit to the proper functioning of the employer’s business. Mim. 6472 provided that the doctrine was inapplicable whenever an employee’s receipt of a benefit represents compensation for services.]

Coexisting with the regulations and administrative determinations of the Treasury, but independent of them, is a body of case law also applying the “convenience of the employer” test to exclude from an employee’s statutory income benefits conferred by his employer.

An early case is *Jones v. United States*, 60 Ct. Cl. 552 (1925). There, the Court of Claims ruled that neither the value of quarters provided an Army officer for nine months of a tax year nor payments in commutation of quarters paid the officer for the remainder of the year were includable in income. The decision appears to rest both on a conclusion that public quarters, by tradition and law, were not “compensation received as such” within the meaning of § 213 of the Revenue Act of 1921, 42 Stat. 237, and also on the proposition that “public quarters for the housing of ... officers is as much a military necessity as the procurement of implements of warfare or the training of troops.” 60 Ct. Cl. at 569; 565-568. ...

Subsequent judicial development of the “convenience of the employer” doctrine centered primarily in the Tax Court. In two reviewed cases decided more than a decade apart, *Benaglia v. Commissioner*, 36 B.T.A. 838 (1937), and *Van Rosen v. Commissioner*, 17 T.C. 834 (1951), that court settled on the business necessity

rationale for excluding food and lodging from an employee's income.<sup>53</sup> *Van Rosen*'s unanimous decision is of particular interest in interpreting the legislative history of the 1954 recodification of the Internal Revenue Code, since it predates that recodification by only three years. There, the Tax Court expressly rejected any reading of *Jones, supra*, that would make tax consequences turn on the intent of the employer, even though the employer in *Van Rosen*, as in *Jones*, was the United States, and, also as in *Jones*, the subsistence payments involved in the litigation were provided by military regulation. [footnote omitted]. In addition, *Van Rosen* refused to follow the *Jones* holding with respect to cash allowances, apparently on the theory that a civilian who receives cash allowances for expenses otherwise nondeductible has funds he can "take, appropriate, use and expend," 17 T.C. at 838, in substantially the same manner as "any other civilian employee whose employment is such as to permit him to live at home while performing the duties of his employment." *Id.* at 836, 839-840. It is not clear from the opinion whether the last conclusion is based on notions of equity among taxpayers or is simply an evidentiary conclusion that, since *Van Rosen* was allowed to live at home while performing his duties, there was no business purpose for the furnishing of food and lodging.

Two years later, the Tax Court, in an unreviewed decision in *Doran v. Commissioner*, 21 T.C. 374 (1953), returned in part to the "employer's characterization" rationale rejected by *Van Rosen*. In *Doran*, the taxpayer was furnished lodging in kind by a state school. State law required the value of the lodging to be included in the employee's compensation. Although the court concluded that the lodging was furnished to allow the taxpayer to be on 24-hour call, a reason normally sufficient to justify a "convenience of the employer" exclusion, [footnote omitted] it required the value of the lodging to be included in

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<sup>53</sup> "The better and more accurate statement of the reason for the exclusion from the employee's income of the value of subsistence and quarters furnished in kind is found, we think, in *Arthur Benaglia*, 36 B.T.A. 838, where it was pointed out that, on the facts, the subsistence and quarters were not supplied by the employer and received by the employee 'for his personal convenience[,] comfort or pleasure, but solely because he could not otherwise perform the services required of him.' In other words, though there was an element of gain to the employee, in that he received subsistence and quarters which otherwise he would have had to supply for himself, he had nothing he could take, appropriate, use and expend according to his own dictates, but, rather, the ends of the employer's business dominated and controlled, just as in the furnishing of a place to work and in the supplying of the tools and machinery with which to work. The fact that certain personal wants and needs of the employee were satisfied was plainly secondary and incidental to the employment."

*Van Rosen v. Commissioner*, 17 T.C. at 838.

income on the basis of the characterization of the lodging as compensation under state law. The approach taken in *Doran* is the same as that in *Mim*, 6472, *supra*. [footnote omitted] However, the Court of Appeals for the Second Circuit, in *Diamond v. Sturr*, 221 F.2d 264 (1955), on facts indistinguishable from *Doran*, reviewed the law prior to 1954 and held that the business necessity view of the “convenience of the employer” test, “having persisted through the interpretations of the Treasury and the Tax Court throughout years of reenactment of the Internal Revenue Code,” was the sole test to be applied. 221 F.2d at 268.

## D

Even if we assume that respondent’s meal allowance payments could have been excluded from income under the 1939 Code pursuant to the doctrine we have just sketched, we must nonetheless inquire whether such an implied exclusion survives the 1954 recodification of the Internal Revenue Code. [citation omitted]. Two provisions of the 1954 Code are relevant to this inquiry: § 119 and § 120 [footnote omitted], now repealed [footnote omitted], which allowed police officers to exclude from income subsistence allowances of up to \$5 per day.

In enacting § 119, the Congress was determined to “end the confusion as to the tax status of meals and lodging furnished an employee by his employer.” H.R. Rep. No. 1337, 83d Cong., 2d Sess., 18 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess., 19 (1954). However, the House and Senate initially differed on the significance that should be given the “convenience of the employer” doctrine for the purposes of § 119. As explained in its Report, the House proposed to exclude meals from gross income “if they [were] furnished at the place of employment and the employee [was] required to accept them at the place of employment as a condition of his employment.” H.R. Rep. No. 1337, *supra*, at 18; *see* H.R. 8300, 83d Cong., 2d Sess., § 119 (1954). Since no reference whatsoever was made to the concept, the House view apparently was that a statute “designed to end the confusion as to the tax status of meals and lodging furnished an employee by his employer” required complete disregard of the “convenience of the employer” doctrine.

The Senate, however, was of the view that the doctrine had at least a limited role to play. After noting the existence of the doctrine and the Tax Court’s reliance on state law to refuse to apply it in *Doran v. Commissioner*, *supra*, the Senate Report states:

“Your committee believes that the House provision is ambiguous in providing that meals or lodging furnished on the employer’s premises, which the employee is required to accept as a condition of his employment,

are excludable from income whether or not furnished as compensation. Your committee has provided that the basic test of exclusion is to be whether the meals or lodging are furnished primarily for the convenience of the employer (and thus excludable), or whether they were primarily for the convenience of the employee (and therefore taxable). However, in deciding whether they were furnished for the convenience of the employer, the fact that a State statute or an employment contract fixing the terms of the employment indicate the meals or lodging are intended as compensation is not to be determinative. This means that employees of State institutions who are required to live and eat on the premises will not be taxed on the value of the meals and lodging even though the State statute indicates the meals and lodging are part of the employee's compensation." S. Rep. No. 1622, *supra*, at 19.

In a technical appendix, the Senate Report further elaborated:

"Section 119 applies only to meals or lodging furnished in kind. Therefore, any cash allowances for meals or lodging received by an employee will continue to be includible in gross income to the extent that such allowances constitute compensation." *Id.* at 190-91.

After conference, the House acquiesced in the Senate's version of § 119. Because of this, respondent urges that § 119, as passed, did not discard the "convenience of the employer" doctrine, but indeed endorsed the doctrine shorn of the confusion created by Mim. 6472 and cases like *Doran*. Respondent further argues that, by negative implication, the technical appendix to the Senate Report creates a class of noncompensatory cash meal payments that are to be excluded from income. We disagree.

The Senate unquestionably intended to overrule *Doran* and rulings like Mim. 6472. Equally clearly, the Senate refused completely to abandon the "convenience of the employer" doctrine as the House wished to do. On the other hand, the Senate did not propose to leave undisturbed the convenience of the employer doctrine as it had evolved prior to the promulgation of Mim. 6472. The language of § 119<sup>54</sup> quite plainly rejects the reasoning behind rulings ... which rest on the employer's characterization of the nature of a payment. [footnote omitted]. This conclusion is

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<sup>54</sup> "[T]he provisions of an employment contract ... shall not be determinative of whether ... meals ... are intended as compensation."

buttressed by the Senate's choice of a term of art, "convenience of the employer," in describing one of the conditions for exclusion under § 119. In so choosing, the Senate obviously intended to adopt the meaning of that term as it had developed over time, except, of course, to the extent § 119 overrules decisions like *Doran*. As we have noted above, *Van Rosen v. Commissioner*, 17 T.C. 834 (1951), provided the controlling court definition at the time of the 1954 recodification, and it expressly rejected the *Jones* theory of "convenience of the employer" – ... and adopted as the exclusive rationale the business necessity theory. See 17 T.C. at 838-840. The business necessity theory was also the controlling administrative interpretation of "convenience of the employer" prior to *Mim*. 6472. See *supra* at 434 U.S. 85-86, and n 19. Finally, although the Senate Report did not expressly define "convenience of the employer," it did describe those situations in which it wished to reverse the courts and create an exclusion as those where "an employee must accept ... meals or lodging in order properly to perform his duties." S. Rep. No. 1622, *supra*, at 190.

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 noncompensatory cash payments – is without merit. If cash meal allowances could be excluded on the mere showing that such payments served the convenience of the employer, as respondent suggests, then cash would be more widely excluded from income than meals in kind, an extraordinary result given the presumptively compensatory nature of cash payments and the obvious intent of § 119 to narrow the circumstances in which meals could be excluded. Moreover, there is no reason to suppose that Congress would have wanted to recognize a class of excludable cash meal payments. The ... precedents [supporting] exclusion of cash ... rest on the proposition that the convenience of the employer can be inferred from the characterization given the cash payments by the employer, and the heart of this proposition is undercut by both the language of § 119 and the Senate Report. Finally, as petitioner suggests, it is much more reasonable to assume that the cryptic statement in the technical appendix – "cash allowances ... will continue to be



includable in gross income to the extent that such allowances constitute compensation” – was meant to indicate only that meal payments otherwise deductible under § 162(a)(2) of the 1954 Code [footnote omitted] were not affected by § 119.

Moreover, even if we were to assume with respondent that cash meal payments made for the convenience of the employer could qualify for an exclusion notwithstanding the express limitations upon the doctrine embodied in § 119, there would still be no reason to allow the meal allowance here to be excluded. Under the pre-1954 “convenience of the employer” doctrine, respondent’s allowance is indistinguishable from that in *Van Rosen v. Commissioner, supra*, and hence it is income. ... In any case, to avoid the completely unwarranted result of creating a larger exclusion for cash than kind, the meal allowances here would have to be demonstrated to be necessary to allow respondent “properly to perform his duties.” There is not even a suggestion on this record of any such necessity.

....

Reversed.

MR. JUSTICE BLACKMUN, with whom THE CHIEF JUSTICE joins, dissenting.

....

I fear that state troopers the country over, not handsomely paid to begin with, will never understand today’s decision. And I doubt that their reading of the Court’s opinion – if, indeed, a layman can be expected to understand its technical wording – will convince them that the situation is as clear as the Court purports to find it.

#### *Notes and Questions:*

1. In the first sentence of its opinion, the Court set forth the issues it undertook to resolve. How did it resolve those issues?
2. Whether meal money falls within an exclusion and whether it is gross income are separate questions. With respect to the second question, let’s review: What facts were particularly bad for Officer Kowalski and why? What strings were attached



to the meal money that were different than the strings attached to any worker's wages?

3. Why would an employer provide in a contract that lodging is intended to be compensatory?

4. How important should the *employer's* treatment of meal money – separate accounting, no commingling of funds – be in resolution of the question of whether cash-for-meals should be included in an employee's gross income? Isn't that a red herring in determining whether taxpayer Kowalski has enjoyed an accession to wealth? The Tax Court concluded that the meal money was not intended to be additional compensation, but was nevertheless includable in taxpayer's gross income.

5. In the first footnote of the case, the Court quoted a case that quoted *Benaglia*. Taxpayer Benaglia's employer provided him accommodations at the Royal Hawaiian Hotel and meals in the hotel dining room because otherwise taxpayer could not perform the services required of him as manager of that and other hotels. Moreover, Benaglia was denied the discretion to spend this accession to wealth in any manner that he saw fit.

- Have we seen the “deprivation of discretion” theme before?
- What conclusion do these holdings suggest?
- See Reg. § 1.119-1(a)(3)(i).

6. Surely even a taxpayer denied a choice in her purchase of meals or lodging and whose employment requires that any meal that she does eat be taken where and when the employer orders derives *some* consumption benefit that she would have paid *something* for if the employer had not provided it. Does it have to be all-or-nothing?

- Section 274(n)(1) limits *deductions* (not exclusions) for food or beverages to 50% of the amount spent. The Code implicitly treats the other 50% as a personal expenditure and so subject to federal income tax – but it is the one who pays for the meal who must pay the income tax, not (necessarily) the one who consumes it.
- How important is administrative ease in this? How important is accuracy? If 50% isn't the right figure (and neither is another figure), should we revert to all-or-nothing? Perhaps 50% is simply a “least-bad” figure.

7 Should “underpayment” of a class of workers provide any support whatsoever for a conclusion that § 119 encompasses the cash payments in this case – as Justice

Blackmun suggests? How many people do *not* feel that they are “underpaid?”

- Were the view of Justice Blackmun to have prevailed, the consequences would have been highly unfortunate. How so and why? What economic distortions would have resulted?

8. What interest should the State of New Jersey, Officer Kowalski’s employer, have in the outcome of this case? If Officer Kowalski must pay income tax on his meal money, the State of New Jersey may find that it must increase the wages of its state troopers. It is entirely possible that the State of New Jersey captured all the tax savings that Justice Blackmun feels all state troopers deserve.

9. Using the figures that the Court provided, Officer Kowalski received 13% (\$1371 out of \$10,437) tax-free. Naturally, this affects the amount of income tax that others must pay if the Government is to raise a certain amount of revenue. Moreover, other workers who might pay income tax on \$9066 – the amount on which Officer Kowalski *did* pay income tax – who do not receive meal money that they may spend any way they wish probably would understand very well the system’s discriminatory treatment of two different taxpayers’ unequal accessions to wealth – contrary to Justice Blackmun’s inferential suggestion that this decision is difficult for lay people to understand.

10. In a sense, the *Kowalski* case presents the tip of an iceberg. Notice the topics of §§ 105, 106, 107, 125, 127, 129, 132, 137. These code sections name benefits that an employer can provide employees that are not subject to income tax to either the employer or the employee. These provisions assure that like taxpayers who work for different employers are *not* taxed alike.

11. Presumably, the accessions to wealth that employers offer employees that employees may in turn exclude from their gross income empower employers to customize the type of workforce they want. Maybe that is good. Airlines can pay less-than-market wages to persons who like to travel. Retailers can give employee discounts to persons who would (enthusiastically) shop at their establishments anyway. And so on.

- Consider this proposition: instead of aspiring to horizontal *equality*, aspire to horizontal *equity* by permitting a fixed ceiling on the value of excludable benefits that employers may provide employees. See William P. Kratzke, *The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income*, 60 TAX LAW. 1, 3-8 (2006) (effective rate of federal income and employment taxes would be more progressive).

12. Read Reg. § 1.119-1(a)(2)(ii)(d).

- Do you think that someone lobbied to have this provision included in the regulations? Who?

13. Consider:

13a. Fishing Expeditions, Inc. flies fishing parties to remote cabins that it owns in Alaska. Its employees are small-airplane pilots, guides, and cooks. Obviously while servicing a fishing party, the employees must reside at a remote cabin and take meals there also. The employees must pay Fishing Expeditions, Inc. \$200 per week, which Fishing Expeditions collects by deducting this amount from their paychecks.

- True or false? The employees must include the \$200 in their gross income.

*See* § 119(b)(3); Reg. § 1.119-1(a)(3)(ii).

13b. Cicely is an employee of the Hanford Nuclear Works. The HNR is located 60 miles from the nearest structure and 70 miles from the nearest town. HNR maintains some barracks-style housing onsite that it provides various workers, who are typically in their 20s and single for free. The value of this housing is \$500 per month. To be fair to the other workers, HNR pays a housing stipend of \$500 per month to employees who elect to live in the nearest town and commute to the jobsite.

- Tax consequences to the workers who live onsite?
- Tax consequences to the workers who live in town?

#### *F. Employee Fringe Benefits: § 132*

Prior to 1984 – and as taxpayer Kowalski argued – there evolved an uneven patchwork of “fringe benefits” that employers and employees alike assumed were not subject to income tax. This cost the Treasury revenue and resulted in horizontal inequities. Congress addressed the problem, and in 1984, “drew a line in the sand.” The following is an explanation of what Congress did and why.

*Deadweight Loss:* Deadweight loss is someone's loss and no one's gain. The *value* of a good or service to a person is what the person is willing to pay for it. Everyone seeks to maximize value to herself through purchasing choices within the limits of her after-tax income. Do exclusions from gross income cause deadweight loss? Yes.

Consider: Taxpayer pays income taxes at a marginal rate of 25%. Taxpayer is willing to pay \$90 for a benefit and no more. Taxpayer would have to earn \$120 to pay tax on the income necessary to purchase the benefit for \$90. Naturally, taxpayer would be willing to pay less. The market price of the benefit is \$100. Taxpayer will not purchase this benefit, but will spend her after-tax income in ways that maximize her own consumer surplus. Producers in turn strive to provide taxpayer goods and services at a cost to them that is less than the price taxpayer (and others) are willing to pay. All producers make a profit, so the markets are "sustainable." The economy works with *allocative efficiency*.

Now suppose that the Code excludes the benefit from taxpayer's gross income if her employer provides it. Taxpayer's employer offers to provide the benefit to taxpayer if taxpayer will accept a \$100 reduction in pay. Should taxpayer accept the offer?

From taxpayer's perspective, she can choose to keep the \$100 in wages; this nets taxpayer \$75 after taxes. But because of the exclusion, taxpayer can rationally choose to accept the benefit. That is because taxpayer essentially "pays" \$75 for something she values at \$90. That's \$15 of consumer surplus.

Unfortunately, the producers of the things taxpayer would have bought with her \$75 of after-tax income lose the sales. The surplus value that they and taxpayer would have created by entering value-increasing bargains is lost – and replaced by a transaction that most assuredly does not increase *after-tax* value. No one captures the net loss in surplus value. It is *deadweight loss*.

All exclusions from gross income imply some deadweight loss. Assume that you had access to any information you wanted. How would you determine whether the nation should absorb such deadweight losses?

**H. Rep. No. 98-432 (II)**, 98<sup>th</sup> Cong., 2d Sess. 1984, at 412, 1984 U.S.C.C.A.N. 697, 1215, 1984 WL 37400, to accompany H.R. 4170.

....

In providing statutory rules for exclusion of certain fringe benefits for income and payroll tax purposes, the committee has attempted to strike a balance between two competing objectives.

First, the committee is aware that in many industries, employees may receive, either free or at a discount, goods and services which the employer sells to the general public. In many cases, these practices are long established, and have been treated by employers, employees, and the IRS as not giving rise to taxable income. Although employees may receive an economic benefit from the availability of these free or discounted goods or services, employers often have valid business reasons, other than simply providing compensation, for encouraging employees to avail themselves of the products which they sell to the public. For example, a retail clothing business will want its salespersons to wear, when they deal with customers, the clothing which it seeks to sell to the public. In addition, the fact that the selection of goods and services usually available from a particular employer usually is restricted makes it appropriate to provide a limited exclusion, when such discounts are generally made available to employees, for the income employees realize from obtaining free or reduced-cost goods or services. The committee believes, therefore, that many present practices under which employers may provide to a broad group of employees, either free or at a discount, the products and services which the employer sells or provides to the public do not serve merely to replace cash compensation. These reasons support the committee's decision to codify the ability of employers to continue these practices without imposition of income or payroll taxes.

The second objective of the committee's bill is to set forth clear boundaries for the provision of tax-free benefits. ... [A]dministrators of the tax law have not had clear guidelines in this area, and hence taxpayers in identical situations have been treated differently. The inequities, confusion, and administrative difficulties for businesses, employees, and the IRS ... have increased substantially in recent years. The committee believes that it is unacceptable to allow these conditions ... to continue any longer.

In addition, the committee is concerned that without any well-defined limits on the ability of employers to compensate their employees tax-free by using a medium other than cash, new practices will emerge that could shrink the income tax base significantly, and further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash. A shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security system above ... Finally, an unrestrained expansion of noncash compensation would increase inequities among employees in different types of businesses, and among employers as well.

The nondiscrimination rule is an important common thread among the types of fringe benefits which are excluded under the bill from income and employment taxes. Under the bill, most fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. The committee believes that it would be fundamentally unfair to provide tax-free treatment for economic benefits that are furnished only to highly paid executives. Further, where benefits are limited to the highly paid, it is more likely that the benefit is being provided so that those who control the business can receive compensation in a nontaxable form; in that situation, the reasons stated above for allowing tax-free treatment would not be applicable. Also, if highly paid executives could receive free from taxation economic benefits that are denied to lower-paid employees, while the latter are compensated only in fully taxable cash, the committee is concerned that this situation would exacerbate problems of noncompliance among taxpayers. In this regard, some commentators argue that the current situation – in which the lack of clear rules for the tax treatment of nonstatutory fringe benefits encourages the nonreporting of many types of compensatory benefits – has led to nonreporting of types of cash income which are clearly taxable under present-law rules, such as interest and dividends.

In summary, the committee believes that by providing rules which essentially codify many present practices under which employers provide their own products and services tax-free to a broad group of employees ... the bill substantially improves the equity and administration of the tax system.

## C. Explanation of Provisions

### 1. Overview

Under the bill, certain fringe benefits provided by an employer are excluded from the recipient employee's gross income for federal income tax purposes and from the wage base (and, if applicable, the benefit base) for purposes of income tax withholding, FICA, FUTA, and RTA.

....

Any fringe benefit that does not qualify for exclusion under the bill (for example, free or discounted goods or services which are limited to corporate officers) and that is not excluded under another statutory fringe benefit provision of the code is taxable to the recipient under ... §§ 61 and 83, and is includible in wages for employment tax purposes, at the excess of its fair market value over any amount paid by the employee for the benefit.

*Section 83:* Read § 83(a) and skim § 83(b, c, d, f, h). For now, § 83(a) establishes that receipt of property in exchange for services is gross income to the one performing the services. That is hardly profound. The larger concern of § 83 is with the timing of recognition of that income and associated deductions, matters we consider in Chapter 9.

### *Notes and Questions:*

1. As the Report implies, the notion that fringe benefits were nontaxable had gotten out of hand. The approach of Congress was to define fringe benefits that *are* excludible from gross income and to draw a line in the sand: “this far and no farther.” The Court in *Kowalski* explained and applied this principle.

2. Read § 132. Originally, § 132 named only four exclusions. Congress has added other carefully defined “qualified” fringe benefits that are excluded from an *employee's* gross income. Consider these problems:

1. Phillip works for Sports World, a mega-sporting goods store. Phillip enjoys being outdoors and so would probably spend a lot of time shopping at Sports World, even if he didn't work there. Last year, Sports World sold \$10M worth of sporting goods. The cost of its merchandise was \$7M; its overhead was \$2M. Sports World offers its employees a 25% employee discount on items that employees purchase. Phillip purchased a fishing boat that retails for \$1000. Phillip paid \$750.

- Tax consequences to Phillip?

1a. One week later, Phillip sold the fishing boat to his brother for \$1050.

- Tax consequences to Phillip?
- See § 132(a)(2) and § 132(c).

1b. Sports World is situated in a large, oddly-shaped building that had stood empty for several years. Service merchants in the area (restaurants, dry cleaners, dentists, optometrists, etc.) were anxious that Sports World would occupy the building and readily entered into reciprocal arrangements whereby employees of Sports World were entitled to a 20% discount off the retail prices of these merchants' services. Sports World agreed to give only a 10% discount for the employees of these service merchants. Last week, Phillip paid \$80 for dental services that normally cost \$100. A nearby optometrist purchased a tent from Sports World that normally retails for \$100 for only \$90.

- Tax consequences to Phillip?
- Tax consequences to the optometrist?
- See § 132(i); Reg. § 1.132-3(a)(3).

2. Mesquite Airlines is a commercial airline. It offers its employees free standby air travel. Moreover, Mesquite Airlines has entered into a reciprocal agreement with several other airlines whereby employees of Mesquite may fly standby for free on other airlines, and employees of the other airlines may fly free on Mesquite Airlines. Megan is a retired airline pilot who flew airplanes for Mesquite Airlines for 35 years. Megan flew standby on a Mesquite Airlines flight; the normal fare was \$400.

- Tax consequences to Megan? See § 132(h).

2a. Megan flew standby on another airline. The normal fare was \$400.

- Tax consequences to Megan?

2b. Without charging her, Mesquite Airlines permitted Megan to reserve her seat for two weeks from now. The normal fare was \$400.

- Tax consequences to Megan?

3. When the University of Memphis Law School moved into its home in downtown Memphis, faculty members chose their offices pursuant to a system that incorporated consideration of rank and seniority. Staff offices have a rental value of \$3600 per year. Professor K now has a corner office with a nice view of



the Mississippi River. The rental value of the “worst” faculty office is \$4800 per year. The rental value of Professor K’s office is \$14,400 per year.

- Tax consequences to Professor K? *See* § 132(a)(3) and § 132(d).

3a. Same facts. The Law School purchased for Professor K and one other professor (but no one else) online access to the CCH FEDERAL TAX REPORTER. The retail cost of this access is \$2500 per year.

- Tax consequences to Professor K?
- Is there any other information you need to answer this question?

*Code and Regulations:* By now you should have gained some facility flipping between the provisions of the Code and the Regulations. Within that context, this reminder might be appropriate. The Code is the text that Congress enacted. It is law so long as it is consistent with the Constitution. The Regulations are text that the Treasury Department adopted to construe the Code. It also is law, so long as it is consistent with the Code and with the Constitution. You have already seen implementation of this hierarchy in cases that you have read.

4. Joe the Plumber, Inc. sells plumbing services to customers. It has a policy of offering employees a 25% discount on plumbing services that they purchase from Joe the Plumber, Inc. However, Joe the Plumber, Inc. offers a 40% discount to its “highly-compensated” employees. An employee purchased plumbing services that normally cost \$200 for \$150. One of Joe the Plumber’s highly-compensated employees purchased the same services for \$120.

- Tax consequences to the employee?
- Tax consequences to the highly-compensated employee?
- See* § 132(j)(1).

5. Lotsa Refunds, Inc. is a tax return preparer that does a volume business among unbanked, low-income persons. The corporation has ten employees. At the end of a very hectic tax season, Lotsa Refunds presented each of its employees with a \$50 prepaid Mastercard cash card, in addition to their normal wages. This was because of the gratitude Lotsa Refunds felt for its employees having worked long hours against tight deadlines. Lotsa Refunds’ highly-compensated employees did not receive such a card.

- Tax consequences to the employees?

5a. The employees of Lotsa Refunds, Inc. worked from 7 a.m. until 12 midnight every night between April 1 and April 15.

Section 274(n): Read § 274(n)(1). How does it affect the rule of § 132(e)(2)? Pay attention to the difference between a deduction and an exclusion.

Criminal activity increases after midnight, so Lotsa Refunds paid for Uber rides for all its employees on those days – both from and to work in the morning. Assume that a typical fare is \$15.

•Tax consequences to the employees? *See* Reg.

§ 1.132-6(d)(2)(iii)(A, B, and C).

•Are there any more facts you might wish to know?

6. Springfield Memorial Hospital operates a cafeteria for its workers. Its prices for each food item cover the direct operating costs of selling that item. This price is less than the price for which it would be sold in a for-profit cafeteria. Some of the hospital's workers are on call for emergencies at all times, even during their mealtimes. The mealtime of these workers is 30 minutes. These employees have special vouchers in the cafeteria which permit them to take food equal to \$9 "worth" of food. Other personnel may eat in the cafeteria, but must pay the charge listed for each food item; these persons are not on call, and many of them do not eat in the cafeteria. Overall, the cafeteria loses money because most employees in the first group do eat in the cafeteria.

•Tax consequences to the first group of employees?

•Tax consequences to the second group of employees?

•*See* § 132(e)(2), including carryout paragraph.

*Tax Cuts and Jobs Act:* The Tax Cuts and Jobs Act suspends from 2018 through 2025 exclusion of an employer-provided qualified bicycle commuting fringe. § 132(a)(5), (f)(1)(D), (f)(8). The Act also suspends for the same years an exclusion for employer-paid moving expenses. §§ 132(a)(6), (g)(1 and 2).

Section 274(l) now denies employers a deduction for any *expense* (the word “expense” does not have the same meaning as the word “value”) incurred to provide transportation to an employee for “travel between the employee’s residence and place of employment, except as necessary for ensuring the safety of the employee.” § 274(l)(1). For tax years 2018 to 2025, this limitation does not apply in connection with a “qualified bicycle commuting reimbursement[.]” § 274(l)(2). Expenses in excess of the statutorily prescribed maxima (as indexed for inflation) are deductible by employers and are included in the gross income of employees. See *generally*, I.R.S. Notice 2018-52, 2018-52 I.R.B. 1067 (“Parking Expenses for Qualified Transportation Fringes Under § 274(a) and § 512(a)(7) of the Internal Revenue Code”).

Be alert to congressional treatment of transportation fringes. Whereas most fringe benefits are not subject to income taxation at either the employer or employee level, transportation fringes might be subject to income taxation at one level – and that level might be the employer level. Read the applicable statutes carefully.

7. Assume that the indexed amounts applicable to § 132(f)(2)(A and B) is \$280 per month. Delphic Paperworks, Inc.’s headquarters are situated in the downtown area of Metroville, a large city with a lot of traffic. Four hundred people work at the headquarters. Next door to the headquarters is a parking lot that charges \$280/month for a parking place. In recognition of the traffic and parking problems that its employees face, Delphic gives every employee at its headquarters a choice: it will provide transportation in a commuter highway vehicle as defined in § 132(f)(5)(B)), or it will arrange with the garage to provide a parking place for the employee, or pay \$280 cash to the employee. Some employees take only the “free” ride to work, some take only the parking place, and others take the cash.

- Tax consequences to the employees who take the ride to work?
- Tax consequences to the employees who take the parking place?
- Tax consequences to the employees who take the cash?
- Delphic’s expenses would be deductible under § 162, right? See §§ 274(a)(4) and 274(l)(1).



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: The Taxability of Employment Connected Payments: Fringe Benefits, Meals and Lodging, Unemployment Compensation, and Social Security Benefits.*

### *G. Cafeteria Plans, § 125*

Normally, a taxpayer may not avoid realizing gross income by turning her back on cash. Hence, if an employer were to give all employees a choice between, say, \$5000 cash or \$5000 of dependent care assistance, taxpayer would have to realize gross income no matter which choice she made. Either the employee accepted the cash (taxable) or *could have* accepted the cash (also taxable).

- *Some* of an employer's workforce might be parents whose children require, say, after-school care. To avoid application of this "constructive receipt" doctrine, the employer would have to offer a dependent care assistance program to *all* employees.

- The non-parents would give up wages for this benefit, even though they derive no value from it.

- If the employer did not offer such a program, the parents could not avail themselves of the § 129 exclusion.

**Donating leave pay to charity:** Employers may offer leave-based donation programs whereby employees may elect to forgo vacation, sick, or personal leave in exchange for cash payments that the employer makes to charitable organizations. The IRS announced that such payments will not be treated as wages paid to employees, provided the payments are made to charitable organizations for the relief of victims of COVID-19. The employer who otherwise meets the requirements of either § 170 or § 162 may treat the payment as a charitable contribution or a trade or business expense. Payment had to be made before 2021. See Notice 2020-46, 2020-27 I.R.B. 7. This rule has been extended to payments made before 2022. Notice 2021-42, IR-2021-142.

Section 125 mitigates these effects substantially, and gives employers and employees the power to customize a benefits package to a point – or to accept cash.

A participant in a "cafeteria plan" does *not* realize gross income simply because she may choose to receive cash or to choose to receive one of the plan's qualified benefits that the employer offers.

- Section 125(f) defines a

“qualified benefit” to be any benefit which is not includible in the gross income of an employee *except* for § 106(b) (Archer MSAs), § 117 (scholarships, qualified tuition reduction), § 127 (employer educational assistance programs), and § 132 (fringe benefits).

- However, qualified transportation fringes are treated in the same manner as other qualified benefits of a cafeteria plan, § 132(f)(4).
- Moreover, group-term life insurance (*see* ¶ 79) in excess of \$50,000 is a qualified benefit.
- Reg. § 1.125-1(a)(3) lists qualified benefits that an employer may offer in a cafeteria plan.

Section 125(j) authorizes “simple cafeteria plans for small businesses.”

Proposed Reg. § 1.125-5(a)(1) authorizes flexible spending arrangements whereby employees agree to a reduction in their salary to be spent on a use-it-or-lose-it basis on qualified benefits.

Why should an employer offer a cafeteria plan?

CAA, Taxpayer Certainty and Disaster Relief Act of 2020 § 214 provides that taxpayers may carry over unused amounts in their flexible spending accounts for health and dependent care expenses from 2020 to 2021, and from 2021 to 2022.

## Wrap-up Questions for Chapter 3

1. In what ways – good or bad – do you think exclusions from gross income affect markets? It may help to consider one example, e.g., the market for health care.
2. What does it mean that an exclusion may be “captured” by someone other than the taxpayer Congress intended to benefit? Consider the exclusion from gross income of scholarships offered by someone *other than the school* or the rental value of parsonages.
3. Why is the receipt of cash so rarely excluded from a taxpayer’s gross income? If an employer gave an employee a gift card to a particular store, should the employee be treated as having received cash for purposes of the income tax? Are there additional facts you might want to know?
4. Are there any statutory exclusions from gross income that you feel should be repealed? Which ones and why? Can you think of any benefits that *should* be excluded? How about identity theft protection services provided to data breach victims? See I.R.S. Announcement 2015-22 (Aug. 14, 2015), *available at* 2015 WL 4769571.
5. What is deadweight loss? Which exclusions do you think cause the most deadweight loss?

## What have you learned?

Can you explain or define –

- The difference between an exclusion and a deduction
- Capture of the benefit of an exclusion
- How exclusions distort markets; how they cause deadweight loss
- Gifts under the Code and their treatment
- The effect of gift tax paid on the donee’s basis
- The limitations of the excludability from income of a bequest
- The limitations of the excludability from income of a prize (§§ 74, 274(j))
- Why only high-income people (should) purchase the bonds of state and local governments?
- What are the important exclusions from gross income that the Code provides?
- What are the important employment-based exclusions from gross income that the Code provides?

## Chapter 4: Loans and Cancellation of Indebtedness

### I. Tax Consequences of Borrowing Money

#### *The Tax Formula:*

→(gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)  
  
EQUALS (taxable income)  
  
Compute income tax liability from tables in § 1(j) (indexed for inflation)  
MINUS (credits against tax)

In this chapter, we consider the tax consequences of borrowing money. A taxpayer who borrows money has that much more money to spend. A taxpayer who borrows money also has an obligation to repay the loan. One precisely offsets the other. For this reason, there are no tax consequences to taking out a loan. Furthermore, taxpayer is entitled to spend the borrowed money on investment or consumption – and we treat such a taxpayer the same as we would a taxpayer who made such a purchase or investment with after-tax income. Taxpayer’s expenditure entitles him to basis in whatever asset he may purchase.

This does not mean that taxpayer is entitled to income that is not subject to income tax. Consider how taxpayer will meet his obligation to repay the loan. Taxpayer will have to acquire money that *is* subject to income tax – perhaps by working at a job in exchange for wages. Taxpayer will pay income tax on that income, and use what remains after payment of taxes to repay the loan. By taking out a loan, taxpayer has made a future consumption choice, i.e., repayment of the loan. Consistent with the principle that borrowing money is not

#### *The Tax Code and Economic Growth:*

A taxpayer’s opportunity to invest borrowed funds prior to the time that he has paid income tax on the income necessary to invest an equivalent amount has tremendous growth implications for the nation’s economy. Imagine how much more slowly the economy would grow if borrowed funds were subject to income tax immediately upon receipt. There would still be markets for credit, but the higher cost of borrowing would mean that there would be less borrowing – and slower growth.

income to the taxpayer is the rule that repayment of loan principal is not deductible.

For a good summary of the topics covered in this chapter, see Douglas Kahn & Jeffrey H. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAW. 161 (2015).

## II. Cancellation of Indebtedness

All of this assumes that taxpayer will indeed repay the full amount of the loan. Consider now what happens when we no longer make this

assumption. Taxpayer does not repay the loan, and for whatever reason, no longer owes it.

- Taxpayer has enjoyed the benefits of an expenditure on consumption or investment without paying income tax on that consumption or investment.
- Taxpayer no longer commits his future consumption choices to repayment of the loan.
- Should we not regard this as an accession to wealth and treat it as gross income? See § 61(a)(11).

Or: perhaps the assets in which taxpayer has invested the borrowed funds (e.g., a business venture) and upon which taxpayer relies to repay the loan shrink in value so that taxpayer is no longer able to repay the loan.

- Should this excuse a failure to repay the loan because such shrinkage can hardly be regarded as an “accession to wealth?”
- If we deem such a shrinkage not to be an “accession to wealth,” we effectively merge the borrowing transaction and the spending or investing of the loan proceeds into one transaction. Is this appropriate? Or should we account separately for –
  - the borrowing and repayment, and
  - the fate of the enterprise in which taxpayer spends or invests the loan proceeds?

Or: Perhaps taxpayer can take advantage of market conditions to satisfy his obligation by paying less than the amount that he originally borrowed.

What answers to these questions does this leading case suggest?



**United States v. Kirby Lumber Co., 284 U.S. 1 (1931)**

MR. JUSTICE HOLMES delivered the opinion of the court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for \$12,126,800 for which it received their par value. Later in the same year, it purchased in the open market some of the same bonds at less than par, the difference of price being \$137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of (November 23) 1921, c. 136, § 213(a), gross income includes “gains or profits and income derived from any source whatever,” and, by the Treasury Regulations authorized by § 1303, that have been in force through repeated reenactments, “If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.” Article 545(1)(c) of Regulations 62, under Revenue Act of 1921. [citations to more regulations omitted]. We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment, the marks had fallen in value, which, so far as it went, was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here, there was no shrinkage of assets, and the taxpayer made a clear gain. As a result of its dealings, it made available \$137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364.

Judgment reversed.

*Notes and Questions:*

1. How does it happen that Kirby Lumber Company could buy back its bonds in the open market for less than it obtained when it issued the bond?

2. What is a “shrinkage of assets?” Was the holding in *Kerbaugh-Empire* wrong? Why (or why not)?

- Evidently, there was a “shrinkage of assets” in *Kerbaugh-Empire*, but not in *Kirby Lumber*.

3. What should we make of the “made available” language of the Court?

- Suppose that taxpayer is hopelessly insolvent. Let’s say that taxpayer has assets with a fmV of \$152,000, but has liabilities of \$379,000. Liabilities exceed assets by \$227,000. One creditor settles a \$110,000 debt for property worth \$18,000. Now the taxpayer has assets with a fmV of \$134,000 and liabilities of \$269,000. Liabilities now exceed assets by \$135,000, i.e., \$92,000 less than before this settlement. Has this transaction really “made available” \$92,000 to taxpayer?

- No, said the Fifth Circuit in *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5<sup>th</sup> Cir. 1934):

There is a reduction or extinguishment of liabilities without any increase of assets. There is an absence of such a gain or profit as is required to come within the accepted definition of income. ... [T]he cancellation of the respondent’s past due debt ... did not have the effect of making the respondent’s assets greater than they were before that transaction occurred. Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income.

- Reducing the degree by which taxpayer is insolvent from \$227,000 to \$135,000 is not sufficient to constitute gross income. What if the reduction had been from \$227,000 to \$100. Where is the line?

4. (note 3 continued) In *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 291-92 (1937), taxpayer was insolvent and had filed a petition for voluntary bankruptcy. Taxpayer’s creditors wrote off \$104,000 of debt in exchange for payments totaling \$15,000 to keep taxpayer from further pursuing relief through a bankruptcy proceeding. After this exchange, the value of taxpayer’s assets exceeded its liabilities by \$40,000. Taxpayer’s

net assets were increased from zero to \$39,596.93 as a result of the cancellation of indebtedness by its creditors, and to that extent it had assets which ceased to be offset by any liability. ... [T]he cancellation of [taxpayer's] debts had the effect of making its assets greater than they were before that transaction occurred. It is true that 'gain' or 'profit' is essential to the existence of taxable 'income' ... and we believe that 'gain', as commonly understood, was realized here when [taxpayer], who was hopelessly insolvent, received by the action of its creditors an increment to its assets clear and free of any claims of the creditors. ... [W]e conclude that the assets freed to the [taxpayer] by the composition of creditors had an exchange value. Under such facts ..., [taxpayer] realized taxable gain ...

*Id.* at 292.

5. The “making available assets” language meant – practically uniformly among lower courts – that an insolvent debtor realized gross income from cancellation of indebtedness *only to the extent* such cancellation made the debtor solvent. In fact, some courts held that the cancellation of debt of an insolvent debtor was not “income” under the Sixteenth Amendment. *See* Ann K. Wooster, *Application of the 16<sup>th</sup> Amendment to U.S. Constitution – Taxation of Specific Types of Income*, 46 A.L.R. FED. 2d 301 (2010) § 12 (debt forgiveness income).

6. Back to *Kerbaugh-Empire*: A loan is a transaction. Taxpayer may use loan proceeds in another transaction. Logically, the loan and the spending or investment of proceeds are two different transactions that taxpayer should have to account for separately. In the absence of any statutory provision governing exclusion of cancellation of indebtedness income, the Code essentially required the Commissioner prior to 1954 to kick a taxpayer when he was down. We see what happened. *Dallas Transfer* and *Lakeland Grocery* focused on taxpayer's insolvency to exclude at least some coi income from taxpayer's gross income. The holding in *Kerbaugh-Empire* seemed to permit a court to focus on the success of the enterprise in which taxpayer invested loan proceeds to determine whether taxpayer had to include cancellation of indebtedness in his gross income.

- Section 108 changes this, *infra*, but § 108 does *not* convert business losses into excludable cancellation of indebtedness income.

- The court in *United States v. Gehl*, 50 F.3d 12, 1995 WL 115589 (8<sup>th</sup> Cir.), *cert. denied*, 516 U.S. 899 (1995), chapter 3, *supra* sorted all this out.

7. In 1954, Congress added §§ 61(a)(11), 108, and 1017 to the Code.<sup>55</sup> Read §§ 61(a)(11),<sup>56</sup> 108(a)(1)(A and B), 108(d)(1 through 3). Do you see the influence of cases such as *Dallas Transfer & Terminal Warehouse* and *Lakeland Grocery* – as well as of cases holding that the meaning of “income” in the 16<sup>th</sup> Amendment does not encompass discharge of indebtedness (doi) when taxpayer does not thereby become solvent? *See also* Reg. § 1.61-12(b)(1) (adopted in 1957).

8. Section 108(e)(1) provides that there is no insolvency exception from the general rule that gross income includes income from discharge of indebtedness other than what § 108 provides.

- When the other provisions of § 108 apply, § 108 appears to “preempt the field” – much as §§ 119 and 132 preempt their respective fields. *See* BORIS I. BITTKER, MARTIN J. MCMAHON, JR., & LAWRENCE A. ZELENAK, *supra* at 4-21 to 4-22.

9. Read § 108(b). It implicitly requires a taxpayer who enjoys doi income to determine how much doi income he is not recognizing. What is a “tax attribute?”

- It is a phrase that we use often, but that the Code does not define. We surmise its meaning by reading § 108(b).
- A “tax attribute” is a tax characteristic of a taxpayer. Section 108(b) lists various “tax attributes” that might reduce taxpayer’s tax liability *in the future*. That list includes: net operating loss, general business credit, minimum tax credit, capital loss carryover, basis, passive activity loss and credit carryovers, and foreign tax credit carryovers.
- What is the effect of § 108(b) on the holdings of cases such as *Dallas Transfer & Terminal Warehouse* and *Lakeland Grocery*? Define the “exclusion” from gross income that § 108 provides a taxpayer who is in bankruptcy or insolvent.
- Tax attributes named in § 108(b) reduce a taxpayer’s tax liability at some future time. Does it matter how far into the future the reduction occurs?
  - The consequence of reducing a tax attribute is that taxpayer’s future tax liability will not decrease.
  - To the extent that a taxpayer has tax attributes, § 108 does not in

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<sup>55</sup> *See* Boris I. Bittker, Martin J. McMahon, Jr., & Lawrence A. Zelenak, *Federal Income Taxation of Individuals* ¶ 4.05[2] at 4-21 (3d ed. 2002).

<sup>56</sup> The Tax Cuts and Jobs Act (2017) deleted alimony from the list of items included in “gross income” and renumbered the remaining items. “Discharge of indebtedness income” is now included in “gross income” at § 61(a)(11).

fact exclude doi income from taxpayer's gross income, but instead defers the effect of its recognition to the day that a tax attribute would have reduced taxpayer's tax liability.

10. Section 108(b)(2)(E) provides for basis reductions, and § 108(b)(5) permits the taxpayer to elect to reduce his basis in depreciable property before reducing other tax attributes. Such an election would matter to the taxpayer only if he has attributes listed in § 108(b)(2)(A, B, C, or D) and wants to preserve them.

11. (Note 10 continued): *Reduction of tax attributes and reductions of basis*: Section 1017 and Reg. § 1.1017-1 provide some rather technical rules governing the sequence of reductions in taxpayer's basis in his property.

- Read § 1017(b)(2). What rule does it state for basis reductions under 108(b)(2)(E) and under 108(b)(5)?
- Read 1017(a). The reduction is made to the basis of any property held by the taxpayer at the beginning of the tax year following the tax year in which the debt discharge occurs (§ 1017(a)).
  - Taxpayer need not reduce ("spend") his tax attributes upon the discharge of indebtedness but rather may use them to reduce tax liability for the year of discharge.
  - Then taxpayer may also reduce basis.

12. Consider:

- 12a. Taxpayer owns real property, fmV = \$100,000, ab = \$135,000. This is all of taxpayer's property. Taxpayer has no other assets, not even cash. Taxpayer has liabilities of \$120,000. Is taxpayer insolvent for purposes of § 108? By how much?
- 12b. Taxpayer owns real property, fmV = \$135,000, ab = \$100,000. This is all of taxpayer's property. Taxpayer has no other assets, not even cash. Taxpayer has liabilities of \$120,000. Is taxpayer insolvent for purposes of § 108? By how much?
- 12c. Taxpayer owns real property, ab = \$80,000, fmV = \$125,000. This is all of taxpayer's property, except that taxpayer also has \$5000 of cash. Taxpayer's real property is subject to a debt of \$110,000 that he owes to creditor. Taxpayer did not purchase the property from creditor. Taxpayer was having difficulty making payments, so creditor agreed to reduce taxpayer's debt to \$95,000. How much doi income must taxpayer include

in his gross income under §§ 61(a)(11)/108?

•12d. Taxpayer owns real property, ab = \$80,000, fmv = \$125,000. This is all of Taxpayer's property, except that Taxpayer has \$20,000 of cash. Taxpayer's real property is subject to a debt of \$150,000 that she owes to creditor. Taxpayer did not purchase the property from creditor. Taxpayer was having difficulty making payments. Creditor agreed to reduce taxpayer's debt from \$150,000 to \$130,000 in exchange for an immediate cash payment of \$10,000. Taxpayer agreed and made the payment. How much doi income must taxpayer include in her gross income under §§ 61/108?

•12e. Same facts as 12d, except that taxpayer has filed for bankruptcy. The creditor makes the same arrangement with taxpayer. How much doi income must taxpayer include in her gross income under §§ 61/108? [Disregard the effect of such a payment on the bankruptcy proceeding.]

### III. Settlements of Legal Disputes Over Obligations to Pay or Repay

When a borrower does not repay a loan, a creditor may quite predictably sue. The ensuing court case may raise certain issues<sup>57</sup> such as whether the parties intended a loan and repayment, whether a putative loan agreement is legally (un)enforceable, whether the parties even know the amount of the loan, and so on. The parties may seek to reduce litigation costs and risks by settling for a known and certain amount that the debtor can and will pay. What should be the tax consequences of such settlements? Keep in mind that one party transferred money or money's worth to the other who spent it on consumption, an element of the SHS definition of "income." The following case involves a settlement. The court discusses *Zarin*. Pay close attention to the court's description of *Zarin* and its criticism of the holding in *Zarin*. Note also the court's brief but important definition of a nonrecourse mortgage and how its characteristics affect the assumptions that we usually make about liability for repayment of a loan.

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<sup>57</sup> An afternoon of weekday television courtroom shows demonstrates the myriad ways such claims are raised and resolved.

**Preslar v. Commissioner**, 167 F.3d 1323 (CA10 1999).

BRISCOE, Circuit Judge.

... The Tax Court held the Preslars' settlement of a loan obligation for less than the face amount of the loan did not create taxable income because the contested liability/disputed debt exception to the general discharge-of-indebtedness income rule rendered the write-off nontaxable. We ... reverse and remand.

I.

Layne Preslar, a real estate agent of twenty-five years, commenced negotiations in 1983 to purchase a 2500-acre ranch near Cloudcroft, New Mexico. High Nogal Ranch, Inc., owned the ranch and was a debtor-in-possession in a Chapter 11 bankruptcy proceeding. Citizens State Bank of Carrizozo, Security Bank and Trust of Alamogordo, and Moncor Bank held mortgages in the ranch. Moncor Bank, which had been experiencing serious financial difficulties and whose interest was subordinate to the other banks, took the lead in assisting in negotiations between High Nogal and Preslar. Moncor Bank's actions were designed to avoid foreclosure and recoup as much of its loan as possible.

On July 12, 1983 ..., Layne and Sue Preslar agreed to purchase the ranch for \$1 million, with the sale to be financed by Moncor Bank. The agreement expressly referred to the fact that Moncor Bank was financing the purchase, but only the Preslars and the president of High Nogal signed the contract on September 1, 1983. The Preslars executed a \$1 million promissory note in favor of Moncor Bank, secured by a mortgage on the ranch. The Preslars were to pay fourteen annual installments of \$66,667, with interest at twelve percent per annum, with final payment due September 1, 1998. Moncor Bank used \$760,000 of the loan proceeds to satisfy the mortgages of Citizens State Bank and Security Bank and Trust. The Preslars thus received title to the ranch free and clear of all of High Nogal's prior mortgages.

The Preslars intended to develop the ranch as a sportsman's resort by subdividing 160 acres and selling one- to two-acre lots for cabins or vacation homes, and permitting lot owners to hunt and engage in other outdoor recreational activities on the remaining 2,340 acres. The goal was to sell each cabin lot for approximately \$16,500, with total gross revenues exceeding \$1.5 million. The Preslars' 1989 joint tax return indicates several lots sold for substantially higher amounts.



Moncor Bank permitted the Preslars to repay their loan by assigning the installment sales contracts of purchasers of cabin lots to Moncor Bank at a discount. ... When each cabin lot was sold, the Preslars assigned and physically transferred the written sales contract to Moncor Bank. In return, Moncor Bank credited the Preslars' debt obligation in an amount equal to 95 percent of the stated principal contract price, regardless of actual payments received from the purchaser. Moncor Bank received a security interest in each lot sold to protect its interests in the event a purchaser defaulted. Between September 1983 and August 1985, the Preslars sold nineteen cabin lots and had assigned most of the contracts to Moncor Bank prior to its declared insolvency. Moncor Bank had credited the Preslars' principal loan balance with approximately \$200,000. Funds applied to interest are not included in this amount; thus, the aggregate amount of discounted installment contracts assigned to Moncor Bank exceeded \$200,000.

In August 1985, Moncor Bank was declared insolvent and the Federal Deposit Insurance Corporation (FDIC) was appointed as receiver. The FDIC notified the Preslars of the insolvency and advised them to make all future payments on their loan to the FDIC. The FDIC refused to accept further assignments of sale contracts as repayment and ordered the Preslars to suspend sales of cabin lots. The Preslars complied with the suspension directive, but made no further payments on the loan.

The Preslars filed an action against the FDIC for breach of contract in September 1985, seeking an order requiring the FDIC to accept assignment of sales contracts as loan repayment. The parties settled the action in December 1988 after the FDIC agreed to accept \$350,000 in full satisfaction of the Preslars' indebtedness. The Preslars borrowed the \$350,000 from another bank and, after the funds were remitted to the FDIC, the original \$1 million promissory note was marked paid.

At the time of the settlement, the unpaid balance on the Preslars' loan was \$799,463. The Preslars paid a total of \$550,537 on the loan (\$350,000 settlement plus \$200,537 credited for assignment of sales contracts). Therefore, as a result of the settlement, the Preslars' outstanding debt obligation was reduced by \$449,463 (\$1 million less \$550,537).

The Preslars did not include the \$449,463 debt write-off as discharge-of-indebtedness income on their 1989 joint tax return. Rather, they opted to reduce their basis in the ranch by \$430,000 pursuant to ... Code § 108(e)(5) ... The Preslars' 1989 tax return was audited and they were assessed a deficiency because (1) they



had realized \$449,463 in discharge-of-indebtedness income, and (2) they were not eligible to treat such income as a purchase price adjustment under § 108(e)(5). ...

The Preslars sought a redetermination of the deficiency in United States Tax Court, insisting they were free to treat their settlement with the FDIC as a purchase price adjustment pursuant to § 108(e)(5) and/or common law. .. At no time, however, did the Preslars dispute their underlying liability on the \$1 million note.

The Commissioner responded that the Preslars could not invoke § 108(e)(5) because that provision applies only to situations where the seller of property agrees to reduce the amount of the purchaser's debt flowing from the property sale. In this case, the Commissioner argued, the property seller was High Nogal. The party responsible for reducing the Preslars' debt was not the seller but was the FDIC (as receiver for Moncor Bank), thereby rendering § 108(e)(5) inapplicable. The Commissioner also argued the common law purchase price adjustment rule did not survive the adoption of § 108(e)(5). ...

The Tax Court ruled in favor of the Preslars without addressing the purchase price adjustment issue. Instead, the court *sua sponte* invoked the contested liability doctrine and held the Preslars' unusual payment arrangement with Moncor Bank caused their liability for the full \$1 million loan to be brought into question. The court determined the true amount of the Preslars' indebtedness was not firmly established until they settled with the FDIC; thus, no discharge-of-indebtedness income could have accrued to the Preslars as a result of the settlement. ...

## II.

....

### **Discharge-of-Indebtedness Income**

Section 61(a) of the ... Code broadly defines “gross income” as all income from whatever source derived except as expressly provided otherwise. ... The phrase is intended to capture all accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955). From its enactment, the sweeping scope of this provision and its statutory predecessors has been consistently emphasized by the Supreme Court. *See Commissioner v. Schleier*, 515 U.S. 323, 327-28 (1995); *Glenshaw Glass*, 348 U.S. at 429-32 & n. 11.

This case centers around the Commissioner's determination of the Preslars' discharge-of-indebtedness income after they settled their loan obligation with the FDIC in December 1988. The concept of discharge-of-indebtedness income, first articulated in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), and later codified in 26 U.S.C. § 61(a)[(11)], requires taxpayers who have incurred a financial obligation that is later discharged in whole or in part, to recognize as taxable income the extent of the reduction in the obligation. ... Loans ordinarily are not taxable because the borrower has assumed an obligation to repay the debt in full at some future date. See *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983). Discharge-of-indebtedness principles come into play, however, if that assumption of repayment proves erroneous. Otherwise, taxpayers could secure income with no resulting tax liability.

It is undisputed that the Preslars financed their purchase of the ranch in 1983 by executing a \$1 million promissory note in favor of Moncor Bank. It is similarly uncontested that when the Preslars settled their lawsuit with the FDIC in 1988, thereby extinguishing all obligations arising from the 1983 loan, only \$550,537 had been paid on the loan principal. Nevertheless, the Tax Court ruled the Preslars' underlying debt was disputed and fell within the judicially-created contested liability exception to discharge-of-indebtedness income.

### **Contested Liability/Disputed Debt Exception**

The contested liability or, as it is occasionally known, disputed debt doctrine rests on the premise that if a taxpayer disputes the *original amount* of a debt in good faith, a subsequent settlement of that dispute is treated as the amount of debt cognizable for tax purposes. *Zarin v. Commissioner*, 916 F.2d 110, 115 (3d Cir.1990). In other words, the excess of the original debt over the amount determined to have been due may be disregarded in calculating gross income. *Id.* The few decisions that have interpreted this doctrine have generated considerable controversy.

The origins of the contested liability doctrine can be traced to *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263 (1939), a case arising during the Great Depression. In that case, a New York corporation purchased 100 shares of a bank's stock and signed a \$21,700 note as payment. When the note matured, the stock was worthless. The corporation sued the bank for rescission, insisting the loan contravened state law and the bank had failed to fulfill its promise to guarantee the corporation against loss. Shortly thereafter, the state superintendent of banks closed the bank because of insolvency and initiated a countersuit against the corporation

for the amount of the note. The parties ultimately settled the consolidated proceedings with the corporation paying the superintendent \$10,850 in return for discharge of the debt. ... The Commissioner ... assessed a \$10,850 deficiency, representing the amount of the original loan over the settlement figure. The Board of Tax Appeals reversed the ruling ..., concluding the corporation's ownership of the shares and the degree of liability on the note were highly unclear. *See id.* at 1265 (There is question whether the taxpayer bought property in 1929 and question as to its liability *and the amount thereof.*) (emphasis added). The Board found the corporation's financial obligations could not be assessed definitively prior to resolution of its dispute with the superintendent and, since settlement compromised the parties' claims and precluded recognition of their legal rights, the existence and amount of the corporation liability were not fixed until the date of settlement. Thus, release of the note did not amount to a gain for the corporation.

In *Zarin*, the court embraced the reasoning of *N. Sobel* while reversing the Commissioner's recognition of discharge-of-indebtedness income. The state gaming commission identified Zarin as a compulsive gambler and ordered an Atlantic City casino to refrain from issuing him additional credit, but the casino ignored the commission. When Zarin's debt surpassed \$3.4 million, the casino filed a state action to collect the funds. Zarin initially denied liability on the grounds the casino's claim was unenforceable under New Jersey law. The parties later settled the dispute for \$500,000. After Zarin failed to account for the debt write-off on his tax return, the Commissioner assessed a deficiency for approximately \$2.9 million, the amount by which Zarin's underlying debt exceeded his settlement with the casino. The Tax Court affirmed. However, a divided Third Circuit held Zarin had no discharge-of-indebtedness income because, *inter alia*, his transaction with the casino arose from a contested liability. 916 F.2d at 115-16. Citing no authority, the majority reasoned that [w]hen a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute. *Id.* at 116. Therefore, the \$500,000 settlement fixed the amount of loss and the amount of debt cognizable for tax purposes. *Id.*

The problem with the Third Circuit's holding is it treats liquidated and unliquidated debts alike. The whole theory behind requiring that the *amount* of a debt be disputed before the contested liability exception can be triggered is that only in the context of disputed debts is the ... IRS unaware of the exact consideration initially exchanged in a transaction. *See Daniel Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 Tax L.Rev. 215, 256 (1990). The mere fact that a taxpayer challenges the enforceability

of a debt in good faith does not necessarily mean he or she is shielded from discharge-of-indebtedness income upon resolution of the dispute. To implicate the contested liability doctrine, the original amount of the debt must be unliquidated. A total denial of liability is not a dispute touching upon the amount of the underlying debt. [footnote omitted]. One commentator has observed:

Enforceability of the debt ... should not affect the tax treatment of the transaction. If the parties initially treated the transaction as a loan when the loan proceeds were received, thereby not declaring the receipt as income, then the transaction should be treated consistently when the loan is discharged and income should be declared in the amount of the discharge.

Gregory M. Giangiordano, *Taxation – Discharge of Indebtedness Income – Zarin v. Commissioner*, 64 Temp. L.Rev. 1189, 1202 n.88 (1991). A holding to the contrary would strain IRS treatment of unenforceable debts and, in large part, disavow the Supreme Court’s mandate that the phrase gross income be interpreted as broadly as the Constitution permits. See *Glenshaw Glass*, 348 U.S. at 432 & n. 11.

....

The Tax Court in this case and the court in *Zarin* cited *United States v. Hall*, 307 F.2d 238 (10th Cir.1962), in support of their contested liability holdings. In *Hall*, the taxpayer incurred gambling losses at a Las Vegas club in an estimated range of \$145,000 to \$478,000. One of the owners of the club agreed to forgive the debt in return for a one-half interest in the taxpayer’s cattle. Just prior to transfer of the interest in the cattle, which had a base value of \$148,110, the parties mutually agreed to assess the taxpayer’s losses at \$150,000. The Commissioner sought to assess the taxpayer with \$1,890 as discharge-of-indebtedness income. Without raising the contested liability doctrine, we rejected the Commissioner’s position and held a gambling debt, being unenforceable in every state, has but slight potential and does not meet the requirements of debt necessary to justify the mechanical operation of general rules of tax law relating to cancellation of debt. *Id.* at 241.

... Even if parts of *Hall* remain viable, however, the opinion would offer little refuge to the Preslars. The debt in *Hall* was unliquidated. The taxpayer’s underlying obligation, therefore, could not be assessed prior to settlement with the club owner. Such a scenario is not present here.

....

... The Tax Court's invocation of the contested liability doctrine in the face of the record presented was unwarranted.

### **Purchase Price Adjustment**

Another method by which taxpayers can avoid discharge-of-indebtedness income is to classify their debt reductions as purchase price adjustments. This rule permits taxpayers to reflect their debt reduction by adjusting the basis of their property rather than recognizing an immediate gain as cancellation of indebtedness. Although this principle had been part of the common law for decades, Congress codified the rule as part of the Bankruptcy Tax Act of 1980, Pub.L. No. 96-589, § 2(a), 94 Stat. 3389, 3389-90 (1980) (codified at 26 U.S.C. § 108(e)(5)). The statute now provides:

If –

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur –

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,

then such reduction shall be treated as a purchase price adjustment.

26 U.S.C. § 108(e)(5) (1988).

The Preslars cannot treat their settlement with the FDIC as a purchase price reduction. Section 108(e)(5) applies only to direct agreements between a purchaser and seller. S.Rep. No. 96-1035 at 16 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7031. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), the purchase price reduction exception is not available and normal discharge-of-indebtedness rules control. *Id.*; see 2 *Mertens Law of Federal Income Taxation* §§ 11.20, 11.25. The seller in this case was High Nopal. ... As neither Moncor Bank nor its receiver, the FDIC, was the seller of the property, the loan settlement the Preslars negotiated with the FDIC does not permit them to invoke the debt reduction as a purchase price adjustment under § 108(e)(5). [footnoted omitted].

The Preslars seek to avoid the requirements of § 108(e)(5) by arguing the transaction is embraced by: ... the common law purchase price reduction doctrine[.]

...

....

*Common Law Purchase Price Reduction Doctrine* – The Preslars insist the common law purchase price reduction doctrine may be invoked in cases where 26 U.S.C. § 108(e)(5) is inapplicable. The Commissioner responds that § 108(e)(5) has displaced the common law on this issue and, in any event, a debt reduction by a third-party lender was not considered a purchase price adjustment under common law. [citation omitted].

....

... [Section] 108(e)(5) was intended, at least in part, to create uniformity in this jurisprudence. *See* S.Rep. No. 96-1035 at 16-17 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7031-32 (This provision is intended to eliminate disagreements between the IRS and the debtor as to whether, in a particular case to which the provision applies, the debt reduction should be treated as discharge income or a true price adjustment.). If, as the Preslars argue, the common law rule remains viable and permits taxpayers involved in third-party transactions to treat their debt reductions as purchase price adjustments rather than additions to their gross income, § 108(e)(5) would be rendered meaningless. We agree with the Commissioner's rationale for imposing the direct seller-purchaser negotiation requirement, as articulated in a 1992 revenue ruling:

An agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement. The debt reduction relates solely to the debt and results in discharge of indebtedness income to the debtor.

Rev. Rul. 92-99, 1992-2 C.B. 35. Accordingly, the Preslars may not treat their settlement with the FDIC as a common law purchase price reduction.

....

### III.

We REVERSE the Tax Court's vacatur of the Commissioner's determination of tax deficiency and imposition of untimely filing penalties and REMAND the case with instructions to enter judgment in favor of the Commissioner.

EBEL, Circuit Judge, dissenting [omitted].

#### *Notes and Questions:*

1. What was the holding of *Hall* as the court articulated it? Is such a holding sound?
2. The court reviewed the facts and holding of *N. Sobel v. Commissioner*. Was there any question that the face amount of taxpayer's note was \$21,700? What facts seem to lead to a conclusion that there was a question as to the amount of the liability? Perhaps *N. Sobel* itself was wrongly decided.
3. Zarin was a compulsive gambler who incurred debts to the casino from which he obtained chips on credit. He always intended to repay his obligations. What form did Zarin's consumption take?
  - gambling?
  - losing at gambling?
  - Should it make a difference?
  - Does a compulsive gambler such as Mr. Zarin realize an accession to wealth or "value" by gambling more?
4. Taxpayer argued that "discharge of his gambling debt was income from gambling against which he may offset his losses."
  - This does not treat the loan and use of the chips as separate transactions.
5. Articulate the policies behind state laws that make contracts unenforceable. Do any of these policies suggest anything about whether there was an accession to wealth and so also doi income?
  - unconscionable contracts are not enforceable because of unequal bargaining power;
  - illegal contracts are not enforceable because the state will not lend its

assistance to enforce an illegal bargain;

- some contracts are unenforceable because the state deems normal presumptions about rationality and the ability to know what is beneficial to oneself inapplicable in certain circumstances, e.g., contract with a minor or incompetent.

6. Are there not unenforceable contracts that nevertheless create an accession to wealth? On the other hand, are there not enforceable contracts that include an obligation to make a payment that do *not* create an accession to wealth? See Douglas Kahn & Jeffrey H. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAW. 161, 200 (2015) (e.g., enforceable promise to contribute money to a charity).

7. What if the debtor reaches a compromise with the creditor, but never actually disputed that he owed the creditor a sum certain? See *Melvin v. Commissioner*, T.C. Memo 2009-199, 2009 WL 2869816 (2009); *Rood v. Commissioner*, TC Memo 1996-248, 1996 WL 280899 (1996) (gambling debt).

8. For a debt to be cancelled, the creditor must receive *nothing* in return. The creditor is entitled to a bad debt deduction. § 166. What treatment does § 166 accord non-business bad debts?

9. Consider:

- 9a. Taxpayer engaged the services of Attorney and incurred a bill of \$1000. The fmV of taxpayer's assets is \$10,000, and taxpayer has \$5000 of cash. Taxpayer has liabilities of \$25,000. Taxpayer entered an agreement to do 80 hours of filing and word processing for Attorney. After taxpayer performed these services, Attorney told taxpayer that "you owe me nothing." Now taxpayer's liabilities are \$24,000, and she has assets with fmV = \$10,000 plus \$5000 cash. How much doi income must Taxpayer report?

- See *Canton v. United States*, 226 F.2d 313, 317-18 (8<sup>th</sup> Cir. 1955), *cert. denied*, 350 U.S. 965 (1956).

- 9b. Taxpayer borrowed \$25,000 from her uncle to pay for her third year of law school at one of America's "Best Value Law Schools" (according to *preLaw Magazine*). Taxpayer and her uncle formalized the arrangement in writing, Taxpayer to pay 6% interest on her declining balance once she began making payments to her uncle after completing law school. At



Taxpayer's commencement day party, her uncle announced to her that "I forgive the loan I made to you. You are free and clear as far as I'm concerned." At the time, Taxpayer's liabilities (including the \$25,000 owed to her uncle) did *not* exceed the fmv of her assets. How much doi income must taxpayer report?

•9c. Taxpayer, a highly skilled craftsman, entered into a contract to produce a custom-made table for Customer's dining room. Customer paid Taxpayer \$4000 on the day they entered the agreement with a promise to pay \$4000 more on delivery. Taxpayer was to deliver the table six months after signing. Taxpayer never got around to making the table. At first, Customer patiently waited past the contractual deadline for the table, but finally sued for a refund of the \$4000. Customer had waited more than 6 years to bring the suit, so it was dismissed as not having been brought within the limitation period.

- True or false: Taxpayer does not have doi income because the debt is unenforceable.

- See, e.g., *Securities Co. v. United States*, 85 F. Supp. 532, (S.D.N.Y. 1948).

•9d. Taxpayer took his automobile to Repair Shop to have some routine maintenance work done. Repair Shop promised to do the work for \$300. When Taxpayer returned to pick up his automobile, he told Repair Shop that he only had \$250 in cash, but would get the rest by tomorrow. Repair Shop manager responded by saying, "Gimme the \$250 and forget the rest." Taxpayer was solvent throughout. How much doi income must Taxpayer report?

10. In dissenting from the Tax Court's holding in *Zarin* that taxpayer did derive gross income from the cancellation of indebtedness, Judge Tannenwald observed:

I think it highly significant that in all the decided cases involving the cancellation of indebtedness, the taxpayer had, ... 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.

Is consumption, i.e., spending the borrowed money for something, a necessary element to treating a discharge of indebtedness as gross income? Suppose that

taxpayer had agreed to pay another's debt. The creditor subsequently discharged *taxpayer* from this obligation. Should that discharge be considered gross income? After all, taxpayer received no funds from the "creditor" with which he could exercise any right of consumption. *See* Douglas Kahn & Jeffrey H. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAW. 161, 200 (2015) ("The gist of the transactional approach is to examine the entire transaction beginning with the creation of the debt and ending with the cancellation. [footnote omitted]. If the debtor did not obtain a tax benefit because of the debt, the debtor should not have COD income.")

11. *Note on Modifications of Loans and Discharge of Indebtedness*: Recall that in *Cottage Savings Ass'n v. CIR* (*supra* chapter 2), two savings and loan associations exchanged the debt obligations of homeowners. Each s&l "realized" the fmV of the debt obligations that it received from the other and computed its tax losses according to the formula of § 1001. This realization helped the taxpayers in their efforts to recognize tax losses. Suppose that a creditor and debtor modify the terms of their agreement, e.g., reduced (increased) payments, reduced (increased) interest rates, longer (shorter) term. We can imagine a multitude of reasons a modification might occur. A significant modification of a debt obligation *can* amount to a realization event, requiring creditor and debtor to compute gain or loss on the modification, coupled with debtor's possible recognition of doi income. *See* Reg. § 1.1001-3(a)(1) (rules for determining whether modification of debt instrument results in exchange).<sup>58</sup> The modification must be "significant." Reg. § 1.1001-3(b). The regulations'<sup>59</sup> treatment of a modification as an exchange contemplate two considerations: (1) whether there is a "modification," *see* Reg. § 1.1001-3(c), and (2) whether a modification is "significant," *see* Reg. § 1.1001-3(e).

A "modification" is "any alteration, including any deletion or addition, in whole or in part, of a legal right or obligation of the issuer or a holder of a debt instrument ..." Reg. § 1.1001-3(c)(1)(i). This does not include alterations that occur by operation of the debt instrument itself, e.g., annual resetting of interest rate based upon an index. Reg. § 1.1001-3(c)(1)(ii). The substitution of a new obligor, the addition or deletion of a co-obligor, or a change in an obligation from recourse to

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<sup>58</sup> The cited regulation does not apply to exchanges of debt instruments between holders and so does not apply to cases such as *Cottage Savings Ass'n v. CIR*.

<sup>59</sup> These paragraphs summarize the regulations at Reg. § 1.1001-3 – and admittedly omit many details.

non-recourse (or vice versa) is a modification. Reg. § 1.1001-3(c)(2)(i). An alteration that results in an instrument or property right that is not debt is a modification, unless the alteration occurs pursuant to a holder's option to convert the debt into equity. Reg. § 1.1001-3(c)(2)(ii). Except for certain unilateral exercises of an option, the exercise of an option by either the issuer or holder that results in change to a term of the debt instrument is a modification. Reg. § 1.1001-3(c)(2 and 3). Neither the issuer's failure to perform nor the holder's temporary forbearance to exercise rights upon default is a modification. Reg. § 1.1001-3(c)(4).

A modification is "significant" if "the legal rights or obligations that are altered and the degree to which they are altered are economically significant." Reg. § 1.1001-3(e)(1). A change in the yield of a debt instrument is "significant" if it varies from the unmodified instrument by more than the greater of 25 basis points or 5% of the annual yield. Reg. § 1.1001-3(e)(2)(ii). A change in the timing of payments is "significant" if it results in the "material deferral of scheduled payments." Reg. § 1.1001-3(e)(3)(i). With some exceptions, the substitution of a new obligor on a recourse debt instrument is "significant." Reg. § 1.1001-3(e)(4)(i)(A). The substitution of a new obligor on a nonrecourse debt instrument is *not* a significant modification. Reg. § 1.1001-3(e)(4)(ii). A change in the collateral securing a debt obligation that results in a change in payment expectations is "significant." Reg. § 1.1001-3(e)(4)(iv)(A and B). A change in the priority of a debt instrument relative to other debt instruments is significant if it results in a change in payment expectations. Reg. § 1.1001-3(e)(4)(v). An alteration that results in an instrument or property right that is not debt is significant. Reg. § 1.1001-3(e)(5)(i). A change in an obligation from recourse to non-recourse (or vice versa) is significant. Reg. § 1.1001-3(e)(5)(ii).

### **Problems:**

1. Harry Homeowner borrowed \$500,000 to purchase a home from First National Bank at 2% interest. When the prevailing interest rate on home mortgage rose to 8%, First National Bank told Harry that it would accept a cash payment of \$350,000 in full satisfaction of the outstanding loan balance of \$490,000. Harry paid the bank \$350,000. What should be the tax consequences of this restructuring? Why would First National Bank make such an offer?
2. Hillary Carbuyer borrowed \$20,000 for five years from Churn 'n' Burn Autos, a used car dealership, to buy a used pickup truck. The interest rate on the loan was 6.5%. Her monthly payment was \$391.32. After making twenty-four payments,

Carbuyer still owed \$12,769.89. Carbuyer lost her job, but quickly found another one that did not pay quite as well. She spoke with the credit manager at Churn 'n' Burn Autos and obtained an agreement to stretch her remaining payments out over five years, but the interest rate on the loan increased to 7.5%. Her monthly payment would now be \$255.88.

- Should there be any tax consequences? What approach would you use to determine what those tax consequences would be?

#### IV. Section 108(a)'s Other Provisions

Section 108(a)(1)(A and B) codifies and limits court-developed rules that govern the discharge of indebtedness of debtors who are in bankruptcy or insolvent. Section 108 also provides rules governing discharge of indebtedness of a (1) taxpayer's qualified farm indebtedness (§ 108(a)(1)(C)), (2) a non-subchapter C taxpayer's qualified real property business indebtedness (§ 108(a)(1)(D)), (3) a taxpayer's qualified principal residence indebtedness discharged by the end of 2025 or pursuant to an arrangement entered before that date (§ 108(a)(1)(D)), (4) a taxpayer's student loan indebtedness (§ 108(f)), and (5) a taxpayer's purchase money indebtedness (§ 108(e)(5)). Section 108(i) also provided for deferral of gain resulting from a taxpayer's reacquisition of a debt instrument as in *Kirby Lumber*.

- “Qualified farm indebtedness” is debt (but not purchase money debt) that a taxpayer incurred “in connection with” taxpayer’s operation of a farming trade or business, § 108(g)(1). The “qualified farm indebtedness” rules give *solvent* farmers many of the benefits that § 108 gives to insolvent debtors.

- “Qualified real property business indebtedness” is debt (other than “qualified farm indebtedness”) that taxpayer (other than a C corporation, § 108(a)(1)(D)) incurs or assumes “in

connection with” real property that secures the debt that taxpayer uses in a trade or business. § 108(c)(3)(A). Taxpayer may elect, § 108(c)(3)(C), to have the amount discharged reduce the bases of taxpayer’s “depreciable real property” to the extent that the loan principal immediately before the discharge exceeds the fmV of such property (less the principal amount of any other loans that the same property secures). § 108(c)(2)(A). The amount

CAA, Covid-Related Tax Relief Act of 2020, §§ 276, 278 provide that forgiveness of “Paycheck Protection Program Loans” are not included in a taxpayer’s gross income.
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discharged may not exceed the aggregate bases of taxpayer's depreciable real property. § 108(c)(2)(B).

•“Qualified principal residence indebtedness” is up to \$750,000 of debt that taxpayer incurred to acquire, construct, or substantially improve taxpayer's principal residence, which secures the loan. § 108(h)(2), § 108(h)(5). The amount discharged reduces taxpayer's basis in the home, but not below \$0. § 108(h)(1). Congress enacted § 108(a)(1)(E) in response to a national financial crisis and to encourage homeowners not to default on their home mortgages when they are “under water.” Notice that unlike the case of “qualified real property business indebtedness,” the amount of permissible basis reduction is the taxpayer's basis in the home, not the amount by which taxpayer's basis exceeds the property's fmv. This provision will not apply to discharges of “qualified principal residence indebtedness” that occur after December 31, 2025 or pursuant to a written arrangement entered after December 31, 2025.

•“Discharges of Student Loans” are excluded from a taxpayer's gross income when the discharge is pursuant to a provision of the loan whereby the discharge is on condition that an individual work for a certain period in certain professions<sup>60</sup> for any of a broad class (as opposed to one or a few specific employers) of employers. § 108(f)(1). The lender must be –

A student receiving a “qualified emergency financial aid grant” does not include the amount in his/her gross income. CAA, Covid-Related Tax Relief Act of 2020 § 277.

- the United States (or an instrumentality or agency), § 108(f)(1)(A),
- a state, territory, possession, the District of Columbia, or political subdivision, § 108(f)(1)(B),
- a public benefit corporation exempt from income tax under § 501(c)(3) that has assumed control over a state, county, or municipal hospital and whose employees are deemed to be public employees under state law, § 108(f)(1)(C), OR
- an educational institution when funds are provided by an entity

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<sup>60</sup> “The professions to which the provision refers are medicine, nursing, and teaching.” STAFF OF JT. COMM. ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 1200 (Jt. Comm. Print 1984).

already named OR pursuant to the institution's program designed to encourage students to serve in occupations with unmet needs or in areas with unmet needs under the supervision of a governmental unit or organization exempt from income tax under §§ 501(a) and 501(c)(3), § 108(f)(1)(D). The discharge may not be for services performed for any of these entities. § 108(f)(3).

Gross income also does not include loan repayments or forgiveness under certain federal and state programs "intended to provide for the increased availability of health care services in underserved or health shortage areas ..." § 108(f)(4).

- For tax years 2021 to 2025, gross income does not include discharged student loans incurred for post-secondary educational expenses. § 108(f)(5).

•"Discharge of Purchase Money Indebtedness" is not excluded from a taxpayer's gross income but rather is treated as a purchase price reduction. § 108(e)(5). The debt must be owed by the purchaser of property to the seller of the property and arise from the purchase. § 108(e)(5)(A). The debtor must be solvent and not in bankruptcy. § 108(e)(5)(B). The reduction must otherwise constitute discharge of indebtedness income – as opposed to, say, reduction of debt principal in exchange for services. § 108(e)(5)(C). This provision is useful when buyer and seller resolve a dispute over the quality of goods by a reduction in the purchaser's debt obligation.

## **V. Transactions Involving Property Subject to a Loan**

Taxpayer may use the proceeds of a loan – from the seller of the property or from a third-party lender – to purchase property and to give the property so purchased as security or collateral for the loan. Such property is "encumbered by" or "subject to" the outstanding principal amount of the loan. Can borrower count the money that he borrowed as part of his basis when in fact taxpayer did not purchase the property with after-tax money?

- Yes. Borrower has an obligation to repay the loan and will repay it with money that has been subject to income tax. It does not matter whether borrower borrowed the money from the seller or from a third party.
- When borrower sells the property subject to the loan, the buyer will pay the fmV of the property minus the loan balance. The buyer is treated as having paid the borrower/seller cash equal to the amount of the loan

balance. Thus, the seller must include the loan balance in his “amount realized” under § 1001(a).

- Once we permit the borrower to use untaxed borrowed funds to obtain basis in property, the rest of the analysis must follow.

- We assume that the borrower will honor his obligation to repay the loan.

- Consider:

- Taxpayer owns Blackacre. She bought it for \$10,000, and its ab = \$10,000. At a time when the fmV of Blackacre was \$50,000, Taxpayer borrowed \$30,000 and put up Blackacre as collateral. Taxpayer sold Blackacre to Buyer who paid her \$20,000 cash and assumed the \$30,000 loan secured by Blackacre. What is Taxpayer’s taxable gain? May taxpayer treat the amount borrowed as part of his adjusted basis in the property? Why?

- Taxpayer borrows \$30,000 from Bank. Taxpayer uses the borrowed money to purchase Whiteacre for \$30,000; taxpayer also gives a mortgage to Bank. Taxpayer sold Whiteacre to Buyer for \$20,000 cash plus assumption of the \$30,000 loan. What is taxpayer’s taxable gain?

- May taxpayer treat the amount borrowed as part of his adjusted basis in the property? Why?

- When do loan proceeds count in basis? When do they not count in basis? What does the Supreme Court say about this in *Tufts, infra*?

- Now consider the following two arrangements by which lender and borrower might structure a loan:

*Recourse obligation:* A recourse obligation is one for which the borrower is *personally liable*. If the borrower defaults and the collateral that the borrower put up to obtain the loan is insufficient to satisfy the borrower’s obligation, the lender may pursue other assets of the borrower to satisfy the debt. The risk that a loss may occur because the fmV of the property decreases prior to default thus falls on the *borrower*.

- This point may encourage a borrower to pay down a loan, even when its principal amount is greater than the fmV of the property securing the loan. Otherwise, the borrower may lose other assets that he owns.

- If the creditor accepts the collateral as full payment, taxpayer/borrower must recognize gain on the disposition of the collateral as if he had sold it



for its fmV.

- If the creditor accepts the collateral as full payment *and* the fmV of the property is less than the principal amount of the loan, the difference is doi income. *Gehl, supra*.

*Nonrecourse obligation*: A nonrecourse obligation is one for which the borrower is *not personally liable*. Thus, if the borrower defaults, the lender may pursue only the property offered as collateral for the loan. The risk that a loss may occur because the fmV of the property decreases prior to default falls on the *lender*.

- When the fmV of the property is greater than the loan amount, the borrower has an economic incentive to continue making payments on a nonrecourse loan. A borrower should willingly repay a nonrecourse loan of \$80 to obtain property whose fmV is \$100.

- But: if the fmV of the property is less than the outstanding balance of a nonrecourse loan, the borrower may (should?) profitably “walk away.” After all, why should a borrower pay down a nonrecourse loan of \$100 to obtain a piece of property whose fmV is \$80?

- This point might encourage lenders to reduce the amount of nonrecourse debt that borrowers owe them when the value of the underlying collateral decreases. *Cf.* § 108(a)(1)(C, D, E). After all, the property’s fmV is not greater when the lender owns it than it was when the borrower owned it. If the creditor reduces the loan principal to the property’s fmV or less, borrower is more likely to make payments on the loan and not to “walk away.”

- If a nonrecourse borrower defaults on a loan and surrenders the property he put up as collateral whose fmV is less than the loan principal, exactly how much doi results from a *freeing of assets*?

- This question may arise when a borrower sells or surrenders property subject to a nonrecourse obligation at a time when the fmV of the underlying property is less than the principal of the nonrecourse obligation.

- What would be the rule if the obligation were a recourse obligation?

- Arguably, a taxpayer who sells or surrenders property subject to a nonrecourse obligation should be permitted to deduct loss to the extent § 165 permits. The loss on the sale or surrender of property subject to a non-recourse obligation would be the adjusted basis in the property minus its fmV. Prior to *Tufts*, this was the position many



taxpayers took upon sale or surrender of property subject to a nonrecourse obligation because

[t]he return of a note which represents no personal liability of a taxpayer does not free any assets except those from which the note might otherwise have been paid. Since the underlying theory of income from cancellation of indebtedness is the freeing of the debtor's assets from liability for the debt, any such income is limited to the amount of assets freed by the cancellation.

*Collins v. CIR*, T.C. Memo 1963-285, 1963 WL 613 (1963).

- How does the treatment that taxpayers routinely accorded loss property subject to a nonrecourse obligation violate the first guiding principle of the income tax noted in chapter 1, *supra*?

- Notice the contention of the taxpayer in the following important case.

**Commissioner v. Tufts**, 461 U.S. 300 (1983).

JUSTICE BLACKMUN delivered the opinion of the Court.

Over 35 years ago, in *Crane v. Commissioner*, 331 U.S. 1 (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.

## I

On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. Six days later, the partnership entered into a mortgage loan agreement with the Farm & Home Savings Association (F&H). Under the

agreement, F&H was committed for a \$1,851,500 loan for the complex. In return, the partnership executed a note and a deed of trust in favor of F&H. The partnership obtained the loan on a nonrecourse basis: neither the partnership nor its partners assumed any personal liability for repayment of the loan. Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership.

The construction of the complex was completed in August, 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was \$44,212. In each tax year, all partners claimed as income tax deductions their allocable shares of ordinary losses and depreciation. The deductions taken by the partners in 1971 and 1972 totalled \$439,972. Due to these contributions and deductions, the partnership's adjusted basis in the property in August, 1972, was \$1,455,740.

In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of workers. As a result, the partnership's rental income was less than expected, and it was unable to make the payments due on the mortgage. Each partner, on August 28, 1972, sold his partnership interest to an unrelated third party, Fred Bayles. As consideration, Bayles agreed to reimburse each partner's sale expenses up to \$250; he also assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed \$1,400,000. Each partner reported the sale on his federal income tax return and indicated that a partnership loss of \$55,740 had been sustained.<sup>61</sup> The Commissioner of Internal Revenue, on audit, determined that the sale resulted in a partnership capital gain of approximately \$400,000. His theory was that the partnership had realized the full amount of the nonrecourse obligation.<sup>62</sup>

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<sup>61</sup> The loss was the difference between the adjusted basis, \$1,455,740, and the fair market value of the property, \$1,400,000. ... [You should recognize that this was the treatment that the Tax Court accorded such transactions in *Collins, supra*.]

<sup>62</sup> The Commissioner determined the partnership's gain on the sale by subtracting the adjusted basis, \$1,455,740, from the liability assumed by Bayles, \$1,851,500. Of the resulting figure, \$395,760, the Commissioner treated \$348,661 as capital gain, pursuant to § 741 of the Internal Revenue Code of 1954, and \$47,099 as ordinary gain under the recapture provisions of § 1250 of the Code. The application of § 1250 in determining the character of the gain is not at issue here.

Relying on *Millar v. Commissioner*, 577 F.2d 212, 215 (CA3), *cert. denied*, 439 U.S. 1046 (1978), the United States Tax Court, in an unreviewed decision, upheld the asserted deficiencies. The United States Court of Appeals for the Fifth Circuit reversed. That court expressly disagreed with the *Millar* analysis, and, in limiting *Crane v. Commissioner*, *supra*, to its facts, questioned the theoretical underpinnings of the *Crane* decision. We granted certiorari to resolve the conflict.

## II

... Section 1001 governs the determination of gains and losses on the disposition of property. Under § 1001(a), the gain or loss from a sale or other disposition of property is defined as the difference between “the amount realized” on the disposition and the property’s adjusted basis. Subsection (b) of § 1001 defines “amount realized:” “The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.” At issue is the application of the latter provision to the disposition of property encumbered by a nonrecourse mortgage of an amount in excess of the property’s fair market value.

## A

In *Crane v. Commissioner*, *supra*, this Court took the first and controlling step toward the resolution of this issue. Beulah B. Crane was the sole beneficiary under the will of her deceased husband. At his death in January, 1932, he owned an apartment building that was then mortgaged for an amount which proved to be equal to its fair market value, as determined for federal estate tax purposes. The widow, of course, was not personally liable on the mortgage. She operated the building for nearly seven years, hoping to turn it into a profitable venture; during that period, she claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make payments upon the mortgage principal. In computing her basis for the depreciation deductions, she included the full amount of the mortgage debt. In November, 1938, with her hopes unfulfilled and the mortgagee threatening foreclosure, Mrs. Crane sold the building. The purchaser took the property subject to the mortgage and paid Crane \$3,000; of that amount, \$500 went for the expenses of the sale.

Crane reported a gain of \$2,500 on the transaction. She reasoned that her basis in the property was zero (despite her earlier depreciation deductions based on including the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received. The Commissioner disputed this claim. He asserted that Crane’s basis in the property, under [what is now § 1014] was the

property's fair market value at the time of her husband's death, adjusted for depreciation in the interim, and that the amount realized was the net cash received plus the amount of the outstanding mortgage assumed by the purchaser.

In upholding the Commissioner's interpretation of § [1014] [footnote omitted], the Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each payment on the mortgage. The Court rejected Crane's claim that any loss due to depreciation belonged to the mortgagee. The effect of the Court's ruling was that the taxpayer's basis was the value of the property undiminished by the mortgage.

The Court next proceeded to determine the amount realized under [what is now § 1001(b)]. In order to avoid the "absurdity," of Crane's realizing only \$2,500 on the sale of property worth over a quarter of a million dollars, the Court treated the amount realized as it had treated basis, that is, by including the outstanding value of the mortgage. To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss. The Court refused to construe one section of the Revenue Act so as "to frustrate the Act as a whole."

*Taxpayer's equity in property.* Taxpayer's "equity in property" is the value of taxpayer's ownership interest. If the property is subject to a liability, then taxpayer's equity interest EQUALS the fmv of the property MINUS the liability to which the property is subject.

Crane, however, insisted that the nonrecourse nature of the mortgage required different treatment. The Court, for two reasons, disagreed. First, excluding the nonrecourse debt from the amount realized would result in the same absurdity and frustration of the Code. Second, the Court concluded that Crane obtained an economic benefit from the purchaser's assumption of the mortgage identical to the benefit conferred by the cancellation of personal debt. Because the value of the property in that case exceeded the amount of the mortgage, it was in Crane's economic interest to treat the mortgage as a personal obligation; only by so doing could she realize upon sale the appreciation in her equity represented by the \$2,500 boot. The purchaser's assumption of the liability thus resulted in a taxable economic benefit to her, just as if she had been given, in addition to the boot, a sum of cash sufficient to satisfy the mortgage. [footnote omitted].

In a footnote, pertinent to the present case, the Court observed:

“Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.” 331 U.S. at 14, n. 37.

## B

This case presents that unresolved issue. We are disinclined to overrule *Crane*, and we conclude that the same rule applies when the unpaid amount of the nonrecourse

*Boot:* The term “boot” comes from the phrase “to boot.” This colloquialism has become an important concept in much of tax law. In this case, there was an exchange of property for assumption of a mortgage, plus a little cash “to boot.” If you take more tax courses, you will encounter the term “boot” many more times.

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,<sup>63</sup> the Commissioner has chosen to accord it the same treatment he gives to a recourse mortgage loan. 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. [footnote omitted]. See *United States v. Hendler*, 303 U.S. 564, 566-567 (1938). Because no difference between recourse and nonrecourse obligations is recognized in calculating basis [footnote omitted], *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended, and will have received an unwarranted increase in the basis

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<sup>63</sup> The Commissioner might have adopted the theory, implicit in *Crane*'s contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. Note, *Federal Income Tax Treatment of Nonrecourse Debt*, 82 COLUM. L. REV. 1498, 1514 (1982); Lurie, *Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability*, 6 TAX L. REV. 319, 323 (1951); cf. Brief for Respondents 16 (nonrecourse debt resembles preferred stock). Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis. Note, 82 COLUM. L. REV. at 1515; [citation omitted].

... We note only that the *Crane* Court's resolution of the basis issue presumed that, when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. 331 U.S. at 6. Under the *Crane* approach, the mortgagee is entitled to no portion of the basis. *Id.* at 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 COLUM. L. REV. at 1513 (treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that *Crane* departed from traditional analysis that basis is taxpayer's investment in property).

of his property. [footnote omitted]. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.

## C

The Commissioner, in fact, has applied this rule even when the fair market value of the property falls below the amount of the nonrecourse obligation. Reg. § 1.1001-2(b) [footnote omitted]; Rev. Rul. 76-111. Because the theory on which the rule is based applies equally in this situation, *see Millar v. Commissioner*, 67 T.C. 656, 660 (1977), *aff'd on this issue*, 577 F.2d 212, 215-216 (CA3), *cert. denied*, 439 U.S. 1046 (1978); [footnote omitted] *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.<sup>64</sup>

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<sup>64</sup> Professor Wayne G. Barnett, as amicus in the present case, argues that the liability and property portions of the transaction should be accounted for separately. Under his view, there was a transfer of the property for \$1.4 million, and there was a cancellation of the \$1.85 million obligation for a payment of \$1.4 million. The former resulted in a capital loss of \$50,000, and the latter in the realization of \$450,000 of ordinary income. Taxation of the ordinary income might be deferred under § 108 by a reduction of respondents' bases in their partnership interests.

Although this indeed could be a justifiable mode of analysis, it has not been adopted by the Commissioner. Nor is there anything to indicate that the Code requires the Commissioner to adopt it. We note that Professor Barnett's approach does assume that recourse and nonrecourse debt may be treated identically.

The Commissioner also has chosen not to characterize the transaction as cancellation of indebtedness. We are not presented with, and do not decide, the contours of the cancellation-of-indebtedness doctrine. We note only that our approach does not fall within certain prior interpretations of that doctrine. In one view, the doctrine rests on the same initial premise as our analysis here – an obligation to repay – but the doctrine relies on a freeing-of-assets theory to attribute ordinary income to the debtor upon cancellation. *See Commissioner v. Jacobson*, 336 U.S. 28, 38-40 (1949); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 284 U.S. 3 (1931). According to that view, when nonrecourse debt is forgiven, the debtor's basis in the securing property is reduced by the amount of debt canceled, and realization of income is deferred until the sale of the property. *See Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519, 520 (1934). Because that interpretation attributes income only when assets are freed, however, an insolvent debtor realizes income just to the extent his assets exceed his liabilities after the cancellation. *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 292 (1937). Similarly, if the nonrecourse indebtedness exceeds the value of the securing property, the taxpayer never realizes the full amount of the obligation canceled, because the tax law has not recognized negative basis.

Although the economic benefit prong of *Crane* also relies on a freeing-of-assets theory, that theory is irrelevant to our broader approach. In the context of a sale or disposition of property 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



Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. The only difference between that mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. [footnote omitted]. If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.

This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free, and included them in his basis on the understanding that he had an obligation to repay the full amount. See *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357, 359 (CA2 1952); Bittker, *Tax Shelters, Nonrecourse Debt, and the Crane Case*, 33 TAX L. REV. 277, at 284 n.7 (1978). When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received, and thus realizes value to that extent within the meaning of § 1001(b). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.

Moreover, this approach avoids the absurdity the Court recognized in *Crane*. Because of the remedy accompanying the mortgage in the nonrecourse situation, the depreciation in the fair market value of the property is relevant economically only to the mortgagee, who, by lending on a nonrecourse basis, remains at risk. To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss. [footnote omitted]. Such a result would be to construe "one section of the Act ... so as ... to defeat the intention of another or to frustrate the Act as a whole." 331 U.S. at 13.

In the specific circumstances of *Crane*, the economic benefit theory did support the Commissioner's treatment of the nonrecourse mortgage as a personal obligation. The footnote in *Crane* acknowledged the limitations of that theory when applied to

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of the outstanding liability is included in the amount realized. Thus, the problem of negative basis is avoided.



a different set of facts. *Crane* also stands for the broader proposition, however, that a nonrecourse loan should be treated as a true loan. We therefore hold that a taxpayer must account for the proceeds of obligations he has received tax-free and included in basis. Nothing in either § 1001(b) or in the Court’s prior decisions requires the Commissioner to permit a taxpayer to treat a sale of encumbered property asymmetrically, by including the proceeds of the nonrecourse obligation in basis but not accounting for the proceeds upon transfer of the encumbered property. [citation omitted].

### III

....

### IV

When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation. We find this interpretation to be consistent with *Crane v. Commissioner*, 331 U.S. 1 (1947), and to implement the statutory mandate in a reasonable manner. [citation omitted].

The judgment of the Court of Appeals is therefore reversed.

*It is so ordered.*

JUSTICE O’CONNOR, concurring.

I concur in the opinion of the Court, accepting the view of the Commissioner. I do not, however, endorse the Commissioner’s view. Indeed, were we writing on a slate clean except for the decision in *Crane v. Commissioner*, 331 U.S. 1 (1947), I would take quite a different approach – that urged upon us by Professor Barnett as amicus.

*Crane* established that a taxpayer could treat property as entirely his own, in spite of the “coinvestment” provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any way tie nonrecourse debt to the cost of property or to the proceeds upon disposition. I see no reason to treat the purchase, ownership, and eventual disposition of property differently because the taxpayer also takes out a mortgage, an independent transaction. In this case, the

taxpayer purchased property, using nonrecourse financing, and sold it after it declined in value to a buyer who assumed the mortgage. ...

The logical way to treat ... this case ... is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan. Under *Crane*, the fair market value of the property on the date of acquisition – the purchase price – represents the taxpayer's basis in the property, and the fair market value on the date of disposition represents the proceeds on sale. The benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than the fair market value of the property, for that is all the mortgagee can expect to collect on the mortgage. His gain or loss on the disposition of the property equals the difference between the proceeds and the cost of acquisition. Thus, the taxation of the transaction in property reflects the economic fate of the property. If the property has declined in value, as was the case here, the taxpayer recognizes a loss on the disposition of the property. The new purchaser then takes as his basis the fair market value as of the date of the sale. [citations omitted].

In the separate borrowing transaction, the taxpayer acquires cash from the mortgagee. He need not recognize income at that time, of course, because he also incurs an obligation to repay the money. Later, though, when he is able to satisfy the debt by surrendering property that is worth less than the face amount of the debt, we have a classic situation of cancellation of indebtedness, requiring the taxpayer to recognize income in the amount of the difference between the proceeds of the loan and the amount for which he is able to satisfy his creditor. 26 U.S.C. § [61(a)(11)]. 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,

**Tax Shelters:** Tax shelters create a mismatch in timing between claiming deductions and reporting taxable gain. Taxpayer claims deductions against borrowed money and reports taxable gain only upon sale of the property. What might this mismatch in timing of deductions and taxable gain be worth? See present value tables, Chapter 2, *supra*.

Rev. Rul. 76-111, is now reflected in the regulations. Reg. § 1.1001-2 (1982). In the light of the numerous cases in the lower courts including the amount of the unrepaid proceeds of the mortgage in the proceeds on sale or disposition [citations omitted], it is difficult to conclude that the Commissioner's interpretation of the statute exceeds the bounds of his discretion. As the Court's opinion demonstrates, his interpretation is

defensible. One can reasonably read § 1001(b)'s reference to "the amount realized from the sale or other disposition of property" (emphasis added) to permit the Commissioner to collapse the two aspects of the transaction. As long as his view is a reasonable reading of § 1001(b), we should defer to the regulations promulgated by the agency charged with interpretation of the statute. [citations omitted]. Accordingly, I concur.

#### *Notes and Questions:*

1. Notice that taxpayers' allowable depreciation deductions reduced their adjusted basis in the property. Why is it necessary that this be the rule?

- Aside from computation of gain under § 1001, what significance is there in the fact that taxpayer includes borrowed money in determining his adjusted basis in property?

2. What was in this for Fred Bayles? How was he going to profit by assuming a nonrecourse obligation that was greater than the fmV of the property?

3. Does this case unmoor cancellation of indebtedness income from the necessity of establishing a "freeing of assets" or a "shrinking of assets?"

- The Court's opinion does not treat *any* of the loan as having been cancelled.

It is *all* included in “amount realized.”

4. Read Reg. § 1.1001-2(a)(2). It seems to apply Justice O’Connor’s/Professor Barnett’s theory to discharge of *recourse* liability when the fmV of the property is less than the outstanding principal of the loan. Why the difference?

•Did the lender Farm & Home Savings Association discharge any indebtedness in *Tufts*?

**Taxpayer’s Minimum Gain:** After *Tufts*, irrespective of the fmV of the property, taxpayer’s *minimum* gain on its disposition is the amount of the nonrecourse loan assumed by the purchaser MINUS the adjusted basis of the property. Taxpayer will not realize less gain than that upon disposition of property subject to a nonrecourse loan. Do you see why?

5. Property that is subject to depreciation is *not* a capital asset. § 1221(a)(2). A special wartime measure, § 1231, allows taxpayer to treat such property held for more than one year as a capital asset if a sale or disposition produces gain.

**Rev. Rul.** 90-16, 1990-1 C.B. 12

....

Property transfer by insolvent taxpayer in satisfaction of debt secured by property. A transfer of property to a bank in satisfaction of a debt on which the taxpayer is personally liable and which is secured by the property is a disposition upon which gain is recognized under §§ 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the property exceeds the taxpayer’s adjusted basis in the property.

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer’s basis in satisfaction of a debt for which the

taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under §§ 1001(c) and 61(a)(3) of the Internal Revenue Code?

## FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, X obtained a loan from an unrelated bank. X was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of § 108(d)(3) of the Code) and defaulted on the debt. X negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released X from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000x dollars, X's adjusted basis in the subdivision was 8,000x dollars, and the amount due on the debt was 12,000x dollars, which did not represent any accrued but unpaid interest. After the transaction X was still insolvent.

## LAW AND ANALYSIS

Sections 61(a)(3) and [61(a)(11)] of the Code provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which § 108(a)(1)(B) applies, the amount excluded under § 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in § 108(d)(3)).

Reg. § 1.61-6(a) provides that the specific rules for computing the amount of gain or loss from dealings in property under § 61(a)(3) are contained in § 1001 and the regulations thereunder.

Section 1001(a) of the Code provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in § 1011 for determining gain.

Section 1001(b) of the Code provides that the amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received.

Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under § 1001, on the sale or exchange of property shall be recognized.

Reg. § 1.1001-2(a)(1) provides that, except as provided in § 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under [§ 61(a)(11)]. Example (8) under § 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 (\$7,500 – \$6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under § 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under § 108(a)(1)(B) of the Code, the full amount of X's discharge of indebtedness income is excluded from gross income because that

amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a ‘disposition’ within the scope of the gain or loss provisions of § 1001 of the Code. *See Helvering v. Hammel*, 311 U.S. 504 (1941); *Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513 (1941); and *Danenberg v. Commissioner*, 73 T.C. 370 (1979), *acq.*, 1980-2 C.B. 1.

## HOLDING

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under §§ 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the subdivision transferred exceeds X’s adjusted basis. Subject to the application of § 108 of the Code, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.

## Notes and Questions:

1. What would have been the result if the adjusted basis of the property had been \$7000x?
2. Why is it so important to this revenue ruling that taxpayer is insolvent?
3. You should recognize that the holding in *Gehl* is in exact accord with the IRS’s position in this revenue ruling.
4. Read Reg. § 1.1001-3(b). You might have to get this regulation on Westlaw or Lexis. A “material modification” of a debt instrument results in an exchange for purposes of § 1001(a). What is the effect of this treatment?
5. Would the result have been the same if the loan had been without recourse? Read on.

**Rev. Rul. 91-31, 1991-C.B. 19-1**  
**DISCHARGE OF INDEBTEDNESS**

...

**ISSUE**

If the principal amount of an undersecured nonrecourse debt is reduced by the holder of the debt who was not the seller of the property securing the debt, does this debt reduction result in the realization of discharge of indebtedness income for the year of the reduction under [§ 61(a)(11)] of the Internal Revenue Code or in the reduction of the *basis* in the property securing the debt?

**FACTS**

In 1988, individual A borrowed \$1,000,000 from C and signed a note payable to C for \$1,000,000 that bore interest at a fixed market rate payable annually. A had no personal liability with respect to the note, which was secured by an office building valued at \$1,000,000 that A acquired from B with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was \$800,000 and the outstanding principal on the note was \$1,000,000, C agreed to modify the terms of the note by reducing the note's principal amount to \$800,000. The modified note bore adequate stated interest within the meaning of § 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by § 108(a) do not apply.

**LAW AND ANALYSIS**

Section [61(a)(11)] of the Code provides that gross income includes income from the discharge of indebtedness. Reg. § 1.61-12(a) provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer's residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than



the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under [§ 61(a)(11)] of the Code, whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm's length transaction at less than their face amount.

In *Commissioner v. Tufts*, 461 U.S. 300 (1983), the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. See § 1.1001-2(c), Example 7, of the Income Tax Regulations.

In *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of \$250,000 for a \$40,000 cash payment (rather than surrender of the \$2,500 collateral) resulted in \$210,000 of discharge of indebtedness income. The court, following the *Tufts* holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in *Gershkowitz* where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes \$200,000 of discharge of indebtedness income in 1989 as a result of the modification of A's note payable to C.

In an earlier Board of Tax Appeals decision, *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer's gain or loss upon the sale of the property in a later year, held that the taxpayer's basis in the property should have been reduced

by the amount of the mortgage debt forgiven in the earlier year.

The *Tufts* and *Gershkowitz* decisions implicitly reject any interpretation of *Fulton Gold* that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. *Fulton Gold*, interpreted in this manner, is inconsistent with *Tufts* and *Gershkowitz*. Therefore, that interpretation is rejected and will not be followed.

## HOLDING

The reduction of the principal amount of an undersecured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under § [61(a)(11)] of the Code.

### *Notes and Questions:*

1. *Compare Gershkowitz* (summarized in Rev. Rul. 91-31) and *Tufts*. When and why does it matter whether taxpayer is relieved of a nonrecourse obligation through doi or through realization of the amount of the obligation?
2. What is the rule of Rev. Rul. 82-202, as stated in Rev. Rul. 91-31?
  - We've asked about this before.
3. If the creditor *is* the seller of the property – i.e., the debt was purchase money debt – the revenue ruling implies that the holding might be different.
  - What do you think should be the result in such a case?
    - No doi income, but a reduction of basis?
    - A purchase price (and basis) reduction if taxpayer is solvent?
    - No doi income, and amount of debt included in debtor's "amount realized" – as in *Tufts*?
  - See Reg. § 1.1001-2(c), Example 7 (which the IRS cites in connection with its discussion of *Tufts*).
4. To what extent should taxpayer take account of nonrecourse debt in determining whether he is insolvent for purposes of applying § 108? In Rev. Rul. 92-53, 1992-2 C.B. 48, the IRS stated that

the amount by which a nonrecourse debt exceeds the fair market value of the property securing the debt is taken into account in determining whether, and to what extent, a taxpayer is insolvent within the meaning of § 108(d)(3) of the Code, but only to the extent that the excess nonrecourse debt is discharged.

Nonrecourse debt up to the fmv of the property is taken into account. Why shouldn't the full excess of the amount of the nonrecourse debt over the fmv of the property – even that which is not discharged – be taken into account? How does the IRS's treatment of nonrecourse debt preserve taxpayer's "fresh start" – but no more?

## VI. Transactions Treated as Loans

The use of borrowed money for a term is not free, just as the use of a "borrowed" apartment for a term is not free. A person pays for the use of another's money by paying interest. The payment and receipt of interest have certain tax consequences. Payment of interest might be deductible from a taxpayer's ordinary income. *See* § 163. The recipient of interest realizes gross income. *See* 61(a)(4). Lenders and borrowers usually create loans with another transaction in mind, e.g., purchase of property, investment. *Those* transactions generate certain tax consequences that may differ from the tax consequences of payment of interest, e.g., taxation of capital gains at a rate lower than the tax rate on ordinary income (*see* chapter 10, *infra*). When parties to a transaction combine a loan with another transaction (e.g., a seller-financed purchase), the Code's rules may create and carve out an interest element. The Code also provides some timing rules that govern transactions in which the parties fail to specify when interest is paid.

Consider: (1) Clifton Corporation issued \$10M worth of bonds on January 1, 2018. For each \$10,000 bond that an investor purchased, Clifton Corporation promised to pay \$15,007.30 on January 1, 2024. Taxpayer Linda invested \$10,000 on January 1, 2018 in Clifton Corporation bonds. She held the Clifton Corporation bonds until their maturity on January 1, 2024 at which time Clifton Corporation paid her \$15,007.30. Obviously, Linda realized \$5007.30 of interest income. When? Obviously, Clifton Corporation paid \$5007.30 in interest. When?

(1a) Suppose that Linda had sold the Clifton Corporation bond on January 1, 2021 for \$13,000. Obviously (?) Linda realized a total of \$3000 of income. When? How

much of it was interest income and how much of it was gain derived from dealing in property? The Buyer would have a \$13,000 basis in the bond. How should Buyer treat his eventual receipt of \$15,007.30? When?

(2) Seller agreed to sell Blackacre to Buyer for \$3,500,000. Seller's basis in Blackacre was \$2,500,000. The terms of the agreement were that Buyer would pay Seller \$350,000 every year for ten years. The parties stated no other terms of their agreement. Assume that Buyer made all the required payments. Upon fulfillment of all his obligations, what is Buyer's basis in Blackacre? How much interest income must Seller recognize in each of years 1 through 10? How much must Seller recognize as gain derived from dealing in property?

These transactions all involve the unstated payment and receipt of interest. Sections 1271 to 1288 and 483<sup>65</sup> deal with variations of the issues that these hypothetical fact patterns raise. Our concern is with basic principles and not the details of implementation. These provisions essentially "read into" the parties' agreements the payment and receipt of interest annually and require tax treatment to track such payment and receipt. The effect of such requirements is that the parties must account for interest on a compounding basis. When the principal does not decline – as with Clifton Corporation's payment of interest on a bond – the amount of interest per period (one year) will increase over time. When the principal does decline – as with Buyer's payment of principal plus interest on the declining principal in the second example – the amount of interest per period will decrease from one year to the next.<sup>66</sup>

The terms of these arrangements all required performance of obligations at different times and thereby raised time value of money issues. The Code sections create an interest rate and prescribe a certain compounding period – essentially semi-annual. We will note the compounding period that the sections relevant to this discussion requires, *but we will borrow from the tables in chapter 2* that follow the *Bruun* case. Those tables reflect compounding interest on an annual basis.

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<sup>65</sup> We will not consider § 483, but its rules are similar to those we examine here for the transactions to which it applies.

<sup>66</sup> Google "mortgage interest amortization schedule." Choose one. I found the one at <https://financial-calculators.com/amortization-schedule> to be user friendly to political science majors and others resistant to finance formulas. The user can play around with the variables that determine interest and principal.

*Examples (1) and (1a):* Section 1272(a)(1) provides for inclusion of interest income in the gross income of a holder of a debt instrument as the interest accrues, i.e., taxpayer Linda in Example (1) must include in her gross income interest as if Clifton had paid it and it was compounded semi-annually (§ 1272(a)(5)).

- Section 1273(a)(1) defines “original issue discount” to be the redemption price at maturity minus the issue price.

- In Example (1) above, the “original issue discount” would be  $\$15,007.30 - \$10,000 = \$5007.30$ . This happens to be the interest that would be paid if the interest rate were 7%. Use that figure when working from table 1 in chapter 2.<sup>67</sup>

- By using table 1, we learn that Linda should include \$700 in her gross income one year after making her investment. Because she has paid income tax on \$700, Linda’s basis in the bond increases to \$10,700. § 1272(d)(2).

- Section 163(e)(1) provides for the same measurement of any allowable interest deduction for the Clifton Corporation.

- After two years, Linda’s interest income will total \$1449. Because she already included \$700 in her gross income, her interest income for year 2 that she must include in her gross income is \$749.<sup>68</sup> Notice that it was more than it was in year 1.

After three years, Linda would have paid tax on a total of \$2250 of interest income. She must include \$801 of interest income in her gross income for year 3 – again, more than her interest income in year 2. The basis in her bond would be \$12,250. She would realize \$750 of gain from dealing in property upon its sale for \$13,000. See Example (1a).

- Buyer paid a “premium,” i.e., Buyer paid \$750 more than Linda’s adjusted basis in the bond. Buyer will step into Linda’s shoes and recognize interest income on the bond. However, Buyer will reduce the interest based upon a similar calculation of the \$750 premium spread over the time remaining to maturity of the bond. § 1272(a)(7).

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<sup>67</sup> Table 1 in chapter 2 provides values that are compounded annually. Hence, these values are not quite accurate in the context of § 1272, which requires daily compounding.

<sup>68</sup> Technically, § 1272(a)(3 and 4) requires a recalculation of interest based upon an increasing “issue price” and a decreasing length of time until redemption.

*Example 2:* Section 1274 provides that when a debt instrument is given in exchange for property (§ 1274(c)(1)), the interest must be at least the “applicable federal rate” (AFR). If it is not, then the debt payments are structured as if the interest rate is the AFR.

- The AFR depends on the term of the debt instrument – whether short-term, mid-term, or long-term. The Treasury Department determines AFRs monthly. § 1274(d).
- The *imputed principal* amount of a debt instrument is the sum of the present values of all future payments. The present value is determined by using the AFR compounded semi-annually. § 1274(b)(1 and 2).
- In Example 2, assume again that the interest rate is 7%. Refer to table 3<sup>69</sup> in the materials following *Bruun*, i.e., the table that gives the present value of a fixed annuity payment. The multiplier for ten years is 7.0236. The annual payment is \$350,000.  $\$350,000 \times 7.0236 = \$2,458,260$ .
- Since Seller will receive a total of \$3,500,000, the difference between that amount and \$2,458,260 must be interest, i.e., \$1,041,740. The parties will allocate it on the same yield-to-maturity principles of § 1272 applicable to OID.
- Even though Seller will have \$1M of income from the transaction, Seller actually *lost* money on the sale. Seller will realize substantial interest income – which is subject to a higher tax rate than long-term capital gain.

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<sup>69</sup> Table 3 in chapter 2 provides values that are compounded annually. Hence, these values are not quite accurate in the context of § 1274, which requires semiannual compounding.

## Wrap-up Questions for Chapter 4

Reminder: For a good summary of the topics covered in this chapter, see Douglas Kahn & Jeffrey H. Kahn, *Cancellation of Debt and Related Transactions*, 69 TAX LAW. 161 (2015).

1. What is wrong with the shrinkage of assets doctrine? Why should a loan and the use of loan proceeds be treated as separate transactions?
2. What should be the applicability of the “disputed debt doctrine” to cases where the amount of a debt is fixed and determined, but its enforceability (in a court) is highly unlikely? Taxpayer borrows money to engage in an illegal transaction.
3. The Bankruptcy Code, 11 U.S.C. § 523(a)(8) makes discharge of a student loan quite difficult, i.e., bankrupt must show “undue hardship on the debtor and the debtor’s dependents.” Section 108(f)(1) of the I.R.C. excludes doi income from a taxpayer’s gross income when “discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period in certain professions for any of a broad class of employers.” What should be the practical effect of these provisions?
4. What reasons might support treating receipt of loan proceeds as gross income and treating repayment of the loan as deductible? What would be the effects on the economy?
5. You have seen that various types of loans fall within § 108 and are therefore subject to the favorable treatment that that section provides. Should there be others? Some argue that *any* forgiveness of a student loan should be excluded from gross income. Do you agree?

### What have you learned?

Can you explain or define –

- Why a taxpayer does not in fact exclude the proceeds of a loan from his gross income?
- What is §108’s treatment of doi income if taxpayer is in a bankruptcy proceeding?
- What is § 108’s treatment of doi income if taxpayer is insolvent?
- When a taxpayer is insolvent?
- What are the conditions of excludability of a purchase money debt reduction under § 108(e)(5)?

- What a recourse loan is; what a non-recourse loan is?
- Why the buyer's assumption of a loan to which property is subject must be included in the seller's "amount realized"?



## Chapter 5: Progressivity and Assignment of Income

The principle of progressive taxation is that tax rates applicable to increments of taxable income increase. Currently there are seven marginal brackets – eight if we count income that is below the threshold of taxable income.<sup>70</sup> If a taxpayer can spread her income among other taxpayers, more of taxpayer's income will be subject to the lowest marginal rates of tax and less to the higher rates of tax.

The following table illustrates the point. It shows the income tax burden of a person whose taxable income is \$210,000. Hypothetical marginal tax brackets are as noted. The total tax burden of this taxpayer is \$50,000.

### *The Tax Formula:*

(gross income)  
MINUS deductions named in § 62

EQUALS (adjusted gross income (AGI))

MINUS (standard deduction or itemized deductions)

MINUS (deduction for "qualified business income")

EQUALS (taxable income)

→ Compute income tax liability from tables in § 1(j) (indexed for inflation)

MINUS (credits against tax)

Taxable Income range	Marginal Tax Rate	Tax
\$0 to \$10,000	0%	\$0
\$10,000 to \$60,000	10%	\$5,000
\$60,000 to \$110,000	20%	\$10,000
\$110,000 to \$160,000	30%	\$15,000
\$160,000 to \$210,000	40%	\$20,000
Total		\$50,000

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<sup>70</sup> The standard deduction assures that some income is not subject to any income tax.

Our taxpayer might try to reduce her tax burden by “assigning” some of her taxable income to persons she controls – perhaps two children. Our taxpayer might decide that she and each of the two children should receive \$70,000 of the original \$210,000 total. The new tax computation table would be the following:

Taxable Income range	Marginal Tax Rate	Tax
\$0 to \$10,000	0%	\$0
\$10,000 to \$60,000	10%	\$5000
\$60,000 to \$110,000	20%	\$2000 <sup>71</sup>
Total		\$7000 x 3 = \$21,000

The total tax burden of three different persons, each with taxable income of \$70,000, would be less than half the tax burden of one person with taxable income of \$210,000.<sup>72</sup> This characteristic of progressive tax rates has led taxpayers to create many schemes to “split income” so that more of it would be subject to lower rates of income tax.

The courts have created the “assignment of income”<sup>73</sup> doctrine to prevent abusive income splitting. In addition, Congress has created some statutory rules that limit assignments of income. We begin with the leading case.

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<sup>71</sup> Only \$10,000 of each taxpayer’s taxable income would be subject to the 20% rate of income tax.

<sup>72</sup> Three different standard deductions would alter the precise tax burdens.

<sup>73</sup> This is really a misnomer. The “assignment of income” doctrine prevents assignment of income. A more accurate name would be the “non-assignment of income” doctrine.

## I. Compensation for Services

**Lucas v. Earl**, 281 U.S. 111 (1930).

JUSTICE HOLMES delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the circuit court of appeals. A writ of certiorari was granted by this Court.

By the contract, made in 1901, Earl and his wife agreed "that any property either of us now has or may hereafter acquire ... in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds, issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship." The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

The Revenue Act of 1918 approved February 24, 1919, c. 18, §§ 210, 211, 212(a), 213(a), 40 Stat. 1057, 1062, 1064, 1065, imposes a tax upon the net income of every individual including "income derived from salaries, wages, or compensation for personal service ... of whatever kind and in whatever form paid," § 213(a). The provisions of the Revenue Act of 1921 ... are similar to those of the above. A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that, taking the question more technically, the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because, however the matter might stand between husband and wife, he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them, and provide that

the tax could not be escaped by anticipatory arrangements and contracts, however skillfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us, and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

*Notes and Questions:*

1. This case is the origin of the “assignment of income” doctrine, i.e., a taxpayer cannot assign her income tax liability to another by assigning income not yet earned to another.

2. The Earls entered their contract in 1901 – at a time when most people believed that a federal personal income tax was unconstitutional and fifteen years before Congress enacted the income tax statute. This “anticipatory assignment” could hardly have had as a purpose the avoidance of federal income tax liability.

- In fact, Guy Earl probably utilized the contract as an estate planning device. He was not in good health, and by this simple contract, he was able to pass half of his property – already owned or to be acquired – to his wife without need of probate. At the time, there was no right of survivorship in California community property. See Patricia A. Cain, *The Story of Earl: How Echoes (and Metaphors) from the Past Continue to Shape the Assignment of Income Doctrine*, in TAX STORIES 305, 315 (Paul Caron, ed., 2d ed. 2009).

3. Is Mr. Earl subject to income tax in this case because he earned the income or because he exercised a right to assign its receipt prospectively?

4a. Consider: Taxpayer was a server at a restaurant and collected tips from customers. At the end of each shift, she would “tip out” various other restaurant employees, including busboys, bartenders, cooks, and other servers who assisted her during particularly busy times.

- The Commissioner argues that Taxpayer’s gross income includes *all* the tip income. Taxpayer may deduct as a trade or business expense what she pays other employees.

- Taxpayer argued that what she paid other employees was not even gross

income to her.

- Why does one characterization rather than the other matter? Read §§ 62(a)(1), 67(a, b, g).

- What result?

- See, e.g., *Brown v. Commissioner*, T.C. Memo 1996-310, 1996 WL 384904 (1996).

4b. Taxpayer was a partner in a partnership. Partnerships do not pay income taxes. Rather, individual partners are liable for income tax on their individual distributive shares of partnership profits. Taxpayer and his wife entered an agreement whereby she was made a full and equal partner with him. Wife performed no services and the other partners were not a party to this agreement.

- Taxpayer argued that he should be taxed on one half of his partnership distributive share, and his wife should be taxed on one half of his distributive share. This case predates married filing jointly tax returns.

- What result?

- See *Burnet v. Leininger*, 285 U.S. 136, 142 (1932).

5. How useful is the tree-fruits metaphor in resolving difficult questions of assignment of income?

- Taxpayer works for Mega Corporation. Taxpayer was personally responsible for generating \$1M of new business for Mega. Mega paid taxpayer his usual salary of \$100,000. Next year, Mega will give taxpayer a 50% raise. On how much income should taxpayer be liable for income tax –

- in year 1?

- in year 2?

**Poe v. Seaborn**, 282 U.S. 101 (1930).

MR. JUSTICE ROBERTS delivered the opinion of the Court.

Seaborn and his wife, citizens and residents of the State of Washington, made for the year 1927 separate income tax returns as permitted by the Revenue Act of 1926, c. 27, § 223 (U.S.C.App., Title 26, § 964).

During and prior to 1927, they accumulated property comprising real estate, stocks, bonds and other personal property. While the real estate stood in his name alone, it

is undisputed that all of the property, real and personal, constituted community property, and that neither owned any separate property or had any separate income.

The income comprised Seaborn's salary, interest on bank deposits and on bonds, dividends, and profits on sales of real and personal property. He and his wife each returned one-half the total community income as gross income, and each deducted one-half of the community expenses to arrive at the net income returned.

The Commissioner of Internal Revenue determined that all of the income should have been reported in the husband's return, and made an additional assessment against him. Seaborn paid under protest, claimed a refund, and, on its rejection, brought this suit.

The district court rendered judgment for the plaintiff; the Collector appealed, and the circuit court of appeals certified to us the question whether the husband was bound to report for income tax the entire income, or whether the spouses were entitled each to return one-half thereof. This Court ordered the whole record to be sent up.

The case requires us to construe §§ 210(a) and 211(a) of the Revenue Act of 1926 (44 Stat. 21, U.S.C.App. Tit. 26, §§ 951 and 952), and apply them, as construed, to the interests of husband and wife in community property under the law of Washington. These sections lay a tax upon the net income of every individual. [footnote omitted] The Act goes no farther, and furnishes no other standard or definition of what constitutes an individual's income. The use of the word "of" denotes ownership. It would be a strained construction, which, in the absence of further definition by Congress, should impute a broader significance to the phrase.

The Commissioner concedes that the answer to the question involved in the cause must be found in the provisions of the law of the state as to a wife's ownership of or interest in community property. What, then, is the law of Washington as to the ownership of community property and of community income including the earnings of the husband's and wife's labor?

The answer is found in the statutes of the state [footnote omitted] and the decisions interpreting them.

These statutes provide that, save for property acquired by gift, bequest, devise, or inheritance, all property however acquired after marriage by either husband or wife

or by both is community property. On the death of either spouse, his or her interest is subject to testamentary disposition, and, failing that, it passes to the issue of the decedent, and not to the surviving spouse. While the husband has the management and control of community personal property and like power of disposition thereof as of his separate personal property, this power is subject to restrictions which are inconsistent with denial of the wife's interest as co owner. The wife may borrow for community purposes and bind the community property. [citation omitted]. Since the husband may not discharge his separate obligation out of community property, she may, suing alone, enjoin collection of his separate debt out of community property. [citation omitted]. She may prevent his making substantial gifts out of community property without her consent. [citation omitted]. The community property is not liable for the husband's torts not committed in carrying on the business of the community. [citation omitted].

The books are full of expressions such as "the personal property is just as much hers as his" [citation omitted]; "her property right in it [(an automobile)] is as great as his" [citation omitted]; "the title of the spouse therein was a legal title, as well as that of the other" [citation omitted].

Without further extending this opinion, it must suffice to say that it is clear the wife has, in Washington, a vested property right in the community property equal with that of her husband, and in the income of the community, including salaries or wages of either husband or wife, or both. ...

The taxpayer contends that, if the test of taxability under Sections 210 and 211 is ownership, it is clear that income of community property is owned by the community, and that husband and wife have each a present vested one-half interest therein.

The Commissioner contends, however, that we are here concerned not with mere names, nor even with mere technical legal titles; that calling the wife's interest vested is nothing to the purpose, because the husband has such broad powers of control and alienation that, while the community lasts, he is essentially the owner of the whole community property, and ought so to be considered for the purposes of §§ 210 and 211. He points out that, as to personal property, the husband may convey it, may make contracts affecting it, may do anything with it short of committing a fraud on his wife's rights. And though the wife must join in any sale of real estate, he asserts that the same is true, by virtue of statutes, in most states which do not have the community system. He asserts that control without

accountability is indistinguishable from ownership, and that, since the husband has this, quoad community property and income, the income is that “of” the husband under §§ 210, 211 of the income tax law.

We think, in view of the law of Washington above stated, this contention is unsound. The community must act through an agent. This Court has said with respect to the community property system [citation omitted] that “property acquired during marriage with community funds became an acquêt 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.”

<i>quoad</i> : as to; as long as; until <i>acquêt</i> : property
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....

The obligations of the husband as agent of the community are no less real because the policy of the state limits the wife’s right to call him to account in a court. Power is not synonymous with right. Nor is obligation coterminous with legal remedy. The law’s investiture of the husband with broad powers by no means negatives the wife’s present interest as a co-owner.

We are of opinion that, under the law of Washington, the entire property and income of the community can no more be said to be that of the husband than it could rightly be termed that of the wife.

....

The Commissioner urges that we have, in principle, decided the instant question in favor of the government. He relies on [citations omitted] and *Lucas v. Earl*, 281 U. S. 111.

....

In the *Earl* case, a husband and wife contracted that any property they had or might thereafter acquire in any way, either by earnings (including salaries, fees, etc.) or any rights by contract or otherwise, “shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants. ...” We held that assuming the validity of the contract under local law, it still remained true that



the husband's professional fees, earned in years subsequent to the date of the contract, were his individual income, "derived from salaries, wages, or compensation for personal service" under § 210, 211, 212(a) and 213 of the Revenue Act of 1918. The very assignment in that case was bottomed on the fact that the earnings would be the husband's property, else there would have been nothing on which 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 answer to such argument, however, is that the constitutional requirement of uniformity is not intrinsic, but geographic. [citations omitted]. And differences of state law, which may bring a person within or without the category designated by Congress as taxable, may not be read into the Revenue Act to spell out a lack of uniformity. [citation omitted].

The district court was right in holding that the husband and wife were entitled to file separate returns, each treating one-half of the community income as his or her respective incomes, and its judgment is

Affirmed.

THE CHIEF JUSTICE and MR. JUSTICE STONE took no part in the consideration or decision of this case.

*Notes and Questions:*

1. Is the distinction of ownership by operation of state law rather than by operation of a contract convincing? Would you expect the same resolution of the conflict to be applied to partnership allocations of income embodied in a partnership agreement, i.e., in a contract? Why the difference?
2. When taxpayer lawfully performed services for which insurance commissions were paid but which taxpayer could not legally receive, the Supreme Court held that taxpayer did not have sufficient dominion over the income to be required to include it in its gross income. *Comm'r v. First Security Bank of Utah*, 405 U.S. 394, 405 (1972) (“We think that fairness requires the tax to fall on the party that actually receives the premiums, rather than on the party that cannot.”).
3. Rather than assign salary income to another, can a taxpayer effectively waive her right to receive a salary? See *Giannini v. Commissioner*, 129 F.2d 638 (9<sup>th</sup> Cir. 1942).



Do the CALI Lesson, *Basic Federal Income Taxation: Assignment of Income: Services*.

## **II. Income Splitting: the Joint Return**

The following excerpt from a legislative report from 2001 reviews the ebb and flow of policy in the choice of tax bracket breakpoints for different filing statuses. In 2001, there was a “marriage penalty” at all income levels. Not everyone liked this. Who would prefer it? The tax brackets to which the excerpt refers have changed, but the policy considerations remain relevant.

**Joint Committee on Taxation, *Overview of Present Law and Economic Analysis Relating to the Marriage Tax Penalty, the Child Tax Credit, and the Alternative Minimum Tax* 2-11 (March 7, 2001).**

## **I. Marriage Tax Penalty**

### **A. Present Law and Legislative Background**

#### **Present Law**

##### **In general**

A marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). A marriage bonus exists when the sum of the tax liabilities of the individuals is greater than their combined tax liability under a joint return.

....

#### **Legislative Background**

The marriage penalty ... dates from changes in the structure of individual income tax rates in 1969.<sup>74</sup> To understand the effect of those changes, one needs to go back to 1948, when separate rate schedules for married couples filing joint returns and single taxpayers were introduced.

Before 1948, there was only one income tax schedule, and all individuals were liable for tax as separate filing units. Under this tax structure, there was neither a marriage penalty nor a marriage bonus. However, this structure created an incentive to split incomes because, with a progressive income tax rate structure, a married couple with only one spouse earning income could reduce their combined tax liability if they could split their income and assign half to each spouse. While the Supreme Court upheld the denial of contractual attempts to split income,<sup>75</sup> it ruled that in States with

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<sup>74</sup> In 1951, a separate rate schedule was created for unmarried heads of household with dependents (“head of household” status). Because the bracket breakpoints and standard deduction were more than half of those for joint returns, marriage penalties arose for some taxpayers eligible for filing as head of household.

<sup>75</sup> *Lucas v. Earl*, 281 U.S. 111 (1930).

community property laws, income splitting was required for community income.<sup>76</sup> As income tax rates and the number of individuals liable for income taxes increased before and during World War II, States had an increasing incentive to adopt community property statutes to give their citizens the tax benefits of income splitting.

The Revenue Act of 1948 provided the benefit of income splitting to all married couples by establishing a separate tax schedule for married couples filing joint returns. That schedule was designed so that married couples would pay twice the tax of a single taxpayer having one-half the couple's taxable income.<sup>77</sup> ... 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. This schedule created a marriage penalty for some taxpayers.

....

### **Marriage neutrality versus equal taxation of married couples with equal incomes**

Any system of taxing married couples requires making a choice among three different concepts of tax equity. One concept is that the tax system should be "marriage neutral;" that is, the tax burden of a married couple should be exactly equal to the combined tax burden of two single persons where one has the same income as the husband and the other has the same income as the wife. A second concept of equity is that, because married couples frequently consume as a unit, couples with the same income should pay the same amount of tax regardless of how the income is divided between them. ... A third concept of equity is that the income tax should be progressive; that is, as income rises, the tax burden should rise as a percentage of income.

These three concepts of equity are mutually inconsistent. A tax system can generally satisfy any two of them, but not all three. The current tax system is progressive: as a

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<sup>76</sup> *Poe v. Seaborn*, 282 U.S. 101 (1930).

<sup>77</sup> This relationship between rate schedules is the same as that between joint returns and separate returns for married couples under present law.

taxpayer's income rises, the tax burden increases as a percentage of income. It also taxes married couples with equal income equally: It specifies the married couple as the tax unit so that married couples with the same income pay the same tax. But it is not marriage neutral.<sup>78</sup> A system of mandatory separate filing for married couples would sacrifice the principle of equal taxation of married couples with equal incomes for the principle of marriage neutrality unless it were to forgo progressivity. [footnote omitted]

There is disagreement as to whether equal taxation of couples with equal incomes is a better principle than marriage neutrality.<sup>79</sup> Those who hold marriage neutrality to be more important tend to focus on marriage penalties that may arise ... and argue that tax policy discourages marriage and encourages unmarried individuals to cohabit without getting married, thereby lowering society's standard of morality. Also, they argue that it is simply unfair to impose a marriage penalty even if the penalty does not actually deter anyone from marrying.

Those who favor the principle of equal taxation of married couples with equal incomes argue that as long as most couples pool their income and consume as a unit, two married couple[s] with \$20,000 of income are equally well off regardless of whether their income is divided \$10,000-\$10,000 or \$15,000-\$5,000. Thus, it is argued, those two married couples should pay the same tax ... By contrast, a marriage-neutral system with progressive rates would involve a larger combined tax on the married couple with the unequal income division. The attractiveness of the principle of equal taxation of couples with equal incomes may depend on the extent to which married couples actually pool their incomes. [footnote omitted]

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<sup>78</sup> Even if the bracket breakpoints and the standard deduction amounts for unmarried taxpayers (and for married taxpayers filing separate returns) were half of those for married couples filing a joint return, the current tax system would not be marriage neutral. Many married couples would still have marriage bonuses. As described below, the joint return in such a system would allow married couples to pay twice the tax of a single taxpayer having one-half the couple's taxable income. With progressive rates, this income splitting may result in reduced tax liabilities for some couples filing joint returns. For example, consider a married couple in which one spouse has \$60,000 of income and the other has none. By filing a joint return, the couple pays the same tax as a pair of unmarried individuals each with \$30,000 of income. With progressive taxation, the tax liability on \$30,000 would be less than half of the tax liability on \$60,000. Thus the married couple has a marriage bonus: the joint return results in a smaller tax liability than the combined tax liability of the spouses if they were not married.

<sup>79</sup> This discussion assumes that the dilemma cannot be resolved by moving to a proportional tax (i.e. a single rate on all income for all taxpayers) system. A proportional system would automatically produce marriage neutrality and equal taxation of couples with equal incomes.

An advocate of marriage neutrality could respond that the relevant comparison is not between a two-earner married couple where the spouses have equal incomes and a two-earner married couple with an unequal income division, but rather between a two-earner married couple and a one-earner married couple with the same total income. Here, the case for equal taxation of the two couples may be weaker, because the non-earner in the one-earner married couple benefits from more time that may be used for unpaid work inside the home, other activities or leisure. ...

### **Marriage penalty, labor supply, and economic efficiency**

Most analysts discuss the marriage penalty or marriage bonus as an issue of fairness, but the marriage penalty or bonus also may create economic inefficiencies. The marriage penalty or bonus may distort taxpayer behavior. ... There is no statistical evidence that the marriage penalty or marriage bonus has altered taxpayers' decisions to marry. ...

Some analysts have suggested that the marriage penalty may alter taxpayers' decisions to work. As explained above, a marriage penalty exists when the sum of the tax liabilities of two unmarried individuals filing their own tax returns (either single or head of household returns) is less than their tax liability under a joint return (if the two individuals were to marry). This is the result of a tax system with increasing marginal tax rates. The marriage penalty not only means the total tax liability of the two formerly single taxpayers is higher after marriage than before marriage, but it also generally may result in one or both of the formerly single taxpayers being in a higher marginal tax rate bracket. That is, the additional tax on an additional dollar of income of each taxpayer is greater after marriage than it was when they were both single. Economists argue that changes in marginal tax rates may affect taxpayers' decisions to work. Higher marginal tax rates may discourage household saving and labor supply by the newly married household. ... Some have suggested that the labor supply decision of the lower earner or "secondary earner" in married households may be quite sensitive to the household's marginal tax rate. [footnote omitted]

The possible disincentive effects of a higher marginal tax rate on the secondary worker arise in the case of couples who experience a marriage bonus as well. In the specific example above, the couple consisted of one person in the labor force and one person not in the labor force. As noted previously, such a circumstance generally results in a marriage bonus. By filing a joint return, the lower earner may become subject to the marginal tax rate of the higher earner. By creating higher marginal tax

rates on secondary earners, joint filing may discourage a number of individuals from entering the work force or it may discourage those already in the labor force from working additional hours. [footnote omitted]

#### Eliminating or reducing the marriage penalty

....

To eliminate the marriage penalty through a change in the rate structure, the brackets for all unmarried taxpayers (both singles and heads of household) would have to be half as large as the married, filing joint brackets. ... [A] structure with rates for married taxpayers at twice the level of single and heads of households would cause marriage bonuses. Another effect of such a step would be that single individuals and heads of household with identical incomes would find their tax liabilities nearly the same. ...

#### *Questions and comments:*

1. Examine the tax brackets at the front of your Code as well as the current standard deduction for the different filing statuses. To whom and to what extent did Congress respond when it created these relationships in brackets in 2017?
2. What percentage of married filing jointly is the breakpoint for single taxpayers in the 10% bracket, the 12% bracket, the 22% bracket, the 24% bracket, the 32% bracket, the 35% bracket, and the 37% bracket?
  - What would happen to the marriage penalty as the breakpoint percentage increases? What is the breakpoint percentage at the 37% bracket?
3. The excerpt identifies three policies that “bracketologists” might pursue. What are they? Is it possible to pursue all three policies? What policies did the Code pursue in 2001? Examine the brackets for taxpayers who are married filing jointly and for taxpayer who are single. What policies does the Code pursue after 2017?
4. Are the current (2018 through 2025) brackets marriage neutral? *See* 5<sup>th</sup> footnote of the excerpt and second to last paragraph of excerpt.
5. What incentives does marriage neutrality – as opposed to a marriage penalty – create for a married couple to derive as much untaxed imputed income as possible

by arranging for one spouse to perform unpaid tasks at home rather than work at a job that pays a market rate of wages?

### III. Income Derived from Property

Re-read *Helvering v. Horst* in Chapter 2. Why did taxpayer Horst lose?

**Helvering v. Eubank**, 311 U.S. 122 (1940).

MR. JUSTICE STONE delivered the opinion of the Court.

This is a companion case to *Helvering v. Horst*, ... and presents issues not distinguishable from those in that case.

Respondent, a general life insurance agent, after the termination of his agency contracts and services as agent, made assignments in 1924 and 1928, respectively, of renewal commissions to become payable to him for services which had been rendered in writing policies of insurance under two of his agency contracts. The Commissioner assessed the renewal commissions paid by the companies to the assignees in 1933 as income taxable to the assignor in that year ... The Court of Appeals for the Second Circuit reversed the order of the Board of Tax Appeals sustaining the assessment. We granted certiorari.

No purpose of the assignments appears other than to confer on the assignees the power to collect the commissions, which they did in the taxable year. ...

For the reasons stated at length in the opinion in the *Horst* case, we hold that the commissions were taxable as income of the assignor in the year when paid. The judgment below is

Reversed.



The separate opinion of MR. JUSTICE McREYNOLDS.

...

The assignment in question denuded the assignor of all right to commissions thereafter to accrue under the contract with the insurance company. He could do nothing further in respect of them; they were entirely beyond his control. In no proper sense were they something either earned or received by him during the taxable year. The right to collect became the absolute property of the assignee, without relation to future action by the assignor.

A mere right to collect future payments for services already performed is not presently taxable as “income derived” from such services. It is property which may be assigned. Whatever the assignor receives as consideration may be his income, but the statute does not undertake to impose liability upon him because of payments to another under a contract which he had transferred in good faith under circumstances like those here disclosed.

....

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

*Notes and Questions:*

1. The Court’s majority says that this case presents issues like those in *Horst, supra*?
  - Is that accurate?
2. Should the right to collect compensation income for services performed become property simply by the passage of time, e.g., one year?
  - Should the tax burden fall upon the one who earns the income only if that person receives the compensation in the same year?
3. Do you see any latent problems of horizontal equity in the opinion of Justice McReynolds? Taxpayers have endeavored from the beginning to convert compensation income from ordinary income into property. Courts are very careful not to permit this to occur.

- Why do you think that taxpayer wanted to transfer his rights to receive future renewal commissions to a corporation that he controlled? Were there tax advantages to doing this?

**Blair v. Commissioner**, 300 U.S. 5 (1937)

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

This case presents the question of the liability of a beneficiary of a testamentary trust for a tax upon the income which he had assigned to his children prior to the tax years and which the trustees had paid to them accordingly.

The trust was created by the will of William Blair, a resident of Illinois who died in 1899, and was of property located in that State. One-half of the net income was to be paid to the donor's widow during her life. His son, the petitioner Edward Tyler Blair, was to receive the other one-half and, after the death of the widow, the whole of the net income during his life. In 1923, after the widow's death, petitioner assigned to his daughter, Lucy Blair Linn, an interest amounting to \$6,000 for the remainder of that calendar year, and to \$9,000 in each calendar year thereafter, in the net income which the petitioner was then or might thereafter be entitled to receive during his life. At about the same time, he made like assignments of interests, amounting to \$9,000 in each calendar year, in the net income of the trust to his daughter Edith Blair and to his son, Edward Seymour Blair, respectively. In later years, by similar instruments, he assigned to these children additional interests, and to his son William McCormick Blair other specified interests, in the net income. The trustees accepted the assignments and distributed the income directly to the assignees.

....

... The Board [of Tax Appeals] ... overruled the Commissioner's determination as to the petitioner's [income tax] liability. The Circuit Court of Appeals ... reversed the Board. That court ... 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.

....

... The question [is] 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.

... In [*Lucas v. Earl*, 281 U.S. 111], the question was whether an attorney was taxable for the whole of his salary and fees earned by him in the tax years, or only upon one-half by reason of an agreement with his wife by which his earnings were to be received and owned by them jointly. We were of the opinion that the case turned upon the construction of the taxing act. We said that “the statute could tax salaries to those who earned them, and provide that the tax could not be escaped by anticipatory arrangements and contracts, however skilfully devised, to prevent the salary when paid from vesting even for a second in the man who earned it.” That was deemed to be the meaning of the statute as to compensation for personal service, and the one who earned the income was held to be subject to the tax. ... [This case is] not on point. The tax here is not upon earnings which are taxed to the one who earns them. Nor is it a case of income attributable to a taxpayer by reason of the application of the income to the discharge of his obligation. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716; [citations omitted]. There is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion; or of the taxpayer’s retention of control. *Corliss v. Bowers*, 281 U.S. 376; *Burnet v. Guggenheim*, 288 U.S. 280.

In the instant case, the tax is upon income as to which, in the general application of the revenue acts, the tax liability attaches to ownership. *See Poe v. Seaborn*, *supra*; [citation omitted].

The Government points to the provisions of the revenue acts imposing upon the beneficiary of a trust the liability for the tax upon the income distributable to the beneficiary. But the term is merely descriptive of the one entitled to the beneficial interest. These provisions cannot be taken to preclude valid assignments of the beneficial interest, or to affect the duty of the trustee to distribute income to the owner of the beneficial interest, whether he was such initially or becomes such by valid assignment. The one who is to receive the income as the owner of the beneficial interest is to pay the tax. If, under the law governing the trust, the beneficial interest is assignable, and if it has been assigned without reservation, the assignee thus becomes the beneficiary, and is entitled to rights and remedies accordingly. We find nothing in the revenue acts which denies him that status.

The decision of the Circuit Court of Appeals turned upon the effect to be ascribed to the assignments. The court held that the petitioner had no interest in the corpus of the estate, and could not dispose of the income until he received it. Hence, it was said that “the income was his,” and his assignment was merely a direction to pay over to others what was due to himself. The question was considered to involve “the date when the income became transferable.” The Government refers to the terms of the assignment – that it was of the interest in the income “which the said party of the first part now is, or may hereafter be, entitled to receive during his life from the trustees.” From this, it is urged that the assignments “dealt only with a right to receive the income,” and that “no attempt was made to assign any equitable right, title or interest in the trust itself.” This construction seems to us to be a strained one. We think it apparent that the conveyancer was not seeking to limit the assignment so as to make it anything less than a complete transfer of the specified interest of the petitioner as the life beneficiary of the trust, but that, with ample caution, he was using words to effect such a transfer. ...

The will creating the trust entitled the petitioner during his life to the net income of the property held in trust. He thus became the owner of an equitable interest in the corpus of the property. *Brown v. Fletcher*, 235 U.S. 589, 598-599; *Irwin v. Gavit*, 268 U.S. 161, 167-168; *Senior v. Braden*, 295 U.S. 422, 432; *Merchants’ Loan & Trust Co. v. Patterson*, 308 Ill. 519, 530, 139 N.E. 912. By virtue of that interest, he was entitled to enforce the trust, to have a breach of trust enjoined, and to obtain redress in case of breach. The interest was present property alienable like any other, in the absence of a valid restraint upon alienation. [citations omitted]. The beneficiary may thus transfer a part of his interest, as well as the whole. See RESTATEMENT OF THE LAW OF TRUSTS, §§ 130, 132 et seq. The assignment of the beneficial interest is not the assignment of a chose in action, but of the “right, title, and estate in and to property.” *Brown v. Fletcher*, *supra*; *Senior v. Braden*, *supra*. See BOGERT, TRUSTS AND TRUSTEES, vol. 1, § 183, pp. 516, 517; 17 COLUMBIA LAW REVIEW, 269, 273, 289, 290.

We conclude that the assignments were valid, that the assignees thereby became the owners of the specified beneficial interests in the income, and that, as to these interests, they, and not the petitioner, were taxable for the tax years in question. The judgment of the Circuit Court of Appeals is reversed, and the cause is remanded with direction to affirm the decision of the Board of Tax Appeals.

It is so ordered.

*Notes and Questions:*

1. The Court spent several paragraphs establishing that Edward Tyler Blair had the power to dispose of his interest as he wished. Why was the exercise of this discretion sufficient to shift the tax burden to the recipient when it was not sufficient in *Helvering v. Horst*?

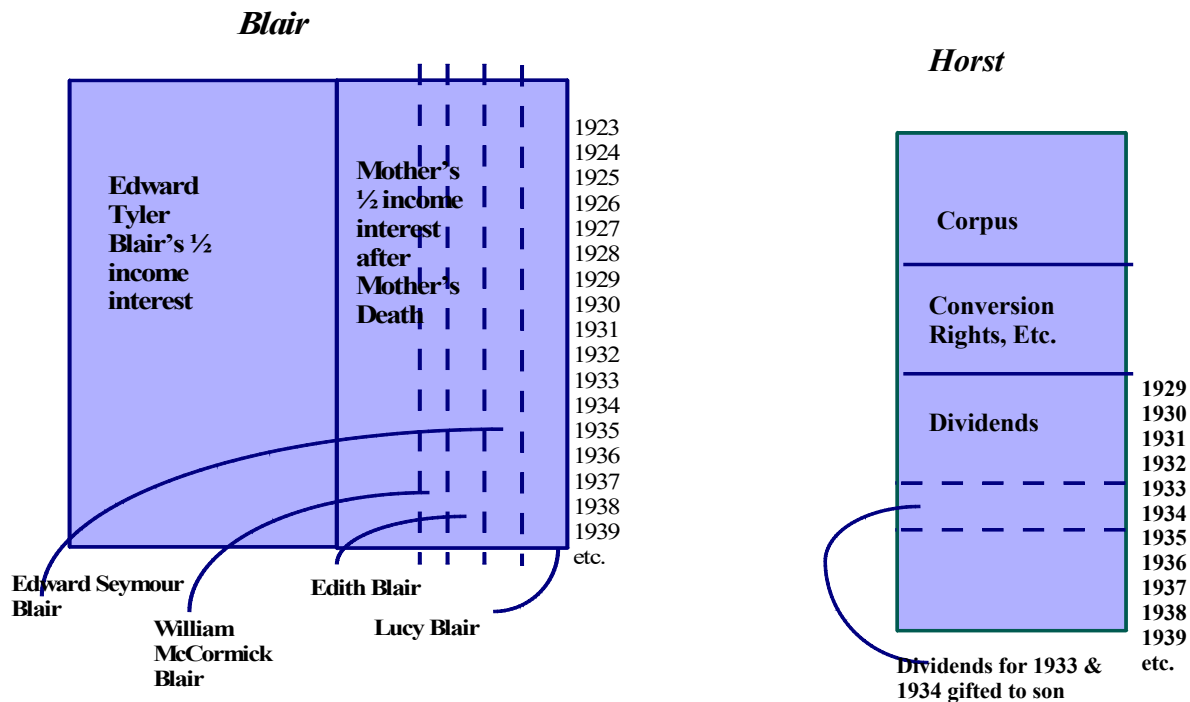
2. William Blair died. Through his will, he devised *part* of his property to a trust. We are not told who received the remainder of his property. Edward Tyler William Blair was an income beneficiary of *part* of the trust. We are not told of the final disposition of the corpus of the trust. We are told that Edward had no interest in the corpus of the estate. Edward assigned fractional interests “in each calendar year thereafter, in the net income which [Edward] was then or might thereafter be entitled to receive during his life.” It appears that Edward’s *entire* interest was as a beneficiary of the trust. He then assigned to various sons and daughters a *fraction* of his *entire interest*.

- Exactly what interest did William Blair, Jr. *retain* after these dispositions?
- Compare this to what the taxpayer in *Helvering v. Horst*, *supra*, chapter 3, retained.
- Is this difference a sound basis upon which the Court may reach different results?

3. Think of the ownership of “property” as the ownership of a “bundle of sticks.” Each stick represents a particular right. For example, a holder of a bond may own several sticks, e.g., the right to receive an interest payment in each of ten consecutive years might be ten sticks, the right to sell the bond might be another stick, the right to the proceeds upon maturity might be another stick. Imagine that we lay the sticks comprising a bond, one on top of the other. Then we slice off a piece of the property. We might slice horizontally – and thereby take all or a portion of only one or a few sticks. Or we might slice vertically – and thereby take an identically proportional piece of every stick.

Consider the accompanying diagrams of *Horst* and *Blair*. Do they suggest an analytical model in “assignment of income derived from property” cases?

- Slice vertically rather than horizontally?



4. Taxpayer was the life beneficiary of a testamentary trust. In December 1929, she assigned a specified number of dollars from the income of the trust to certain of her children for 1930. The trustee paid the specified children as per Taxpayer's instructions.

- *Exactly* what interest did Taxpayer *retain* after these dispositions?
- Should Taxpayer-life beneficiary or the children that she named to receive money in 1930 be subject to income tax on the trust income paid over to the children? See *Harrison v. Schaffner*, 312 U.S. 579, 582-83 (1941).

5. Taxpayer established a trust with himself as trustee and his wife as beneficiary. The trust was to last for five years unless either Taxpayer or his wife died earlier. Taxpayer placed securities that he owned in the trust. The trust's net income was to be held for Taxpayer's wife. Upon termination of the trust, the corpus was to revert to Taxpayer and any accumulated income was to be paid to his wife.

- *Exactly* what interest did Taxpayer *retain* after these dispositions?
- Should Taxpayer-settlor-trustee or his wife be subject to income tax on the trust income paid over to Taxpayer's wife? See *Helvering v. Clifford*, 309 U.S. 331, 335 (1940).

5a. Now suppose that Taxpayer placed property in trust, the income from which was to be paid to his wife until she died and then to their children. Taxpayer “reserved power ‘to modify or alter in any manner, or revoke in whole or in part, this indenture and the trusts then existing, and the estates and interests in property hereby created[.]?’” Taxpayer did *not* in fact exercise this power, and the trustee paid income to Taxpayer’s wife.

- Exactly* what interest did Taxpayer *retain* after this disposition?
- Should the trust income be taxable income to Taxpayer or to his wife?
- See Corliss v. Bowers*, 281 U.S. 376, 378 (1930).

6. Again: is the tree-fruits analogy useful in difficult cases? Consider what happens when the fruit of labor is property from which income may be derived.

**Heim v. Fitzpatrick**, 262 F.2d 887 (2<sup>d</sup> Cir. 1959).

Before SWAN and MOORE, Circuit Judges, and KAUFMAN, District Judge.

SWAN, Circuit Judge.

This litigation involves income taxes of Lewis R. Heim, for the years 1943 through 1946. On audit of the taxpayer’s returns, the Commissioner of Internal Revenue determined that his taxable income in each of said years should be increased by adding thereto patent royalty payments received by his wife, his son and his daughter. The resulting deficiencies were paid under protest to defendant Fitzpatrick, Collector of Internal Revenue for the District of Connecticut. Thereafter claims for refund were filed and rejected. The present action was timely commenced ... It was heard upon an agreed statement of facts and supplemental affidavits. Each party moved for summary judgment. The plaintiff’s motion was denied and the defendant’s granted. ...

Plaintiff was the inventor of a new type of rod end and spherical bearing. In September 1942 he applied for a patent thereon. On November 5, 1942 he applied for a further patent on improvements of his original invention. Thereafter on November 17, 1942 he executed a formal written assignment of his invention and of the patents which might be issued for it and for improvements thereof to The

Heim Company.<sup>80</sup> This was duly recorded in the Patent Office and in January 1945 and May 1946 plaintiff's patent applications were acted on favorably and patents thereon were issued to the Company. The assignment to the Company was made pursuant to an oral agreement, subsequently reduced to a writing dated July 29, 1943, by which it was agreed (1) that the Company need pay no royalties on bearings manufactured by it prior to July 1, 1943; (2) that after that date the Company would pay specified royalties on 12 types of bearings; (3) that on new types of bearings it would pay royalties to be agreed upon prior to their manufacture; (4) that if the royalties for any two consecutive months or for any one year should fall below stated amounts, plaintiff at his option might cancel the agreement and thereupon all rights granted by him under the agreement and under any and all assigned patents should revert to him, his heirs and assigns; and (5) that this agreement is not transferable by the Company.

In August 1943 plaintiff assigned to his wife 'an undivided interest of 25 per cent in said agreement with The Heim Company dated July 29, 1943, and in all his inventions and patent rights, past and future, referred to therein and in all rights and benefits of the First Party (plaintiff) thereunder \* \* \*.' A similar assignment was given to his son and another to his daughter. Plaintiff paid gift taxes on the assignments. The Company was notified of them and thereafter it made all royalty payments accordingly. As additional types of bearings were put into production from time to time the royalties on them were fixed by agreement between the Company and the plaintiff and his three assignees.

The Commissioner of Internal Revenue decided that all of the royalties paid by the Company to plaintiff's wife and children during the taxable years in suit were taxable to him. This resulted in a deficiency which the plaintiff paid ...

The appellant contends that the assignments to his wife and children transferred to them income-producing property and consequently the royalty payments were taxable to his donees, as held in *Blair v. Commissioner*, 300 U.S. 5. [footnote omitted]. Judge Anderson, however, was of opinion that (151 F. Supp. 576):

'The income-producing property, i.e., the patents, had been assigned by the taxpayer to the corporation. What he had left was a right to a portion of the

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<sup>80</sup> The stock of The Heim Company was owned as follows: plaintiff 1%, his wife 41%, his son and daughter 27% each, and his daughter-in-law and son-in-law 2% each



income which the patents produced. He had the power to dispose of and divert the stream of this income as he saw fit.’

Consequently he ruled that the principles applied by the Supreme Court in *Helvering v. Horst*, 311 U.S. 112 and *Helvering v. Eubank*, 311 U.S. 122 required all the royalty payments to be treated as income of plaintiff.

The question is not free from doubt, but the court believes that the transfers in this case were gifts of income-producing property and that neither *Horst* nor *Eubank* requires the contrary view. In the *Horst* case the taxpayer detached interest coupons from negotiable bonds, which he retained, and made a gift of the coupons, shortly before their due date, to his son who collected them in the same year at maturity. *Lucas v. Earl*, 281 U.S. 111, which held that an assignment of unearned future income for personal services is taxable to the assignor, was extended to cover the assignment in *Horst*, the court saying,

‘Nor is it perceived that there is any adequate basis for distinguishing between the gift of interest coupons here and a gift of salary or commissions.’

In the *Eubank* case the taxpayer assigned a contract which entitled him to receive previously earned insurance renewal commissions. In holding the income taxable to the assignor the court found that the issues were not distinguishable from those in *Horst*. No reference was made to the assignment of the underlying contract.<sup>81</sup>

In the present case more than a bare right to receive future royalties was assigned by plaintiff to his donees. Under the terms of his contract with The Heim Company he retained the power to bargain for the fixing of royalties on new types of bearings, i.e., bearings other than the 12 products on which royalties were specified. This power was assigned and the assignees exercised it as to new products. Plaintiff also retained a reversionary interest in his invention and patents by reason of his option to cancel the agreement if certain conditions were not fulfilled. This interest was

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<sup>81</sup> These decisions were distinguished by Judge Magruder in *Commissioner v. Reece*, 1 Cir., 233 F.2d 30. In that case, as in the case at bar, the taxpayer assigned his patent to a corporation in return for its promise to pay royalties, and later made a gift of the royalty contract to his wife. It was held that this was a gift of income-producing property and was effective to make the royalties taxable to her. *See also* *Nelson v. Ferguson*, 56 F.2d 121 (3rd Cir.), *cert. denied*, 286 U.S. 565; *Commissioner v. Hopkinson*, 126 F.2d 406 (2d Cir.); and 71 HARVARD LAW REVIEW 378.

also assigned. The fact that the option was not exercised in 1945, when it could have been, is irrelevant so far as concerns the existence of the reversionary interest. We think that the rights retained by plaintiff and assigned to his wife and children were sufficiently substantial to justify the view that they were given income-producing property.

In addition to Judge Anderson's ground of decision appellee advances a further argument in support of the judgment, namely, that the plaintiff retained sufficient control over the invention and the royalties to make it reasonable to treat him as owner of that income for tax purposes. *Commissioner v. Sunnen*, 333 U.S. 591 is relied upon. There a patent was licensed under a royalty contract with a corporation in which the taxpayer-inventor held 89% of the stock. An assignment of the royalty contract to the taxpayer's wife was held ineffective to shift the tax, since the taxpayer retained control over the royalty payments to his wife by virtue of his control of the corporation, which could cancel the contract at any time. The argument is that, although plaintiff himself owned only 1% of The Heim Company stock, his wife and daughter together owned 68% and it is reasonable to infer from depositions introduced by the Commissioner that they would follow the plaintiff's advice. Judge Anderson did not find it necessary to pass on this contention. But we are satisfied that the record would not support a finding that plaintiff controlled the corporation whose active heads were the son and son-in-law. No inference can reasonably be drawn that the daughter would be likely to follow her father's advice rather than her husband's or brother's with respect to action by the corporation.

....

For the foregoing reasons we hold that the judgment should be reversed and the cause remanded with directions to grant plaintiff's motion for summary judgment.

So ordered.

#### *Notes and Questions:*

1. *Eubank* involved labor that created an identifiable and assignable right to receive income in the future. How does *Heim v. Fitzpatrick* differ from *Eubank*? After all, a patent is the embodiment of (considerable) work.

2. A patent is no longer (§ 1221(a)(3)(A)) a capital asset to the taxpayer whose personal efforts created it. Otherwise it is a capital asset that the holder has presumptively held for more than one year. § 1235(a), (b)(1). However, this rule does not apply to transfers between related persons as defined in §§ 267(b, c) or 707(b) and modified by § 1235(c)(1, 2).

•In *Heim*, to whom would § 1235 matter?

**Contingent fee arrangements:** When a taxpayer-plaintiff enters a contingent fee arrangement with her attorney, has taxpayer anticipatorily assigned income? Or has taxpayer partially assigned income-producing *property*?

- Is the contingent-fee attorney a joint owner of the client's claim?
- Does it matter that the relationship between client and attorney is principal and agent?

•No and yes, said the Supreme Court in *CIR v. Banks*, 543 U.S. 426 (2005). State laws that may protect the attorney do not change this, so long as they do not alter the fundamental principal-agent relationship.

•So: taxpayer-plaintiff must otherwise include whatever damages she receives in her gross income, including the amount of the contingent fee that she must pay her attorney.

If the expenses of producing taxable income are deductible, what difference does it make? See §§ 67(a), 67(g) ("miscellaneous deductions"), and 55(a), 56(b)(1)(A)(i) (alternative minimum tax). And see § 62(a)(20). When would § 62(a)(20) affect your answer?

If the damages plaintiff recovers are *not* otherwise included in her gross income (see, e.g., § 104(a)(2)), she is not permitted to deduct the expenses of litigation? Why not?



Do the CALI Lesson, *Basic Federal Income Taxation: Assignment of Income: Property*.

## IV. Interest Free Loans and Unstated Interest

Consider these scenarios:

- Father has a large savings account, and daughter is 18 years old. Daughter is enrolled at Private University. Father and mother have planned for many years for this day and saved enough to pay for Daughter's tuition. They have saved \$1M, and the annual interest income on this amount is \$80,000. Father and mother are in the 37% marginal income tax bracket. Daughter is in the 0% marginal income tax bracket. An income of \$80,000 would place Daughter in the 22% marginal tax bracket – although some of that income would not be subject to any tax, some would be subject to 10% tax, and some would be subject to 12% tax. Father and mother decide to loan Daughter \$1M interest free. Daughter will deposit the money in an interest-bearing account and use the interest income to pay her tuition and other expenses for four years. With diploma in hand, Daughter will repay the loan.

- Are there any income tax problems with this?
- Read § 7872(a)(1), (c)(1)(A), (e), (f)(2), (f)(3).
  - [By the way, § 7872 applies both to the income tax and to the gift tax.]
- What result under these provisions?

- Corporation very much wants to hire Star Employee and has made a generous salary offer. To sweeten the deal, Corporation offers to loan \$1M to Star Employee interest free so that Star Employee can purchase a house in an otherwise expensive housing market. Star Employee will repay the loan at the rate of \$40,000 per year for the next 25 years. Star Employee must pay the full principal of the loan if she stops working for corporation. Star Employee may not transfer her interest in the loan.

- Are there any income tax problems with this?
- Read § 7872(a), (c)(1)(B), (e), (f)(2), (f)(5).
- What result under these provisions?

- Closely-held Corporation is owned by four shareholders. If the corporation pays dividends to shareholders, the dividend income is subject to income tax for the shareholders. The payments are not deductible to Corporation. Closely-held Corporation loans each shareholder \$100,000 interest free. Shareholders will repay the loans at the rate of \$1000 per year for the next 100 years.

- Are there any income tax problems with this?
- Read § 7872(b), (c)(1)(C), (e), (f)(1), (f)(2), (f)(6).
- What result under these provisions?

•*The “Kiddie” Tax*

- Read §§ 1(g); 1(h).



Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Taxation of Minor Children’s Income*

- Note: the § 63(c)(5)(A) amount is indexed. Assume for purposes of this Lesson that the amount is \$900. Assume that the § 63(c)(5)(B) amount is \$300. [These values are subject to change.]



Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Below Market Loans*.

- Note: Learn the points made in questions 1-2, but keep in mind that we are concerned with income tax, not gift tax. Read § 7872(d)(2) carefully.

## Wrap-Up Questions for Chapter 5

1. It has been observed that the actual federal tax<sup>82</sup> burdens among different American taxpayers are not very progressive. Federal tax burdens could be made more progressive simply by capping a taxpayer's total allowable exclusions, deductions, and credits. Perhaps a cap of \$25,000 would be appropriate. Maybe it should be more, maybe less. What do you think of the idea of increasing progressivity by enacting such caps?
2. At what point does it not pay to spend money to gain income that will not be subject to federal income tax?
3. When the IRS in its enforcement mission must come up with an interest rate, it turns to the "applicable Federal rate." When § 7872 is applicable, what might be wrong with reliance on such a uniform rate?
4. Congress has made the tax burden on the combined income of taxpayers who file married filing jointly exactly twice the tax burden on single persons with half the income of the couple. This arrangement applies to those taxpayers whose taxable income places them in all but the 35% or 37% tax brackets. This reduced the tax rate on married persons from what it was before Congress enacted this change. Is that preferable to giving relief only to those couples where both spouses work, as was the case when the Code provided for a credit based on the amount of income earned by the spouse who earned less?
5. Comment on the following rough outline of a flat tax: Remove all deductions, exclusions, and credits from the Code. Retain only those associated with the production of income so that the income tax is a tax only on "net" income. All taxpayers would be entitled to a \$40,000 exemption. The tax would be a flat rate on all taxpayers to the extent their gross income exceeds \$40,000.

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82 ... including Social Security, Medicare, and unemployment taxes, as well as income taxes.

## **What have you learned?**

Can you explain or define –

- What is income splitting?
- What is the marriage penalty? What is the marriage bonus?
- What is the assignment-of-income doctrine? How does it apply to income derived from services? How does it apply to income derived from property?
- In what way is a below-market loan an assignment of income?

## Chapter 6: Deductions: Business Expenses

### *The Tax Formula:*

(gross income)

→ MINUS deductions named in § 62

EQUALS (adjusted gross income (AGI))

→ MINUS (standard deduction or itemized deductions)

MINUS (deduction for “qualified business income”)

EQUALS (taxable income)

Compute income tax liability from tables in § 1(j) (indexed for inflation)

MINUS (credits against tax)

Our income tax system taxes only “net income.” The Code incorporates principles that prevent taxing as income the expenses of deriving that income. Section 162 provides a deduction for “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business[.]” Read § 162(a).

The Code does not provide a definition of “trade or business.”<sup>83</sup> The Supreme Court observed the following when it held that a full-time gambler was engaged in a “trade or business:”

Of course, not every income-producing and profit-making endeavor constitutes a trade or business. The income tax law, almost from the beginning, has distinguished between a business or trade, on the one hand, and “transactions entered into for profit but not connected with ... business or trade,” on the other. *See* Revenue Act of 1916, § 5(a), Fifth, 39 Stat. 759. Congress “distinguished the broad range of income or profit producing activities from those satisfying the narrow category of trade or business.” We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer’s primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.<sup>84</sup>

<sup>83</sup> See generally Paula Wolff, Annot., What constitutes trade or business under Internal Revenue Code (U.S.C.A. Title 26), 161 A.L.R. FED. 245 (2008).

<sup>84</sup> *Commissioner v. Groetzinger*, 480 U.S. 23, 35 (1987) (alternative minimum tax; citation omitted).



This excerpt informs that there is a distinction between a “trade or business” and “transactions entered into for profit but not connected with” a trade or business. Investing fits the latter description. Congress extended the principles of § 162(a) to “expenses for the production of income” when it added § 212 to the Code. However, expenses for the production of income – as contrasted with a trade or business – are not deductible “above the line.” § 62(a)(1). There is also a distinction between a “trade or business” and a hobby or amusement. The Code limits deductions for an activity “not engaged in for profit” to the gross income derived from the activity.<sup>85</sup> For the years 2018 to 2025, Congress suspended these so-called “miscellaneous deductions” – thereby treating such endeavors as “personal activities.” *See* § 67(g).

Section 162 limits deductibility of trade or business expenses to those that are “ordinary and necessary.” Section 162 allows a deduction only for expenses of “carrying on” a trade or business. Hence, the costs of searching for a business to purchase, pre-opening organization costs, etc. are not deductible. § 195. Taxpayer in such cases has no trade or business to “carry on.” On the other hand, an existing business that incurs the same expenses to expand its business may deduct them. Whether an existing business is seeking merely to expand or to enter a new trade or business “depends on the facts and circumstances of each case.”<sup>86</sup>

In addition to § 162, § 163(a) allows a deduction for interest paid or accrued. For taxpayers whose average gross receipts for the 3-year period ending with the immediately preceding tax year are \$25,000,000 or more, § 448(c)(1), § 163(j) limits their interest deduction to the amount of their business interest income plus 30% of their trade or business income. § 163(j)(1 and 8).<sup>87</sup> Section 165(a) allows a deduction for losses.

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<sup>85</sup> §§ 183(a) and (b)(2). Furthermore, a taxpayer must attribute to such an activity a share of deductions allowable without regard to whether an activity is engaged in for profit, e.g., real estate taxes, to the activity, § 183(b)(1). This may have the effect of reducing by displacement the allowable deduction for expenses attributable to the hobby or amusement activity. Moreover, the deductions are “below-the-line” and subject to the 2% floor of § 67 for miscellaneous deductions. A presumption in favor of the taxpayer to the effect that the “activity is engaged in for profit” arises if he derives gross income from the activity greater than deductions attributable to it for three of the previous five consecutive tax years. § 183(d).

<sup>86</sup> Private Letter Ruling 9331001.

<sup>87</sup> A special rule applies to taxpayers who sell motor vehicles from inventory. § 163(j)(1 and 9) (additional floor financing costs also deductible).

*Timing of Trade or Business Expense Deductions:* Taxpayer may “consume” (i.e., use up) what he buys to produce income in his trade or business at different rates. With regard to such consumption, consider the following possibilities:

- Taxpayer may purchase an input and immediately consume it to make taxable income. Taxpayer purchases a tank of gasoline. We expect that such expenditures would be immediately deductible in full. We sometimes call such treatment “expensing.”

Read § 263: Capital Expenditures: Notice that § 263(a)(1) denies a deduction for “amounts paid out” for “permanent improvements or betterments” to increase the value of taxpayer’s property. This does not mean that such amounts are *never* deductible. “Amounts paid out” are deductible as the improvement or betterment is consumed. See §§ 167, 168.

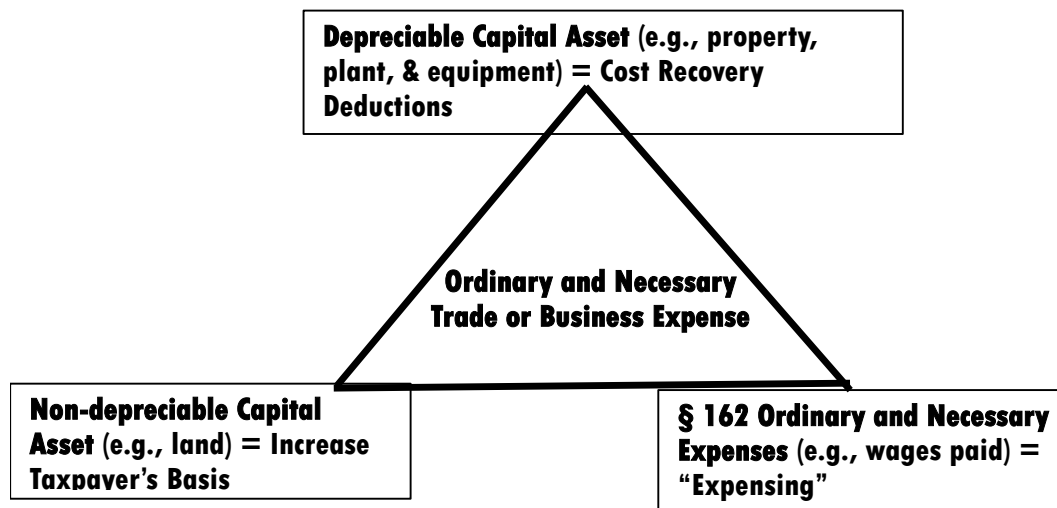
- Alternatively, taxpayer may purchase an input that he will consume more slowly and that will enable him to earn income for more than the current tax year. Taxpayer will eventually “consume” that input. Taxpayer might purchase a machine that will enable him to generate income for the next ten years. Taxpayer has made an “investment” rather than an expenditure on an item that he immediately consumes. A mere change in the form in which taxpayer holds wealth is not a taxable event. We implement this principle by crediting taxpayer with basis equal to the cost of the input (e.g., the machine). Taxpayer then consumes only a part of the item that he purchased to generate income. What taxpayer consumes is no longer invested, and taxpayer has to that extent “de-invested” the amount consumed. The Code implements in several places a scheme that (theoretically) matches such consumption with the income that the expenditure generates.<sup>88</sup> The Code permits a deduction for such partial consumption under the headings of depreciation, amortization, or more recently, cost recovery. Since such consumption represents a “deinvestment,” taxpayer must adjust his basis in the productive asset downward. We sometimes call this tax treatment of the purchase and use of a productive asset “capitalization.”

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<sup>88</sup> The Code also implements a matching of income with expenses when taxpayer derives gross income by selling from inventory. The Code has special rules that prohibit taxpayer from deferring recognition of income derived from sales from inventory by building up deductions through purchase of inventory in advance of the time he makes sales.

•Yet another possibility is that taxpayer may purchase an input that enables him to produce income but never consumes that input, e.g., land, a legal education. There should logically be no deduction – immediately or in the future – for such expenditures. Taxpayer will have a basis in such an asset, but can only recover it for income tax purposes upon sale of the asset. We also call this tax treatment of the purchase and use of such an asset “capitalization.”

*Business Expenses: Deduction Disputes:* We think of disputes between a taxpayer and the Commissioner as binary in nature. The taxpayer argues one thing and the Commissioner argues the (only) opposite. For example, money that the taxpayer finds in a piano is or is not gross income; there are no other possibilities. Disputes concerning trade or business expenditures involve more possibilities. Initially expenditures are “ordinary and necessary” or they are not (binary). *Cf. Gilliam, infra.* Assuming an expenditure is an “ordinary and necessary” trade or business expense, it may be immediately deductible, it may never be deductible, or it may be deductible over an extended period during which it is consumed. Any of these matters can be the point on which a case turns.



In the materials ahead, we very roughly consider the placement of expenditures into one group or another – whether expense or capital. Both the Commissioner and taxpayers are aware of the time value of money. Taxpayer usually wants to classify purchases of inputs that enable him to generate income in a manner to permit the earliest deduction. The Commissioner of course wants the opposite result. Try to

determine the controlling principles by which to resolve these issues of classification.

## **I. Expense or Capital**

The following cases involve the proper tax treatment of expenditures to purchase income-producing assets – whether immediately deductible, deductible over their useful life, or not deductible.

### **Welch v. Helvering, 290 U.S. 114 (1933)**

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922, petitioner was the secretary of the E.L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to reestablish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfillment of that resolve, he made payments of substantial amounts during five successive years. ... The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital expenditures, an outlay for the development of reputation and goodwill. The Board of Tax Appeals sustained the action of the Commissioner and the Court of Appeals for the Eighth Circuit affirmed. The case is here on certiorari.

...

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. [citation omitted]. He certainly thought they

were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is nonetheless a variable affected by time and place and circumstance. “Ordinary” in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser v. United States*, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times, there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning [citations omitted], we should have to say that payment in such circumstances, instead of being ordinary, is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree, and not of kind. One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner’s income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the petitioner has the burden of proving it to be wrong. [citations omitted]. Unless we can say from facts within our knowledge that these are ordinary and necessary

expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to his own standing he repays the stolen money, wiping off, it may be, his income for the year. The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the goodwill of an old partnership. [citation omitted]. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

Many cases in the federal courts deal with phases of the problem presented in the case at bar. To attempt to harmonize them would be a futile task. They involve the appreciation of particular situations at times with border-line conclusions. Typical illustrations are cited in the margin.<sup>89</sup>

The decree should be  
Affirmed.

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<sup>89</sup> Ordinary expenses: *Commissioner v. People's Pittsburgh Trust Co.*, 60 F.2d 187, expenses incurred in the defense of a criminal charge growing out of the business of the taxpayer; *American Rolling Mill Co. v. Commissioner*, 41 F.2d 314, contributions to a civic improvement fund by a corporation employing half of the wage earning population of the city, the payments being made, not for charity, but to add to the skill and productivity of the workmen ...; *Corning Glass Works v. Lucas*, 59 App. D.C. 168, 37 F.2d 798, donations to a hospital by a corporation whose employees with their dependents made up two-thirds of the population of the city; *Harris & Co. v. Lucas*, 48 F.2d 187, payments of debts discharged in bankruptcy, but subject to be revived by force of a new promise. *Cf.* *Lucas v. Ox Fibre Brush Co.*, 281 U.S. 115, where additional compensation, reasonable in amount, was allowed to the officers of a corporation for services previously rendered.

Not ordinary expenses: *Hubinger v. Commissioner*, 36 F.2d 724, payments by the taxpayer for the repair of fire damage, such payments being distinguished from those for wear and tear; *Lloyd v. Commissioner*, 55 F.2d 842, counsel fees incurred by the taxpayer, the president of a corporation, in prosecuting a slander suit to protect his reputation and that of his business; *One Hundred Five West Fifty-Fifth Street v. Commissioner*, 42 F.2d 849, and *Blackwell Oil & Gas Co. v. Commissioner*, 60 F.2d 257, gratuitous payments to stockholders in settlement of disputes between them, or to assume the expense of a lawsuit in which they had been made defendants; *White v. Commissioner*, 61 F.2d 726, payments in settlement of a lawsuit against a member of a partnership, the effect being to enable him to devote his undivided efforts to the partnership business and also to protect its credit.

*Notes and Questions:*

1. The word “ordinary” as used in the phrase “ordinary and necessary” provides a line of demarcation between expenditures currently deductible *and* those that are either never deductible *or* deductible only over time, i.e., through depreciation, amortization, or cost recovery allowances.

- Since the expenses in *Welch* were not “ordinary,” the next question is whether taxpayer could deduct them over time through depreciation or amortization.
- What should be relevant in making this determination?
- Do you think that the expenses in *Welch v. Helvering* should be recoverable through depreciation or amortization allowances?
- In the second paragraph of the Court’s footnote, the Court cited several cases. Which expenditures should taxpayer be able to deduct over time through depreciation or amortization, and which should taxpayer not be able to deduct at all – probably ever?

2. Consider these three rationales of the Court’s opinion: the expenditures were too personal to be deductible, were too bizarre to be ordinary, and were capital so not deductible.

- Personal: Welch felt a moral obligation, as many in Minnesota in such circumstances did at the time, to pay the corporation’s debts. In fact, Welch repaid the debts on the advice of bankers. This would seem to make business the motivation for repaying these debts.
- Bizarre: Others in Minnesota behaved the same way, i.e., repaid the debts of a bankrupt predecessor.
- Capital: The expenditures were no doubt capital in nature. However, they were arguably only an investment designed to generate income for a finite period. As such, the expenditures should be depreciable or amortizable.
- See Joel S. Newman, *The Story of Welch: The Use (and Misuse) of the “Ordinary and Necessary” Test for Deducting Business Expenses*, in TAX STORIES 197-224 (Paul Caron ed., 2d ed. 2009).

3. What should be the tax consequences of making payments to *create* goodwill? What should be the tax consequences of *maintaining or repairing* goodwill?

4. By paying the debts of a bankrupt, no-longer-in-existence corporation, was Thomas Welch trying to *create* goodwill or to *maintain or repair* it? Whose goodwill?

- Consider: Conway Twitty (actually Harold Jenkins) was a famous country music singer. He formed a chain of fast food restaurants (“Twitty Burger, Inc.”). He persuaded seventy-five friends in the country music business to invest with him. The venture failed. Twitty was concerned about the effect of the adverse publicity on his *country music* career. He repaid the investors himself.

- If Twitty were trying to protect the reputation of Twitty Burger, the expenditures would surely have been nondeductible. Twitty Burger after all was defunct.

- The court found as a fact that one’s reputation in the country music business is very important.

- Deductible? *See Harold L. Jenkins v. Commissioner*, T.C. Memo 1983-667, 1983 WL 14653.

5. What should be the tax treatment of expenditures incurred to acquire property that has an indefinite useful life?

**Woodward v. Commissioner**, 397 U.S. 572 (1970)

MR. JUSTICE MARSHALL delivered the opinion of the Court.

....

Taxpayers owned or controlled a majority of the common stock of the Telegraph-Herald, an Iowa publishing corporation. The Telegraph-Herald was incorporated in 1901, and its charter was extended for 20-year periods in 1921 and 1941. On June 9, 1960, taxpayers voted their controlling share of the stock of the corporation in favor of a perpetual extension of the charter. A minority stockholder voted against the extension. Iowa law requires “those stockholders voting for such renewal . . . [to] purchase at its real value the stock voted against such renewal.” Iowa Code § 491.25 (1966).

Taxpayers attempted to negotiate purchase of the dissenting stockholder’s shares, but no agreement could be reached on the “real value” of those shares.



Consequently, in 1962, taxpayers brought an action in state court to appraise the value of the minority stock interest. The trial court fixed a value, which was slightly reduced on appeal by the Iowa Supreme Court, [citations omitted]. In July, 1965, taxpayers purchased the minority stock interest at the price fixed by the court.

During 1963, taxpayers paid attorneys', accountants', and appraisers' fees of over \$25,000, for services rendered in connection with the appraisal litigation. On their 1963 federal income tax returns, taxpayers claimed deductions for these expenses, asserting that they were "ordinary and necessary expenses paid ... for the management, conservation, or maintenance of property held for the production of income" deductible under § 212 ... The Commissioner of Internal Revenue disallowed the deduction "because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation." The Tax Court sustained the Commissioner's determination, with two dissenting opinions, and the Court of Appeals affirmed. We granted certiorari to resolve the conflict over the deductibility of the costs of appraisal proceedings between this decision and the decision of the Court of Appeals for the Seventh Circuit in *United States v. Hilton Hotels Corp.*, [397 U.S. 580 (1970)]. [footnote omitted] We affirm.

Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible. [footnote omitted] See § 263. Such expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold. If an expense is capital, it cannot be deducted as "ordinary and necessary," either as a business expense under § 162 of the Code or as an expense of "management, conservation, or maintenance" under § 212.<sup>90</sup>

It has long been recognized, as a general matter, that costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures. The most familiar example of such treatment is the capitalization of brokerage fees for the sale or purchase of securities, as explicitly provided by a longstanding Treasury regulation, Reg. § 1.263(a)-2(e), and as approved by this Court in *Helvering v. Winmill*, 305 U.S. 79 (1938), and *Spreckels v. Commissioner*, 315 U.S. 626 (1942). The Court recognized that brokers' commissions are "part of the

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<sup>90</sup> The two sections are in *pari materia* with respect to the capital-ordinary distinction, differing only in that § 212 allows deductions for the ordinary and necessary expenses of nonbusiness profitmaking activities. See *United States v. Gilmore*, 372 U.S. 39, 44-45 (1963). ...

acquisition cost of the securities,” *Helvering v. Winmill*, *supra*, at 305 U.S. 84, and relied on the Treasury regulation, which had been approved by statutory reenactment, to deny deductions for such commissions even to a taxpayer for whom they were a regular and recurring expense in his business of buying and selling securities.

The regulations do not specify other sorts of acquisition costs, but rather provide generally that “[t]he cost of acquisition ... of ... property having a useful life substantially beyond the taxable year” is a capital expenditure. Reg. § 1.263(a)-2(a). Under this general provision, the courts have held that legal, brokerage, accounting, and similar costs incurred in the acquisition or disposition of such property are capital expenditures. *See, e.g., Spangler v. Commissioner*, 323 F.2d 913, 921 (C.A. 9th Cir.1963); *United States v. St. Joe Paper Co.*, 284 F.2d 430, 432 (C.A. 5th Cir.1960). [citation omitted]. The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it.

More difficult questions arise with respect to another class of capital expenditures, those incurred in “defending or perfecting title to property.” Reg. § 1.263(a)-2(c). In one sense, any lawsuit brought against a taxpayer may affect his title to property – money or other assets subject to lien. [footnote omitted] The courts, not believing that Congress meant all litigation expenses to be capitalized, have created the rule that such expenses are capital in nature only where the taxpayer’s “primary purpose” in incurring them is to defend or perfect title. *See, e.g., Rassenfoss v. Commissioner*, 158 F.2d 764 (C.A. 7th Cir.1946); *Industrial Aggregate Co. v. United States*, 284 F.2d 639, 645 (C.A. 8th Cir.1960). This test hardly draws a bright line, and has produced a melange of decisions which, as the Tax Court has noted, “[i]t would be idle to suggest ... can be reconciled.” *Ruoff v. Commissioner*, 30 T.C. 204, 208 (1958). [footnote omitted]

Taxpayers urge that this “primary purpose” test, developed in the context of cases involving the costs of defending property, should be applied to costs incurred in acquiring or disposing of property as well. And if it is so applied, they argue, the costs here in question were properly deducted, since the legal proceedings in which they were incurred did not directly involve the question of title to the minority stock, which all agreed was to pass to taxpayers, but rather was concerned solely with the value of that stock. [footnote omitted]

We agree with the Tax Court and the Court of Appeals that the “primary purpose” test has no application here. That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect a taxpayer’s title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be “defending or perfecting title.” Such uncertainty is not called for in applying the regulation that makes the “cost of acquisition” of a capital asset a capital expense. In our view, application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.

A test based upon the taxpayer’s “purpose” in undertaking or defending a particular piece of litigation would encourage resort to formalism and artificial distinctions. For instance, in this case, there can be no doubt that legal, accounting, and appraisal costs incurred by taxpayers in negotiating a purchase of the minority stock would have been capital expenditures. See *Atzingen-Whitehouse Dairy Inc. v. Commissioner*, 36 T.C. 173 (1961). Under whatever test might be applied, such expenses would have clearly been “part of the acquisition cost” of the stock. *Helvering v. Winmill*, *supra*. Yet the appraisal proceeding was no more than the substitute that state law provided for the process of negotiation as a means of fixing the price at which the stock was to be purchased. Allowing deduction of expenses incurred in such a proceeding, merely on the ground that title was not directly put in question in the particular litigation, would be anomalous.

Further, a standard based on the origin of the claim litigated comports with this Court’s recent ruling on the characterization of litigation expenses for tax purposes in *United States v. Gilmore*, 372 U.S. 39 (1963). This Court there held that the expense of defending a divorce suit was a nondeductible personal expense, even though the outcome of the divorce case would affect the taxpayer’s property holdings, and might affect his business reputation. The Court rejected a test that looked to the consequences of the litigation, and did not even consider the taxpayer’s motives or purposes in undertaking defense of the litigation, but rather examined the origin and character of the claim against the taxpayer, and found that the claim arose out of the personal relationship of marriage.

The standard here pronounced may, like any standard, present borderline cases, in which it is difficult to determine whether the origin of particular litigation lies in the process of acquisition. [footnote omitted] This is not such a borderline case. Here state law required taxpayers to “purchase” the stock owned by the dissenter. In the absence of agreement on the price at which the purchase was to be made,

litigation was required to fix the price. Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price.<sup>91</sup> Thus, the expenses incurred in that litigation were properly treated as part of the cost of the stock that the taxpayers acquired.

Affirmed.

*Notes and Questions:*

1. Will taxpayers be permitted to claim depreciation or amortization deductions for the expenditures in question? Why or why not?
2. This case arose under § 212, not § 162. Section 212 deductions are “miscellaneous deductions” under § 67 and are disallowed until tax year 2026. § 67(g). However, § 162 and § 212 are in *pari materia* with each other. See the Court’s first footnote.
3. The “origin of the claim” rather than “taxpayer’s purpose” governs deductibility under § 162 (and 212).
4. M owned certain real estate in Memphis, Tennessee. In 2018, M entered into contracts to lease the properties for a term of fifty years, and in 2018 paid commissions and fees to a real estate broker and attorney for services in obtaining the contracts.
  - For tax purposes, how should M treat the real estate brokerage commissions?
  - See *Renwick v. United States*, 87 F.2d 123, 125 (7<sup>th</sup> Cir. 1936); *Meyran v. Commissioner*, 63 F.2d 986 (3<sup>d</sup> Cir. 1933).

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<sup>91</sup> ... [W]herever a capital asset is transferred to a new owner in exchange for value either agreed upon or determined by law to be a fair quid pro quo, the payment itself is a capital expenditure, and there is no reason why the costs of determining the amount of that payment should be considered capital in the case of the negotiated price and yet considered deductible in the case of the price fixed by law. See *Isaac G. Johnson & Co. v. United States*, 149 F.2d 851 (C.A.2d Cir.1945) (expenses of litigating amount of fair compensation in condemnation proceeding held capital expenditures).

*Start-up Expenses of a Business:* No deduction is permitted for the start-up expenses of a proprietorship (§ 195), corporation (§ 248), or partnership (§ 709) – except as specifically provided. What would be the rationale of this treatment?

5. S owned stock in several different companies. He sold 100 shares of IBM stock for a nice profit and incurred a brokerage commission of \$500. For tax purposes, how should S treat the brokerage commissions?

- Does it make any difference whether S treats the brokerage commission as an ordinary and necessary expense of investment activity or as a decrease in his “amount realized?”
- See *Spreckels v. Commissioner*, 315 U.S. 626 (1942); cf. 67(g).

6. W purchased the IBM stock that S sold, *supra*. W incurred a brokerage commission of \$500. For tax purposes, how should W treat the brokerage commissions?

- Does it make any difference whether W treats the brokerage commission as an ordinary and necessary expense of investment activity or as an increase in his basis?
- See *Helvering v. Winmill*, 305 U.S. 79 (1938).

### **A. Expense or Capital: Cost of Constructing a *Tangible* Capital Asset**

What should be the tax treatment of the cost of taxpayer’s self-construction of a productive asset for it to use in its own business? Should there be a parallel between such activity and the tax treatment we accord imputed income?

**Commissioner v. Idaho Power Co.**, 418 U.S. 1 (1974)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

This case presents the sole issue whether, for federal income tax purposes, a taxpayer is entitled to a deduction from gross income, under [I.R.C.] § 167(a) ...<sup>92</sup>

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<sup>92</sup> § 167. Depreciation.

(a) General rule. There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –

... for depreciation on equipment the taxpayer owns and uses in the construction of its own capital facilities, or whether the capitalization provision of § 263(a)(1) of the Code<sup>93</sup> ..., bars the deduction.

The taxpayer claimed the deduction, but the Commissioner ... disallowed it. The Tax Court ... upheld the Commissioner's determination. The United States Court of Appeals for the Ninth Circuit, declining to follow a Court of Claims decision, *Southern Natural Gas Co. v. United States*, 412 F.2d 1222, 1264-1269 (1969), reversed. We granted certiorari in order to resolve the apparent conflict between the Court of Claims and the Court of Appeals.

## I

... The taxpayer-respondent, Idaho Power Company, ... is a public utility engaged in the production, transmission, distribution, and sale of electric energy. The taxpayer keeps its books and files its federal income tax returns on the calendar year accrual basis. The tax years at issue are 1962 and 1963.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities. [footnote omitted]. The major work has consisted of transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

During 1962 and 1963, the tax years in question, taxpayer owned and used in its business a wide variety of automotive transportation equipment, including passenger cars, trucks of all descriptions, power-operated equipment, and trailers. Radio communication devices were affixed to the equipment, and were used in its daily operations. The transportation equipment was used in part for operation and maintenance and in part for the construction of capital facilities having a useful life of more than one year.

....

- 
- (1) of property used in the trade or business, or
  - (2) of property held for the production of income.

<sup>93</sup> § 263. Capital expenditures.

- (a) General rule. No deduction shall be allowed for –
  - (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

... [O]n its books, in accordance with Federal Power Commission-Idaho Public Utilities Commission prescribed methods, the taxpayer capitalized the construction-related depreciation, but, for income tax purposes, that depreciation increment was [computed on a composite life of ten years under straight-line and declining balance methods, and] claimed as a deduction under § 167(a). [footnote omitted]

Upon audit, the Commissioner ... disallowed the deduction for the construction-related depreciation. He ruled that that depreciation was a nondeductible capital expenditure to which § 263(a)(1) had application. He added the amount of the depreciation so disallowed to the taxpayer's adjusted basis in its capital facilities, and then allowed a deduction for an appropriate amount of depreciation on the addition, computed over the useful life (30 years or more) of the property constructed. A deduction for depreciation of the transportation equipment to the extent of its use in day-to-day operation and maintenance was also allowed. The result of these adjustments was the disallowance of depreciation, as claimed by the taxpayer on its returns, in the net amounts of \$140,429.75 and \$96,811.95 for 1962 and 1963, respectively. This gave rise to asserted deficiencies in taxpayer's income taxes for those two years of \$73,023.47 and \$50,342.21.

The Tax Court agreed with the [Commissioner.] ...

The Court of Appeals, on the other hand, perceived in the ... Code ... the presence of a liberal congressional policy toward depreciation, the underlying theory of which is that capital assets used in business should not be exhausted without provision for replacement. The court concluded that a deduction expressly enumerated in the Code, such as that for depreciation, may properly be taken, and that "no exception is made should it relate to a capital item." Section 263(a)(1) ... was found not to be applicable, because depreciation is not an "amount paid out," as required by that section. ...

The taxpayer asserts that its transportation equipment is used in its "trade or business," and that depreciation thereon is therefore deductible under § 167(a)(1) ... The Commissioner concedes that § 167 may be said to have a literal application to depreciation on equipment used in capital construction,<sup>94</sup> but contends that the

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<sup>94</sup> For purposes of the issue here presented, the key phrase of § 167(a)(1) is "property used in the trade or business." ...

provision must be read in light of § 263(a)(1), which specifically disallows any deduction for an amount “paid out for new buildings or for permanent improvements or betterments.” He argues that § 263 takes precedence over § 167 by virtue of what he calls the “priority-ordering” terms (and what the taxpayer describes as “housekeeping” provisions) of § 161 of the Code<sup>95</sup> ... and that sound principles of accounting and taxation mandate the capitalization of this depreciation.

It is worth noting the various items that are not at issue here. ... There is no disagreement as to the allocation of depreciation between construction and maintenance. The issue thus comes down primarily to a question of timing, ... that is, whether the construction-related depreciation is to be amortized and deducted over the shorter life of the equipment or, instead, is to be amortized and deducted over the longer life of the capital facilities constructed.

## II

Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time, a capital asset is consumed and, correspondingly over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted.<sup>96</sup> As the process of consumption continues,

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Since the Commissioner appears to have conceded the literal application of § 167(a) to Idaho Power’s equipment depreciation, we need not reach the issue whether the Court of Appeals has given the phrase “used in the trade or business” a proper construction. For purposes of this case, we assume, without deciding, that § 167(a) does have a literal application to the depreciation of the taxpayer’s transportation equipment used in the construction of its capital improvements.

<sup>95</sup> § 161. Allowance of deductions. In computing taxable income under § 63(a), there shall be allowed as deductions the items specified in this part, subject to the exceptions provided in part IX (§§ 261 and following, relating to items not deductible).”

<sup>96</sup> The Committee on Terminology of the American Institute of Certified Public Accountants has discussed various definitions of depreciation and concluded that:

These definitions view depreciation, broadly speaking, as describing not downward changes of value regardless of their causes, but a money cost incident to exhaustion of usefulness. The term is sometimes applied to the exhaustion itself, but the committee considers it desirable to emphasize the cost concept as the primary, if not the sole, accounting meaning of the term: thus, depreciation means the cost of such exhaustion, as wages means the cost of labor.” 2 APB Accounting Principles, Accounting Terminology Bulletin No. 1 -- Review and Resume 48, p. 9512 (1973) (emphasis in original).



and depreciation is claimed and allowed, the asset's adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. The Court stated in *Hertz Corp. v. United States*, 364 U.S. 122, 126 (1960): [T]he purpose of depreciation accounting is to allocate the expense of using an asset to the various periods which are benefited by that asset. [citations omitted]. When the asset is used to further the taxpayer's day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.

The Court of Appeals opined that the purpose of the depreciation allowance under the Code was to provide a means of cost recovery, *Knoxville v. Knoxville Water Co.*, 212 U.S. 1, 13-14 (1909), and that this Court's decisions, e.g., *Detroit Edison Co. v. Commissioner*, 319 U.S. 98, 101 (1943), endorse a theory of replacement through "a fund to restore the property." Although tax-free replacement of a depreciating investment is one purpose of depreciation accounting, it alone does not require the result claimed by the taxpayer here. Only last Term, in *United States v. Chicago, B. & Q. R. Co.*, 412 U.S. 401 (1973), we rejected replacement as the strict and sole purpose of depreciation:

"Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is ... [depreciation] reflects the cost of an existing capital asset, not the cost of a potential replacement." *Id.* at 415.

Even were we to look to replacement, it is the replacement of the constructed facilities, not the equipment used to build them, with which we would be concerned. If the taxpayer now were to decide not to construct any more capital facilities with its own equipment and employees, it, in theory, would have no occasion to replace its equipment to the extent that it was consumed in prior construction.

Accepted accounting practice<sup>97</sup> and established tax principles require the capitalization of the cost of acquiring a capital asset. In *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), the Court observed: “It has long been recognized, as a general matter, that costs incurred in the acquisition ... of a capital asset are to be treated as capital expenditures.” This principle has obvious application to the acquisition of a capital asset by purchase, but it has been applied, as well, to the costs incurred in a taxpayer’s construction of capital facilities. [citations omitted]. [footnote omitted]

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. § 162(a)(1) ... But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized, and are then entitled to be amortized over the life of the capital asset so acquired. [citations omitted].

Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of construction equipment does not represent the final disposition of the taxpayer’s investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer’s cost or investment in the capital asset. ... By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized. [citations omitted].

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax

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<sup>97</sup> The general proposition that good accounting practice requires capitalization of the cost of acquiring a capital asset is not seriously open to question. The Commissioner urges, however, that accounting methods, as a rule, require the treatment of construction-related depreciation of equipment as a capital cost of the facility constructed. Indeed, there is accounting authority for this. *See, e.g.*, W. PATON, *ASSET ACCOUNTING* 188, 192-193 (1952); H. FINNEY & H. MILLER, *PRINCIPLES OF ACCOUNTING – INTRODUCTORY* 246-247 (6th ed. 1963) (depreciation as an expense should be matched with the production of income); W. PATON, *ACCOUNTANTS’ HANDBOOK* 652 (3d ed. 1943); Note, 1973 *DUKE L.J.* 1377, 1384; Note, 52 *N.C. L. REV.* 684, 692 (1974).

parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor's equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost, of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals' holding would lead to disparate treatment among taxpayers, because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost, including depreciation charged to it by the contractor.

....

[Taxpayer argued that the language of § 263(a)(1), which denies a current deduction for “new buildings or for permanent improvements or betterments,” only applies when taxpayer has “paid out” an “amount.” Depreciation, taxpayer argued, represented a decrease in value – not an “amount ... paid out.” The Court rejected this limitation on § 263's applicability. Instead, the Court accepted the IRS's administrative construction of that phrase to mean “cost incurred.” Construction-related depreciation is such a cost.] In acquiring the transportation equipment, taxpayer “paid out” the equipment's purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in *Brooks v. Commissioner*, 50 T.C. at 935, “depreciation – inasmuch as it represents a using up of capital – is as much an expenditure' as the using up of labor or other items of direct cost.”

Finally, the priority-ordering directive of § 161 – or, for that matter, ... § 261<sup>98</sup> – requires that the capitalization provision of § 263(a) take precedence, on the facts here, over § 167(a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are “subject to the exceptions provided in part IX.” Part VI includes § 167, and Part IX includes § 263. The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere (as, for example, in § 404, relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

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<sup>98</sup> § 261. General rule for disallowance of deductions. In computing taxable income no deduction shall in any case be allowed in respect of the items specified in this part.

The Court of Appeals concluded, without reference to § 161, that § 263 did not apply to a deduction, such as that for depreciation of property used in a trade or business, allowed by the Code even though incurred in the construction of capital assets. [footnote omitted] We think that the court erred in espousing so absolute a rule, and it obviously overlooked the contrary direction of § 161. To the extent that reliance was placed on the congressional intent, in the evolution of the 1954 Code, to provide for “liberalization of depreciation,” H.R. Rep. No. 1337, 83d Cong., 2d Sess., 22 (1954), that reliance is misplaced. The House Report also states that the depreciation provisions would “give the economy added stimulus and resilience without departing from realistic standards of depreciation accounting.” *Id.* at 24. To be sure, the 1954 Code provided for new and accelerated methods for depreciation, resulting in the greater depreciation deductions currently available. These changes, however, relate primarily to computation of depreciation. Congress certainly did not intend that provisions for accelerated depreciation should be construed as enlarging the class of depreciable assets to which § 167(a) has application or as lessening the reach of § 263(a). [citation omitted].

We hold that the equipment depreciation allocable to taxpayer’s construction of capital facilities is to be capitalized.

The judgment of the Court of Appeals is reversed.

It is so ordered.

MR. JUSTICE DOUGLAS, dissenting. [omitted].

#### *Notes and Questions:*

1. The Court noted that the net of taxpayer’s disallowed depreciation deductions was \$140,429.75 and \$96,811.95 for 1962 and 1963 respectively. The useful life of the items that taxpayer was constructing was three or more times as long as the useful life of the equipment it used to construct those items. This case is about the fraction of the figures noted here that taxpayer may deduct – after the item is placed in service.

- Assuming straight-line depreciation of the equipment, the difference in the parties’ treatment of a depreciation deduction was the difference between 1/10 and 1/30 of 1/10 of the cost of equipment.

2. Why do we allow deductions for depreciation? Is it that –

- “capital assets used in business should not be exhausted without provision for replacement”?
- physical consumption of a capital asset reduces its value and utility, and a depreciation deduction implicitly recognizes this.

- obsolescence may reduce the value and utility of an asset, even if the asset is not exhausted and could still function, e.g., a twenty-year old personal computer? *See* the Court’s fifth footnote.

- a depreciation deduction in effect allocates the expense of using an asset to the various periods which are benefitted by that asset?

How do these rationales apply to a case where taxpayer consumes depreciable assets in the construction of income-producing capital assets?

*Taxpayer’s books and taxpayer’s tax books:* Distinguish between taxpayer’s books (“its books”) and taxpayer’s tax books (“for federal income tax purposes”). For what purposes does taxpayer keep each set of books? Do you think that they would ever be different? Why or why not?

3. Aside from the Code’s mandate in § 1016(a)(2), why must a taxpayer reduce its adjusted basis in an asset subject to depreciation?

4. How did the Court’s treatment of depreciation in this case prevent the distortion of income?

5. Why might Congress *want* to mismatch the timing of income and expenses and thereby distort income?

*Sections 161 and 261:* How does the language of §§ 161 and 261 create an ordering rule? What deductions do §§ 262 to 280H create?

6. The case demonstrates again how important the time value of money is.

## **B. Expense or Capital: Cost of “Constructing” an *Intangible* Capital Asset**

What should be the rule when taxpayer self-creates an *intangible* asset that it can use to generate taxable income? Are there any (obvious) difficulties to applying the rule of *Idaho Power* to such a situation? Identify what taxpayer in *INDOPCO* argued was the rule of *Lincoln Savings*? Would taxpayer’s statement of that rule solve those difficulties?

### **INDOPCO, Inc. v. Commissioner, 503 U.S. 79 (1992)**

JUSTICE BLACKMUN delivered the opinion of the Court.

In this case we must decide whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as “ordinary and necessary” business expenses under § 162(a) of the Internal Revenue Code.

#### **I**

... Petitioner INDOPCO, Inc., formerly named National Starch and Chemical Corporation and hereinafter referred to as National Starch, ... manufactures and sells adhesives, starches, and specialty chemical products. In October 1977, representatives of Unilever United States, Inc., ... (Unilever), [footnote omitted] expressed interest in acquiring National Starch, which was one of its suppliers, through a friendly transaction. National Starch at the time had outstanding over 6,563,000 common shares held by approximately 3,700 shareholders. The stock was listed on the New York Stock Exchange. Frank and Anna Greenwall were the corporation’s largest shareholders and owned approximately 14.5% of the common. The Greenwalls, getting along in years and concerned about their estate plans, indicated that they would transfer their shares to Unilever only if a transaction tax free for them could be arranged.

Lawyers representing both sides devised a “reverse subsidiary cash merger” that they felt would satisfy the Greenwalls’ concerns. Two new entities would be created – National Starch and Chemical Holding Corp. (Holding), a subsidiary of Unilever, and NSC Merger, Inc., a subsidiary of Holding that would have only a transitory existence. ... [Some of National Starch’s shares were exchanged for

preferred shares of Unilever (not taxed), and some were exchanged for cash (taxed).]

In November 1977, National Starch's directors were formally advised of Unilever's interest and the proposed transaction. At that time, Debevoise, Plimpton, Lyons & Gates, National Starch's counsel, told the directors that under Delaware law they had a fiduciary duty to ensure that the proposed transaction would be fair to the shareholders. National Starch thereupon engaged the investment banking firm of Morgan Stanley & Co., Inc., to evaluate its shares, to render a fairness opinion, and generally to assist in the event of the emergence of a hostile tender offer.

Although Unilever originally had suggested a price between \$65 and \$70 per share, negotiations resulted in a final offer of \$73.50 per share, a figure Morgan Stanley found to be fair. Following approval by National Starch's board and the issuance of a favorable private ruling from the Internal Revenue Service that the transaction would be tax free ... for those National Starch shareholders who exchanged their stock for Holding preferred, the transaction was consummated in August 1978.<sup>99</sup>

Morgan Stanley charged National Starch a fee of \$2,200,000, along with \$7,586 for out-of-pocket expenses and \$18,000 for legal fees. The Debevoise firm charged National Starch \$490,000, along with \$15,069 for out-of-pocket expenses. National Starch also incurred expenses aggregating \$150,962 for miscellaneous items – such as accounting, printing, proxy solicitation, and Securities and Exchange Commission fees – in connection with the transaction. No issue is raised as to the propriety or reasonableness of these charges.

On its federal income tax return ... National Starch claimed a deduction for the \$2,225,586 paid to Morgan Stanley, but did not deduct the \$505,069 paid to Debevoise or the other expenses. Upon audit, the Commissioner of Internal Revenue disallowed the claimed deduction and issued a notice of deficiency. Petitioner sought redetermination in the United States Tax Court, asserting, however, not only the right to deduct the investment banking fees and expenses but, as well, the legal and miscellaneous expenses incurred.

The Tax Court, in an unreviewed decision, ruled that the expenditures were capital in nature and therefore not deductible under § 162(a) in the 1978 return as “ordinary

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<sup>99</sup> Approximately 21% of National Starch common was exchanged for Holding preferred. The remaining 79% was exchanged for cash.



and necessary expenses.” The court based its holding primarily on the long-term benefits that accrued to National Starch from the Unilever acquisition. The United States Court of Appeals for the Third Circuit affirmed, upholding the Tax Court’s findings that “both Unilever’s enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch.” In so doing, the Court of Appeals rejected National Starch’s contention that, because the disputed expenses did not “create or enhance ... a separate and distinct additional asset,” see *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354 (1971), they could not be capitalized and therefore were deductible under § 162(a). We granted certiorari to resolve a perceived conflict on the issue among the Courts of Appeals.<sup>100</sup>

## II

Section 162(a) ... allows the deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” In contrast, § 263 ... allows no deduction for a capital expenditure – an “amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.” § 263(a)(1). The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer’s cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. See 26 U.S.C. §§ 167(a) and 336(a); Reg. § 1.167(a) (1991). Through provisions such as these, the Code endeavors to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e. g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (CA 11 1982), *cert. denied*, 463 U.S. 1207 (1983).

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<sup>100</sup> Compare the Third Circuit’s opinion, 918 F.2d at 430, with *NCNB Corp. v. United States*, 684 F.2d 285, 293-294 (4th Cir. 1982) (bank expenditures for expansion-related planning reports, feasibility studies, and regulatory applications did not “create or enhance separate and identifiable assets,” and therefore were ordinary and necessary expenses under § 162(a)), and *Briarcliff Candy Corp. v. Commissioner*, 475 F.2d 775, 782 (2d Cir. 1973) (suggesting that *Lincoln Savings* “brought about a radical shift in emphasis,” making capitalization dependent on whether the expenditure creates or enhances a separate and distinct additional asset). See also *Central Texas Savings & Loan Assn. v. United States*, 731 F.2d 1181, 1184 (5th Cir. 1984) (inquiring whether establishment of new branches “creates a separate and distinct additional asset” so that capitalization is the proper tax treatment).



In exploring the relationship between deductions and capital expenditures, this Court has noted the “familiar rule” that “an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer.” *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See §§ 161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a “complete list of nondeductible expenditures,” *Lincoln Savings*, 403 U.S. at 358, § 263 serves as a general means of distinguishing capital expenditures from current expenses. See *Commissioner v. Idaho Power Co.*, 418 U.S. at 16. For these reasons, deductions are strictly construed and allowed only “as there is a clear provision therefor.” *New Colonial Ice Co. v. Helvering*, 292 U.S., at 440; *Deputy v. Du Pont*, 308 U.S., at 493. [footnote omitted]

The Court also has examined the interrelationship between the Code’s business expense and capital expenditure provisions. [footnote omitted.] In so doing, it has had occasion to parse § 162(a) and explore certain of its requirements. For example, in *Lincoln Savings*, we determined that, to qualify for deduction under § 162(a), “an item must (1) be ‘paid or incurred during the taxable year,’ (2) be for ‘carrying on any trade or business,’ (3) be an ‘expense,’ (4) be a ‘necessary’ expense, and (5) be an ‘ordinary’ expense.” 403 U.S. at 352. See also *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (the term “necessary” imposes “only the minimal requirement that the expense be ‘appropriate and helpful’ for ‘the development of the [taxpayer’s] business,’” quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933)); *Deputy v. Du Pont*, 308 U.S. at 495 (to qualify as “ordinary,” the expense must relate to a transaction “of common or frequent occurrence in the type of business involved”). The Court has recognized, however, that the “decisive distinctions” between current expenses and capital expenditures “are those of degree and not of kind,” *Welch v. Helvering*, 290 U.S. at 114, and that because each case “turns on its special facts,” *Deputy v. Du Pont*, 308 U.S. at 496, the cases sometimes appear difficult to harmonize. See *Welch v. Helvering*, 290 U.S. at 116.

National Starch contends that the decision in *Lincoln Savings* changed these familiar backdrops and announced an exclusive test for identifying capital expenditures, a test in which “creation or enhancement of an asset” is a prerequisite to capitalization, and deductibility under § 162(a) is the rule rather than the

exception. We do not agree, for we conclude that National Starch has overread *Lincoln Savings*.

In *Lincoln Savings*, we were asked to decide whether certain premiums, required by federal statute to be paid by a savings and loan association to the Federal Savings and Loan Insurance Corporation (FSLIC), were ordinary and necessary expenses under § 162(a), as Lincoln Savings argued and the Court of Appeals had held, or capital expenditures under § 263, as the Commissioner contended. We found that the “additional” premiums, the purpose of which was to provide FSLIC with a secondary reserve fund in which each insured institution retained a pro rata interest recoverable in certain situations, “serv[e] to create or enhance for Lincoln what is essentially a separate and distinct additional asset.” 403 U.S. at 354. “[A]s an inevitable consequence,” we concluded, “the payment is capital in nature and not an expense, let alone an ordinary expense, deductible under § 162(a).” *Ibid*.

*Lincoln Savings* stands for the simple proposition that a taxpayer’s expenditure that “serves to create or enhance ... a separate and distinct” asset should be capitalized under § 263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under § 263. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure. *See General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 716 (CA8) (although expenditures may not “resul[t] in the acquisition or increase of a corporate asset, ... these expenditures are not, because of that fact, deductible as ordinary and necessary business expenses”), *cert. denied*, 379 U.S. 832 (1964).

Nor does our statement in *Lincoln Savings*, 403 U.S. at 354, that “the presence of an ensuing benefit that may have some future aspect is not controlling” prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure.<sup>101</sup> Although the mere presence of an incidental future

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<sup>101</sup> Petitioner contends that, absent a separate-and-distinct-asset requirement for capitalization, a taxpayer will have no “principled basis” upon which to differentiate business expenses from capital expenditures. We note, however, that grounding tax status on the existence of an asset would be unlikely

benefit – “some future aspect” – may not warrant capitalization, a taxpayer’s realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. *See United States v. Mississippi Chemical Corp.*, 405 U.S. 298, 310 (1972) (expense that “is of value in more than one taxable year” is a nondeductible capital expenditure); *Central Texas Savings & Loan Assn. v. United States*, 731 F.2d 1181, 1183 (CA5 1984) (“While the period of the benefits may not be controlling in all cases, it nonetheless remains a prominent, if not predominant, characteristic of a capital item”). Indeed, the text of the Code’s capitalization provision, § 263(a)(1), which refers to “permanent improvements or betterments,” itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.

### III

In applying the foregoing principles to the specific expenditures at issue in this case, we conclude that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever’s acquisition of its shares are deductible as ordinary and necessary business expenses under § 162(a).

Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as “entirely speculative” or “merely incidental,” the Tax Court’s and the Court of Appeals’ findings that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record. For example, in commenting on the merger with Unilever, National Starch’s 1978 “Progress Report” observed that the company would “benefit greatly from the availability of Unilever’s enormous resources, especially in the area of basic technology.” (Unilever “provides new opportunities and resources”). Morgan Stanley’s report to the National Starch board concerning the fairness to shareholders of a possible business combination with Unilever noted that National Starch management “feels that some synergy may exist with the Unilever organization given a) the nature of the Unilever chemical, paper, plastics and packaging operations ... and b) the strong consumer products orientation of Unilever United States, Inc.”

In addition to these anticipated resource-related benefits, National Starch obtained benefits through its transformation from a publicly held, freestanding corporation

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to produce the bright-line rule that petitioner desires, given that the notion of an “asset” is itself flexible and amorphous. *See Johnson*, 53 TAX NOTES, at 477-478.

into a wholly owned subsidiary of Unilever. The Court of Appeals noted that National Starch management viewed the transaction as “swapping approximately 3500 shareholders for one.” Following Unilever’s acquisition of National Starch’s outstanding shares, National Starch was no longer subject to what even it terms the “substantial” shareholder-relations expenses a publicly traded corporation incurs, including reporting and disclosure obligations, proxy battles, and derivative suits. The acquisition also allowed National Starch, in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares of preferred and to reduce the total number of authorized shares of common from 8,000,000 to 1,000.

Courts long have recognized that expenses such as these, “incurred for the purpose of changing the corporate structure for the benefit of future operations are not ordinary and necessary business expenses.” *General Bancshares Corp. v. Commissioner*, 326 F.2d, at 715 (quoting *Farmers Union Corp. v. Commissioner*, 300 F.2d 197, 200 (CA9), *cert. denied*, 371 U.S. 861 (1962)). See also B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 5-33 to 5-36 (5th ed. 1987) (describing “well-established rule” that expenses incurred in reorganizing or restructuring corporate entity are not deductible under § 162(a)). Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure.<sup>102</sup> Although support for these decisions can be found in the specific terms of § 162(a), which require that deductible expenses be “ordinary and necessary” and incurred “in carrying on any trade or business,”<sup>103</sup> courts more frequently have characterized an expenditure as capital in nature because “the purpose for which the expenditure is

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<sup>102</sup> See, e.g., *McCrary Corp. v. United States*, 651 F.2d 828 (2d Cir. 1981) (statutory merger under 26 U.S.C. § 368(a)(1)(A)); *Bilar Tool & Die Corp. v. Commissioner*, 530 F.2d 708 (6th Cir. 1976) (division of corporation into two parts); *E. I. du Pont de Nemours & Co. v. United States*, 432 F.2d 1052 (3rd Cir. 1970) (creation of new subsidiary to hold assets of prior joint venture); *General Bancshares Corp. v. Commissioner*, 326 F.2d 712, 715 (8th Cir.) (stock dividends), *cert. denied*, 379 U.S. 832 (1964); *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244 (2d Cir. 1953) (recapitalization).

<sup>103</sup> See, e.g., *Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872, 873-874 (CA2 1936) (recognizing that expenses may be “ordinary and necessary” to corporate merger, and that mergers may be “ordinary and necessary business occurrences,” but declining to find that merger is part of “ordinary and necessary business activities,” and concluding that expenses are therefore not deductible); Greenstein, *The Deductibility of Takeover Costs After National Starch*, 69 TAXES 48, 49 (1991) (expenses incurred to facilitate transfer of business ownership do not satisfy the “carrying on [a] trade or business” requirement of § 162(a)).

made has to do with the corporation's operations and betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." *General Bancshares Corp. v. Commissioner*, 326 F.2d at 715. See also *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (CA2 1953). The rationale behind these decisions applies equally to the professional charges at issue in this case.

#### IV

The expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as "ordinary and necessary" business expenses under § 162(a). The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

The judgment of the Court of Appeals is affirmed.

It is so ordered.

#### *Notes and Questions:*

1. The *INDOPCO* decision was not well received in the business community. Why not?

- Should taxpayer in *INDOPCO* amortize the intangible that it purchased? – over what period?

2. Capitalization of expenditures to construct a tangible asset followed by depreciation, amortization, or cost recovery works more predictably than when expenditures are directed towards the "construction" of an intangible asset. Why do you think that this is so?

- Perhaps because a tangible asset physically deteriorates over time and so its useful life is more easily determinable.

3. *Advertising and marketing campaigns*: A marketing campaign requires current and future expenditures, but the "asset" it creates (consumer loyalty? brand recognition?) should endure past the end of the campaign. It is not even possible to know when this asset no longer generates income – as would be the case with an asset as tangible as, say, a building. A rational approach to depreciation,

amortization, or cost recovery requires that we not only be able to recognize when an expenditure no longer generates income, but also be able to predict how long that would be.

- Consider expenditures for advertising. Not only do these problems emerge, but answers would be different from one taxpayer to the next.

4. The compliance costs of a rule that requires taxpayer to capitalize expenditures that generate income into the future can be enormous. At least one case was litigated all the way to the Supreme Court. *Cf. Newark Morning Ledger Co. v. United States*, 507 U.S. 546 (1993) (at-will subscription list is not goodwill and purchaser of newspaper permitted to depreciate it upon proof of value and useful life).

5. Perhaps there is something to be said for National Starch's contention that capitalization required the "creation or enhancement of a separate and distinct asset." Moreover, its statement in the third footnote ("absent a separate-and-distinct-asset requirement for capitalization, a taxpayer will have no 'principled basis' upon which to differentiate business expenses from capital expenditures") just might be accurate. The Court dismissed this argument in the next sentence of the footnote by observing that the Court's position essentially is no worse than taxpayer's.

6. "Deduction rather than capitalization becomes more likely as the link between the outlay and a readily identifiable asset decreases, and as the asset to which the outlay is linked becomes less and less tangible." Joseph Bankman, *The Story of INDOPCO: What Went Wrong in the Capitalization v. Deduction Debate*, in *TAX STORIES* 228 (Paul Caron ed., 2d ed. 2009).

- "Deduction also becomes more likely for expenses that are recurring, or fit within a commonsense definition of ordinary and necessary." *Id.*

7. Lower courts gradually began to read *Lincoln Savings* as *requiring* the creation or enhancement of a separate and distinct asset. *Id.* at 233.

- Nevertheless, the Supreme Court was correct in its reading of *Lincoln Savings* to the effect "that the creation of a separate and distinct asset well may be a sufficient, but not a necessary, condition to classification as a capital expenditure."

8. On the other hand, does the Court announce that the presence of "some future benefit" is a sufficient condition to classification as a capital expenditure?

9. The *INDOPCO* holding called into question many long-standing positions that taxpayers had felt comfortable in taking. The cost of complete and literal compliance with every ramification of the holding would have been enormous. The IRS produced some (favorable to the taxpayer) clarifications in revenue rulings concerning the deductibility of certain expenditures. See Joseph Bankman, *The Story of INDOPCO: What Went Wrong in the Capitalization v. Deduction Debate*, in TAX STORIES 244-45 (Paul Caron ed., 2d ed. 2009). In 2004, the IRS published final regulations. *Guidance Regarding Deduction and Capitalization of Expenditures*, 69 Fed. Reg. 436 (Jan. 5, 2004). The regulations represented an IRS effort to allay fears and/or provide predictability to the application of capitalization rules. In its “Explanation and Summary of Comments Concerning § 1.263(a)-4,” the IRS wrote:

The final regulations identify categories of intangibles for which capitalization is required. ... [T]he final regulations provide that an amount paid to acquire or create an intangible not otherwise required to be capitalized by the regulations is not required to be capitalized on the ground that it produces significant future benefits for the taxpayer, unless the IRS publishes guidance requiring capitalization of the expenditure. If the IRS publishes guidance requiring capitalization of an expenditure that produces future benefits for the taxpayer, such guidance will apply prospectively. ...

*Id.* at 436. This positivist approach limits application of the “significant future benefits” theory to require capitalization of untold numbers of expenditures.

10. The “capitalization list” appears in Regs. §§ 1.263(a)-4(b)(1) and 1.263(a)-5(a).

- an amount paid to another party to acquire an intangible;
- an amount paid to create an intangible specifically named in Reg. § 1.263(a)-4(d);
- an amount paid to create or enhance a separate and distinct intangible asset;
- an amount paid to create or enhance a future benefit that the IRS has specifically identified in published guidance;
- an amount paid to “facilitate” (as that term is specifically defined) an acquisition or creation of any of the above-named intangibles; and
- amounts paid or incurred to facilitate acquisition of a trade or business, a change in the capital structure of a business entity, and various other transactions.



11. Moreover, Reg. § 1.263(a)-4(f)(1) states a 12-month rule, i.e., that a taxpayer is not required to capitalize ... any right or benefit for the taxpayer that does not extend beyond the earlier of –
- (i) 12 months after the first date on which the taxpayer realizes the right or benefit; or
  - (ii) The end of the taxable year following the taxable year in which the payment is made.
12. When taxpayers incur recurring expenses intended to provide future benefits – notably advertising – what is gained by strict adherence to capitalization principles?
- In *Encyclopaedia Britannica, Inc. v. Commissioner*, 685 F.2d 212, 217 (7<sup>th</sup> Cir. 1982), Judge Posner wrote:

If one really takes seriously the concept of a capital expenditure as anything that yields income, actual or imputed, beyond the period (conventionally one year, [citation omitted]) in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from. [citation omitted]. It would require capitalizing every salesman's salary, since his selling activities create goodwill for the company and goodwill is an asset yielding income beyond the year in which the salary expense is incurred. The administrative costs of conceptual rigor are too great. The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be.



13. (Note 12, continued): Imagine: An author spends \$5 every year for pen and paper with which to write books. Each book will generate income for the author for 5 years. Let's assume that "the rules" permit such a taxpayer to deduct \$1 of that \$5 expenditure in each of the succeeding five years. This tax treatment matches the author's expenses with his income. The accompanying table demonstrates that this taxpayer will (eventually) be deducting \$5 every year.

year # ➡ amt spent	1	2	3	4	5	6	7	8
\$5	1	1	1	1	1			
\$5		1	1	1	1	1		
\$5			1	1	1	1	1	
\$5				1	1	1	1	1
\$5					1	1	1	1
\$5						1	1	1
\$5							1	1
\$5								1
year by year total	1	2	3	4	5	5	5	5

•Beginning in year 5, how much does the year by year total change? Does this table suggest that there is an easier way to handle recurring capital expenditures than to require taxpayer to capitalize and depreciate every such expenditure?

14. You are expected to recognize a capitalization of intangibles issue – but the details of the regulations are left to a more advanced tax course.

## C. Expense or Capital: Protecting Stock Investment or Protecting Employment

**United States v. Generes**, 405 U.S. 93 (1972)

MR. JUSTICE BLACKMUN delivered the opinion of the Court.

A debt a closely held corporation owed to an indemnifying shareholder employee became worthless in 1962. The issue in this federal income tax refund suit is whether, for the shareholder employee, that worthless obligation was a business or a nonbusiness bad debt within the meaning and reach of §§ 166(a) and (d) of the ... Code<sup>104</sup> and of the implementing Regulations § 1.166-5.<sup>105</sup>

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<sup>104</sup> § 166. Bad debts.

(a) General rule. –

(1) Wholly worthless debts. – There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

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(d) Nonbusiness debts. –

(1) General rule. – In the case of a taxpayer other than a corporation –

(A) subsection[] (a) ... shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 6 months.

(2) Nonbusiness debt defined. – For purposes of paragraph (1), the term ‘nonbusiness debt’ means a debt other than –

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.

<sup>105</sup> Reg. § 1.166-5 Nonbusiness debts.

\* \* \* \*

(b) Nonbusiness debt defined. For purposes of section 166 and this section, a nonbusiness debt is any debt other than –

\* \* \* \*

(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

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, [footnote omitted] prevailed in a jury trial in the District Court. On the Government's appeal, the Fifth Circuit affirmed by a divided vote. Certiorari was granted to resolve a conflict among the circuits. [footnote omitted.]

## I

The taxpayer, as a young man in 1909, began work in the construction business. His son-in law, William F. Kelly, later engaged independently in similar work. During World War II, the two men formed a partnership in which their participation was equal. The enterprise proved successful. In 1954, Kelly Generes Construction Co., Inc., was organized as the corporate successor to the partnership. It engaged in the heavy-construction business, primarily on public works projects.

The taxpayer and Kelly each owned 44% of the corporation's outstanding capital stock. The taxpayer's original investment in his shares was \$38,900. The remaining 12% of the stock was owned by a son of the taxpayer and by another son-in law.

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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. ...

Mr. Generes was president of the corporation, and received from it an annual salary of \$12,000. Mr. Kelly was executive vice-president, and received an annual salary of \$15,000.

The taxpayer and Mr. Kelly performed different services for the corporation. Kelly worked full time in the field, and was in charge of the day-to-day construction operations. Generes, on the other hand, devoted no more than six to eight hours a week to the enterprise. He reviewed bids and jobs, made cost estimates, sought and obtained bank financing, and assisted in securing the bid and performance bonds that are an essential part of the public project construction business. Mr. Generes, in addition to being president of the corporation, held a full-time position as president of a savings and loan association he had founded in 1937. He received from the association an annual salary of \$19,000. The taxpayer also had other sources of income. His gross income averaged about \$40,000 a year during 1959-1962.

Taxpayer Generes from time to time advanced personal funds to the corporation to enable it to complete construction jobs. He also guaranteed loans made to the corporation by banks for the purchase of construction machinery and other equipment. In addition, his presence with respect to the bid and performance bonds is of particular significance. Most of these were obtained from Maryland Casualty Co. That underwriter required the taxpayer and Kelly to sign an indemnity agreement for each bond it issued for the corporation. In 1958, however, in order to eliminate the need for individual indemnity contracts, taxpayer and Kelly signed a blanket agreement with Maryland whereby they agreed to indemnify it, up to a designated amount, for any loss it suffered as surety for the corporation. Maryland then increased its line of surety credit to \$2,000,000. The corporation had over \$14,000,000 gross business for the period 1954 through 1962.

In 1962, the corporation seriously underbid two projects and defaulted in its performance of the project contracts. It proved necessary for Maryland to complete the work. Maryland then sought indemnity from Generes and Kelly. The taxpayer indemnified Maryland to the extent of \$162,104.57. In the same year, he also loaned \$158,814.49 to the corporation to assist it in its financial difficulties. The corporation subsequently went into receivership and the taxpayer was unable to obtain reimbursement from it.

In his federal income tax return for 1962 the taxpayer took his loss on his direct loans to the corporation as a nonbusiness bad debt. He claimed the indemnification

loss as a business bad debt and deducted it against ordinary income.<sup>106</sup> 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.<sup>107</sup> The court refused the Government's request for an instruction that the applicable standard was that of dominant, rather than significant, motivation.<sup>108</sup>

... [T]he jury found that the taxpayer's signing of the indemnity agreement was proximately related to his trade or business of being an employee of the corporation. Judgment on this verdict was then entered for the taxpayer.

The Fifth Circuit majority approved the significant motivation standard so specified and agreed with a Second Circuit majority in *Weddle v. Commissioner*, 325 F.2d 849, 851 (1963), in finding comfort for so doing in the tort law's concept of proximate cause. Judge Simpson dissented. 427 F.2d at 284. He agreed with the holding of the Seventh Circuit in *Niblock v. Commissioner*, 417 F.2d 1185 (1969),

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<sup>106</sup> This difference in treatment between the loss on the direct loan and that, on the indemnity is not explained. *See, however, Whipple v. Commissioner*, 373 U. S. 193 (1963).

<sup>107</sup> "A debt is proximately related to the taxpayer's trade or business when its creation was significantly motivated by the taxpayer's trade or business, and it is not rendered a non-business debt merely because there was a non-qualifying motivation as well, even though the non-qualifying motivation was the primary one."

<sup>108</sup> "You must, in short, determine whether Mr. Generes' dominant motivation in signing the indemnity agreement was to protect his salary and status as an employee or was to protect his investment in the Kelly Generes Construction Co." "Mr. Generes is entitled to prevail in this case only if he convinces you that the dominant motivating factor for his signing the indemnity agreement was to insure the receiving of his salary from the company. It is insufficient if the protection or insurance of his salary was only a significant secondary motivation for his signing the indemnity agreement. It must have been his dominant or most important reason for signing the indemnity agreement."

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. [citations omitted.]

B. Although arising in somewhat different contexts, two tax cases decided by the Court in recent years merit initial mention. In each of these cases, a major shareholder paid out money to or on behalf of his corporation and then was unable to obtain reimbursement from it. In each, he claimed a deduction assertable against ordinary income. In each, he was unsuccessful in this quest:

1. In *Putnam v. Commissioner*, 352 U. S. 82 (1956), the taxpayer was a practicing lawyer who had guaranteed obligations of a labor newspaper corporation in which he owned stock. He claimed his loss as fully deductible ... The Court ... held that the loss was a nonbusiness bad debt subject to short-term capital loss treatment ... The loss was deductible as a bad debt or not at all. *See* Rev. Rul. 60-48, 1961 Cum. Bull. 112.

2. In *Whipple v. Commissioner*, 373 U. S. 193 (1963), the taxpayer had provided organizational, promotional, and managerial services to a corporation in which he owned approximately an 80% stock interest. He claimed that this constituted a trade or business, and, hence, that debts owing him by the corporation were business bad debts when they became worthless in 1953. The Court also rejected that contention, and held that Whipple's investing was not a trade or business, that is, that "[d]evoting one's time and energies to the affairs of a corporation is not, of itself,

and without more, a trade or business of the person so engaged.” 373 U.S. at 202. The rationale was that a contrary conclusion would be inconsistent with the principle that a corporation has a personality separate from its shareholders, and that its business is not necessarily their business. The Court indicated its approval of the Regulations’ proximate relation test:

Moreover, there is no proof (which might be difficult to furnish where the taxpayer is the sole or dominant stockholder) that the loan was necessary to keep his job or was otherwise proximately related to maintaining his trade or business as an employee. *Compare Trent v. Commissioner*, [291 F.2d 669 (CA2 1961)]. 373 U.S. at 204.

The Court also carefully noted the distinction between the business and the nonbusiness bad debt for one who is both an employee and a shareholder.<sup>109</sup>

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

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<sup>109</sup> “Even if the taxpayer demonstrates an independent trade or business of his own, care must be taken to distinguish bad debt losses arising from his own business and those actually arising from activities peculiar to an investor concerned with, and participating in, the conduct of the corporate business.” 373 U.S. at 202.

been a policy of the income tax structure ever since the Revenue Act of 1916 ... The point, however, is that the tax statutes have made the distinction, that the Congress therefore intended it to be a meaningful one, and that the distinction is not to be obliterated or blunted by an interpretation that tends to equate the business bad debt with the nonbusiness bad debt. We think that emphasis upon the significant rather, than upon the dominant, would have a tendency to do just that.

B. Application of the significant motivation standard would also tend to undermine and circumscribe the Court's holding in *Whipple*, and the emphasis there that a shareholder's mere activity in a corporation's affairs is not a trade or business. As Chief Judge Lumbard pointed out in his separate and disagreeing concurrence in *Weddle*, *supra*, 325 F.2d at 852-853, both motives – that of protecting the investment and that of protecting the salary – are inevitably involved, and an inquiry whether employee status provides a significant motivation will always produce an affirmative answer and result in a judgment for the taxpayer.

C. The dominant motivation standard has the attribute of workability. It provides a guideline of certainty for the trier of fact. The trier then may compare the risk against the potential reward and give proper emphasis to the objective, rather than to the subjective. As has just been noted, an employee-shareholder, in making or guaranteeing a loan to his corporation, usually acts with two motivations, the one to protect his investment and the other to protect his employment. By making the dominant motivation the measure, the logical tax consequence ensues and prevents the mere presence of a business motive, however small and however insignificant, from controlling the tax result at the taxpayer's convenience. This is of particular importance in a tax system that is so largely dependent on voluntary compliance.

D. The dominant motivation test strengthens, and is consistent with, the mandate of § 262 of the Code, ... that “no deduction shall be allowed for personal, living, or family expenses” except as otherwise provided. It prevents personal considerations from circumventing this provision.

E. The dominant motivation approach to § 166(d) is consistent with that given the loss provisions in § 165(c)(1), *see*, for example, *Imbesi v. Commissioner*, 361 F.2d 640, 644 (CA3 1966), and in § 165(c)(2), *see Austin v. Commissioner*, 298 F.2d 583, 584 (CA2 1962). In these related areas, consistency is desirable. *See also Commissioner v. Duberstein*, 363 U. S. 278, 286 (1960).

F. ...



G. The Regulations' use of the word "proximate" perhaps is not the most fortunate, for it naturally tempts one to think in tort terms. The temptation, however, is best rejected, and we reject it here. In tort law, factors of duty, of foreseeability, of secondary cause, and of plural liability are under consideration, and the concept of proximate cause has been developed as an appropriate application and measure of these factors. It has little place in tax law, where plural aspects are not usual, where an item either is or is not a deduction, or either is or is not a business bad debt, and where certainty is desirable.

#### IV

The conclusion we have reached means that the District Court's instructions, based on a standard of significant, rather than dominant, motivation are erroneous, and that, at least, a new trial is required. We have examined the record, however, and find nothing that would support a jury verdict in this taxpayer's favor had the dominant motivation standard been embodied in the instructions. Judgment n.o.v. for the United States, therefore, must be ordered. *See Neely v. Eby Construction Co.*, 386 U. S. 317 (1967).

As Judge Simpson pointed out in his dissent, 427 F.2d at 284-285, the only real evidence offered by the taxpayer bearing upon motivation was his own testimony that he signed the indemnity agreement "to protect my job," that "I figured, in three years' time, I would get my money out," and that "I never once gave it [his investment in the corporation] a thought." [footnote omitted]

The statements obviously are self-serving. In addition, standing alone, they do not bear the light of analysis. What the taxpayer was purporting to say was that his \$12,000 annual salary was his sole motivation, and that his \$38,900 original investment, the actual value of which, prior to the misfortunes of 1962, we do not know, plus his loans to the corporation, plus his personal interest in the integrity of the corporation as a source of living for his son-in law and as an investment for his son and his other son-in law, were of no consequence whatever in his thinking. The comparison is strained all the more by the fact that the salary is pre-tax and the investment is tax-paid. With his total annual income about \$40,000, Mr. Generes may well have reached a federal income tax bracket of 40% or more for a joint return in 1958-1962. §§ 1 and 2 of the 1954 Code ... The \$12,000 salary thus would produce for him only about \$7,000 net after federal tax and before any state income tax. This is the figure, and not \$12,000, that has any possible significance for

motivation purposes, and it is less than 1/5 of the original stock investment.  
[footnote omitted]

We conclude on these facts that the taxpayer's explanation falls of its own weight, and that reasonable minds could not ascribe, on this record, a dominant motivation directed to the preservation of the taxpayer's salary as president of Kelly Generes Construction Co., Inc.

The judgment is reversed, and the case is remanded with direction that judgment be entered for the United States.

It is so ordered.

MR. JUSTICE POWELL and MR. JUSTICE REHNQUIST took no part in the consideration or decision of this case.

MR. JUSTICE MARSHALL, concurring (omitted).

MR. JUSTICE WHITE, with whom MR. JUSTICE BRENNAN joins.  
While I join Parts I, II, and III of the Court's opinion and its judgment of reversal, I would remand the case to the District Court with directions to hold a hearing on the issue of whether a jury question still exists as to whether taxpayer's motivation was "dominantly" a business one in the relevant transactions ...

MR. JUSTICE DOUGLAS, dissenting. [omitted.]

*Notes and Questions:*

1. What were the stakes in the outcome of the case? See §§ 1211(b) (\$1000 limit at the time the Court decided *Generes*), 1212(b).
2. What about Kelly? Should he be permitted to deduct any amounts that he paid to Maryland Casualty Co.? Would it make a difference if Kelly were an employee rather than an owner of the business? Who was the owner of Kelly Generes Construction, Inc.'s business?
3. Investing is *not* a trade or business. Rather it is comprised of transactions entered for profit, but not connected with a trade or business. Section 212 defines the

“below-the-line” deductions available to a taxpayer who incurs expenses in pursuit of profit outside of a trade or business

- An employee is engaged in the trade or business of being an employee.
- Section 67(g) suspends until 2026 “miscellaneous deductions” – which include investment expenses and the trade or business expenses of an employee.
- Section 62(a)(3) puts capital losses “above the line” and so not subject to § 67(g). *See* § 63(d)(1).

4. What information should be critical to the valuation of taxpayer’s stock? In a closely-held corporation in which shareholders, officers, employees, and creditors are usually the same people who wear different hats on different occasions – is it ever realistic to say that a bad debt is “one or the other in its entirety?”

#### **D. Expense or Capital: Repair vs. Improvement**

A recurring question is whether an expenditure is to repair an asset and so deductible or to improve an asset and so must be capitalized. Section 263(a) denies a deduction for “[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property” and for “[a]ny amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.” Sections 161 and 261 make § 162 subject to and subordinate to § 263. Reg. § 1.162-4(a) restates this prioritization; it provides in part that “[a] taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized.”

The line between deductibility of repair expenditures and capitalization of improvement expenditures has often been the subject of dispute between taxpayers and the government in the context of a taxpayer’s trade or business. We look at two old cases and note what were important factors in deciding that an expenditure was for a deductible repair or for a capital improvement. More recently, the IRS and Treasury have undertaken through regulations to articulate workable standards and procedures to assure more taxpayers predictable treatment. We will explore the high points of the portions of these regulations most relevant to this topic.

**Midland Empire Packing Co. v. Commissioner**, 14 T.C. 635 (1950).

....

ARUNDELL, Judge:

The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under § [162(a)] ... on the theory it was an expenditure for a repair ...

The respondent [Commissioner] has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes. Treasury Regulations 111, from which we quote in the margin,<sup>[110]</sup> is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In *Illinois Merchants Trust Co., Executor*, 4 B.T.A. 103, 106, we discussed this subject in some detail and in our opinion said:

It will be noted that the first sentence of the [regulation] ... relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind the purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property nor does it appreciably

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<sup>110</sup> § 29.23(a)-4. REPAIRS.— The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditures. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property, should be charged against the depreciation reserve if such account is kept. (See §§ 29.23(l)-1 to 29.23(l)-10, inclusive.) [The regulation that the court quoted became the substance of Reg. § 1.162-4 (*superseded* after 2011). As we shall see, Treasury and the IRS have substantially revised it.]

prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

... [F]or some 25 years prior to the taxable year [(1943)] petitioner [Midland Empire] had used the basement rooms of its plant [situated in Billings near the Yellowstone River] as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery [of the Yale Oil Corporation] had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oilproof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work, [\$4,868.81,] which it seeks to deduct as a repair. The basement was not enlarged by this work [and in fact petitioner's operating space contracted], nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

[Midland charged the \$4,868.81 to repair expense on its regular books and deducted that amount on its tax returns as an ordinary and necessary business expense for the fiscal year 1943. The Commissioner, in his notice of deficiency, determined that the cost of oilproofing was not deductible ... as an ordinary and necessary expense ... in 1943.]

While it is conceded on brief that the expenditure was ‘necessary,’ respondent contends that the encroachment of the oil nuisance on petitioner’s property was not an ‘ordinary’ expense in petitioner’s particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of ‘ordinary’ ... Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one’s property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

....

[The petitioner thereafter filed suit against Yale, on April 22, 1944, in a cause of action sounding in tort ... This action was to recover damages for the nuisance created by the oil seepage. ... Petitioner subsequently settled its cause of action against Yale for \$11,659.49 and gave Yale a complete release of all liability. This release was dated October 23, 1946.]

In our opinion, the expenditure of \$4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. ...

#### *Notes and Questions:*

1. The court said: “It is none too easy to determine on which side of the line certain expenditures fall so that they may be accorded their proper treatment for tax purposes.”

- What facts convinced the court to place the expenditure on the “repair” side of the line?

2. In the fifth-to-last paragraph of the case, the court stated conclusions taken almost verbatim from the regulation. Does this give you any idea of the type of evidence that taxpayer must have presented?

- Whether an expenditure added to the value of an asset or prolonged its useful life were critical considerations.

*War-time and shortly thereafter.* During WW I and WW II, tax rates were considerably higher than they were in peacetime. In what ways did this make timing an especially important matter?

3. The Yale Oil Corporation owned a nearby oil-refining plant and storage area and its discharges caused the problems that Midland Empire had to address. Yale Oil made a payment to Midland Empire to settle the nuisance suit brought against it. May Yale Oil deduct the amount it paid to settle the case, or should it capitalize that amount? *Cf. Mt. Morris Drive-In, infra*?

- What tax treatment should Midland accord the \$11,659.49 payment it received from Yale?

**Mt. Morris Drive-In Theatre Co. v. Commissioner**, 25 T.C. 272 (1955), *aff'd*, 238 F.2d 85 (6<sup>th</sup> Cir. 1956)

....

#### FINDINGS OF FACT.

....

In 1947 petitioner purchased 13 acres of farm land located on the outskirts of Flint, Michigan, upon which it proceeded to construct a drive-in or outdoor theatre. Prior to its purchase by the petitioner the land on which the theatre was built was farm land and contained vegetation. The slope of the land was such that the natural drainage of water was from the southerly line to the northerly boundary of the property and thence onto the adjacent land, owned by David and Mary D. Nickola, which was used both for farming and as a trailer park. The petitioner's land sloped sharply from south to north and also sloped from the east downward towards the west so that most of the drainage from the petitioner's property was onto the southwest corner of the Nickolas' land. The topography of the land purchased by

petitioner was well known to petitioner at the time it was purchased and developed. The petitioner did not change the general slope of its land in constructing the drive-in theatre, but it removed the covering vegetation from the land, slightly increased the grade, and built aisles or ramps which were covered with gravel and were somewhat raised so that the passengers in the automobiles would be able to view the picture on the large outdoor screen.

As a result of petitioner's construction on and use of this land rain water falling upon it drained with an increased flow into and upon the adjacent property of the Nickolas. This result should reasonably have been anticipated by petitioner at the time when the construction work was done.

The Nickolas complained to the petitioner at various times after petitioner began the construction of the theatre that the work resulted in an acceleration and concentration of the flow of water which drained from the petitioner's property onto the Nickolas' land causing damage to their crops and roadways. On or about October 11, 1948, the Nickolas filed a suit against the petitioner ... asking for an award for damages done to their property by the accelerated and concentrated drainage of the water and for a permanent injunction restraining the defendant from permitting such drainage to continue. ... [T]he suit was settled by an agreement dated June 27, 1950. This agreement provided for the construction by the petitioner of a drainage system to carry water from its northern boundary across the Nickolas' property and thence to a public drain. The cost of maintaining the system was to be shared by the petitioner and the Nickolas, and the latter granted the petitioner and its successors an easement across their land for the purpose of constructing and maintaining the drainage system. The construction of the drain was completed in October 1950 under the supervision of engineers employed by the petitioner and the Nickolas at a cost to the petitioner of \$8,224, which amount was paid by it in November 1950. The performance by the petitioner on its part of the agreement to construct the drainage system and to maintain the portion for which it was responsible constituted a full release of the Nickolas' claims against it. The petitioner chose to settle the dispute by constructing the drainage system because it did not wish to risk the possibility that continued litigation might result in a permanent injunction against its use of the drive-in theatre and because it wished to eliminate the cause of the friction between it and the adjacent landowners, who were in a position to seriously interfere with the petitioner's use of its property for outdoor theatre purposes. A settlement based on a monetary payment for past damages, the petitioner believed, would not remove the threat of claims for future damages.



... In its petition the petitioner asserted that the entire amount spent to construct the drainage system was fully deductible in 1950 as an ordinary and necessary business expense incurred in the settlement of a lawsuit, or, in the alternative, as a loss, and claimed a refund of part of the \$10,591.56 of income and excess profits tax paid by it for that year.

The drainage system was a permanent improvement to the petitioner's property, and the cost thereof constituted a capital expenditure.

....

KERN, Judge:

When petitioner purchased, in 1947, the land which it intended to use for a drive-in theatre, its president was thoroughly familiar with the topography of this land which was such that when the covering vegetation was removed and graveled ramps were constructed and used by its patrons, the flow of natural precipitation on the lands of abutting property owners would be materially accelerated. Some provision should have been made to solve this drainage problem in order to avoid annoyance and harassment to its neighbors. If petitioner had included in its original construction plans an expenditure for a proper drainage system no one could doubt that such an expenditure would have been capital in nature.

Within a year after petitioner had finished its inadequate construction of the drive-in theatre, the need of a proper drainage system was forcibly called to its attention by one of the neighboring property owners, and under the threat of a lawsuit filed approximately a year after the theatre was constructed, the drainage system was built by petitioner who now seeks to deduct its cost as an ordinary and necessary business expenses, or as a loss.

We agree with respondent that the cost to petitioner of acquiring and constructing a drainage system in connection with its drive-in theatre was a capital expenditure.

Here was no sudden catastrophic loss caused by a 'physical fault' undetected by the taxpayer in spite of due precautions taken by it at the time of its original construction work as in *American Bemberg Corporation*, 10 T.C. 361; no unforeseeable external factor as in *Midland Empire Packing Co.*, 14 T.C. 635; and no change in the cultivation of farm property caused by improvements in technique and made many years after the property in question was put to productive use as in

*J. H. Collingwood*, 20 T.C. 937. In the instant case it was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner's capital investment was incomplete. In addition, it should be emphasized that here there was no mere restoration or rearrangement of the original capital asset, but there was the acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system.

That this drainage system was acquired and constructed and that payments therefor were made in compromise of a lawsuit is not determinative of whether such payments were ordinary and necessary business expenses or capital expenditures. 'The decisive test is still the character of the transaction which gives rise to the payment.' *Hales-Mullaly v. Commissioner*, 131 F.2d 509, 511, 512.

In our opinion the character of the transaction in the instant case indicates that the transaction was a capital expenditure.

Reviewed by the Court.

Decision will be entered for the respondent.

RAUM, J., with whom FISHER, J., agrees, concurring: [omitted]

RICE, J. dissenting:

... [T]he expenditure which petitioner made was an ordinary and necessary business expense, which did not improve, better, extend, increase, or prolong the useful life of its property. The expenditure did not cure the original geological defect of the natural drainage onto the Nickolas' land, but only dealt with the intermediate consequence thereof. ... I cannot agree with the majority that the expenditure here was capital in nature.

OPPER, JOHNSON, BRUCE, and MULRONEY, JJ., agree with this dissent.

*Notes and Questions:*

1. Upon reading *Midland Empire* and *Mt. Morris Drive-In*, do you get the feeling that repair vs. improvement – at least in close cases – comes down to who can argue facts that fit within certain considerations better? Notice and consider:

- The magnitude of what was done to the properties in the two cases was probably comparable.
- Neither taxpayer could continue in business without making the expenditure.
- Is “foreseeability” really the distinction between these two cases? “Foreseeability” of course is a very malleable term.
- On the other hand, did the expenditures in the two cases increase the value of taxpayers’ properties for the use they made or their properties?

2. Does “quantitative” eventually becomes “qualitative?” Suppose taxpayer makes many discrete repairs; can they together add up to a renovation? Consider this excerpt from *United States v. Wehrli*, 400 F.2d 686 (10<sup>th</sup> Cir. 1968):

In the continuing quest for formularization, the courts have superimposed upon the criteria in the repair regulation an overriding precept that an expenditure made for an item which is part of a “general plan” of rehabilitation, modernization, and improvement of the property, must be capitalized, even though, standing alone, the item may appropriately be classified as one of repair. ... Whether the plan exists, and whether a particular item is part of it, are usually questions of fact to be determined by the fact finder based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done, e.g., whether the work was done to suit the needs of an incoming tenant, or to adapt the property to a different use, or, in any event, whether what was done resulted in an appreciable enhancement of the property’s value.

*Id.* at 689 (citations and footnotes omitted). Quantity does eventually become quality. Application of the general standards of *Wehrli* will certainly lead to disputes between taxpayers and the IRS. Generalized standards can inherently be unpredictable in application. The IRS and Treasury have worked to provide more predictability in this area through a revenue ruling and most recently rulemaking. As often happens, the difficulty that the IRS and Treasury faced in drafting regulations was to make them general enough to be applicable to a broad range of

situations and a great number of taxpayers, yet specific enough to provide meaningful guidance.

3. The excerpt from *Illinois Merchants Trust Co.* that the court in *Midland Empire* quoted referenced “replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use.” On the other hand, “[a] repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition.” *Id.* Consider some routine (?) maintenance procedures for an automobile. If the taxpayer uses the automobile in a trade or business, should taxpayer treat them as repairs or as expenditures to be capitalized?

- changing the oil every 6000 miles; this will certainly prolong the life of the automobile, for failure to do so will destroy the engine;
- replacing tires warranted for 20,000 miles with tires warranted for 60,000 miles;
- equipping the automobile with a trailer hitch so that taxpayer can attach a flatbed trailer and transport large items;
- replacing an engine block that cracked on a cold winter night because taxpayer had not flushed the radiator and filled it with antifreeze.

4. In Rev. Rul. 2001-4, the IRS reviewed the statements of several courts. The following is an excerpt:

Any properly performed repair, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to the repair. Consequently, courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), *acq.*, V-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In *Estate of Walling v. Commissioner*, 373 F.2d 192-93 (3<sup>rd</sup> Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to “put” or “keep” property in ordinary efficient

operating condition. In *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), *nonacq. on other grounds*, 1964-2 C.B. 8, the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property. ...

Even if the expenditures include the replacement of numerous parts of an asset, if the replacements are a relatively minor portion of the physical structure of the asset, or of any of its major parts, such that the asset as whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repairs or maintenance expenses. [citations omitted]. The same conclusion is true even if such minor portion of the asset is replaced with new and improved materials. [citation omitted].

If, however, a major component or a substantial structural part of the asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. [citations omitted].

In addition, although the high cost of work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. [citations omitted].

Similarly, the fact that a taxpayer is required by a regulatory authority to make certain repairs or to perform certain maintenance on an asset in order to continue operating the asset in its business does not mean that the work performed materially increases the value of such asset, substantially prolongs its useful life, or adapts it to a new use. [citations omitted].

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. *United States v. Wehrli*, 400 F.2d 686, 689 (10<sup>th</sup> Cir. 1968). Whether a general plan of rehabilitation

exists, and whether a particular repair or maintenance item is part of it, are questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. *Id.* at 690. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. [citations omitted].

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. [citations omitted].

On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. [citations omitted].

5. Consider again our servicing of an automobile.

- changing the oil “keeps” the automobile in operating condition – it does not “put” the automobile in an ordinarily efficient operating condition over its probable useful life for the uses for which it was acquired. It does not prolong the life of the automobile, materially increase its value, or make it adaptable to a different use. Deduct as repair.
- replacing worn out tires with better tires has not appreciably prolonged the life of the automobile or made it more useful. However, it may have increased the value of the automobile to more than it was, even when the 20,000-mile tires were new. Capitalize.
- equipping the automobile with a trailer hitch may have adapted the automobile to a different use than transporting passengers and made the automobile more useful. Capitalize.
- replacing the engine block is the replacement of a major component or a substantial structural part of the automobile that results in increasing the value, life expectancy, or use of an otherwise permanently and completely inoperable automobile. Capitalize.

These answers are obvious, right?

6. This revenue ruling did not put an end to disputes between the government and taxpayers. See *Fedex Corp. v. United States*, 291 F. Supp. 2d 699 (W.D. Tenn. 2003), *aff'd*, 412 F.3d 617 (6<sup>th</sup> Cir. 2005). In *Fedex*, the court determined that an entire aircraft rather than one of its engines on which work was performed was the appropriate “unit of property” to distinguish between a repair and an improvement. *Id.* at 712. The court considered four factors in making this determination:

First, ... whether the taxpayer and the industry treat the component part as part of the larger unit of property for regulatory, market, management, or accounting purposes. Second, ... whether the economic useful life of the component part is coextensive with the economic useful life of the larger unit of property. Third, ... whether the larger unit of property and smaller unit of property can function without each other. Finally, ... whether the component part can be and is maintained while affixed to the larger unit of property.

*Id.* at 710. The court also addressed the problem that all repairs prolong the useful life of an asset in the sense that but for certain repairs, the unit of property becomes inoperable. Rather than compare the condition of the property immediately before and immediately after the repair as the government had urged (*id.* at 714), the court compared the condition of the property immediately after the repair with its condition immediately after the last such repair. *Id.* at 716.<sup>111</sup> The court found that the airplane was not worth more than it was immediately after the last servicing of the engine.

7. In September 2013, the IRS and the Treasury Department announced final rules and regulations concerning taxpayer treatment of the costs of acquisition, production, or improvement of tangible property.<sup>112</sup> The focus of these regulations is now on a “unit of property” rather than adding to the value of property or prolonging its useful life. Capitalization determinations are now made with respect to an appropriate “unit of property” – as in *FedEx*.

•*Unit of property*: The regulations provide a definition of a “unit of property,” i.e., “all the components that are functionally interdependent comprise a single unit of property. Components of property are functionally

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<sup>111</sup> This was the test of *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 334 (1962), *nonacq.* on other grounds, 1964-2 C.B. 8.

<sup>112</sup> Guidance Regarding Deduction and Capitalization of Expenditures Related to Tangible Property, 78 Fed. Reg. 57686-01 (2013).

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.” Reg. 1.263-3(e)(3)(i). There are some exceptions.

- Focus on a “unit of property” often goes far to resolve questions of deductible repair versus capitalized improvement. The larger the “unit of property,” the more substantial may be the components on which work is merely a “repair.” See e.g., *Fedex Corp. v. United States*, 291 F. Supp. 2d 699, 712 (W.D. Tenn. 2003), *aff’d*, 412 F.3d 617 (6<sup>th</sup> Cir. 2005) (entire aircraft rather than engine was unit of property; cost of servicing engine deductible).

8. The regulations create so-called safe harbor exceptions to these rules of capitalization. Taxpayer conformance to the rules of these safe harbors assures them of a certain tax treatment. The regulations also provide that taxpayers may treat “routine maintenance” as a deductible expenditure. In many instances, taxpayers may follow their own accounting practices.

9. *Per se Rules*: The regulations create some per se rules that will require capitalization of certain expenditures:

- New buildings or permanent improvements or betterments to increase value*: Reg. § 1.263(a)-1(a) denies deductions for amounts paid for new buildings or for permanent improvements or betterments to increase the value of any property or estate. It also denies deductions for amounts paid to restore property or to make good the exhaustion of property for which an allowance has been made.

- Buildings as units of property*: Each building and each structural component is a separate single unit of property. Reg. § 1.263(a)-3(e)(2)(i). The structural components of a building include HVAC systems, plumbing systems, electrical systems, all escalators, all elevators, fire-protection and alarm systems, security systems, gas distribution systems, and other components identified in published guidance in the Federal Register or the Internal Revenue Bulletin. Reg. § 1.263(a)-3(e)(2)(B).

- Acquired or produced tangible property*: Reg. § 1.263(a)-2(d)(1) provides in part: “Acquired or produced tangible property – (1) Requirement to capitalize. Except [for maintenance and supplies and for the de minimis safe harbor,] a taxpayer must capitalize amounts paid to acquire or produce a unit of real or personal property ... including leasehold improvements, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. ...



•**Improvements.** Reg. § 1.263(a)-3(d) provides in part: “Requirement to capitalize amounts paid for improvements. Except [for “small taxpayers,” reliance on taxpayer’s own accounting treatment of expenditures, and de minimis expenditures,] ... a taxpayer generally must capitalize the related amounts ... paid to improve a unit of property owned by the taxpayer. ... For purposes of this section, a unit of property is improved if the amounts paid for activities performed after the property is placed in service by the taxpayer –

- (1) Are for 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 ...”

•**Betterments:** Taxpayer must capitalize a “betterment to a unit of property.” Reg. § 1.263(a)-3(j)(1). A “betterment” –

- “(i) Ameliorates a material condition or defect that either existed prior to the taxpayer’s acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production;
- (ii) Is for a material addition, including a physical enlargement, expansion, extension, or addition of a major component ... to the unit of property or a material increase in the capacity, including additional cubic or linear space, of the unit of property; or
- (iii) Is reasonably expected to materially increase the productivity, efficiency, strength, quality, or output of the unit of property.”

Reg. § 1.263(a)-3(j)(1).

- Would the improvement in *Mr. Morris Drive-In* be a betterment?

•**Restoration:** Taxpayer must capitalize amounts paid to restore property. Reg. § 1.263(a)-3(k)(1). A “restoration” –

- “(i) Is for the replacement of a component of a unit of property for which the taxpayer has properly deducted a loss for that component, other than a casualty loss ...;
- (ii) Is for the replacement of a component of a unit of property for which the taxpayer has properly taken into account the adjusted basis of the component in realizing gain or loss resulting from the sale or exchange of the component;
- (iii) Is for the restoration of damage to a unit of property for which the taxpayer is required to take a basis adjustment as a result of a casualty loss ... or relating to a casualty event ...;

- (iv) Returns the unit 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;
- (v) Results in the rebuilding of the unit of property to a like-new condition after the end of its class life ...; or
- (vi) Is for the replacement of a part or a combination of parts that comprise a major component or a substantial structural part of a unit of property ...”

Reg. § 1.263(a)-3(k)(1). Whether “a part or a combination of parts ... comprise a major component or a substantial structural part of a unit of property” depends on all of the facts and circumstances, including “the quantitative and qualitative significance of the part or combination of parts in relation to the unit of property.” Reg. § 1.263(a)-3(k)(6)(i). Application of this regulation will require distinguishing between parts that are “a major component or a substantial structural part of a unit of property” and those that are not.

•*Adaptation*: Taxpayer must capitalize amounts paid to adapt a unit of property to a new use. Reg. § 1.263(a)-3(l)(1). An “adaptation” adapts “a unit of 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.” Reg. § 1.263(a)-3(l)(1). In the case of a building, the adaptation adapts the building to a “new or different use.” Reg. § 1.263(a)-3(l)(2).

10. *Safe Harbors*: The capitalization rules create several safe harbors:

•*De minimis Expenditures*: Reg. § 1.263(a)-1(f)(1)(i) provides an elective de minimis safe harbor under which taxpayers with “applicable financial statements” may deduct expenditures of up to \$5000 per invoice that it treats as an expense on its “applicable financial statement” and in accord with its written accounting procedures. There is no limit to the number of times taxpayer may rely on this safe harbor during a tax year.

•An “applicable financial statement” is – in order of preference – (1) a financial statement that taxpayer must file with the SEC, (2) a certified audited financial statement that taxpayer uses for credit purposes, reports to shareholders or the like, or for any other substantial non-tax purpose, and (3) a financial statement that taxpayer must provide to a federal or state government agency other than the SEC or the IRS. Reg. § 1.263-1(f)(4).

- Taxpayers without an applicable financial statement, but who maintain throughout the year accounting procedures that treat an item as an expense for non-tax purposes, may expense up to \$500 per invoice. Reg. § 1.263(a)-1(f)(1)(ii).

The importance of this safe harbor is that it eases the accounting burdens of taxpayers – both by not requiring capitalization of de minimis amounts and by allowing taxpayer to use the same accounting information that it uses for certain parties other than the IRS.

- “*Small Taxpayers*”: A “small taxpayer” – one whose average gross receipts for the three preceding taxable years does not exceed \$10M – may elect not to apply the improvements provision to building property “if the total amount paid during the taxable year for repairs, maintenance, improvements, and similar activities performed on the ... building property does not exceed the lesser of” 2% of the unadjusted basis [of \$1M or less] of the building property or \$10,000. Reg. § 1.263(a)-3(h)(1, 3, and 4).

- “*Routine Maintenance*”: “Routine maintenance” does not improve property. Reg. § 1.263(a)-3(i)(1). “Routine maintenance” is recurring activities that a taxpayer expects to perform in order to keep the building or each building system in “ordinarily efficient operating condition.” In order to be “routine” in the case of a building, taxpayer must expect to perform the activities more than once during the 10-year period following placement in service. In order to be “routine” in the case of other property, taxpayer must expect at the time of placement into service to perform the activities more than once during the class life of the property. Reg. § 1.263(a)-3(i)(i, ii).

- “*Elections to Capitalize*”: A taxpayer may elect to capitalize all repair and maintenance costs as improvements consistent with the manner in which it keeps its own books and records. § 1.263(a)-3(n)(1). This permits taxpayers who conservatively capitalized all repair and maintenance costs to elect not to undertake the burden of changing their practices.

11. Reg. § 1.162-4(a) permits expensing of residual amounts as “repairs and maintenance.” Additionally, Reg. § 1.162-3 establishes rules for the timing and deductibility of incidental and non-incidental “materials and supplies.” “Materials and supplies” are tangible property that taxpayer uses or consumes in its operations that is not inventory that

- is a component that taxpayer acquires to maintain, repair, or improve a unit of tangible property and that is not acquired as a part of any single unit of tangible property,
- is fuel, lubricants, water, and the like – that taxpayer reasonably expects to consume in 12 months or less, beginning when taxpayer uses the items in its operations,
- is a unit of property with an “economic useful life” (i.e., the period over which taxpayer may reasonably expect the property to be useful and relying on taxpayer’s assessment in its “applicable financial statement” if it has one, Reg. § 1.162-3(c)(4)), of 12 months or less, beginning when the taxpayer uses or consumes the item in its operations,
- is a unit of property whose acquisition cost or production cost is \$200 or less, *or*
- is identified in the Federal Register or the Internal Revenue Bulletin as “materials and supplies.”

Reg. § 1.162-3(c)(1).

“Incidental materials and supplies” are those that taxpayer keeps on hand and of which taxpayer keeps no record of consumption or takes no physical inventory at the beginning and end of the taxable year. Taxpayer may deduct the costs of “incidental materials and supplies” in the year in which it pays for them, provided that its income is clearly reflected. Reg. § 1.162-3(a)(2). “Non-incidental materials and supplies” are, presumably, all other materials and supplies. Taxpayer may deduct their costs when it first uses or consumes them in its operations. Reg. § 1.162-3(a)(1).

“Materials and supplies” are neither a capital asset under § 1221 nor “property used in the trade or business” under § 1231. Reg. § 1.162-3(g). There is no provision to capitalize “materials and supplies” except for rotatable spare parts, temporary spare parts, and standby emergency spare parts. Taxpayer must deduct expenditures for other “materials and supplies” at the appropriate time.

## 12. Examples and hypotheticals:

12a. J provides legal services to its clients. J purchases a laptop computer and a printer for its employees to use in providing legal services. Are the computer and printer a single unit of property or separate units of property? *See* Reg. § 1.263(a)-3(e)(6), Example 9.

12b. H owns locomotives that it uses in its railroad business. Each locomotive consists of various components, such as an engine, generators, batteries, and trucks. H acquired a locomotive with all its components. Is the locomotive a single unit of property? *See* Reg. § 1.263(a)-3(e)(6), Example 8.

12c. In Year 1, A purchases 10 printers at \$250 each for a total cost of \$2500 as indicated by the invoice. Assume that each printer is a unit of property. A does not have an AFS. A has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property that costs less than \$500, and A treats the amounts paid for the printers as an expense on its books and records. May A deduct the cost of the printers? *See* Reg. § 1.263(a)-1(f)(7), Example 1.

- Same facts, except that the printers cost \$600 each. A has accounting procedures in place at the beginning of Year 1 to expense amounts paid for property costing less than \$1000, and A treats the amounts paid for the printers as an expense on its books and records. May A deduct the cost of the printers? *See* Reg. § 1.263(a)-1(f)(7), Example 2.

12d. A purchases new cash registers for use in its retail store located in leased space in a shopping mall that cost \$6000 each. Assume each cash register is a unit of property and is not a material or supply. May A deduct the cost of the cash registers? *See* Reg. § 1.263(a)-2(d)(2), Example 1.

12e. E is a towboat operator that owns and leases a fleet of towboats. Each towboat is equipped with two diesel-powered engines. Each towboat, including its engines, is the unit of property and has a class life of 18 years. At the time that E places its towboats into service, E is aware that approximately every three to four years E will need to perform scheduled maintenance on the two towboat engines to keep the engines in their ordinarily efficient operating condition. This maintenance is completed while the engines are attached to the towboat and involves the cleaning and inspecting of the engines to determine which parts are within acceptable operating tolerances and can continue to be used, which parts must be reconditioned to be brought back to acceptable tolerances, and which parts must be replaced. Engine parts replaced during these procedures are replaced with comparable and commercially available replacement parts. The towboat engines are not rotatable spare parts. In Year 1, E acquired a new towboat, including its two engines, and placed the towboat into service. In Year 5, E pays amounts to perform scheduled maintenance on both engines in the towboat. Should E be permitted to deduct these expenses as routine maintenance? *See* Reg. § 1.263(a)-3(i)(6), Example 9.

12f. Consider the following: In Year 1, X purchased a store located on a parcel of land that contained underground gasoline storage tanks left by prior occupants. The parcel of land is the unit of property. The tanks had leaked, causing soil contamination. X was not aware of the contamination at the time of purchase. In Year 2, X discovered the contamination and incurred costs to remediate the soil. May X deduct the expenses of soil remediation, or must X capitalize the expenditure? *See* Reg. 1.263(a)-3(j)(3), Example 1.

12g. X owns an office building that was constructed with insulation that contained asbestos. The health dangers of asbestos were not widely known when the building was constructed. Several years after X places the building into service, X determined that certain areas of asbestos-containing insulation had begun to deteriorate and could eventually pose a health risk to employees. Therefore, X decided to remove the asbestos-containing insulation from the building and replace it with new insulation that was safer to employees, but no more efficient or effective than the asbestos insulation. May X deduct the expenses of removal of the asbestos and replacement with safer insulation, or must X capitalize the expenditure? *See* Reg. 1.263(a)-3(j)(3), Example 2.

12h. X acquires a building for use in its business of providing assisted living services. Before and after the purchase, the building functioned as an assisted living facility. However, at the time of the purchase, X was aware that the building was in a condition below the standards that it requires for facilities used in its business. Immediately after the acquisition and during the following two years, while X continued to use the building as an assisted living facility, X incurred costs for extensive repairs and maintenance, and the acquisition of new property to bring the facility into the high-quality condition for which X's facilities are known. The work included repairing damaged drywall; repainting and re-wallpapering; replacing flooring materials, windows, and tiling and fixtures in bathrooms; replacing window treatments, furniture, and cabinets; and repairing or replacing roofing materials, heating and cooling systems. May X deduct the expenses of bringing the facility into high-quality condition, or must X capitalize the expenditure? *See* Reg. 1.263(a)-3(j)(3), Example 5 (i and ii).

12i. D owns a parcel of land on which it previously operated a manufacturing facility. Assume that the land is the unit of property. During the course of D's operation of the manufacturing facility, the land became contaminated with wastes from its manufacturing processes. D discontinues manufacturing operations at the

site and decides to develop the property for residential housing. In anticipation of building residential property, D pays an amount to remediate the contamination caused by D's manufacturing process. In addition, D pays an amount to regrade the land so that it can be used for residential purposes. May D deduct the amounts it paid to clean up the waste? What about the amounts it paid to regrade the land? *See* Reg. § 1.263(a)-3(l)(3), Example 4.

## II. Deductibility Under §§ 162 or 212

After determining that an expense is *not* a capital expenditure, § 162 (and § 212), coupled with § 274 define and delimit the precise scope of expenses of generating income that taxpayer may deduct. Read § 162(a). How many *specific* types of trade or business expenses does it name? We consider several § 162 issues.

- Read § 262. What are the consequences of a court concluding that an expenditure is for a personal expense?

### A. Travel Expenses

Read § 162(a)(2).

**Commissioner v. Flowers**, 326 U.S. 465 (1946)

MR. JUSTICE MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of § [162(a)(2)] of the Internal Revenue Code, [footnote omitted] allowing a deduction for income tax purposes of “traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business.”

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There, he has paid taxes, voted, schooled his children, and established social and religious connections. He built a house in Jackson nearly thirty years ago, and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.



In 1906, the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927, he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927, and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter, he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice-president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of general solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally, and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of time he would spend in each of the two cities, and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile, but not in Jackson. When he worked in Jackson, his law firm provided him with office space, although he no longer participated in the firm's business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary's expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer's participation was advisory only, and was no different from his participation in the railroad's legal business in other areas.

The taxpayer's principal post of business was at the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson, and the taxpayer participated in that litigation.



During 1939, he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940, he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted \$900 in his 1939 income tax return and \$1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile.<sup>113</sup> The Commissioner disallowed the deductions, which action was sustained by the Tax Court. But the Fifth Circuit Court of Appeals reversed the Tax Court's judgment, and we granted certiorari because of a conflict between the decision below and that reached by the Fourth Circuit Court of Appeals in *Barnhill v. Commissioner*, 148 F.2d 913.

The portion of § [162(a)(2)] authorizing the deduction of "traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business" is one of the specific examples given by Congress in that section of "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." It is to be contrasted with the provision of § [262(a)] of the Internal Revenue Code, disallowing any deductions for "personal, living, or family expenses." ... In pertinent part, [the applicable regulation] states that "Traveling expenses, as ordinarily understood, include railroad fares and meals and lodging. If the trip is undertaken for other than business purposes, the railroad fares are personal expenses, and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including railroad fares, meals, and lodging, are business expenses. ... Only such expenses as are reasonable and necessary in the conduct of the business and directly attributable to it may be deducted. ... Commuters' fares are not considered as business expenses, and are not deductible."

Three conditions must thus be satisfied before a traveling expense deduction may be made under § [162(a)(2)]:

(1) The expense must be a reasonable and necessary traveling expense, as that term

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<sup>113</sup> No claim for deduction was made by the taxpayer for the amounts spent in traveling from Mobile to Jackson. ...

is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.

(2) The expense must be incurred “while away from home.”

(3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

Whether particular expenditures fulfill these three conditions so as to entitle a taxpayer to a deduction is purely a question of fact in most instances. See *Commissioner v. Heininger*, 320 U. S. 467, 475. And the Tax Court’s inferences and conclusions on such a factual matter, under established principles, should not be disturbed by an appellate court. *Commissioner v. Scottish American Co.*, 323 U.S. 119; *Dobson v. Commissioner*, 320 U. S. 489.

In this instance, the Tax Court, without detailed elaboration, concluded that “The situation presented in this proceeding is, in principle, no different from that in which a taxpayer’s place of employment is in one city and, for reasons satisfactory to himself, he resides in another.” It accordingly disallowed the deductions on the ground that they represent living and personal expenses, rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court’s findings of fact, but reversed its judgment on the basis that it had improperly construed the word “home” as used in the second condition precedent to a traveling expense deduction under § [162(a)(2)] The Tax Court, it was said, erroneously construed the word to mean the post, station, or place of business where the taxpayer was employed – in this instance, Mobile – and thus erred in concluding that the expenditures in issue were not incurred “while away from home.” The Court below felt that the word was to be given no such “unusual” or “extraordinary” meaning in this statute, that it simply meant “that place where one in fact resides” or “the principal place of abode of one who has the intention to live there permanently.” Since the taxpayer here admittedly had his home, as thus defined, in Jackson, and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word “home” in § [162(a)(2)] with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. 4 MERTENS, LAW OF FEDERAL INCOME TAXATION (1942) § 25.82. The

Tax Court [footnote omitted] and the administrative rulings<sup>114</sup> have consistently defined it as the equivalent of the taxpayer's place of business. *See Barnhill v. Commissioner, supra*. On the other hand, the decision below and *Wallace v. Commissioner*, 144 F.2d 407, have flatly rejected that view, and have confined the term to the taxpayer's actual residence. [citation omitted].

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court's opinion, as we read it, was grounded neither solely nor primarily upon that agency's conception of the word "home." Its discussion was directed mainly toward the relation of the expenditures to the railroad's business, a relationship required by the third condition of the deduction. Thus, even if the Tax Court's definition of the word "home" was implicit in its decision, and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad's business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. ...

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer's employer, the railroad. Jackson was his regular home. Had his post of duty been in that city, the cost of maintaining his home there and of commuting or driving to work concededly would be nondeductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer's post of duty was in Mobile, thereby increasing the costs of transportation, food, and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad's business as were his personal and living costs in

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<sup>114</sup> [The pertinent regulation] does not attempt to define the word "home," although the Commissioner argues that the statement therein contained to the effect that commuters' fares are not business expenses, and are not deductible "necessarily rests on the premise that home, for tax purposes, is at the locality of the taxpayer's business headquarters." Other administrative rulings have been more explicit in treating the statutory home as the abode at the taxpayer's regular post of duty. *See, e.g.*, O.D. 1021, 5 Cum. Bull. 174 (1921); I.T. 1264, I-1 Cum. Bull. 122 (1922); I.T. 3314, 1939-2 Cum. Bull. 152; G.C.M. 23672, 1943 Cum. Bull. 66.

Jackson. They were incurred solely as the result of the taxpayer's desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad's legal business. The railroad did not require him to travel on business from Jackson to Mobile, or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer's work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of § [162(a)(2)] could arise only when the railroad's business forced the taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler's business headquarters. The exigencies of business, rather than the personal conveniences and necessities of the traveler, must be the motivating factors. Such was not the case here.

It follows that the court below erred in reversing the judgment of the Tax Court.

Reversed.

MR. JUSTICE JACKSON took no part in the consideration or decision of this case.

MR. JUSTICE RUTLEDGE, dissenting.

I think the judgment of the Court of Appeals should be affirmed. When Congress used the word "home" in § [162] of the Code, I do not believe it meant "business headquarters." And, in my opinion, this case presents no other question.

....

Congress gave the deduction for traveling away from home on business. The commuter's case, rightly confined, does not fall in this class. One who lives in an adjacent suburb or City and by usual modes of commutation can work within a

distance permitting the daily journey and return, with time for the day's work and a period at home, clearly can be excluded from the deduction on the basis of the section's terms equally with its obvious purpose. ... If the line may be extended somewhat to cover doubtful cases, it need not be lengthened to infinity or to cover cases as far removed from the prevailing connotation of commuter as this one. Including it pushes "commuting" too far, even for these times of rapid transit.<sup>115</sup>

Administrative construction should have some bounds. It exceeds what are legitimate when it reconstructs the statute to nullify or contradict the plain meaning of nontechnical terms not artfully employed. ...

By construing "home" as "business headquarters;" by reading "temporarily" as "very temporarily" into § [162]; by bringing down "ordinary and necessary" from its first sentence into its second;<sup>116</sup> by finding "inequity" where Congress has said none exists; by construing "commuter" to cover long distance, irregular travel, and by conjuring from the "statutory setting" a meaning at odds with the plain wording of the clause, the Government makes over understandable ordinary English into highly technical tax jargon. ...

### *Notes and Questions:*

1. Reg. § 1.162-2 is now the regulation covering "traveling expenses." Its provisions have not materially changed from those that the Court quoted in *Flowers*.

2. Can commuting expenses *ever* meet the third requirement of deductibility, i.e.,

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<sup>115</sup> Conceivably men soon may live in Florida or California and fly daily to work in New York and back. Possibly they will be regarded as commuters when that day comes. But, if so, that is not this case and, in any event, neither situation was comprehended by Congress when § [162] was enacted.

<sup>116</sup> The language is:

"All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business. . . ."

§ [162(a)], Internal Revenue Code.

“a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer?”

*Flowers* and the cases that follow rest on an assumption that taxpayers work in one place and reside in another. This conception of commuting and work was evolving before the pandemic. The pandemic eroded (if not obliterated) this binary conception of work and residence further. A question for the years ahead is how tax law should adapt to these changes.

3. Does Justice Rutledge have a point? After all, the Court later construed the word “gift” in its ordinary sense in *Duberstein*.

4. Upon application of the Court’s standards, why will taxpayer’s home usually be the “post, station, or place of business where the taxpayer [is] employed?”

5. Robert Rosenspan was a jewelry salesman who worked on a commission basis and paid his own traveling expenses without reimbursement. In 1964, two New York City jewelry manufacturers employed him. For 300 days during the year he traveled by automobile through an extensive sales territory in the Midwest. He stayed at motels and ate at restaurants. Five times per year he returned to New York and spent several days at his employers’ offices. There he performed a variety of services essential to his work, i.e., cleaned his sample case, checked orders, discussed customers’ credit problems, recommended changes in stock, attended annual staff meetings, and the like. He used his brother’s Brooklyn home as a personal residential address. He kept some clothing and other belongings there. He voted and filed his income tax returns from that address. On his trips to New York City, “out of a desire not to abuse his welcome at his brother’s home, he stayed more often” at an inn near the John F. Kennedy Airport.

***Reimbursement of Non-deductible Expenditures:*** Taxpayer paid his expenses and tried to deduct them. What result if taxpayer’s employer had paid for taxpayer’s train tickets, hotels, and meals while in Mobile? Would (should) that have solved taxpayer’s problems – or made them worse? See discussion of *Brandl v. Commissioner*, *infra*.

•What tax issue(s) do these facts raise? How should they be resolved?

•See *Rosenspan v. United States*, 438 F.2d 905 (2d Cir.), *cert. denied*, 404 U.S. 864 (1971).

5a. Folkman, an airline pilot, was stationed in San Francisco International Airport as an employee of Pan American World Airways. He flew infrequently as a pilot

with Pan American because of his low seniority. His principal work was that of navigator. To maintain his proficiency as a jet pilot, and to earn extra income, Folkman enlisted in a military reserve program, which required that he live in Reno, Nevada, about 250 miles from San Francisco. Folkman and his family moved from their home near the San Francisco airport, to Reno. Folkman divided his time between flying with Pan American from his San Francisco base and flying for the Nevada Air National Guard. During an average month Folkman spent 10 to 13 days performing services for Pan American and four to seven days fulfilling his military reserve flying obligations. Whether he was scheduled to fly for the National Guard on a given day, Folkman routinely returned to Reno immediately after his Pan American flights. Folkman spent more time in Reno than in San Francisco, but derived approximately 85% of his earnings from his Pan American employment.

***Reimbursement or Other Expense Allowance Arrangement:*** An employee may not deduct his trade or business expenses until 2026. § 67(g). In 2026, the employee may only claim that deduction if he itemizes deductions. Deductions of an employee's trade or business expenses are subject to the 2% floor for "miscellaneous deductions." See § 67(a). An employee must include any employer reimbursement in his gross income and pay income tax on most or all of it.

However, § 62(a)(2)(A) permits taxpayer to reduce his AGI by trade or business expenditures (i.e., deduct "above-the-line") if his employer (or the employer's agent or a third party) has a "reimbursement or other expense allowance arrangement." See also Reg. § 1.62-2. The net effect of such employer reimbursement of employee trade or business expenses is a wash. The arrangement must require substantiation of deductible expenditures so that such arrangements do not become a means by which employees can receive compensation without paying income tax on it.

How is a "reimbursement or other expense allowance arrangement" advantageous to both employer and employee?

- What tax issue(s) do these facts raise? How do you think they should be resolved and why?
- See *Folkman v. United States*, 615 F.2d 493 (9<sup>th</sup> Cir. 1980).



5b. Taxpayer Brandl was employed by Strong Electric Co. as a traveling technical representative. His duties were to visit, assist, and sell to Strong dealers throughout the United States. Taxpayer travelled a great deal. Strong's headquarters are in Toledo, Ohio. Taxpayer neither owned nor rented an apartment or house in Toledo. When Taxpayer was in Toledo he either stayed at a motel or with his brother and sister-in-law. When Taxpayer stayed with his brother he paid no rent but did help pay for groceries and household items, and worked around the house doing maintenance and remodeling. He usually was away from Toledo visiting customers from four to six weeks at a time, but on occasion he was away for up to three months. When Taxpayer traveled he stayed in hotels. When Taxpayer was at Strong headquarters in Toledo he took care of paper work, wrote letters to customers he had visited, and helped with general office work. During the tax year, Taxpayer spent a total of three months in Toledo. Taxpayer received personal mail at his brother's home in Toledo, and he had an Ohio driver's license. For the tax year in question, Strong paid Taxpayer \$8,288.68 for his travel expenses. Taxpayer did not include that amount in income. Taxpayer did not claim a deduction for traveling expenses while away from home.

- Must Taxpayer Brandl include the \$8288.68 in his taxable income?
- If so, may he deduct that amount as a "travel expense" under § 162(a)(2)?
- See *Brandl v. Commissioner*, T.C. Memo 1974-160 (1974).

**Hantzis v. Commissioner**, 638 F.2d 248 (1<sup>st</sup> Cir.), *cert. denied*, 452 U.S. 962 (1981)

LEVIN H. CAMPBELL, Circuit Judge.

The Commissioner of Internal Revenue (Commissioner) appeals a decision of the United States Tax Court that allowed a deduction under § 162(a)(2) ,, for expenses incurred by a law student in the course of her summer employment. ...

In the fall of 1973 Catharine Hantzis (taxpayer), formerly a candidate for an advanced degree in philosophy at the University of California at Berkeley, entered Harvard Law School in Cambridge, Massachusetts, as a full-time student. During her second year of law school she sought unsuccessfully to obtain employment for the summer of 1975 with a Boston law firm. She did, however, find a job as a legal assistant with a law firm in New York City, where she worked for ten weeks beginning in June 1975. Her husband, then a member of the faculty of Northeastern



University with a teaching schedule for that summer, remained in Boston and lived at the couple's home there. At the time of the Tax Court's decision in this case, Mr. and Mrs. Hantzis still resided in Boston.

On their joint income tax return for 1975, Mr. and Mrs. Hantzis reported the earnings from taxpayer's summer employment (\$3,750) and deducted the cost of transportation between Boston and New York, the cost of a small apartment rented by Mrs. Hantzis in New York and the cost of her meals in New York (\$3,204). The deductions were taken under § 162(a)(2) ...

... [The case turns on whether Mrs. Hantzis incurred expenses while away from home so that her expenses are deductible under § 162(a)(2).]

We think the critical step in defining "home" in these situations is to recognize that the "while away from home" requirement has to be construed in light of the further requirement that the expense be the result of business exigencies. The traveling expense deduction obviously is not intended to exclude from taxation every expense incurred by a taxpayer who, in the course of business, maintains two homes. Section 162(a)(2) seeks rather "to mitigate the burden of the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses." [citations omitted]. Consciously or unconsciously, courts have effectuated this policy in part through their interpretation of the term "home" in § 162(a)(2). Whether it is held in a particular decision that a taxpayer's home is his residence or his principal place of business, the ultimate allowance or disallowance of a deduction is a function of the court's assessment of the reason for a taxpayer's maintenance of two homes. If the reason is perceived to be personal, the taxpayer's home will generally be held to be his place of employment rather than his residence and the deduction will be denied. [citations omitted]. If the reason is felt to be business exigencies, the person's home will usually be held to be his residence and the deduction will be allowed. *See, e.g., Frederick v. United States*, 603 F.2d 1292 (8th Cir. 1979); [citations omitted]. We understand the concern of the concurrence that such an operational interpretation of the term "home" is somewhat technical and perhaps untidy, in that it will not always afford bright line answers, but we doubt the ability of either the Commissioner or the courts to invent an unyielding formula that will make sense in all cases. The line between personal and business expenses winds through infinite factual permutations; effectuation of the travel expense provision requires that any principle of decision be flexible and sensitive to statutory policy.

Construing in the manner just described the requirement that an expense be incurred “while away from home,” we do not believe this requirement was satisfied in this case. Mrs. Hantzis’ trade or business did not require that she maintain a home in Boston as well as one in New York. Though she returned to Boston at various times during the period of her employment in New York, her visits were all for personal reasons. It is not contended that she had a business connection in Boston that necessitated her keeping a home there; no professional interest was served by maintenance of the Boston home as would have been the case, for example, if Mrs. Hantzis had been a lawyer based in Boston with a New York client whom she was temporarily serving. The home in Boston was kept up for reasons involving Mr. Hantzis, but those reasons cannot substitute for a showing by Mrs. Hantzis that the exigencies of her trade or business required her to maintain two homes.<sup>117</sup> Mrs. Hantzis’ decision to keep two homes must be seen as a choice dictated by personal, albeit wholly reasonable, considerations and not a business or occupational necessity. We therefore hold that her home for purposes of § 162(a)(2) was New York and that the expenses at issue in this case were not incurred “while away from home.”<sup>118</sup>

... We hold merely that for a taxpayer in Mrs. Hantzis’ circumstances to be “away from home in the pursuit of a trade or business,” she must establish the existence of some sort of business relation both to the location she claims as “home” and to the location of her temporary employment sufficient to support a finding that her duplicative expenses are necessitated by business exigencies. This, we believe, is

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<sup>117</sup> In this respect, Mr. and Mrs. Hantzis’ situation is analogous to cases involving spouses with careers in different locations. Each must independently satisfy the requirement that deductions taken for travel expenses incurred in the pursuit of a trade or business arise while he or she is away from home. *See Chwalow v. Commissioner*, 470 F.2d 475, 477-78 (3d Cir. 1972) (“Where additional expenses are incurred because, for personal reasons, husband and wife maintain separate domiciles, no deduction is allowed.”); *Hammond v. Commissioner*, 213 F.2d 43, 44 (5th Cir. 1954); *Foote v. Commissioner*, 67 T.C. 1 (1976); *Coerver v. Commissioner*, 36 T.C. 252 (1961). This is true even though the spouses file a joint return. *Chwalow, supra*, 470 F.2d at 478.

<sup>118</sup> The concurrence reaches the same result on essentially the same reasoning, but under what we take to be an interpretation of the “in pursuit of business” requirement. We differ from our colleague, it would seem, only on the question of which precondition to deductibility best accommodates the statutory concern for “the taxpayer who, because of the exigencies of his trade or business, must maintain two places of abode and thereby incur additional and duplicate living expenses.” *See supra*. Neither the phrase “away from home” nor “in pursuit of business” effectuates this concern without interpretation that to some degree removes it from “the ordinary meaning of the term.” (Keeton, J., concurring). However, of the two approaches, we find that of the concurrence more problematic than that adopted here.

the meaning of the statement in *Flowers* that “[b]usiness trips are to be identified *in relation to* business demands and the traveler’s business headquarters.” 326 U.S. at 474 (emphasis added). On the uncontested facts before us, Mrs. Hantzis had no business relation to Boston; we therefore leave to cases in which the issue is squarely presented the task of elaborating what relation to a place is required under § 162(a)(2) for duplicative living expenses to be deductible.

Reversed.

KEETON, District Judge, concurring in the result.

....

... I read the [majority] opinion as indicating that in a dual residence case, the Commissioner must determine whether the exigencies of the taxpayer’s trade or business require her to maintain both residences. If so, the Commissioner must decide that the taxpayer’s principal residence is her “home” and must conclude that expenses associated with the secondary residence were incurred “while away from home,” and are deductible. If not, as in the instant case, the Commissioner must find that the taxpayer’s principal place of business is her “home” and must conclude that the expenses in question were not incurred “while away from home.” The conclusory nature of these determinations as to which residence is her “home” reveals the potentially confusing effect of adopting an extraordinary definition of “home.”

A word used in a statute can mean, among the cognoscenti, whatever authoritative sources define it to mean. Nevertheless, it is a distinct disadvantage of a body of law that it can be understood only by those who are expert in its terminology. Moreover, needless risks of misunderstanding and confusion arise, not only among members of the public but also among professionals who must interpret and apply a statute in their day-to-day work, when a word is given an extraordinary meaning that is contrary to its everyday usage.

The result reached by the court can easily be expressed while also giving “home” its ordinary meaning, and neither Congress nor the Supreme Court has directed that “home” be given an extraordinary meaning in the present context. *See Flowers, supra, Stidger, supra, and Peurifoy, supra.* In *Rosenspan v. United States, supra*, Judge Friendly, writing for the court, rejected the Commissioner’s proposed definition of home as the taxpayer’s business headquarters, concluding that in

§ 162(a)(2) “‘home’ means ‘home.’” *Id.* at 912.

When Congress uses a non-technical word in a tax statute, presumably it wants administrators and courts to read it in the way that ordinary people would understand, and not “to draw on some unexpressed spirit outside the bounds of the normal meaning of words.” *Addison v. Holly Hill Fruit Prods., Inc.*, 322 U.S. 607, 617 (1944).

*Id.* at 911. [citation omitted].

In analyzing dual residence cases, the court’s opinion advances compelling reasons that the first step must be to determine whether the taxpayer has business as opposed to purely personal reasons for maintaining both residences. This must be done in order to determine whether the expenses of maintaining a second residence were, “necessitated by business, as opposed to personal, demands,” and were in this sense incurred by the taxpayer “while away from home in pursuit of trade or business.” Necessarily implicit in this proposition is a more limited corollary that is sufficient to decide the present case: When the taxpayer has a business relationship to only one location, no traveling expenses the taxpayer incurs are “necessitated by business, as opposed to personal demands,” regardless of how many residences the taxpayer has, where they are located, or which one is “home.”

In the present case, although the taxpayer argues that her employment required her to reside in New York, that contention is insufficient to compel a determination that it was the nature of her trade or business that required her to incur the additional expense of maintaining a second residence, the burden that § 162(a)(2) was intended to mitigate. Her expenses associated with maintaining her New York residence arose from personal interests that led her to maintain two residences rather than a single residence close to her work.<sup>119</sup> While traveling from her principal residence to a second place of residence closer to her business, even though “away from home,” she was not “away from home in pursuit of business.” Thus, the expenses at issue in this case were not incurred by the taxpayer “while away from home in pursuit of trade or business.”

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<sup>119</sup> For reasons explained by the court, the temporary nature of her employment does not bring the case within those as to which Congress was mitigating the burden of duplicative expenses when enacting § 162(a)(2).

In the contrasting case in which a taxpayer has established that both residences were maintained for business reasons, § 162(a)(2) allows the deduction of expenses associated with travel to, and maintenance of, one of the residences if they are incurred for business reasons and that abode is not the taxpayer's home. A common sense meaning of "home" works well to achieve the purpose of this provision.

In summary, the court announces a sound principle that, in dual residence cases, deductibility of traveling expenses depends upon a showing that both residences were maintained for business reasons. If that principle is understood to be derived from the language of § 162(a)(2) taken as a whole, "home" retains operative significance for determining which of the business-related residences is the one the expense of which can be treated as deductible. In this context, "home" should be given its ordinary meaning to allow a deduction only for expenses relating to an abode that is not the taxpayer's principal place of residence. On the undisputed facts in this case, the Tax Court found that Boston was the taxpayer's "home" in the everyday sense, i.e., her principal place of residence. Were the issue relevant to disposition of the case, I would uphold the Tax Court's quite reasonable determination on the evidence before it. However, because the taxpayer had no business reason for maintaining both residences, her deduction for expenses associated with maintaining a second residence closer than her principal residence to her place of employment must be disallowed without regard to which of her two residences was her "home" under § 162(a)(2).

#### *Notes and Questions:*

1. Obviously, the meaning of "home" is not to be determined by the ordinary use of the term. Right?
2. Does the court's opinion conflate the second and third requirements of *Flowers*?
3. On which of the *Flowers* requirements does Judge Keeton rely to deny taxpayers a deduction?
4. What was taxpayer's (insufficient) reason for maintaining a home in Boston?
5. Taxpayer owned and operated a very successful swimming pool construction business in Lynnfield, Massachusetts. He also owned and operated a very successful horse breeding and racing business in Lighthouse Point, Florida. From

November through April, he resided in Florida. From May through October, he resided in Massachusetts. Taxpayer owned a home in both Florida and Massachusetts and traveled between them to tend to his businesses.

- Does Taxpayer have two tax homes so that he may deduct the travel expenses associated with neither of them?
- What guidance do the opinions in *Hantzis* offer in answering this question?
- See *Andrews v. Commissioner*, 931 F.2d 132 (1<sup>st</sup> Cir. 1991) (“major” post of duty; “minor” post of duty).

5a. For the past five years, Taxpayers (Mr. and Mrs. Chwalow) have maintained a residence in Bala Cynwyd, Pennsylvania. Mrs. Chwalow is a teacher in the Philadelphia public school system and specializes in working with deaf children. Dr. Chwalow is a physicist whose specialty is military optics and electrooptics encompassing areas such as night vision, laser range finding, missile guidance, aerial reconnaissance, etc. Dr. Chwalow works for IBM in Washington, D.C., where he rents an apartment. He uses public transportation to get to his job. Mrs. Chwalow continues to live in Bala Cynwyd, Pennsylvania.

- May either Mr. or Mrs. Chwalow deduct meal and lodging expenses as “travel expenses” under § 162(a)(2)?
- See *Chwalow v. Commissioner*, 470 F.2d 475 (3<sup>rd</sup> Cir. 1972).

5b. Taxpayer Dews was a coach on the staff of the Atlanta Braves baseball team. He and his wife lived in Albany, Georgia. In the course of over 20 years in professional baseball, Dews had 37 different assignments, including as a manager of farm teams in the Atlanta organization. During one 4-year period, he was a coach for the Atlanta team. He maintained an apartment in Atlanta.

- May Dews deduct the expenses of traveling between Albany and Atlanta? May he deduct the expenses of living in Atlanta?
- See *Dews v. Commissioner*, T.C. Memo. 1987-353, available at 1987 WL 40405.

**United States v. Correll**, 389 U.S. 299 (1967)

MR. JUSTICE STEWART delivered the opinion of the Court.

The Commissioner of Internal Revenue has long maintained that a taxpayer traveling on business may deduct the cost of his meals only if his trip requires him to stop for sleep or rest. The question presented here is the validity of that rule.

The respondent in this case was a traveling salesman for a wholesale grocery company in Tennessee. [footnote omitted] He customarily left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner. In his income tax returns for 1960 and 1961, he deducted the cost of his morning and noon meals as “traveling expenses” incurred in the pursuit of his business “while away from home” under [I.R.C.] § 162(a)(2) ... [footnote omitted]. Because the respondent’s daily trips required neither sleep nor rest, the Commissioner disallowed the deductions, ruling that the cost of the respondent’s meals was a “personal, living” expense under § 262 [footnote omitted], rather than a travel expense under § 162(a)(2). The respondent paid the tax, sued for a refund in the District Court, and there received a favorable jury verdict.<sup>120</sup> The Court of Appeals for the Sixth Circuit affirmed, holding that the Commissioner’s sleep or rest rule is not “a valid regulation under the present statute.” In order to resolve a conflict among the circuits on this recurring question of federal income tax administration, [footnote omitted] we granted certiorari.

Under § 162(a)(2), taxpayers “traveling ... away from home in the pursuit of trade or business” may deduct the total amount “expended for meals and lodging.”<sup>121</sup> As a result, even the taxpayer who incurs substantial hotel and restaurant expenses because of the special demands of business travel receives something of a windfall,

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<sup>120</sup> After denying the Government’s motion for a directed verdict, the District Judge charged the jury that it would have to “determine under all the facts of this case whether or not” the Commissioner’s rule was “an arbitrary regulation as applied to these plaintiffs under the facts in this case.” He told the jury to consider whether the meal expenses were “necessary for the employee to properly perform the duties of his work.” “Should he have eaten them at his home, rather than . . . away from home, in order to properly carry on this business or to perform adequately his duties as an employee of this produce company[?]” “You are instructed that the cost of meals while on one-day business trips away from home need not be incurred while on an overnight trip to be deductible, so long as the expense of such meals ... proximately results from the carrying on the particular business involved and has some reasonable relation to that business.” Under these instructions, the jury found for the respondent. The District Court denied the Government’s motion for judgment notwithstanding the verdict.

<sup>121</sup> Prior to the enactment in 1921 of what is now § 162(a)(2), the Commissioner had promulgated a regulation allowing a deduction for the cost of meals and lodging away from home, but only to the extent that this cost exceeded “any expenditures ordinarily required for such purposes when at home.” *Treas. Reg. 45* (1920 ed.), Art. 292, 4 Cum. Bull. 209 (1921). Despite its logical appeal, the regulation proved so difficult to administer that the Treasury Department asked Congress to grant a deduction for the “entire amount” of such meal and lodging expenditures. *See* Statement of Dr. T. S. Adams, Tax Adviser, Treasury Department, in Hearings on H.R. 8245 before the Senate Committee on Finance, 67th Cong., 1st Sess., at 50, 234-235 (1921). Accordingly § 214(a)(1) of the Revenue Act of 1921, c. 136, 42 Stat. 239, for the first time included that language that later became § 162(a)(2). ...



for at least part of what he spends on meals represents a personal living expense that other taxpayers must bear without receiving any deduction at all.<sup>122</sup> Not surprisingly, therefore, Congress did not extend the special benefits of § 162(a)(2) to every conceivable situation involving business travel. It made the total cost of meals and lodging deductible only if incurred in the course of travel that takes the taxpayer “away from home.” The problem before us involves the meaning of that limiting phrase.

In resolving that problem, the Commissioner has avoided the wasteful litigation and continuing uncertainty that would inevitably accompany any purely case-by-case approach to the question of whether a particular taxpayer was “away from home” on a particular day. [footnote omitted] Rather than requiring “every meal-purchasing taxpayer to take pot luck in the courts,” [footnote omitted] the Commissioner has consistently construed travel “away from home” to exclude all trips requiring neither sleep nor rest,<sup>123</sup> regardless of how many cities a given trip may have touched, [footnote omitted] how many miles it may have covered,<sup>124</sup> or how many hours it may have consumed. [footnote omitted] By so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application, but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who, of course, cannot deduct the cost of the meals they eat on the road. *See Commissioner v. Flowers*, 326 U.S. 465.

Any rule in this area must make some rather arbitrary distinctions [footnote omitted], but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury. [footnote omitted] And the

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<sup>122</sup> Because § 262 makes “personal, living, or family expenses” nondeductible, the taxpayer whose business requires no travel cannot ordinarily deduct the cost of the lunch he eats away from home. But the taxpayer who can bring himself within the reach of § 162(a)(2) may deduct what he spends on his noontime meal although it costs him no more, and relates no more closely to his business, than does the lunch consumed by his less mobile counterpart.

<sup>123</sup> The Commissioner’s interpretation, first expressed in a 1940 ruling, I.T. 3395, 1910-2 Cum. Bull. 64, was originally known as the overnight rule. *See Commissioner v. Bagley*, [374 F.2d 204,] 205.

<sup>124</sup> The respondent seldom traveled farther than 55 miles from his home, but he ordinarily drove a total of 150 to 175 miles daily.



Commissioner's rule surely makes more sense than one which would allow the respondent in this case to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office.

The Court of Appeals nonetheless found in the "plain language of the statute" an insuperable obstacle to the Commissioner's construction. We disagree. The language of the statute – "meals and lodging ... away from home" – is obviously not self-defining. [footnote omitted] And to the extent that the words chosen by Congress cut in either direction, they tend to support, rather than defeat, the Commissioner's position, for the statute speaks of "meals and lodging" as a unit, suggesting – at least arguably – that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well. [footnote omitted] Ordinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel,<sup>125</sup> and Congress might well have thought that only taxpayers in that category should be permitted to deduct their living expenses while on the road.<sup>126</sup>

...

Alternatives to the Commissioner's sleep or rest rule are, of course, available. [footnote omitted] Improvements might be imagined. [footnote omitted] But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing "all needful rules and regulations for the enforcement" of the Internal Revenue Code. 26 U.S.C. § 7805(a). In this area of limitless factual variations, "it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments." *Commissioner v. Stidger*, 386 U.S. 287, 296. The role of

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<sup>125</sup> The taxpayer must ordinarily "maintain a home for his family at his own expense even when he is absent on business," *Barnhill v. Commissioner*, 148 F.2d 913, 917, and if he is required to stop for sleep or rest, "continuing costs incurred at a permanent place of abode are duplicated." *James v. United States*, 308 F.2d 204, 206. The same taxpayer, however, is unlikely to incur substantially increased living expenses as a result of business travel, however far he may go, so long as he does not find it necessary to stop for lodging. ...

<sup>126</sup> The court below thought that "[i]n an era of supersonic travel, the time factor is hardly relevant to the question of whether or not ... meal expenses are related to the taxpayer's business. ..." 369 F.2d 87, 89-90. But that completely misses the point. The benefits of § 162(a)(2) are limited to business travel "away from home," and all meal expenses incurred in the course of such travel are deductible, however unrelated they may be to the taxpayer's income-producing activity. To ask that the definition of "away from home" be responsive to the business necessity of the taxpayer's meals is to demand the impossible.

the judiciary in cases of this sort begins and ends with assuring that the Commissioner's regulations fall within his authority to implement the congressional mandate in some reasonable manner. Because the rule challenged here has not been shown deficient on that score, the Court of Appeals should have sustained its validity. The judgment is therefore Reversed.

MR. JUSTICE MARSHALL took no part in the consideration or decision of this case.

MR. JUSTICE DOUGLAS, with whom MR. JUSTICE BLACK and MR. JUSTICE FORTAS concur, dissenting.

The statutory words "while away from home," § 162(a)(2), may not, in my view, be shrunken to "overnight" by administrative construction or regulations. "Overnight" injects a time element in testing deductibility, while the statute speaks only in terms of geography. As stated by the Court of Appeals:

"In an era of supersonic travel, the time factor is hardly relevant to the question of whether or not travel and meal expenses are related to the taxpayer's business, and cannot be the basis of a valid regulation under the present statute." *Correll v. United States*, 369 F.2d 87, 89-90.

I would affirm the judgment below.

*Notes and Questions:*

1. Is this an appropriate area for a bright line rule that may unfairly "catch" some taxpayers?
2. Read the instruction that the federal district court gave to the jury (in a footnote). Does it seem that the standard resembles the standard that the Court later adopted for § 119?
3. Under § 162(a)(2), how strong must the nexus be between the actual meals and a business purpose? See the Court's last footnote. Does your answer make the approach of the commissioner seem more reasonable?

4. Did the majority's statement of the Commissioner's rule require an "overnight" stay – as Justice Douglas claimed in his dissent?

- The rule was originally an "overnight" rule. I.T. 3395, 1940-2 C.B. 64. The IRS endorsed the "sleep or rest" rule in Rev. Rul. 61-221, 1961-2 C.B. 34 for purposes of deducting the expense of *sleeping*.

5. F.M. Williams was a railroad conductor with more than forty years of service with the Atlanta and West Point Railroad and the Western Railway of Alabama. Every other day Williams got up shortly after five in the morning, left his house in Montgomery, Alabama, in time to arrive at the railroad station at 6:45 a.m., attended to duties at the station, left Montgomery on the Crescent at 7:40 a.m., arrived in Atlanta, Georgia, at 12:15 p.m., took six hours off, returned to duty in time to leave Atlanta at 6:15 p.m. on the Piedmont, pulled in to Montgomery at 10:15 p.m., left the Piedmont, and reached home about midnight. It is a long, hard day. The railroad never ordered Williams to rent a room in Atlanta, nor required him to sleep during the layover period. For years, however, because he felt he needed sleep and rest in Atlanta before his return run, Williams rented a reasonably priced room in the Gordon Hotel, a small hotel near the railroad station. At the hotel he had lunch and dinner, rested and slept, bathed and freshened up before boarding the Piedmont. He had the same room for eight years. His superiors knew that he could be reached in Atlanta at the Gordon Hotel; taxpayer was subject to call at all times. In 1955 Captain Williams incurred expenses of \$796 for meals, lodging, and tips at the Gordon Hotel during his layover in Atlanta.

- Should Williams be permitted to deduct the expenses that he incurred at the Gordon Hotel?
- What issues (sub-issues) do these facts raise?
- See *Williams v. Patterson*, 286 F.2d 333 (5<sup>th</sup> Cir. 1961).

5a. Taxpayer B was a ferryboat captain. He worked in the Puget Sound area of Washington State. During the summer months, he typically worked 18-hour days for seven consecutive days. Then he would have seven consecutive days off. His schedule was the same in the winter, except that he would typically captain a ship from Seattle to Victoria. The return voyage would be six hours later. During the six-hour layover, he would take a nap on a cot provided by his employer. He would also purchase one or two meals.

- Should taxpayer B be permitted to deduct the cost of his meals?
- See *Bissonnette v. Commissioner*, 127 T.C. 124 (2006).

5b. Taxpayers were employees at the Nevada Test Site, a nuclear testing facility. Las Vegas, Nevada, the closest habitable community to the Test Site, is 65 miles south of the Camp Mercury control point, located at the southernmost boundary of the Test Site, and 130 miles from the northernmost boundary of the Test Site. Because of the potential dangers arising out of the activities conducted at the Test Site, the government chose this location precisely because of its remoteness from populated areas. All the taxpayers assigned to the Test Site received, in addition to their regular wages, a per diem allowance for each day they reported for work at the Test Site. The amount of the allowance varied. Employees reporting to Camp Mercury received \$5 per day; those reporting to any forward area received \$7.50 per day. Employees received these allowances without regard to the actual costs incurred by them for transportation, meals, or lodging. A private contractor maintained meal and lodging facilities onsite. Employees were responsible for procuring transportation, meals, and occasionally overnight lodging when they had to work overtime.

- Should Taxpayers be permitted to *exclude* their per diem allowances? *See Commissioner v. Kowalski*, 434 U.S. 77 (1977), *supra*.
- Disregarding the fact that for employees, meal and lodging expenses would be “miscellaneous deductions” and so suspended until tax year 2026, § 67(g) –
  - Should Taxpayers be permitted to *deduct* the cost of their travel?
  - Should Taxpayers be permitted to *deduct* the cost of their meals?
  - Should Taxpayers be permitted to *deduct* the cost of their lodging?
- See Coombs v. Commissioner*, 608 F.2d 1269 (9<sup>th</sup> Cir. 1979).



Read the second sentence of the carryout paragraph that ends § 162(a). It refers to § 162(a)(2). Also read § 274(m)(3). Then do the CALI Lesson: *Basic Federal Income Taxation: Deductions: Traveling Expenses*.

### *B. Reasonable Salaries*

Read § 162(a)(1). How would you determine the reasonableness of salaries? What constraints exist outside of the Code that prevent payment of excessive salaries or other compensation? What conditions make it more (or less) likely that a taxpayer

is paying a greater-than-reasonable salary?

- Notice that the approach of the Code is to deny a deduction to the one who pays an excessive salary. Hence, both the recipient of the salary and the employer would pay tax on the amount paid in salary that the employer may not deduct.

**Exacto Spring Corp. v. Commissioner**, 196 F.3d 833 (7<sup>th</sup> Cir. 1999).

POSNER, Chief Judge.

This appeal from a judgment by the Tax Court, requires us to interpret and apply § 162(a)(1), which allows a business to deduct from its income its “ordinary and necessary” business expenses, including a “reasonable allowance for salaries or other compensation for personal services actually rendered.” In 1993 and 1994, Exacto Spring Corporation, a closely held corporation engaged in the manufacture of precision springs, paid its cofounder, chief executive, and principal owner, William Heitz, \$1.3 and \$1.0 million, respectively, in salary. The Internal Revenue Service thought this amount excessive, that Heitz should not have been paid more than \$381,000 in 1993 or \$400,000 in 1994, with the difference added to the corporation’s income, and it assessed a deficiency accordingly, which Exacto challenged in the Tax Court. That court found that the maximum reasonable compensation for Heitz would have been \$900,000 in the earlier year and \$700,000 in the later one – figures roughly midway between his actual compensation and the IRS’s determination – and Exacto has appealed.

In reaching its conclusion, the Tax Court applied a test that requires the consideration of seven factors, none entitled to any specified weight relative to another. The factors are, in the court’s words, “(1) the type and extent of the services rendered; (2) the scarcity of qualified employees; (3) the qualifications and prior earning capacity of the employee; (4) the contributions of the employee to the business venture; (5) the net earnings of the employer; (6) the prevailing compensation paid to employees with comparable jobs; and (7) the peculiar characteristics of the employer’s business.” It is apparent that this test, though it or variants of it (one of which has the astonishing total of 21 factors, *Foos v. Commissioner*, 41 T.C.M. (CCH) 863, 878-79 (1981)), are encountered in many cases, *see, e.g.* *Edwin’s Inc. v. United States*, 501 F.2d 675, 677 (7<sup>th</sup> Cir.1974); *Owensby & Kritikos, Inc. v. Commissioner*, 819 F.2d 1315, 1323 (5<sup>th</sup> Cir.1987); *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115, 119 (6<sup>th</sup> Cir.1949); 1 BORIS I.

BITTKER & LAWRENCE LOKKEN, *FEDERAL TAXATION OF INCOME, ESTATES, AND GIFTS* ¶ 22.2.2, p. 22-21 (3d ed.1999), leaves much to be desired – being, like many other multi-factor tests, “redundant, incomplete, and unclear.” *Palmer v. City of Chicago*, 806 F.2d 1316, 1318 (7th Cir.1986).

To begin with, it is nondirective. No indication is given of how the factors are to be weighed in the event they don’t all line up on one side. And many of the factors, such as the type and extent of services rendered, the scarcity of qualified employees, and the peculiar characteristics of the employer’s business, are vague.

Second, the factors do not bear a clear relation either to each other or to the primary purpose of § 162(a)(1), which is to prevent dividends (or in some cases gifts), which are not deductible from corporate income, from being disguised as salary, which is. *E.g., Rapco, Inc. v. Commissioner*, 85 F.3d 950, 954 n. 2 (2d Cir.1996). Suppose that an employee who let us say was, like Heitz, a founder and the chief executive officer and principal owner of the taxpayer rendered no services at all but received a huge salary. It would be absurd to allow the whole or for that matter any part of his salary to be deducted as an ordinary and necessary business expense even if he were well qualified to be CEO of the company, the company had substantial net earnings, CEOs of similar companies were paid a lot, and it was a business in which high salaries are common. The multi-factor test would not prevent the Tax Court from allowing a deduction in such a case even though the corporation obviously was seeking to reduce its taxable income by disguising earnings as salary. The court would not allow the deduction, but not because of anything in the multi-factor test; rather because it would be apparent that the payment to the employee was not in fact for his services to the company. Reg. § 1.162-7(a); 1 BITTKER & LOKKEN, *supra*, ¶ 22.2.1, p. 22-19.

Third, the seven-factor test invites the Tax Court to set itself up as a superpersonnel department for closely held corporations, a role unsuitable for courts, as we have

Irruption: a breaking or bursting in; a violent incursion or invasion.

repeatedly noted in the Title VII context, *e.g., Jackson v. E.J. Brach Corp.*, 176 F.3d 971, 984 (7th Cir. 1999), and as the Delaware Chancery Court has noted in the more germane context of derivative suits alleging excessive compensation of corporate employees. *Gagliardi v. TriFoods Int’l, Inc.*, 683 A.2d 1049, 1051 (Del. Ch. 1996). The test – the irruption of “comparable worth” thinking (see, *e.g., American Nurses’ Ass’n v. Illinois*, 783 F.2d 716 (7th Cir. 1986)) in a new context

– invites the court to decide what the taxpayer’s employees should be paid on the basis of the judges’ own ideas of what jobs are comparable, what relation an employee’s salary should bear to the corporation’s net earnings, what types of business should pay abnormally high (or low) salaries, and so forth. The judges of the Tax Court are not equipped by training or experience to determine the salaries of corporate officers; no judges are.

Fourth, since the test cannot itself determine the outcome of a dispute because of its nondirective character, it invites the making of arbitrary decisions based on uncanalized discretion or unprincipled rules of thumb. The Tax Court in this case essentially added the IRS’s determination of the maximum that Mr. Heitz should have been paid in 1993 and 1994 to what he was in fact paid, and divided the sum by two. It cut the baby in half. One would have to be awfully naive to believe that the seven-factor test generated this pleasing symmetry.

Fifth, because the reaction of the Tax Court to a challenge to the deduction of executive compensation is unpredictable, corporations run unavoidable legal risks in determining a level of compensation that may be indispensable to the success of their business.

The drawbacks of the multi-factor test are well illustrated by its purported application by the Tax Court in this case. With regard to factor (1), the court found that Heitz was “indispensable to Exacto’s business” and “essential to Exacto’s success.” Heitz is not only Exacto’s CEO; he is also the company’s chief salesman and marketing man plus the head of its research and development efforts and its principal inventor. The company’s entire success appears to be due on the one hand to the research and development conducted by him and on the other hand to his marketing of these innovations (though he receives some additional compensation for his marketing efforts from a subsidiary of Exacto). The court decided that factor (1) favored Exacto.

Likewise factor (2), for, as the court pointed out, the design of precision springs, which is Heitz’s specialty, is “an extremely specialized branch of mechanical engineering, and there are very few engineers who have made careers specializing in this area,” let alone engineers like Heitz who have “the ability to identify and attract clients and to develop springs to perform a specific function for that client.... It would have been very difficult to replace Mr. Heitz.” Notice how factors (1) and (2) turn out to be nearly identical.



Factors (3) and (4) also supported Exacto, the court found. “Mr. Heitz is highly qualified to run Exacto as a result of his education, training, experience, and motivation. Mr. Heitz has over 40 years of highly successful experience in the field of spring design.” And his “efforts were of great value to the corporation.” So factor (4) duplicated (2), and so the first four factors turn out to be really only two.

With regard to the fifth factor – the employer’s (Exacto’s) net earnings – the Tax Court was noncommittal. Exacto had reported a loss in 1993 and very little taxable income in 1994. But it conceded having taken some improper deductions in those years unrelated to Heitz’s salary. After adjusting Exacto’s income to remove these deductions, the court found that Exacto had earned more than \$1 million in each of the years at issue net of Heitz’s supposedly inflated salary.

The court was noncommittal with regard to the sixth factor – earnings of comparable employees – as well. The evidence bearing on this factor had been presented by expert witnesses, one on each side, and the court was critical of both. The taxpayer’s witness had arrived at his estimate of Heitz’s maximum reasonable compensation in part by aggregating the salaries that Exacto would have had to pay to hire four people each to wear one of Heitz’s “hats,” as chief executive officer, chief manufacturing executive, chief research and development officer, and chief sales and marketing executive. Although the more roles or functions an employee performs the more valuable his services are likely to be, *Dexsil Corp. v. Commissioner*, 147 F.3d 96, 102-03 (2d Cir.1998); *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241, 1245-46 (9th Cir.1983), an employee who performs four jobs, each on a part-time basis, is not necessarily worth as much to a company as four employees each working full time at one of those jobs. It is therefore arbitrary to multiply the normal full-time salary for one of the jobs by four to compute the reasonable compensation of the employee who fills all four of them. Anyway salaries are determined not by the method of comparable worth but, like other prices, by the market, which is to say by conditions of demand and supply. Especially in the short run, salaries may vary by more than any difference in the “objective” characteristics of jobs. An individual who has valuable skills that are in particularly short supply at the moment may command a higher salary than a more versatile, better-trained, and more loyal employee whose skills are, however, less scarce.

The Internal Revenue Service’s expert witness sensibly considered whether Heitz’s compensation was consistent with Exacto’s investors’ earning a reasonable return (adjusted for the risk of Exacto’s business), which he calculated to be 13%. But in



concluding that Heitz's compensation had pushed the return below that level, he neglected to consider the concessions of improper deductions, which led to adjustments to Exacto's taxable income. The Tax Court determined that with those adjustments the investors' annual return was more than 20% despite Heitz's large salary. The government argues that the court should not have calculated the investors' return on the basis of the concessions of improper deductions, because when Heitz's compensation was determined the corporation was unaware that the deductions would be disallowed. In other words, the corporation thought that its after-tax income was larger than it turned out to be. But if the ex ante perspective is the proper one, as the government contends, it favors the corporation if when it fixed Heitz's salary it thought there was more money in the till for the investors than has turned out to be the case.

What is puzzling is how disallowing deductions and thus increasing the taxpayer's tax bill could increase the investors' return. What investors care about is the corporate income available to pay dividends or be reinvested; obviously money paid in taxes to the Internal Revenue Service is not available for either purpose. The reasonableness of Heitz's compensation thus depends not on Exacto's taxable income but on the corporation's profitability to the investors, which is reduced by the disallowance of deductions – if a corporation succeeds in taking phantom deductions, shareholders are better off because the corporation's tax bill is lower. But the government makes nothing of this. Its only objection is to the Tax Court's having taken account of adjustments made after Heitz's salary was fixed. Both parties, plus the Tax Court, based their estimates of investors' returns on the after-tax income shown on Exacto's tax returns, which jumped after the deductions were disallowed, rather than on Exacto's real profits, which declined. The approach is inconsistent with a realistic assessment of the investors' rate of return, but as no one in the case questions it we shall not make an issue of it.

Finally, under factor (7) ("peculiar characteristics"), the court first and rightly brushed aside the IRS's argument that the low level of dividends paid by Exacto (zero in the two years at issue, but never very high) was evidence that the corporation was paying Heitz dividends in the form of salary. The court pointed out that shareholders may not want dividends. They may prefer the corporation to retain its earnings, causing the value of the corporation to rise and thus enabling the shareholders to obtain corporate earnings in the form of capital gains taxed at a lower rate than ordinary income. The court also noted that while Heitz, as the owner of 55% of Exacto's common stock, obviously was in a position to influence his salary, the corporation's two other major shareholders, each with 20% of the stock,

had approved it. They had not themselves been paid a salary or other compensation, and are not relatives of Heitz; they had no financial or other incentive to allow Heitz to siphon off dividends in the form of salary.

Having run through the seven factors, all of which either favored the taxpayer or were neutral, the court reached a stunning conclusion: “We have considered the factors relevant in deciding reasonable compensation for Mr. Heitz. On the basis of all the evidence, we hold that reasonable compensation for Mr. Heitz” was much less than Exacto paid him. The court’s only effort at explaining this result when Exacto had passed the seven-factor test with flying colors was that “we have balanced Mr. Heitz’ unique selling and technical ability, his years of experience, and the difficulty of replacing Mr. Heitz with the fact that the corporate entity would have shown a reasonable return for the equity holders, after considering petitioners’ concessions.” *Id.* But “the fact that the corporate entity would have shown a reasonable return for the equity holders” after the concessions is on the same side of the balance as the other factors; it does not favor the Internal Revenue Service’s position. The government’s lawyer was forced to concede at the argument of the appeal that she could not deny the possibility that the Tax Court had pulled its figures for Heitz’s allowable compensation out of a hat.

The failure of the Tax Court’s reasoning to support its result would alone require a remand. But the problem with the court’s opinion goes deeper. The test it applied does not provide adequate guidance to a rational decision. We owe no deference to the Tax Court’s statutory interpretations, its relation to us being that of a district court to a court of appeals, not that of an administrative agency to a court of appeals. 26 U.S.C. § 7482(a)(1); [citations omitted]. The federal courts of appeals, whose decisions do of course have weight as authority with us even when they are not our own decisions, have been moving toward a much simpler and more purposive test, the “independent investor” test. *Dexsil Corp. v. Commissioner, supra*; *Elliotts, Inc. v. Commissioner, supra*, 716 F.2d at 1245-48; *Rapco, Inc. v. Commissioner, supra*, 85 F.3d at 954-55. We applaud the trend and join it.

Because judges tend to downplay the element of judicial creativity in adapting law to fresh insights and changed circumstances, the cases we have just cited prefer to say (as in *Dexsil* and *Rapco*) that the “independent investor” test is the “lens” through which they view the seven (or however many) factors of the orthodox test. But that is a formality. The new test dissolves the old and returns the inquiry to basics. The Internal Revenue Code limits the amount of salary that a corporation can deduct from its income primarily in order to prevent the corporation from

eluding the corporate income tax by paying dividends but calling them salary because salary is deductible and dividends are not. (Perhaps they should be, to avoid double taxation of corporate earnings, but that is not the law.) In the case of a publicly held company, where the salaries of the highest executives are fixed by a board of directors that those executives do not control, the danger of siphoning corporate earnings to executives in the form of salary is not acute. The danger is much greater in the case of a closely held corporation, in which ownership and management tend to coincide; unfortunately, as the opinion of the Tax Court in this case illustrates, judges are not competent to decide what business executives are worth.

There is, fortunately, an indirect market test, as recognized by the Internal Revenue Service's expert witness. A corporation can be conceptualized as a contract in which the owner of assets hires a person to manage them. The owner pays the manager a salary and in exchange the manager works to increase the value of the assets that have been entrusted to his management; that increase can be expressed as a rate of return to the owner's investment. The higher the rate of return (adjusted for risk) that a manager can generate, the greater the salary he can command. If the rate of return is extremely high, it will be difficult to prove that the manager is being overpaid, for it will be implausible that if he quit if his salary was cut, and he was replaced by a lower-paid manager, the owner would be better off; it would be killing the goose that lays the golden egg. The Service's expert believed that investors in a firm like Exacto would expect a 13% return on their investment. Presumably they would be delighted with more. They would be overjoyed to receive a return more than 50% greater than they expected – and 20%, the return that the Tax Court found that investors in Exacto had obtained, is more than 50% greater than the benchmark return of 13%.

When, notwithstanding the CEO's "exorbitant" salary (as it might appear to a judge or other modestly paid official), the investors in his company are obtaining a far higher return than they had any reason to expect, his salary is presumptively reasonable. We say "presumptively" because we can imagine cases in which the return, though very high, is not due to the CEO's exertions. Suppose Exacto had been an unprofitable company that suddenly learned that its factory was sitting on an oil field, and when oil revenues started to pour in its owner raised his salary from \$50,000 a year to \$1.3 million. The presumption of reasonableness would be rebutted. There is no suggestion of anything of that sort here and likewise no suggestion that Mr. Heitz was merely the titular chief executive and the company was actually run by someone else, which would be another basis for rebuttal.

The government could still have prevailed by showing that while Heitz's salary may have been no greater than would be reasonable in the circumstances, the company did not in fact intend to pay him that amount as salary, that his salary really did include a concealed dividend though it need not have. This is material (and the "independent investor" test, like the multi-factor test that it replaces, thus incomplete, though invaluable) because any business expense to be deductible must be, as we noted earlier, a bona fide expense as well as reasonable in amount. The fact that Heitz's salary was approved by the other owners of the corporation, who had no incentive to disguise a dividend as salary, goes far to rebut any inference of bad faith here, which in any event the Tax Court did not draw and the government does not ask us to draw.

The judgment is reversed with directions to enter judgment for the taxpayer. Reversed.

*Notes and Questions:*

1. Judge Posner is right in describing what is probably still the prevailing standard as a multi-factor test – with all the problems that go with it. *See* E.L. Kellett, Annot., *Reasonableness of Compensation Paid to Officers or Employees, so as to Warrant Deduction Thereof in Computing Employer's Income Tax*, 10 A.L.R. FED.3d 125.

•The Tax Court will not apply the "independent investor test" unless the case is appealable to a court that has expressly adopted it. *Clary Hood, Inc. v. Commissioner*, T.C. Memo 2022-15

2. For what reasons would a taxpayer "pay," i.e., compensate, an employee more than a reasonable amount of salary?

•The court observed that a shareholder derivative suit is a “more germane context” in which to evaluate excessive compensation? Why would this be true?

*What’s at stake?* A corporation pays its shareholders dividends from the after-tax profits it has earned over and above its (deductible) expenses. A corporation may not deduct the amount of dividends that it pays to shareholders. Shareholders who receive dividends must pay income tax on them. Thus, corporate profits that a corporation distributes to shareholders are subject to income taxation twice – once at the corporate level and once at the shareholder level.

A corporation may deduct salaries that it pays. § 162(a)(1). Thus, a salary is subject to tax only at the employee level.

What is the tax treatment of a gift that a corporation gives to an employee? See *Duberstein, supra*; §§ 102(c), 274(b).

3. In *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9<sup>th</sup> Cir. 1983), the Ninth Circuit considered the hypothetical investor because the “employee” was the sole shareholder of the corporation. The court remanded for consideration of factors that should include the reasonableness of a salary and the reasonableness of a formula by which a bonus was determined.

4. In *Menard, Inc. v. Commissioner*, 560 F.3d 620 (7<sup>th</sup> Cir. 2009), the Seventh Circuit (opinion by Posner) determined that compensation of \$7.1M in 1998 was not excessive. There was no indication of shareholder disappointment with their 18.8% return.

5. In *Mulcahy, Pauritsch, Salvador & Co v. Commissioner*, 680 F.3d 867, 872 (7<sup>th</sup> Cir. 2012), the Seventh Circuit (opinion by Posner) affirmed the judgment of the Tax Court that “consulting fees” were disguised dividends that otherwise would have left investors with a 0% return.

6. Read § 162(m). Notice that it only applies to publicly held corporations. How effective do you think § 162(m) is at curtailing excessive compensation? Keep in mind that the Tax Cuts and Jobs Act reduced the maximum corporate tax rate from 35% to 21%. See David I. Walker, *Expanding and Effectively Repealing the Executive Pay Deductibility Limitations*, TAX NOTES 1819 (Sept. 24, 2018).

### *C. Ordinary and Necessary Expenses*

Section 162(a) allows taxpayer to deduct all ordinary and necessary expenses paid or incurred in carrying on any trade or business, but §§ 162 and 274 limit trade or business deductions incurred for certain purposes.

Section 212 allows a similar deduction for the ordinary and necessary expenses that taxpayer pays or incurs –

- for the production or collection of income,
- for the management, conservation, or maintenance of property held for the production of income, or
- in connection with the determination, collection, or refund of any tax.
- Section 67(g) suspends “miscellaneous deductions” until 2026. Section 212 deductions are included in “miscellaneous deductions.”
- This will encourage taxpayers to characterize their activities as a trade or business.

We consider here a few recurring issues.

#### 1. Personal vs. Trade or Business

We have already seen that § 162(a)(2) implicitly treats taxpayer’s choice of where to live as a personal one (*Flowers*). So is the choice to be marry (*Hantzis*). Hence, taxpayer may not deduct expenditures associated with these choices. § 262(a). These are not the only life choices that the Code implicitly treats as “personal.”

**Smith v. Commissioner**, 40 B.T.A. 1038 (1939), *aff’d* 113 F.2d 114 (2d Cir. 1940).

....

#### OPINION – OPPER

Respondent determined a deficiency of \$23.62 in petitioner’s 1937 income tax. This was due to the disallowance of a deduction claimed by petitioners, who are husband and wife, for sums spent by the wife in employing nursemaids to care for petitioners’ young child, the wife, as well as the husband, being employed. ...

Petitioners would have us apply the ‘but for’ test. They propose that but for the nurses the wife could not leave her child; but for the freedom so secured she could not pursue her gainful labors; and but for them there would be no income and no tax. This thought evokes an array of interesting possibilities. The fee to the doctor, but for whose healing service the earner of the family income could not leave his sickbed; [footnote omitted] the cost of the laborer’s raiment, for how can the world proceed about its business unclothed; the very home which gives us shelter and rest and the food which provides energy, might all by an extension of the same proposition be construed as necessary to the operation of business and to the creation of income. Yet these are the very essence of those ‘personal’ expenses the deductibility of which is expressly denied. [citation omitted]

We are told that the working wife is a new phenomenon. This is relied on to account for the apparent inconsistency that the expenses in issue are now a commonplace, yet have not been the subject of legislation, ruling, or adjudicated controversy. But if that is true it becomes all the more necessary to apply accepted principles to the novel facts. We are not prepared to say that the care of children, like similar aspects of family and household life, is other than a personal concern. The wife’s services as custodian of the home and protector of its children are ordinarily rendered without monetary compensation. There results no taxable income from the performance of this service and the correlative expenditure is personal and not susceptible of deduction. [citation omitted] Here the wife has chosen to employ others to discharge her domestic function and the services she performs are rendered outside the home. They are a source of actual income and taxable as such. But that does not deprive the same work performed by others of its personal character nor furnish a reason why its cost should be treated as an offset in the guise of a deductible item.

We are not unmindful that, as petitioners suggest, certain disbursements normally personal may become deductible by reason of their intimate connection with an occupation carried on for profit. In this category fall entertainment [citation omitted], and traveling expenses [citation omitted], and the cost of an actor’s wardrobe [citation omitted]. The line is not always an easy one to draw nor the test simple to apply. But we think its principle is clear. It may for practical purposes be said to constitute a distinction between those activities which, as a matter of common acceptance and universal experience, are ‘ordinary’ or usual as the direct accompaniment of business pursuits, on the one hand; and those which, though they may in some indirect and tenuous degree relate to the circumstances of a profitable occupation, are nevertheless personal in their nature, of a character applicable to

human beings generally, and which exist on that plane regardless of the occupation, though not necessarily of the station in life, of the individuals concerned. *See Welch v. Helvering*, 290 U.S. 111.

In the latter category, we think, fall payments made to servants or others occupied in looking to the personal wants of their employers. [citation omitted]. And we include in this group nursemaids retained to care for infant children.

Decision will be entered for the respondent.

*Notes and Questions:*

1. The B.T.A. says that the expenses of a nursemaid “are the very essence of those ‘personal expenses the deductibility of which is expressly denied.’”
  - What was the personal choice that taxpayer made in this case that made these expenses non-deductible?
2. We have already noted §§ 21 and 129. These provisions reverse the *result* of *Smith*, but not its construction of § 162.
  - What do these provisions say about the underlying rationale of *Smith*, particularly the role of the wife and mother?



Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Dependent Care Credit*.

2. Limitations on Deductibility of Ordinary and Necessary Trade or Business Expenses



Consider the source of a limitation on the deductibility of expenses that taxpayer incurs to generate income that the following cases consider:

**Commissioner v. Tellier**, 383 U.S. 687 (1966).

MR. JUSTICE STEWART delivered the opinion of the Court.

The question presented in this case is whether expenses incurred by a taxpayer in the unsuccessful defense of a criminal prosecution may qualify for deduction from taxable income under § 162(a), which allows a deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. ...” [footnote omitted] The respondent Walter F. Tellier was engaged in the business of underwriting the public sale of stock offerings and purchasing securities for resale to customers. In 1956, he was brought to trial upon a 36-count indictment that charged him with violating the fraud section of the Securities Act of 1933 [footnote omitted] and the mail fraud statute, [footnote omitted] and with conspiring to violate those statutes. [footnote omitted] He was found guilty on all counts, and was sentenced to pay an \$18,000 fine and to serve four and a half years in prison. The judgment of conviction was affirmed on appeal. [footnote omitted] In his unsuccessful defense of this criminal prosecution, the respondent incurred and paid \$22,964.20 in legal expenses in 1956. He claimed a deduction for that amount on his federal income tax return for that year. The Commissioner disallowed the deduction, and was sustained by the Tax Court. The Court of Appeals for the Second Circuit reversed in a unanimous en banc decision, and we granted certiorari. We affirm the judgment of the Court of Appeals.

There can be no serious question that the payments deducted by the respondent were expenses of his securities business under the decisions of this Court, and the Commissioner does not contend otherwise. In *United States v. Gilmore*, 372 U.S. 39, we held that “the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test of whether the expense was ‘business’ or ‘personal’” within the meaning of § 162(a). *Cf. Kornhauser v. United States*, 276 U.S. 145; *Deputy v. du Pont*, 308 U.S. 488. The criminal charges against the respondent found their source in his business activities as a securities dealer. The

respondent's legal fees, paid in defense against those charges, therefore clearly qualify under *Gilmore* as "expenses paid or incurred ... in carrying on any trade or business" within the meaning of § 162(a).

The Commissioner also concedes that the respondent's legal expenses were "ordinary" and "necessary" expenses within the meaning of § 162(a). Our decisions have consistently construed the term "necessary" as imposing only the minimal requirement that the expense be "appropriate and helpful" for "the development of the [taxpayer's] business." *Welch v. Helvering*, 290 U.S. 111; *cf. Kornhauser v. United States*, *supra*, at 276 U.S. 152; *Lilly v. Commissioner*, 343 U.S. 90, 93-94; *Commissioner v. Heininger*, 320 U.S. 467, 320 U.S. 471; *McCulloch v. Maryland*, 4 Wheat. 316, 17 U.S. 413-415. The principal function of the term "ordinary" in § 162(a) is to clarify the distinction, often difficult, between those expenses that are currently deductible and those that are in the nature of capital expenditures, which, if deductible at all, must be amortized over the useful life of the asset. *Welch v. Helvering*, *supra*, at 290 U.S. 113-116. [footnote omitted] The legal expenses deducted by the respondent were not capital expenditures. They were incurred in his defense against charges of past criminal conduct, not in the acquisition of a capital asset. Our decisions establish that counsel fees comparable to those here involved are ordinary business expenses, even though a "lawsuit affecting the safety of a business may happen once a lifetime." *Welch v. Helvering*, *supra*, at 290 U.S. 114. *Kornhauser v. United States*, *supra*, at 276 U.S. 152-153; *cf. Trust of Bingham v. Commissioner*, 325 U.S. 365, 376. [footnote omitted]

It is therefore clear that the respondent's legal fees were deductible under § 162(a) if the provisions of that section are to be given their normal effect in this case. The Commissioner and the Tax Court determined, however, that, even though the expenditures meet the literal requirements of § 162(a), their deduction must nevertheless be disallowed on the ground of public policy. That view finds considerable support in other administrative and judicial decisions.<sup>127</sup> It finds no

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<sup>127</sup> See Sarah Backer, 1 B.T.A. 214; Norvin R. Lindheim, 2 B.T.A. 229; Thomas A. Joseph, 26 T.C. 562; Burroughs Bldg. Material Co. v. Commissioner, 47 F.2d 178 (C.A.2d Cir.); Commissioner v. Schwartz, 232 F.2d 94 (C.A.5th Cir.); Acker v. Commissioner, 258 F.2d 568 (C.A.6th Cir.); Bell v. Commissioner, 320 F.2d 953 (C.A.8th Cir.); Peckham v. Commissioner, 327 F.2d 855, 856 (C.A.4th Cir.); Port v. United States, 163 F. Supp. 645. See also Note, Business Expenses, Disallowance, and Public Policy: Some Problems of Sanctioning with the Internal Revenue Code, 72 YALE L.J. 108; 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.49 ff. Compare Longhorn Portland Cement Co., 3 T.C. 310; G.C.M. 24377, 1944 Cum. Bull. 93; Lamont, Controversial Aspects of Ordinary and Necessary Business Expense, 42 TAXES 808, 833-834.

support, however, in any regulation or statute or in any decision of this Court, and we believe no such “public policy” exception to the plain provisions of § 162(a) is warranted in the circumstances presented by this case.

We start with the proposition that the federal income tax is a tax on net income, not a sanction against wrongdoing. That principle has been firmly imbedded in the tax statute from the beginning. One familiar facet of the principle is the truism that the statute does not concern itself with the lawfulness of the income that it taxes. Income from a criminal enterprise is taxed at a rate no higher and no lower than income from more conventional sources. “[T]he fact that a business is unlawful [does not] exempt it from paying the taxes that if lawful it would have to pay.” *United States v. Sullivan*, 274 U.S. 259. See *James v. United States*, 366 U.S. 213.

With respect to deductions, the basic rule, with only a few limited and well defined exceptions, is the same. During the Senate debate in 1913 on the bill that became the first modern income tax law, amendments were rejected that would have limited deductions for losses to those incurred in a “legitimate” or “lawful” trade or business. Senator Williams, who was in charge of the bill, stated on the floor of the Senate that

“[T]he object of this bill is to tax a man’s net income; that is to say, what he has at the end of the year after deducting from his receipts his expenditures or losses. It is not to reform men’s moral characters; that is not the object of the bill at all. The tax is not levied for the purpose of restraining people from betting on horse races or upon ‘futures,’ but the tax is framed for the purpose of making a man pay upon his net income, his actual profit during the year. The law does not care where he got it from, so far as the tax is concerned, although the law may very properly care in another way.” 50 Cong. Rec. 3849.<sup>128</sup>

The application of this principle is reflected in several decisions of this Court. As recently as *Commissioner v. Sullivan*, 356 U.S. 27, we sustained the allowance of a deduction for rent and wages paid by the operators of a gambling enterprise, even

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<sup>128</sup> In challenging the amendments, Senator Williams also stated:

“In other words, you are going to count the man as having money which he has not got, because he has lost it in a way that you do not approve of.”

50 Cong. Rec. 3850.

though both the business itself and the specific rent and wage payments there in question were illegal under state law. In rejecting the Commissioner's contention that the illegality of the enterprise required disallowance of the deduction, we held that, were we to "enforce as federal policy the rule espoused by the Commissioner in this case, we would come close to making this type of business taxable on the basis of its gross receipts, while all other business would be taxable on the basis of net income. If that choice is to be made, Congress should do it." *Id.* at 356 U.S. 29. In *Lilly v. Commissioner*, 343 U.S. 90, the Court upheld deductions claimed by opticians for amounts paid to doctors who prescribed the eyeglasses that the opticians sold, although the Court was careful to disavow "approval of the business ethics or public policy involved in the payments. ..." 343 U.S. at 97. And in *Commissioner v. Heininger*, 320 U.S. 467, a case akin to the one before us, the Court upheld deductions claimed by a dentist for lawyer's fees and other expenses incurred in unsuccessfully defending against an administrative fraud order issued by the Postmaster General.

Deduction of expenses falling within the general definition of § 162(a) may, to be sure, be disallowed by specific legislation, since deductions "are a matter of grace and Congress can, of course, disallow them as it chooses." *Commissioner v. Sullivan*, 356 U.S. at 28.<sup>129</sup> The Court has also given effect to a precise and longstanding Treasury Regulation prohibiting the deduction of a specified category of expenditures; an example is lobbying expenses, whose nondeductibility was supported by considerations not here present. *Textile Mills Securities Corp. v. Commissioner*, 314 U.S. 326; *Cammarano v. United States*, 358 U.S. 498. But where Congress has been wholly silent, it is only in extremely limited

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<sup>129</sup> Specific legislation denying deductions for payments that violate public policy is not unknown. *E.g.*, Internal Revenue Code of 1954, § 162(c) (disallowance of deduction for payments to officials and employees of foreign countries in circumstances where the payments would be illegal if federal laws were applicable; *cf.* Reg. § 1.162-18); § 165(d) (deduction for wagering losses limited to extent of wagering gains). *See also* Stabilization Act of 1942, § 5(a), 56 Stat. 767, 50 U.S.C. App. § 965(a) (1946 ed.), Defense Production Act of 1950, § 405(a), 64 Stat. 807, *as amended*, c. 275, § 104(i), 65 Stat. 136 (1951), 50 U.S.C. App. § 2105(a) (1952 ed.), and Defense Production Act of 1950, § 405(b), 64 Stat. 807, 50 U.S.C. App. § 2105(b) (1952 ed.) (general authority in President to prescribe extent to which payments violating price and wage regulations should be disregarded by government agencies, including the Internal Revenue Service; *see* Rev. Rul. 56-180). *Cf.* § 1.162-1(a), which provides that "Penalty payments with respect to Federal taxes, whether on account of negligence, delinquency, or fraud, are not deductible from gross income;" Joint Committee on Internal Revenue Taxation, Staff Study of Income Tax Treatment of Treble Damage Payments under the Antitrust Laws, Nov. 1, 1965, p. 16 (proposal that § 162 be amended to deny deductions for certain fines, penalties, treble damage payments, bribes, and kickbacks).

circumstances that the Court has countenanced exceptions to the general principle reflected in the *Sullivan*, *Lilly*, and *Heininger* decisions. Only where the allowance of a deduction would “frustrate sharply defined national or state policies proscribing particular types of conduct” have we upheld its disallowance. *Commissioner v. Heininger*, 320 U.S. at 473. Further, the “policies frustrated must be national or state policies evidenced by some governmental declaration of them.” *Lilly v. Commissioner*, 343 U.S. at 97. (Emphasis added.) Finally, the “test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.” *Tank Truck Rentals v. Commissioner*, 356 U.S. 30, 35. In that case, as in *Hoover Motor Express Co. v. United States*, 356 U.S. 38, we upheld the disallowance of deductions claimed by taxpayers for fines and penalties imposed upon them for violating state penal statutes; to allow a deduction in those circumstances would have directly and substantially diluted the actual punishment imposed.

The present case falls far outside that sharply limited and carefully defined category. No public policy is offended when a man faced with serious criminal charges employs a lawyer to help in his defense. That is not “proscribed conduct.” It is his constitutional right. *Chandler v. Fretag*, 348 U.S. 3. See *Gideon v. Wainwright*, 372 U.S. 335. In an adversary system of criminal justice, it is a basic of our public policy that a defendant in a criminal case have counsel to represent him.

Congress has authorized the imposition of severe punishment upon those found guilty of the serious criminal offenses with which the respondent was charged and of which he was convicted. But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed.<sup>130</sup> To deny a deduction for expenses incurred in the

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<sup>130</sup> Cf. Paul, The Use of Public Policy by the Commissioner in Disallowing Deductions, 1954 SO. CALIF. TAX INST. 715, 730-731: “... Section 23(a)(1)(A) [the predecessor of § 162(a)] is not an essay in morality, designed to encourage virtue and discourage sin. It ‘was not contrived as an arm of the law to enforce State criminal statutes. ...’ Nor was it contrived to implement the various regulatory statutes which Congress has from time to time enacted. The provision is more modestly concerned with ‘commercial net income’ – a businessman’s net accretion in wealth during the taxable year after due allowance for the operating costs of the business. ... There is no evidence in the Section of an attempt to punish taxpayers ... when the Commissioner feels that a state or federal statute has been flouted. The statute hardly operates ‘in a vacuum’ if it serves its own vital function and leaves other problems to other statutes.”

unsuccessful defense of a criminal prosecution would impose such a burden in a measure dependent not on the seriousness of the offense or the actual sentence imposed by the court, but on the cost of the defense and the defendant's particular tax bracket. We decline to distort the income tax laws to serve a purpose for which they were neither intended nor designed by Congress.

The judgment is

Affirmed.

*Deductibility of Legal Expenses:* In both *Woodward, supra*, and *Tellier*, the Court cited *United States v. Gilmore*, 372 U.S. 39 (1963). In *Gilmore*, taxpayer and his wife cross-claimed for divorce. Taxpayer owned controlling stock interests in three corporations, each of which owned a General Motors dealership. He received a substantial income from these corporations. His wife made sensational allegations, and had she prevailed, she could receive more than half the stock and/or GM would terminate the corporations' franchises. Fearing such consequences of losing, taxpayer spent large sums to fight his wife's allegation and prevailed. Taxpayer sought to deduct his legal expenses attributable to resistance of his wife's claims under § 212. The Commissioner argued that such expenses were personal or family expenses. The court of claims allocated 20% of the fees to the divorce and 80% to the conservation of property. The CIR argued that deductibility under either § 162 or § 212 turned "not upon the consequences to [taxpayer] of a failure to defeat his wife's community property claims, but upon the origin and nature of the claims themselves." The Court agreed: "[T]he characterization as 'business' or 'personal,' of the litigation costs of resisting a claim depends on whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim[.]" The Court stated its "origin of the claim" test thus: "[T]he origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer is the controlling basic test of whether the expense was 'business' or 'personal[.]'" None of taxpayer's legal expenses were deductible. "It is enough to say that ... the wife's claims stemmed entirely from the marital relationship, and not, under any tenable view of things, from income-producing activity."

### *Notes and Questions:*

1. Why should the standard of "necessary" under § 162 be a minimal one, i.e., appropriate and helpful? Are there forces other than the rules of § 162 that will provide controls on the amounts that a taxpayer spends to further his/her/its business?

- Recall the statement in *Welch v. Helvering*: Taxpayer "certainly thought [payments to creditors of a bankrupt corporation were necessary], and we should be slow to override his judgment."

2. The income tax is a tax only on net income. One significant exception to this – explicitly stated in the Code – is § 280E. The expenses of carrying on the trade or business of trafficking in controlled substances are not deductible.

- In *Alpenglow Botanicals, LLC v. United States*, 894 F.3d 1187, 1199-202 (CA10 2018), *cert. denied*, 139 S. Ct. 2745 (2019), the court held that Congress could consistent with the Sixteenth Amendment, deny taxpayers deductions for the trade or business expenses of trafficking in marijuana – even though the sale of marijuana is lawful in 28 states.

- The disallowance of deductions extends to deductions for depreciation and charitable contributions. *See San Jose Wellness v. Commissioner*, 156 T.C. 62 (2021).

3. What norms does a refusal to incorporate public policy into the Code further?

- A refusal to incorporate public policy into the Code hardly means that there is no public policy limitation on deductibility under § 162. Rather, those limitations must be explicitly stated in the statute itself.

- See Court’s discussion of the point and its third footnote.

- Note the topics covered in §§ 162(b, c, e, f, g, k, l, and m).

4. The term “ordinary” has a relatively special meaning as used in § 162. What is it?

5. In *Tellier*, taxpayer was a criminal. He nevertheless could deduct the “ordinary and necessary” trade or business expenses arising from this character flaw.

- Should taxpayer be permitted to deduct the ordinary and necessary expenses associated with mental “flaws?” Is *Gilliam* distinguishable from *Tellier*?



**Gilliam v. Commissioner**, 51 T.C. Memo. 515 (1986), *available at* 1986 WL 21482.

## MEMORANDUM FINDINGS OF FACT AND OPINION

CHABOT, JUDGE:

### FINDINGS OF FACT

....

[Taxpayer] Gilliam is, and was at all material periods, a noted artist. His works have been exhibited in numerous art galleries throughout the United States and Europe ... In addition, Gilliam is, and was at all material periods, a teacher of art. On occasion, Gilliam lectured and taught art at various institutions.

Gilliam accepted an invitation to lecture and teach for a week at the Memphis Academy of Arts in Memphis, Tennessee. On Sunday, February 23, 1975, he flew to Memphis to fulfill this business obligation.

Gilliam had a history of hospitalizations for mental and emotional disturbances and continued to be under psychiatric care until the time of his trip to Memphis. In December 1963, Gilliam was hospitalized in Louisville; Gilliam had anxieties about his work as an artist. For periods of time in both 1965 and 1966, Gilliam suffered from depression and was unable to work. In 1970, Gilliam was again hospitalized. In 1973, while Gilliam was a visiting artist at a number of university campuses in California, he found it necessary to consult an airport physician; however, when he returned to Washington, D.C., Gilliam did not require hospitalization.

Before his Memphis trip, Gilliam created a 225-foot painting for the Thirty-fourth Biennial Exhibition of American Painting at the Corcoran Gallery of Art (hereinafter sometimes referred to as ‘the Exhibition’). The Exhibition opened on Friday evening, February 21, 1975. In addition, Gilliam was in the process of preparing a giant mural for an outside wall of the Philadelphia Museum of Art for the 1975 Spring Festival in Philadelphia. The budget plans for this mural were due on Monday, February 24, 1975.

On the night before his Memphis trip, Gilliam felt anxious and unable to rest. On

Sunday morning, Gilliam contacted Ranville Clark (hereinafter sometimes referred to as ‘Clark’), a doctor Gilliam had been consulting intermittently over the years, and asked Clark to prescribe some medication to relieve his anxiety. Clark arranged for Gilliam to pick up a prescription of the drug Dalmane on the way to the airport. Gilliam had taken medication frequently during the preceding 10 years. Clark had never before prescribed Dalmane for Gilliam.

On Sunday, February 23, 1975, Gilliam got the prescription and at about 3:25 p.m., he boarded American Airlines flight 395 at Washington National Airport, Washington, D.C., bound for Memphis. Gilliam occupied a window seat. He took the Dalmane for the first time shortly after boarding the airplane.

About one and one-half hours after the airplane departed Washington National Airport, Gilliam began to act in an irrational manner. He talked of bizarre events and had difficulty in speaking. According to some witnesses, he appeared to be airsick and held his head. Gilliam began to feel trapped, anxious, disoriented, and very agitated. Gilliam said that the plane was going to crash and that he wanted a life raft. Gilliam entered the aisle and, while going from one end of the airplane to the other, he tried to exit from three different doors. Then Gilliam struck Seiji Nakamura (hereinafter sometimes referred to as ‘Nakamura’), another passenger, several times with a telephone receiver. Nakamura was seated toward the rear of the airplane, near one of the exits. Gilliam also threatened the navigator and a stewardess, called for help, and cried. As a result of the attack, Nakamura sustained a one-inch laceration above his left eyebrow which required four sutures. Nakamura also suffered ecchymosis of the left arm and pains in his left wrist. Nakamura was treated for these injuries at Methodist Hospital in Memphis.

On arriving in Memphis, Gilliam was arrested by Federal officials. On March 10, 1975, Gilliam was indicted. He was brought to trial in the United States District Court for the Western District of Tennessee, Western Division, on one count of violation of 49 U.S.C. § 1472(k) (relating to certain crimes aboard an aircraft in flight) and two counts of violation 49 U.S.C. § 1472(j) (relating to interference with flight crew members or flight attendants). Gilliam entered a plea of not guilty to the criminal charges. ... After Gilliam presented all of his evidence, the district court granted Gilliam’s motion for a judgment of acquittal by reason of temporary insanity.

Petitioners paid \$8250 and \$8600 for legal fees in 1975 and 1976, respectively, in connection with both the criminal trial and Nakamura’s civil claim. In 1975,

petitioners also paid \$3800 to Nakamura in settlement of the civil claim.

Petitioners claimed deductions for the amounts paid in 1975 and 1976 on the appropriate individual income tax returns. Respondent disallowed the amounts claimed in both years attributable to the incident on the airplane. [footnote omitted].

\* \* \*

Gilliam's trip to Memphis was a trip in furtherance of his trades or businesses.

....

## OPINION

Petitioners contend that they are entitled to deduct the amounts paid in defense of the criminal prosecution and in settlement of the related civil claim under § 162. [footnote omitted]. Petitioners maintain that the instant case is directly controlled by our decision in *Dancer v. Commissioner*, 73 T.C. 1103 (1980). According to petitioners, '[t]he clear holding of *Dancer* is \*\*\* that expenses for litigation arising out of an accident which occurs during a business trip are deductible as ordinary and necessary business expenses.' Petitioners also contend that *Clark v. Commissioner*, 30 T.C. 1330 (1958), is to the same effect as *Dancer*.

Respondent maintains that *Dancer* and *Clark* are distinguishable. Respondent contends that the legal fees paid are not deductible under either § 162 or § 212 because the criminal charges against Gilliam were neither directly connected with nor proximately resulted from his trade or business and the legal fees were not paid for the production of income. Respondent maintains that 'the criminal charges which arose as a result of \*\*\* (the incident on the airplane), could hardly be deemed 'ordinary,' given the nature of (Gilliam's) profession.' Respondent contends 'that the provisions of § 262 control this situation.' As to the settlement of the related civil claim, respondent asserts that since Gilliam committed an intentional tort, the settlement of the civil claim constitutes a nondeductible personal expense.

We agree with respondent that the expenses are not ordinary expenses of Gilliam's trade or business.

Section 162(a) [footnote omitted] allows a deduction for all the ordinary and necessary expenses of carrying on a trade or business. In order for the expense to

be deductible by a taxpayer, it must be an ordinary expense, it must be a necessary expense, and it must be an expense of carrying on the taxpayer's trade or business. If any one of these requirements is not met, the expense is not deductible under § 162(a). *Deputy v. du Pont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933); *Kornhauser v. United States*, 276 U.S. 145 (1928). In *Deputy v. du Pont*, the Supreme Court set forth a guide for application of the statutory requirement that the expense be 'ordinary', as follows (308 U.S. at 494-497):

[...] Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happens but once in the taxpayer's lifetime. Cf. *Kornhauser v. United States*, *supra*. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. *Welch v. Helvering*, *supra*, 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under [§ 162(a)] does not necessarily make it such in connection with another business. \*\*\* As stated in *Welch v. Helvering*, *supra*, pp. 113-114: '... What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance.' 22 F. Supp. 589, 597.

One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.

Review of the many decided cases is of little aid since each turns on its special facts. But the principle is clear. [...] [T]he fact that the payments might have been necessary ... is of no aid. For Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary. *Welch v. Helvering*, *supra*.

... It undoubtedly is ordinary for people in Gilliam's trades or businesses to travel (and to travel by air) in the course of such trades or businesses; however, we do not believe it is ordinary for people in such trades or businesses to be involved in altercations of the sort here involved in the course of any such travel. The travel was not itself the conduct of Gilliam's trades or businesses. Also, the expenses here involved are not strictly a cost of Gilliam's transportation. Finally, it is obvious that

neither the altercation nor the expenses were undertaken to further Gilliam's trades or businesses.

We conclude that Gilliam's expenses are not ordinary expenses of his trades or businesses.

It is instructive to compare the instant case with *Dancer v. Commissioner*, *supra*, upon which petitioners rely. In both cases, the taxpayer was traveling on business. In both cases, the expenses in dispute were not the cost of the traveling, but rather were the cost of an untoward incident that occurred in the course of the trip. In both cases, the incident did not facilitate the trip or otherwise assist the taxpayer's trade or business. In both cases, the taxpayer was responsible for the incident; in neither case was the taxpayer willful. In *Dancer*, the taxpayer was driving an automobile; he caused an accident which resulted in injuries to a child. The relevant expenses were the taxpayer's payments to settle the civil claims arising from the accident. 73 T.C. at 1105. In the instant case, Gilliam was a passenger in an airplane; he apparently committed acts which would have been criminal but for his temporary insanity, and he injured a fellow passenger. Gilliam's expenses were the costs of his successful legal defense, and his payments to settle Nakamura's civil claim.

In *Dancer*, we stated as follows (73 T.C. at 1108-1109):

It is true that the expenditure in the instant case did not further petitioner's business in any economic sense; nor is it, we hope, the type of expenditure that many businesses are called upon to pay. Nevertheless, neither factor lessens the direct relationship between the expenditure and the business. Automobile travel by petitioner was an integral part of this business. *As rising insurance rates suggest, the cost of fuel and routine servicing are not the only costs one can expect in operating a car. As unfortunate as it may be, lapses by drivers seem to be an inseparable incident of driving a car. Anderson v. Commissioner* (81 F.2d 457 (CA10 1936)). Costs incurred as a result of such an incident are just as much a part of overall business expenses as the cost of fuel. (Emphasis supplied.)

*Dancer* is distinguishable.

In *Clark v. Commissioner*, *supra*, also relied on by petitioners, the expenses consisted of payments of (a) legal fees in defense of a criminal prosecution and (b) amounts to settle a related civil claim. In this regard, the instant case is similar to

*Clark*. In *Clark*, however, the taxpayer's activities that gave rise to the prosecution and civil claim were activities directly in the conduct of Clark's trade or business. In the instant case, Gilliam's activities were not directly in the conduct of his trades or businesses. Rather, the activities merely occurred in the course of transportation connected with Gilliam's trades or businesses. And, as we noted in *Dancer v. Commissioner*, 73 T.C. at 1106, 'in cases like this, where the cost is an adjunct of and not a direct cost of transporting an individual, we have not felt obliged to routinely allow the expenditure as a transportation cost deduction.'

Petitioners also rely on *Commissioner v. Tellier*, 383 U.S. 687 (1966), in which the taxpayer was allowed to deduct the cost of an unsuccessful criminal defense to securities fraud charges. The activities that gave rise to the criminal prosecution in *Tellier* were activities directly in the conduct of Tellier's trade or business. Our analysis of the effect of *Clark v. Commissioner*, applies equally to the effect of *Commissioner v. Tellier*.

In sum, Gilliam's expenses were of a kind similar to those of the taxpayers in *Tellier* and *Clark*; however the activities giving rise to Gilliam's expenses were not activities directly in the conduct of his trades or businesses, while Tellier's and Clark's activities were directly in the conduct of their respective trades or businesses. Gilliam's expenses were related to his trades or businesses in a manner similar to those of the taxpayer in *Dancer*; however Gilliam's actions giving rise to the expenses were not shown to be ordinary, while Dancer's were shown to be ordinary. *Tellier*, *Clark*, and *Dancer* all have similarities to the instant case; however, *Tellier*, *Clark*, and *Dancer* are distinguishable in important respects. The expenses are not deductible under § 162(a). [footnote omitted].

We hold for respondent.

*Notes and Questions:*

1. Were the expenses incurred by taxpayer “necessary?”

2. By what means did the court in fact implement a public policy limitation on taxpayer’s trade or business expense? Why were the deductions that taxpayer claimed denied?

*If not “ordinary” ...:* In *Welch*, the opposite of an “ordinary” expense was a capital expense. What is the opposite of “ordinary” in *Gilliam*?

- because they were “extraordinary” for taxpayer’s trade or business?
  - If so, are there trades or businesses in which such expenditures would not be extraordinary?
  - What if airline employees hit taxpayer in order to control him and incurred legal expenses and paid tort damages? Should their expenses be deductible? These expenses would be the very type of expenses that Gilliam could not deduct.

3. Even when taxpayer incurs ordinary and necessary trade or business expenses, taxpayer might not be entitled to deduct them.

4. *Who was Sam Gilliam?* Sam Gilliam was a noted African American artist who was born in Tupelo, Mississippi and grew up in Louisville, Kentucky. After receiving his master’s degree in painting from the University of Louisville in 1961, he accepted a teaching position in Washington, D.C. at McKinley Technical High School. He was a natural teacher who kept his door open to students and artists. However, Gilliam also had an occasional explosive outbursts, attributed to a bipolar disorder. Shortly after moving to Washington, D.C., his career took off. He became known as the father of draped canvasses because he was the first to drape a painted canvas without use of a frame. He received countless private and public commissions for his unique work. He experimented with geometric collages in different shades of black, quilted paintings, and textured paintings that incorporated metal forms. In May 2022, Gilliam displayed a series of colorful tondo, or circular, paintings with beveled edges at the Hirshhorn Museum and Sculpture Garden in Washington, D.C. This was his last exhibition before he died on June 25, 2022. See, e.g., Michael O’Sullivan, *Sam Gilliam, abstract artist who went beyond the frame, dies at 88*, WASHINGTON POST (June 27, 2022), <https://washingtonpost.com/obituaries/2022/06/27/artist-sam-gilliam-dies/>; *Sam Gilliam*, WIKIPEDIA.

*Note:* Congress has determined that it is not appropriate for taxpayers to benefit from making certain types of expenditures or from making expenditures for certain purposes. The denial (or limitation<sup>131</sup>) may extend to the expenditure itself – not merely to the statutory basis of the deduction – whether trade or business, or something else. Some of these provisions are the following:

- Section 265 provides that no deduction is allowed for the expenses allocable to tax exempt income. § 265(a)(1). The same is true of interest expenses incurred to purchase or carry obligations on which interest is “wholly exempt” from income taxes. § 265(a)(2).

- The Paycheck Protection Program (PPP) made loans available to employers to help them retain their employees during COVID lockdowns. So long as employers used these funds for approved purposes, the loans would be forgiven *and* the resulting debt not included in taxpayer-employer’s gross income. In Rev. Rul. 2020-32, 2020-21 I.R.B. 837 and Rev. Rul. 2020-27, 2020-50 I.R.B. 1552, the IRS announced that employers could not deduct expenses funded by such loans.

- Congress stepped in to reverse this position in 2021. In Rev. Rul. 2021-2, 2021-4 I.R.B. 495, the IRS (of course) acceded to this position. *See* Consolidated Appropriations Act, 2021, P.L. 116-260.

- Obviously a deviation from normal tax principles was necessary to pursue bigger objectives.

- Section 274(a):* A taxpayer may not deduct the expenses of entertainment, facilities for entertainment,<sup>132</sup> club dues, or providing an employee a “qualified transportation fringe.” There are exceptions. *See* § 274(e)(4, 5, 6).

- Section 274 does not preclude deduction of 50% of the expense of *food and beverage* during or at entertainment events if purchased separately, provided their cost is separately stated. Reg. § 1.274-11(b)(1)(ii) (definition of “food or beverage”).

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<sup>131</sup> We have already encountered § 274(b), which limits deductions under § 162 or § 212 for expenditures on gifts to \$25.

<sup>132</sup> This limit on deductions does not extend to expenses for food and beverages and facilities for entertainment on the employer’s premises primarily for taxpayer’s employees. § 274(e)(1).



- Section 274(c)*: Section 274(c) limits deductions under §§ 162/212 of “travel expenses” for foreign travel if such expenses are not “allocable” to taxpayer’s trade or business activity engaged in for profit. This “allocation limitation applies if such travel exceeds one week or the time spent pursuing trade or business or profit-making activity is not 75% or more of the total time of such travel.

- Section 274(h)*: Section 274(h) limits deductions as a trade or business expense for expenditures made to attend a convention, seminar, or similar meeting outside of North America. Section 274(h)(2) drastically curtails deductions for such expenditures for attending a convention, seminar, or similar meeting aboard a cruise ship. Section 274(h)(7) denies deductibility of such expense altogether under § 212.

- Section 274(j)*: Section 274(j) limits deduction for employee achievement awards.

- Section 274(m)*: Section 274(m)(1) limits deductions for transportation by water. Section 274(m)(2) denies any deduction for expenses of travel as a form of education.

- Section 274(n)*: Section 274(n)(1) restricts the deductibility of food and beverage expenses to 50% of the amount of the expense.

CCA, Taxpayer Certainty and Disaster Tax Relief Act of 2020, § 210, added § 274(n)(2)(D) which provides that 100% of the cost of business meals furnished in a restaurant is deductible through December 31, 2022.

- Section 274(o)*: Section 274(o) will, beginning January 1, 2026, deny employer deductions for the expenses of providing meals for its convenience (*see* § 119) or for operating an eating facility whose benefit is a de

minimis fringe for its employees (*see* § 132(e)(2)).

- Section 276*: Section 276 denies any deduction for expenditures made to benefit directly or indirectly a political party or political candidate.

- Section 279*: Section 279 limits the deduction for interest paid “by a corporation” to make a corporate acquisition to \$5M.

- Section 280A*: Section 280A limits deductions for business use of a dwelling unit that taxpayer (individual or S corporation) uses as a residence. Section 280A(a) provides taxpayer is entitled to *no deduction for such use* “[e]xcept as otherwise provided in” § 280A itself. Section 280A(c) provides those exceptions.

- Section 280A(c)(1) permits deductions when taxpayer regularly uses a portion of the dwelling “exclusively” –

- as a principal place of business, including a place that taxpayer uses for administrative or management activities of taxpayer's trade or business, and there is no other fixed location where taxpayer conducts substantial management or administrative activities,
- as a place of business that patients, clients, or customers use to meet with taxpayer "in the normal course of his trade or business," OR
- in connection with taxpayer's trade or business "in the case of a separate structure which is not attached to the dwelling unit."
- Section 280A(c)(2) permits deductions when taxpayer regularly uses space in the dwelling unit to store inventory or product samples that taxpayer sells at retail or wholesale, provided the dwelling unit is the only fixed location of taxpayer's trade or business.
- Section 280A(c)(3) permits deductions when they are attributable to rental of the dwelling unit.
- Section 280A(c)(4) permits deductions attributable to use of a portion of the dwelling unit for licensed child or dependent care services.

Section 280A(c)(5) limits the amount of any deductions attributable to business use of the home to the gross income that taxpayer derives from such use. § 280A(c)(5)(A). Section 280A(c)(5) and Prop. Reg. § 1-280A-2(i)(5) provide a sequence in which taxpayer may claim deductions attributable to the business activity, namely –

1. deductions attributable to such trade or business and allocable to the portion of the dwelling unit that taxpayer uses that the Code would allow taxpayer even if he did not conduct a trade or business in the dwelling unit, e.g., real property taxes, § 164(a)(1), mortgage interest, § 163(h)(2)(D).
2. deductions attributable to such trade or business use that do not reduce basis, e.g., utilities, homeowners' insurance.
3. basis-reducing deductions, i.e., depreciation.

If taxpayer's deductions exceed his gross income derived from the business use of the dwelling unit that he uses as a home, taxpayer may carry those deductions forward to succeeding years.

- Notice that unless taxpayer operates a trade or business in the home

that is genuine, in the sense that it is profitable, it is unlikely that taxpayer will ever be able to exploit all the deductions that business use of a home would generate. A taxpayer who does not carry on a profitable trade or business in the home will likely carry forward unused deductions forever.

- Notice also that the sequence of deductions that § 280A(c)(5) and Prop. Reg. § 1.280A-2(i)(5) mandate requires taxpayer first to “use up” the deductions to which he would be entitled even if he did not use his dwelling unit for business activities.

- The deductions that might motivate taxpayer to claim business use of a home are the ones to which he would not otherwise be entitled to claim, e.g., a portion of homeowners’ insurance, utilities, other expenses of home ownership, and (perhaps most importantly) depreciation. Those deductions may be effectively out of reach.

- Section 280B*: Taxpayer must capitalize – not deduct – the cost of demolishing any structure.

- Section 280E*: Taxpayer may not claim a deduction or credit for any amount paid to carry on the trade or business of trafficking in controlled substances.

- Section 280G*: Section 280G(a) denies any deduction for “any excess parachute payment” (“golden parachute payment”). This is the amount by which such a parachute payment exceeds a “base amount,” i.e., an individual’s annualized taxable compensation. A “parachute payment” is a payment made to a person who performs services for the corporation and who is an officer, shareholder, or highly compensated individual when the payment is contingent on a change in ownership or control of the corporation of its assets that exceeds three times the base amount. Thus, a payment to any of “disqualified individuals” is a “parachute payment” only if it exceeds three times the “base amount.” But if a payment is a “parachute payment,” *all* of the excess of that payment over the base amount is not deductible.



Do the CALI Lesson, *Basic Federal Income Taxation: Reasonable Compensation, Miscellaneous Business Deductions, and Business Losses*

**Moss v. Commissioner**, 758 F.2d 211 (7<sup>th</sup> Cir. 1985)

POSNER, Circuit Judge

The taxpayers, a lawyer named Moss and his wife, appeal from a decision of the Tax Court disallowing federal income tax deductions of a little more than \$1,000 in each of two years, representing Moss's share of his law firm's lunch expense at the Café Angelo in Chicago. ...

Moss was a partner in a small trial firm specializing in defense work, mostly for one insurance company. Each of the firm's lawyers carried a tremendous litigation caseload, averaging more than 300 cases, and spent most of every working day in courts in Chicago and its suburbs. The members of the firm met for lunch daily at the Café Angelo near their office. At lunch the lawyers would discuss their cases with the head of the firm, whose approval was required for most settlements, and they would decide which lawyer would meet which court call that afternoon or the next morning. Lunchtime was chosen for the daily meeting because the courts were in recess then. The alternatives were to meet at 7:00 a.m. or 6:00 p.m., and these were less convenient times. There is no suggestion that the lawyers dawdled over lunch, or that the Café Angelo is luxurious.

The framework of statutes and regulations for deciding this case is simple, but not clear. Section 262 of the Internal Revenue Code disallows, "except as otherwise expressly provided in this chapter," the deduction of "personal, family, or living expenses." Section 119 excludes from income the value of meals provided by an employer to his employees for his convenience, but only if they are provided on the employer's premises; and § 162(a) allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including – ... (2) traveling expenses (including amounts expended for meals ...) while away from home...." Since Moss was not an employee but a partner in a partnership not taxed as an entity, since the meals were not served on the employer's premises, and since he was not away from home (that is, on an overnight trip away from his place of work, *see United States v. Correll*, 389 U.S. 299 (1967)), neither § 119 nor § 162(a)(2) applies to this case. The Internal Revenue Service concedes, however, that meals are deductible under § 162(a) when they are ordinary and necessary business expenses (provided the expense is substantiated with adequate records, *see* § 274(d)) even if they are not within the express permission of any other provision and even though the expense of commuting to and from work, a traveling expense but not one incurred away from

home, is not deductible. Reg. § 1.262-1(b)(5); *Fausner v. Commissioner*, 413 U.S. 838 (1973) (per curiam).

The problem is that many expenses are simultaneously business expenses in the sense that they conduce to the production of business income and personal expenses in the sense that they raise personal welfare. This is plain enough with regard to lunch; most people would eat lunch even if they didn't work. Commuting may seem a pure business expense, but is not; it reflects the choice of where to live, as well as where to work. Read literally, § 262 would make irrelevant whether a business expense is also a personal expense; so long as it is ordinary and necessary in the taxpayer's business, thus bringing § 162(a) into play, an expense is (the statute seems to say) deductible from his income tax. But the statute has not been read literally. There is a natural reluctance, most clearly manifested in the regulation disallowing deduction of the expense of commuting, to lighten the tax burden of people who have the good fortune to interweave work with consumption. To allow a deduction for commuting would confer a windfall on people who live in the suburbs and commute to work in the cities; to allow a deduction for all business-related meals would confer a windfall on people who can arrange their work schedules so they do some of their work at lunch.

Although an argument can thus be made for disallowing any deduction for business meals, on the theory that people have to eat whether they work or not, the result would be excessive taxation of people who spend more money on business meals because they are business meals than they would spend on their meals if they were not working. Suppose a theatrical agent takes his clients out to lunch at the expensive restaurants that the clients demand. Of course he can deduct the expense of their meals, from which he derives no pleasure or sustenance, but can he also deduct the expense of his own? He can, because he cannot eat more cheaply; he cannot munch surreptitiously on a peanut butter and jelly sandwich brought from home while his client is wolfing down tournedos Rossini followed by 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. Commissioner*, 21 T.C. 170, 173 (1953).

Because the law allows this generous deduction, which tempts people to have more (and costlier) business meals than are necessary, the Internal Revenue Service has every right to insist that the meal be shown to be a real business necessity. This condition is most easily satisfied when a client or customer or supplier or other outsider to the business is a guest. Even if Sydney Smith was wrong that “soup and fish explain half the emotions of life,” it is undeniable that eating together fosters camaraderie and makes business dealings friendlier and easier. It thus reduces the costs of transacting business, for these costs include the frictions and the failures of communication that are produced by suspicion and mutual misunderstanding, by differences in tastes and manners, and by lack of rapport. A meeting with a client or customer in an office is therefore not a perfect substitute for a lunch with him in a restaurant. But it is different when all the participants in the meal are coworkers, as essentially was the case here (clients occasionally were invited to the firm’s daily luncheon, but Moss has made no attempt to identify the occasions). They know each other well already; they don’t need the social lubrication that a meal with an outsider provides – at least don’t need it daily. If a large firm had a monthly lunch to allow partners to get to know associates, the expense of the meal might well be necessary, and would be allowed by the Internal Revenue Service. *See Wells v. Commissioner*, 36 T.C.M. 1698, 1699 (1977), *aff’d without opinion*, 626 F.2d 868 (9th Cir. 1980). But Moss’s firm never had more than eight lawyers (partners and associates), and did not need a daily lunch to cement relationships among them.

It is all a matter of degree and circumstance (the expense of a testimonial dinner, for example, would be deductible on a morale-building rationale); and particularly of frequency. Daily – for a full year – is too often, perhaps even for entertainment of clients, as implied by *Hankenson v. Commissioner*, 47 T.C.M. 1567, 1569 (1984), where the Tax Court held nondeductible the cost of lunches consumed three or four days a week, 52 weeks a year, by a doctor who entertained other doctors who he hoped would refer patients to him, and other medical personnel.

We may assume it was necessary for Moss’s firm to meet daily to coordinate the work of the firm, and also, as the Tax Court found, that lunch was the most convenient time. But it does not follow that the expense of the lunch was a necessary business expense. The members of the firm had to eat somewhere, and

the Café Angelo was both convenient and not too expensive. They do not claim to have incurred a greater daily lunch expense than they would have incurred if there had been no lunch meetings. Although it saved time to combine lunch with work, the meal itself was not an organic part of the meeting, as in the examples we gave earlier where the business objective, to be fully achieved, required sharing a meal.

The case might be different if the location of the courts required the firm's members to eat each day either in a disagreeable restaurant, so that they derived less value from the meal than it cost them to buy it, *cf. Sibla v. Commissioner*, 611 F.2d 1260, 1262 (9th Cir. 1980); or in a restaurant too expensive for their personal tastes, so that, again, they would have gotten less value than the cash equivalent. But so far as appears, they picked the restaurant they liked most. Although it must be pretty monotonous to eat lunch the same place every working day of the year, not all the lawyers attended all the lunch meetings and there was nothing to stop the firm from meeting occasionally at another restaurant proximate to their office in downtown Chicago; there are hundreds.

An argument can be made that the price of lunch at the Café Angelo included rental of the space that the lawyers used for what was a meeting as well as a meal. There was evidence that the firm's conference room was otherwise occupied throughout the working day, so as a matter of logic Moss might be able to claim a part of the price of lunch as an ordinary and necessary expense for work space. But this is cutting things awfully fine; in any event Moss made no effort to apportion his lunch expense in this way.

AFFIRMED.

### *Notes and Questions:*

1. What requirement of deductibility under § 162 did taxpayer Moss fail to meet?
2. If this firm had only monthly lunches, the court seems to say that the cost of such lunches might have been deductible. Why should such meals be treated differently than the daily lunches at Café Angelo?





Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Trade or Business Deductions*.

### 3. Education Expenses



Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Education Expenses*.

- Read Reg. § 1.162-5.
- Read §§ 274(m)(2), 274(n).

A taxpayer may incur expenses for various educational activities, e.g., training, that he may deduct as ordinary and necessary business expenses. Recall that in *Welch v. Helvering*, the Court indicated that investment in one's basic education is a nondeductible investment in human capital. Not surprisingly, then, the regulations draw lines around education undertaken to meet the minimum requirements of a trade or business or to qualify for a new trade or business. Reg. § 1.162-5 implements these distinctions.

Reg. § 1.162-5(a) states the general rule that expenditures made for education are deductible, even when those expenditures may lead to a degree, if the education –

“(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship status, or rate of compensation.”

*Id.* However, *even expenditures that meet one of these two conditions* are not deductible if –

- the expenditures are “made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. ... The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for



qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.” Reg. § 1.162-5(b)(2)(i). OR

- the expenditures are “made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business.” Reg. § 1.162-5(b)(3)(i).

Consider:

Pere Alegal works for a downtown Memphis law firm. He works under the supervision of attorneys and does the same type of work that the firm’s attorneys do. The firm’s partners advise Alegal that if he does not obtain a law license, he will not be retained. Alegal therefore enrolled in one of the nation’s best-value law schools. Pere will continue to work for the firm. Alegal incurs the expenses of tuition, books, etc. At the end of the educational program, Alegal passed the bar examination and obtained a license to practice law. Alegal continues to work for the firm and in fact his job functions did not change at all.

- If Alegal sought to deduct the expenses of his legal education, could he argue that his job functions did not change at all once he obtained his law license?
- Is it relevant that a law license did not cause Alegal to take up a new trade or business?

#### 4. Home Mortgage, Investment, and Business Interest: § 163

Section 163(a) provides that interest on indebtedness paid or accrued is deductible.

*Interest on mortgage paid or accrued to acquire a personal residence:* The deduction allowed by § 163(a) for interest paid or accrued does not extend to “personal interest,” with some exceptions. § 163(h). The most significant of these exceptions is for interest paid or accrued to acquire a “qualified personal residence.” §§ 163(h)(2)(D), 163(h)(3)(A)(i). A “qualified personal residence” is the “principal residence” of the taxpayer plus one other residence of the taxpayer used as a residence, §§ 163(h)(4)(A), i.e., a dwelling that taxpayer uses during the taxable year as a residence for the greater of 14 days or 10% of the number of days for which the unit is rented, § 163(h)(4)(A)(i), *cross-referencing* § 280A(d)(1).

A dwelling that taxpayer does not rent out at all during the taxable year but which he uses for 14 days during the year counts as a “residence.” § 163(h)(4)(A)(iii). The residence must secure the indebtedness. § 163(h)(3)(B)(i)(II). In the event a taxpayer refinances acquisition indebtedness, the deduction is limited to the interest paid or accrued on the amount refinanced. § 163(h)(3)(B)(i).

The Tax Cuts and Jobs Act limits this deduction to interest paid or accrued on up to \$750,000 until 2026. §§ 163(h)(3)(B), 163(h)(3)(F)(i)(II). At that time, the limit reverts to \$1,000,000. §§ 163(h)(3)(b)(ii), 163(h)(3)(F). Sections 163(h)(3)(A)(ii) and 163(h)(3)(C) also permit a taxpayer to deduct interest paid or accrued on up to \$100,000 of “home equity indebtedness,” but the Tax Cuts and Jobs Act suspended this deduction until 2026. § 163(h)(3)(F)(i)(I).

*Investment interest:* An individual taxpayer may deduct “investment interest” only to the extent of his “net investment income.” § 163(d)(1). Taxpayer may carry forward excess interest paid or accrued to the succeeding year. § 163(d)(2). “Investment interest” is interest paid or accrued on “indebtedness properly allocable to property held for investment.” § 163(d)(3)(A). “Net investment income” is “investment income” minus “investment expenses.” § 163(d)(4)(A). “Investment income” is gross income from property taxpayer holds for investment (e.g., dividends, capital gains, § 163(h)(5)(A)(i), *cross-referencing* § 469(e)(1)), plus gain derived from disposition of property held for investment, minus “net capital gain” computed by taking into account only gains and losses from disposition of property held for investment, plus only so much of the “net capital gain” taxpayer wishes to take into account for this purpose. § 163(d)(4)(B). An individual’s tax liability depends on the tax rate applicable to various forms of income. “Adjusted net capital gain” includes “qualified dividends” and is subject to tax rates of 0%, 15%, or 20% – depending on the amount of a taxpayer’s “taxable income.” These rates are lower than the tax rates imposed on an individual’s “ordinary income.” If taxpayer elects to take net capital into account for purposes of computing his investment interest deduction (taken against ordinary income), he loses the benefit of the lower capital gains rates otherwise applicable to qualified dividends. 1(h)(D)(i). The Code cautions that investment income and expenses do not include the income and expenses of “passive activities.” § 163(d)(4)(D) (such expenses taken into account under § 469).

*Business interest:* Small businesses, i.e., those whose average gross receipts do not exceed \$25M over the three-year period ending in the taxable year that precedes the taxable year in which interest is paid or accrued, may deduct all of the “business

interest” paid or accrued. § 163(j)(3), *cross-referencing* § 448(c). The Tax Cuts and Jobs Act reconfigured the limits on the deductibility of business interest that other taxpayers pay or accrue. Such taxpayers may not deduct more than the business income of the taxpayer, plus 30% of their “adjusted taxable income,” plus their “floor plan financing interest.” § 163(j)(1). Excess interest not allowed as a deduction may be carried forward to the succeeding year. § 163(j)(2). “Business interest” and “business interest income” are interest paid or accrued or includible in taxpayer’s gross income that is properly allocable to a trade or business – with some exceptions. §§ 163(j)(5, 6, 7). “Adjusted taxable income” is taxable income computed without regard to a net operating loss deduction (§ 172) or “qualified business income” deduction (§ 199A). Prior to 2022, “adjusted taxable income” was computed without regard to any allowable deduction for depreciation, amortization, or depletion. § 163(j)(8)(v). Computation of “adjusted taxable income” that takes account of depreciation, amortization, or depletion will reduce the allowable amount of a taxpayer’s business interest deduction. “Floor plan financing interest” is the interest paid or accrued to finance the acquisition of motor vehicles held for sale or lease where the inventory secures the financing. § 163(j)(9).

## 5. Section 172<sup>133</sup>

The costs of earning taxable income are offset against that income. Ours is a system that generally taxes only “net income.” The Tax Code requires an annual accounting of income and deductible expenses. A taxpayer’s income may fluctuate between losses and profitability from one year to the next. This could raise serious problems of fairness if losses cannot offset gross income. Section 172 permits some netting of business gains and losses between different tax years by permitting taxpayer to deduct net operating losses incurred in one tax year against his taxable income in a succeeding tax year.

- Read § 172(c). It defines a “net operating loss” (NOL) to be the excess of deductions allowed over gross income.

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<sup>133</sup> The Tax Cuts and Jobs Act curtailed the immediate availability of NOLs to reduce a taxpayer’s taxable income. Previously, all taxpayers could carry back an NOL two years, and in some cases five years. Also, there was no 80% of taxable income cap on the taxpayer’s NOL deduction.

•Read § 172(d). Its effect is to limit the deductions that would “take taxpayer’s taxable income negative” to essentially trade or business expenses.<sup>134</sup> For individual taxpayers, capital losses are deductible only to the extent of capital gains, § 172(d)(2)(A); no deduction is allowed for personal exemptions, § 172(d)(3); nonbusiness deductions are allowed only to the extent of taxpayer’s non-trade or business income, § 172(d)(4); the § 199A qualified business income deduction is not allowed, § 172(d)(8).

CARES Act, § 2303 amended § 172 to provide that net losses incurred in 2018, 2019, and 2020 could be carried back five years except for losses incurred by real estate investment trusts. This will enable businesses that suffer net operating losses during the pandemic to claim refunds of income taxes paid during the prior five years.

Farmers may elect not to apply this 5-year carryback for losses arising in 2018, 2019, and 2020. CAA, Covid-Related Tax Relief Act of 2020, § 282.

•After 2020, § 172(a)(2) permits NOL carryovers and limited carrybacks to reduce taxpayer’s taxable income. Taxpayer may deduct the *lesser* of –

- net operating loss carryovers to the taxable year plus net operating loss carrybacks

- OR

- 80% of taxpayer’s taxable income computed without regard to the NOL deduction. § 172(a).

•Unused NOLs carry over indefinitely. § 172(b)(1)(A)(ii). Taxpayer must carry an NOL to the earliest taxable year to which it can be carried. § 170(b)(2).

- A taxpayer may carry back an NOL which is a farming loss to each of the two years preceding the year in which the loss was incurred. § 170(b)(1)(B)(i). The taxpayer may elect not to carry a farming loss back. § 170(b)(1)(B)(iv).<sup>135</sup>

- The effect of allowing a *carryback* is to get money into the pockets of the affected taxpayer(s) quickly.

<sup>134</sup> Section 461(j) disallows a deduction for “excess business losses of noncorporate taxpayers,” i.e., trade or business losses in excess of \$250,000 (or in excess of \$500,000 for taxpayers married filing jointly). The disallowed amount becomes an NOL the following tax year. See chapter 10-IV-D, *infra*.

<sup>135</sup> An insurance company other than a life insurance company (i.e., property and casualty insurance companies) must carry an NOL back two years. Its NOLs expire after twenty years. § 172(b)(1)(C).

Consider:

In 2021, taxpayer had net losses of \$500,000. Taxpayer is neither a farmer nor an insurance company. Determine taxpayer's taxable income under the rules of § 172 if taxpayer's taxable income would otherwise have been the following amounts for the years in question. Disregard § 461(l).

- 2021: \$100,000
- 2022: (\$500,000)
- 2023: \$50,000.
- 2024: \$75,000.
- 2025: \$120,000.
- 2026: \$165,000
- 2027: \$200,000
- 2028: \$100,000
- 2029: \$60,000

#### *D. Special Rules to Encourage Business Activity and Exploitation of Natural Resources*

##### 1. Section 199A: “Qualified Business Income” Deduction

In the Tax Cuts and Jobs Act, Congress repealed § 199, which had provided a deduction for a portion of a taxpayer's income derived from domestic production activities. In its place, Congress enacted § 199A.<sup>136</sup> Section 199A provides a deduction to certain taxpayers who derive income in a trade or business that they own until and through December 31, 2025. § 199A(i). The availability of the deduction depends on the amount of taxpayer's trade or business income and, at higher levels of such income, the specific types of those trades or businesses. The gist of § 199A is that non-C-corporation owners of trades or businesses may deduct (up to) 20% of their business income – thereby effectively paying income tax on as little as 80% of such income. The rules governing availability of the deduction become more exacting as the amount of a taxpayer's “taxable income” increases. As usual, definitions and conditions define the scope of a § 199A deduction.

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<sup>136</sup> The TCJA was signed into law on December 22, 2017. On March 23, 2018, Congress amended § 199A to provide a deduction from the income of certain agricultural or horticultural cooperatives. *See* § 199A(g). That deduction is beyond the scope of this introductory discussion.

Section 199A(a) states that a taxpayer may deduct the *lesser* of two amounts: (1) taxpayer's "combined qualified business income amount" (CQBIA), or (2) 20% of taxpayer's (taxable income<sup>137</sup> minus net capital gain<sup>138</sup>). § 199A(a). The "*combined qualified business income amount*" is itself a figure that is 20% of a larger amount. *See* § 199A(b)(1 and 2).

- The second of the two amounts named by § 199A(a) is fairly easily measured.
- Section 199A measures the first of the two amounts (CQBIA) more granularly.
- Once measured, § 199A(a) requires a comparison.
  - Observation: If a taxpayer has no income from a business that he owns, his "combined qualified business income amount" will be \$0. Obviously that amount will be the lesser of two figures. Thus, § 199A only helps taxpayers who own a trade or business.
- Defining the taxpayer's "combined qualified business income amount" requires us to dive into the middle of Section 199A and then to work our way back up.
  - Initially, note that a taxpayer's CQBIA is 20% of the sum of a taxpayer's "qualified business income" subject to conditions applicable to each "qualified trade or business," plus 20% of his [qualified REIT dividends income plus qualified publicly traded partnership income]. § 199A(b)(1).

**Taxpayers** who may avail themselves of this deduction may be sole proprietors or owners of "pass-through" entities or partnerships. "Pass-through" entities pay no income tax. Rather their income tax items (items of income, gain, deduction, and loss) "pass through" to the individual owners of the trade or business.<sup>139</sup>

- Taxpayers who are C corporations, § 199A(a), may *not* avail themselves

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<sup>137</sup> "Taxable income" is gross income minus allowable deductions, § 63(a), except for the deduction that § 199A itself allows. § 199A(e)(1).

<sup>138</sup> "Net capital gain" is a taxpayer's "net long-term capital gain" minus "net short-term capital loss." § 1222(11); *see* chapter 10, *infra*. For non-corporate taxpayers and for purposes of § 199A, § 1(h)(11) includes within *net capital gain* dividends paid by domestic corporations, dividends paid by corporations incorporated in a country with which the United States has a tax treaty, or dividends paid by foreign corporations whose stock is readily traded in an established securities market in the United States.

<sup>139</sup> *See* § 199A(f)(1)(A)(i) (§ 199A applies at the individual or S corporation shareholder level).

of a § 199A deduction. Performance of services as an “employee” is not a “qualified trade or business,”<sup>140</sup> § 199A(d)(1)(B).

**CQBIA and Qualified Business Income.** *Initially*, CQBIA includes 20% of a taxpayer’s “qualified business income.” “Qualified business income” (QBI)<sup>141</sup> is the net income taxpayer derives from the conduct of a “qualified trade or business” to the extent the income tax items are “effectively connected with the conduct of a trade or business within the United States ...” § 199A(c)(1); § 199A(c)(3)(A)(i). QBI does *not* include various items of investment income.<sup>142</sup> Net losses carry over to succeeding years. § 199A(c)(2).

- Section 199A defines “*qualified trade or business*” as any trade or business other than a “specified service trade or business” or the trade or business of performing services as an employee. § 199A(d)(1). BUT: the definition of “qualified trade or business” varies, depending on the level of a taxpayer’s “taxable income.”

- Section 199A articulates these variations by establishing a “threshold amount” – which refers to a level of a taxpayer’s “taxable income,” indexed for inflation. *See* § 199A(e)(2). Section 199A establishes consequences that depend upon whether taxpayer’s “taxable income” falls below the “threshold amount,” falls above the “threshold amount” but within a phase-out range, or falls above the “threshold amount” plus the phase-out range.

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<sup>140</sup> Partners who derive income from a partnership in a capacity other than as a partner or who receive guaranteed payments may not avail themselves of a deduction under § 199A. § 199A(c)(4).

<sup>141</sup> QBI does not include “qualified REIT dividends” or “qualified publicly trade partnership income.” § 199A(c)(1). Section 199A(a)(1)(B) names these income items separately and includes them in a taxpayers “combined qualified business income amount,” i.e., CQBIA.

<sup>142</sup> Specifically, the net amount of QBI does not include capital gains/losses, dividend income, interest income not properly allocable to a trade or business, gains/losses from commodities transactions or gains/loss from foreign currency transactions, gains/losses from certain “notional” contracts, amounts received from annuity contracts not connected with a trade or business properly allocable to one of these items. § 199A(c)(3)(B).



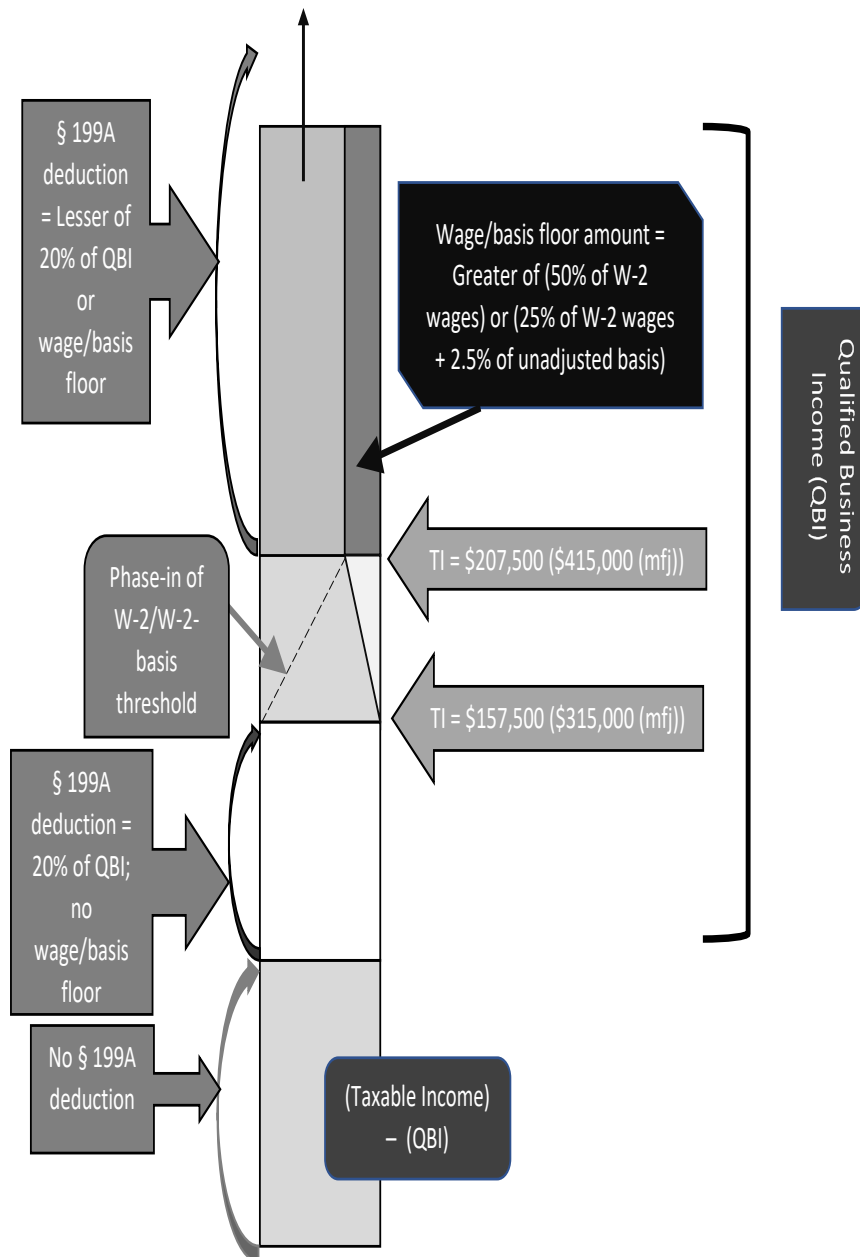
**Threshold Income Amounts: Relevance to Specified Trade or Businesses, and to CQBIA.** Section 199A(e)(2) defines a “threshold amount,” which serves as the threshold at which restrictions on the § 199A deduction “phase in.” The “threshold amount” is \$157,500, indexed for inflation, § 199A(e)(2)(B), and twice that amount for a joint return. § 199A(e)(2)(A). The “threshold amount” is relevant for two purposes:

- (1) Special rules limit that availability of the § 199A deduction for taxpayers engaged in a “specified service trade or business” (SSTB). A “*specified service trade or business*” is a “trade or business involving the performance of services in the fields of” health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage service, and any trade or business where the principal asset is the reputation of one or more of its employees or owners, § 1202(e)(3)(A), cross-referenced and as modified by § 199A(d)(2) (not including engineering or architecture). Additionally, a “specified trade or business” is any trade or business “which involves performance of services that consist of investing, trading, or dealing in securities ..., partnership interests, or commodities ...” § 199A(d)(2)(B). A taxpayer engaged in an SSTB whose “taxable income” is greater than the threshold amount will see the availability of a § 199A deduction gradually phase out altogether. *See* § 199A(d)(1)(A), § 199A(d)(2).
- (2) Taxpayers engaged in *any* trade or business (including an SSTB) that generates QBI whose “taxable income” is less than the threshold amount may include 20% of that QBI in their CQBIA, irrespective of conditions applicable to taxpayers whose “taxable income” is more than the threshold amount. *See* § 199A(d)(3) (SSTB), § 199A(b)(3)(A) (wage and basis requirements). But: wage and property restrictions “phase in” as the “taxable income” of the owner of a *non-SSTB* rises above the threshold amount by \$50,000 (or \$100,000 for taxpayers married filing jointly), *infra*.



## Visualizing § 199A QBI

- Work from the bottom up, QBI by QBI.
- Deduct CQBIA or 20% of  $[(\text{taxable income}) \div (\text{NCG})]$ , whichever is less.



• Dollar figures are indexed for inflation.

Basic Income Tax 2023-2024

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**Taxpayer's CQBIA:** A taxpayer's CQBIA is the sum of –

- 20% of taxpayer's aggregate amount of qualified REIT dividends<sup>143</sup> and qualified publicly-traded partnership income,<sup>144</sup> § 199A(d)(3); PLUS
- 20% of the QBI of each qualified trade or business, *but not more than the greater of*
  - 50% of the W-2 wages taxpayer pays with respect to that trade or business,<sup>145</sup> OR
  - 25% of the W-2 wages taxpayer pays with respect to that trade or business plus 2.5% of the unadjusted basis of “qualified property.”<sup>146</sup> § 199A(b)(2)(B).

There are three different tax treatments of taxpayer's QBI – depending on the level of taxpayer's “taxable income.”

- (1) Taxpayers who own a “qualified trade or business” that is not a “specified service trade or business” may deduct their CQBIA computed without regard to the W-2 and/or qualified property conditions if the taxpayer's *taxable income* does not exceed the indexed threshold amount. § 199A(b)(3)(A).
- (2) *If* taxpayer's *taxable income* does exceed the indexed threshold amount by less than \$50,000 (\$100,000 for a taxpayer married filing jointly), and *if* taxpayer's QBI determined without regard to the W-2 and qualified property conditions would be greater than the relevant W-2 wage/property basis limitation, *then* taxpayer must reduce his QBI by the percentage of \$50,000 (\$100,000 for taxpayers married filing jointly) by which 20% of

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<sup>143</sup> A “qualified REIT dividend” is any dividend from a real estate investment trust that is neither a capital gain dividend nor a “qualified dividend” under § 1(h)(11). § 199A(e)(3).

<sup>144</sup> “Qualified publicly traded partnership income” is the net amount of a partner's allocable share of income tax items from a publicly traded partnership not treated as a corporation, § 199A(e)(4)(A) (referencing §199A(c)(3 and 4), or gain from the sale of an interest in a publicly traded partnership to the extent it is treated as an amount realized from the sale or exchange of property other than a capital asset. §199A(e)(4)(B).

<sup>145</sup> Special rules reduce the CQBIA of a “qualified trade or business” that is a patron of a “specified agricultural or horticultural cooperative.” *See* § 199A(b)(7). These rules prevent double-counting some income for deduction purposes. The details are beyond the scope of this discussion.

<sup>146</sup> “Qualified business property” is depreciable property that the taxpayer uses in his qualified trade or business to produce QBI and holds at the close of the taxable year. § 199A(b)(6)(A). The depreciation period must not have ended before the close of the taxable year, § 199A(b)(6)(A)(iii), but that period is extended to the *later* of the date that is ten years after the property was placed in service or the last day of the last full year to which the applicable recovery period would apply. § 199A(b)(6) (without regard to the alternate depreciation system).

his QBI exceeds the otherwise applicable W-2 and qualified property conditions. § 199A(b)(3)(B).

- Example: Taxpayer is a sole proprietor. Taxpayer's filing status is married filing jointly. Taxpayer has \$100K of QBI and \$350K of taxable income.<sup>147</sup> Taxpayer paid W-2 wages of \$10K. Taxpayer has no depreciable property. Taxpayer would be entitled to a \$20K § 199A deduction if there were no wage/basis condition. *See* §§ 199A(b)(2)(A); 199A(b)(3)(B)(iii)(I). Taxpayer's "taxable income" exceeds the threshold amount by \$35K, i.e., [\$350K – \$315K]. The W-2 wage condition is 50% of \$10K, i.e., \$5K. §§ 199A(b)(2)(B); 199A(b)(3)(B)(iii)(I). Taxpayer's potential § 199A deduction exceeds the wage condition by \$15K, i.e. (\$20,000 – \$5,000). This is the "excess amount." § 199A(b)(3)(B)(iii). Taxpayer's § 199A deduction is reduced from its unrestricted potential by the percentage of the "excess amount" equal to the same percentage that \$35K is of \$100K, i.e., 35%. 35% of \$15K = \$5,250. Taxpayer may claim a §199A deduction of \$14,750. § 199A(b)(3)(b)(i, ii).

- Example: Same facts except that taxpayer paid \$0 in W-2 wages. The W-2 wage limitation is \$0. Taxpayer's potential § 199A deduction exceeds the wage limitation by \$20,000. 35% of \$20,000 = \$7,000. Taxpayer may claim a § 199A deduction of \$13,000.

- (3) When a taxpayer's "taxable income" exceeds the "threshold amount" plus \$50,000 (\$100,000 for taxpayers married filing jointly), taxpayer computes his §199A deduction by applying the W-2/property basis rules noted above.

**Specified Service Trade or Business (SSTB):** Taxpayers engaged in a "specified service trade or business" may include the income they derive from such a trade or business in their CQBIA *if* their "taxable income" is less than the threshold level. The amount of SSTB income that they may include in the CQBIA decreases to \$0 as their taxable income rises above the threshold. *See* § 199A(b)(3)(A), § 199A(d)(3). Thus, there are three levels of § 199A deductions for a taxpayer engaged in an SSTB:

- (1) Taxpayers whose "taxable income" is less than the threshold amount and are engaged in an SSTB may treat all of their trade or business income as QBI without restrictions.

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<sup>147</sup> Taxpayer had a lot of itemized deductions.

•(2) Taxpayers engaged in an SSTB whose “taxable income” is greater than the threshold amount but less than the threshold amount plus \$50,000 (\$100,000 for taxpayers married filing jointly) may include in their QBI the “applicable percentage” of all the SSTB income items. The same “applicable percentage” applies to the wage/basis limitations restrictions applicable to CQBIA, *infra*. The “applicable percentage” is 100% minus the percentage that taxpayer’s excess “taxable income” is relative to \$50,000 (\$100,000 for taxpayers married filing jointly). § 199A(d)(3)(B). Taxpayer’s excess “taxable income” is the amount by which taxpayer’s “taxable income” exceeds the threshold amount.

•Example:<sup>148</sup> Taxpayer has taxable income of \$200,000, of which \$125,000 is attributable to an accounting sole proprietorship in which he pays wages of \$40,000 to employees. Taxpayer uses no depreciable property. Taxpayer has an “applicable percentage” of 15%, determined thus:

$$\begin{aligned} &1 - [(\$200,000 - \$157,500)/\$50,000]^{149} \\ &1 - \$42,500/\$50,000 \\ &1 - 0.85 \\ &0.15, \text{ or } 15\% \end{aligned}$$

In determining includible QBI, taxpayer takes into account 15% of \$125,000, i.e., \$18,750. In determining the includible W-2 wages, taxpayer takes into account 15% of \$40,000, i.e., \$6000. Taxpayer’s CQBIA deduction is the lesser of<sup>150</sup> –  
20% of \$18,750, i.e., \$3750<sup>151</sup> or  
50% of \$6000,<sup>152</sup> i.e., \$3000.

Taxpayer may take a § 199A deduction of \$3000.

•(3) Taxpayers engaged in an SSTB with taxable income greater than the threshold amount plus \$50,000 (\$100,000 for taxpayers married filing

<sup>148</sup> This example is derived from *Conference Report on H.R. 1, Tax Cuts and Jobs Act*, H. REP. 115-466 (1<sup>st</sup> Sess. 2017).

<sup>149</sup> § 199A(d)(3)(B).

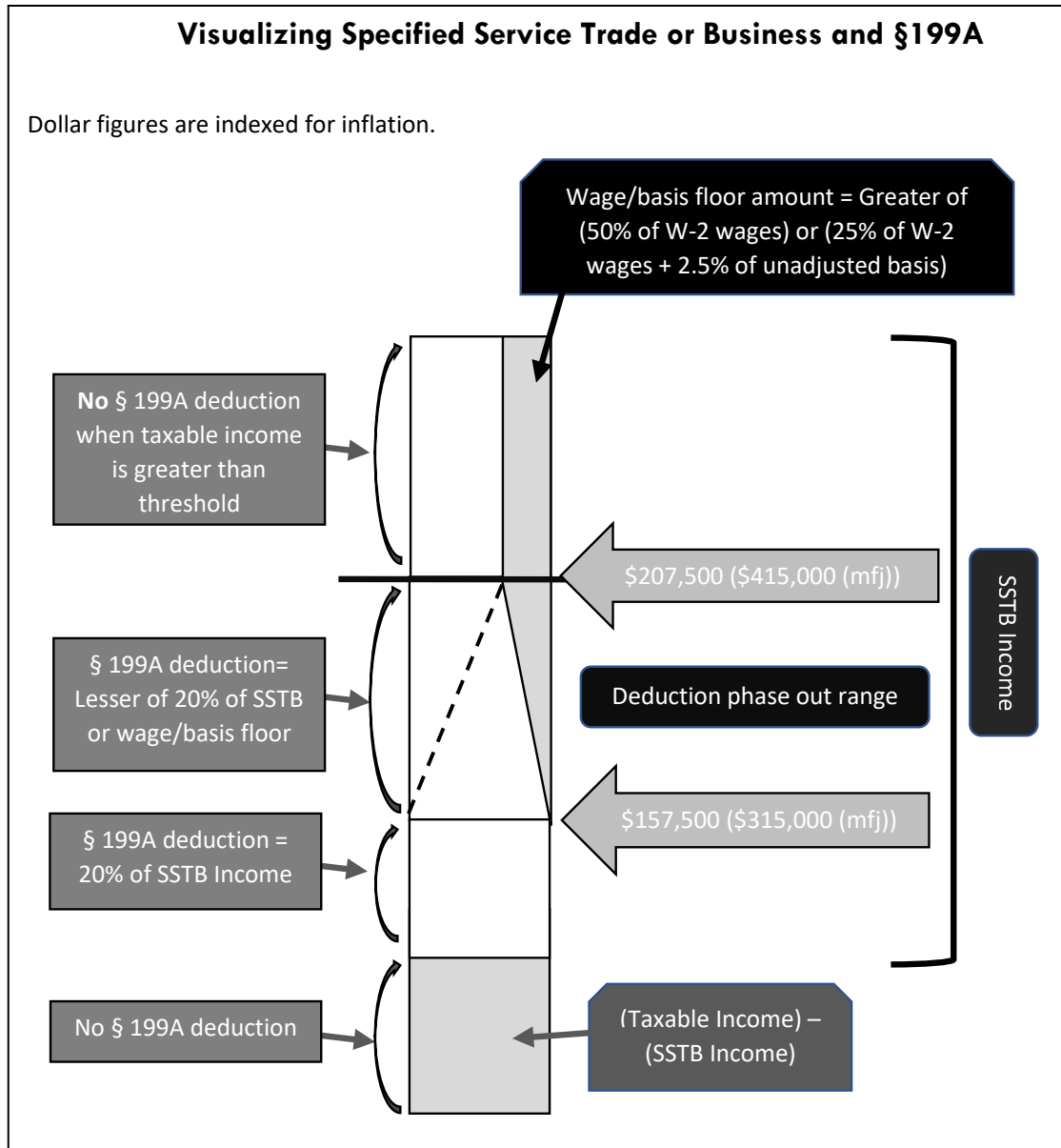
<sup>150</sup> ... i.e., the lesser of 20% of QBI or 50% of W-2 wages. Thus, the Code requires a pro-rated application of rules applicable to a non-SSTB taxpayer.

<sup>151</sup> § 199A(d)(3)(A)(ii).

<sup>152</sup> § 199A(d)(3)(A)(ii).

jointly) are not entitled to any § 199A deduction.

See generally Robert E. Ward, *Tax Cuts and Jobs Act of 2017 – Individual Tax Provisions*, TAXES THE TAX MAGAZINE 49, 51-53 (July 2018).



QBI is of course included in a taxpayer's "taxable income." The difference between taxpayer's "taxable income" and "net capital gain" will be less than a taxpayer's CQBIA when the taxpayer derives a substantial portion of his taxable income from capital gains and "qualified dividends." As a taxpayer's net capital gain increases his CQBIA eventually becomes the *greater* figure.

- Describe a typical taxpayer for whom the CQBIA would be the greater amount. Describe a typical taxpayer for whom the CQBIA would be the lesser amount.

*Comment:* Section 199A replaced § 199, a measure designed to encourage all taxpayers, including corporations, to engage in manufacturing trades or businesses in the United States. Section 199A, on the other hand, provides benefits only to "pass-through" entities and sole proprietorships. The justification for this different treatment for corporations lies in the fact that the TCJA reduced the top corporate tax rate from 35% to 21%. By defining the limits of the § 199A deduction through reference to W-2 wages and depreciable property used to generate income effectively connected with a trade or business within the United States, Congress clearly aims to encourage certain forms of economic activity within the United States. Notice that § 199A is not part of the Code's methods of determining a taxpayer's net income. Rather, it provides a reward for doing something that Congress wants pass-through entities that own a trade or business to do, i.e., generate taxable income from American workers and/or depreciable property situated in the United States. *And:* the more profit such a taxpayer can derive from his domestic economic activities, the greater his deduction.

Section 199 was an effort to make U.S. manufacturers more competitive vis-a-vis foreign competition. A byproduct of this effort would be that export activity would increase. By rewarding successful businesses, Congress is (likely to be) rewarding exporters the most. Congress has pursued similar objectives in other tax legislation, but the World Trade Organization (WTO) found that such legislation violated the General Agreement on Tariffs and Trade (GATT). Section 199A may also be vulnerable to a challenge before the WTO.<sup>153</sup>

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<sup>153</sup> Section 199 provided a deduction to all taxpayers, including C corporations, engaged in domestic production activities. The business activity on which § 199A focuses is different, but the intent to stimulate only *domestic* business activity is apparent.

**Problems:**

\*In these problems, use the figures that appear in the text of § 199A, not the figures that have been indexed for inflation.

1. Mary Taxpayer is married and lives in a medium-sized town with a large university. Mary and her husband live only a few blocks from the university. She and her husband file their income tax return married filing jointly. Taxpayer and husband both have jobs from which they derive employment income. Their wage income from these jobs is \$250,000. They have \$50,000 of net capital gain. In addition, Mary has a t-shirt silk screening business that she runs out of the couple's garage. The university has athletic teams that participate in several sports. When there is a home game, thousands of people descend on the town to attend the games. Mary pays attention to the athletic schedules and designs and produces t-shirts in only a few hours with timely messages. She sells the t-shirts to persons that pass by several kiosks that she rents. Her gross revenue from t-shirt sales for the tax year is \$180,000. Deductions for supplies and kiosk rental come to \$30,000. She pays two employees a total of \$40,000 in wages. She has no "qualified REIT dividends" or "qualified publicly-traded partnership income."

1A. How much can Mary and her husband claim as a § 199A deduction?

1B. What if Mary and her husband had total taxable wages income from their other jobs of \$100,000, and still had the same capital gain and business income from the sale of t-shirts?

1C. What if Mary and her husband had total taxable income from their other jobs of \$500,000?

2. Mike Perch is a baseball player for the Rockville Hellions. He makes a minor league salary and works in the off-season in a brewery where his employer paid him wages. His "taxable income" from these jobs is \$50,000. He also made \$10,000 of net capital gain. On the side, he has his own business as a personal trainer "to the stars." He grossed \$85,000 as a personal trainer. He paid an assistant, Lopez Schaden, an illegal immigrant, \$20,000 cash under-the-table. These are all of his expenses. Hence, he netted \$65,000 as a personal trainer. Perch lives alone in an apartment and his tax filing status is single. Perch has no "qualified REIT dividends" or "qualified publicly-traded partnership income."

2A. How much can Perch claim for a § 199A deduction?

2B. Suppose Perch's "taxable income" from his wages as a baseball player and brewery worker was \$100,000. Furthermore, suppose that Lopez Schaden is not an illegal immigrant and that the wages Perch paid him are W-2 wages. How much could Perch claim as a § 199A deduction?

2C. Suppose Perch made the major leagues and quit his job at the brewery. His salary jumped to \$500,000. He continued his trade or business of being a personal trainer with the same revenue and expenses. How much could Perch claim as a § 199A deduction?

## 2. Section 611: The Depletion Deduction

Section 611(a) provides for a deduction in computing taxable income for depletion. This deduction is available for "mines, oil and gas wells, other natural deposits, and timber[.]"<sup>154</sup> The depletion allowance deduction resembles the depreciation deduction, *infra*, in that both deductions are a form of cost recovery of capital investments. Unlike the depreciation deduction, which is an allowance for the gradual consumption of an asset that the taxpayer *uses to produce a product* (or to provide a service), the depletion allowance deduction is an allowance for the cost recovery of wasting assets that *are* the product.<sup>155</sup> The depletion allowance is part of the cost of the thing that the taxpayer sells.

Congress enacted the depletion allowance deduction as a means for fossil fuel companies and mine operators to deduct an amount equal to the reduction in value of their mineral reserves as they extracted and sold the mineral. § 611(a). The deduction allows a taxpayer to recover its capital investment so that the investment will not diminish as the minerals are extracted and sold.<sup>156</sup> Despite this purpose, there is no requirement that the taxpayer invest any money in the mineral rights,<sup>157</sup> and taxpayer does not have to have legal title to take advantage of the deduction.<sup>158</sup>

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<sup>154</sup> I.R.C. § 611(a).

<sup>155</sup> *Commissioner v. Southwest Exploration Co.*, 350 U.S. 308, 312 (1956) (depletion allowance "based on the theory that the extraction of minerals gradually exhausts the capital investment in the mineral deposit").

<sup>156</sup> *Id.* at 312.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.*



First codified in 1913, the depletion allowance deduction was originally limited to mines – and only 5% of the gross value of a mine’s reserves could be deducted in a year.<sup>159</sup> Over time, the depletion allowance deduction has expanded to include resources other than those from mining – such as oil, gas, and timber – and to allow for deductions greater than 5%.

Anyone with an “economic interest” may share<sup>160</sup> in the depletion allowance deduction.<sup>161</sup> “An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital.”<sup>162</sup> A broad range of economic interests exists whose owners may claim the depletion allowance deduction.

There are now two ways to calculate a depletion allowance deduction, and taxpayer chooses the one that yields the greater deduction. However, taxpayer may not choose percentage depletion in the case of an interest in timber.<sup>163</sup>

*Cost Depletion:* Under cost depletion, taxpayer allocates annually an equal amount of basis<sup>164</sup> to each recoverable unit.<sup>165</sup> Taxpayer may claim the deduction when it sells the unit<sup>166</sup> or cuts the timber.<sup>167</sup> Depletion allowance deductions – allowed or

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<sup>159</sup> 5 William H. Byrnes, IV & Christopher M Sove, *Mertens Law of Fed. Income Tax’n* § 24:132 (rev. 2013), *available* on Westlaw.

<sup>160</sup> *See, e.g.,* Commissioner v. Southwest Exploration Co., 350 U.S. 308, 309 (1956) (Court granted cert “because both the drilling company and the upland owners cannot be entitled to depletion on the same income”).

<sup>161</sup> *See* Palmer v. Bender, 257 U.S. 551, 557 (1933) (conveyance of leased property in exchange for cash bonus, future payment, plus 1/8 royalty sufficient to claim depletion allowance deduction, irrespective of fact that taxpayer may have retained no legal interest in the mineral content of the land).

<sup>162</sup> Reg. § 1.611-1(b)(1).

<sup>163</sup> I.R.C. § 613(a) (percentage method applicable to “mines, wells, and [certain] other natural deposits”).

<sup>164</sup> I.R.C. § 612 (same as adjusted basis in § 1011 for “purpose of determining gain upon sale or other disposition of” the property).

<sup>165</sup> Reg. § 1.611-2(a)(1) (mines, oil and gas wells, and other natural deposits); Reg. § 1.611-3(b) (timber).

<sup>166</sup> Reg. § 1.611-2(a)(1) (mines, oil and gas wells, and other natural deposits).

<sup>167</sup> Reg. § 1.611-3(b)(1) (timber).

allowable – reduce taxpayer’s basis in the property until the basis is \$0.<sup>168</sup> At that time, taxpayer may shift to percentage depletion, except when taxpayer claims depletion allowance deductions for timber. Recapture of depletion allowance deductions upon sale or exchange of the property is subject to income taxation at ordinary income rates.<sup>169</sup>

*Percentage Depletion:* Percentage depletion is a deduction based on a specified percentage of taxpayer’s *gross* income from different named activities<sup>170</sup> of up to 50% of *the taxable* income from the activity.<sup>171</sup> The limit is 100% of taxable income from oil and gas properties.<sup>172</sup> However, Sections 613(d) and 613A disallow any depletion allowance deduction for oil and gas wells, except for some small independent producers and royalty owners of domestic oil and gas.<sup>173</sup> Their percentage depletion allowance deduction is 15%<sup>174</sup> of gross income, limited to 65% of taxable income.<sup>175</sup> A percentage depletion allowance deduction is available even though taxpayer has no basis remaining in the asset.

The percentage depletion method serves to encourage the further development and exploitation of certain natural resources. This is important in a time when we believe that preservation of natural resources should be national policy.<sup>176</sup> In recent years, depletion allowance deductions have increased significantly: in 2003, total corporate depletion allowance deductions were nearly \$10.2 billion, while in 2013, total corporate depletion allowance deductions rose to more than \$26.9 billion.<sup>177</sup>

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<sup>168</sup> I.R.C. § 1016(a)(1)(2); Reg. § 1.611-2(b)(2) (cost depletion for mines, oil and gas wells, and other natural deposits); Reg. § 1.611-3(c)(1) (timber).

<sup>169</sup> I.R.C. § 1254(a).

<sup>170</sup> I.R.C. § 613(a and b) (the percentages range from 5% to 22%).

<sup>171</sup> I.R.C. § 613(a).

<sup>172</sup> *Id.* But see §§ 613(d), 613A.

<sup>173</sup> See Reg. § 1.613A-3 (details of exemption for independent producers and royalty owners).

<sup>174</sup> I.R.C. § 613A(c)(1).

<sup>175</sup> I.R.C. § 613A(d)(1).

<sup>176</sup> For an argument that the depletion deduction provides a tax incentive for companies that extract minerals but does little to preserve the environment from which the minerals were extracted, see Wendy B. Davis, *Elimination of the Depletion Deduction for Fossil Fuels*, 26 SEATTLE U. L. REV. 197 (2002).

<sup>177</sup> The IRS now publishes *Statistics of Income* historical data tables only online. The relevant tables are at [http://www.irs.gov/file\\_source/pub/irs-soi/histab13e.xls](http://www.irs.gov/file_source/pub/irs-soi/histab13e.xls) (line 66).

### III. Depreciation, Amortization, and Cost Recovery

We have encountered at several points the principle that taxpayer's consumption of only a part of a productive asset to generate taxable income entitles taxpayer to a deduction for only that amount of consumption. Such consumption represents a taxpayer's de-investment in and consumption of the asset and so must result in a reduction of basis. We take up here the theoretical bases and mechanics of some of the Code's depreciation provisions. The following case provides a good review of depreciation principles and congressional tinkering with them as a means of pursuing certain economic policies.

#### **Liddle v. Commissioner**, 65 F.3d 329 (3<sup>d</sup> Cir. 1995)

McKEE, Circuit Judge:

In this appeal from a decision of the United States Tax Court we are asked to decide if a valuable bass viol can be depreciated under the Accelerated Cost Recovery System when used as a tool of trade by a professional musician even though the instrument actually increased in value while the musician owned it. We determine that, under the facts before us, the taxpayer properly depreciated the instrument and therefore affirm the decision of the Tax Court.

#### I.

Brian Liddle, the taxpayer here, is a very accomplished professional musician. Since completing his studies in bass viol at the Curtis Institute of Music in 1978, he has performed with various professional music organizations, including the Philadelphia Orchestra, the Baltimore Symphony, the Pennsylvania ProMusica and the Performance Organization.

In 1984, after a season with the Philadelphia Orchestra, he purchased a 17th century bass viol made by Francesco Ruggeri (c. 1620-1695), a luthier who was active in Cremona, Italy. Ruggeri studied stringed instrument construction under Nicolo Amati, who also instructed Antonio Stradivari. Ruggeri's other contemporaries include the craftsmen Guadanini and Guarneri. These artisans were members of a group of instrument makers known as the Cremonese School.

Liddle paid \$28,000 for the Ruggeri bass, almost as much as he earned in 1987 working for the Philadelphia Orchestra. The instrument was then in an excellent state of restoration and had no apparent cracks or other damage. Liddle insured the instrument for its then-appraised value of \$38,000. This instrument was his principal instrument and he used it continuously to earn his living, practicing with it at home as much as seven and one-half hours every day, transporting it locally and out of town for rehearsals, performances and auditions. Liddle purchased the bass because he believed it would serve him throughout his professional career – anticipated to be 30 to 40 years.

Despite the anticipated longevity of this instrument, the rigors of Liddle’s profession soon took their toll upon the bass and it began reflecting the normal wear and tear of daily use, including nicks, cracks, and accumulations of resin. At one point, the neck of the instrument began to pull away from the body, cracking the wood such that it could not be played until it was repaired. Liddle had the instrument repaired by renown [sic] artisans. However, the repairs did not restore the instrument’s “voice” to its previous quality. At trial, an expert testified for Liddle that every bass loses mass from use and from oxidation and ultimately loses its tone, and therefore its value as a performance instrument decreases. Moreover, as common sense would suggest, basses are more likely to become damaged when used as performance instruments than when displayed in a museum. Accordingly, professional musicians who use valuable instruments as their performance instruments are exposed to financial risks that do not threaten collectors who regard such instruments as works of art, and treat them accordingly.

There is a flourishing market among nonmusicians for Cremonese School instruments such as Mr. Liddle’s bass. Many collectors seek primarily the “label”, i.e., the maker’s name on the instrument as verified by the certificate of authenticity. As nonplayers, they do not concern themselves with the physical condition of the instrument; they have their eye only on the market value of the instrument as a collectible. As the quantity of these instruments has declined through loss or destruction over the years, the value of the remaining instruments as collectibles has experienced a corresponding increase.

Eventually, Liddle felt the wear and tear had so deteriorated the tonal quality of his Ruggeri bass that he could no longer use it as a performance instrument. Rather than selling it, however, he traded it for a Domenico Busan 18th century bass in

May of 1991. The Busan bass was appraised at \$65,000 on the date of the exchange, but Liddle acquired it not for its superior value, but because of the greater tonal quality.

Liddle and his wife filed a joint tax return for 1987, and claimed a depreciation deduction of \$3,170 for the Ruggeri bass under the Accelerated Cost Recovery System (“ACRS”), § 168. [footnote omitted] The Commissioner disallowed the deduction asserting that the “Ruggeri bass in fact will appreciate in value and not depreciate.” Accordingly, the Commissioner assessed a deficiency of \$602 for the tax year 1987. The Liddles then filed a petition with the Tax Court challenging the Commissioner’s assertion of the deficiency. A closely divided court entered a decision in favor of the Liddles. This appeal followed. [footnote omitted]

## II.

[The Commissioner conceded that an asset can appreciate in value and still be subject to a depreciation deduction.]

Here, the Commissioner originally argued that the ACRS deduction under § 168 is inappropriate here because the bass actually appreciated in value. However, the Commissioner has apparently abandoned that theory, presumably because an asset can appreciate in market value and still be subject to a depreciation deduction under tax law. *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272, 277 (1966) (“tax law has long recognized the accounting concept that depreciation is a process of estimated allocation which does not take account of fluctuations in valuation through market appreciation.”); *Noyce v. Commissioner*, 97 T.C. 670, 1991 WL 263146 (1991) (taxpayer allowed to deduct depreciation under § 168 on an airplane that appreciated in economic value from the date of purchase to the time of trial).

Here, the Commissioner argues that the Liddles can claim the ACRS deduction only if they can establish that the bass has a determinable useful life. Since Mr. Liddle’s bass is already over 300 years old, and still increasing in value, the Commissioner asserts that the Liddles can not establish a determinable useful life and therefore can not take a depreciation deduction. In addition, the Commissioner argues that this instrument is a “work of art” which has an indeterminable useful life and is therefore not depreciable.

... Prior to 1981, § 167 governed the allowance of depreciation deductions with respect to tangible and intangible personality. Section 167 provided, in relevant part, as follows:

## Sec. 167. DEPRECIATION

(a) General Rule. – There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) –

- (1) of property used in the trade or business, or
- (2) of property held for the production of income.

26 U.S.C. § 167(a). The regulations promulgated under § 167 provided that in order to qualify for the depreciation deduction, the taxpayer had to establish that the property in question had a determinable useful life. Reg. § 1.167(a)-1(a) and (b). The useful life of an asset was not necessarily the useful life “inherent in the asset but [was] the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business....” Reg. § 1.167(a)-1(b). Nonetheless, under § 167 and its attendant regulations, a determinable useful life was the sine qua non for claiming the deduction. *See, Harrah’s Club v. United States*, 661 F.2d 203, 207 (1981) (“Under the regulation on depreciation, a useful life capable of being estimated is indispensable for the institution of a system of depreciation.”).

Under § 167, the principal method for determining the useful life of personalty was the Asset Depreciation Range (“ADR”) system. Personalty eligible for the ADR system was grouped into more than 100 classes and a guideline life for each class was determined by the Treasury Department. *See* Reg. § 1.167(a)-11. A taxpayer could claim a useful life up to 20% longer or shorter than the ADR guideline life. Reg. § 1.167(a)-11(4)(b). The ADR system was optional with the taxpayer. Reg. § 1.167(a)-11(a). For personalty which was not eligible for ADR, and for taxpayers who did not choose to use ADR, the useful life of an asset was determined according to the unique circumstances of the particular asset or by an agreement between the taxpayer and the Internal Revenue Service. STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, 97th Cong. ...

In 1981, convinced that tax reductions were needed to ensure the continued economic growth of the country, Congress passed the Economic Recovery Tax Act of 1981, P. L. 97-34 (“ERTA”). *Id.* It was hoped that the ERTA tax reduction program would “help upgrade the nation’s industrial base, stimulate productivity and innovation throughout the economy, lower personal tax burdens and restrain the growth of the Federal Government.” *Id.* Congress felt that prior law and rules governing depreciation deductions need to be replaced “because they did not

provide the investment stimulus that was felt to be essential for economic expansion.” *Id.* Further, Congress believed that the true value of the depreciation deduction had declined over the years because of high inflation rates. *Id.* As a result, Congress believed that a “substantial restructuring” of the depreciation rules would stimulate capital formation, increase productivity and improve the country’s competitiveness in international trade. *Id.* Congress also felt that the prior rules concerning the determination of a useful life were “too complex”, “inherently uncertain” and engendered “unproductive disagreements between taxpayers and the Internal Revenue Service.” *Id.* To remedy the situation, Congress decided

that a new capital cost recovery system should be structured which de-emphasizes the concept of useful life, minimizes the number of elections and exceptions and is easier to comply with and to administer.

*Id.*

Accordingly, Congress adopted the Accelerated Cost Recovery System (“ACRS”) in ERTA. The entire cost or other basis of eligible property is recovered under ACRS eliminating the salvage value limitation of prior depreciation law. GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 at 1450. ACRS was codified in I.R.C. § 168, which provided, in relevant part, as follows:

Sec. 168. Accelerated cost recovery system

(a) Allowance of Deduction. – There shall be allowed as a deduction for any taxable year the amount determined under this section with respect to recovery property.

(b) Amount of Deduction.-

(1) In general. – Except as otherwise provided in this section, the amount of the deduction allowable by subsection (a) for any taxable year shall be the aggregate amount determined by applying to the unadjusted basis of recovery property the applicable percentage determined in accordance with the following table:

\* \* \* \* \*

(c) Recovery Property. – For purposes of this title –

(1) Recovery Property Defined. – Except as provided in subsection (e), the term “recovery property” means tangible property of a character subject to the allowance for depreciation –

(A) used in a trade or business, or

(B) held for the production of income.

26 U.S.C. § 168. ACRS is mandatory and applied to “recovery property” placed in service after 1980 and before 1987.<sup>178</sup>

Section 168(c)(2) grouped recovery property into five assigned categories: 3-year property, 5-year property, 10-year property, 15-year real property and 15-year public utility property. Three year property was defined as § 1245 property<sup>179</sup> with a class life of 4 years or less. Five year property is all § 1245 property with a class life of more than 4 years. Ten year property is primarily certain public utility property, railroad tank cars, coal-utilization property and certain real property described in I.R.C. § 1250(c). Other long-lived public utility property is in the 15-year class. § 168(a)(2)(A), (B) and (C). Basically, 3-year property includes certain short-lived assets such as automobiles and light-duty trucks, and 5-year property included all other tangible personal property that was not 3-year property. Most eligible personal property was in the 5-year class.

The Commissioner argues that ERTA § 168 did not eliminate the pre-ERTA § 167 requirement that tangible personalty used in a trade or business must also have a determinable useful life in order to qualify for the ACRS deduction. She argues that the phrase “of a character subject to the allowance for depreciation” demonstrates that the pre-ERTA § 167 requirement for a determinable useful life is the threshold criterion for claiming the § 168 ACRS deduction.

Much of the difficulty inherent in this case arises from two related problems. First, Congress left § 167 unmodified when it added § 168; second, § 168 contains no standards for determining when property is “of a character subject to the allowance for depreciation.” In the absence of any express standards, logic and common sense

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<sup>178</sup> In the Tax Reform Act of 1986, P. L. 99-514, Sec. 201, Congress made substantial changes to I.R.C. § 168. In particular, Congress deleted the “recovery property” concept from the statute.

<sup>179</sup> Section 1245 property is, inter alia, any personal property which is or has been property of a character subject to allowance for depreciation provided in § 167. § 1245(a)(3).



would dictate that the phrase must have a reference point to some other section of the Internal Revenue Code. Section 167(a) would appear to be that section. As stated above, that section provides that “[t]here shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear ... of property used in a trade or business....” The Commissioner assumes that all of the depreciation regulations promulgated under § 167 must, of necessity, be imported into § 168. That importation would include the necessity that a taxpayer demonstrate that the asset have a demonstrable useful life, and (the argument continues) satisfy the phrase “tangible property of a character subject to the allowance for depreciation” in § 168.

However, we do not believe that Congress intended the wholesale importation of § 167 rules and regulations into § 168. Such an interpretation would negate one of the major reasons for enacting the Accelerated Cost Recovery System. Rather, we believe that the phrase “of a character subject to the allowance for depreciation” refers only to that portion of § 167(a) which allows a depreciation deduction for assets which are subject to exhaustion and wear and tear. Clearly, property that is not subject to such exhaustion does not depreciate. Thus, we hold that “property of a character subject to the allowance for depreciation” refers to property that is subject to exhaustion, wear and tear, and obsolescence. However, it does not follow that Congress intended to make the ACRS deduction subject to the § 167 useful life rules, and thereby breathe continued life into a regulatory scheme that was bewildering, and fraught with problems, and required “substantial restructuring.”

We previously noted that Congress believed that prior depreciation rules and regulations did not provide the investment stimulus necessary for economic expansion. Further, Congress believed that the actual value of the depreciation deduction declined over the years because of inflationary pressures. In addition, Congress felt that prior depreciation rules governing the determination of useful lives were much too complex and caused unproductive disagreements between taxpayers and the Commissioner. Thus, Congress passed a statute which “de-emphasizes the concept of useful life.” GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 at 1449. Accordingly, we decline the Commissioner’s invitation to interpret § 168 in such a manner as to re-emphasize a concept which Congress has sought to “de-emphasize.”

The Commissioner argues that de-emphasis of useful life is not synonymous with abrogation of useful life. As a general statement, that is true. However, the position of the Commissioner, if accepted, would reintroduce unproductive disputes over

useful life between taxpayers and the Internal Revenue Service. Indeed, such is the plight of Mr. Liddle.

Congress de-emphasized the § 167 useful life rules by creating four short periods of time over which taxpayers can depreciate tangible personalty used in their trade or business. These statutory “recovery periods ... are generally unrelated to, but shorter than, prior law useful lives.” GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981 at 1450. The four recovery periods are, in effect, the statutorily mandated useful lives of tangible personalty used in a trade or business.

The recovery periods serve the primary purpose of ERTA. Once a taxpayer has recovered the cost of the tangible personalty used in a trade or business, i.e., once the taxpayer has written off the asset over the short recovery period, his or her basis in that asset will be zero and no further ACRS deduction will be allowed. To avail himself or herself of further ACRS deductions, the taxpayer will have to purchase a new asset. Thus, because the recovery period is generally shorter than the pre-ERTA useful life of the asset, the taxpayer’s purchase of the new asset will increase capital formation and new investment and, as a result, promote the Congressional objective for continued economic expansion.

Thus, in order for the Liddles to claim an ACRS deduction, they must show that the bass is recovery property as defined in § 168(c)(1). It is not disputed that it is tangible personalty which was placed in service after 1980 and that it was used in Brian Liddle’s trade or business. What is disputed is whether the bass is “property of a character subject to the allowance for depreciation.” We hold that that phrase means that the Liddles must only show that the bass was subject to exhaustion and wear and tear. The Tax Court found as a fact that the instrument suffered wear and tear during the year in which the deduction was claimed. That finding was not clearly erroneous. Accordingly, the Liddles are entitled to claim the ACRS deduction for the tax year in question.

Similarly, we are not persuaded by the Commissioner’s “work of art” theory, although there are similarities between Mr. Liddle’s valuable bass, and a work of art. The bass, is highly prized by collectors; and, ironically, it actually increases in value with age much like a rare painting. Cases that addressed the availability for depreciation deductions under § 167 clearly establish that works of art and/or collectibles were not depreciable because they lacked a determinable useful life. *See Associated Obstetricians and Gynecologists, P.C. v. Commissioner*, 762 F.2d 38 (6th Cir.1985) (works of art displayed on wall in medical office not depreciable);

*Hawkins v. Commissioner*, 713 F.2d 347 (8th Cir.1983) (art displayed in law office not depreciable); *Harrah's Club v. United States*, 661 F.2d 203 (1981) (antique automobiles in museum not depreciable). *See also*, Rev. Rul. 68-232 (“depreciation of works of art generally is not allowable because ‘[a] valuable and treasured art piece does not have a determinable useful life.’”).

... In Brian Liddle’s professional hands, his bass viol was a tool of his trade, not a work of art. It was as valuable as the sound it could produce, and not for its looks. Normal wear and tear from Liddle’s professional demands took a toll upon the instrument’s tonal quality and he, therefore, had every right to avail himself of the depreciation provisions of the Internal Revenue Code as provided by Congress.

### III.

Accordingly, for the reasons set forth above, we will affirm the decision of the tax court.

#### *Notes and Questions:*

1. Note the court’s account of the evolution of depreciation law. In its first footnote, the court noted that “recovery property” is no longer part of § 168. Section 168 now applies to “any tangible property.”
2. The Second Circuit reached a similar result in *Simon v. Commissioner*, 68 F.3d 41 (2d Cir. 1995), *Nonacq.* 1996-29 I.R.B. 4, 1996-2 C.B. 1, 1996 WL 33370246 (cost recovery allowance for a violin bow).

#### *Note: Sections 167 and 168*

Section 167 still governs depreciation. It has been supplemented – to the point that it has been replaced – by § 168 for *tangible* property – but not for *intangible* property. The allowable depreciation deduction of § 167(a) is what is described in § 168 when it is applicable. § 168(a). When § 168 is applicable, its application is mandatory. § 168(a) (“shall be determined”). Application of § 168 is much more mechanical and predictable than application of § 167. The Third Circuit described the mechanics of applying § 167 – and of course, the greater accuracy that § 167 (may have) yielded came at a high administrative cost, both to the taxpayer and to

the IRS. The Commissioner’s argument that taxpayer must demonstrate that an asset has a “determinable useful life” in order to claim a deduction for depreciation is an accurate statement of the law of § 167. Applying § 167 required placing an asset into an “Asset Depreciation Range” (ADR), deriving its useful life, determining its future “salvage value,” and then calculating the actual depreciation deduction according to an allowable method. The court in *Liddle* described this system as “bewildering, and fraught with problems[.]” While ADRs are no longer law, they are still used to determine the “class life” of an asset which in turn determines the type of property that it is – whether 3-year, 5-year, 7-year, 10-year, 15-year, or 20-year property. § 168(e)(1).

The late 1970s and early 1980s was a time of slow economic growth and very high inflation. The court describes the congressional response, i.e., the Economic Recovery Tax Act of 1981 (ERTA). Clearly, Congress – at the urging of President Reagan – was using tax rules as a device to stimulate the economy. Congress modified the system so that property placed in service in 1986 and after would be subject to the “Modified Accelerated Cost Recovery System” (MACRS). Sufficient time has passed that we do not often have to distinguish between ACRS and MACRS; often we simply refer to the current system as ACRS. Notice that § 168 uses the phrase “accelerated cost recovery system” (ACRS) – implying that we no longer consider this to be “depreciation.” As we see in the succeeding paragraphs, taxpayers who place property in service to which § 168 applies may “write it off” much faster than they could under the old rules. The Third Circuit in *Liddle* explained what Congress was trying to accomplish by adopting these rules.

Section 168(e) requires that we identify the “classification of property.” Certain property is classified as 3-year property, 5-year property, 7-year property, 10-year property, 15-year property, and 20-year property. § 168(e)(3). Property not otherwise described is first defined according to the old class life rules, § 168(e)(1), § 168(i)(1), and then placed into one of these classifications. For such properties, the recovery period corresponds to the classification of the property. *See* § 168(c). In addition, § 168(b)(3) names certain properties whose recovery period is prescribed in § 168(c).

- You should read through these sub-sections – particularly § 168(e)(3), § 168(e)(1), and § 168(c).
- Notice that § 168(e)(3)(C)(v) provides that property without a class life and not otherwise classified is classified as 7-year property. Section 168(e)(3)(C)(v) thus serves as a sort of “default” provision when taxpayers

purchase items such as bass viol. At the time the Liddles filed their tax return, the default period was five years.

Section 168(b)(4) treats salvage value as zero. This eliminates one point of dispute between taxpayers and the IRS. The basis for depreciation is the adjusted basis provided in § 1011. § 167(c)(1).

Section 168(d) prescribes certain “conventions.” We generally treat all property to which § 168 applies as if it were placed in service *or* disposed of at the midpoint of the taxpayer’s taxable year. § 168(d)(1 and 4(A)) (“half-year convention”). In the case of real property, we treat it as if it were placed in service or disposed of at the midpoint of the month in which it was placed in service or disposed of. § 168(d)(2) and (4)(B) (“mid-month convention”). A special rule precludes the abuse of these conventions through back-loading. We treat all property to which § 168 applies as if it were placed in service at the midpoint of the quarter in which it was placed in service *if* more than 40% of the aggregate bases of such property was placed in service during the last quarter of the taxpayer’s tax year. § 168(d)(3)(A). In making this 40% determination, taxpayer does not count nonresidential real property, residential rental property, a railroad grading or tunnel bore, and property placed in service and disposed of during the same taxable year. § 168(d)(3)(B).

Section 168(b) prescribes three cost recovery methods. The straight-line method applies to certain property for which the recovery period is relatively long. § 168(b)(3). This of course means that taxpayer divides the item’s basis by the applicable recovery period. In the first and last year of ownership, taxpayer applies the applicable convention to determine his “cost recovery” deduction. A more rapid method of cost recovery applies to property whose classification is 15 or 20 years, i.e., 150% of declining balance. § 168(b)(2)(A). This method also applies to specifically named property. § 168(b)(2)(B and C). A still more rapid method of cost recovery applies to 3-year, 5-year, 7-year, and 10-year property, i.e., 200% of declining balance. § 168(a).

- A taxpayer may irrevocably elect to apply one of the slower methods of cost recovery to one or more classes of property. § 168(b)(2)(C), § 168(b)(3)(D), § 168(b)(5).
- Rather than work through the 150% and 200% of declining balance methods of cost recovery, we are fortunate that the IRS has promulgated Rev. Proc. 87-57. This revenue procedure has several tables that provide the appropriate multiplier year by year for whatever the recovery period for

certain property is. The tables incorporate and apply the depreciation method and the appropriate convention.

- Familiarize yourself with these tables.

Section 168(g)(2) provides an “alternate depreciation system” which provides for straight-line cost recovery over a longer period than the rules of § 168 noted thus far. Taxpayer may irrevocably elect to apply the “alternate depreciation system” to *all the property in a class* placed in service during the taxable year. § 168(g)(7). Taxpayer may make this election separately with respect to each nonresidential real property or residential rental property. § 168(g)(7).

- A taxpayer might make such an election to avoid paying the alternative minimum tax. *See* § 56(a)(1).

Accelerating cost recovery is one policy tool that Congress may use to encourage investment in certain types of property at certain times. *See* § 168(k), *infra*. Congress and the President have increasingly resorted to this tool to stimulate economic growth – even if not necessary.

Consider:

1. Taxpayer purchased a racehorse on January 2, 2022 for \$10,000 and “placed it in service” immediately. Taxpayer purchased no other property subject to ACRS allowances during the year.

- What is Taxpayer’s ACRS allowance for 2024?

Taxpayer sold the horse on December 31, 2024 for \$9000.

- What is Taxpayer’s adjusted basis in the racehorse?
- What is Taxpayer’s taxable gain from this sale?

2. Taxpayer purchased a “motorsports entertainment complex” on October 1, 2022 for \$10M. *See* § 168(e)(3)(C)(ii). Assume that there is no backloading problem.

- What is Taxpayer’s ACRS allowance for 2022?
- What is Taxpayer’s ACRS allowance for 2023?
- What is Taxpayer’s ACRS allowance for 2024?
- What is Taxpayer’s ACRS allowance for 2025?
- What is Taxpayer’s ACRS allowance for 2026?
- What is Taxpayer’s ACRS allowance for 2027?
- What is Taxpayer’s ACRS allowance for 2028?
- What is Taxpayer’s ACRS allowance for 2029?

### *Section 179 and § 168(k) Bonus Depreciation*

Section 179 permits a taxpayer to treat “the cost of any § 179 property as an expense which is not chargeable to capital account.” § 179(a). The limit of this deduction beginning in tax year 2016 is \$1,000,000, § 179(b)(1), and the limit is indexed for inflation, § 179(b)(6).<sup>180</sup> The limit is reduced dollar for dollar by the amount by which the cost of § 179 property that taxpayer places into service exceeds \$2,500,000. § 179(b)(2). The § 179 deduction is limited to the amount of taxable income that taxpayer derived from the active conduct of a trade or business (computed without regard to any § 179 deduction) during the taxable year. § 179(b)(3)(A). Taxpayers whose § 179 deduction is subject to one of these limitations may carry it forward to succeeding years. § 179(b)(3)(B).

- To encourage small business investment during the recent (2007 to 2009) recession, Congress dramatically increased the § 179 limit.
- § 179 property is tangible property to which § 168 applies or § 1245 property purchased “for use in the active conduct of a trade or business.” § 179(d)(1). § 179 property also includes computer software. § 179(d)(1)(A)(ii). The taxpayer may elect to include “qualified real property” in his § 179 property. § 179(d)(1)(B)(ii). “Qualified real property” includes various improvements to existing real property. *See* § 179(e), § 168(e)(6).
- After taking a § 179 deduction, taxpayer may apply the rules of § 168 to his remaining basis.

After the terrorist attacks of September 11, 2001, economic activity in the United States, particularly in New York City, slowed dramatically. One congressional response was to provide for “temporary” bonus depreciation for “qualified property.” *See* § 168(k). The TCJA (2017) dramatically increased the availability of bonus depreciation. Section 168(k) calls for a phasing out of the bonus depreciation. For taxpayers who place in service “qualified property” their depreciation deduction “shall include” the “applicable percentage” of their adjusted basis in the year that they place it in service. § 168(k)(1)(A). They then reduce their basis in the “qualified property” for purposes of computing their remaining cost recovery deductions. § 168(k)(1)(B). Until 2023, the bonus depreciation is 100%. § 168(k)(6)(B)(i). The “applicable percentage” decreases by twenty percentage points in each successive tax year, i.e., to 80%, 60%, 40%, 20%, and 0%.

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<sup>180</sup> As recently as tax year 1992, the limit was \$10,000. Obviously § 179 serves a different purpose than it did when it was enacted.



§ 168(k)(6)(A). The bonus depreciation is not phased out completely until 2027. § 168(k)(6)(B). “Qualified property” is property that has a recovery period of 20 years or less. § 168(k)(2)(A)(i)(I). It can also be computer software property, water utility property, qualified film or television production, or a live theatrical production. § 168(k)(2)(A)(i).<sup>181</sup>

The original use of the property must begin with the taxpayer. § 168(k)(2)(A)(ii). *Alternatively*, taxpayer may claim bonus depreciation for the acquisition and placing in service of used property, § 168(k)(2)(A)(ii) and § 168(k)(2)(E)(ii)(I), so long as taxpayer did not acquire the used property from a related party or in a carryover basis transaction or by inheritance. § 168(k)(2)(A)(ii), § 168(k)(2)(E)(ii)(II), § 179(d)(2 and 3). Taxpayer must place the property in service before 2027. § 168(k)(2)(iii). Moreover, the benefits that §§ 179 and 168(k) provide are cumulative – so a taxpayer may “write off” very substantial investments in productive assets.

### *Section 197*

Section 197 permits the amortization of “§ 197 intangibles.” § 197(a). A “§ 197 intangible” includes such intangibles as goodwill, going concern value, intellectual property, a license or permit granted by a government, etc. § 197(d)(1). Section 197 permits ratable amortization over 15 years of the *purchase price* (as opposed to the cost of self-creation) of such intangibles. § 197(a), § 197(c)(2).

- Congress intended that § 197 put an end to expensive contests between the IRS and taxpayers over whether such items could be amortized at all, and if so, the applicable useful life. Now a “one-size-fits-all” approach applies to all such intangibles.

### *Section 195: Start-Up Expenses*

Section 195 provides that no deductions are allowed for start-up expenditures of a trade or business “[e]xcept as otherwise provided in this section.” Section 195(c)(1)(A) defines “start-up expenditures” to be amounts paid or incurred to –

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<sup>181</sup> There are many detailed definitions and conditions to § 168(k) that are more than we need to consider at this point. You should understand that Congress has used “bonus” depreciation as a tool of stimulating the economy and that Congress has regularly extended the applicability of § 168(k).



- investigate the creation of acquisition of an active trade or business,
- create an active trade or business, or
- engage in an activity for profit and for the production of income before the date on which the active trade or business begins.

Such expenditures must otherwise be deductible if they were “paid or incurred in connection with” an existing active trade or business. § 195(c)(1)(B).

Section 195(b)(1) *does* permit a taxpayer to elect to deduct the lesser of –

- all the start-up expenses of the trade or business, or
- \$5000, reduced by the amount by which taxpayer’s start-up expenses exceed \$50,000.

Taxpayer may amortize the remainder of his start-up expenditures over 180 months (15 years). § 195(b)(1)(B). Similar rules apply to the start-up expenditures of a partnership (§ 709) and a corporation (§ 248).

There are quite likely to be expenditures other than these “start-up expenditures” associated with the establishment of a trade or business. They are not deductible or amortizable – ever. Why do you think that Congress should be so stingy in permitting taxpayers to deduct expenditures incurred to start a trade or business?



Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Basic Depreciation, ACRS, and MACRS Concepts*.

### *Section 280F: Mixing Business and Personal*

A taxpayer may make expenditures to purchase items that are helpful in earning income *and* useful in taxpayer’s personal life as well. An automobile may fit this description. These points may lead some taxpayers to purchase items that they might not otherwise purchase, or to purchase items that are more expensive than they might otherwise purchase. Congress has addressed these points in § 280F. Section 280F limits deductions associated with the purchase and use of so-called “listed property.”

Section 280F(d)(4)(A) defines “listed property” to be a passenger automobile, any property used as a means of transportation, any property generally used for entertainment, recreation, or amusement, and any other property that the Secretary

specifies.<sup>182</sup> Section 280F(d)(3)(A) denies “employee” deductions for use of listed property unless “such use is for the convenience of the employer and required as a condition of employment.”

Section 280F provides the following types of limitations on cost recovery and § 179 expensing deductions: an absolute dollar limit on such deductions for listed property, a percentage limitation on such deductions for listed property, and a combination of a percentage limitation on an absolute dollar limit on such deductions.

- Absolute dollar limit on depreciation deductions for listed property: Sections 280F(a)(1)(A and B) place an absolute limit on the amount of depreciation allowable for any passenger automobile. The amounts are indexed for inflation. § 280F(d)(7). Nevertheless, the allowable amounts might channel a taxpayer’s choice of automobile.<sup>183</sup>

- Read §§ 280F(a)(1)(A and B). Consider this to be 2018. Taxpayer was a real estate agent and purchased a Mercedes-Benz for \$100,000 to squire clients around from property to property. An automobile is 5-year property. § 168(e)(3)(B)(i). Assume that taxpayer uses the automobile only for trade or business purposes. For the first four years (i.e., 2018 to 2021), Taxpayer’s total cost recovery as limited by § 280F(a)(1)(A) is \$41,360. Assume that Taxpayer will not be able to use § 179. *See* § 280F(d)(1). When would taxpayer have recovered all the cost of the automobile? *See* § 280F(a)(1)(B)(ii).

- Percentage limitation on depreciation deductions for listed property: If a taxpayer uses property partly for business and partly for personal purposes, he must determine the percentage of total use that is trade or business use. *See* §§ 280F(d)(6)(A and B). Only the trade or business use portion of depreciation is deductible *if* the percentage of total use is more than 50% for trade or business. *See* § 280F(b)(3). If the percentage of total use is not more than 50% trade or business, § 280F(b)(1) provides that the alternative depreciation system of § 168(g) applies. Sections 168(g) of course

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<sup>182</sup> The Tax Cuts and Jobs Act deleted “computer and peripheral equipment” from the list of “listed property.”

<sup>183</sup> The sum of the amounts in § 280F(a)(1)(A) for 2018 is \$41,360. This figure is subject to adjustment for inflation. § 280F(d)(7). For learning purposes, we will ignore such adjustments. In addition, we will ignore the bonus adjustment that § 168(k)(2)(F) temporarily permits. *See generally* Rev. Proc. 2022-17, 2022-13 I.R.B. 930.

prescribes less favorable straight-line cost recovery over a longer recovery period. If taxpayer used an item predominantly for trade or business, elected to use an accelerated method of cost recovery, and subsequently made a use of it that is not predominantly for trade or business, then taxpayer must recapture the cost recovery that exceeded what would have been allowed under § 168(g) in prior years. § 280F(b)(2).

- Consider: Taxpayer purchased a Hummer – which is not a passenger automobile. *See* § 280F(d)(5)(A). However, it is property used for transportation. Assume that a Hummer is 7-year property under § 168(e)(3)(B) with a class life of 10 years. Taxpayer paid \$100,000 for the Hummer. Taxpayer used the Hummer 75% for trade or business in both 2020 and 2021. In 2022, Taxpayer used the Hummer 25% for trade or business. In 2023, and all subsequent years, Taxpayer used the Hummer 75% for trade or business. What is Taxpayer's cost recovery allowance for 2020? – 2021? 2022? 2023? – 2024? – 2025? – 2026? – 2027? – 2028? – 2029? – 2030?

- Perhaps we have discovered another reason to elect cost recovery under the alternative depreciation system of § 168(g).

In computing the depreciation deduction for any given year, we assume that all of taxpayer's use of listed property over the recovery period was for trade or business purposes. § 280F(d)(2). Thus, a pro rata reduction of allowable cost recovery for less than predominantly business use does not extend the cost recovery period.

- Combination of a percentage limitation on an absolute dollar limit on cost recovery deductions: In the case of passenger automobiles, the absolute dollar limit on cost recovery deductions is applied first. Then limitations based on less-than-predominant trade or business use are applied. § 280F(a)(2).

## Wrap-Up Questions for Chapter 6

1. What is the relationship between depreciation and basis? Why does the relationship have to be what it is? Feel free to state your answer in Haig-Simons terms.
2. This chapter has offered three different tax treatments of expenses. What are they? What rationales support each?
3. We tax net income? What economic distortions would occur if we taxed gross receipts?
4. What economic distortions occur if we accelerate depreciation allowances? – if we give deductions to certain activities when they are profitable, for example § 199A?
5. Do depletion allowances encourage (too much) exploitation of natural resources?

## What have you learned?

Can you explain or define –

- What makes a trade or business expenditure “necessary?” What makes a trade or business expenditure (extra) “ordinary?”
- How acquisition costs of an asset should be treated under §§ 162, 212, and 263?
- What is the “origin of the claim” rule for determining the deductibility of litigation expenses?
- What is the importance of the ordering rule of §§ 161/261?
- What is the difference between deductibility under § 162 or § 212 and capitalization under § 263?
- What is the Tax Code’s treatment of business bad debts? What is the Tax Code’s treatment of non-business bad debts?
- What is the Tax Code’s treatment of expenditures for repairs? What is the Tax Code’s treatment of expenditures for improvements?
- What does it mean to be “away from home” for purposes of § 162(a)(2)?
- How should a taxpayer determine what is a reasonable salary that he may deduct under § 162(a)(1)?
- Why might a taxpayer prefer to deduct expenses as ordinary and necessary to carrying on a trade or business rather than as ordinary and necessary for income-producing activities? Distinguish a trade or business from an income-producing activity.
- Why are child care expenses not deductible as an ordinary and necessary trade or business expense?
- What is the source of public policy limitations on deductions under § 162?
- What is the “role” of §§ 261 to 280H of the Code?
- What is “cost recovery?”
- How does rapid cost recovery stimulate economic growth?
- What is “listed property?”

## Chapter 7: Personal Deductions and the Standard Deduction

### *The Tax Formula:*

(gross income)

→ MINUS deductions named in § 62

EQUALS (adjusted gross income (AGI))

→ MINUS (standard deduction or itemized deductions)

MINUS (deduction for “qualified business income”)

EQUALS (taxable income)

Compute income tax liability from tables in § 1(j) (indexed for inflation)

MINUS (credits against tax)

To say that an expenditure is personal is to say that taxpayer may not shift the tax burden on the income necessary to make the expenditure to other taxpayers. The choice of where to live is a personal matter, so taxpayer must pay income tax on the income necessary to pay the commuting expenses associated with that choice. *Flowers*. The choice to be married is a personal matter, so taxpayer must pay income tax on the income necessary to pay the travel expenses that marriage necessitates. *Hantzis*. The choice to have children is a personal matter,

so taxpayer must pay income tax on the income necessary to pay the expenses that having children necessitates. *Smith*. In theory the Code might allow deductions for *no* personal expenditures.

However, the Code has always permitted deductions from some personal expenditures. The Code allows a taxpayer to reduce her taxable income by a *standard deduction*, i.e., deduction of a fixed amount that differs among individuals only according to their filing status, and whether they have reached a certain age or are blind. § 63(b)(1), (c), (f).<sup>184</sup> If a taxpayer spends more on selected personal items than the standard deduction, taxpayer may elect to *itemize* them rather than claim the standard deduction. § 63(e)(1).

A slightly different consideration is that taxpayers have no choice but to spend *some* of their income for themselves and their families to survive. The Code has allowed a deduction of a fixed amount for each dependent that the taxpayer supports (i.e., exemptions). §§ 151, 152. For tax years 2018 through 2025, the Code allows *no*

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<sup>184</sup> Corporations do not benefit from a standard deduction. They incur no “personal” expenses from which a deduction from taxable income should be allowed.

deduction for personal exemptions. § 151(d)(5). For those years, Congress doubled the standard deduction and doubled (and later trebled) the child tax credit.

The Code provides other tools to reduce the tax burden on income necessary to make certain expenditures. Some of these favored expenditures *are* personal in nature. The Code implements policies favoring certain expenditures through –

- Exclusions from gross income:* We considered the subject of exclusions from gross income in chapter 3, *supra*. We observed that Congress has pursued certain policies concerning certain “accessions to wealth” by allowing taxpayers simply not to count them in determining the amount of income tax they must pay.

- To the taxpayer, an exclusion from gross income saves in income taxes – and so is worth – the taxpayer’s marginal tax rate multiplied by the amount excluded from gross income.

- Deductions that reduce adjusted gross income:* In §§ 161 to 199A Congress has defined deductions available both to individual taxpayers and to corporate taxpayers. In §§ 211 to 224 Congress has defined deductions available only to individual taxpayers. In §§ 241 to 250, Congress has defined deductions available only to corporate taxpayers. In § 62, Congress named certain of these deductions that reduce an individual taxpayer’s “adjusted gross income.” For the individual taxpayer, a deduction named in § 62 has the practical effect of reducing taxpayer’s taxable income. Section 62’s deductions are *in addition to* the standard deduction or itemized deductions. Moreover, the amount of some itemized deductions is determined by taxpayer’s adjusted gross income.

- To the taxpayer, a deduction named in § 62 saves in income taxes – and so is worth – the taxpayer’s marginal tax rate multiplied by the amount of the deduction.

- Standard deduction OR itemized deductions that reduce taxable income:* In computing her taxable income, a taxpayer may deduct a standard deduction. Alternatively, a taxpayer may elect to itemize her deductions that § 62 does not name and reduce her taxable income by the total of those deductions. § 63. Naturally a taxpayer will elect to deduct the amount that is greater.

- To the taxpayer, a “below-the-line” deduction saves in income taxes – and so is worth – the taxpayer’s marginal tax rate multiplied by the amount of the standard deduction or an itemized deduction.

- Credits against tax liability:* After computing her income tax liability, taxpayer may be entitled to one or more credits against that tax liability. The

amount of a credit reduces dollar-for-dollar taxpayer's income tax liability. The amount of a credit is usually limited to a percentage of what taxpayer spent on the creditable item.

- To the taxpayer, a credit saves in income taxes – and so is worth – the amount of the credit. Notice: A tax credit is worth precisely the same amount as a § 62 deduction while placing the taxpayer in a tax bracket equal to the percentage of the expenditure allowed as a credit.

- Example, a 20% credit on dependent care expenses has the same worth to a taxpayer in an imaginary 20% tax bracket as a § 62 deduction of such an expense.

- Since the amount of the credit is usually limited to a percentage of the named expense, taxpayers whose tax rate is higher than that percentage would reduce their income tax liability more with an above-the-line deduction. Taxpayers whose tax rate is lower than that percentage reduce their income tax liability more with a credit than with an above-the-line deduction.

- This suggests that Congress can use tax credits as a tool to assist lower income taxpayers more than higher income taxpayer without denying a tax benefit altogether to higher income taxpayers. Simply set the percentage of the creditable expense at a point between those tax brackets Congress wants to benefit more and those whom Congress wants to benefit less.<sup>185</sup>

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<sup>185</sup> To illustrate: Suppose that taxpayer spends \$1000 on a benefit. The expense might be deductible, or it might be creditable. In the table, compare the *net cost* to taxpayers in different tax brackets of the benefit when its cost is deductible or 20% of its cost is creditable. If the Code provides for a deduction, which taxpayers pay more for the benefit and which taxpayers pay less?



•Moreover, some credits are “refundable” and some are “nonrefundable.” *See* table of contents to Code, chapter 1, subchapter A. subparts A and C. A nonrefundable credit can reduce a taxpayer’s income tax liability only to \$0. A refundable credit can reduce a taxpayer’s income tax liability to less than \$0. Thus, a refundable credit functions as a government benefit program. An example of refundable credit is the earned income credit, § 32.

•*Note on the Tax Cuts and Jobs Act:* Tax laws may lead taxpayers to structure their lives and affairs in certain ways, especially when they expect the law not to change significantly. A *change* in existing tax law may require taxpayers to adjust their expectations – and their expenditure choices. The Tax Cuts and Jobs Act *doubled* the standard deduction for all taxpayers and suspended several itemized deductions until 2026.<sup>186</sup> Over 60% fewer taxpayers elected to itemize deductions. Henceforth, the taxable income of taxpayers who previously itemized but no longer can will increase *relative to* taxpayers with like amounts of adjusted gross income who did

Taxpayer’s Tax Bracket	Net Cost of Benefit with a Deduction	Net Cost of Benefit with 20% Tax Credit
10%	\$900	\$800
12%	\$880	\$800
22%	\$780	\$800
24%	\$760	\$800
32%	\$680	\$800
35%	\$650	\$800
37%	\$630	\$800

<sup>186</sup> *See* § 163(h)(3)(F)(i) (disallowing deduction for home equity indebtedness; capping interest on new acquisition debt to indebtedness of \$750,000 (\$375,000 for married, filing separate return)); § 165(h)(5) (limiting personal casualty loss deduction to losses incurred in Federally declared disaster); § 217 (disallowing deductions of moving expenses, *see also* § 132(g)(2)); § 67(g) (disallowing “miscellaneous deductions” otherwise subject to a 2%-of-AGI floor, which include employee trade or business expenses and the expenses paid or incurred for production of income or to hold property for the production of income (§ 212)).

not itemize. The tradeoff for this rearrangement of tax burdens is that tax brackets were lowered slightly for all taxpayers; at the high end, there is much less progressivity than previously.<sup>187</sup>

Taxpayers who structure their affairs with an eye on the Tax Code will be driven to seek accessions to wealth that are excludable – perhaps an employee benefit, that are listed in § 62 and so deductible without the need to itemize, or that are creditable against income tax. Congress will also learn that when it wants to lessen a burden of taxpayers who make a named expenditure, it matters more than previously that the tool it uses is *not* an itemized deduction.

With this as background, consider why there should be an allowable deduction of, exclusion of, or credit for *any* personal expenses. We might preliminarily observe that there are four basic purposes:

1. We want to encourage taxpayers to incur a certain personal expense. We *choose* to make a “tax expenditure.” In this group, we should place charitable contributions, home mortgage interest, and adoption expenses.
2. We want to provide some relief to those taxpayers whose personal expenditures result – at best – from the exercise of choice among unappealing alternatives. When discretion among consumption choices is absent, we have seen that a court is less likely to find that a taxpayer’s accession to wealth is in fact gross income. *Cf. Gotcher; Benaglia, supra*. Conversely, when taxpayers may spend an accession to wealth any way they choose – as when they receive cash – they have realized gross income. *See Kowalski, supra*. However, taxpayers must on occasion make some expenditures that we feel do not result from meaningful choices. The Code names some occasions when the absence of such discretion entitles a taxpayer to deduct (or exclude) an expenditure from her gross income. Examples include casualty losses and medical expenses.
3. We want to enlarge the tax base. Some taxpayer expenses are not necessarily trade or business expenses, but they enhance a taxpayer’s ability to generate taxable income. If they do that, they would also enlarge the tax base. We should encourage taxpayers to make such expenditures. In this group, we place the Code’s provisions for child care and education.

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<sup>187</sup> For all but the highest income earners, the tax cuts were not “epic” or the “biggest in history” as the President claimed.

4. We want taxpayers to save to meet a future expense that they know they will have to pay. The Code encourages such saving by various means, e.g., deferring the income tax on the income taxpayer sets aside to spend later on selected items of consumption, not taxing the growth of a fund established to meet future consumption of selected items, shifting (and presumably lightening) the tax burden from the growth of a fund that taxpayer established to another taxpayer. In this group, we should place the Code's provisions for setting money aside for retirement, medical expenses, or educational expenses.

We examine *some*<sup>188</sup> of the Code's provisions providing favorable treatment for some personal expenses.

## I. "Tax Expenditures"

Congress may use the tax code to encourage<sup>189</sup> (at least not to discourage) taxpayers to make certain expenditures. In § 170, Congress allows taxpayers a deduction for charitable contributions. This, coupled with the exemption from income tax that many charities enjoy,<sup>190</sup> may provide sufficient incentive for some taxpayers to support the good work certain charities do.

In § 164, Congress has allowed a deduction for certain taxes that taxpayer has paid or accrued. Section 275 specifically disallows a deduction for certain taxes that taxpayer may have paid or accrued. These rules may encourage some taxpayers to engage in activities subject to a deductible tax, most notably, owning property.

- As noted, in the Tax Cuts and Jobs Act Congress doubled the standard deduction. At the same time, it suspended the deduction for foreign real property taxes and capped a taxpayer's total deductions for state and local taxes paid (i.e., "SALT") until 2026 at \$10,000. § 164(b)(6).

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<sup>188</sup> Among the provisions that we do not cover are § 163(h)'s allowance of a deduction for home mortgage interest and §§ 221/62(a)(17)'s deduction of \$2500 of interest paid on education loans (a § 62 deduction) which is subject to an income phaseout. A deduction of interest paid on home equity indebtedness has been suspended until 2026. § 163(h)(3)(F)(i)(I). The deduction of interest paid on acquisition indebtedness has been temporarily limited to the interest paid on \$750,000 of indebtedness rather than \$1,000,000 of indebtedness. § 163(h)(3)(F)(i)(II).

<sup>189</sup> See *National Federation of Business v. Sebelius*, 567 U.S. 519, 567 (2012) (Congress may shape individual decisions through exercise of taxing power).

<sup>190</sup> See § 501(a).

- Congress also *increased* the allowable deduction for cash contributions to charity from 50% of a taxpayer's contribution base to 60%. § 170(b)(G).
- Can you identify policies that Congress has opted to pursue in these *changes*?

The definitions (read: conditions) of the items for which an expenditure is deductible structure the policy that Congress pursues. Of course, it is the IRS that enforces that policy, at least in the first instance.

With respect to both charitable contributions and payment of taxes, a taxpayer may try to characterize payments that provide a benefit for the taxpayer as either a charitable contribution or as payment of a tax. For example, a taxpayer might contribute money to a university on the condition that the university grant a scholarship to taxpayer's daughter. Or a taxpayer may pay her share of a condominium-owners' association's assessment to remodel the association's common areas. In neither case should taxpayer be permitted to claim a deduction. Instead the taxpayer has simply "purchased something." These are easy cases. How do we determine whether taxpayer has merely bought something – or has made a charitable contribution or paid a tax?

#### *A. Charitable Contributions*

Section 170(a)(1) permits taxpayers to deduct charitable contributions that they make within a taxable year. Section 170(c) defines a "charitable contribution" to be a gift "to or for the use of" certain types of organizations.

Such organizations include any political subdivision of a state, so long as the "contribution is made for exclusively public purposes." § 170(c)(1). Consider: Taxpayers entered into an agreement to purchase certain property contingent on the City Council rezoning it to permit use for a trailer court and shopping center. To assure access to the portion intended for a mobile home development, the rezoning proposal provided for dedication of a strip of the property for a public road. The road would also provide access or frontage for a public school, a church, and a home for the aged. Taxpayers completed their purchase and made the contemplated transfer to the city. The City Council formally adopted the rezoning ordinance.

- Should taxpayers be permitted a charitable deduction for the value of the land it donated to the city to be used for a road?
- Should the fact that the City of Tucson benefitted from taxpayer's

donation of the land be sufficient to permit taxpayer a deduction, irrespective of her motive in making the donation?

•Would it matter if the dedication of the land to the City did not in fact increase the value of Taxpayers' property?

•*See Stubbs v. United States*, 428 F.2d 885 (9<sup>th</sup> Cir. 1970), *cert. denied*, 400 U.S. 1009 (1971).

If a charitable contribution deduction turns on a weighing of benefits against the taxpayer's cost, whose benefit should be relevant – benefit to the public or benefit to the taxpayer?

**Rolfs v. Commissioner**, 668 F.3d 888 (7<sup>th</sup> Cir. 2012)

HAMILTON, Circuit Judge.

Taxpayers Theodore R. Rolfs and his wife Julia Gallagher (collectively, the Rolfs) purchased a three-acre lakefront property in the Village of Chenequa, Wisconsin. Not satisfied with the house that stood on the property, they decided to demolish it and build another. To accomplish the demolition, the Rolfs donated the house to the local fire department to be burned down in a firefighter training exercise. The Rolfs claimed a \$76,000 charitable deduction on their 1998 tax return for the value of their donated and destroyed house. The IRS disallowed the deduction, and that decision was upheld by the United States Tax Court. The Rolfs appeal. To support the deduction, the Rolfs needed to show a value for their donation that exceeded the substantial benefit they received in return. The Tax Court found that they had not done so. We agree and therefore affirm.

Charitable deductions for burning down a house in a training exercise are unusual but not unprecedented. By valuing their gifts as if the houses were given away intact and without conditions, taxpayers like the Rolfs have claimed substantial deductions from their taxable income. But this is not a complete or correct way to value such a gift. When a gift is made with conditions, the conditions must be taken into account in determining the fair market value of the donated property. As we explain below, proper consideration of the economic effect of the condition that the house be destroyed reduces the fair market value of the gift so much that no net value is ever likely to be available for a deduction, and certainly not here.

What is the fair market value of a house, severed from the land, and donated on the condition that it soon be burned down? There is no evidence of a functional market of willing sellers and buyers of houses to burn. Any valuation must rely on analogy. The Rolfs relied primarily on an appraiser's before-and-after approach, valuing their entire property both before and after destruction of the house. The difference showed the value of the house as a house available for unlimited use. The IRS, on the other hand, presented experts who attempted to value the house in light of the condition that it be burned. The closest analogies were the house's value for salvage or removal from the site intact.

The Tax Court first found that the Rolfs received a substantial benefit from their donation: demolition services valued by experts and the court at approximately \$10,000. The court then found that the Rolfs' before-and-after valuation method failed to account for the condition placed on the gift requiring that the house be destroyed. The court also found that any valuation that did account for the destruction requirement would certainly be less than the value of the returned benefit. We find no error in the court's factual or legal analysis. The IRS analogies provide reasonable methods for approximating the fair market value of the gift here. The before-and-after method does not.

### *I. Legal Background Concerning Charitable Donations Under Section 170(a)*

The legal principles governing our decision are well established, and the parties focus their dispute on competing valuation methodologies. We briefly review the relevant law, addressing some factual prerequisites along the way.

The requirements for a charitable deduction are governed by statute. Taxpayers may deduct from their return the verifiable amount of charitable contributions made to qualified organizations. 26 U.S.C. § 170(a)(1). Everyone agrees that the Village of Chenequa and its volunteer fire department are valid recipients of charitable contributions as defined under section 170(c). To qualify for deduction, contributions must also be unrequited – that is, made with “no expectation of a financial return commensurate with the amount of the gift.” *Hernandez v. Comm’r of Internal Revenue*, 490 U.S. 680, 690 (1989). The IRS and the courts look to the objective features of the transaction, not the subjective motives of the donor, to determine whether a gift was intended or whether a commensurate return could be expected as part of a quid pro quo exchange. *Id.* at 690–91.

The Treasury regulations implement the details of § 170, instructing taxpayers how to prove a deduction to the IRS and how to value donated property using its fair market value. Under § 1.170A-1(c) of the regulations, fair market value is to be determined as of the time of the contribution and under the hypothetical willing buyer/willing seller rule, wherein both parties to the imagined transaction are assumed to be aware of relevant facts and free from external compulsion to buy or sell. 26 C.F.R. § 1.170A-1(c). As with the question of the purpose of the claimed gift, fair market value requires an objective, economic inquiry and is a question of fact.

We can assume, as the record suggests, that the Rolfs were subjectively motivated at least in part by the hope of deducting the value of the demolished house on their tax return. Applying the objective test, however, we treat their donation the same as we would if it were motivated entirely by the desire to further the training of local firefighters. Objectively, the purpose of the transaction was to make a charitable contribution to the fire department for a specific use. ... The Tax Court found ... that when the transaction was properly evaluated, the Rolfs (a) received a substantial benefit in exchange for the donated property and (b) did not show that the value of the donated property exceeded the value of the benefit they received. We also agree with these findings. There was no net deductible value in this donation in light of the return benefit to the Rolfs.

A charitable contribution is a “transfer of money or property without adequate consideration.” *United States v. American Bar Endowment*, 477 U.S. 105, 118 (1986). A charitable deduction is not automatically disallowed if the donor received any consideration in return. Instead, as the Supreme Court observed in *American Bar Endowment*, some donations may have a dual purpose, as when a donor overpays for admission to a fund-raising dinner, but does in fact expect to enjoy the proverbial rubber-chicken dinner and accompanying entertainment. Where “the size of the payment is clearly out of proportion to the benefit received,” taxpayers can deduct the excess, provided that they objectively intended it as a gift. *Id.* at 116–18 (...). In practice then, the fair market value of any substantial returned benefit must be subtracted from the fair market value of the donation.

This approach differs from that of the Tax Court in *Scharf v. Comm’r of Internal Revenue*, T.C.M. 1973-265, an earlier case that allowed a charitable deduction for property donated to a fire department to be burned. In *Scharf*, a building had been partially burned and was about to be condemned. The owner donated the building to the fire department so it could burn it down the rest of the way. The Tax Court



compared the value of the benefit obtained by the donor (land cleared of a ruined building) to the value of the public benefit in the form of training for the firefighters, and found that the public benefit substantially exceeded the private return benefit. Thus, the donation was deemed allowable as a legitimate charitable deduction, and the court proceeded to value the donation using the established insurance loss figure for the building. The *Scharf* court did not actually calculate a dollar value for the public benefit, and if it had tried, it probably would have found the task exceedingly difficult. Although *Scharf* supports the taxpayers' claimed deduction here, its focus on public benefit measured against the benefit realized by the donor is not consistent with the Supreme Court's later reasoning in *American Bar Endowment*. The Supreme Court did not rely on amorphous concepts of public benefit at all, but focused instead on the fair market value of the donated property relative to the fair market value of the benefit returned to the donor. 477 U.S. at 116–18. The Tax Court ruled correctly in this case that the *Scharf* test “has no vitality” after *American Bar Endowment*. 135 T.C. at 487.

With this background, the decisive legal principle for the Tax Court and for us is the common-sense requirement that the fair market valuation of donated property must take into account conditions on the donation that affect the market value of the donated property. This has long been the law. *See Cooley v. Comm'r of Internal Revenue*, 33 T.C. 223, 225 (1959) (“property otherwise intrinsically more valuable which is encumbered by some restriction or condition limiting its marketability must be valued in light of such limitation”). ...

## *II. Valuation Methods*

As this case demonstrates, however, knowing that one must account for a condition in a valuation opens up a second tier of questions about exactly how to do so. ...

In this case there is no evidence of an actual market for, and thus no real or hypothetical willing buyers of, doomed houses as firefighter training sites. ... Sometimes fire departments ... conduct exercises using donated or abandoned property, but there is also no record evidence of any fire departments paying for such property. Without comparators from any established markets, the parties presented competing experts who advocated different valuation methods. The taxpayers relied on the conventional real estate market, as if they had given the fire department fee ownership of the house. The IRS relied on the salvage market and the market for relocated houses, attempting to account for the conditions proposed in the gift.



... [The taxpayers' expert witness compared the value of the land with the house on it with the value of the land without the house.] He subtracted the latter from the former to estimate \$76,000 as the value of the house alone.

... While this approach might superficially seem like a reasonable way to back into an answer for the house's value apart from the underlying land, the before-and-after method cannot properly account for the conditions placed on the recipient with a gift of this type. The Tax Court properly rejected use of the before-and-after method for valuing a donation of property on the condition that the property be destroyed.

... The IRS asserted that a comparable market could be sales of houses, perhaps historically or architecturally important structures, where the buyer intends to have the house moved to her own land. Witness Robert George is a professional house mover who has experience throughout Wisconsin lifting houses from their foundations and transporting them to new locations. He concluded that it would cost at least \$100,000 to move the Rolfs' house off of their property. Even more important, he opined that no one would have paid the owners more than nominal consideration to have moved this house. In his expert opinion, the land in the surrounding area was too valuable to warrant moving such a modest house to a lot in the neighborhood. George also opined that the salvage value of the component materials of the house was minimal and would be offset by the labor cost of hauling them away. ... Based on this testimony, the IRS argued that since the house would have had negligible value if sold under the condition that it be separated from the land and moved away, the house must also have had negligible value if sold under the condition that it be burned down.

The Tax Court found that the parties to the donation understood that the house must be promptly burned down, and the court credited testimony by the fire chief that he knew the house could be put to no other use by the department. The court rejected the taxpayers' before-and-after method as an inaccurate measure of the value of the house "as donated" to the department. The taxpayers' method measured the value of a house that remained a house, on the land, and available for residential use. The conditions of the donation, however, required that the house be severed from the land and destroyed. The Tax Court, accepting the testimony of the IRS experts, concluded that a house severed from the land had no substantial value, either for moving off-site or for salvage. Moving and salvage were analogous situations that the court found to be reasonable approximations of the actual scenario. We agree with these conclusions, which follow the *Cooley* principle by taking into account the economic effect of the main condition that the taxpayers put on their donation.

The Tax Court correctly required, as a matter of law, that the valuation must incorporate any reduction in market value resulting from a restriction on the gift. ... We find no clear error in the factual findings and conclude further that it would have been an error of law to ascribe any weight to the taxpayers' before-and-after valuation evidence.

....

... The taxpayers here gave away only the right to come onto their property and demolish their house, a service for which they otherwise would have paid a substantial sum. ... The demolition condition placed on the donation of the house reduced the fair market value of the house to a negligible amount, well enough approximated by its negligible salvage value.

....

... The value of the training exercises to the fire department is not in evidence. The fire chief testified in the Tax Court that he could not assign a specific value to the significant public benefit of the training – but in any event, we know from *American Bar Endowment* that trying to measure the benefit to the charity is not the appropriate approach. ...

The Tax Court also undertook a fair market valuation of the benefit received by the taxpayers. The expert witnesses for the IRS both agreed with Mr. Rolfs' own testimony (based on his investigation) that the house would cost upwards of \$10,000 to demolish. ... We see no error in the Tax Court's factual determination, based on the available evidence and testimony, that the Rolfs received a benefit worth at least \$10,000.

When property is donated to a charity on the condition that it be destroyed, that condition must be taken into account when valuing the gift. In light of that condition, the value of the gift did not exceed the fair market value of the benefit that the donating taxpayers received in return. Accordingly, the judgment of the Tax Court is Affirmed. [footnote omitted]

*Notes and Questions:*

1. How does the test of *American Bar Endowment* as the court articulates it differ from the test that the Tax Court (evidently) applied in *Scharf*?
2. Why should taxpayer be able to claim the fmv of the property as the amount to be deducted when that amount is greater than the adjusted basis of the property?
  - Shouldn't taxpayer be limited to a deduction equal to the property's adjusted basis? See § 170(e)(1)(A).
3. In 1971, the IRS issued Rev. Rul. 71-447 in which it stated the position that a private school that does not have a racially non-discriminatory policy as to students is not "charitable" within the common-law concepts reflected in §§ 170 and 501(c)(3). The IRS relied on this position to revoke the tax-exempt status of two private schools. The United States Supreme Court upheld this determination:

There can thus be no question that the interpretation of § 170 and § 501(c)(3) announced by the IRS in 1970 was correct. That it may be seen as belated does not undermine its soundness. It would be wholly incompatible with the concepts underlying tax exemption to grant the benefit of tax-exempt status to racially discriminatory educational entities, which "exer[t] a pervasive influence on the entire educational process." [citation omitted] Whatever may be the rationale for such private schools' policies, and however sincere the rationale may be, racial discrimination in education is contrary to public policy. Racially discriminatory educational institutions cannot be viewed as conferring a public benefit within the "charitable" concept ... or within the Congressional intent underlying § 170 and § 501(c)(3).

*Bob Jones University v. United States*, 461 U.S. 574, 595-96 (1983). The schools' tax-exempt status was lost. Donors could not claim a charitable contribution deduction for contributing money to it.

- This is one area where public policy *is* a part of income tax law.

4. A gift "to" an organization and a gift "for the use of" an organization are not the same thing. The Supreme Court construed the meaning of the phrase "to or for the use of" in § 170(c) in *Davis v. United States*, 495 U.S. 472 (1990). Taxpayers' sons were missionaries for the Church of Jesus Christ of Latter-Day Saints. Taxpayers deposited amounts into the individual accounts of their sons. The Church had

requested the payments and set their amounts. The Church issued written guidelines, instructing that the funds be used exclusively for missionary work. In accordance with the guidelines, petitioners' sons used the money primarily to pay for rent, food, transportation, and personal needs while on their missions. Taxpayers claimed that these amounts were deductible under § 170. The Supreme Court denied the deductibility of such payments and adopted the IRS's interpretation of the phrase. "[W]e conclude that a gift or contribution is 'for the use of' a qualified organization when it is held in a legally enforceable trust for the qualified organization or in a similar legal arrangement." *Id.* at 485. "[B]ecause petitioners did not donate the funds in trust for the Church, or in a similarly enforceable legal arrangement for the benefit of the Church, the funds were not donated 'for the use of' the Church for purposes of § 170." *Id.* at 486. And while "the Service's interpretation does not require that the qualified organization take actual possession of the contribution, it nevertheless reflects that the beneficiary [(organization)] must have significant legal rights with respect to the disposition of donated funds." *Id.* at 483.

5. There are limits to the amount of a charitable contribution that a taxpayer may deduct. Section 170's rules are complex.

- An individual has a "contribution base," i.e., adjusted gross income without regard to an NOL carryback. § 170(b)(1)(H).
- A taxpayer may deduct in a taxable year only a certain percentage of her "contribution base," the percentage limit dependent on the *type of property* that taxpayer contributes, the *type of charity* to which the contribution is made, and whether the contribution is "*to*" or "*for the use of*" the organization.

6. *Type of property*: A charitable contribution may take one of several forms. It may of course take the form of cash. It may also take the form of "ordinary income" property. And:

- A charitable contribution may be of "capital gain property," i.e., a "capital asset the sale of which at its fair market value at the time of the contribution would have resulted in gain which would have been long-term capital gain" (LTCG) because taxpayer held it for more than one year or § 1231 property. § 170(b)(1)(C)(iv).
- The *fmv* of the property is the amount of the allowable deduction. Reg. § 1.170A-1(c)(1). This means that the LTCG on such property

*is never taxed* – thus creating a true loophole.<sup>191</sup>

- If the donee's use of the property is unrelated to the charity's purpose, the charity disposes of the property before the last day of the taxable year without a certification that it made a substantial use related to its charitable purpose, the charity is a certain type of private foundation, the property was intellectual property, *or* the property is self-created taxidermy property – then the deduction is limited to the taxpayer's basis in the property or its fmV, whichever is lower. § 170(e)(1)(B).

- A charitable contribution may be of property, the gain on whose sale would *not* be long-term capital gain.

- The taxpayer's deduction is limited to her adjusted basis in the property or its fmV, whichever is less. § 170(e)(1)(A).

- If a charitable contribution of property is partly a sale, then the taxpayer's basis in the property is allocated pro rata according to the amount realized on the sale portion of the transaction and the fmV of the property. § 170(e)(2); Reg. § 1.1011-2(b). Taxpayer recognizes gain on the sale portion of such a transaction.

7. *Type of charity*: Section 170(c) describes five numbered types of charities, and taxpayer may deduct contributions to them. However, § 170(b) classifies these charities further.

- The Code creates so-called “A” charities, § 170(b)(1)(A), and “B” charities, § 170(b)(1)(B).

- *Generally*,<sup>192</sup> “A” charities include churches, educational organizations, organizations that provide medical care, research, or education, university endowment funds, governmental units if the gift is for public purposes, publicly supported organizations with certain specified purposes, certain private foundations, and organizations that support certain other tax-exempt organizations. § 170(b)(1)(A).

- “B” charities are all other charities described in § 170(c). § 170(b)(1)(B).

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<sup>191</sup> Unlike the exclusion from gross income for interest income derived from state and municipal bonds, the market for “capital gain” property does not drive the price down to reflect the tax benefits of owning such property.

<sup>192</sup> This paragraph is a generalization and omits a daunting number of details that a course in non-profit organizations might cover. We are not going to summarize rules governing contributions of “qualified conservation easements,” amounts paid to maintain certain students as members of the taxpayer's household, or other more narrowly-focused rules.

This *generally*<sup>193</sup> includes veterans' organizations, fraternal societies, nonprofit cemeteries, and certain nonoperating foundations.

8. The CAA, § 212, amended § 170(p) to provide a deduction of up to \$300 (\$600 for taxpayers m/fj) for individuals who contribute cash to an "A" charity. The CARES Act, § 2204, added § 62(a)(22) to the Code. It permits a \$300 (\$600 for taxpayers m/fj) "above-the-line" deduction to non-itemizing taxpayers who contribute cash to an "A" charity – except for contributions to a supporting organization or to a donor-advised fund. This deduction is available only for tax year 2021.

9. *Deductible contributions to or for the use of:* A taxpayer's allowable contributions are subject to the following limitations:

- For tax years 2018 to 2025, taxpayer may deduct *cash* contributions of up to 60%<sup>194</sup> of her contribution base to "A" charities, § 170(b)(1)(G)(i);
- Taxpayer may carry excess *cash* contributions to "A" charities to each of the succeeding five tax years in sequence, § 170(b)(1)(G)(ii); otherwise –
- Taxpayer may deduct up to 50% of her contribution base to "A" charities,

CARES Act § 2205: For 2020, this provision raises to 100% of AGI the deduction limit of an individual for cash contributions to an "A" charity; this limit is reduced by the amount of all of a taxpayer's other allowable charitable contributions. Excess contributions are carried over.

For corporations, the deduction limit for cash contributions to an "A" charity is increased to 25% of the taxpayer's taxable income. This limit is reduced by the amount of all of a corporation's other allowable charitable contributions. Excess contributions are carried over.

CAA § 213 extended these provision through 2021.

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<sup>193</sup> *Id.*

<sup>194</sup> The limit is otherwise 50%. Tax Cuts and Jobs Act temporarily increased the limit to 60% for cash contributions. Section 170 had suspended temporarily the 50% limit for cash contributions to organizations providing relief in named hurricane and wildfire areas. The Tax Cuts and Jobs Act limit does not depend upon providing relief from particular disasters.

§ 170(b)(1)(A); otherwise <sup>195</sup>

- Taxpayer may carry excess contributions *to* “A” charities to each of the five succeeding years in sequence, § 170(d)(1)(A);
- Taxpayer may deduct up to 30% of her contribution base *to* “B” charities, or *for the use of* “A” or “B” charities, § 170(b)(1)(B);
- Taxpayer may carry excess contributions *to* “B” charities or *for the use of* “A” or “B” charities to each of the succeeding five tax years in sequence, §§ 170(d)(1)(B), 170(d)(1)(A).
  - Taxpayer may *also* deduct up to 30% of her contribution base *to* “A” charities of “capital gain property,” § 170(b)(1)(C)(i);
  - Taxpayer may carry excess contributions of “capital gain property” *to* “A” charities to each of the succeeding five tax years in sequence, §§ 170(b)(1)(C)(ii), 170(d)(1)(A);
- Taxpayer may deduct up to 20% of her contribution base *to* “B” charities or *for the use of* “A” or “B” charities of “capital gain property,” § 170(b)(1)(D)(i);
- Taxpayer may carry excess contributions of “capital gain property” *to* “B” charities or *for the use of* “A” or “B” charities to each of the succeeding five tax years in sequence, §§ 170(b)(1)(D)(ii), 170(d)(1)(A).

•These limitations are presented in a certain order. Every type of contribution is subject to the limitations imposed on gifts *above it* – except for the two cumulative 30% limits that nevertheless are subject to the overall 50% limit.<sup>196</sup> § 170(b)(1)(B)(ii), § 170(b)(1)(C)(i), § 170(b)(1)(D)(i).

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<sup>195</sup> See Brad Bedingfield & Nancy Dempze, *The Disappearing 60% Deduction – New Charitable Giving Limits Are Not as Generous as They Appear*, TAXATION OF EXEMPTS 36-41 (Sept.-Oct. 2018) (explaining contribution limit under TCJA).

<sup>196</sup> Stated differently, the contributions to organizations with a higher rank on the list reduce dollar for dollar the limits applicable to contributions to organizations with a lower rank on the list.



- Example: Taxpayer donates property worth 40% of her contribution base to an “A” charity. Taxpayer also contributed “capital gain property” with a

Between January 1, 2018 and February 17, 2019 (i.e., 60 days after enactment of the Taxpayer Certainty and Disaster Relief Act of 2019, corporations could deduct cash contributions in excess of its otherwise allowable charitable contributions up to 100% of its taxable income if made to support relief efforts in a “qualified disaster area.” Taxpayer Certainty and Disaster Relief Act of 2019, Pub. L. No. 116-92, Div. Q, § 204(a). The TCDTR, § 304(a) extended this to February 25, 2021 (i.e., 60 days after enactment of the Taxpayer Certainty and Disaster Relief Act of 2020.

fmv equal to 30% of her contribution base to “A” charities. This latter contribution is subject to the 50% limit on contributions to “A” charities. Hence, taxpayer must carry  $\frac{2}{3}$  of her “capital gain property” contributions to the next succeeding tax year as a contribution of “capital gain property” to an “A” charity.

- Moreover, as the sequence of the list implies, carryovers may be used only subject to the contribution limits of the succeeding year. § 170(d)(1)(A)(i). The carryforward period is five years. § 170(d)(1)(A). Taxpayers must work within these rules to manage their charitable contributions efficiently.

10. *Corporations*: A corporation may deduct only 10% of its taxable income as charitable contributions. § 170(b)(2)(A). A corporation may not circumvent this limitation by recharacterizing a contribution or gift that qualifies as a charitable contribution as a business expenditure. § 162(b). A corporation computes its taxable income for purposes of calculating this limit without regard to any dividends-received deduction, NOL carryback, § 199A deduction for qualified pass-through business income, and capital loss carryback. § 170(b)(2)(C). A corporation may carry over an excess contribution to each of the next succeeding five tax years. § 170(d)(2)(A). The carryover cannot operate to increase an NOL in a succeeding year. § 170(d)(2)(B).

11. Taxpayer made a \$1000 contribution to WKNO-FM, the local public radio station. WKNO-FM is an “A” organization. Because Taxpayer gave “at the \$1000 level,” WKNO-FM presented Taxpayer with an HD radio. WKNO-FM had purchased several such radios for its fund-raising drive at a cost of \$163 each. The fmv of the radio was \$200. Taxpayer already owned an HD radio so she put the new one – still in the box it came in – in the attic. How much may Taxpayer deduct



as a charitable contribution?

•See *Shoshone-First National Bank v. United States*, 29 A.F.T.R.2d 72-323, 72-1 USTC (CCH) ¶ 9119, 1971 WL 454 (D. Wyo. 1971).

11a. Playhouse on the Circle will “sell the house” to any organization willing to pay \$2500 to see a private showing on a Sunday afternoon of the play it is currently showing. A ticket to see the same play on Saturday night – the immediately preceding night – normally costs \$35. Many charities engage Playhouse on the Circle to raise funds for their organization. St. Marlboro, an “A” organization engaged in medical research to determine the consequences of smoking only a few cigarettes a day, has “bought the house” and is selling tickets for \$35/each. If Taxpayer purchased four tickets at a total cost of \$140, how much should Taxpayer be permitted to deduct as a charitable contribution if Taxpayer throws the tickets away because she is not the least bit interested in seeing the play that Playhouse is currently showing?

•See Rev. Rul. 67-246, 1967-2 C.B. 104 (Example 3).

11b. Taxpayer has \$100,000 of adjusted gross income. Taxpayer made the following charitable contributions:

- \$20,000 cash to her church, an “A” charity;
- “long-term capital gain property” to her favorite university, an “A” charity, ab = \$10,000, fmv = \$80,000;
- “long-term capital gain property” to the sorority of which she was a member during her years in college, a “B” organization, ab = \$15,000, fmv = \$40,000.

*Very wealthy taxpayers:* The “Giving Pledge” is a campaign to encourage the world’s wealthiest people to give to philanthropic causes. About 231 persons or couples have made the pledge. What problems do § 170’s contribution limitations create for persons who accumulated vast wealth but whose income is no longer what it was? Bill Gates, Warren Buffett, Larry Ellison, Michael Bloomberg, Mark Zuckerberg, Vladimir Potanin, Ted Turner, and Elon Musk have signed on.

What is Taxpayer’s allowable charitable contribution deduction? What charitable contribution carryovers will Taxpayer have?

11c. Taxpayer has \$200,000 of adjusted gross income. Taxpayer made no charitable contributions except for the following transaction:

- Taxpayer sold to a “B” charity some stock that he purchased

many years ago for \$10,000. Its current fmv = \$50,000. Taxpayer sold the stock to the charity for \$10,000.

What are the tax consequences to Taxpayer?



Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Charitable Contribution Deductions: Basic Concepts and Computations*.

### *B. Taxes Paid*

Section 164 names some taxes that are deductible, irrespective of the circumstances of the taxpayer. These taxes do not have to be connected with a trade or business, or with the production of income. They are deductible simply because taxpayer paid them. Section 275 names certain taxes that are not deductible.

There is of course an involuntary element of paying any of the taxes that § 164 names. However, there is also an element of choice involved in the sense that some taxes are simply the cost of owning property – wherever situated – or making income in one place rather than another. Moreover, the taxes named support governments other than the federal government. Hence the taxpayer's costs of taxes associated with the choices that taxpayer makes are borne at least in part by the federal government.

For tax years 2018 to 2025, there is a \$10,000 cap on the deduction of real property taxes, personal property taxes, state and local income taxes, and state and local sales taxes. § 164(b)(6)(B). Moreover, Congress suspended the deduction for foreign real property taxes. § 164(b)(6)(A). These limitations do not apply to taxes otherwise fully deductible when they are “paid or accrued in carrying on a trade or business or an” expense incurred for the production of income. § 164(b)(6) (carryout ¶).

- The cap is constitutional. *See New York v. Yellin*, 2021-2 USTC ¶ 50,224 (CCH) (CA2 2021).

- Such caps and limitations on itemized deductions increase the number of taxpayers who do not itemize their deductions.

- Blue state workarounds and Reg. § 1.170A-1(h)(3)*: In response to the TCJA's \$10,000 cap on so-called SALT (state and local tax) deductions, some states (notably, Connecticut, New Jersey, and New York) enacted statutes that provided for credits against state income tax liability for

contributions made to certain charities. In response, Treasury has issued final rules that limit the deductibility of such contributions. *See* Contributions in Exchange for State or Local Credits, 84 Fed. Reg. 27513-01 (June 13, 2019). Such contributions would of course likely result from an expectation of a quid pro quo. So: Reg. § 1.170A-1(h)(3)(i) disallows a charitable contribution deduction to the extent taxpayer receives or expects to receive a state or local tax credit. This provision does not apply if the total amount of state and local tax credits received or expected to be received is 15% or less than the taxpayer's payment or the fair market value of property transferred by the taxpayer. Reg. § 1.170A-1(h)(3)(vi). A deduction is still allowed, so long as the amount of the deduction does not exceed the amount of the payment or the fair market value of the property transferred. Reg. § 1.170A-1(h)(3)(ii).

- Pass-Through Entity Workaround:* Partnerships and S corporations (i.e., “small business corporations”) do not pay income tax, but rather “pass through” their “bottom-line” income to their partners or shareholders. As opposed to items of income, deduction, gain, loss, and credit that might affect individual partners or shareholders differently (e.g., the matching of long-term capital gains and losses at the individual level), the “bottom-line” income of a “pass-through” entity does not affect the income tax consequences to individual partners or shareholders differently. “Bottom line” income of a pass-through entity will encompass deductions of the business, and that includes state and local taxes that the *entity* owes and pays; there is no cap on the amount of such taxes that the entity may deduct in computing its “bottom-line” income. The effect of this is that there is no cap on state and local taxes that can reduce the income tax liability of partners of a partnership or shareholders of an S corporation. The first sentence of the carryout paragraph of § 164(b)(6) seems to contemplate precisely this. In response, some states permit pass-through entities to elect to have state and local *income* taxes imposed at the entity level (i.e., “specified income tax payments”).

- The IRS has announced that it intends to propose regulations to clarify that a partnership or S corporation may deduct taxes imposed on its income in computing its non-separately taxable income or loss, i.e., bottom-line income or loss. Specifically, deductibility will extend to “specified income tax payments” that partnerships or corporations pay to satisfy *their* state income tax liability, without regard to whether the imposition of the tax is the result of an entity election. Effectively the owners of pass-through entities may avail

themselves of an unlimited above-the line deduction of state income tax.

- See Notice 2020-75, 2020-49 I.R.B. 1453.

Some important points about §§ 164/275 are the following:

- To be deductible, a “personal property tax” must be an ad valorem tax, § 164(b)(1), i.e., “substantially in proportion to the value of the personal property.” Reg. § 1.164-3(c)(1). Hence, payment of a uniform “wheel tax” imposed on automobiles is not deductible.

- A taxpayer may deduct *either* state and local income taxes *or* state and local sales taxes. § 164(b)(5)(A). For a time, state and local sales taxes were not deductible.

- What are the fairness implications of these current and former rules for taxpayers who reside in states that raise most of their revenue through income taxes, through sales taxes, or through a combination of income and sales taxes?

- Section 164(c)(1) provides in part: “Taxes assessed against local benefits of a kind tending to increase the value of the property assessed” are not deductible. Reg. § 1.164-4(a) provides in part: “A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction.”

- If a property owner may not deduct an assessment for the construction of, say, sidewalks in her neighborhood, should the property owner be permitted to add the amount of the assessment to her basis in her property?

- If real property is sold during a tax year, § 164(d) requires pro rating the real property tax allocable to seller and buyer according to the number of days each owned the property. The seller is treated as owning the property up to the day before the sale. § 164(d)(1)(A).

- How should a seller treat real estate taxes that the seller has already paid and for which she received reimbursement from the buyer? See § 1001(b)(1); Reg. § 1.1001-1(b)(1).

- How should a seller treat real estate taxes that are the obligation of the seller but which the purchaser pays, perhaps because they are only due after the date of sale? *See* § 1001(b)(2); Reg. § 1.1001-1(b)(2).
- The last sentence of § 164(a) provides that taxes paid in connection with the sale or acquisition of property are to be treated as amount realized or cost.
- If this treatment of such taxes does not (ultimately) alter taxpayer's taxable income, what difference does it make to deduct a payment as opposed to reducing the amount realized or increasing the cost?



Do the CALI Lesson, *Basic Federal Income Taxation: Deductions: Deductions for Taxes*.



Do the CALI Lesson, *Basic Federal Income Taxation: Interest Deductions*.

## II. Denial of Discretion in Choosing How or What to Consume

### A. Medical and Dental Expenses

Section 213(a) allows a taxpayer to deduct expenses of medical care “paid during the taxable year, not compensated for by insurance or otherwise” to the extent such expenses exceed 7.5% of the taxpayer’s adjusted gross income. This includes the expenses of *prescription* drugs or of insulin. § 213(b). Section 213(d)(1)(A) defines “medical care” expenses to include expenditures “for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.” Medical care expenses also include the expenses of transportation “primarily for and essential to medical care,” certain long-term care services, and insurance that covers “medical care” as so defined. § 213(d)(1).

- Why should there be a floor on the deductibility of medical expenses? Why should the determinant of that floor be a taxpayer’s adjusted gross income? *See* William P. Kratzke, *The (Im)Balance of Externalities in Employment-Based Exclusions from Gross Income*, 60 THE TAX LAWYER 1, 24-25 (2006).

- Think: What is the profile of taxpayers most likely to claim a medical expense deduction? *See id.* What type of medical expenditures are such taxpayers likely to make?

In *Ochs*, we are met once again by the chicken-and-egg question of when taxpayer's personal circumstances can support a deduction for certain expenditures. *Why* did taxpayer have little choice in making the expenditure?

**Ochs v. Commissioner**, 195 F.2d 692 (2<sup>d</sup> Cir.), *cert. denied*, 344 U.S. 827 (1952)

The question raised by this appeal is whether the taxpayer Samuel Ochs was entitled under § [213] of the Internal Revenue Code to deduct the sum of \$1,456.50 paid by him for maintaining his two minor children in day school and boarding school as medical expenses incurred for the benefit of his wife. ...

The Tax Court made the following findings:

‘During the taxable year petitioner was the husband of Helen H. Ochs. They had two children, Josephine age six and Jeanne age four.

‘On December 10, 1943, a thyroidectomy was performed on petitioner’s wife. A histological examination disclosed a papillary carcinoma of the thyroid with multiple lymph node metastases, according to the surgeon’s report. During the taxable year the petitioner maintained his two children in day school during the first half of the year and in boarding school during the latter half of the year at a cost of \$1,456.50. Petitioner deducted this sum from his income for the year 1946 as a medical expense under § [213] ...

‘During the taxable year, as a result of the operation on December 10, 1943, petitioner’s wife was unable to speak above a whisper. Efforts of petitioner’s wife to speak were painful, required much of her strength, and left her in a highly nervous state. Petitioner was advised by the operating surgeon that his wife suffered from cancer of the throat, a condition which was fatal in many cases. ... Petitioner became alarmed when, by 1946, his wife’s voice had failed to improve ... Petitioner and his wife consulted a reputable physician and were advised by him that if the children were not separated from petitioner’s wife she would not improve and her nervousness

and irritation might cause a recurrence of the cancer. Petitioner continued to maintain his children in boarding school after the taxable year here involved until up to the end of five years following the operation of December 10, 1943, petitioner having been advised that if there was no recurrence of the cancer during that time his wife could be considered as having recovered from the cancer.

‘During the taxable year petitioner’s income was between \$5,000 and \$6,000. Petitioner’s two children have not attended private school but have lived at home and attended public school since a period beginning five years after the operation of December 10, 1943. Petitioner’s purpose in sending the children to boarding school during the year 1946 was to alleviate his wife’s pain and suffering in caring for the children by reason of her inability to speak above a whisper and to prevent a recurrence of the cancer which was responsible for the condition of her voice. He also thought it would be good for the children to be away from their mother as much as possible while she was unable to speak to them above a whisper.

‘Petitioner’s wife was employed part of her time in 1946 as a typist and stenographer. On account of the impairment which existed in her voice she found it difficult to hold a position and was only able to do part-time work. At the time of the hearing of this proceeding in 1951, she had recovered the use of her voice and seems to have entirely recovered from her throat cancer.’

The Tax Court said in its opinion that it had no reason to doubt the good faith and truthfulness of the taxpayer ..., but it nevertheless held that the expense of sending the children to school was not deductible as a medical expense under the provisions of § [213] ...

In our opinion the expenses incurred by the taxpayer were non-deductible family expenses within the meaning of § [262(a)] of the Code rather than medical expenses. Concededly the line between the two is a difficult one to draw, but this only reflects the fact that expenditures made on behalf of some members of a family unit frequently benefit others in the family as well. The wife in this case had in the past contributed the services – caring for the children – for which the husband was required to pay because, owing to her illness, she could no longer care for them. If, for example, the husband had employed a governess for the children, or a cook, the wages he would have paid would not be deductible. Or, if the wife had died, and

the children were sent to a boarding school, there would certainly be no basis for contending that such expenses were deductible. The examples given serve to illustrate that the expenses here were made necessary by the loss of the wife's services, and that the only reason for allowing them as a deduction is that the wife also received a benefit. We think it unlikely that Congress intended to transform family expenses into medical expenses for this reason. The decision of the Tax Court is further supported by its conclusion that the expenditures were to some extent at least incurred while the wife was acting as a typist in order to earn money for the family. ...

The decision is affirmed.

FRANK, Circuit Judge (dissenting).

....

... The Commissioner argued, successfully in the Tax Court, that, because the money spent was only indirectly for the sake of the wife's health and directly for the children's maintenance, it could not qualify as a 'medical expense.' Much is made of the fact that the children themselves were healthy and normal – and little of the fact that it was their very health and normality which were draining away the mother's strength. The Commissioner seemingly admits that the deduction might be a medical expense if the wife were sent away from her children to a sanitarium for rest and quiet, but asserts that it never can be if, for the very same purpose, the children are sent away from the mother – even if a boarding school for the children is cheaper than a sanitarium for the wife. I cannot believe that Congress intended such a meaningless distinction, that it meant to rule out all kinds of therapeutic treatment applied indirectly rather than directly – even though the indirect treatment be 'primarily for the \*\*\* alleviation of a physical or mental defect or illness.' [footnote omitted]. The cure ought to be the doctor's business, not the Commissioner's.

The only sensible criterion of a 'medical expense' – and I think this criterion satisfies Congressional caution without destroying what little humanity remains in the Internal Revenue Code – should be that the taxpayer, in incurring the expense, was guided by a physician's bona fide advice that such a treatment was necessary to the patient's recovery from, or prevention of, a specific ailment.



....

In the final analysis, the Commissioner, the Tax Court and my colleagues all seem to reject Mr. Ochs' plea because of the nightmarish spectacle of opening the floodgates to cases involving expense for cooks, governesses, baby-sitters, nourishing food, clothing, frigidaire, electric dish-washers – in short, allowances as medical expenses for everything 'helpful to a convalescent housewife or to one who is nervous or weak from past illness.' I, for one, trust the Commissioner to make short shrift of most such claims. [footnote omitted] The tests should be: Would the taxpayer, considering his income and his living standard, normally spend money in this way regardless of illness? Has he enjoyed such luxuries or services in the past? Did a competent physician prescribe this specific expense as an indispensable part of the treatment? Has the taxpayer followed the physician's advice in most economical way possible? Are the so-called medical expenses over and above what the patient would have to pay anyway for his living expenses, i.e., room, board, etc.? Is the treatment closely geared to a particular condition and not just to the patient's general good health or well-being?

My colleagues are particularly worried about family expenses, traditionally nondeductible, passing as medical expenses. They would classify the children's schooling here as a family expense, because, they say, it resulted from the loss of the wife's services. I think they are mistaken. The Tax Court specifically found that the children were sent away so they would not bother the wife, and not because there was no one to take care of them. Och's expenditures fit into the Congressional test for medical deductions because he was compelled to go to the expense of putting the children away primarily for the benefit of his sick wife. Expenses incurred solely because of the loss of the patient's services and not as a part of his cure are a different thing altogether. *Wendell v. Commissioner*, 12 T.C. 161, for instance, disallowed a deduction for the salary of a nurse engaged in caring for a healthy infant whose mother had died in childbirth. The case turned on the simple fact that, where there is no patient, there can be no deduction.

Thus, even here, expense attributed solely to the education, at least of the older child, should not be included as a medical expense. See *Stringham v. Commissioner*, *supra*. Nor should care of the children during that part of the day when the mother would be away, during the period while she was working part-time. *Smith v. Commissioner*, 40 B.T.A. 1038, *aff'd* 2d Cir., 113 F.2d 114. The same goes for any period when the older child would be away at public school during the day. In so far as the costs of this private schooling are thus allocable,

I would limit the deductible expense to the care of the children at the times when they would otherwise be around the mother. ...

...

*Notes and Questions:*

1. Is the rationale offered by the court consistent with the tax rules concerning imputed income?

- Does the rationale seem a bit reminiscent of the rationale in *Smith*?

2. What caused taxpayer to have to incur the expenses on his relatively modest income of sending the children to boarding school?

- Would taxpayers have had to bear these expenses if they did not have children?

- Would taxpayers have had to bear these expenses if Mrs. Ochs did not have throat cancer?

3. How much discretion did taxpayer have in incurring the expenses at issue in *Ochs*? If taxpayer had paid for Mrs. Ochs to reside in a sanitarium, that expense would qualify as a medical expense.

4. Consider: Prior to 1962 Mrs. Gerstacker had a history of emotional-mental problems which had grown gradually worse. In 1962 she ran away from mental hospitals twice after voluntarily entering them. Her doctors advised Mr. Gerstacker that successful treatment required their continued control so that Mrs. Gerstacker could not leave and disrupt her therapy. They recommended guardianship proceedings and hospitalization in Milwaukee Sanitarium, Wauwatosa, Wisconsin. Mr. Gerstacker instituted guardianship proceedings. Both Mr. and Mrs. Gerstacker employed attorneys. The court appointed guardians. Mrs. Gerstacker was hospitalized from 1962 until the latter part of 1963 when she was released by her doctors for further treatment on an out-patient basis. The guardianship was then terminated on the recommendation of her doctors because it was no longer necessary due to improved condition of the patient.

- Should the legal expenses for establishing, conducting, and terminating the guardianship be deductible as medical expenses? For whose benefit were the expenses incurred?

- See *Gerstacker v. Commissioner*, 414 F.2d 448 (6<sup>th</sup> Cir. 1969).



Do the CALI Lesson, *Basic Federal Income Taxation: Medical Expense Deductions*.

### *B. Casualty Losses*

Read § 165(c)(3), § 165(e), § 165(h), § 165(i).

Losses caused by “fire, storm, shipwreck, or other casualty, or from theft” do not usually result from personal consumption choices. Hence, a deduction seems appropriate. From the beginning, a problem has been to distinguish between a “bad hair day” and the type of damage that represents such a deprivation of consumption choice that a taxpayer should be permitted to share her burden with other taxpayers. Consider:

- We drop a plate, and it breaks. It’s called “life,” not a casualty.
- We willingly assume a risk and complain when something untoward happens. We own a cat and an expensive vase and leave them together in the same room. The cat knocks the vase over, and it breaks. *See Dyer v. Commissioner*, T.C. Memo. 1961-141, 1961 WL 424 (1961) (not a casualty).
- We deliberately cause a casualty. An arsonist claims a casualty loss deduction when she burns down her own house. After all, her loss was quite literally caused by “fire.” *See Blackmun v. Commissioner*, 88 T.C. 677, 681 (1987), *aff’d*, 867 F.2d 605 (1<sup>st</sup> Cir. 1988) (violation of public policy).
- We engage in a business where a certain amount of breakage is predictable. Taxpayer operates a fleet of taxicabs, and a few of them are damaged in traffic accidents.

The line between “life” and casualty has not proved to be easy to draw – and one does not have to search the digests very hard to find contradictory results. Moreover, the availability of insurance to protect against financial loss that a casualty causes may lead us to conclude that taxpayers should avail themselves of such protection. The cost of the folly of going uninsured should not be one that other taxpayers should bear when the foreseeable and insurable loss materializes. The involuntary conversion rules of § 1033, *see* chapter 2, *supra*, become more important. This is the position that Congress has taken for tax years 2018 to 2025. § 165(b)(5)(A). For those years, the deduction for personal casualty losses is limited

to personal casualty losses attributable to a Federally declared disaster. § 165(h)(5)(A).

•*Calculation of the personal casualty loss deduction.*

- Section 165(h) limits the losses that an individual may deduct as casualty losses.

- Reg. § 1.165-7(b)(1) limits *all* casualty losses – whether trade or business, transactions entered into for profit, or personal – to the lesser of the property’s fmV before the casualty reduced by the fmV of the property after the casualty OR the property’s adjusted basis.

- If the property is used in a trade or business or held for the production of income AND it is totally destroyed by the casualty, the allowable loss is limited to the adjusted basis of the property.

- What is the theoretical underpinning of these limitations?

- Section 165(h)(1) limits the deductibility of personal loss for *each* casualty to the amount by which the loss exceeds \$100.

- Section 165(h)(3)(A) defines “personal casualty gain” to be “recognized gain from any involuntary conversion of property” resulting from a casualty. Section 165(h)(3)(B) defines “personal casualty loss” to be a casualty loss after reduction by \$100.

- Section 165(h)(2) limits the deductibility of all personal casualty losses to the amount by which they exceed personal casualty gains and by which this net amount exceeds 10% of a taxpayer’s adjusted gross income. Taxpayer may

Taxpayer Certainty and Disaster Relief Act of 2019, Pub. L. No. 116-92, Div. Q, § 204(b) increased the amount that a taxpayer who suffers a personal casualty loss as the result of a presidentially-declared disaster may deduct. In the case of such disasters, a taxpayer may deduct all losses in excess of \$500. This type of personal casualty loss deduction is available irrespective of whether taxpayer itemizes. Taxpayer’s standard deduction is increased by the amount of such loss. The loss must occur during the “incident period,” i.e., the period specified by the Federal Emergency Management Agency (FEMA), but no later than 30 days after enactment of the statute. § 201(4).

The TCDTR, § 304(b) extended the availability of this deduction to February 25, 2021 (i.e., 60 days after enactment of the Taxpayer Certainty and Disaster Relief Act of 2020).

reduce her adjusted gross income by the net personal casualty loss in making this 10% determination. § 165(h)(4)(A).

- In the event personal casualty gains exceed personal casualty losses, taxpayer must treat all such gains and all such losses as if they resulted from the sales or exchanges of capital assets. § 165(h)(2)(B).
- For tax years 2018 to 2025, the casualty *loss* deduction is limited to losses attributable to a Federally declared disaster. Casualty losses other than those attributable to a Federally declared disaster do not offset casualty gains attributable to a Federally declared disaster. § 165(h)(5)(B)(i).
  - In the case of casualties other than those attributable to a Federally declared disaster, no deduction for loss is allowed. Taxpayer should still net personal casualty losses against personal casualty gains to reduce the capital gain she must recognize from the event. The personal casualty gain attributable to a Federally declared disaster is not used in the computation of personal casualty gain attributable to other casualties. § 165(h)(5)(B)(ii).
  - These rules manifest the importance of insurance – both in defining what is a casualty and in compensating for loss from a casualty – and of the deferral rule of § 1033 for involuntary conversions.
- A taxpayer suffering a casualty loss in a Federally declared disaster area may elect to claim the casualty loss deduction for the taxable year immediately preceding the taxable year in which the disaster occurred. This provision should help get funds into the hands of the victims of Federally declared disasters quickly. § 165(i)(1). The casualty loss is then treated as having occurred in the year for which the deduction is claimed. § 165(i)(2).

### III. Creating a More Efficient and Productive Economy

There are some deductions that the Code permits that promote a more efficient or productive economy. Under this heading, we might include dependent care expenses incurred so that taxpayer can work. We have already examined such expenditures.

- Also under this heading are the expenses of moving to a better – and presumably more valuable – job. Sections §§ 82, 217, 62(a)(15), 132(a)(6), and 132(g) create a set of rules assuring that a taxpayer pays no income tax on the income necessary to move to a new or different job. But: the Tax

Cuts and Jobs Act suspended the operation of these provisions for tax years 2018 to 2025. *See* §§ 132(g)(2) and 217(k).

Sections 221 and 62(a)(17) provide a deduction for interest paid on student loans. Because the § 221 deduction is named in § 62(a)(17), taxpayer benefits from this deduction even when she claims the standard deduction. The maximum interest deduction is \$2500, and the availability of the deduction phases out as taxpayers' AGI rises. The phaseout range is indexed for inflation and is \$155,000 to \$185,000 for tax year 2020 for taxpayers married filing jointly (half those amounts for unmarried taxpayers). § 221(b)(2)(B) (Rev. Proc. 2022-38, § 3.30). The phaseout range is \$70,000 to \$85,000 for single taxpayers. *Id.*

- What do you think the profile of the student is for whom this deduction would have the greatest impact?

The Code also provides *credits* that reduce the tax liability of a taxpayer, for pursuing education – which should enlarge the tax base.

- Section 25A provides two credits for investment in a taxpayer's, her spouse's, or her dependent's education.

- The American Opportunity Credit provides a credit of up to \$2500 for an education expenditure of \$4000. Taxpayer may claim the credit for each of four consecutive years. § 25A(b)(2)(A). Taxpayer may not claim the credit if she has completed the first four years of post-secondary education. § 25A(b)(2)(C). Forty percent of the credit is refundable. § 25A(i).

- The Lifetime Learning Credit alternatively, § 25A(c)(2)(A) (only American Opportunity Credit or Lifetime Learning Credit available on one individual), provides a credit of up to 20% of \$10,000 of educational expenses. There is no limit to the number of times a Lifetime Learning Credit can be claimed for an individual.

- Both the American Opportunity Tax Credit and the Lifetime Learning Credit are subject to income phaseouts. For taxpayers married filing jointly, the credit is phased out at AGI levels between \$160,000 and \$180,000 (between \$80,000 and \$90,000 for other taxpayers).

- These phaseouts imply that taxpayers with higher incomes do not need strong incentives (or perhaps any incentives) to incur such expenses.

- What do you think the profile of the student is for whom these credits would have the greatest impact?

## IV. Deferral Until Consumption

An “income tax” is a tax on income. A “consumption tax” is a tax on consumption. We have largely regarded the Code as creating an income tax. The Code actually creates a hybrid whereby income that a taxpayer holds in order to spend later on certain items of consumption is not subject to tax – if at all – until taxpayer actually spends it on those forms of consumption. Taxpayers know that they may one day retire and no longer have the income that their employment provided. They know that they may one day need money to pay for health care services. They know that they may one day need money to pay for the education of their children. The Code implicitly encourages taxpayers to set money aside to meet a personal expense they know they will incur later.

The Code may permit taxpayer to set money aside in an account and pay income tax on that money only when it is withdrawn to spend on consumption. *See* §§ 219(a), 62(a)(7) (money deposited in individual retirement account (IRA) deductible above-the-line; indexed limitation on deposit and indexed income phaseout applicable; taxable upon withdrawal). The Code may permit taxpayer to set aside after-tax money, never subject return on the investment of that money to tax, and permit withdrawal for taxpayer’s later consumption. *See* § 408A (“Roth IRA;” same deposit limit as § 219 (“traditional IRA”), with higher indexed income phaseout).<sup>197</sup> The Code may permit taxpayer to set aside after-tax money, defer tax on resulting investment income, and shift the tax burden to another whose tax bracket should be lower than taxpayer’s tax bracket. *See* § 529 (savings for tuition with state agency or educational institution; no contribution limits; beneficiary subject to income tax as if in receipt of annuity income); § 530 (Coverdell education savings account; annual contribution limits per beneficiary; contributors subject to relatively high income phaseout; beneficiary taxed on investment income of account; funds can be spent on elementary and secondary education). The Code may permit taxpayer to deduct without having to itemize the amount set aside for later consumption *and* not subject that amount or investment return to income tax, even upon consumption. *See* §§ 223, 106(d), 62(a)(19) (health savings accounts; excludable if funded by employer, deductible if funded by taxpayer).

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<sup>197</sup> There are other devices by which taxpayers and/or their employers can fund a pension. The mechanics of these devices will fall into one of these patterns. We defer consideration of them to a course on pension planning.



Financial institutions are usually very interested in you being interested in at least some of these accounts. Question: Is it better to deduct a current deposit to one of these accounts and pay income tax later or to deposit after-tax income in the account and never pay income tax on the investment income? This is one point of distinction between these patterns, and it is the question you must answer when deciding between a traditional IRA or a Roth IRA, assuming you may contribute to either without being subject to an income phaseout. Now for some smoke and mirrors.

Imagine: Taxpayer has \$5000 of income to deposit in an IRA or to deposit in a Roth IRA after paying income tax on it. Taxpayer is a 20% bracket taxpayer. Over the course of 30 years, savings will grow by a multiple of six (implying an interest rate between 6% and 7%, *see* Table 1 in the notes following *Bruun*).

- Traditional IRA*: Taxpayer deposits \$5000 in an IRA without paying income tax on it. In 30 years, taxpayer will have \$30,000 in her account. Upon withdrawal, taxpayer must pay a 20% income tax, i.e., \$6000. This will leave taxpayer \$24,000.
- Roth IRA*: Taxpayer must pay income tax of \$1000 (i.e., 20% of \$5000) on \$5000 and deposit the balance of \$4000 in her account. In thirty years, taxpayer will have \$24,000 in her account – the same amount she would have in her account if she had deposited the money in a traditional IRA.

Does this mean there is no difference between a traditional IRA and a Roth IRA? Hardly.

- While § 408A(c)(2) seemingly establishes the same cumulative limit for contributions to a Roth IRA as to a traditional IRA, one difference lies in the fact that deposits in a Roth IRA have already been taxed whereas contributions to a traditional IRA have not. AND: \$5000 of pre-tax money is *not* equal in value to \$5000 of after-tax money. In fact, the contribution limit for a Roth IRA is higher.

Does this mean that we should always prefer a Roth IRA to a traditional IRA? Hardly.

- The income that is spent on consumption in retirement is subject to tax at some point. We *assumed* that the rate of tax was the same, whether paid prior to deposit of money or upon withdrawal.
- How likely is that to be true?
  - Congress periodically changes tax brackets and it most certainly will change tax brackets sometime in the next thirty years.



- Furthermore, even without such bracket tinkering, it is unlikely that the income tax bracket of a taxpayer would be the same on dates that are thirty years apart. In retirement, most taxpayers have less income than they did in their working years and so are in a lower bracket. The Roth IRA (likely) requires payment of income tax when the taxpayer “is at the top of her game,” i.e., when her tax bracket is the highest it will ever be. The pattern is reversed for a traditional IRA, i.e., deductible when the deduction is worth more than it will ever be.
- Determining the relative merits of a traditional IRA and a Roth IRA requires that we examine the assumptions that we made in this exercise very carefully.
- One more assumption to question:* Who is the taxpayer? In the case of education funding accounts (§§ 529, 530), the student becomes the taxpayer. The taxpayer-depositor may be able to shift the tax burden on investment return from herself (presumably high bracket taxpayer) to the student (presumably low bracket taxpayer).<sup>198</sup>

*Final Note: Limitations on Deductions: Floors, Phaseouts, and Phasedowns*

We know that deduction floors and income phaseouts or phasedowns can reduce the availability of various income-tax-reducing measures to some taxpayers. The effect of these limitations on deductions is to raise the tax bracket of affected taxpayers by an undetermined amount and makes comparison of effective tax rates between two or more taxpayers extremely difficult.

Section § 68 provides an overall phasedown on itemized deductions. This phasedown has been suspended for tax years 2018 to 2025. § 68(f).

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<sup>198</sup> Recall that in *Horst*, taxpayer failed in his effort to execute such an inter-generational transfer of tax burdens. Taxpayer Horst’s technique of tax-burden-shifting has become a tool to encourage funding education expenses.

## Wrap-Up Questions for Chapter 7

1. Describe how § 170(e)(1)(A), which permits a deduction of the fmV of gifts of property to charity rather than the adjusted basis of the property, creates a “true” loophole.
2. Why should state and local property taxes and/or state and local income or sales taxes be deductible? What policies do such deductions pursue? Why should there be a \$10,000 limit to the deductibility of the sum of these deductions?
3. Congress recently increased the floor for medical deductions from 7.5% of AGI to 10% of agi (and later back to 7.5%). The floor was once 3%. The general trend of this floor has been upward. How are these movements in the floor likely to affect who may take the medical expense deduction and how big a deduction they may take?
4. What is the effect of deferring income tax on the income necessary to purchase a benefit, e.g., a comfortable retirement?
5. Should Congress implement its tax policy with greater use of credits against tax liability rather than deductions or exclusions from gross income? Why? What about phasedowns or phaseouts?

## What have you learned?

Can you explain or define –

- Whose benefit, donor’s or donee’s, is relevant in weighing the costs of a charitable contribution against its benefits?
- What is an individual’s contribution base? Why is it relevant?
- Whether a taxpayer may deduct both state and local income taxes, and state and local sales taxes?
- Who, in this time of the Affordable Care Act, is most likely to benefit from the medical expense deduction?
- How the Code measures a personal casualty loss and the extent to which taxpayer may have to recognize casualty gain until tax year 2026?
- How credits for education expenses promote a more productive economy?
- How tax credits ameliorate the upside-down effect of deductions and exclusions?

## Chapter 8: Tax Consequences of Divorce and Intra-Family Transactions

### I. Introduction

The tax consequences of marriage, support of a family, and divorce reflect how we choose to apply the basic principles that we tax income once and only once and that expenditures for personal consumption are not deductible. Taxpayer chooses whether to have a spouse or a child, so expenditures for the support of a spouse or a child presumably are not deductible. The same is true of expenditures to divorce.

The definition of “marriage” is a matter of state law; state law determines who is and who is not married.<sup>199</sup> State law also defines the rights that spouses have with respect to their property and income before, during, and after the marriage. State law governs adoptions and so is determinative of who is a “child” of the taxpayer. State (or local) law also governs the placement of foster children. State law defines the obligations that family members have towards each other – notably that parents have obligations of support for their children up to a certain age. This may affect whether one person is a dependent of a taxpayer.

We already know that the filing status “married filing jointly” implies that married persons are in fact one taxpaying unit, whether one or both contribute to its taxable income. The fact that a taxpayer provides financial support to a person other than a spouse may give that other person the tax status of “dependent” and entitle taxpayer

#### *The Tax Formula:*

(gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
→ MINUS (standard deduction or itemized deductions)  
→ MINUS (deduction for “qualified business income”)

EQUALS (taxable income)

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

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<sup>199</sup> States may not deny same-sex couples the right to marry. *See* Obergefell v. Hodges, 576 U.S. 644, 675-76, (2015) (fundamental liberty as well as Due Process and Equal Protection rights).

to a reduction of his tax liability. Section 151 gives (gave?) taxpayer a deduction of a fixed exemption amount for each of the taxpayer's dependents. The Tax Cuts and Jobs Act for tax years 2018 to 2025 fixes the exemption amount at zero. § 151(d)(5)(A). However, for the same years § 24 provides credits for dependents other than spouses. We learn shortly that whether one is a dependent of taxpayer usually turns on the existence of a family relationship. Moreover, § 32 conditions one level of the earned income credit on taxpayer having one more qualifying child.

We consider here the tax ramifications of marriage and family – before, during, and after.

## II. Before Marriage

The Code treats a married couple as one taxpayer – although spouses may elect to be taxed separately. *Until* they are married, they remain separate taxpayers – although one might be a dependent of the other. Aside from contractual undertakings, the law does not require one to support the other. Taxpayers may enter certain transactions with each other in contemplation of marriage, but presumptively such transactions are arm's-length transactions.

### **Farid-es-Sultaneh v. Commissioner**, 160 F.2d 812 (2<sup>d</sup> Cir. 1947)

CHASE, Circuit Judge.

The problem presented by this petition is to fix the cost basis to be used by the petitioner in determining the taxable gain on a sale she made in 1938 of shares of corporate stock. She contends that it is the adjusted value of the shares at the date she acquired them because her acquisition was by purchase. The Commissioner's position is that she must use the adjusted cost basis of her transferor because her acquisition was by gift. The Tax Court agreed with the Commissioner and redetermined the deficiency accordingly.

....

The petitioner is an American citizen who filed her income tax return for the calendar year 1938 ... and ... reported sales during that year of 12,000 shares of the common stock of the S.S. Kresge Company at varying prices per share, for the total

sum of \$230,802.36 which admittedly was in excess of their cost to her. ...

In December 1923 when the petitioner, then unmarried, and S.S. Kresge, then married, were contemplating their future marriage, he delivered to her 700 shares of the common stock of the S.S. Kresge Company which then had a fair market value of \$290 per share. The shares ... were to be held by the petitioner “for her benefit and protection in the event that the said Kresge should die prior to the contemplated marriage between the petitioner and said Kresge.” The latter was divorced from his wife on January 9, 1924, and on or about January 23, 1924 he delivered to the petitioner 1800 additional common shares of S.S. Kresge Company which were also ... to be held by the petitioner for the same purposes as were the first 700 shares he had delivered to her. On April 24, 1924, and when the petitioner still retained the possession of the stock so delivered to her, she and Mr. Kresge executed a written ante-nuptial agreement wherein she acknowledged the receipt of the shares “as a gift made by the said Sebastian S. Kresge, pursuant to this indenture, and as an ante-nuptial settlement, and in consideration of said gift and said ante-nuptial settlement, in consideration of the promise of said Sebastian S. Kresge to marry her, and in further consideration of the consummation of said promised marriage” she released all dower and other marital rights, including the right to her support to which she otherwise would have been entitled as a matter of law when she became his wife. They were married in New York immediately after the ante-nuptial agreement was executed and continued to be husband and wife until the petitioner obtained a final decree of absolute divorce from him on, or about, May 18, 1928. No alimony was claimed by, or awarded to, her.

The stock so obtained by the petitioner from Mr. Kresge had a fair market value of \$315 per share on April 24, 1924, and of \$330 per share on, or about May 6, 1924, when it was transferred to her on the books of the corporation. She held all of it for about three years, but how much she continued to hold thereafter is not disclosed except as that may be shown by her sales in 1938. Meanwhile her holdings had been increased by a stock dividend of 50%, declared on April 1, 1925; one of 10 to 1 declared on January 19, 1926; and one of 50%, declared on March 1, 1929. Her adjusted basis for the stock she sold in 1938 was \$10.66⅔ per share computed on the basis of the fair market value of the shares which she obtained from Mr. Kresge at the time of her acquisition. His adjusted basis for the shares she sold in 1938 would have been \$0.159091.

When the petitioner and Mr. Kresge were married he was 57 years old with a life expectancy of 16½ years. She was then 32 years of age with a life expectancy of

33¾ years. He was then worth approximately \$375,000,000 and owned real estate of the approximate value of \$100,000,000.

The Commissioner determined the deficiency on the ground that the petitioner's stock obtained as above stated was acquired by gift within the meaning of that word as used in § [102] and, as the transfer to her was after December 31, 1920, used as the basis for determining the gain on her sale of it the basis it would have had in the hands of the donor. This was correct if the just mentioned statute is applicable, and the Tax Court held it was on the authority of *Wemyss v. Commissioner*, 324 U.S. 303, and *Merrill v. Fahs*, 324 U.S. 308.

The issue here presented cannot, however, be adequately dealt with quite so summarily. The *Wemyss* case determined the taxability to the transferor as a gift, under [the Federal Gift Tax] ... of property transferred in trust for the benefit of the prospective wife of the transferor pursuant to the terms of an ante-nuptial agreement. It was held that the transfer, being solely in consideration of her promise of marriage, and to compensate her for loss of trust income which would cease upon her marriage, was not for an adequate and full consideration in money or money's worth ... [and] was not one at arm's length made in the ordinary course of business. But we find nothing in this decision to show that a transfer, taxable as a gift under the gift tax, is ipso facto to be treated as a gift in construing the income tax law.

In *Merrill v. Fahs*, *supra*, it was pointed out that the estate and gift tax statutes are in pari materia and are to be so construed. *Estate of Sanford v. Commissioner*, 308 U.S. 39, 44. The estate tax provisions in the Revenue Act of 1916 required the inclusion in a decedent's gross estate of transfers made in contemplation of death, or intended to take effect in possession and enjoyment at or after death except when a transfer was the result of "a bona fide sale for a fair consideration in money or money's worth." [citation omitted]. The first gift tax became effective in 1924, and provided *inter alia*, that where an exchange or sale of property was for less than a fair consideration in money or money's worth the excess should be taxed as a gift. [citation omitted]. While both taxing statutes thus provided, it was held that a release of dower rights was a fair consideration in money or money's worth. *Ferguson v. Dickson*, 3 Cir., 300 F. 961, *cert. denied*, 266 U.S. 628; *McCaughn v. Carver*, 3 Cir., 19 F.2d 126. Following that, Congress in 1926 replaced the words "fair consideration" in the 1924 Act limiting the deductibility of claims against an estate with the words "adequate and full consideration in money or money's worth" and in 1932 the gift tax statute as enacted limited consideration in the same way. Rev. Act 1932, § 503. Although Congress in 1932 also expressly provided that the

release of marital rights should not be treated as a consideration in money or money's worth in administering the estate tax law, Rev. Act of 1932, § 804, 26 U.S.C.A. ..., and failed to include such a provision in the gift tax statute, it was held that the gift tax law should be construed to the same effect. *Merrill v. Fahs*, *supra*.

We find in this decision no indication, however, that the term "gift" as used in the income tax statute should be construed to include a transfer which, if made when the gift tax were effective, would be taxable to the transferor as a gift merely because of the special provisions in the gift tax statute defining and restricting consideration for gift tax purposes. A fortiori, it would seem that limitations found in the estate tax law upon according the usual legal effect to proof that a transfer was made for a fair consideration should not be imported into the income tax law except by action of Congress.

In our opinion the income tax provisions are not to be construed as though they were in pari materia with either the estate tax law or the gift tax statutes. They are aimed at the gathering of revenue by taking for public use given percentages of what the statute fixes as net taxable income. Capital gains and losses are, to the required or permitted extent, factors in determining net taxable income. What is known as the basis for computing gain or loss on transfers of property is established by statute in those instances when the resulting gain or loss is recognized for income tax purposes and the basis for succeeding sales or exchanges will, theoretically at least, level off tax-wise any hills and valleys in the consideration passing either way on previous sales or exchanges. When Congress provided that gifts should not be treated as taxable income to the donee there was, without any correlative provisions fixing the basis of the gift to the donee, a loophole which enabled the donee to make a subsequent transfer of the property and take as the basis for computing gain or loss its value when the gift was made. Thus it was possible to exclude from taxation any increment in value during the donor's holding and the donee might take advantage of any shrinkage in such increment after the acquisition by gift in computing gain or loss upon a subsequent sale or exchange. It was to close this loophole that Congress provided that the donee should take the donor's basis when property was transferred by gift. Report of Ways and Means Committee (No. 350, P. 9, 67th Cong., 1st Sess.). This change in the statute affected only the statutory net taxable income. The altered statute prevented a transfer by gift from creating any change in the basis of the property in computing gain or loss on any future transfer. In any individual instance the change in the statute would but postpone taxation and presumably would have little effect on the total volume of income tax

revenue derived over a long period of time and from many taxpayers. Because of this we think that a transfer which should be classed as a gift under the gift tax law is not necessarily to be treated as a gift income-tax-wise. Though such a consideration as this petitioner gave for the shares of stock she acquired from Mr. Kresge might not have relieved him from liability for a gift tax, had the present gift tax then been in effect, it was nevertheless a fair consideration which prevented her taking the shares as a gift under the income tax law since it precluded the existence of a donative intent.

Although the transfers of the stock made both in December 1923, and in the following January by Mr. Kresge to this taxpayer are called a gift in the ante-nuptial agreement later executed and were to be for the protection of his prospective bride if he died before the marriage was consummated, the “gift” was contingent upon his death before such marriage, an event that did not occur. Consequently, it would appear that no absolute gift was made before the ante-nuptial contract was executed and that she took title to the stock under its terms, *viz*: in consideration for her promise to marry him coupled with her promise to relinquish all rights in and to his property which she would otherwise acquire by the marriage. Her inchoate interest in the property of her affianced husband greatly exceeded the value of the stock transferred to her. It was a fair consideration under ordinary legal concepts of that term for the transfers of the stock by him. *Ferguson v. Dickson, supra*; *McCaughn v. Carver, supra*. She performed the contract under the terms of which the stock was transferred to her and held the shares not as a donee but as a purchaser for a fair consideration.

....

Decision reversed.

*Estate and Gift Tax*: The estate and gift taxes are in *pari materia* with each other. Neither is in *pari materia* with the income tax. What does this mean?

CLARK, Circuit Judge (dissenting)  
(omitted).

### *Notes and Questions:*

1. Did the Commissioner lose out on taxing any transactions in 1923 and 1924? Which ones?

- Remember: the exchange of property whose value has appreciated or depreciated to pay for something is a recognition event. Why?



- What did the parties buy and sell in this case?

2. What did taxpayer give as consideration in this case? How much did she pay for the consideration that she gave? When was the money that she used to pay for it subject to income tax?

- How is this contrary to the sale-of-blood cases – where the amount realized is taxed in full?

*S.S. Kresge*: Who was S.S. Kresge? What did he do to make stock in his corporation go up so much in value?

3. If there had been no ante-nuptial agreement, would the court's holding have been the same?

- What if the parties had married and *then* executed a post-nuptial agreement with the same terms as the ante-nuptial agreement?

### III. During Marriage

#### *A. Tax Consequences of Support Obligations*

Consider this variation of *Cidis v. White*, 71 Misc. 2d 481, 336 N.Y.S.2d 362 (Dist. Ct. Nassau Cty., 1972): Dependent daughter without her parents' knowledge made an appointment with Dr. White to be fitted for contact lenses. Dr. White ordered the contact lenses, and they were of no use to anyone except for daughter Cidis. Daughter Cidis was a minor, and her contracts were voidable under state law. Father Cidis elected to void the contract. Dr. White sued for quasi-contract and restitution.

- Assume that Father Cidis has an obligation to provide Daughter Cidis with "necessaries."
- Should Father Cidis be liable for the fmV of the contact lenses – not on the theory that there was an admittedly voidable contract, but because Dr. White provided his daughter with a "necessary?"
  - Are contact lenses one of life's "necessaries" if Daughter Cidis does not see very well?
  - Would it matter that contact lenses are cheaper than spectacles?
- If contact lenses are a "necessary" and Dr. White delivered the contact lenses to Daughter Cidis, but neither Father Cidis nor Daughter Cidis would pay for them, does *Father Cidis* have gross income? Why or why not?

## *B. Filing Status*

We know that the “filing status” of a taxpayer determines the tax rate applicable to increments of taxable income. We also know that there are such things as a “marriage bonus” and a “marriage penalty” – depending on the relative pre-marital income levels of the spouses. We have already considered the relative burdens of each of the filing statuses. Now we briefly consider the rules that place a taxpayer in one filing status or another.

*Married Filing Jointly and Married Filing Separately:* Section 1(a) provides that married persons who file a single tax return and certain surviving spouses must pay an income tax at the tax brackets specified. For income tax purposes, state law determines whether two persons are married.

- Section 7703 states various rules concerning application of tax rules to marriage and separation. Read it.
  - What is the rule established by § 7703(a)(1)?
  - What is the rule established by § 7703(a)(2)?
  - What is the rule established by § 7703(b)?
- Section 2(a) defines “surviving spouse.” Read it.

Section 1(d) provides that married persons who do not file a single tax return jointly (i.e., they are “married filing separately”) must pay an income tax at the tax brackets specified.

*Head of Household:* Section 1(b) provides that a “head of household” must pay an income tax at the tax brackets specified.

- Section 2(b) defines “head of household.” Read it.
  - Can a married person be a “head of household?”
  - Can a surviving spouse be a “head of household?”

*Unmarried Individuals:* Section 1(c) provides that every unmarried individual – other than a surviving spouse or head of household – must pay an income tax at the tax brackets specified.



Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Filing Status*.

### *C. Dependents*

Section 152 defines “dependent.”

- A “dependent” must be either a “*qualifying child*” or a “*qualifying relative*.” § 152(a).
- A dependent must be a citizen, national, resident of the United States, or resident of a country contiguous with the United States. § 152(b)(3)(A). This limitation does not apply to an adopted child who has the same principal place of abode as a taxpayer and is a member of the taxpayer’s household, provided that the taxpayer is a citizen or national of the United States. § 152(b)(3)(B).
- A dependent may not claim another as a dependent. § 152(b)(1).
- A spouse who files a joint return cannot be the dependent of another taxpayer. § 152(b)(2).

Section 151(a) provides that a taxpayer who is an “individual” is entitled to a deduction of an “exemption amount” for each “dependent,” § 151(c). In addition, a taxpayer who files “married filing jointly” may claim a deduction of the exemption amount for both himself and his spouse. Reg. § 1.151-1(b) (third sentence, two exemptions allowed). A taxpayer who is married but does not file a joint return may claim a deduction of the exemption amount for a spouse who has no gross income and is not the dependent of another taxpayer, § 151(b). The “exemption amount” is a fixed amount per dependent, *see* § 151(d)(1), indexed for inflation, § 151(d)(4). A taxpayer may not deduct an “exemption amount” for any person for whom a dependency deduction is allowable to another taxpayer, § 151(d)(2).

For tax years 2018 to 2025, the exemption amount is zero. § 151(d)(5)(A). The deduction has been replaced with a doubled child tax credit (to \$2000) available to taxpayers at higher income levels, a refundable tax credit of up to \$1400 for taxpayers unable to take full advantage of the child tax credit, and a \$500 tax credit for each “qualifying relative.” § 24(h)(2, 5, 4). Under the temporary rules, the definition of “qualifying child” and “qualifying relative” remain important.

***Qualifying Child:*** A “qualifying child” is an individual who meets certain requirements of relationship, place of abode, age, support, and filing status. § 152(c)(1).

- ***Relationship:*** A “qualifying child” can be –
  - a child of the taxpayer, § 152(c)(1), i.e., son, daughter, stepson,

stepdaughter, or a foster child placed by an authorized placement agency or under court order (§152(f)(1)(A and C)) or a descendant of such an individual, § 152(c)(2)(A). Taxpayer's legal adoption of a son, daughter, stepson, or stepdaughter renders a person a child of the taxpayer by blood. § 152(f)(1)(B); OR

- a brother, sister, stepbrother, or stepsister or a descendant of any such relative. § 152(c)(2)(B). This includes a half-brother or half-sister. § 152(f)(4).

- *Abode*: A "qualifying child" must have "the same principal place of abode as the taxpayer for more than one-half" of the year. § 152(c)(1)(B).

- There are special rules when the "qualifying child" is the child of divorced parents. If the "qualifying child" receives over one-half of his support during the year from his parents (including as a parent's contribution the contribution of a new spouse, § 152(e)(6)) who either –

- are divorced, § 152(e)(1)(A)(i),
- are separated under a written separation agreement, § 152(e)(1)(A)(ii), or
- live apart for all the last six months of the calendar year, § 152(e)(1)(A)(iii),

- *and* the child is in the custody of one or both the parents for more than one-half of the calendar year, then the custodial parent (i.e., the parent having custody for the greater portion of the calendar year, § 152(e)(4)(A)), may claim the child as a dependent, *unless*

- The custodial parent executes a Form 8332 by which the custodial parent declares that he will not claim the child as a dependent, § 152(e)(2)(A), and
- The noncustodial parent attaches Form 8332 to his tax return. § 152(e)(2)(B).

- These special rules for divorced parents do not apply to any case where the child received over one-half of his support under a so-called "multiple support agreement." § 152(e)(5).

- *Age*: A "qualifying child" must be younger than the taxpayer (§ 152(c)(3)(A)) and –

- not yet 19 years old, § 152(c)(3)(i), *unless*
  - the individual is permanently and totally disabled at any time during the year, § 152(c)(3)(B), *or*

- the child is a student who is not yet 24 years old, § 152(c)(3)(A)(ii). A “student” who is an individual who is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training. § 152(f)(2).

- Support*: A “qualifying child” is one who did not provide more than one-half of his own support. § 152(c)(1)(D). Scholarships are not taken into account. § 152(f)(5).

- Filing status*: A “qualifying child” may not file a joint return other than to claim a refund with his spouse. § 152(c)(1)(E).

It can happen that two or more persons can claim the same “qualifying child” as a dependent. In such a case, the “qualifying child” is treated as the “qualifying child” of –

- a parent, § 152(c)(4)(A)(i):

- If more than one parent can claim the “qualifying child” and the parents do not file a joint return, § 152(c)(4)(B), the child is the “qualifying child” of –

- the parent with whom the child resided the longest during the taxable year, § 152(c)(4)(B)(i), or

- if the child resided with each parent an equal amount of time, the parent with the highest adjusted gross income. § 152(c)(4)(B)(ii).

- In the event the child *is* a “qualifying child” with respect to a parent but no parent claims the “qualifying child,” another taxpayer may claim the child as a dependent *if* that taxpayer’s adjusted gross income is higher than the highest adjusted gross income of a parent. § 152(c)(4)(C).

- If the child *is not* a “qualifying” child as to a parent, the taxpayer with the highest adjusted gross income for whom the individual is a “qualifying child” may claim the child as a dependent. § 152(c)(4)(A)(ii).

*N.B.*: Section 151 allowed (allows?) a deduction of an “exemption amount” for each of taxpayer’s “dependents.” § 151(a, b, and c). As noted, the “exemption amount” for tax years 2018 to 2025 is zero. Instead, taxpayers may be entitled to a “child tax credit” of \$2000. § 24(h)(2). Prior to enactment of the Tax Cuts and Jobs Act, the credit was \$1000. The conditions of the “child tax credit” are not a perfect fit with

§ 151(c) (dependent deduction) and § 152(c) (qualifying child). The “child tax credit” is only available until the child turns 17, § 24(a)(1), not 19 (24 in the case of a student). Moreover, the credit is not available for a child who is a resident of a country contiguous to the United States. § 24(c)(2). However, a “qualifying child” who is 17 or older may still be a dependent for which taxpayer is entitled to a \$500 tax credit. § 24(h)(4)(A). The “child tax credit” is non-refundable. § 26(a). The “child tax credit” is subject to an income phaseout when a taxpayer’s modified adjusted gross income exceeds \$400,000 for taxpayers married filing jointly or \$200,000 for other taxpayers. § 24(h)(3), § 24(b)(1) (credit reduced by 5% of excess). Prior to enactment of the TCJA, the phaseout began at \$110,000 for taxpayers married filing jointly and at \$75,000 for unmarried taxpayers. § 24(b)(2).

For taxpayers whose tax liability is reduced to \$0 and so cannot avail themselves of the full “child tax credit,” § 24(d) creates “an additional child tax credit” (ACTC). The ACTC is refundable to the extent a taxpayer could not use the full \$2000 “child tax credit.” The TCJA caps the credit at \$1400 (indexed for inflation) per qualifying child. § 24(h)(5). The ACTC is only available to a taxpayer with *earned income*. The refundable amount is equal to 15% of the amount by which taxpayer’s earned income exceeds \$2500 or by which taxpayer’s social security taxes exceed taxpayer’s earned income credit if taxpayer has 3 or more qualifying children – WHICHEVER is greater. § 24(h)(5), § 24(d)(1)(B). The amount of the ACTC is subject to the additional condition that the “child tax credit” plus the ACTC cannot exceed \$2000. § 24(d)(1)(A).

ARPA, § 9611, 26 U.S.C. 24(i): For tax year 2021, the child tax credit is increased from \$2000 per qualifying child to \$3000 and to \$3600 per qualifying child who has not attained the age of 6. The credit is made refundable. Furthermore, the credit is available until the child turns 18. The Secretary may make periodic payments to taxpayers of this credit. The credit is subject to a phase-out.

The amount of the “additional child tax credit” is dependent on the amount by which taxpayer’s earned income exceeds \$3000. Because the pandemic caused widespread job loss, taxpayers may opt to use their 2019 earned income to determine the amount of this credit for tax year 2020. CAA § 211.

For purposes of the Earned Income Credit, ARPA, § 9626 extends this election forward to 2021.

**Qualifying Relative:** A “qualifying relative” is an individual who meets certain requirements of relationship, gross income, support, and status.

•**Relationship:** A “qualifying relative” with respect to the taxpayer may be –

- a child or descendant of a child, § 152(d)(2)(A), i.e., son, daughter, stepson, stepdaughter, or a foster child placed by an authorized placement agency or under court order (§152(f)(1)(A and C)) or a descendant of such an individual, § 152(c)(2)(A). Taxpayer’s legal adoption of a son, daughter, stepson, or stepdaughter renders such a person a child of the taxpayer by blood. § 152(f)(1)(B);
- a brother, sister, stepbrother, or stepsister. § 152(d)(2)(B). This includes a half-brother or half-sister. § 152(f)(4);
- a father or mother or ancestor of a father or mother; § 152(d)(2)(C);
- a stepfather or stepmother, § 152(d)(2)(D);
- a son or daughter of a brother or sister (i.e., nephew or niece), § 152(d)(2)(E);
- a brother or sister of the father or mother (i.e., uncle or aunt), § 152(d)(2)(F);
- a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law, § 152(d)(2)(G);
- an individual, other than one who was at any time during the taxable year a spouse, who for the taxable year has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household. § 152(d)(2)(H).
- An individual is not a member of taxpayer’s household if at any time during the taxable year the relationship between the individual and the taxpayer is in violation of local law. § 152(f)(3).

•**Gross Income:** The gross income of a “qualifying relative” may not be equal to or more than the exemption amount.<sup>200</sup> § 152(d)(1)(B).

• The gross income of a permanently and totally disabled individual

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<sup>200</sup> For tax years 2018 to 2025, the personal exemption amount is zero. § 151(d)(5)(A). However, for purposes of determining dependency, the personal exemption amount is not taken into account. § 151(d)(5)(B). For tax year 2023, the personal exemption amount is \$4700. Rev. Proc. 2022-38, § 3.24. The same exemption amount will apply in determining eligibility for the \$500 credit for a dependent other than a “qualifying child,” § 24(h)(4)(A), and in determining whether a taxpayer is a “head of household.” § 2(b)(1)(A)(ii). See generally I.R.S. Notice 2018-70, 2018-38 I.R.B. 441 (“Guidance on Qualifying Relative and the Exemption Amount”).



does not include income attributable to services rendered at a charitable institution that provides special instruction or training designed to alleviate the disability, § 152(d)(4)(B), and the individual's principal reason for his presence there is the availability of medical care and the income arises only from activities at the institution incident to such medical care, § 152(d)(4)(A). § 152(d)(4).

•*Support*: Taxpayer must provide over one-half of the individual's support

CARES Act, § 2201, 26 U.S.C. § 6428: This section provides for a refundable credit for 2020 of \$1200 for individuals, \$2400 for joint returns, and \$500 for each qualifying child (see accompanying text). These credits phase out at the rate of 5% of taxpayers' agi that exceeds \$150,000 (married filing jointly), \$112,500 (head of household), and \$75,000 (single individual). Section 6428(f) provides that the Secretary is to refund or credit these amounts "as rapidly as possible."

In the CAA, the Covid-Related Tax Relief Act of 2020, § 272 added § 6428A to the Code, which provides an additional refundable credit of \$600 for individuals and \$1200 for joint returns plus a \$600 credit for each of taxpayer's "qualifying children." These credits are subject to the same phase out as the CARES Act credit.

ARPA, § 9601, 26 U.S.C. § 6428B: This section provides for a refundable credit for 2021 of \$1400 for individuals, \$2800 for joint returns, and \$1400 for each dependent, i.e., qualifying child or qualifying relative, 26 U.S.C. § 6428B(e)(1) ("dependent" as defined in § 152)). These amounts phase out as taxpayer's agi rises to \$80,000 for individuals, \$160,000 for taxpayers married filing jointly, and \$120,000 for taxpayers filing as head of household.

for the calendar year. § 152(d)(1)(C).

•An alimony or separate maintenance payment is not counted as payment for support of a dependent.

§ 152(d)(5)(A).

•*Multiple Support*

*Agreements*: If there is no taxpayer who contributed over one-half of an individual's support,

§ 152(d)(3)(A),

•a taxpayer for whom the individual would

otherwise have been a "qualifying individual,"

§ 152(d)(3)(B), and

•who contributed more than 10% of the individual's support,

§ 152(d)(3)(C),

•may claim the individual as a dependent provided that all others who contributed more than 10% of the individual's support file a declaration that they will not claim the individual



as a dependent, § 152(d)(3)(D).

- The rules governing treatment of an individual whose parents are divorced that govern the individual's abode apply as well to determinations between the parents with respect to support. § 152(e)(1).

- Status*: A “qualifying relative” may not be a “qualifying child” of the taxpayer or of any other taxpayer. § 152(d)(1)(D).

*N.B.*: The exemption amount for tax years 2018 to 2025 is zero. The TCJA creates a \$500 tax credit for dependents other than those qualifying for the “child tax credit.” § 24(h)(4)(A).

*Comment*: We have seen the near elimination of any marriage penalty. We have seen the exemption amount reduced to zero. We note that the Tax Cuts and Jobs Act doubled the standard deduction. But the effect of this doubling is mitigated by the suspension of many deductions, capping the SALT deductions at \$10,000, and denying a deduction for personal exemptions.

Consider the change in emphasis that the doubled “child tax credit” brings about. The indexed exemption amount for 2017 was \$4050. A taxpayer in the 10% tax bracket saved \$405 per exemption. The same taxpayer who benefits from a \$2000 “child tax credit” would have to have a deduction of \$20,000 to obtain the same level of saving. For a 12% taxpayer, the same figures are \$486 and \$16,666.67. For a 22% bracket taxpayer, the figures are \$891 and \$9090. What do these numbers say about the use of credits rather than deductions?

Do you see a discernible trend in Congress’s attitude about families with children? Remember, *Smith* and *Ochs* are still good law.

#### *D. Intra-Family Transactions*

In various sections, the Tax Code creates presumptions that the members of a family share a common interest and addresses that presumption.<sup>201</sup>

- We may choose to ignore every tax aspect of a transaction between family members. In many respects, § 1041 (discussed *infra*) has this effect.

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<sup>201</sup> We defer discussion of some of these presumptions to more advanced courses. See § 318.

- We may curtail the tax advantages of transactions where close relationships could lead to abuse.
- Read §§ 267(a)(1), 267(b)(1), 267(c)(2), 267(c)(4), 267(d),<sup>202</sup> and 1041.

Consider:

1. Taxpayer owned Greenacre. Taxpayer's adjusted basis in Greenacre was \$25,000. Taxpayer sold Greenacre to his grandson for \$15,000, its fmV.
  - How much loss may Taxpayer deduct under § 165(a and c(2))? *See* §§ 267(a)(1), 267(b)(1), 267(c)(4).
  - What is grandson's basis in Greenacre?
  - Now suppose that Grandson sold Greenacre to Clive for –
    - \$10,000. How much loss could Grandson deduct?
    - \$20,000. How much gain (loss?) must Grandson report? *See* § 267(d).
    - \$30,000. How much gain must Grandson report? *See* § 267(d).
2. Have we seen this pattern of gain and loss recognition before?
3. Would your answers be different if Taxpayer had sold Greenacre to his uncle? – grandmother? – nephew?
4. Would your answers be different if Taxpayer had sold Greenacre to his husband? *See* § 1041.

#### IV. After Marriage: Tax Consequences of Divorce

Divorce renders spouses separate taxpayers with interests that should (at some point) no longer be presumed to be the same. Various rights and obligations may ensue, and their origins might be –

- a legal duty,
- ownership of property, or
- an agreement.

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<sup>202</sup> These selected parts of § 267 apply to transactions between family members. Be aware that the scope of § 267 is broader than merely transactions involving family members. We defer discussion of these other transactions to later tax courses.

### *A. Alimony and Property Settlement*

The “law” imposes various duties upon persons. The source of a duty may be a relationship. For example, a parent may have a duty to provide “necessaries” for his minor child.

- If a parent fails in that duty and a third person steps up and pays money to fulfill that duty, must the parent recognize gross income?
- If a family member has a duty to another that requires some payment of money to fulfill, should such payment give rise to a deduction?
  - What answers do cases such as *Flowers*, *Hantzis*, *Smith*, and *Ochs* imply?

- Consider –

**Gould v. Gould**, 245 U.S. 151 (1917)

MR. JUSTICE McREYNOLDS delivered the opinion of the Court.

A decree of the Supreme Court for New York County entered in 1909 forever separated the parties to this proceeding, then and now citizens of the United States, from bed and board, and further ordered that plaintiff in error pay to Katherine C. Gould during her life the sum of \$3000 every month for her support and maintenance. The question presented is whether such monthly payments during the years 1913 and 1914 constituted parts of Mrs. Gould's income within the intendment of the act of Congress approved October 3, 1913, 38 Stat. 114, 166, and were subject as such to the tax prescribed therein. The court below answered in the negative, and we think it reached the proper conclusion.

....

In *Audubon v. Shufeldt*, 181 U.S. 575, 577-578, we said:

“Alimony does not arise from any business transaction, but from the relation of marriage. It is not founded on a contract, express or implied, but on the natural and legal duty of the husband to support the wife. The general obligation to support is made specific by the decree of the court of appropriate jurisdiction. ... Permanent alimony is regarded rather as a portion of the husband's estate to which the wife is equitably entitled than

as strictly a debt; alimony from time to time may be regarded as a portion of his current income or earnings. ...”

The net income of the divorced husband subject to taxation was not decreased by payment of alimony under the court’s order, and, on the other hand, the sum received by the wife on account thereof cannot be regarded as income arising or accruing to her within the enactment.

The judgment of the court below is

Affirmed.

*Notes and Questions:*

1. What basis of the obligation to pay alimony does the Court recognize?
2. The holding in *Gould* was the rule until World War II. At that time, tax brackets increased to such a level that many men came out below \$0 when they paid alimony and the income tax on the alimony. Congress acted. It made alimony a § 62 deduction to the payor and gross income to the payee. This permitted (encouraged) divorcing spouses to characterize any payment as alimony. The source of their obligation became agreement or court order. The parties could enlarge the pie they had to split by arranging to have the ex-spouse in the lower tax bracket be liable for income tax on the alimony.
3. This has all changed. In the Tax Cuts and Jobs Act, Congress repealed all the alimony provisions of the Code for any divorce or separation instrument executed after December 31, 2018. As of tax year 2019, we revert to the rule of *Gould v. Gould*.
4. *Property* settlement: A property settlement divides marital property – assets as well as debts. Presumably, the spouses purchased assets with after-tax dollars and so its allocation to one spouse or the other should *not* be the occasion for another layer of income tax.

### *B. Payments to Ex-Spouses to Surrender Rights*

We might suppose that the event of divorce should vest (or re-vest) each ex-spouse with property rights that can be bought and sold – with all the tax consequences that should naturally flow from such transactions.

- *Should* the event of divorce cause us to treat rights that can only exist between spouses as property that can be bought and sold in commercial transactions? How should we value such rights?<sup>203</sup>

- The United States Supreme Court addressed these questions in *United States v. Davis*, 370 U.S. 65 (1962).

**Note** on *United States v. Davis*, 370 U.S. 65 (1962) and § 1041

In *United States v. Davis*, H transferred pursuant to a property settlement appreciated stock (basis = \$74,775.37, fmv = \$82,250) to W in exchange for W's surrender of all claims against H, including dower and all rights of testacy and intestacy under Delaware state law. The Government argued that the transfer was made in exchange for an independent legal obligation. Taxpayer H argued that the transfer was comparable to a nontaxable division of property between two co-owners. The Court concluded that Delaware state law did not make W a co-owner of the stock – as might occur in community property states. Instead, H exchanged stock for W's surrender of claims against him. In the absence of any method to value what W surrendered, the Court – by assuming that the parties engaged in an even exchange – treated H as realizing the fmv of the stock. Since that was more than his basis in the stock, the Court agreed that H's taxable gain was the fmv of the stock minus his basis. As for W, the Court held that she acquired a basis in the stock she received equal to the amount H realized.

- The Court treated inchoate rights that can only exist in marriage as if they were property that can be bought and sold. The Court treated the parties the same way we would expect courts to treat strangers who exchanged properties. H exchanged appreciated property to pay for something; that is a recognition event.

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<sup>203</sup> *Farid-es-Sultaneh* examined some of these same questions in the pre-marriage context.

**Section 1041:** Does § 1041 create opportunities to save divorcing spouses income taxes? What if the tax brackets of the divorcing spouses are not going to be the same?

- Giving W a tax basis equal to the fmV of what H surrendered is no more correct here than it was in *Farid-es-Sultaneh*.

- Congress responded to *Davis*.

- Read § 1041. The division of property between divorcing spouses is now a non-recognition event.

- How would the result in *Davis* have been different if § 1041 were the law at the time the case was decided?

- In what ways does § 1041 differ from § 1015?

- Is the rule of § 1041 better than the holding of *Davis*?

### C. Child Support

Child support payments are made to fulfill a parental obligation. Both parents have this obligation. Fulfillment of this obligation does not create any right to a deduction, but only to a dependent deduction (a tax credit for tax years 2018 to 2025) of the exemption amount. The same is true after dissolution of the marriage. The Code has some special rules for allocation of the dependent deduction (tax credit) in its definitions of “qualifying child” and “qualifying relative,” *supra*. Furthermore, receipt of child support payments is not gross income to the payee.

A parent has an obligation to support his minor children. If someone else fulfills that obligation, it seems that the parent has realized gross income. Change the facts: instead of a person with no parental obligation *making* payments, it is a person *with* a parental obligation who *fails* to make payments (an all-too-frequent occurrence). The former spouse is left to make up the difference.

### Rev. Rul. 93-27, 1993-1 C.B. 32

#### ISSUE

Is a taxpayer entitled to a nonbusiness bad debt deduction under § 166(a)(1) of the Code for the amount of the taxpayer’s own payment in support of the taxpayer’s children caused by an arrearage in court-ordered child support payments owed by a former spouse?

## FACTS

The taxpayer, A, was divorced in 1989 from B and was granted custody of their two minor children. Pursuant to a property settlement and support agreement that was incorporated into the divorce decree, B agreed to pay to A \$500 per month for child support. During 1991, B failed to pay \$5,000 of this obligation. Because of B's arrearage, A had to spend \$5,000 of A's own funds in support of A's children.

## LAW AND ANALYSIS

Section 166(a)(1) of the Code allows as a deduction any debt that becomes worthless within the taxable year.

Section 166(b) of the Code provides that for purposes of § 166(a), the amount of the deduction for any worthless debt is the adjusted basis provided in § 1011 for determining the loss from the sale or other disposition of property.

Section 1011 of the Code generally provides that the adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, is the basis as determined under § 1012.

Section 1012 of the Code provides that the basis of property is the cost of the property.

In *Swenson v. Commissioner*, 43 T.C. 897 (1965), the taxpayer claimed a bad debt deduction under § 166(a)(1) of the Code for an uncollectible arrearage in child support payments from a former spouse. The Tax Court denied the deduction on the ground that § 166(b) precluded any deduction because the taxpayer had no basis in the debt created by the child support obligation. The taxpayer had argued that her basis consisted of the expenditures for child support she was forced to make from her own funds as a result of the father's failure to make his required payments. The court pointed out, however, that the father's obligation to make the payments had been imposed by the divorce court and was not contingent on the taxpayer's support expenditures. It stated that those expenditures neither created the arrearage nor constituted its cost to the taxpayer. *Swenson*, at 899.

The Tax Court has followed the decision in *Swenson* on similar facts in *Perry v. Commissioner*, 92 T.C. 470 (1989); *Meyer v. Commissioner*, T.C.M. 1984-487;

*Pierson v. Commissioner*, T.C.M. 1984-452; and *Diez-Arguellos v. Commissioner*, T.C.M. 1984-356.

In the present case, as in those above, B's obligation to make the child support payments to A was imposed directly by the court. A's own child support expenditures did not create or affect B's obligation to A under the divorce decree. Accordingly, A did not have any basis in B's obligation to pay child support, and A may not claim a bad debt deduction under § 166(a)(1) of the Code with regard to an arrearage in those payments.

....

#### HOLDING

A taxpayer is not entitled to a bad debt deduction under § 166(a)(1) of the Code for the amount of the taxpayer's own payment in support of the taxpayer's children caused by an arrearage in court-ordered child support payments owed by a former spouse.

#### *Notes and Questions:*

1. A problem for "A" is that she wants a deduction but no other taxpayer realizes an equal amount of gross income.
  - If the Commissioner determined that B should include \$5000 in his gross income, should a court uphold the Commissioner's position?
2. Should the failure of one ex-spouse to make child support payments to the other ex-spouse be a matter for the IRS? One suspects that IRS involvement might lead to fewer child support arrearages.



## Wrap-Up Questions for Chapter 8

1. The basis of the *Davis* case was that taxpayer's wife's interest partook "more of a personal liability of the husband than a property interest of the wife." Hence, taxpayer merely fulfilled his obligation by giving up appreciated property – a recognition event. Was Congress right to reverse the holding?
2. Mr. Davis would have benefited from § 1041. Exactly how does § 1041 affect Mrs. Davis's basis in her inchoate marital rights?
3. What should happen if H and W jointly own all the stock of a corporation that owns a McDonald's franchise. They divorce. McDonald's does not allow divorced spouses to own jointly a franchise. As part of their property settlement, H and W agree that the *corporation* will redeem W's stock. For this, W must pay tax on the gain. In reaching this agreement, the parties carefully considered its tax consequences. Specifically, a large chunk of cash would go to W, and she would pay income tax at the capital gains rate – much lower than the tax rate on ordinary income. W decides not to pay the tax on the gain and to argue in court that the corporation, a third party, was paying the property settlement obligation of H. Hence, *he* should be subject to income tax on *dividend* income, which was taxable at ordinary income rates. What result? See *Arnes v. United States*, 981 F.2d 456 (9<sup>th</sup> Cir. 1992) and *Commissioner v. Arnes*, 102 T.C. 522 (1994). What is the effect of Reg. § 1.1041-2(c)?
4. Section 23 provides a capped dollar-for-dollar tax credit for various adoption expenses that is subject to an income phaseout at relatively high levels of AGI. Section 137 provides an exclusion from gross income for an employee who benefits from his employer's adoption assistance program. In the Tax Cuts and Jobs Act, Congress *doubled* the child tax credit for tax years 2018 to 2025 from \$1000 to \$2000 and changed the *deductible* exemption amount for dependents other than qualifying children from (what would have been) \$4150 (in 2018) to a flat \$500 tax *credit*. From what you have learned of tax policies towards various personal choices in preceding chapters, what trends do you see in provisions such as these?

## What have you learned?

Can you explain or define –

- What it means for the federal income tax and the federal gift tax to be *not* in pari materia?
- How § 267 treats losses in transactions between related persons?
- What the rule of § 1041 is? How does it differ from the rule of § 1015?
- In what ways property settlements, alimony, and child support differ conceptually?

## Chapter 9: Timing of Income and Deductions: Annual Accounting and Accounting Principles

### I. Annual Accounting

After *Glenshaw Glass* (chapter 2, *supra*), we know that one element of “gross income” that taxpayer must recognize is taxpayer’s dominion and control of it. After *Cottage Savings & Loan* (chapter 2, *supra*), we know that a realization requirement applies to deductible losses as well as to income. It is not always obvious just exactly *when* taxpayer has dominion and control over income or has realized a deductible loss. Consider some problematic scenarios:

- Taxpayer receives money, has “dominion and control” over it, and would normally count it as “gross income” – but learns in a subsequent year that she must give at least some of the money back.
- Taxpayer has “dominion and control” over money but knows that she *might* have to return it if certain contingencies occur. For example, a court has determined that taxpayer is entitled to money and has received it, but the judgment on which her receipt of money was based has been appealed. If taxpayer loses the appeal, she will have to return the money. In the meantime, taxpayer may spend the money any way she chooses.
- Taxpayer has entered into a contract that calls for various acts of performance to occur over more than one year, perhaps many years. The taxpayer pays expenses in some years and receives payments in some years. However, in any given year, there is no transactional matching of expenditures and receipts. In some years, expenses are very high; in other years receipts are very high. When taxpayer does receive money, she may spend it any way she chooses.

#### *The Tax Formula:*

→ (gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
→ MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)  
  
EQUALS (taxable income)

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

The Internal Revenue Code requires taxpayers to compute their taxable income *annually*. See § 441. This can prove to be quite inconvenient for a taxpayer – and even a bit misleading, as in the third scenario above, i.e., where taxpayer enters into a contract calling for performance over a period of several years. We examine here some basic rules that have evolved to govern income timing questions.

**Claim of Right doctrine:** Taxpayer must include in her gross income an item when she has a “claim of right” to it. In *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424 (1932), the Supreme Court stated the doctrine thus:

If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.

**Burnet v. Sanford & Brooks**, 282 U.S. 359 (1931)

MR. JUSTICE STONE delivered the opinion of the Court.

In this case, certiorari was granted, 281 U.S. 707, to review a judgment of the court of appeals for the Fourth Circuit, reversing

an order of the Board of Tax Appeals, which had sustained the action of the Commissioner of Internal Revenue in making a deficiency assessment against respondent for income and profits taxes for the year 1920.

From 1913 to 1915, inclusive, respondent, a Delaware corporation engaged in business for profit, was acting for the Atlantic Dredging Company in carrying out a contract for dredging the Delaware River, entered into by that company with the United States. In making its income tax returns for the years 1913 to 1916, respondent added to gross income for each year the payments made under the contract that year, and deducted its expenses paid that year in performing the contract. The total expenses exceeded the payments received by \$176,271.88. The tax returns for 1913, 1915, and 1916 showed net losses. That for 1914 showed net income.

In 1915, work under the contract was abandoned, and in 1916 suit was brought in the Court of Claims to recover for a breach of warranty of the character of the material to be dredged. Judgment for the claimant was affirmed by this Court in 1920. *United States v. Atlantic Dredging Co.*, 253 U.S. 1. It held that the recovery was upon the contract, and was “compensatory of the cost of the work, of which

the government got the benefit.” From the total recovery, petitioner received in that year the sum of \$192,577.59, which included the \$176,271.88 by which its expenses under the contract had exceeded receipts from it, and accrued interest amounting to \$16,305.71. Respondent having failed to include these amounts as gross income in its tax returns for 1920, the Commissioner made the deficiency assessment here involved, based on the addition of both items to gross income for that year.

The court of appeals ruled that only the item of interest was properly included, holding, erroneously, as the government contends, that the item of \$176,271.88 was a return of losses suffered by respondent in earlier years, and hence was wrongly assessed as income. Notwithstanding this conclusion, its judgment of reversal and the consequent elimination of this item from gross income for 1920 were made contingent upon the filing by respondent of amended returns for the years 1913 to 1916, from which were to be omitted the deductions of the related items of expenses paid in those years. Respondent insists that, as the Sixteenth Amendment and the Revenue Act of 1918, which was in force in 1920, plainly contemplate a tax only on net income or profits, any application of the statute which operates to impose a tax with respect to the present transaction, from which respondent received no profit, cannot be upheld.

If respondent’s contention that only gain or profit may be taxed under the Sixteenth Amendment be accepted without qualification, *see Eisner v. Macomber*, 252 U.S. 189; *Doyle v. Mitchell Brothers Co.*, 247 U.S. 179, the question remains whether the gain or profit which is the subject of the tax may be ascertained, as here, on the basis of fixed accounting periods, or whether, as is pressed upon us, it can only be net profit ascertained on the basis of particular transactions of the taxpayer when they are brought to a conclusion.

All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer’s transactions during a fixed accounting period, either the calendar year or, at the option of the taxpayer, the particular fiscal year which he may adopt. Under ... the Revenue Act of 1918, 40 Stat. 1057, respondent was subject to tax upon its annual net income, arrived at by deducting from gross income for each taxable year all the ordinary and necessary expenses paid during that year in carrying on any trade or business, interest and taxes paid, and losses sustained, during the year. ... [G]ross income “includes ... income derived from ... business ... or the transaction of any business carried on for gain or profit, or gains

or profits and income derived from any source whatever.” The amount of all such items is required to be included in the gross income for the taxable year in which received by the taxpayer, unless they may be properly accounted for on the accrual basis under § 212(b). *See United States v. Anderson*, 269 U.S. 422; *Aluminum Castings Co. v. Rotzahn*, 282 U.S. 92.

That the recovery made by respondent in 1920 was gross income for that year within the meaning of these sections cannot, we think, be doubted. The money received was derived from a contract entered into in the course of respondent’s business operations for profit. While it equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses incurred in the prosecution of the work under the contract, for the purpose of earning profits. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income. *See Doyle v. Mitchell Brothers Co.*, *supra*, 247 U.S. at 185.

That such receipts from the conduct of a business enterprise are to be included in the taxpayer’s return as a part of gross income, regardless of whether the particular transaction results in net profit, sufficiently appears from the quoted words of § 213(a) and from the character of the deductions allowed. Only by including these items of gross income in the 1920 return would it have been possible to ascertain respondent’s net income for the period covered by the return, which is what the statute taxes. The excess of gross income over deductions did not any the less constitute net income for the taxable period because respondent, in an earlier period, suffered net losses in the conduct of its business which were in some measure attributable to expenditures made to produce the net income of the later period.

....

But respondent insists that, if the sum which it recovered is the income defined by the statute, still it is not income, taxation of which without apportionment is permitted by the Sixteenth Amendment, since the particular transaction from which it was derived did not result in any net gain or profit. But we do not think the amendment is to be so narrowly construed. A taxpayer may be in receipt of net income in one year and not in another. The net result of the two years, if combined in a single taxable period, might still be a loss, but it has never been supposed that that fact would relieve him from a tax on the first, or that it affords any reason for

postponing the assessment of the tax until the end of a lifetime, or for some other indefinite period, to ascertain more precisely whether the final outcome of the period, or of a given transaction, will be a gain or a loss.

The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. ... While, conceivably, a different system might be devised by which the tax could be assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer's being required to pay a tax on income in one period exceeded by net losses in another.

Under the statutes and regulations in force in 1920, two methods were provided by which, to a limited extent, the expenses of a transaction incurred in one year might be offset by the amounts actually received from it in another. One was by returns on the accrual basis ..., which provides that a taxpayer keeping accounts upon any basis other than that of actual receipts and disbursements, unless such basis does not clearly reflect its income, may, subject to regulations of the Commissioner, make its return upon the basis upon which its books are kept. *See United States v. Anderson*, and *Aluminum Castings Co. v. Routzahn*, *supra*. The other was under Treasury Regulations (Article 121 of Reg. 33 of Jan. 2, 1918 ... providing that, in reporting the income derived from certain long-term contracts, the taxpayer might either report all of the receipts and all of the expenditures made on account of a particular contract in the year in which the work was completed or report in each year the percentage of the estimated profit corresponding to the percentage of the total estimated expenditures which was made in that year.

... [R]espondent [does not] assert, that it ever filed returns in compliance either with these regulations ... or otherwise attempted to avail itself of their provisions; nor, on this record, do any facts appear tending to support the burden, resting on the

taxpayer, of establishing that the Commissioner erred in failing to apply them. *See Niles Bement Pond Co. v. United States*, 281 U.S. 357, 361.

The assessment was properly made under the statutes. Relief from their alleged burdensome operation, which may not be secured under these provisions, can be afforded only by legislation, not by the courts.

Reversed.

*Notes and Questions:*

1. The corporate income tax rate in 1913, 1914, and 1915 was 1%. The rate was 2% in 1916. The rate was 10% in 1920 with a \$2000 exemption.

CARES Act, § 2303 amended § 172 to provide that net losses incurred in 2018, 2019, and 2020 could be carried back five years except for losses incurred by real estate investment trusts. This will enable businesses that suffer net operating losses during the pandemic to claim refunds of income taxes paid during the prior five years.

Farmers may elect not to apply this 5-year carryback for losses arising in 2018, 2019, and 2020. CAA, Covid-Related Tax Relief Act of 2020, § 282.

2. The Court held out the possibility that taxpayer might keep accounts on the accrual basis or on a percentage-of-completion basis in the case of long-term contracts. What do you think these methods are? Would one or the other of these methods have been better for taxpayer? Why?

3. The Code of course now has one more mechanism by which a transaction in one year may offset a transaction in another: the net operating loss (§ 172). Taxpayers may carry trade or business losses forward indefinitely. *See* chapter 6, *supra*.

4. Interesting questions involving the impact of annual accounting on taxpayers arise

when tax rates change. Tax rates often change because of war – they increase because of the war and decrease after the war.



**United States v. Lewis**, 340 U.S. 590 (1951)

MR. JUSTICE BLACK delivered the opinion of the Court.

Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: in his 1944 income tax return, respondent reported about \$22,000 which he had received that year as an employee's bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent's bonus had been improperly computed; under compulsion of the state court's judgment, he returned approximately \$11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full \$22,000 unconditionally as his own, in the good faith though "mistaken" belief that he was entitled to the whole bonus.

On the foregoing facts, the Government's position is that respondent's 1944 tax should not be recomputed, but that respondent should have deducted the \$11,000 as a loss in his 1946 tax return. *See* G.C.M. 16730, XV-1 CUM. BULL. 179 (1936). The Court of Claims, however, relying on its own case, *Greenwald v. United States*, 57 F. Supp. 569, held that the excess bonus received "under a mistake of fact" was not income in 1944, and ordered a refund based on a recalculation of that year's tax. We granted certiorari because this holding conflicted with many decisions of the courts of appeals, *see, e.g., Haberkorn v. United States*, 173 F.2d 587, and with principles announced in *North American Oil Consolidated v. Burnet*, 286 U.S. 417.

In the *North American Oil* case, we said: "If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent." 286 U.S. at 424. Nothing in this language permits an exception merely because a taxpayer is "mistaken" as to the validity of his claim.

...

Income taxes must be paid on income received (or accrued) during an annual accounting period. *Cf.* I.R.C. §§ 41, 42, and *see Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 363. The "claim of right" interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. *See* cases collected in 2 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 12.103. We see no reason why the Court should depart from this well settled

interpretation merely because it results in an advantage or disadvantage to a taxpayer. [footnote omitted]

Reversed.

MR. JUSTICE DOUGLAS, dissenting. ....

*Notes and Questions:*

1. Marginal tax brackets decreased a little after the end of WWII. Hence, taxpayer's deduction in 1946 did not save as much in income tax as the same amount of income in 1944 cost him.

2. Congress has enacted § 1341 to mitigate the effect of the *Lewis* rule. When § 1341 applies, taxpayer is required to pay a tax in the year of repayment that is the lesser of –

- tax liability computed in that year with the repayment treated as a deduction, or
- tax liability computed by applying a credit equal in amount to the increase in tax liability caused by payment of income tax in the year of inclusion in gross income.

3. Notice that § 1341 does *not* reopen taxpayer's tax return from the earlier tax year, thereby maintaining the integrity of the principle of annual accounting.

4. Read § 1341. Note carefully the conditions of its applicability, or the following two CALI lessons will be more difficult than they need to be.



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Claim of Right Doctrine*.



Do the CALI Lesson, *Basic Federal Income Taxation: Taxable Income and Tax Computation: Claim of Right Mitigation Doctrine*.

5. We might consider *Lewis* to be a case of “income first/deduction later.” What if we reverse that: “deduction first/income later?”

**Rosen v. Commissioner**, 71 T.C. 226 (1978), *aff'd*, 611 F.2d 942 (CA1. Cl. 1980)

Raum

The Commissioner determined deficiencies in petitioners' Federal income tax as follows:

<i>Year</i>	<i>Deficiency</i>
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....	
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1974	30,191.42
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....

Prior to December 20, 1972, petitioners [Sidney W. Rosen and Lorraine S. Rosen, husband and wife] were the owners of the land and buildings located on the southeasterly corner of High Street and Walnut Street, Fall River, Mass. (hereinafter the property). The property consisted of approximately 8,010 square feet of land on which was situated a three-story frame house containing five apartments and a two-car garage....

....

On June 20, 1973, the petitioners made a gift of the property, less a small portion retained for themselves, to the Union Hospital, Fall River, Mass. (the hospital). The value of the property transferred to the hospital by the petitioners, at the date of transfer, was \$48,000, and the petitioners claimed and were allowed a charitable contribution deduction of that amount in respect of the gift of the property. [footnote omitted].

The transfer by the petitioners to the hospital was made without any restrictions as to the use of the property and without imposing any obligation of any nature on the hospital. In 1974, the hospital found itself in financial difficulty and was unable to make use of the property. In addition, the building forming part of the property had remained vacant since its receipt by the hospital, and substantial damage had been done to the building by the weather and vandals. The building had deteriorated to the point where the board of trustees of the hospital felt it was becoming a liability and, accordingly, they voted on August 27, 1974, to transfer the property back to the petitioners without consideration. [footnote omitted]. The hospital was under no obligation, legal or otherwise, to return the property to the petitioners.

The parties have stipulated that the value of the property, at the time it was transferred to the petitioners by the hospital, was \$25,000....

The Commissioner determined that petitioners must include in gross income, on account of the return of the property to them by ... the hospital ... \$25,000 in ... 1974 ... The petitioners claim, however, that they need include no amounts in their gross income in respect of the return of the property by either the city or the hospital. The Commissioner has not challenged the bona fides of any of the transactions, and the only question is whether petitioners must include in their gross income, in the year[] of the retransfer[] from the city and the hospital, the fair market value of the property returned. We hold that they are required to do so.

It has long been established that the receipt of money or property which might not otherwise be regarded as income may nevertheless constitute income within the meaning of the statute (§ 61 ...) if it represents the repayment, restoration, or return of an item which the taxpayer had deducted in an earlier year. The general concept has often been referred to as the “tax benefit rule.”<sup>204</sup>

The tax benefit rule has widespread applicability to a variety of different receipts. See 1 J. Mertens, *Law of Federal Income Taxation*, §§ 7.34-7.37(2) (1974 rev.). Familiar examples appear in cases involving the recovery of a bad debt which had been deducted on the returns of a prior year, e.g., *Askin & Marine Co. v. Commissioner*, 66 F.2d 776 (2d Cir.); *Putnam Nat. Bank v. Commissioner*, 50 F.2d 158 (5th Cir.); and in cases where excises or other taxes paid and deducted from gross income in a prior year are refunded in a later year, e.g., *Rothensies v. Electric Battery Co.*, 329 U.S. 296, 298; *Estate of Block v. Commissioner*, 39 B.T.A. 338, affirmed sub nom. *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), certiorari denied 311 U.S. 658. ... Moreover, the so-called tax benefit rule has been explicitly recognized in § 111(a) of the Code which places limitations on the amounts to be included in gross income in specified types of restorations. Thus, it provides that gross income does not include the recovery of a “bad debt, prior tax,

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<sup>204</sup> The rationale for the rule was set forth in *Estate of Block v. Commissioner*, 39 B.T.A. 338, 341, affirmed sub nom. *Union Trust Co. v. Commissioner*, 111 F.2d 60 (7th Cir.), certiorari denied 311 U.S. 658:

“Income tax liability must be determined for annual periods on the basis of facts as they existed in each period. When recovery or some other event which is inconsistent with what has been done in the past occurs, adjustment must be made in reporting income for the year in which the change occurs.”

See also *Alice Phelan Sullivan Corp. v. Commissioner*, 381 F.2d 399, 402 n. 2 (Ct. Cl.).

or delinquency amount” to the extent of the “recovery exclusion” which is in substance defined ... to mean the amount on account of which the item in question did not result in a reduction of taxes in the earlier year. [footnote omitted].

There can be no serious challenge to the broad sweep of the tax benefit rule, and in considering its applicability here, we even find precedent for applying the rule in a case involving property once the subject of a charitable contribution deduction that is subsequently returned to the donor. In *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct.Cl.), there were returned to the taxpayer two parcels of real estate each of which it had previously donated and claimed as a charitable contribution deduction in a prior year. Each of the original gifts had been made subject to the condition that the property be used for a religious or educational purpose, and when the donee later determined not to use the gift, it was reconveyed to the taxpayer. The Court of Claims held not only that the recoupment properly was classified as income but also that the amount of reportable income was not limited by the more favorable tax rates which were in effect at the time of the original gifts, provided only that the taxpayer had taken full benefit of the deductions available in the earlier years. [citation omitted] [footnote omitted].

Petitioners do not challenge the correctness of the result in *Alice Phelan Sullivan Corp.*, but rather seek to distinguish it. They correctly point out that in *Alice Phelan Sullivan Corp.*, the subject property was returned to the taxpayer pursuant to a condition in the original gift that the property would be returned if it ceased to be used either for a religious or for an educational purpose. Here, by contrast, both of the petitioners’ gifts were unconditional, and neither the city nor the hospital was under any obligation whatsoever to transfer the property back to the petitioners. From this petitioners argue that the property was returned to them by way of a “gift” from the city and the hospital excludable from income under § 102(a), [footnote omitted] and that the tax benefit rule does not apply to receipts subject to § 102(a). We do not agree with the factual predicate to this argument.

As a factual matter, we cannot accept the contention that petitioners received “gifts” as the concept was defined in *Commissioner v. Duberstein*, 363 U.S. 278, 285-286, when the property was reconveyed to them. We think it clear that [the] charitable donee [did not] transfer[] the property back to petitioners out of any detached or disinterested generosity; [footnote omitted] [it] made the transfer[] because [it] found the property to be burdensome and because [it] desired to “undo” the original gift transactions by returning the property to the part[y] who had originally made the gifts to them. [footnote omitted] It would strain our credulity to conclude that

... the hospital would have transferred the property to petitioners without consideration if [it] had originally purchased it from petitioner[] or had obtained it from some other source. The reconveyance[] to petitioner[] [was] not [a] nontaxable “gift[]” within the criteria set forth in *Duberstein*. We therefore need not reach petitioners’ argument that § 102(a) precludes application of the tax benefit rule to these transactions. [footnote omitted]

Petitioners also contend that there has been no “recovery” within the meaning of the tax benefit rule because there has been no receipt of “amounts in respect of” the previously deducted charitable gifts.<sup>205</sup> Petitioners cite the absence of a legal obligation to return the property and urge us to conclude that the reconveyances were totally separate and independent transactions from the original gifts. We are unconvinced.

We agree with the limited proposition that the tax benefit rule requires a sufficient factual nexus between the event producing the tax benefit and the event constituting the recovery to justify viewing the latter event together with the former. See *Dobson v. Commissioner*, 320 U.S. 489, 502; *Farr v. Commissioner*, 11 T.C. 552, 567, affirmed sub nom. *Sloane v. Commissioner*, 188 F.2d 254 (6th Cir.); 1 J. Mertens, *Law of Federal Income Taxation*, § 7.37, at p. 125. See also *Allen v. Trust Co. of Georgia*, 180 F.2d 527 (5th Cir.); *Continental Illinois National Bank v. Commissioner*, 69 T.C. 357, 364-372. However, we have found that the purpose of the reconveyance[] was a desire by the donee[] to reverse the original gift transaction[], and that the reconveyance[] without consideration would not have been made to petitioner[] were it not for the fact that [it was] the original donor[] of the property. The recover[y was] far from the coincidental happenstance[] that petitioner[] would have us believe. This is especially true in light of the relatively short time period[] between the original gifts and the reconveyances.

Nor can we agree, at least in cases where the return of property is not a “gift,” that a legal obligation on the part of the transferor to return the property is always a *sine qua non* for application of the tax benefit rule. We think it sufficient that the transferor specifically intend the transfer to be a repayment, restoration, or return of property formerly belonging to the transferee that was the subject of a previous transaction producing a tax benefit, and that the transferee accept it for such purpose. See *Bear Mill Manufacturing Co. v. Commissioner*, 15 T.C. 703, 706-708;

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<sup>205</sup> See § 1.111-1(a)(2), Income Tax Regs.

*Excelsior Printing Co. v. Commissioner*, 16 B.T.A. 886, 887-888.<sup>206</sup> This was the case in respect of the reconveyance[] by ... the hospital – [it was] intended merely to reverse previous charitable donations. Under these circumstances, we see no reason to allow a windfall tax benefit based upon [the] charitable contribution[] deduction[], particularly when, in the end, petitioners owned the very same property they tried to give away. Cf. *Farr v. Commissioner*, 11 T.C. at 567. The purposes of the tax benefit rule [footnote omitted] served by requiring inclusion in gross income of the fair market value of the property at the times it was returned to petitioners.

... The Commissioner agrees that the amount to be included is to be measured by the \$25,000 stipulated value rather than [\$48,000] which he had previously determined in his deficiency notice. ...

...<sup>207</sup>

*Decision will be entered under Rule 155.*

#### *Notes and Questions:*

1. Congress has not created a legislative counterpart to § 1341.
2. Read § 111.
3. In *Alice Phelan Sullivan* (discussed by the court), taxpayer made gifts of property on condition that the property be used for religious or educational purposes in 1939 and 1940 when taxpayer's marginal tax brackets were 18% and 24% respectively.

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<sup>206</sup> In *Bear Mill Manufacturing Co. v. Commissioner*, 15 T.C. 703, and *Excelsior Printing Co. v. Commissioner*, 16 B.T.A. 886, it was held that there was a taxable recovery of a previously deducted bad debt when a third party, not a party to the loan transaction, and not otherwise legally obligated to repay the debt, made a transfer of property to the creditor with the intention that the debt be satisfied, and the creditor accepted it for the purpose the transferor intended. It should be noted that in both cases we found that the transferor did not intend to make a gift to the creditor.

<sup>207</sup> We do not consider the possible contention that proper application of the tax benefit rule would require a complete reversal of the deduction in the earlier year by including in income of the later year the full amount previously deducted upon complete restoration of the identical property which gave rise to the deduction. Cf. *Alice Phelan Sullivan Corp. v. Commissioner*, 381 F.2d 399, 402 (Ct.Cl.). ...

The donee returned the property in 1957 when taxpayer's marginal tax bracket was 52%. The court applied the rule that we account for our income taxes annually. Taxpayer had to recognize the retransfer of the property as income to be taxed at 52%

4. Consider: In year 1, taxpayer's total itemized deductions were \$18,000. A portion of the itemized deductions was for her contribution of a parcel of land to her church, fmV = \$7000, "so long as used for church purposes." Taxpayer filed single. The standard deduction in year 1 for single persons was \$12,000. In year 4, the church decided not to use the land for church purposes and returned it to taxpayer. Its fmV was still \$7000.

- How much income must taxpayer include in her year 4 tax return?

4a. Same as #4, but the fmV of the land in year 1 was only \$4000? Her total itemized deductions were \$18,000, including \$4000 for the land she contributed to her church.

- How much income must taxpayer include in her year 4 tax return?

4b. Same as #4, but the fmV of the land was \$3000 and taxpayer's total itemized deductions, including her charitable contribution, were \$11,000.

- How much income must taxpayer include in his year 4 tax return?

## II. Deferral Mechanisms

The Code provides various mechanisms by which taxpayer may defer recognition of particular identifiable income.

### *A. Realization*

We have already observed that the realization element of gross income gives taxpayer some discretion to defer recognition of income – and, as in *Cottage Savings & Loan*, to accelerate the recognition of losses.



### *B. Installment Method and Other Pro-rating of Basis*

There are occasions when taxpayer realizes gain on a transaction, but does not receive any cash with which to pay the income tax due on the gain. Perhaps a purchaser does not have cash and cannot procure a bank loan. Taxpayer agrees to permit the purchaser to make installment payments in subsequent years plus interest payments on the declining balance (§ 163(b)). Section 453 requires such a taxpayer to defer recognition of “income”<sup>208</sup> until receipt of installment payments. § 453(a). Taxpayer may elect out of the installment method of reporting income. § 453(d)(1).

- The installment method applies to an “installment sale.” An “installment sale” is one where at least one payment is to be received after the close of the taxable year of disposition of the property. § 453(b)(1).

- However, the installment method does *not* apply to a “dealer disposition” or to sales of “inventory.” § 453(b)(2).

- Moreover, the installment method does *not* apply to a disposition of property in which the seller will have the wherewithal to pay the income tax due on gain. Section 453 does not apply to a disposition of stock or securities traded on an established securities market. § 453(k)(2)(A). Such property is so liquid that it is its own source of cash.

- Section 453 does not apply to a disposition of personal property under a revolving credit plan. § 453(k)(1).

- The “installment” method is a “method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profits (realized or to be realized when payment is completed) bears to the total contract price.” § 453(c).

- Multiply *every payment* received by the following ratio:  
$$(\text{Gross profit})/(\text{Contract Price})$$

- Include the product in gross income in the year of payment of the installment.

- There are some important definitions in the regulations. *See* Reg. § 15A.453-1(b).

- “Gross profit” is the “selling price” less adjusted basis. Reg. § 15A.453-1(b)(2)(v).

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<sup>208</sup> The installment method does not apply to recognition of losses.

- “Selling price” is the gross selling price without reduction “to reflect any existing mortgage or other encumbrance on the property ...” Reg. § 15A.453-1(b)(2)(ii).
- The “contract price” is the total “selling price” –
  - reduced by the debt that the buyer assumes
  - so long as the debt does not exceed the seller’s basis in the property.* Reg. § 15A.453-1(b)(2)(iii).
    - If the debt *does* exceed the seller’s basis, the contract price is reduced by the seller’s basis, not by the amount of the debt. AND:
    - The amount by which the debt exceeds basis is treated as a payment. Reg. § 15A.453-1(b)(3)(i) (11<sup>th</sup> sentence).
  - When the debt assumed by the purchaser exceeds the seller’s basis, what percentage of every payment will seller have to include in her gross income?

•You can see that the effect of the installment method is to pro-rate both the recovery of basis and recognition of gain.

•It may prove necessary to keep a running score of unrecovered basis and of yet-to-be realized profit.

•Section 453B(a) provides that the disposition of an installment obligation is a recognition event to the one who disposed of it. That person would determine her basis in the obligation disposed of and subtract that amount from the amount she realizes to determine gain or loss.



Do the CALI Lesson, *Basic Federal Income Taxation: Timing: Fundamentals of Installment Sales*.

•Do not worry about question 19 on wrap-around mortgages. It is discussed in Regs. §§ 15A.453-1(b)(3)(ii) and 15A.453-1(b)(5) Examples 5 and 6.

The installment method of § 453 enables a taxpayer to defer recognition of gain until she has the wherewithal to pay the tax. However, when taxpayer enters into transactions with related persons solely with a purpose to defer payment of income tax, the Code denies the benefits of the installment method.

•Consider: Father (a high bracket taxpayer) sells daughter (a low bracket taxpayer) Blackacre. Father’s basis in Blackacre is \$20,000. The selling price is \$100,000. Daughter is to make annual payments of \$10,000 plus

interest on the declining balance. Daughter makes no payments and one week later, sells Blackacre to a third party for \$100,000 cash.

- Notice: daughter has no gain/loss to recognize. She has \$100,000 cash in hand with which to fulfill her obligation to pay father \$10,000 per year for the next nine years.
- Father has essentially sold Blackacre at a substantial gain. A person related to him holds the cash from the sale. Father spreads recognition of gain over the ensuing ten years.

Section 453(e) addresses so-called “second dispositions by related persons.”

- Section 453(e)(1) requires taxpayer to treat the amount realized in the “second disposition” (i.e., sale by daughter in the example) as received by the person making the “first disposition” (i.e., father in the example).
- Thus in our example, father would be treated as realizing \$100,000 upon daughter’s sale of Blackacre.

•This rule applies only to a disposition made within two years after the first disposition. § 453(e)(2). However, the running of this two-year period is suspended in the event the risk of loss to the transferee is substantially diminished by the possibility of certain transactions.<sup>209</sup>

•A person is “related” if she bears a relationship to the transferor described in either § 318(a) or § 267(b). § 453(f)(1).

- Section 453(e)(3) limits the amount realized by the transferor making the first disposition to the lesser of –
  - the amount realized in the second disposition, OR
  - the total contract price for the first disposition

MINUS

the aggregate amount of payments received with respect to the first disposition, plus the aggregate amount treated as received under § 453(e).

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<sup>209</sup> Section 453(e)(2)(B) names certain interests or transactions that would substantially diminish a risk of loss, i.e., the holding of a put with respect to the property (or similar property), the holding by another person of a right to acquire the property, or a short sale or any other transaction.

- Installment payments received after the second disposition are not treated as payments with respect to the first disposition to the extent that such payments are less than the amount treated as received on the second disposition. Additional payments are treated as payments with respect to the first disposition. § 453(e)(5).

- Example: Same facts as above. Daughter sells Blackacre in year 1 for \$80,000. Father is treated as realizing \$80,000. Daughter makes payments under the installment contract. The first eight payments are not treated as payments with respect to the first disposition. Father will pay no income tax for receiving these payments. The last two payments will produce taxable income for father as before.

### *C. Contingent Payments*

Suppose that taxpayer sells stock to another. Taxpayer's basis in the stock is \$20,000. The price at which taxpayer sells the stock is \$10,000 plus 10% of the dividends paid by the corporation, payable every year.

- Suppose the same facts except that the selling price is \$10,000 plus 10% of the dividends paid by the corporation for the next 20 years.
- Suppose the same facts except that the selling price is \$10,000 plus 10% of the dividends paid by the corporation up to a maximum of \$25,000.

Notice that on the day the parties enter the contract, the amount that the seller will ultimately realize cannot be known. What is the best way to handle the problem?

### **Burnet v. Logan**, 283 U.S. 404 (1931)

MR. JUSTICE McREYNOLDS delivered the opinion of the Court.

....

Prior to March, 1913, and until March 11, 1916, respondent, Mrs. Logan, owned 250 of the 4,000 capital shares issued by the Andrews & Hitchcock Iron Company. It held 12 percent of the stock of the Mahoning Ore & Steel Company, an operating concern. In 1895, the latter corporation procured a lease for 97 years upon the "Mahoning" mine, and since then has regularly taken therefrom large, but varying,

quantities of iron ore – in 1913, 1,515,428 tons; in 1914, 1,212,287 tons; in 1915, 2,311,940 tons; in 1919, 1,217,167 tons; in 1921, 303,020 tons; in 1923, 3,029,865 tons. The lease contract did not require production of either maximum or minimum tonnage or any definite payments. Through an agreement of stockholders (steel manufacturers), the Mahoning Company is obligated to apportion extracted ore among them according to their holdings.

On March 11, 1916, the owners of all the shares in Andrews & Hitchcock Company sold them to Youngstown Sheet & Tube Company, which thus acquired, among other things, 12 percent of the Mahoning Company's stock and the right to receive the same percentage of ore thereafter taken from the leased mine.

For the shares so acquired, the Youngstown Company paid the holders \$2,200,000 in money, and agreed to pay annually thereafter for distribution among them 60 cents for each ton of ore apportioned to it. Of this cash, Mrs. Logan received  $250/4000 = \$137,500$ , and she became entitled to the same fraction of any annual payment thereafter made by the purchaser under the terms of sale.

....

During 1917, 1918, 1919, and 1920, the Youngstown Company paid large sums under the agreement. Out of these respondent received on account of her 250 shares \$9,900 in 1917; \$11,250 in 1918; \$8,995.50 in 1919; \$5,444.30 in 1920 – \$35,589.80. ...

Reports of income for 1918, 1919, and 1920 were made by Mrs. Logan upon the basis of cash receipts and disbursements. They included no part of what she had obtained from annual payments by the Youngstown Company. She maintains that, until the total amount actually received by her from the sale of her shares equals their value on March 1, 1913, no taxable income will arise from the transaction. ...

On March 1, 1913,<sup>210</sup> the value of the 250 shares then held by Mrs. Logan exceeded

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<sup>210</sup> [Before there was an income tax, there was no need to determine what the basis of property was. Furthermore, it would be unfair to assess an income tax on a taxpayer based upon gain that occurred prior to the effective date of the income tax. The Revenue Act of 1916 provided that for “purposes of ascertaining the gain from the sale or other disposition of property ... acquired before March 1, 1913, the fair market price or value of such property as of March 1, 1913 shall be the basis for determining the amount of such gain derived.” Revenue Act of 1916, ch. 463, §2(c), 39 Stat. 756, 758 (1916). Thus when the Court refers to the value of Mrs. Logan's shares, it is also referencing the shares' basis.]

\$173,089.80 – the total of all sums actually received by her prior to 1921 from their sale (\$137,500 cash in 1916, plus four annual payments amounting to \$35,589.80). That value also exceeded original cost of the shares. ...

The Commissioner ruled that the obligation of the Youngstown Company to pay 60 cents per ton has a fair market value of \$1,942,111.46 on March 11, 1916; that this value should be treated as so much cash, and the sale of the stock regarded as a closed transaction with no profit in 1916. He also used this valuation as the basis for apportioning subsequent annual receipts between income and return of capital. His calculations, based upon estimates and assumptions, are too intricate for brief statement. [footnote omitted] He made deficiency assessments according to the view just stated, and the Board of Tax Appeals approved the result.

The circuit court of appeals held that, in the circumstances, it was impossible to determine with fair certainty the market value of the agreement by the Youngstown Company to pay 60 cents per ton. Also that respondent was entitled to the return of her capital – the value of 250 shares on March 1, 1913, and the assessed value of the interest derived from her mother – before she could be charged with any taxable income. As this had not in fact been returned, there was no taxable income.

We agree with the result reached by the circuit court of appeals.

The 1916 transaction was a sale of stock, not an exchange of property. We are not dealing with royalties or deductions from gross income because of depletion of mining property. Nor does the situation demand that an effort be made to place according to the best available data some approximate value upon the contract for future payments. ... As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation.

When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was \$2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise was in no proper sense equivalent to cash. It had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. Prior to 1921, all receipts from the sale of her shares amounted to less than their value on March 1, 1913. She properly

demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

....

The judgments below are

Affirmed.

*Notes and Questions:*

1. “As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit.”

- The rule of *Logan* is “basis first.” You might imagine that the IRS will take a dim view of this “open transaction” reporting method because it permits a taxpayer maximum deferral of recognition of gain.

- Reg. § 15A.453-1(a) provides that “income from a sale of real property or a casual sale of personal property, where any payment is to be received” in a tax year after the year of sale is to be reported on the installment method – unless the taxpayer elects otherwise.

2. The sale in *Logan* was a “contingent payment sale,” i.e., “a sale or other disposition of property in which the aggregate selling price cannot be determined by the close of that taxable year in which such sale or other disposition occurs.” Reg. § 15A.453-1(c)(1).

3. The regulations classify contingent payment sales as one of three types when taxpayer has not elected out of the installment method: (1) those where a maximum price is determinable; (2) those where a maximum price is not determinable but where the time over which payments will be received is determinable, and (3) those where neither a maximum price nor definite payment term is determinable. Reg. § 15A.453-1(c)(1) (last ¶).

3a. *Stated maximum selling price.* A sale contract has a “stated maximum selling price” if the maximum amount of sales proceeds can be determined as of the end of the tax year in which the sale is made. Reg. § 15A.453-1(c)(2)(i)(A). Assume that all contract contingencies are met. Treat the “stated maximum selling price” as the “selling price.” *Id.* The “gross profit ratio” is adjusted in the year a maximum

selling price is reduced, effective for the tax year of change and for all subsequent payments. *Id.*

- So: if we suppose a sale of stock in which taxpayer has a \$20,000 basis for \$10,000 plus 10% of the dividends paid by the corporation up to a maximum of \$25,000, we apply the installment method to the sale and consider the “selling price” to be \$35,000. That is also the “contract price.”  $(\$35,000 - \$20,000)/\$35,000 = 15/35$  (i.e., 3/7). 3/7 of every payment will be taxable income, and 4/7 of every payment will be recovery of basis.

3b. *Determinable time over which payments will be received*: When the maximum selling price is not determinable, but the time over which payments will be received is determinable, taxpayer allocates the basis to be recovered in equal annual increments. Reg. § 15A.453-1(c)(3)(i).<sup>211</sup> If the recoverable basis in a tax year is greater than the payments received, no loss is allowed unless this occurs in the final payment year. *Id.* When no loss is allowed, the unrecovered basis is carried to the next succeeding tax year. *Id.*

- So: if we suppose a sale of stock in which taxpayer has a \$20,000 basis for \$10,000 plus 10% of the dividends paid by the corporation for the next twenty years, we allocate basis equally over twenty years. Taxpayer would recognize every year’s payments received minus \$1000.

3c. *Neither payments nor time over which payments will be received is determinable*: An agreement that specifies neither the amount of payments nor the time over which payments will be received is subject to “close scrutiny” to assure that the agreement is not one requiring payment of rentals or royalties. Reg. § 15A.453-1(c)(4). If the arrangement is not one calling for payment of rentals or royalties, the seller recovers basis over 15 years. *Id.* If the recoverable basis in a tax year is greater than the payment received, no loss is allowed. *Id.* Disallowed loss is allocated over the remainder of the 15-year term. *Id.* Unrecovered basis at the end of the 15-year term is carried forward from year to year until the basis is recovered or the obligation has become worthless. *Id.* The IRS may shorten the recovery period if necessary to avoid substantial and inappropriate deferral of basis recovery. *Id.* The IRS may also require backloading within the 15-year period recovery of basis if necessary to avoid substantial and inappropriate acceleration of recovery. *Id.*

- So: suppose that taxpayer sells stock to another. Taxpayer’s basis in the

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<sup>211</sup> If the sales agreement incorporates an arithmetic component that is not equal for all taxable years, basis is to be allocated in accordance with that arithmetic component. Reg. § 15A.453-1(c)(3)(i).



stock is \$20,000. The price at which taxpayer sells the stock is \$10,000 plus 10% of the dividends paid by the corporation, payable every year. Taxpayer may recover basis of \$1333 for each of the next fifteen years.

4. *Election out*: If a taxpayer elects out of the installment method, taxpayer must recognize gain on the sale in accordance with the taxpayer's method of accounting. Reg. § 15A.453-1(d)(2)(i). An installment obligation is property and subject to valuation. *Id.* A cash method taxpayer realizes the fmv of the obligation which cannot be less than the fmv of the property sold. Reg. § 15A.453-1(d)(2)(ii). An accrual method taxpayer realizes the total amount payable under the installment obligation. *Id.*

*Financial accounting and the "Generally Accepted Accounting Principles" (GAAP)*: Taxpayers routinely keep track of their income and expenses for more reasons than making an annual accounting to the IRS. They may want to procure a loan from a bank. The bank will want taxpayer to provide it with reason to believe that she can repay the loan. Or taxpayer may want to sell her business. A prospective buyer will want taxpayer to provide some indication of what income she can expect, what assets the business owns, the fmv of those assets, etc. We expect the rules of accounting that taxpayer follows to provide an accurate picture of her business in the context for which information is provided. Those rules are not always the same as they are for determining the income on which taxpayer must pay income tax. The GAAP establishes rules for the accounting profession to follow. There are occasions when taxpayer may wish to utilize these accounting rules when determining her tax liability. In this chapter and elsewhere, notice the occasions when we require (or permit) deviation from GAAP's rules and why.

•Taxpayer must treat as the amount realized in the year of sale the fair market value of the installment obligation. Reg. § 15A.453-1(d)(2)(iii). "Only in those rare and extraordinary cases involving sales for a contingent payment obligation in which the fair market value of the obligation ... cannot reasonably be ascertained will the taxpayer be entitled to assert that the transaction is 'open.'" *Id.*



Do the CALI Lesson, *Basic Federal Income Taxation: Timing Installment Sales: Second Dispositions by Related Parties and Contingent Payments*

### III. Basic Accounting Rules

Taxpayer must account for her income annually. Here we consider *how* taxpayer accounts for it. Section 446(a) provides that: “Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.” There are some caveats to this facially permissive statement.

Section 446(b) establishes the standard that taxpayer’s method of accounting must “clearly reflect income.” Section 446(c) establishes “permissible methods” of accounting. We will consider the two most important of them: “cash receipts and disbursements method” and “accrual method.” The regulations define these phrases. Reg. § 1.446-1(c)(1)(i and ii) provide in part:

(i) *Cash receipts and disbursements method.* – Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually made. ...

(ii) *Accrual method.* – (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the

Rule of Thumb (and no more than that):  
*Cash method:* “follow the money.” Income is not income unless taxpayer has received money, property, or services. When taxpayer has received money, property, or services, it *is* income – even if taxpayer may not yet have actually “earned” it. The same is true of deductions. Taxpayer is not entitled to a deduction unless she has actually paid the deductible expense.  
*Accrual method:* follow the obligation. Taxpayer must recognize income when she is *entitled* to receive it – even if taxpayer has not actually received payment. Similarly, taxpayer is entitled to a deduction when she is obligated to pay an expense – even if taxpayer has not actually paid the expense. Section 461(h) also requires that “economic performance” occur before taxpayer may claim a deduction.

amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. ...

In the next subsections of the text, we consider a few of the principles that these accounting methods incorporate.

Section 446(d) provides that a “taxpayer engaged in more than one trade or business may, in computing taxable income, use a different method of accounting for each trade or business.” However –

- A C corporation or a partnership with a C corporation partner whose average gross receipts for the last 3-taxable year period exceeds \$25M may not use the cash receipts and disbursements method of accounting. §§ 448(a)(1 and 2), 448(b)(3), 448(c)(1).
- A tax shelter may not use the cash receipts and disbursements method of accounting. § 448(a)(3).
- A taxpayer who uses an inventory must use the accrual method “with regard to purchases and sales[.]” Reg. § 1.446-1(c)(2)(ii).

#### *A. Cash Method*

The virtue of the cash method is that it is simple. Its main shortcoming is that it does not always present an accurate picture of the taxpayer’s economic well-being. It can also be subject to manipulation. If a taxpayer does not want to pay income tax on income, all taxpayer must do is defer its receipt. If a taxpayer wants to increase her deductions, taxpayer simply prepays deductible expenses – perhaps years in advance.

- Section 461(g) addresses prepayment of interest. Read § 461(g). What problem does it address and how does it address it? What is a “point?”
- Don’t forget that § 263 (capitalization) covers intangibles that will help to produce income past the end of the current tax year. *See* Reg. § 1.263(a)-4(c)(1) (list of intangibles – includes insurance contract and lease).

Various rules address the receipt of income under the cash method.

## 1. Cash Equivalent

Receipt of a “cash equivalent” is the receipt of cash. A check is considered the equivalent of cash. So is a credit card charge. On the payment side, payment by check is made when taxpayer delivers it in the manner that taxpayer normally does, e.g., by mail. Payment by credit card is made when the charge is incurred.

In an important case, the United States Court of Appeals for the Fifth Circuit considered whether a promissory note or contract right is a “cash equivalent” and said:

A promissory note, negotiable in form, is not necessarily the equivalent of cash. Such an instrument may have been issued by a maker of doubtful solvency or for other reasons such paper might be denied a ready acceptance in the market place. We think the converse of this principle ought to be applicable. We are convinced that if a promise to pay of a [(1)] solvent obligor is [(2)] unconditional and assignable, [(3)] not subject to set-offs, and [(4)] is of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money, such promise is the equivalent of cash and taxable in like manner as cash would have been taxable had it been received by the taxpayer rather than the obligation.

*Cowden v. Commissioner*, 289 F.2d 20, 24 (5<sup>th</sup> Cir. 1961). A “promissory note” is treated as “property” and so its receipt is income to the extent of its fmV. What are the factors that make receipt of a promissory note “gross income?”

On the other hand, giving a promissory note is *not* the equivalent of payment and does not entitle the maker to a deduction, even if the recipient of the note must include the fmV of the note in her gross income. See *Don E. Williams Co. v. Commissioner*, 429 U.S. 569, 579 (1977). “The promissory note, even when payable on demand and fully secured, is still, as its name implies, only a promise to pay, and does not represent the paying out or reduction of assets. A check, on the other hand, is a direction to the bank for immediate payment, is a medium of exchange, and has come to be treated for federal tax purposes as a conditional payment of cash.” *Id.* at 582-83.

## 2. Constructive Receipt

Reg. § 1.451-2(a) provides in part:

**Constructive receipts of income.** – (a) *General rule.* – Income although not actually reduced to a taxpayer’s possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer’s control of its receipt is subject to substantial limitations or restrictions. ...

Consider:

Taxpayer Paul Hornung played in the NFL championship game on December 31, 1961. The game was in Green Bay, Wisconsin and ended at 4:30 p.m. The editors of Sport Magazine named him the most valuable player of the game and informed him of this fact. Taxpayer would be given a Corvette automobile, but the editors had neither title nor keys to the automobile at that time. They would present them to taxpayer at a luncheon in New York City on January 3, 1962. Sport Magazine could have presented Mr. Hornung with keys and title on December 31, 1961 – but the automobile was in New York.

- Did taxpayer constructively receive the automobile in 1961? *See Hornung v. Commissioner*, 47 T.C. 428 (1967) (*acq.*).

Taxpayer is a prisoner. The Champion Transportation Services Inc. Profit Sharing and 401(k) Plan mailed a cashier’s check for \$25,000 to his personal residence in 1997. A “house-sitter” lived at the residence during the taxpayer’s period of incarceration. Taxpayer had access to a telephone. Taxpayer was released in 1998 and cashed the check at that time.

- Did taxpayer constructively receive \$25,000 in 1997? *See Roberts v. Commissioner*, T.C. Memo. 2002-281, 2002 WL 31618544.

### 3. Economic Benefit

A cash method taxpayer must include in her gross income the value of an “economic benefit.”

Under the economic-benefit theory, an individual on the cash receipts and disbursements method of accounting is currently taxable on the economic and financial benefit derived from the absolute right to income in the form of a fund which has been irrevocably set aside for him in trust and is beyond the reach of the payor's debtors [*sic* creditors].

*Pulsifer v. Commissioner*, 64 T.C. 245, 246 (1975) (taxpayer realized economic benefit even though winners of Irish Sweepstakes unable to claim prize held in Bank of Ireland until they reached age of 21 or legal representative applied for the funds).

#### **Rev. Rul. 60-31, 1960-1 C.B. 174**

SECTION 451. – GENERAL RULE FOR TAXABLE YEAR OF INCLUSION,  
26 CFR 1.451-1: General rule for taxable year of inclusion

Discussion of the application of the doctrine of constructive receipt to certain deferred compensation arrangements.

Advice has been requested regarding the taxable year of inclusion in gross income of a taxpayer, using the cash receipts and disbursements method of accounting, of compensation for services received under the circumstances described below.

(1) On January 1, 1958, the taxpayer and corporation X executed an employment contract under which the taxpayer is to be employed by the corporation in an executive capacity for a period of five years. Under the contract, the taxpayer is entitled to a stated annual salary and to additional compensation of 10x dollars for each year. The additional compensation will be credited to a bookkeeping reserve account and will be deferred, accumulated, and paid in annual installments equal to one-fifth of the amount in the reserve as of the close of the year immediately preceding the year of first payment. The payments are to begin only upon (a) termination of the taxpayer's employment by the corporation; (b) the taxpayer's becoming a part-time employee of the corporation; or (c) the taxpayer's becoming

partially or totally incapacitated. Under the terms of the agreement, corporation X is under a merely contractual obligation to make the payments when due, and the parties did not intend that the amounts in the reserve be held by the corporation in trust for the taxpayer.

The contract further provides that if the taxpayer should fail or refuse to perform his duties, the corporation will be relieved of any obligation to make further credits to the reserve (but not of the obligation to distribute amounts previously contributed); but, if the taxpayer should become incapacitated from performing his duties, then credits to the reserve will continue for one year from the date of the incapacity, but not beyond the expiration of the five-year term of the contract. There is no specific provision in the contract for forfeiture by the taxpayer of his right to distribution from the reserve; and, in the event he should die prior to his receipt in full of the balance in the account, the remaining balance is distributable to his personal representative at the rate of one-fifth per year for five years, beginning three months after his death.

(2) ...

....

(3) On October 1, 1957, the taxpayer, an author, and corporation Y, a publisher, executed an agreement under which the taxpayer granted to the publisher the exclusive right to print, publish and sell a book he had written. This agreement provides that the publisher will (1) pay the author specified royalties based on the actual cash received from the sale of the published work, (2) render semiannual statements of the sales, and (3) at the time of rendering each statement make settlement for the amount due. On the same day, another agreement was signed by the same parties, mutually agreeing that, in consideration of, and notwithstanding any contrary provisions contained in the first contract, the publisher shall not pay the taxpayer more than 100x dollars in any one calendar year. Under this supplemental contract, sums in excess of 100x dollars accruing in any one calendar year are to be carried over by the publisher into succeeding accounting periods; and the publisher shall not be required either to pay interest to the taxpayer on any such excess sums or to segregate any such sums in any manner.

(4) In June 1957, the taxpayer, a football player, entered into a two-year standard player's contract with a football club in which he agreed to play football and engage in activities related to football during the two-year term only for the club.

In addition to a specified salary for the two-year term, it was mutually agreed that as an inducement for signing the contract the taxpayer would be paid a bonus of 150x dollars. The taxpayer could have demanded and received payment of this bonus at the time of signing the contract, but at his suggestion there was added to the standard contract form a paragraph providing substantially as follows:

The player shall receive the sum of 150x dollars upon signing of this contract, contingent upon the payment of this 150x dollars to an escrow agent designated by him. The escrow agreement shall be subject to approval by the legal representatives of the player, the Club, and the escrow agent.

Pursuant to this added provision, an escrow agreement was executed on June 25, 1957, in which the club agreed to pay 150x dollars on that date to the Y bank, as escrow and the escrow agent agreed to pay this amount, plus interest, to the taxpayer in installments over a period of five years. The escrow agreement also provides that the account established by the escrow agent is to bear the taxpayer's name; that payments from such account may be made only in accordance with the terms of the agreement; that the agreement is binding upon the parties thereto and their successors or assigns; and that in the event of the taxpayer's death during the escrow period the balance due will become part of his estate.

(5) The taxpayer, a boxer, entered into an agreement with a boxing club to fight a particular opponent at a specified time and place. The place of the fight agreed to was decided upon because of the insistence of the taxpayer that it be held there. The agreement was on the standard form of contract required by the state athletic commission and provided, in part, that for his performance taxpayer was to receive 16x% of the gross receipts derived from the match. Simultaneously, the same parties executed a separate agreement providing for payment of the taxpayer's share of the receipts from the match as follows: 25% thereof not later than two weeks after the bout, and 25% thereof during each of the three years following the year of the bout in equal semiannual installments. Such deferments are not customary in prize fighting contracts, and the supplemental agreement was executed at the demand of the taxpayer. ...

....

As previously stated, the individual concerned in each of the situations described above, employs the cash receipts and disbursements method of accounting. Under that method, ... he is required to include the compensation concerned in gross



income only for the taxable year in which it is actually or constructively received. Consequently, the question for resolution is whether in each of the situations described the income in question was constructively received in a taxable year prior to the taxable year of actual receipt.

A mere promise to pay, not represented by notes or secured in any way, is not regarded as a receipt of income within the intendment of the cash receipts and disbursements method. [citations omitted]. See *Zittle v. Commissioner*, 12 B.T.A. 675, in which, holding a salary to be taxable when received, the Board said: 'Taxpayers on a receipts and disbursements basis are required to report only income actually received no matter how binding any contracts they may have to receive more.'

This should not be construed to mean that under the cash receipts and disbursements method income may be taxed only when realized in cash. For, under that method a taxpayer is required to include in income that which is received in cash or cash equivalent. *Henritze v. Commissioner*, 41 B.T.A. 505. And, as stated in the above quoted provisions of the regulations, the 'receipt' contemplated by the cash method may be actual or constructive.

....

... [U]nder the doctrine of constructive receipt, a taxpayer may not deliberately turn his back upon income and thereby select the year for which he will report it. [citation omitted]. Nor may a taxpayer, by a private agreement, postpone receipt of income from one taxable year to another. [citation omitted].

However, the statute cannot be administered by speculating whether the payor would have been willing to agree to an earlier payment. See, for example, *Amend v. Commissioner*, 13 T.C. 178, *acq.*, C.B. 1950-1, and *Gullett v. Commissioner*, 31 B.T.A. 1067, in which the court, citing a number of authorities for its holding, stated:

It is clear that the doctrine of constructive receipt is to be sparingly used; that amounts due from a corporation but unpaid, are not to be included in the income of an individual reporting his income on a cash receipts basis unless it appears that the money was available to him, that the corporation was able and ready to pay him, that his right to receive was not restricted, and that his failure to receive resulted from exercise of his own choice.

Consequently, it seems clear that in each case involving a deferral of compensation a determination of whether the doctrine of constructive receipt is applicable must be made upon the basis of the specific factual situation involved.

Applying the foregoing criteria to the situations described above, the following conclusions have been reached:

(1) The additional compensation to be received by the taxpayer under the employment contract concerned will be includible in his gross income only in the taxable years in which the taxpayer actually receives installment payments in cash or other property previously credited to his account. To hold otherwise would be contrary to the provisions of the regulations and the court decisions mentioned above,

(2) ...

....

(3) Here the principal agreement provided that the royalties were payable substantially as earned, and this agreement was supplemented by a further concurrent agreement which made the royalties payable over a period of years. This supplemental agreement, however, was made before the royalties were earned; in fact, in [sic] was made on the same day as the principal agreement and the two agreements were a part of the same transaction. Thus, for all practical purposes, the arrangement from the beginning is similar to that in (1) above. Therefore, it is also held that the author concerned will be required to include the royalties in his gross income only in the taxable years in which they are actually received in cash or other property.

(4) In arriving at a determination as to the includibility of the 150x dollars concerned in the gross income of the football player, under the circumstances described, in addition to the authorities cited above, consideration also has been given to ... the decision in *Sproull v. Commissioner*, 16 T.C. 244.

....

In *Sproull v. Commissioner*, 16 T.C. 244, *aff'd*, 194 Fed.(2d) 541, the petitioner's employer in 1945 transferred in trust for the petitioner the amount of \$10,500. The trustee was directed to pay out of principal to the petitioner the sum of \$5,250 in 1945 and the balance, including income, in 1947. In the event of the petitioner's prior death, the amounts were to be paid to his administrator, executor, or heirs. The petitioner contended that the Commissioner erred in including the sum of \$10,500 in his taxable income for 1945. In this connection, the court stated:

\*\*\* it is undoubtedly true that the amount which the Commissioner has included in petitioner's income for 1945 was used in that year for his benefit \*\*\* in setting up the trust of which petitioner, or, in the event of his death then his estate, was the sole beneficiary \*\*\*.

The question then becomes \*\*\* was 'any economic or financial benefit conferred on the employee as compensation' in the taxable year. If so, it was taxable to him in that year. This question we must answer in the affirmative. The employer's part of the transaction terminated in 1945. It was then that the amount of the compensation was fixed at \$10,500 and irrevocably paid out for petitioner's sole benefit. \*\*\*.'

Applying the principles stated in the *Sproull* decision to the facts here, it is concluded that the 150x-dollar bonus is includible in the gross income of the football player concerned in 1957, the year in which the club unconditionally paid such amount to the escrow agent.

(5) In this case, the taxpayer and the boxing club, as well as the opponent whom taxpayer had agreed to meet, are each acting in his or its own right, the proposed match is a joint venture by all of these participants, and the taxpayer is not an employee of the boxing club. The taxpayer's share of the gross receipts from the match belong to him and never belonged to the boxing club. Thus, the taxpayer acquired all of the benefits of his share of the receipts except the right of immediate physical possession; and, although the club retained physical possession, it was by virtue of an arrangement with the taxpayer who, in substance and effect, authorized the boxing club to take possession and hold for him. The receipts, therefore, were income to the taxpayer at the time they were paid to and retained by the boxing club by his agreement and, in substance, at his direction, and are

includible in his gross income in the taxable year in which so paid to the club. See the *Sproull* case, *supra*, and *Lucas v. Earl*, 281 U.S. 111.

....

*Notes and Questions:*

1. A “mere promise to pay” is not included in gross income. It should be apparent that at least some of the taxpayers that the Revenue Ruling described planned or could have planned the timing of their receipt of money in such a way as to reduce their tax liability.

- Taxpayers in cases 4 and 5 were presumably subject to income tax earlier than they might have wished. How would you restructure the bargains that they entered to defer the income tax due?
- Would such a restructuring create other risks?

2. Read the excerpt from *Pulsifer* again carefully. Is there not considerable overlap between constructive receipt and economic benefit?

3. Read § 83(a to h). Consider a variant of the facts of Example 1 of Reg. § 1.83- (f).

**Section 83:** The transfer of property in exchange for services is the subject of § 83. Section 83(a) states the commonsense rule that a service provider realizes gross income equal to the fmV of property transferred to her or to anyone else minus any amount paid for the property. However, this rule does *not* apply – unless the service provider elects otherwise, § 83(b) – until the recipient can transfer the property *and* her ownership of it is not subject to a substantial risk of forfeiture. § 83(a) (last sentence). Conditioning a right to property on the performance of substantial future services constitutes a “substantial risk of forfeiture.” § 83(c)(1). Property is not transferable if it is subject to a “substantial risk of forfeiture.” § 83(c)(2). If the service provider elects to include the fmV of property in her taxable income without regard to any restriction, she will have basis equal to the amount on which she paid income tax and a holding period that commences with the transfer of the property. Reg. §§ 1.83-4(a, b). But: should the risk of forfeiture materialize, taxpayer is not entitled to a deduction “in respect of such forfeiture.” § 83(b)(1) (last sentence). The person for whom services were performed is entitled to a deduction under § 162 in the year taxpayer includes the amount in her gross income. § 83(h).

On November 1, 201Y, X Corporation sells to E, an employee, 100 shares of X Corporation stock for \$10/share. At the time of such sale the fmV of the X Corporation stock is \$100/share. Under the terms of the sale, E must perform substantial services for X Corporation until November 1, 202Y or resell the stock to X Corporation for \$10/share. The stock is non-transferable.

- Advise E of her liability for income tax and of options available to her.
- Advise X Corporation of the deductibility of what it is providing to E.
- What are the potential risks and rewards of this compensation arrangement?
- For a review of questions that § 83 has generated, *see* Jasper L. Cummings, *Property for Services*, TAX NOTES FED. Vol. 175, June 6, 2022, 1565.

4. Congress added § 83(i) when it enacted the Tax Cut and Jobs Act. This section provides employees of closely-held corporate employers an election to defer inclusion in gross income the fmV of employer stock that is not readily tradable on an established securities exchange and cannot be sold to the corporation when the employee's rights are first transferable or not subject to a substantial risk of forfeiture. § 83(i)(2)(B). Section 83 (i) addresses the hardship that can befall employees who must otherwise include in their gross income the value of stock when it vests, even if the employee cannot realize on the stock by selling it to pay what may be a substantial tax burden. The fmV of the stock may be high relative to the employee's normal salary. H.R. REP. NO. 115-409, at 339 (2017). The employee must own the stock "in connection with the exercise of an option" or in "settlement of a restricted stock unit" that was given as compensation for services. § 83(i)(2)(A). "A restricted stock unit ("RSU") is a term used for an arrangement under which an employee has the right to receive at a specified time in the future an amount determined by reference to the value of one or more shares of employer stock." H.R. REP. NO. 115-409, at 338 (2017).

The election enables employees of closely held corporations to obtain parity with employees of other employers whose stock is more liquid. They can elect to defer inclusion in their gross income the fmV of stock obtained under these circumstances until the earliest of: the date the stock becomes transferable (including to the employer), the day the employee becomes an owner, officer, or highly-compensated employee, the date the stock becomes readily tradeable on an established securities exchange, the date five years after the stock becomes transferable or not subject to a substantial risk of forfeiture, or the day the employee revokes the election. § 83(i)(1)(B).

There are other rules and safeguards to this treatment. A fuller consideration of § 83(i), its uses, and implications can be deferred to a course on employee benefits.



Do the CALI Lesson, *Basic Federal Income Taxation: Gross Income: Receipt of Property as Compensation*.

### *B. Accrual Method*

In *United States v. Anderson*, 269 U.S. 422, 441 (1926), the United States Supreme Court stated that a taxpayer using the accrual method of accounting must claim a deduction when “all the events [have occurred] which fix the amount of the [liability] and determine the liability of the taxpayer to pay it.” Under the accrual method, the timing of income or deductions does not turn upon actual receipt or payment of money, as it does under the cash method. Its focus is on sufficiently fixed rights and obligations concerning payments. The accrual method more accurately portrays the financial state of the taxpayer than the cash method.

The regulations provide an “all events test” for deductions and another “all events test” for recognition of gross income. Not surprisingly, the regulations are stingier about permitting deductions than requiring recognition of gross income.

*Deductions:* Reg. § 1.461-1(a)(2) provides in part:

Under an accrual method of accounting, a liability ... is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability.

*See* § 461(h)(4). Section 461(h) defines “economic performance.” Section 461(h) sets forth various events that constitute “economic performance” in different circumstances. Generally, “economic performance” is actual performance of an obligation by or for the taxpayer, or making a payment. It is not enough that taxpayer owes or is owed performance or payment.

*Income:* Reg. § 1.451-1(a) provides in part:

Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. ... Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. ... If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

An important condition that the Supreme Court permitted the Commissioner to incorporate into the accrual method of recognizing income is that taxpayer's receipt of *cash* in exchange for its promise to render services to members of a club who might need them at some undetermined future time gave rise to gross income upon receipt of the cash, *American Automobile Assoc. v. United States*, 367 U.S. 687 (1961), irrespective of what Generally Accepted Accounting Principles (GAAP) might otherwise prescribe. *Id.* at 693. Taxpayer argued that it should be permitted to recognize a pro rated amount of income monthly. *See also Automobile Club of Michigan v. Commissioner*, 353 U.S. 180 (1957).

While the Commissioner prevailed on the question of whether an accrual method taxpayer must include advance payments in its gross income in the year of receipt, the IRS offered an accommodation in Rev. Proc. 2004-23, 2004-1 C.B. 991 whereby accrual method taxpayers who receive an advance payment could

(i) include the advance payment in gross income for the year of receipt ... to the extent recognized in revenues in its applicable financial statement ... for that taxable year, and

(ii) include the remaining amount of the advance payment in gross income in accordance with § 5.02(1)(a)(ii) of this revenue procedure[ in the next succeeding taxable year.]

In the Tax Cuts and Jobs Act, Congress added §§ 451(b) and 451(c). These provisions essentially codified these paragraphs of Rev. Proc. 2004-23. Section 451(b) provides that for taxpayers who compute their taxable income on the accrual method they must treat an item of income as meeting the all-events test no later than when it is taken into account as revenue in “an applicable financial statement” or another financial statement that the Secretary of the Treasury prescribes. § 451(b)(1)(A). Section 451(b)(3) provides a ranked list of documents that constitute an “applicable financial statement” (AFR):

1. a financial statement certified to be prepared in accordance with generally accepted accounting principles and filed with the Securities Exchange Commission (Form 10-K or annual statement to shareholders). If taxpayer has no such financial statement, then –
2. a financial statement certified to be prepared in accordance with generally accepted accounting principles and used for credit purposes, to report to shareholders, partners, other proprietors, or to beneficiaries, or for any other substantial nontax purpose. If taxpayer has no such financial statement, then –
3. a financial statement made on the basis of international financial reporting standards and filed with an agency of a foreign government that is equivalent to the United States SEC which has reporting standards no less stringent than those of the SEC. If taxpayer has no such financial statement, then –
4. a financial statement filed with any other regulatory or governmental body that the Secretary of the Treasury names.

Section 451(c) makes taxpayer’s deferral of advance cash payments elective (§ 451(c)(1)(B)), but only to the extent that it is not included in taxpayer’s income in its AFR to the next taxable year following receipt. § 451(c)(1)(B)(ii). *See* W. Eugene Seago, *The Direction of the Accrual Basis Income Formula Has Changed*, TAX NOTES FED. Vol. 171, May 31, 2021, 1371; Shannon R. Jemiolo, Ian Redpath, & Thomas Vogel. *How the TCJA Changed the Income Recognition Rules*, TAX NOTES, Apr. 19, 2021, at 369.

Rev. Proc. 2004-34 illustrated the rule with examples, some of which are included here. Cumulatively, they inform us how these rules work.



**Rev. Proc.** 2004-34, 2004-1 C.B. 991.

....

Example 1. On November 1, 2004, A, in the business of giving dancing lessons, receives an advance payment for a 1-year contract commencing on that date and providing for up to 48 individual, 1-hour lessons. A provides eight lessons in 2004 and another 35 lessons in 2005. In its ... financial statement, A recognizes  $\frac{1}{6}$  of the payment in revenues for 2004, and  $\frac{5}{6}$  of the payment in revenues for 2005. A uses the Deferral Method. For federal income tax purposes, A must include  $\frac{1}{6}$  of the payment in gross income for 2004, and the remaining  $\frac{5}{6}$  of the payment in gross income for 2005.

Example 2. Assume the same facts as in Example 1, except that the advance payment is received for a 2-year contract under which up to 96 lessons are provided. A provides eight lessons in 2004, 48 lessons in 2005, and 40 lessons in 2006. In its ... financial statement, A recognizes  $\frac{1}{12}$  of the payment in revenues for 2004,  $\frac{6}{12}$  of the payment in revenues for 2005, and  $\frac{5}{12}$  of the payment in gross revenues for 2006. For federal income tax purposes, A must include  $\frac{1}{12}$  of the payment in gross income for 2004, and the remaining  $1\frac{1}{12}$  of the payment in gross income for 2005.

....

Example 4. On July 1, 2004, C, in the business of selling and repairing television sets, receives an advance payment for a 2-year contract under which C agrees to repair or replace, or authorizes a representative to repair or replace, certain parts in the customer's television set if those parts fail to function properly. In its ... financial statement, C recognizes  $\frac{1}{4}$  of the payment in revenues for 2004,  $\frac{1}{2}$  of the payment in revenues for 2005, and  $\frac{1}{4}$  of the payment in revenues for 2006. C uses the Deferral Method. For federal income tax purposes, C must include  $\frac{1}{4}$  of the payment in gross income for 2004 and the remaining  $\frac{3}{4}$  of the payment in gross income for 2005.

Example 5. On December 2, 2004, D, in the business of selling and repairing television sets, sells for \$200 a television set with a 90-day warranty on parts and labor (for which D, rather than the manufacturer, is the obligor). D regularly sells television sets without the warranty for \$188. In its applicable financial statement, D allocates \$188 of the sales price to the television set and \$12 to the 90-day warranty, recognizes  $\frac{1}{3}$  of the amount allocable to the warranty (\$4) in revenues for 2004, and recognizes the remaining  $\frac{2}{3}$  of the amount allocable to the warranty

(\$8) in revenues for 2005. D uses the Deferral Method. For federal income tax purposes, D must include the \$4 allocable to the warranty in gross income for 2004 and the remaining \$8 allocable to the warranty in gross income for 2005.

Example 6. E, in the business of photographic processing, receives advance payments for mailers and certificates that oblige E to process photographic film, prints, or other photographic materials returned in the mailer or with the certificate. E tracks each of the mailers and certificates with unique identifying numbers. On July 20, 2004, E receives payments for 2 mailers. One of the mailers is submitted and processed on September 1, 2004, and the other is submitted and processed on February 1, 2006. In its ... financial statement, E recognizes the payment for the September 1, 2004, processing in revenues for 2004 and the payment for the February 1, 2006, processing in revenues for 2006. E uses the Deferral Method. For federal income tax purposes, E must include the payment for the September 1, 2004, processing in gross income for 2004 and the payment for the February 1, 2006, processing in gross income for 2005.

....

Example 12. On December 1, 2004, I, in the business of operating a chain of “shopping club” retail stores, receives advance payments for membership fees. Upon payment of the fee, a member is allowed access for a 1-year period to I’s stores, which offer discounted merchandise and services. In its ... financial statement, I recognizes 1/12 of the payment in revenues for 2004 and 11/12 of the payment in revenues for 2005. I uses the Deferral Method. For federal income tax purposes, I must include 1/12 of the payment in gross income for 2004, and the remaining 11/12 of the payment in gross income for 2005.

Example 13. In 2004, J, in the business of operating tours, receives payments from customers for a 10-day cruise that will take place in April 2005. Under the agreement, J charts a cruise ship, hires a crew and a tour guide, and arranges for entertainment and shore trips for the customers. In its ... financial statement, J recognizes the payments in revenues for 2005. J uses the Deferral Method. For federal income tax purposes, J must include the payments in gross income for 2005.

....

*Notes and Questions:*

1. When must an accrual method taxpayer include receipt of cash in her gross income when the time of performance is uncertain?
2. Why was taxpayer in Example 13 able to defer recognition of income for tax purposes, but taxpayers in the other examples were not?
  - In *Artnell v. Commissioner*, 400 F.2d 981 (7<sup>th</sup> Cir. 1968), the owner of the Chicago White Sox, an accrual method taxpayer, sold tickets in late fall of one year for games scheduled to be played the following spring and summer, the season ending in the first week of October. Baseball fans paid for tickets at that time. [Only recently, has there been much late October baseball in Chicago.] In its financial statement, taxpayer recognizes the payments in revenue for the following spring and summer. Taxpayer sought to defer recognition of this ticket income until the following year. What result?
3. Read § 455. How does is this rule different from the rule of § 451(b, c)?



Do the CALI Lesson, *Basic Federal Income Taxation: Timing: Cash and Accrual Methods of Accounting*.

*C. Inventory*

A taxpayer's accounting method must clearly reflect income. § 446(b). A taxpayer who sells from inventory who uses the cash method can too easily manipulate the cost of the goods that she sells. Hence the regulations require that such taxpayers match the cost of goods sold with the actual sale of the goods. Reg. § 1.446-1(c)(2)(i) provides:

In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized ...

***Sale of Illegal Drugs:*** While no deduction or credit is allowed for carrying on the trade or business of trafficking in illegal drugs, § 280E, those engaged in the trade or business of trafficking in illegal drugs may reduce their gross income by their cost of goods sold (COGS). *Cf. Today's Health Care II LLC v. Commissioner*, T.C. Memo. 2021-96 (IRS allowed COGS to be subtracted from taxpayer's gross receipts).

Reg. § 1.61-3(a) provides the following with respect to gross income derived from “merchandising:”

*In general:* In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold ...

Reg. § 1.471-1(a) provides in part:

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are

necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor.

The formula for determining gross income for sales from inventory is the following:

**GR MINUS COGS EQUALS GI**

or

**GR – COGS = GI**

GR = gross revenue

COGS = cost of goods sold

GI = gross income.

The formula for determining COGS is the following:

$$\text{OI PLUS P MINUS CI} = \text{COGS}$$

or

$$\text{OI} + \text{P} - \text{CI} = \text{COGS}$$

OI = opening inventory

P = purchases of or additions to inventory

CI = closing inventory.

The Code presumes that taxpayer makes sales from the first of the items that she purchased and placed in inventory, i.e., “first-in-first-out” or FIFO. *Cf.* Reg. § 1.472-1(a) (taxpayer “may” elect LIFO). However, taxpayer may elect to treat sales as made from the last inventory items purchased, i.e., “last-in-first-out” of LIFO. *Id.*

***Simple illustration:***

1. Assume taxpayer is not a “small business.” On December 31, 2021, taxpayer opened a retail store for business and spent \$10,000 to acquire 2000 toolboxes at \$5 each. During 2022, taxpayer paid \$6000 to acquire 1000 more toolboxes at \$6 each. Taxpayer sold 2500 toolboxes for \$10 each.

- Taxpayer’s gross revenue was \$25,000, i.e., 2500 x \$10.
- Taxpayer’s opening inventory was \$10,000. Taxpayer’s purchases were \$6000.
- At the end of the year, taxpayer had 500 toolboxes remaining in inventory.
- If we use the FIFO method, we presume that taxpayer sold the toolboxes that she already had at the beginning the year plus the ones she purchased

***Inventory Accounting for Small Businesses:*** In the TCJA, Congress expanded the class of taxpayers who do not have to engage in the inventory accounting described here. A taxpayer whose average annual gross receipts for the 3-taxable-year period ending with the taxable year preceding the taxable year does not exceed \$25M (§ 448(c)(1)) indexed for inflation (§ 448(c)(4)), may employ a method that treats inventory as non-incidental materials or supplies OR that conforms to the taxpayer’s method of accounting reflected in an applicable financial statement or to taxpayer’s books and records “prepared in accordance with the taxpayer’s accounting procedures.” § 471(c)(1)(B). The costs of non-incidental materials and supplies are “deductible in the taxable year in which the materials and supplies are first used in the taxpayer’s operations or are consumed in taxpayer’s operations. Reg. § 1.162-3(a)(1).”

earliest in the year. Hence taxpayer presumptively sold the 2000 toolboxes that she had on hand at the first of the year plus 500 more that she purchased.

$$\text{COGS} = \$10,000 + \$6,000 - \$3,000 = \$13,000$$

$$\text{GI} = \$25,000 - \$13,000 = \$12,000.$$

- The value of the opening inventory of 500 toolboxes at the beginning of the next year is \$3,000, i.e.,  $500 \times \$6$ .

2. Now suppose that taxpayer has adopted the LIFO method.

- Taxpayer's gross revenue remains \$25,000.
- Taxpayer's opening inventory remains \$10,000, and taxpayer's purchases remain \$6,000.
- At the end of the year, taxpayer still has 500 toolboxes on hand.
- Under the LIFO method, we presume that taxpayer sold the toolboxes that she purchased last in time. Thus, we presume that taxpayer sold (in order) the 1,000 toolboxes that she purchased during the year plus 500 that she had on hand at the first of the year.

$$\text{COGS} = \$10,000 + \$6,000 - \$2,500 = \$13,500.$$

$$\text{GI} = \$25,000 - \$13,500 = \$11,500.$$

- The value of the opening inventory of 500 toolboxes at the beginning the next year is \$2,500.

Taxpayer's gross income was less when the price of inventory increased during the year using the LIFO method rather than the FIFO method.

Reg. § 1.471-2(c) permits a FIFO-method taxpayer to elect to value inventory at cost or market, whichever is lower.

3. Same facts as number 1, except that the fmV of toolboxes fell to \$4 by the end of the year. \$4 is less than \$6, so taxpayer will value the toolboxes in inventory at \$4 rather than \$6.

- Taxpayer's closing inventory =  $500 \times \$4 = \$2,000$ .
- Now:

$$\text{COGS} = \$10,000 + \$6,000 - \$2,000 = \$14,000$$

$$\text{GI} = \$25,000 - \$14,000 = \$11,000.$$

If taxpayer anticipates a loss on inventory before it is sold, she might elect cost or market valuation of inventory, whichever is lower.

### **Wrap-Up Questions for Chapter 9**

1. Why do you think that Congress has never enacted a counterpart to § 1341 and imposed a tax rate on recovery of tax benefit items equal to the rate applicable at the time of the deduction?
2. Taxpayer has \$5000 of before-tax income to save in an IRA. Taxpayer anticipates that her tax bracket will never change. Will taxpayer come out ahead with a Roth IRA or a traditional IRA? What if taxpayer anticipates that her tax bracket will be lower in retirement years than in working (and saving) years?
3. How would you structure a retirement plan using Revenue Ruling 60-31 to defer income tax for taxpayers, yet make the payments as secure as possible?

### **What have you learned?**

Can you explain or define –

- What is the claim of right doctrine?
- What is the rule of *Lewis*? What is the rule of § 1341?
- What is the rule of *Rosen*? What is the rule of § 111?
- What is the installment method? When is it applicable? How does it work?
- What is the cash method of accounting? What is a cash equivalent, constructive receipt, or economic benefit?
- What is the significance of a cash method taxpayer receiving a “mere promise to pay?”
- What is the accrual method of accounting? What is the all events test for income? What is the all events test for deductions? What is economic performance?
- Why would some taxpayers who sell merchandise from inventory prefer to compute their gross income under the LIFO method?

## Chapter 10: Character of Income and Computation of Tax

### *The Tax Formula:*

(gross income)  
MINUS deductions named in § 62  
EQUALS (adjusted gross income (AGI))  
MINUS (standard deduction or itemized deductions)  
MINUS (deduction for “qualified business income”)

EQUALS (taxable income)

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

Recall that there are three principles of income taxation that the Code implements. *See* chapter 1. The first of these principles is that “[w]e tax income of a particular taxpayer once and only once.” Section 63(a) defines “taxable income.” In this chapter, we refine the notion of taxing all income once by adding this caveat: for a non-corporate taxpayer, not all income is taxed the same. “Taxable income” has a “character” that determines the tax burden to which it is subject. Under § 1(h), an individual’s tax liability is the sum of the taxes imposed at different rates on income of different characters.

We have seen that the Code states rules whose effect is to match income and expenses over *time*. *See, e.g., Idaho Power, Encyclopaedia Britannica, supra*. The Code also requires taxpayers – with only quite limited exceptions – to match income, gains, losses, and expenses with respect to *character*. *See, e.g.,* § 1211(b). Taxpayers who perceive these points may try to manipulate the character of income and associated expenses, and the Code addresses these efforts. Naturally, a taxpayer prefers gains to be subject to a lower rate of tax, and deductions to be taken against income subject to a higher rate of tax.

We consider here incomes of the following characters: capital gain – both long-term and short-term, depreciation recapture, § 1231 gain, dividends, and passive. What remains is “ordinary income.” *See* § 64. “Taxable income” is subject to the tax rates of § 1(a to e), except for tax years 2018 to 2025 when it is subject to the tax rates of § 1(j)(2)(A to E). Income with certain characters is subject to lower maximum rates. We usually refer to the “taxable income” subject to the rates of § 1(a to e) or to § 1(j)(2)(A to E) as “ordinary income,” as opposed to income whose character is such that it is subject to tax at lower “maximum” rates.



## I. Capital Gain

Section § 61(a)(3) includes within the scope of “gross income” “gains derived from dealings in property.” Section 1001(a) informed us that taxpayer measures such gains (and losses) by subtracting “adjusted basis” from “amount realized.” Individual taxpayers’ gains from the sale or exchange of “capital assets” *might* be subject to maximum tax rates lower than those otherwise applicable to “taxable income.” Hence it is important to know what is a “capital asset.”

### A. “Capital Asset:” Property Held by the Taxpayer

Read § 1221(a). Notice the structure of the definition, i.e., *all* property *except* ... Do not the first two lines of this section imply that “capital asset” is a broad concept? Is there a common theme to the exceptions – at least to some of them?

In *Corn Products Refining Co. v. Commissioner*, 350 U.S. 46 (1955), taxpayer was a manufacturer of products made from corn. Its profitability was vulnerable to price increases for corn. To protect itself against price increases and potential shortages, taxpayer “took a long position in corn futures<sup>[212]</sup>” at harvest time when prices were “favorable.” *Id.* at 48. If no shortage appeared when taxpayer needed corn, it would take delivery on as much corn as it needed and sell the unneeded futures. If there were a shortage, it would sell the futures only as it was able to purchase corn on the spot market. In this manner, taxpayer protected itself against seasonal increases in the price of corn. Taxpayer evidently purchased futures to cover (much) more than the corn it would eventually need. *See id.* at 49 n.5. Taxpayer’s gains far exceeded its losses, and taxpayer treated these sales as sales of capital assets. This would subject its gains to tax rates lower than the tax rate on its ordinary income.<sup>213</sup> At the time, the Code did not expressly exclude transactions of this nature from property constituting a capital asset. The Commissioner argued that taxpayer’s transactions in corn futures were hedges that protected taxpayer from price increases of a commodity that was ““integral to its manufacturing business[,]”” *id.* at 51, and not capital assets. The Tax Court agreed with the Commissioner as did the United

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<sup>212</sup> A “future” entitles the holder to purchase the commodity in the future for a fixed price.

<sup>213</sup> At the time, corporate taxpayers enjoyed long term capital gain tax rates lower than the tax rates on their other income.

States Court of Appeals for the Second Circuit. The United States Supreme Court affirmed. The Court said:

Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The [Code's] preferential treatment [of capital gains] applies to transactions in property which are not the normal source of business income.

*Id.* at 52. Congress later amended § 1221 by adding what is now § 1221(a)(7). A “capital asset” does not include “any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into ...”

•The statutory embodiment of the *Corn Products* rule creates the presumption that a hedge *is* a capital asset transaction *unless* the taxpayer identifies it as an “ordinary income transaction” at the time taxpayer enters the transaction.

We might surmise that a major point of *Corn Products* is that a transaction that is a “surrogate” for a “non-capital” transaction is in fact a non-capital transaction.

In *Arkansas Best Corp. v. Commissioner*, 485 U.S. 212 (1988), taxpayer was a diversified holding company that purchased approximately 65% of the stock of a Dallas bank. The bank needed more capital and so over the course of five years, taxpayer tripled its investment in the bank without increasing its percentage-of-ownership interest. During that time, the financial health of the bank declined significantly. Taxpayer sold the bulk of its stock, retaining only a 14.7% interest. It claimed an ordinary loss on the sale of this stock, arguing that its ownership of the stock was for business purposes rather than investment purposes. The Commissioner argued that the loss was a capital loss. Taxpayer argued that *Corn Products* supported the position that property purchased with a business motive was not a capital asset. The Tax Court agreed with this analysis. The United States Court of Appeals for the Eighth Circuit reversed, finding that the bank stock was clearly a capital asset. The Supreme Court affirmed. The Court refused to define “capital asset” so as to exclude all assets purchased for a business purpose. “The broad definition of the term ‘capital asset’ explicitly makes irrelevant any consideration of the property’s connection with the taxpayer’s business ...” *Id.* at 217. The Court held that the list of exceptions to § 1221's broad definition of “capital asset” is exclusive. *Id.* at 217-18. Instead of defining “capital asset”

narrowly as in *Corn Products*, the Court can broadly construe the inventory exception. *Id.* at 220. The corn futures in *Corn Products* were surrogates for inventory.

- Thus, “capital asset” is indeed “all property” except for the items – broadly defined – specifically named in § 1221(a).
- Read § 1221(a)’s list of exceptions to “capital assets” again. Is (are) there a general theme(s) to these exceptions?
  - Read again the excerpt from *Corn Products*, above.
- The phrase “capital asset” includes personal use property. Thus, if a taxpayer sells his personal automobile for a gain, the gain is subject to tax as capital gain.



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Capital Asset Identification*.

#### *B. Section 1222: Definitions of Terms Relating to Capital Gains and Losses: Long Term and Short Term Gains and Losses*

Read § 1222. You will see that the Code distinguishes between sales or exchanges of capital assets held for one year or less, and sales or exchanges of capital assets held for more than one year.<sup>214</sup> Sections 1222(1, 2, 3 and 4) inform us that *every single sale or exchange of a capital asset* gives rise to one of the following:

- short-term capital gain (STCG);
- short-term capital loss (STCL);
- long-term capital gain (LTCG);
- long-term capital loss (LTCL).

Sections 1222(5, 6, 7, and 8) direct us to net all short-term transactions and to net all long-term transactions.

- net short-term capital gain (NSTCG) = STCG – STCL, but not less than zero;
- net short-term capital loss (NSTCL) = STCL – STCG, but not less than zero;
- net long-term capital gain (NLTCG) = LTCG – LTCL, but not less than zero;

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<sup>214</sup> One year is not more than one year.

•net long-term capital loss (NLTCCL) = LTCL – LTCG, but not less than zero.

Notice the precise phrasing of §§ 1222(9, 10, and 11). The definitions of these phrases are in § 1222, but other code sections assign specific tax consequences to them. Section 1222(11) defines “*net capital gain*” (NCG) to be  
NLTCG – NSTCL

Section 1222(10) defines “net capital loss” to be the excess of capital losses over the amount of capital loss deductions allowed by §1211. A corporation disregards STCL in computing its “net capital loss.”

Section 1222(9) defines “capital gain net income” to be all capital gain, no matter its character, minus all capital loss, no matter its character.

Notice that the definitions of § 1222 implement, at least initially, a matching principle to gains and losses. Short-term losses offset only short-term gains. Long-term losses offset only long-term gains.

**Net capital gain: the effect of mismatching NLTCG and NSTCL:** Reductions in taxable income, whether by exclusion or deduction, “work” only as hard as taxpayer’s marginal bracket to reduce his tax liability. Since NSTCG does not figure into a taxpayer’s “net capital gain,” it is subject to tax at taxpayer’s highest marginal rate on “taxable income,” i.e., “ordinary income.” However, NSTCL reduces income that would otherwise be taxed at a rate lower than taxpayer’s ordinary income rate. Hence, such losses “work” no harder than taxpayer’s marginal rate on his “*net capital gain*” at reducing his tax liability – not as hard as taxpayer’s marginal rate on his ordinary income.

In determining NCG, net short-term capital loss offsets net long-term capital gain. *Section 1222* does not allow any other mismatching. (Section 1211(b) allows some limited mismatching.) The matching principle is very important to individual taxpayers because only the LTCG that remains after allowable offsets (LTCL and NSTCL) is subject to tax at reduced maximum rates; other income is subject to tax at otherwise higher “ordinary income” rates.



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Capital Gain Mechanics* (For questions on “capital gain net income,” see § 1222(9)).

### *C. Deductibility of Capital Losses and Capital Loss Carryforwards*

Section 1211(b) provides that a taxpayer other than a corporation<sup>215</sup> may claim capital losses – without regard to whether they are long-term or short-term – only to the extent of capital gains *plus* the lesser of \$3000 or the excess of such losses over gains. This is one of very few places where the Code permits a taxpayer to mismatch what might be NLTCL against income subject to ordinary income rates, whether STCG or otherwise.

In the event taxpayer incurred losses greater than those allowed by § 1211(b), i.e., a “net capital loss,” § 1222(10), taxpayer may carry them forward until he dies. § 1212(b). Section 1212(b) treats a capital loss-carryover as if it were one of the transactions described in §§ 1222(2 or 4) (i.e., STCL or LTCL) in the next succeeding year.

- The Code establishes some “if ... then” rules that apply after adding a (hypothetical) STCG equal to the lesser of taxpayer’s § 1211(b) deduction or taxpayer’s “adjusted taxable income.” § 1212(b)(2)(A).<sup>216</sup>
  - If the “net capital loss” results from *both* NLTCL and NSTCL, *then* taxpayer first reduces the NSTCL by the amount of his § 1211(b) deduction, and then reduces the NLTCL by the balance (if any) of his § 1211(b) deduction. Taxpayer separately carries forward the remaining NSTCL and NLTCL.
  - If  $\text{NSTCL} > \text{NLTCG}$ , *then* taxpayer carries forward the “net capital loss” as a STCL transaction. § 1212(b)(1)(A) and § 1212(b)(2)(A).
  - If  $\text{NLTCL} > \text{NSTCG}$ , *then* taxpayer carries forward the “net capital loss” as a LTCL transaction. §§ 1212(b)(1)(B) and 1212(b)(2)(A).

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<sup>215</sup> A corporation may claim losses from the sale or exchange of capital assets only to the extent of its capital gains. § 1211(a).

<sup>216</sup> “Adjusted taxable income” equals: (taxable income) + (§ 1211(b) deduction) + (personal exemption deductions) – ((deductions allowed) – (gross income) [but not less than \$0]). § 1212(b)(2)(B).

Example 1: Taxpayer has \$100,000 of “taxable income” derived from wages. For the tax year, taxpayer also has \$5000 of NSTCL and \$4000 of NLTCCL. What is taxpayer’s § 1211(b) deduction, and what is taxpayer’s § 1212(b) capital loss carryover?

- Taxpayer’s capital losses (i.e., \$9000) exceed his capital gains (i.e., \$0) by \$9000. Taxpayer’s § 1211(b) deduction is \$3000. He may deduct \$3000 against his “taxable income” derived from wages. Taxpayer’s has a “net capital loss” (§ 1222(10)), which is \$6000.
- We calculate taxpayer’s capital loss carryovers by first adding \$3000 (the amount of taxpayer’s § 1211(b) deduction) of STCG to his NSTCL.<sup>217</sup> Taxpayer’s NSTCL becomes \$2000; taxpayer’s NLTCCL is \$4000. Taxpayer will carry these amounts forward. In the succeeding year, taxpayer will include \$2000 as a STCL and include \$4000 as a LTCL.

Example 2. Taxpayer has \$100,000 of “taxable income” derived from wages. For the year, taxpayer also has \$8000 of NSTCL and \$2000 of NLTCG.

- Taxpayer’s capital losses exceed his capital gains by \$6000. Taxpayer’s § 1211(b) deduction is \$3000. Taxpayer’s has a “net capital loss” of \$3000.
- We calculate taxpayer’s capital loss carryover by first adding \$3000 of STCG to his NSTCL.<sup>218</sup> Taxpayer’s NSTCL becomes \$5000. Subtract \$2000 from \$5000. § 1212(b)(1)(A). Taxpayer will carry this amount forward. In the succeeding year, taxpayer will include \$3000 as a STCL.

Example 3. Taxpayer has \$100,000 of “taxable income” derived from wages. For the year, taxpayer also has \$11,000 of NSTCG and \$18,000 of NLTCCL.

- Taxpayer’s capital losses exceed his capital gains by \$7000. Taxpayer’s § 1211(b) deduction is \$3000. Taxpayer has a “net capital loss” of \$4000.
- We calculate taxpayer’s capital loss carryover by first adding \$3000 to his NSTCG. Taxpayer’s NSTCG becomes \$14,000. Subtract \$14,000 from \$18,000. Taxpayer will carry forward \$4000 as a LTCL to the succeeding year. § 1212(b)(1)(B).

*Matching the character of gains and losses:* Aside from §§ 1211 and 1212, the Code strictly implements a matching regime with respect to ordinary gains and

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<sup>217</sup>  $-\$5000 + \$3000 = -\$2000$ .

<sup>218</sup>  $-\$8000 + \$3000 = -\$5000$ .

losses, and capital gains and losses. A taxpayer who regularly earns substantial amounts of ordinary income and incurs very large investment losses can use those losses only at the rate prescribed by § 1211(b) in the absence of investment gains.<sup>219</sup>



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Capital Loss Mechanics*.

**Dividends:** For many years, dividend income that individual taxpayers received was taxed as ordinary income. Corporations pay dividends from the profits that remain after they pay income tax on their profits. Corporations may not deduct dividends that they pay to shareholders – so the dividend income that a shareholder receives is subject to two levels of income tax. This double tax has been subject to criticism from the beginning. Nevertheless, it is constitutional. A legislative compromise between removing one level of tax and retaining the rules taxing dividends as ordinary income is § 1(h)(11). “Qualified dividend income” is taxed at the favorable rates applicable to “adjusted net capital gain,” *infra*. “Qualified dividend income” includes dividends paid by domestic corporations and by “qualified foreign corporations.” § 1(h)(11)(B)(i). A “qualified foreign corporation” is one incorporated in a possession of the United States or in a country that is eligible for certain tax-treaty benefits, or one whose stock “is readily tradable on an established securities market in the United States.” § 1(h)(11)(C).

#### *D. Computation of Tax*

We already know that § 1 imposes income taxes on individuals.<sup>220</sup> Section 1(h) creates income “baskets” and subjects these baskets to different rates of income tax. Once an income “basket” has been subject to its rate of tax, the principle that we tax income once applies, i.e., no income will be subject to income tax in more than one basket.

Section 1(h)(1)(A) isolates ordinary income<sup>221</sup> and for tax years 2018 to 2025 subjects it to the progressive tax brackets of § 1(j).<sup>222</sup> Section 1(h) refers to “net

<sup>219</sup> For a spectacular application of this principle, *see* *United States v. Generes*, 405 U.S. 93 (1972).

<sup>220</sup> Section 11 imposes income taxes on corporations.

<sup>221</sup> “Ordinary income” is the income subject to the highest rates imposed on individual taxpayers. It includes gains from the sale or exchanges of non-capital and non-§ 1231 assets, offset by allowable losses on the sales of the same assets. §§ 64, 65.

<sup>222</sup> ... as modified in § 1(i) and as indexed for inflation, *id*.



capital gain,” a phrase that § 1222 defines, i.e., NLTCG – NSTCL. Section 1(h) modifies this definition to produce “adjusted net capital gain,” as noted in the text box on dividends. The importance of defining “adjusted net capital gain” in § 1(h) rather than adding another sub-section to § 1222 is that it applies only to individuals<sup>223</sup> – not to corporations. Also, capital loss carryovers do not offset dividends included in adjusted net capital gain.

Sections 1(h)(1)(B, C, and D) define the next three “baskets” of income, all of which contain taxpayer’s “adjusted net capital gain” income. (See accompanying text box). For tax years 2018 to 2025, each basket is defined with reference to the amount of a taxpayer’s “taxable income.”<sup>224</sup> The income in each of these three baskets is subject to an increasing rate of tax as taxpayer’s “taxable income” increases. Such amounts are indexed for inflation. § 1(j)(5)(C). For tax year 2023,

**Taxing Ordinary Income, “Net Capital Gain,” and “Adjusted Net Capital Gain:”** Not all “net capital gain” income is taxed alike, but no “net capital gain” income is taxed at a rate higher than the rate applicable to a taxpayer’s taxable ordinary income.

Section 1(h) distinguishes between “net capital gain” and “adjusted net capital gain.” Section 1(h)(3) defines the phrase “adjusted net capital gain” to be “net capital gain” MINUS “unrecaptured § 1250 gain,” MINUS “28-percent rate gain,” PLUS “qualified dividend income.” The definition of “adjusted net capital gain” assures that “qualified dividend income” will be taxed at rates applicable to “adjusted net capital gain.” Those rates for individuals, trusts, and estates” are 0%, 15%, 20%.

The definition of “adjusted net capital gain” excludes “unrecaptured § 1250 gain” and “28-percent rate gain.” Such items *are* nevertheless elements of “net capital gain.” They are taxed separately and differently from “adjusted net capital gain.” If taxpayer’s ordinary income rate is lower than the rate otherwise applicable to these forms of capital gain, the lower ordinary income rate applies. Hence, the maximum tax rate on unrecaptured § 1250 gain is 25%, § 1(h)(1)(E), and the maximum tax rate on 28%-rate gain is 28%, § 1(h)(1)(F).

<sup>223</sup> ... and estates and trusts.

<sup>224</sup> In other years, the tax rate on “adjusted net capital gain” has depended on taxpayer’s *marginal tax bracket* otherwise applicable to all his “taxable income.”



the “maximum zero rate amount”<sup>225</sup> for taxpayers married filing jointly is \$89,250 of taxable income, for heads of household it is \$59,750, and for single persons or married taxpayers filing separately, it is \$44,625 (i.e., half of \$89,250). § 1(j)(5)(B)(i). For tax year 2023, the “maximum 15% rate amount”<sup>226</sup> for taxpayers married filing jointly is \$553,850, for heads of household it is \$523,050, and for single persons and married taxpayers filing separately, it is \$276,900 (half of \$553,850). § 1(j)(B)(ii). For taxpayers with “taxable income” in excess of those amounts, the tax rate applicable to their “adjusted net capital gain” is 20%. In addition, (relatively<sup>227</sup>) high income earners must pay a Medicare tax of 3.8% on their net investment income.<sup>228</sup> § 1411. See Rev. Proc. 2022-38 at § 1.03.

The next “basket” is “unrecaptured § 1250 gain.” Section 1(h)(1)(E) subjects unrecaptured depreciation on real property up to the amount of net § 1231 gain (*infra*) to a maximum rate of 25%.

**Unrecaptured § 1250 gain:** “Unrecaptured § 1250 gain” is the income attributable to recapture of depreciation (*infra*) that taxpayer has claimed on real property. It will be included in taxpayer’s net § 1231 gain.

The last basket is “28-percent rate gain.” Section 1(h)(1)(F) subjects “28-percent rate gain” property to a maximum rate of (surprise) 28%. § 1(h)(1)(E).

Taxpayer’s tax liability is the sum of the taxes imposed on these income baskets.

<sup>225</sup> I.e., the amount of a taxpayer’s “taxable income” below which he pays a tax of 0% on his “adjusted net capital gain” income.

<sup>226</sup> I.e., the amount of a taxpayer’s “taxable income” below which he pays a tax of 15% on his “adjusted net capital gain” income.

<sup>227</sup> I.e., those taxpayers whose modified adjusted gross income exceeds \$250,000 in the case of taxpayers married filing jointly, half that amount in the case of married taxpayers filing separately, and \$200,000 in the case of all other taxpayers – to the extent of the excess. § 1411(b).

<sup>228</sup> ... unless a taxpayer’s modified AGI (as defined) less a threshold amount is less.

## II. Sections 1245 and 1250: Depreciation Recapture

The basis of an allowance for depreciation is the notion that during a tax year a taxpayer consumes a portion, but only a portion, of an asset that enables him to generate income over a period longer than one year. The Code treats that bit of “consumption” the same as any other consumption that enables a taxpayer to generate income, i.e., a deduction from *ordinary* income. See §§ 162, 212. Such an allowance requires an equal reduction in taxpayer’s basis in the asset. See § 1016(a)(2).

We learn shortly that the Code treats gain upon the sale of most assets subject to depreciation – and therefore not capital assets, § 1222(a)(2) – that taxpayer has held for more than one year as LTCG. This would mean that whatever gain taxpayer realizes that is attributable to basis reductions resulting from deductions for depreciation would be subject to a lower rate of tax than the income against which taxpayer claimed those deductions.<sup>229</sup> The Code addresses this mismatch of character of income and deductions through “depreciation recapture” provisions, i.e., §§ 1245<sup>230</sup> and 1250.<sup>231</sup>

**Mismatch of NSTCL and different types of LTCG:** Different types of LTCG combine to make up an individual taxpayer’s “net capital gain,” and these types are not all subject to the same tax rates. LTCG that becomes “28% rate gain” or “unrecaptured § 1250 gain” are subject to special capital gain rates. “28-percent rate gain” is the net of LONG-TERM collectibles gains and losses PLUS § 1202 gain, i.e., currently \$0. §§ 1202(a)(4), 1(h)(4). A “collectible” is essentially any work of art, rug or antique, metal or gem, stamps or certain coins, an alcoholic beverage, and anything else that the Secretary of the Treasury designates. § 408(m)(2).

NSTCL reduces first LTCG of the same type, e.g., collectible losses first offset collectible gains. Then in sequence, NSTCL plus a LTCL carryover reduce LTCG that would otherwise be subject to successively lower rates of tax, i.e., first reduce “net capital gain” subject to a tax rate of 28%, then reduce “net capital gain” subject to a tax rate of 25%, and then reduce “net capital gain” subject to a tax rate of 20%, 15%, or 0%. See §§ 1(h)(4)(B)(ii), 1(h)(6)(A)(ii).

<sup>229</sup> Taxpayers could engage in such systematic mismatching prior to 1962.

<sup>230</sup> Congress enacted § 1245 in 1962. Revenue Act of 1962, P.L. 87-834, § 13(a).

<sup>231</sup> Congress enacted § 1250 in 1964. Revenue Act of 1964, P.L. 88-272, § 231(a).

### A. Section 1245

Section 1245 provides that a taxpayer realizes *ordinary income* upon a disposition<sup>232</sup> of “section 1245 property” to be measured by subtracting its adjusted basis from the lesser of the property’s “recomputed basis” or the amount realized.<sup>233</sup> § 1245(a)(1).

- A property’s “recomputed basis” is its adjusted basis plus all “adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.” § 1245(a)(2)(A).

- Taxpayer may establish “by adequate records or other sufficient evidence” that the amount allowed for depreciation or amortization was less than the amount allowable. § 1245(a)(2)(B).

- Deductions allowed by provisions other than § 167 and § 168 – notably expensing provisions that reduce taxpayer’s basis in the property – are also considered to be “amortization,” § 1245(a)(2)(C), and so become a part of the property’s “recomputed basis.”

“Section 1245 property” is property that is subject to an allowance for depreciation under § 167 (which of course includes § 168) and is –

- personal property, § 1245(a)(3)(A),

- other tangible property – not including a building or structural components – that was used as an “integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,” § 1245(a)(3)(B)(i), that constituted a research facility in connection with these activities, § 1245(a)(3)(B)(ii), or that constituted a facility used in connection with such activities for the bulk storage of fungible commodities,

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<sup>232</sup> “Disposition” is a broader term than “sale” or “exchange.” A corporation that distributes property to a shareholder has not sold or exchanged it, but has disposed of it. Such a disposition triggers a tax on the gain computed as if the corporation had sold the property to the shareholder. § 311(b). Some or all the gain might be depreciation recapture.

<sup>233</sup> Actually, if the disposition is other than by sale, exchange, or involuntary conversion, gain taxable as ordinary income is measured by subtracting adjusted basis from the lesser of recomputed basis or the *fmv* of the property, not the amount realized. § 1245(a)(1).

- § 1245(a)(3)(B)(iii),
- real property subject to depreciation *and* whose basis reflects the benefit of certain special or rapid depreciation provisions, § 1245(a)(3)(C),
- a “single purpose agricultural or horticultural structure,” § 1245(a)(3)(D),
- a “storage facility (not including a building or its structural components) used in connection with the distribution of petroleum” products, § 1245(a)(3)(E), or
- a “railroad grading or tunnel bore,” § 1245(a)(3)(F).

*Example:*

•Taxpayer is a professional violinist who plays the violin for the local symphony orchestra. She purchased a violin bow for \$100,000 in May 2019. Treat a violin bow as 7-year property. In January 2021, she sold the bow for \$110,000, its fmV. What is the taxable gain on which taxpayer must pay tax and what is the character of that gain?

•Taxpayer will deduct a cost recovery allowance under § 168. She will apply the half-year convention to both the year in which she placed the bow in service and the year of sale. § 168(d)(4).

•Go to the tables at the front of your Code. In 2019, she will deduct 14.29% of \$100,000, or \$14,290. In 2020 she will deduct 24.49% of \$100,000, or \$24,490. In 2021, she will deduct half of 17.49% of \$100,000, or \$8745.

•Taxpayer’s remaining basis in the violin bow is \$52,475.

•Taxpayer’s “recomputed basis” is \$100,000. It is less than the fmV of the bow. Hence, taxpayer has depreciation recapture income of \$47,525. This is *ordinary income*. The balance of taxpayer’s gain (i.e., \$10,000) is § 1231 gain, *infra*, which will be subject to tax as if it were long term capital gain.

•Suppose that taxpayer sold the violin bow for its fmV of \$90,000.

•Now the fmV of the bow is less than taxpayer’s recomputed basis.

•Hence, taxpayer’s depreciation recapture income is \$37,525. This income is subject to tax as *ordinary income*.

Section 1245 provides specific rules governing certain dispositions.

•Section 1245 does not apply to a disposition by gift. § 1245(b)(1). Instead, the donee takes the donor’s basis for purposes of determining gain – and

includes recapture income in his income upon disposition of the gifted property.

- Section 1245 does not apply to a transfer at death. § 1245(b)(2). Since there is a basis step-up on property acquired from a decedent, § 1014(a), depreciation recapture is not subject to tax at all upon such a disposition.

- In certain tax-free dispositions of property between a subsidiary and its parent corporation, shareholders and a corporation, and partners and a partnership – there is no recognition of depreciation recapture. § 1245(b)(3). Instead, the recipient – who takes a carryover basis – will recognize depreciation recapture income upon disposition of the property.

- In a tax-deferred like-kind exchange (§ 1031) or involuntary conversion (§ 1033), depreciation recapture is subject to tax only to the extent the acquisition of property not qualifying for tax-deferred treatment is subject to tax plus the fmV of non-section 1245 property acquired. § 1245(b)(4). Instead gain on the disposition of the replacement property attributable to depreciation allowances on both the original and the replacement properties is depreciation recapture income.

- Section 1245 does not apply to a tax-deferred distribution of partnership property to a partner. § 1245(b)(5)(A). The partner will recognize depreciation recapture income upon his disposition of the property (subject to some very technical adjustments).

- Section 1245 does not apply to a disposition to a tax-exempt organization, § 1245(b)(3), unless the organization immediately uses the property in a trade or business unrelated to its exemption, § 1245(b)(6)(A). If the tax-exempt organization later ceases to use the property for a purpose related to its exemption, *it* is treated as having made a disposition on the date of such cessation. § 1245(b)(6)(B).

- Special amortization rules apply to reforestation expenditures. § 194. An 84-month amortization period applies. § 194(a)(1). Ten years after acquiring the “amortizable basis” for incurring reforestation expenditures, gain on the disposition of such assets is no longer considered to be depreciation recapture. § 1245(b)(7).

- If taxpayer disposes of more than one amortizable section 197 intangible in one or more related transactions, all section 197 intangibles are considered to be one section 1245 property. § 1245(b)(8)(A). However, this rule does not apply to a section 197 intangible whose fmV is less than its adjusted basis. § 1245(b)(8)(B).

Section 1245(d) provides that § 1245 applies “notwithstanding any other provision of this subtitle.” This means that except to the extent § 1245 itself excepts its own applicability, depreciation recapture will be carved out of the gain on *any* disposition of depreciable or amortizable property and be subject to tax as ordinary income. This important provision limits taxpayer opportunity to mismatch the character of income against which he claims deductions with the character of subsequent resulting gain.

### *B. Section 1250*

Section 1250 treats as ordinary income, § 1250(a)(1)(A), the recapture of so-called “additional depreciation,” i.e., the excess of depreciation adjustments over straight-line adjustments on “section 1250 property” held for more than one year. § 1250(b)(1). Section 1250 property is depreciable real property to which § 1245 does not apply. Since § 168 allowances on real property are all now straight-line, the applicability of § 1250 is limited.

For individual taxpayers, recapture of remaining depreciation allowances on real property are subject to a maximum tax rate of 25%. The balance of any *net* 1231 gain is subject to capital gain treatment as per § 1231, *infra*. Such favorable tax treatment of recapture income for real property relative to the tax treatment of recapture income for personal property is subject to criticism for causing economic distortions and inequity. See Richard L. Schmalbeck & Jay Soled, *Reforming Real Estate Depreciation Recapture*, TAX NOTES, Feb. 16, 2015, at 887.

## **III. Section 1231: Some Limited Mismatching**

During World War II, the nation moved to a war economy. The Government seized many of the nation’s productive assets to convert them to production of items critical to the war effort. The Fifth Amendment to the Constitution of course requires that the owners of such properties be justly compensated. The owners of businesses often did not wish to sell their assets to the Government and then to pay income tax (at wartime rates) on the taxable gains they were forced to recognize. Congress responded by enacting § 1231 – a sort of “heads-I-win-tails-you-lose” measure for taxpayers who found themselves with (substantial amounts of) unplanned-for taxable income. Basically, net gains from such transactions would be *treated as capital* gains; net losses from such transactions would be *treated as*

*ordinary* losses. Don't forget that corporations still enjoyed a capital gains rate preference. World War II ended a long time ago, but § 1231 is still with us. It has become a very important provision in the sale of a business's productive assets. Section 1231 applies to "property used in the trade or business" and to any capital asset held for more than one year in connection with a trade or business. § 1231(a)(3). Section 1231(b) defines "property used in the trade or business" essentially as "property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year[.]" § 1231(b)(1). Such property is the same as the property that § 1221(a)(2) describes, *but which* the taxpayer has held for more than one year. Such property does not encompass property that § 1221(a)(1, 3, and 5) describes.

Section 1231 requires two netting processes – both of which adopt the "heads-I-win-tails-you lose" characterization of transactions. If the first netting process yields a gain, the net gain becomes a part of the second netting process. Those who write about § 1231 often describe this in terms of mixing ingredients in two pots. If the mixture in the first pot yields a net positive, it is added to the second pot; otherwise, it is not added. We are talking about non-statutory terms so we can use any terminology we wish – but let's consider the first netting process to occur in a "firepot." The second netting process occurs in a "hotchpot."

*Firepot:* Section 1231 initially adopts the "heads-I-win-tails-you-lose" principle for "involuntary conversions" resulting from *casualty losses* of "property used in the trade or business" or of a capital asset held for more than one year in connection with a trade or business or transaction entered into for profit. § 1231(a)(4)(C). If a taxpayer's gains and losses from such "involuntary conversions" resulting from casualty losses net to a loss, then § 1231 does not apply to any such gains and losses. § 1231(a)(4) (carryout paragraph). Gains/losses from condemnation are not included in the firepot. The upshot of this "inapplicability" is that such gains and losses are treated as realized on the disposition of non-capital assets, so the net loss will be an ordinary loss. If the gains and losses from such transactions yield a net gain or if the net gain (or net loss) is \$0, then § 1231 is applicable to them. *See* Reg. § 1.1231-1(e)(3). Such transactions are added to the §1231 hotchpot.



*Section 1231 Hotchpot:* Section 1231 requires a netting of “section 1231 gains” and “section 1231 losses.” “Section 1231 gain” is

- gain recognized on the sale or exchange of “property used in the trade or business” plus
- gain recognized on the compulsory or involuntary conversion into money or other property as a result of whole or partial destruction, theft or seizure, or requisition or condemnation of “property used in the trade or business” or a “capital asset held for more than 1 year” that “is held in connection with a trade or business or a transaction entered into for profit.” § 1231(a)(3)(A). But –
- Such gain does *not* include depreciation recapture. § 1245(d), § 1250(h), Reg. § 1.1245-6(a), Reg. § 1.1250-1(e)(1).

“Section 1231 loss” is loss recognized on such sales, exchanges, or conversions – but not, of course, *net losses* resulting from involuntary conversions resulting from casualties. *Compare* § 1231((a)(3)(A)(ii) *with* § 1231(a)(4)(C).

Section 1231(a)(1 and 2) implements the “heads-I-win-tails-you-lose” principle.

- If section 1231 gains for any taxable year exceed section 1231 losses, such gains and losses are *treated as* LTCG or LTCL as the case may be. § 1231(a)(1).<sup>234</sup>
- If section 1231 gains do not exceed<sup>235</sup> section 1231 losses for the taxable year, then such gains and losses are *not treated as* gains and losses derived from sales or exchanges of capital assets. § 1231(a)(2).

A provision so taxpayer-friendly would be subject to some abuse. With only a little planning, a taxpayer may dispose of section 1231 “winners” in one taxable year and section 1231 “losers” in a different taxable year. Hence, § 1231(c) creates a so-called “5-year lookback rule.” For any year in which taxpayer recognizes net

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<sup>234</sup> This rule does not change the character of assets. In a case involving a contract to sell depreciable property – which is not a capital asset, § 1221(a)(2) – that fell through, taxpayer could neither rely on § 1231 because there was no sale, nor on § 1234A (LTCG treatment for cancellation of obligation with respect to property that is a capital asset) to get LTCG treatment. *CRI-Leslie, LLC v. Commissioner*, 882 F.3d 1026,1029 (CA11 2018) (receipt of nonrefundable deposit from would-be buyer of taxpayer’s hotel and restaurant property gave rise to ordinary income).

<sup>235</sup> This would include cases where section 1231 gains equal section 1231 losses.



section 1231 gains, such gains are taxed as ordinary income to the extent taxpayer recognized section 1231 losses during the five most recent preceding taxable years. § 1231(c).



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Identification of Section 1231 Property*.



Do the CALI Lesson, *Basic Federal Income Taxation: Property Transactions: Section 1231 Mechanics*.

#### IV. More Matching

The following materials should make the point that matching income and expenses with respect to character is more than simply the rule of some Code sections: it is a bedrock principle that pervades construction of the Code.

#### **Arrowsmith v. Commissioner, 344 U.S. 6 (1952)**

MR. JUSTICE BLACK delivered the opinion of the Court.

This is an income tax controversy growing out of the following facts ... In 1937, two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937-1940 returns there is no dispute. But, in 1944, a judgment was rendered

against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. [citations omitted]. Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. ... The Commissioner viewed the 1944 payment as part of the original liquidation transaction requiring classification as a capital loss, just as the taxpayers had treated the original dividends as capital gains. Disagreeing with the Commissioner, the Tax Court classified the 1944 payment as an ordinary business loss. Disagreeing with the Tax Court, the Court of Appeals reversed, treating the loss as “capital.” This latter holding conflicts with the Third Circuit’s holding in *Commissioner v. Switlik*, 184 F.2d 299. Because of this conflict, we granted certiorari.

I.R.C. § 23(g) [(1222)] treats losses from sales or exchanges of capital assets as “capital losses,” and I.R.C. § 115(c) [(331)] requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of “capital losses” contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that, had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year.

It is contended, however, that this payment, which would have been a capital transaction in 1940, was transformed into an ordinary business transaction in 1944 because of the well established principle that each taxable year is a separate unit for tax accounting purposes. *United States v. Lewis*, 340 U.S. 590; *North American Oil Consolidated v. Burnet*, 286 U.S. 417. But this principle is not breached by considering all the 1937-1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

....

Affirmed.

MR. JUSTICE DOUGLAS, dissenting. . . . There were no capital transactions in the year in which the losses were suffered. Those transactions occurred and were accounted for in earlier years in accord with the established principle that each year is a separate unit for tax accounting purposes. *See United States v. Lewis*, 340 U.S. 590 (1951). I have not felt . . . that the law made that an inexorable principle. But if it is the law, we should require observance of it – not merely by taxpayers but by the government as well. We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year’s losses as if they diminished last year’s gains

MR. JUSTICE JACKSON, whom MR. JUSTICE FRANKFURTER joins, dissenting. [omitted].

*Notes and Questions:*

1. Upon liquidation of a corporation, the corporation distributes its assets to its shareholders in exchange for their stock. Shareholders treat this as a sale or exchange of a capital asset. § 331(a). Recall from our discussion of *Gilliam* that payment of a tort judgment would have been an ordinary and necessary business expense, deductible under § 162(a).
2. The opinion of Justice Jackson (omitted) spells out just what is at stake. First, recognition of capital losses would save taxpayers less than recognition of the same losses as ordinary. Second, capital losses are – except to the narrow extent permitted by § 1211 – only offset by capital gains. If a taxpayer does not or cannot recognize capital gains, the long-term capital losses simply become a useless asset to the taxpayer. Also, the tax liability of the liquidated corporation should have been less under the majority’s view because of the deductions, but the statute of limitations had no doubt run.
3. Two policies came into conflict in *Arrowsmith*. The Tax Court and Justice Jackson bought into the annual accounting principle. The other principle that permeates the Code is that a taxpayer may not change the character of income or loss – whether capital or ordinary. This is a *very* strong policy that only rarely yields to another policy. Often, taxpayers’ machinations are much more deliberate than they were in this case.

### *A. Matching Tax-Exempt Income and Its Costs*

Ours is an income tax system that taxes net income. But what if certain income is not subject to tax because it falls within an exception to the first of our three guiding principles? Should the expense of producing such income be deductible? Logically, such expenses should not be deductible – and this is indeed a rule that the Code implements in at least two places.

Section 265 denies deductions for the costs of realizing tax exempt income. Section 264(a)(1) provides that a life insurance contract beneficiary's premium payment is not deductible. Of course, the life insurance payments made by reason of death are excluded from the beneficiary's gross income. § 101(a)(1). This same principle generally applies to interest incurred to pay life insurance contract premiums. § 264(a)(4).

### *B. More Matching: Investment Interest*

Section 163(d)(1) limits the interest deduction to interest on indebtedness properly allocable to property held for investment to the extent of taxpayer's "net investment income ... for the taxable year." Taxpayer may elect to treat his "qualified dividend income," see § 1(h)(11)(B), as "investment income," thereby increasing the amount of investment interest he may deduct. § 163(d)(4). Taxpayer may carry forward any investment interest disallowed to the succeeding taxable year. § 163(d)(2). Until 2026, § 67(g) suspends even this deduction.

### *C. Passive Activities Income and Losses*

A passive activity is a trade or business in which the taxpayer does not "materially participate." § 469(c)(1). An individual taxpayer may not deduct aggregate passive activity losses in excess of his passive activity income, nor claim credits in excess of the tax attributable to the aggregate of his net income from passive activities. §§ 469(a)(1), 469(d). We defer discussion of the details of § 469 to a course in partnership tax. The important point here is that there is absolutely no mismatching of losses derived from passive activities with any other type of income – whether ordinary income or portfolio (investment) income – until taxpayer has sold all his interests in passive activities.

#### D. Excess Business Losses of Noncorporate Taxpayers: § 461(l)

For tax years 2018 through 2025, net business loss is limited to \$250,000 per year, indexed for inflation. The limit for a joint return is twice that. Specifically, non-corporate taxpayers may not deduct “excess business loss.” § 461(l)(1)(B). An

The CARES Act § 2304 modified § 461(l) to provide that its effective date is 2021 rather than 2018. ARPA extended § 461(l)’s effectiveness by one year – to the end of 2026. The Inflation Reduction Act of 2022 extended § 461(l)’s effectiveness by two years – to the end of 2028. P.L. 117-169, § 13903, 136 Stat. 1818 at 2014.

“excess business loss” is the aggregate of a taxpayer’s *trade or business losses* minus (the taxpayer’s aggregate gross income *attributable to such trades or business* plus \$250,000). § 461(l)(3)(A). Thus trade or business losses above the threshold cannot offset non-trade or business income or gains. The \$250,000 amount is twice that amount in the case of a joint return, § 461(l)((3)(A)(ii). These figures are adjusted for inflation. § 461(l)(3)(B). A disallowed “excess business loss” is

treated as a “net operating loss” for NOL carryover purposes. § 461(l)(2).<sup>236</sup> Thus, “excess business losses” are disallowed only for the tax year in which they were incurred. Section 461(l) is taken into account *after* application of § 469. § 461(l)(6).

#### E. General Comment about Matching Principles

Perhaps it does not seem very significant that implementation of matching principles results in disallowance of a deduction, loss, or credit because usually there is a carryover. Your attitude may be “pick it up next year.” Reality may be quite different. When losses are “locked inside” an activity or type of income, it probably is the case that circumstances are not going to change radically for a taxpayer from one year to the next. The investor who loses a deduction because of insufficient income of a particular type is not likely suddenly to receive a lot of that type of income during the next year. The effect of implementing matching principles *may be* that the excess expense or loss is simply disallowed – forever. However, forewarned is forearmed. Taxpayers may choose their activities or transactions so that they will have gains against which losses can be matched.

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<sup>236</sup> The rule of § 461(l) is to be applied at the partner or subchapter S shareholder level. § 461(l)(4). Also, § 461(l) is to be applied after § 469 (disallowance of passive activity losses and credits).

## Wrap-Up Questions for Chapter 10

1. What policy (policies) is served by the exceptions to the definition of “capital asset” in §§ 1221(a)(1, 2, 3, 4, 6, 7, 8)?
2. In *Fribourg Navigation Co. v. Commissioner*, 383 U.S. 272 (1966), the Supreme Court held that a taxpayer was entitled to depreciation deductions up to the date it sold an asset. In the days before § 1245 (but after § 1231), why would this have been important?
3. Why should capital loss carryovers expire – and simply disappear – on the death of the taxpayer?
4. In what ways does § 1031 help facilitate growth within our economy?
5. Why should a taxpayer not be permitted to deduct the cost of obtaining tax-exempt income?

## What have you learned?

Can you explain or define –

- What is a capital asset? What types of assets are not capital assets?
- Describe how § 1(h) works?
- Describe the netting of LT/ST capital gains/losses that § 1221 prescribes?
- To what extent does § 1211(b) allow an individual taxpayer to offset capital gains (LT or ST) with capital losses (LT or ST)?
- What is depreciation recapture? Why is it needed? What is its effect?
- What is § 1231 property? What tax treatment does the Code provide for the sale or exchange of § 1231 property? In what way(s) does § 1231 implement a “heads-I-win-tails-you-lose” scheme with the taxpayer?
- What is a like-kind exchange? What is the tax treatment of a like-kind exchange?

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