BASIC INCOME TAX

PRELIMINARY SYLLABUS

Professor Schaffer Summer, 2010

This is a preliminary syllabus for the Basic Income Tax course for summer quarter, 2010. I still have to insert references to a few Code sections which Congress revised this Spring. I'm sending it to you so that you can get an idea of what the course is like and what books you'll need.

Books for Basic Income Tax:

The casebook is Andrews, Basic Federal Income Taxation, 6th edition (Aspen). For the Internal Revenue Code and regulations we use the Code and Regulations book published by Aspen. You don't have to buy a new Code book: any recent version, from any publisher, of selected sections of the Code and Regulations will do, because there's been little new statute law in the last two years. If you mean to take Corporate Tax, check that the Code book you buy contains Subchapter C, Code sections 301-382. The CCH version definitely does.

We also have a textbook: Chirelstein's Federal Income Taxation: A Law Student's Guide to the Leading Cases and Concepts, 10th ed. (Foundation Press). Don't neglect it: as our casebook says, this is probably the most popular and useful student aid.

The Blackboard Pilot Program

We will be using a new version of the Blackboard website as a pilot for the rest of the University, who will get it in January. The purpose is to find parts of the program that don't work and also parts that we don't like. If you find either, please send me an e-mail and I will send it on to the folks who are building and testing the program. To go to the pilot website, type "blackboard9.neu.edu" (without the quotation marks) into your browser. For your other courses, continue to use the old Blackboard 7 system.

You'll find the syllabus on the Blackboard9 website and also assigned course materials. Look for buttons saying "syllabus" and "course materials". We will also have hard copies available from Elsie Chan in Cargill 42.

The assignment for the first day of class is Part II, A, 1&2 of the syllabus.

I. A Guide for the Perplexed

Assignment: the introduction to the case book (Chapter One), especially parts B through E. We won't discuss it in class but it has a lot of information in it and an introduction to commonly used words and phrases peculiar to tax law (Part E). It's a good place to go back to during the course when you feel that you don't understand how all of the little pieces fit together. Chirelstein has a similar introduction to his book, for the same purpose, written with his usual verve.

II. Noncash Receipts in General

A. INCOME IN KIND

1. Assignment:

a. Code § 61(a), Treasury Regulations §§ 1.61(a), 1.61-2(d)(1) & (d)(2).

b. Old Colony Trust Co. v. Comm., p.35, discussed at Chirelstein, ¶ 3.01(b). We will discuss in class the questions on pp. 37-39 of the casebook.

c. Benaglia, p. 39, discussed at Chirelstein, ¶ 1.02.

d. Turner, p. 43, including questions after the case.

e. Memorandum, "Marginal Rates" available in the course materials. The casebook also has an explanation of marginal rates at p. 28-29 as does Chirelstein at pp. 3-8. Take your pick.

2. Questions about Old Colony

a. Old Colony Trust Co. is the law, but where did it come from? Is it the common law? Did the court refer to words in a statute? Which words in which statute? Ask yourself: why is this the right interpretation of the statute?

b. A side issue is found in question 1, pp. 37-38. Present Code § 61(a) is interpreted as having the same meaning as the statute in Old Colony, although its words are different. Why? Here we encounter an important feature of interpretation federal statute law. In interpreting a statute, courts give great weight to the legislative history, especially the reports of the congressional committees which wrote the statute and recommended its adoption to the full Congress.

c. Read the two directors' resolutions adopted by the Company, one in 1916 and one in 1918. Part of your job as a lawyer is to explain to clients what contracts mean. These resolutions are like clauses in employment contracts which fix an employee's compensation. How would you explain to the Company's directors (or Mr. Wood) what their 1918 resolution did?

(1). In trying to understand what the 1918 resolution did and what the alternatives were, you need to understand the concepts of "effective rates" and "marginal rates." These are central concepts you must master in order to go further in this course. Now is the time for you to read the memorandum on the subject in our course materials.

(2). Please be prepared to answer the following questions: Which kind of rate did the 1918 resolution in <u>Old Colony</u> use to compute the federal income tax on Mr. Wood's salary (which the employer had to pay?) (This is really the same as question 4, p. 39 of the casebook.) Suppose for the sake of arithmetic simplicity that the tax rates are the ones set out in the distributed memo on "Marginal Rates." Mr. Wood's salary is $10,000 and his income from unrelated sources is also $10,000. The tax on his total income of $20,000 is $3,000. What part of that $3,000 is the tax on his salary of $10,000? What are the possible answers to this question? Which answer did the 1918 resolution choose? Did the 1918 resolution use a marginal or an effective rate?

(3) Before reading <u>Benaglia</u> (or at least before thinking it out):

It's easier to follow <u>Benaglia</u> if you know how it differs from the general rule (as the judges and counsel undoubtedly did.) See Treas. Reg. §§. 1.61-1(a), 1.61-2(d)(1) and 2(i). Look also at Code § 83(a) of the Code and figure out the answer to this: A client pays her lawyer for legal services by transferring to the lawyer property worth $1,000. There are no restrictions on transferability or possibilities of forfeiture. How is the lawyer taxed under § 83(a)? When? By the way, if the receipt of property were not taxed to the lawyer when the receipt took place, does that mean it would never be taxed? See Chirelstein § 1.01.

(4). Questions about <u>Benaglia</u>

a. None of the opinions in <u>Benaglia</u> mention § 119 of the Code. Why might that be? The citation to <u>Benaglia</u> says "acquiesced in" and then cites "C.B.," which is not a kind of radio, but the Cumulative Bulletin, a publication of the Internal Revenue Service. What might "acquiesced in" mean in this citation?

b. We will discuss in class the questions on p. 43 and questions 1-5 on pp. 45-46.

5. Question about Turner.

In valuing the tickets that Turner won, the court mentions that they were not transferable, that there would be selling costs, etc. Then it also says that Turner was not the sort of person who would have bought the tickets for their list price anyway. Are these two different approaches to valuing the tickets?

III. COMPENSATION FOR LOSSES AND RETURN OF CAPITAL

A. Assignment:

Edward H. Clark, p. 83

Raytheon Production Corp., p. 86

Glenshaw Glass Co., p. 90

Code §§ 61(a)(3), 1001(a) and (b), 1011 and 1012

Treas. Reg. § 1.61-6

Chirelstein, pp.9-12 and ¶ 2.04(b).

B For Class Discussion:

We will spend most of our time in class on the notes in the casebook, at pp. 93-95. In working out problem 1, it may help to think about an employee who is paid at the end of each month. Her salary is $1,000 per month. One payday, her employer fails to pay her. She retains counsel, sues, and eventually recovers $1,000 in damages. Should she be taxed on the $1,000 (less, of course, her expenses of litigation)? If you were a lawyer for the Internal Revenue Service, how would you explain to a court why the $1,000 is taxable?

C. Some guidance and some more questions

Raytheon holds, among other things, that the damages for an "involuntary conversion" of property are to be treated as if they were sales proceeds. We will discuss in class just what Code section says that the taxpayer in the example about Blackacre on p. 89 of the casebook would have had income if it had sold Blackacre. How much would the income be? See §§ 61(a)(3), 1001(a)&(b), 1011, & 1012.

D Partial destruction of property

In Raytheon, on pp. 84, the court discusses the Strother and Farmer & Merchants Bank cases. Are these cases analytically the same as problems 6(a)&(b) on p. 89? See if you can explain how they are similar. The discussion in Raytheon of Strother and Farmer & Merchants Bank gives a hint of how problems 6(a)&(b) would be resolved by a court.

IV. PERSONAL INJURIES

Assignment:

Code § 104 (a)(2).

Problem, Casebook, p 96

Casebook, pp. 96-100, 118 (punitive damages and question following it.)

Chirelstein ¶ 2.04(a)

V Health Insurance.

Assignment:

Code, §§ 106, 125, 223 Treas. Reg. § 1.106-1.

Private Letter Ruling No. 9603011 (in the course materials).

Casebook pp. 119-126

1. In Benaglia, Congress had not spoken, at least explicitly. Now consider an employee whose employer pays for part or all of her health insurance. Absent specific statute law, would that be income to her? How do you know? Now look at § 106(a) of the Code. (As to life insurance, see § 79(a) and as to child care, § 129.) There is also a provision allowing employees to escape tax on amounts which their employers contribute to their pension funds until those amounts are distributed to the employees, a very valuable privilege, as we will see (§ 402(a)).

2. Some people have no health insurance where they work. They have to buy it out of their own pocket, and usually get no deduction for that expense. Does that make § 106 seem less fair?

Suppose Jones makes much more money than Smith does. His marginal rate is 35 percent. Smith has so little income that he pays no income tax. How much tax does each save by the exclusion from the definition of gross income of $1,000 of health insurance premium paid by their employers for each of them? (This question is of great general importance: the answer is the same for all of the deductions and exclusions from income we study in this course.)

In this problem, we looked first at the taxation of people with the same incomes, and then compared the taxation of people with very different incomes. The first is called the test of "horizontal equity" and the second the test of "vertical equity".

3. The United States is unique in the degree to which it uses tax law to make health policy. The tax-free provision of health insurance by employers has become deeply entangled with the problem of the high cost of health care. One point of view about health insurance is that insured consumers who make decisions about how much medical care to buy are unconstrained by the price of care, and so they buy more than they would if they had to pay. This demand drives up the price of care. This is said to be especially true because workers take more of their pay in the form of tax-free insurance than they would if the insurance coverage were taxed. See Casebook Part 6, p. 123. An easier view to understand is that of employers. They just don't want to pay the high cost of their insuring their workers.

One answer to the problem, generally favored by the business world and conservatives, is to redesign employer-provided health care so that workers must take the cost of care into consideration. See Code § 223, enacted in 2002, "Health Savings Accounts" and Casebook Part 7, p. 124. Under this arrangement, the employer provides insurance with a high deductible. The cost to the employer is lower than with standard health insurance because the deductible can be quite high ($10,000 is the maximum deductible for family coverage). The insured employee must decide if ordinary medical expenses like a visit to the doctor are worth paying for out of her own pocket, because the deductible is so high.

The employee can put in her own money and get a deduction for it. Code §223(a). When she uses the money she has put in to pay medical bills it is called a "distribution" and is tax-free to her. See Code §223(f)(1).

The employer may contribute to the employee's account. One popular arrangement is for the employer to give the employee an election: we'll contribute an amount equal to the deductible (or less than the deductible if you like) and reduce your cash salary by that amount. Notice that the employee is still bearing the cost of the health insurance, but by virtue of the reduction of her salary that cost has reduced her taxable income. The employer's contribution to the account is excluded from the employee's gross income under §106(d).

In 2010, as part of the giant health care reform bill, Congress inserted a prospective amendment to §223(d)(2)(A), the definition of "qualified medical expenses." Starting in 2011, "Such term shall include an amount paid for a medicine or drug only if such medicine or drug is a prescribed drug (determined without regard to whether such drug is available without a prescription.) Suppose an insured person, who has put $500 into her health savings account, suffers from an occasional mild headache for which she takes aspirin which costs her $1.00 per bottle. Can she claim reimbursement from the health savings account (which would be a tax-free "distribution".) Is there a way to turn the price of the aspirin into a "qualified medical expense"?

4. (a) Sarah and Anne live together. Sarah works for the Town of Pleasantville, which pays for her health insurance. The Town adopts the policy of providing health insurance for "domestic partners" of its employees, and Anne qualifies as a "domestic partner." According to Private Letter Ruling No. 9603011 in the course materials, does

§106(a) protect both Sarah and Anne from taxation? (Put aside §§104 and 105 until later). What is the legal reasoning used in the letter?

(b) The Town of Pleasantville is in the State of Knowles. Suppose the state legislature adopts a law that permits Sarah and Anne to marry. If they take advantage of this law, Sarah and Anne will be considered married for all purposes of state law. Will they be "spouses" under Code §152?

VI. The Medical Deduction

Assignment:
Code § 213
Ochs, p. 127
Notes, pp. 133-35
Chirelstein ¶ 7.02(a)

Policy Analysis, the medical deduction as a "tax expenditure", pp. 133-34. (optional). You can pursue this interesting subject further at Chap 8B of the casebook.

IV. ANNUAL ACCOUNTING AND TAX BENEFIT RULES

A. Assignment:

Burnet v. Sanford & Brooks Co., p. 140.

Chirelstein ¶ 10.01

We will discuss Notes 1-5, pp. 144-45 in class.

Treas. Reg. §§ 1.451(a) and 1.446(c)(i) and (ii)

B Problem on accounting methods for class discussion:

Note 4, p. 144, discusses a subject of great practical importance. After reading that note and Treas. Reg. §§ 1.451-1(a) and 1.446(c)(i)&(ii), work out the following problem. A firm of architects designs a building and supervises its construction in the years 2000 and 2001. The firm pays salaries to its employees who work on the project, buys supplies, pays rent, etc. The total expenses allocable to the project are $50,000, $25,000 paid in 2000 and $25,000 paid in 2001. The firm finishes half the job in 2000 and this entitles it to be paid $30,000 under its contract with the client. It finishes the rest of the job in 2001 and is entitles to be paid another $30,000 then. The client pays in 2002.

1. Under the cash method of accounting, in what year is the fee includible in the firm's income?
2. How about under the accrual method?
3. The firm's expenses are probably deductible in 2000 and 2001 under either method (a good review of the cash and accrual methods is to figure out why this is so). Which method of reporting the income would give a

more accurate presentation of the firm's financial condition to a potential creditor or to a person interested in becoming a partner? Do you see why accountants sneer at the cash method and why its use may amount to fraud in the law of torts and in federal securities law?

4. Professional firms love the cash method of accounting because they can deduct the expenses of generating income in an earlier year than they include the income itself.

C. The net operating loss deduction-

Assignment: Code §§ 172 and 186.

The net operating loss deduction is Congress' way of undoing the unfairness of the result in Sanford & Brooks.

1. How would Sanford & Brooks come out under Code §§ 172(a)&(b)(1)?
2. One calculates one's net operating loss by going to Code sacs. 172(c)&(d). Try applying them to Sanford & Brooks.
3. Code § 172 is a statute of general application. Relief for cases like Sanford & Brooks is now available under § 186, IRC. If Sanford & Brooks occurred today, which section, 172 or 186, would apply? What was the point of having two relief statutes? Keep in mind that for many years net operating losses could be carried forward for only five years.

D. The Tax Benefit Rules

Assignment:

Dobson, p. 145; Chirelstein, ¶ 10.03

Code §§ 111, 166 and 186.

Treas. Reg. § 1.166-1(e)

Notes, pp. 153-154. We will discuss questions 2, 3 and 4 in class.

1. In Dobson the Tax Court used a tax benefit rule to help out a taxpayer whose deduction would have been wasted otherwise. Today section 111 would do the same. Why didn't the taxpayer in Dobson just carry the wasted deductions forward as net operating losses under § 172, and avoid all that litigation?

2. Suppose the taxpayer in Dobson had his loss from the sale of stock in 1999, couldn't use the deduction in 1999 for lack of income, and recovered damages in 2000. In 2000, does he exclude the damages under § 111, or carry forward his net operating loss from 1999? See Code § 111(c).

3. Jones Corp. sold goods for $10,000 to a customer, but the customer didn't pay. Jones Corp. deducted $10,000 for a "bad debt" (Code § 166) in 1999, but the deduction was of no practical use because in 1999 the corporation had deductions in excess of gross income even without the bad debt. Too bad the bad debt wasn't deductible in 2000 when the corporation's taxable income was very high. The bad debt was never paid. Does the Code provide any relief for the waste of the bad debt deduction? Does the rule in the Dobson case (now Code § 111) help? How about § 172?

> a) A loose end: Should Jones Corp. be allowed to deduct $10,000 or a smaller amount? Why? Suppose It had paid $8,000 for the goods for which the customer never paid?
>
> b) The same loose end in disguise. What if your client, an architect, designs a house for a client, and sends a bill for $10,000, the agreed amount. The client never pays. Will your client be allowed a deduction for $10,000 under § 166? See Treas. Reg. §1.166-1(e). If your answer is "no", you can be sure that your client will be pretty mad. How would you explain to her why she gets no deduction.

E. The tax benefit rule as a rule of inclusion.

Casebook, p. 155.

IV. GIFTS - INCOME TAXATION OF THE RECIPIENT

A. Income Interests

1. Assignment:

Code, § 102

Irwin v. Gavit, p. 157

Chirelstein, ¶ 4.02.

Notes 1-5, pp. 159-60 of the casebook.

We will discuss Notes 1 and 5 in class.

2. In answering question 5, think about a person who is receiving an annuity payment. That person gets to exclude a part of each payment as a return of basis. Why does the Code say that a person who has inherited an income interest in property may not do the same? (As for the amount of the basis of property received as a gift or bequest, see Code §§ 1014 and 1015, and stay tuned for Part B of this Chapter of the casebook.)

3. Chirelstein's discussion of Gavit relies heavily on the idea that a payment to be made in the future has a calculable present value. So will our class discussion. This idea is explained in the Appendix to the Chirelstein book, and also in the essay "Present Value of a Future Payment", in your course materials.

B. Gifts and Bequests of Appreciated Property

1. Gifts during life

Assignment: Code §§. 1001(b), 1015

Andrews, p. 151-52

Taft v. Bowers, p. 165

Chirelstein, ¶ 4.01(a)

Ignore the "Questions" on p. 168. "Problems" on p. 168 of the casebook will be discussed in class.

If you could read and understand the Code, §§ 102, 1001(b), 1014, 1015 you wouldn't have to read anything else. Mere mortals will need the cases, text, etc., because they illustrate and explain the Code and regulations. For the problems on p. 168, look at the first sentence of Code § 1015(a)- all of it.

2. Basis of property acquired from a decedent,

Code §1014

Casebook, pp. 168-171.

Chirelstein ¶ 4.01(b)

Problem 1 p. 171 will be discussed in class.

3. Optional: the federal transfer taxes, p. 172.

4. Does the existence of the federal estate tax, measured by the net value of an estate not by appreciation of its assets, justify §1014's stepup in the basis of assets of a decedent? Congress seems to think so. For this

year, 2010, Congress in 2002 repealed the estate tax, but for budget reasons repealed the rescission for following years. As part of that legislation Congress provided for a carry-over basis in new §1223. At the moment, it looks as if the repeal of the estate tax and carryover basis of decedent's property will be allowed to expire at the end of this year.

V. CAPITAL APPRECIATION, THE REALIZATION REQUIREMENT AND THE VALUE OF DEFERRAL

Assignment: Cottage Savings Assn. p. 247.

A. The problem

Suppose Mr. Smith buys property for $100, and it rises in value to $500. Of course if he sold it for $500, he would have gain of $400, computed under Code § 1001(a).

Now suppose that Mr. Smith does not sell the property. Under our present system, he is not taxed on the increase in value. (For example, § 1001(a) speaks of an "amount realized" and a "sale or other disposition".) Most economists, on the other hand, think of unrealized appreciation as income, since it increases the net worth of the owner.

Much of our tax law is shaped by this "requirement of a realization", as we call it. For example, we have studied how damages for injury to property (the Raytheon case) are taxed as if the property had been sold for the amount received as damages. But there would be no taxation if the property's increase in value above basis had been taxed when it occurred, without a realization. (Of course, the basis of the house would have to be increased by the appreciation taxed, so that it would not be taxed twice.) Indeed, even the simple case of a sale of property for cash would be different: the property's appreciation would already have been taxed.

The Supreme Court held, more than seventy years ago, that Congress lacked power to tax increase in value of property while it occurred, before it was realized, on the ground that unrealized appreciation is not "income" within the meaning of the Sixteenth Amendment of the Constitution. (That is the amendment that authorized income taxation.) This is the only time the Court has held a provision of the income tax invalid because unconstitutional.

What does the Court say in Cottage Farm Savings is the reason for the requirement of a realization. Does it sound like a reason that rises to a constitutional level?

We will now study some of the effects of the requirement of a realization. The first is deferral of tax.

B. Deferral of tax and how it serves to reduce tax.

1. Assignment: Casebook, pp. 235-242

2. We have a memo in the course materials that may help at this point. "The Present Value of a Future Payment" is about the concept of the value of deferring taxes, also discussed in the casebook. You may confine yourself to part I and II of the memo for the moment.

The whole of the Chirelstein book is rightly oriented around this subject: a good place to start is ¶ 1.01.

VI. Nonrecognition Exchanges

A. Like Kind Exchanges

Assignment:

Code § 1031 and regulations thereto

Alderson, p. 258

Chirelstein ¶ 15.01. Omit his discussion of the Jordan Marsh case.

We will discuss questions 1-6 at pp. 263-64 of the Casebook.

B. Involuntary Conversions

Assignment:

Code § 1033

Casebook, p. 269, part (a).

C. Sale of Principle Residence

Assignment:

Casebook, pp. 269-71, part (b).

Questions, p.271, to be discussed in class.

Chirelstein ¶ 15.02

For many years section 1034 allowed homeowners to defer the gain on the sale of their homes if they reinvested the proceeds in another home. In 1997, this was changed to an outright exemption. Look at Code section 121: does anyone now pay tax on gain on the sale of their home?

Despite the repeal of §1034, tax lawyers will need to understand it for many years. Why?

D. Sale to a spouse

Assignment:

Code § 1041

Casebook , p. 1002

VII. Preferential Treatment of Capital Gain

A. Assignment

Code §§ 1(h), 1221 and 1222.

Casebook, pp. 281-84.

Chirelstein, ¶¶ 16.01-.02. Paragraph 16.03 is optional and will not be discussed in class.

B. Current law on capital gain

During most of the years we have had an income tax long-term capital gain was taxed a much lower rate than ordinary income. In 1986, Congress abandoned this scheme, providing the same rate for both. Starting in 1991, preferential rates for capital gain have been gradually restored in a highly complicated way. The new tax increases the preference. It's all at §1(h) of the Code: can you decipher it?

There is no corresponding provision in Code § 11, so corporations have no preferential rate for capital gain.

C. More explanation: Where to find the definition of capital gain.

The definitions of capital gain and loss, long-term and short-term, found in sec 1222, all make the "sale or exchange" of a "capital asset" a necessary condition. The definition of "capital asset" is in § 1221.

There is a memorandum, "Illustrative Examples of Capital and Ordinary Assets", in your course materials, and Chirelstein's sections 16 and 17 cover much of the same ground, if you would like to pursue the question.

D. Questions and issues for class discussion:

1. The exclusion for inventory:

A car dealer sells a Toyota to a customer. Is the dealer's gain capital gain? See § 1221(1). Why do you suppose those who wrote sec 1221 inserted subsection (1)?

2. Reasons for preferential treatment of capital gain

We will discuss this controversial issue in class. The possible justifications for preferential treatment set out on p.283-84 of the casebook are critiqued for some reason on pp. 1088-90. The critique is a good one, even if the casebook's organization is odd.

E. Inflation.

Assignment:

Casebook pp. 284-85

F. Should we tax the part of income that is saved?

Assignment:

Casebook, pp. 286

Chirelstein, pp. 368-69 and Note: *Income Tax, Consumption Tax, Flat Tax*, p. 433.

VIII. Return of Capital and Deferral of Tax

A. Timing Alternatives

Assignment: Casebook pp. 291-294
Treas. Reg. § 1.61-6(a)
Fairfield Plaza, Inc, p. 294
Rev. Rul. 70-510, p. 297.
Chirelstein ¶ 2.01.
We will discuss in class Questions 1 and 2, p. 299.

When a person owns property, tangible or intangible, it's easy to say that a sale brings gain measured by the difference between amount realized and basis (Code § 1001(a)). But suppose our taxpayer is to receive several payments? What part of the whole basis shall used to offset each payment? That's the question being discussed here. It turns out that this kind of transaction is very common in our world. It includes installment sales of property, sales of a part of a piece of property, payments of dividends on stock, repayments of interest and principal on loans, royalties on intellectual property, etc.

B. Introduction to Capital Expenditures, Depreciation and Loss Deductions

Assignment: Casebook pp. 299-304

This is an extremely abstract introduction to these subjects. Don't worry, we'll study them in a more concrete form later in the course. This note is hard to understand unless you know what capital expenditures, depreciation, etc. are, so you may find it more useful for review purposes. Nonetheless, give it a try.

C. Annuities-An illustrative problem of the timing of return of capital.

Assignment:

Code §§. 72(a), (b), &(c)

Treas. Regs. §§ 1.72-1 through1.72-6, 1.72-9

Casebook, pp. 305-08

Chirelstein, ¶ 2.02

"How to Make an Annuity" (in the course materials).

We will do problems 3 and 8, casebook, p. 306 and 308, in class. . We will ask how each of these annuities would be taxed under the pre-1987 law and under present law. When Andrews refers you to Treas. Reg. § 1.72-9, you should take the hint. What is the difference between table I and Table V (newly added) in that regulation? We will use Table V.

Note 5, p. 307, brings us into the world of employee pensions, in practice the most important kind of annuity. Code § 72(f)(2) is an optional brain-twister; do it if you like that sort of thing.

Chirelstein argues that the "correct" method of taxing annuities would be to treat early payments as mainly interest, and the later ones as mainly returns of capital (pp. 36-37). This is not universally accepted. A good reply is in Kahn, Accelerated Depreciation - Tax Expenditure or Proper Allowance for Measuring Net Income? 78 Mich. L. Rev. 1, 19-26 (1979), which also contains a fine primer on taxation of annuities, p. 19-26.

IX. The cash method of accounting.

Assignment:
Treas. Regs. §§ 1.446-1(c)(1)(i), 1.451-1(a) and 1.451-2(a) and (b).
Casebook pp.311-324, including Rev. Rul. 60-31, p. 311.
Chirelstein ¶ 11.01.

X. The accrual method of accounting and exceptions to it.

Assignment:
Casebook pp.328-350, including American Automobile Ass'n, p. 329, Schlude, p. 336 and Rev. Proc. 2004-34, p. 340.

XI. Borrowed Money and Analogous Problems

A. Cancellation of indebtedness Income

Assignment:

Code §§ 61(a)(12) & 108; Treas. Reg. 1.61-12

Casebook - introduction to Chap. 7, p. 415.

Kirby Lumber Co., p. 415.

Chirelstein, ¶ 3.02

Bankruptcy Tax Act of 1980, S. Rep. No. 96-1035 (1980), p. 417.

Zarin, pp. 421 and 428.

Discussion:

The Kirby Lumber Co. case has about it a whiff of prosperity. Here is a company that can pay off a huge debt in cash and make a profit doing it. You might think that this is a headache for the rich only, rather like the high cost of repairing a Rolls-Royce. But one reason for creditors to forgive an indebtedness is that the debtor is broke. If a debtor owes a total of $35,000 and has assets of only $4,500, her creditors might just as well accept, say, $3,500 in discharge of her debts. They can't get much more from further litigation, litigation is expensive and each creditor knows that if it doesn't settle now, some other creditor may get all the assets or the debtor may spend them. And if the debtor goes through bankruptcy proceedings, the creditors are given no choice: the bankruptcy court grants a "discharge" of the debts whether the creditors consent or not. So "income from discharge of indebtedness" is a law for the poor as well as the rich, not to mention middle-class people who have lost their jobs or are hooked on credit cards.

Here are two problems we will discuss in class:

(a) Lets start with nuts and bolts. If Betty Smith who owes $35,000, has $4,500 in assets and settles her debts for $3,500, is she really supposed to pay tax on $31,500 ($35,000 debt less $3,500 payment) out of her remaining $1,000? See Code § 108 (a)(1)(B), (a)(3), and (d)(3). If not, how much income does she have from this transaction?

A crucial question (and a standard one in tax law): if § 108 gives Betty relief, is it forgiveness or deferral? See Code § 108(b)(1) and (b)(2).

(b) Just who has "discharge of indebtedness" income within the meaning of Code § 61(a)(12)? The East Coast Brick Co. borrows $1,000,000 and invests it in a new factory in California. The California venture is a bust, and the company loses $800,000 on it. Of the $800,000 loss, $400,000 is expenses in excess of operating revenue from the California factory, and $400,000 more is from selling for only $600,000 the factory bought for $1,000,000. The Brick Co. is now in bad financial shape. The creditor who lent it $1,000,000 accepts $200,000 in full payment, and is glad to get it. Does the Company really have income under Kirby Lumber and Code § 61(a)(12)? It has just lost its corporate button-down collar shirt in this transaction: how can anyone say it had income? That is what the Bowers v. Kerbaugh Empire case is about, discussed in Kirby Lumber.

(c) Joe is a sculptor. He owes his doctor $1,000. Joe is low on cash, so the doctor agrees to accept one of Joe's sculptures in payment of the debt? Does Joe have cancellation of indebtedness income? Assume the sculpture is worth either $1,000 or $300.

B. Income Held under a Claim of Right

Assignment

Code: § 1341.

North American Oil Consolidated v. Burnet, p. 431

United States v. Lewis, p. 433

Chirelstein, ¶ 10.02.

We will discuss Notes 1-5, omitting problem 3, pp. 435-36, including Code § 1341 as it applies to these cases.

XII. Deductions and Credits:

A. Deductions and the Computation of Tax,

Assignment:

Code §§. 61, 62, 63, 151.

Casebook, pp. 539-551.

Chirelstein, Introduction, and ¶¶ 7.05-7.07(a).

After applying §1 to taxable income we have an amount of tax, but tax credits reduce it. The most important is probably the child tax credit in Code §24.

B. Home Mortgage Deduction

This is by far the most important provision on interest since it affects so many people.

Assignment:

Code §§. 163 (a) and (h).

Casebook, pp. 576-588 (The article by White is optional. It seems to be considered a classic by people who can understand it.)

Chirelstein, ¶ 7.04

For Class discussion: question on nuts and bolts of section 163(h). Look at the definitions of “qualified residence interest” and “acquisition indebtedness” in Code §§ 163(h)(3)(A) and (B).

1. Suppose I buy a house in which I will live. The price is $300,000, and I have $100,000 which I can use for a down payment. I pay the entire $100,000 of my cash for the house, borrowing $200,000 for the purchase, and giving a mortgage on the house for the $200,000. I buy a big boat, too, borrowing the full price of $50,000. Can I deduct the interest I pay on the loan that I use to buy the boat ?
2. Same deal, but instead of using my cash of $100,000 and borrowing $200,000, I pay $50,000 in cash as a down payment and borrow $250,000, giving a mortgage on the house to secure that loan. With the $50,000 in cash that is left I buy the boat. Can I deduct interest payments on the entire $250,000 borrowed?
3. Now assume I have owned the house for 10 years, and never bought a boat. The

mortgage principle is down to $100,000 and the house is worth $350,000. I borrow $50,000 against the house, giving my bank a second mortgage, and use the just-borrowed $50,000 to buy a boat. Can I deduct the interest on the second mortgage? See Code § 163(h)(3)(A)(ii) and 163(h)(3)(C).

4. When interest on a certain kind of debt is treated favorably or unfavorably, it becomes necessary to decide to what the debt should be allocated. For example, the three questions above raise the issue of whether a loan is for the purpose of acquiring a house or a boat. In §163(h), how does one tell?

C. Homeowners

Assignment:

Casebook, pp. 585-594

Chirelstein, ¶¶ 1.03, 7.04.

1. Question for discussion

As you can see, middle class people have their tax breaks, too. Can you think of a reason (or reasons) why home ownership should be so favored in our tax law? (And keep in mind that new Code section 121 means that some or all of the gain on sale of a house usually escapes tax, too.)

2. More questions for discussion

Problems 1 and 2, p. 581, and Question 2 p. 594.

D. Interest on student loans.

Under Code § 163(h), may interest paid on student loans be deducted? Why or why not? As part of a whole program of using tax credits and deductions to subsidize higher education, new § 221, allows the deduction to some payors of a limited amount of student loan interest.

XIII. Personal, Family and Living Expenses

A.
.In General

Code section 262 and its regulations.

B. Childcare as an example of a mixed business and personal expense.

1. Assignment

Code §§. 21, 129, and 125

Smith p. 643

Casebook, Notes 1-9, pp. 644-647

Chirelstein, ¶ 6.01(a), insofar as it deals with the Smith case and ¶7.07(b).

2. What's a credit against tax, anyway?

Up to now, we've studied deductions. Code §21 allows a "credit" against tax instead of a deduction. Be sure you understand the difference between a tax credit and a deduction. See p. 24 and Chapter 9F. of our casebook, pp. 550-51

3. Problem for class discussion:

Joe and Mary are married. Each earns $15,000 in 1999. In that year they pay Sam $2,000 to clean their house once a week. Their first child, Sally, is born in May of 2000. They pay Marcia $1,000 from September to December of 2000 in return for taking care of Sally while Mary is at work. In 2000, Mary earns $10,000 and Joe and Mary again pay Sam $2,000 for cleaning their house once a week. What credit against tax is allowed under Code § 21(a) to Joe and Mary? See Code §§ 21(b)(2)(A), (c) and (d). Does Joe's income in 2000 matter? Why?

4. Another question to be discussed in class: what income class benefited from making § 21 a credit against tax?

Before 1976, there was a deduction for certain childcare expenses (old section 214, now repealed). See Casebook, Note 5, p. 646. Who was helped by the shift to a credit? Who lost out? Can you make an argument that high bracket taxpayers have a special and greater need for a childcare deduction or credit?

5. A way around the rules of § 21.

Suppose Mary and her employer agree to reduce her salary for 1999 by $3,000. Her employer also agrees to reimburse Mary for her child care expenses up to $3,000. This reduces her taxable income by $3,000. See Code §§ 129 and 125, and the explanation in Notes 7 and 8, pp. 646-647. This arrangement undoes Congress' strategy in § 21 of targeting the child care credit to low income persons. It has exactly the same effect as making the cost of childcare deductible in full, up to $3,000 in Mary's case.

C. Clothing as another mixed business and personal expense

Assignment:

Pevsner, p. 647.

The result reached in this particular case is not as important as the general rule it illustrates. Do you think that the costs of clothes worn at work should be made deductible as business expenses?

XIV. Timing of deductions- Capitalization and Depreciation

A. Capitalization of Expenditures

1. Assignment:

Mt Morris Drive-In Theatre Co., p. 766.

Idaho Power Co., p. 770 and Notes pp. 775-79, but omit Notes 7 and 10.

Indopco, Inc. p. 779 and Notes pp. 786-87.

Code sections 263 and 263A, and the regulations to § 263. The Indopco case is pretty much repealed by the new regulations to § 263, Treas. Regs. 1.263(a)-4 and 5.

Chirelstein, ¶¶ 6.03(a)&(b)

2. Questions for class discussion

These cases have in common that in all of them courts are trying to define and explain just what expenditures are nondeductible because they are “capital expenditures”. According to these cases, how does one identify an expenditure, which has to be “capitalized”, rather than deducted?

Why are these expenditures not immediately deductible? Suppose that Mr. and Mrs. Jones have $200,000 in income this year, and they invest $20,000 of it in stock of General Motors. The expenditure is certainly an attempt to make a profit. If you think back to the beginning of this course, you’ll remember that they get a basis for the stock under § 1012 of the Code. Why can’t they get a basis and also deduct the cost immediately? Or, if basis and immediate deduction are mutually exclusive, why can’t they waive the basis and just deduct the cost in the year they buy the stock? Does buying the stock reduce their net worth?

Suppose the Exxon Corporation made $200,000,000 in profit this year, but used every cent of it to build a new refinery. Should that expenditure reduce their taxable income to zero?

What are the stakes for these taxpayers, and for the ones in the cases in this chapter? Are they losing their deductions for their expenditures? Or are they suffering something rather milder? See Note 11, p. 638 of the casebook.

3. Questions about Idaho Power Co., p. 629:

According to the Court, are wages paid to workers who construct a building for the Power Company currently deductible or do they have to be capitalized? What was the Company’s practice as to those wages, and what does the Court say about that practice?

Did either side contend that the price of the Company's trucks and cars was immediately deductible? If there was no dispute that these costs had to be capitalized, then what was the argument about?

B. Depreciation (also known as capital cost recovery or as amortization).

1. Depreciation without Pain (Almost)

a) *Assignment*

Code §§ 167, 168 and 197.

b) Explanation

We've just seen that some business and investment expenditure can't be deducted currently, but are instead "capitalized". When an expense has to be capitalized, the next question is "can the taxpayer depreciate it?" If so, the taxpayer <u>is</u> allowed a deduction, but not all in the year of expenditure.

The basic idea of depreciation is that if a taxpayer spends money for business or investment purposes, and if that expenditure has to be capitalized, one way for the taxpayer to recover its basis (that is, deduct the expenditure) is to spread it over the life of the asset it has bought, deducting a part of the price each year.

Some business expenditures, of which the price of land is the most important, are not deductible currently, nor by depreciation. Instead the buyer of certain assets gets to use the cost basis of the assets only upon sale, where the basis is subtracted from amount realized in computing gain or loss. (Code § 1001(a)). So these taxpayers are also allowed to subtract their expenditure from income: here too, the question is when.

Learning which expenditures can neither be deducted currently nor depreciated (or to say the same thing in different words, <u>must</u> be capitalized but <u>may not</u> be depreciated) is not hard, but the rules are sometimes arbitrary. Goodwill, for example, was not depreciable until 1994, when § 197 was enacted. Buildings may be depreciated in the United States, but not in most other countries.

What <u>is</u> difficult, then, about depreciation? It is that Congress and the Treasury have for many years used it as a way of encouraging investment, rather than measuring the true useful life of the taxpayer's expenditure. Their underlying method is simple: they allow the business taxpayer who buys certain assets to take depreciation deductions earlier than if the straight-line method were used. Or they allow the taxpayer to deduct immediately what would ordinarily have to be deducted over several years (depreciated). Earlier deductions usually favor the taxpayer even though the total amount deducted over the years is never more than the taxpayer's basis. You know why: the time value of money.

When we get to the statutes and administrative rules, life will be easier if you keep in mind that no one expects you to compute depreciation allowances under Code § 168. That is just an arithmetic exercise, and, in practice, accountants and clients do that chore. If you ever want to calculate, say, double declining balance depreciation under Code § 168 there are tables at the beginning of our Code book (pp. xv-xvii) which show you how the numbers work for an investment of $100. (That table uses 150 per cent declining balance for "15-year" and "20-year" property because Code § 168(b)(2) says to do that.) By the way, you can also buy a hand-held calculator (or a program for your computer) that will do depreciation calculations for you, but there's no reason to it for this course.

2. Which assets are depreciable and which are not-- land, good will, new Code § 197

a. *Assignment*

Treas. Regs. 1.167(a)-(2), -(a)(3), (a)(10)(a).

Casebook, p. 830.

Simon, p. 830,

Chirelstein, pp. 179-181.

Newark Morning Ledger, p. 845

Code § 197.

Description of Code § 197, Casebook, pp. 857-861.

Chirelstein, ¶ 6.11.

b. Problems to be discussed in class:

Jane bought a building and rented it to a tenant. She paid $100,000 for land and building together. The land without the building would be worth $20,000. Can she spread the $100,000 cost over the useful life of the building? See Code § 167(g), Treas. Reg. §§ 1.167(a)-2, 1.167(a)-5.

Jane asks if she can take a depreciation deduction on the house she just bought and moved into. See Code 167(a), 265(1), and Treas. Reg. 1.167(a)-2.

Suppose Jane's building is a two-family house, and she moves into the top floor, renting out the bottom floor. What part of her $100,000 can be spread over the useful life of the building?

C. Methods and Rates of Depreciation: The Accelerated Cost Recovery System

1. *Assignment*

Casebook, pp. 861-866.

Chirelstein, ¶¶. 6.09, 610(a)

2. Explanation

How much of a depreciation deduction is allowed each year with respect to a particular asset? That might have been treated as a question of fact: what is the true decline in value of the asset each year? Instead, Congress (often at the President's request) has been treated it as an opportunity to encourage business to purchase new machinery. If the depreciation deduction is made larger in earlier years, the effect is to decrease the true tax rate on the income produced by the purchased equipment. The point of this subchapter of our casebook is to show you how over the last forty years Congress and the Treasury have changed the purpose of the deduction from the measurement of cost to an incentive for investment. Notice that the very name of the present system (Section 168) is not "depreciation" but "accelerated cost recovery system".

The assigned readings will give you an idea of the various techniques Congress and the Treasury have in the past used to move the law in this direction, and some of the consequences.

The present system of methods and rates of depreciation is found in Code § 68. To see how it works, let's take a business which buys a machine. Suppose the Treasury's Asset Depreciation Range (ADR) guidelines give the useful life of the asset as 15 years. According to § 168(a), we need the applicable depreciation method and the recovery period.

For the "method", we find that § 168(b)(1) allows the very favorable 200 percent declining balance method. Two good descriptions of that method are at page 721 of our casebook and ¶ 6.09(d) of Chirelstein, who sometimes calls it "double declining balance."

For the "recovery period" we go to § 168(e) and find that the property is "7-year property" because it is expected to last 15 years. (Is that clear?). Section 168(c) tells us that "7-year property" is, as you would expect, depreciated over 7 years but with the highly accelerated 200 percent declining balance method allowed by § 168(b)).

The point of the exercise is that the true economic life of an asset has very little to do with its "tax life". When Congress decides that it wants to help an industry, it allows it to use some combination of a short useful life for its asset and a fast method of depreciation. If Congress decides that an industry isn't paying enough taxes, it lengthens the useful life for depreciation of assets in that industry, or specifies a slower method of depreciation, or both. In 1986, the real estate tax shelter was zapped in several ways. One of them is in § 168(b)(3), another in § 168(c)

D. The Effect of Accelerated Deductions: or What is at Stake in Rules about Capitalization and Depreciation?

1. *Assignment*

Casebook, pp. 866-872, Chirelstein, ¶ 6.10(a) and Note, “Income Tax, Consumption Tax, Flat Tax”, p.433.

2. Explanation

As I hope you've noticed, we've been discussing the timing of deductions. As usual, taxpayers prefer to take deductions in earlier years in order to defer taxes until later years. Deferring a tax is a way of reducing the rate of tax one pays, even, as shown here, down to zero.

This last part of our study of depreciation is in abstract and ahistorical form: without reference to any particular Code section, regulation, political event, etc. My hope is that this will make more clear what has been at stake over the past forty years in the legislation and administration of our law of depreciation. Chapter 14,C aims at a quantitative statement of the effect of deferring taxes. It tries to state not just that the taxpayer is better off, but to recalculate the tax rate the taxpayer is really paying.

This is tough stuff. If you can't follow the mathematics even after our class on the subject, no harm will be done, but you may still be interested to learn the conclusion, stated in italics on p. 867

The table on p. 868 would be a lot easier to understand if the authors had put minus signs before all the numbers in the 2d and 5th rows. The key to the table is that in line 5, first column, the tax reduction decreases the “investment”.

Andrews uses a hypothetical example of an unnamed investment, which can be deducted entirely in the year made. Certain industries actually have this privilege. For example, most of the cost of exploration and development of mines is immediately deductible. Code §§ 616-617. Most of the cost of drilling an oil well is immediately deductible. If you find yourself advising a small business, § 179 will be important indeed, while if you choose a rural practice,§§ 175, 180 and 182 are for you.