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ﾑChapter2・  
 ｰ ﾐﾌﾓﾓ・4猯・4潛nthischapter,goalistotranslategeneralconceptsandtheoriesintoﾐ  
 X ﾐpositivelaw.WestarttoactuallylookattheCode.Thinkaboutagivenitemorﾐ  
 ﾐ ﾐoutcomeundertheconceptofincome,andthentoproceedtotheoutcomeunderﾐ  
 ・・ ﾐtheCode.Remember,withbasicprinciples,alotofwhat'sintheCodeiswhatyouﾐ  
 ` ｰ ﾐwouldexpecttofindthere,onceyouunderstandtheunderlyingconceptsofataxonﾐ  
 (

x ﾐ"income."ﾐ  
 ・@ ﾐﾌ・4澳ЗТincome・=personalconsumptionplusnetwealthincreases(orminusﾐ  
 ﾐ

ﾐnetwealthdecreases).HowdoesCodereflectthis?ﾐ  
 H

・  
 ﾐﾌ・4澣he・axbase・istaxableincome・・TI)・・which(fornow)isgrossincomelessﾐ  
 ﾘ(

ﾐdeductions・・deduct)・・・I・・conceptually,isallincreasesinwealth(receiptsaswellﾐ  
 ・ ﾐasaccretionstowealth).Lookat・61(a・・andhowexpansiveandopen・ndeditis.ﾐ  
 hｸ  
 ﾐPrimafacie,all"inflow"(accretionstowealth)aregrossincome.Thereareﾐ  
 0 ﾐexceptions(suchasthegiftexclusion),butmostofthemhavetobefoundintheﾐ  
 ・H

ﾐCode.・Lookattaxingformula]・ﾐ  
 ﾀ ﾐﾌ・4潺eductions,conceptually,relateto"outflow."Netwealthdecreases・ay・beﾐ  
 P ﾐdeductible.Butwesawthatconsumptionisgenerallyincludedinthetaxbaseﾐ  
 h ﾐunderanincometax.And・・62・confirmsthatconsumption"expenses"areindeedﾐ  
 ・0 ﾐnotdeductible.Soevenifthereisanetwealthdecrease,ifitisadecreaseusedinﾐ  
 ｨ・ ﾐpersonalconsumption,thedecreaseisnotdeductible.Thelegalpresumption,inﾐ  
 pﾀ ﾐfact,isthat・o・decreasesinwealtharedeductible;inordertodeductanoutlay,youﾐ  
 8・ ﾐhavetofindaCodeprovisionwiththemagicwords,"thereshallbeallowedasaﾐ  
 P ﾐdeduction...."Section162allows"businessexpense"deductions,butthereareﾐ  
 ﾈ ﾐconditions,limitations,andsoon.Section212generallyallowsdeductionofﾐ  
 ・・ ﾐinvestment"expenses."ﾐ  
 Xｨ ﾐﾑﾑﾌ・4瑣SKIP]・sanaside,youmightwonderwhythereareseparateprovisionsforﾐ  
 ・8­ ﾐbusinessexpensedeductionsandinvestmentexpensedeductions.Itissimplyaﾐ  
 ｰ ﾐmatterofhistory.Courtsconstruedeductionprovisionsnarrowly.Someversionofﾐ  
 x‑ﾈ! ﾐ162(a)hasalwaysbeenintheCode,butintheearly1940s・iggins・casetheﾐ  
 @­・" ﾐSupremeCourtmadeitclearthattheword"business"didnotencompassﾐ  
 X# ﾐ"investment."Sinceinvestmentexpensesaredecreasesinwealththatarenotﾐ  
 ﾐ $ ﾐconsumption(andareoutlaysthatareintendedtoproduceincome),theyshouldbeﾐ  
 ・・% ﾐdeductible.Underseparation・fаowersnotions,Congresscan't"overrule"courtﾐ  
 `"ｰ& ﾐdecisionsbyenactingastatutethatsaysthataSupremeCourtdecisionshallhaveﾐ  
 (#x‑' ﾐnoeffectonthelosersofalitigatedcase,butitcan,ofcourse,changetheresultforﾐ  
 ・@­( ﾐtaxpayersbyamendingtheCode.Thechangecouldevenbemaderetroactivetoﾐ  
 ｸ$ ) ﾐapplytothelosersinthelitigatedcase.SoCongressquicklyenacted212(1)&(2).ﾐ  
 %ﾐ \* ﾐThisepisodeshowsthedialecticbetweenCongressandthecourts.Italsoshowsﾐ  
 H&・+ ﾐonewayinwhichtheCodebecomesmorecomplex:provisionsthatoverturnresultsﾐ  
 '`", ﾐofcourtdecisions.・skip]・  
 ﾘ'(#- ﾐﾌ・4瑣roblem1.a・・Markbuysinvestmentstockfor$20,000.Is$20,000outlayisﾐ  
 h)ｸ$/ ﾐdeductible.Intermsofthe"income"definition,thequestioniswhetherit・・1)isaﾐ  
 0\*%0 ﾐdecreaseinwealth(2)thatisnotconsumption・・Thefirststepwithrespecttothisﾐ  
 ・H&1 ﾐissueistoaskwhetherthisisadecreaseinwealth.Theansweris"no."ﾐ  
 ﾀ+'2 ﾐ(Therefore,itisirrelevantwhetherornotitisconsumption.)Markmerelychangedﾐ  
 ・ﾘ'3 ﾐtheformofhiswealthfromcashtostock.UndertheCode,youhavetofindtheﾐ  
 P-(4 ﾐsectionthatauthorizesthedeductionтthesectionthatcontainsthewordsﾔ\_ﾔ"thereﾐ

.h)5 ﾐﾑﾑ・籔ﾖ・簷

ﾑshallbeallowedasadeduction"тbeforeanyamountmaybededucted.Do162andﾐ  
 ﾐ212authorizedeductionhere?Theyreferto"expenses."Dowehavean"expense"ﾐ  
 ・ﾈ ﾐhere?Thetermisnotdefinedin162or212.Iftheoutlayisnotanexpense,whatﾐ  
 ｰ・ ﾐisit?A"capitalexpenditure."Thistermisnotbandiedaboutincommonspeech;ﾐ  
 xX ﾐwheredoesitcomefrom?Businessaccounting.So,capitalexpendituresarenotﾐ  
 @ ﾐdeductedunder162and212,nor(generically)byanyothersection.Infact,theyﾐ

・ ﾐareexpresslydisallowed.・ee・261and263.(Whyenact263?Itwasn'tneeded.ﾐ  
 ﾐ

ｰ ﾐEvenbeforeitwasenactedin1954,capitalexpenditureswerenondeductible.ﾐ  
 ・x ﾐPerhapsitwasenactedsimplytoclarifypriorlawandtogiveTreasuryapretexttoﾐ  
 `@ ﾐissuedetailedregulations.)Andunder1.263(a)・(a),outlaysthatpurchaseanﾐ  
 (

ﾐassetorbenefitthatwilllastsubstantiallybeyondtheendofthetaxableyearareﾐ  
 ・ﾐ

ﾐcapitalexpenditures.ﾐ  
 ｸ・  
 ﾐﾌ・4瑣oMark'sinvestment,hisdecisiontosavebybuyingastockﾐ  
 H(

ﾐinvestment,istaxableunderanincometaxbecausenodeductionisallowedﾐ  
 ・ ﾐforthisinvestment・・Ifwehadaconsumptiontaxthattaxedonlyconsumptionandﾐ  
 ﾘｸ  
 ﾐnotsavings,notinvestment,Markwouldbeallowedadeductionforhiscapitalﾐ  
  ﾐexpenditureтhispurchaseofstock.Thus,thedenialofadeductionforcapitalﾐ  
 hH

ﾐexpendituresisthedefiningdifferencebetweenanincometaxandaconsumptionﾐ  
 0 ﾐtax.ﾐ  
 ・ﾘ ﾐﾌ・4潛nsum,ifsomethingisacapitalexpenditure,itisprobablynondeductible;itﾐ  
 ・h ﾐisunnecessary,therefore,toaskwhetheritinvolvespersonalconsumption.Thatis,ﾐ  
 P0 ﾐwithrespecttodeductionissues,thefirstquestioniswhetherthereisanetwealthﾐ  
 ・ ﾐdecrease,andifso,whetherthenetwealthdecreaseispersonalconsumption.ﾐ  
 ・ﾀ ﾐHere,wehavenonetwealthdecreaseтwehavea"capitalexpenditure"тsoweﾐ  
 ｨ・ ﾐneednevergettothenextquestionregardingwhetherthedecreaseisbusinessorﾐ  
 pP ﾐinvestment,whichshouldreducethetaxbaseatsomepoint,orpersonalﾐ  
 8 ﾐconsumption,whichshouldnotreducethetaxbase.ﾐ  
 ・ ﾐ・4猯・4滷ackto1.a.Thestockgoesdowninvaluethefirstyearandupinvaluetheﾐ  
 ・p‑ ﾐnextyear.DothesevaluefluctuationsproducedeductionsorincomeundertheS・  
 X‑8­ ﾐHТdefinitionofincome?Yes,theyrepresentchangesinwealth.UndertheCode?ﾐ  
 ­ ﾐNo.Howdoweknowthatasamatterofstatutorylaw?Itisimpliedby・・1(a)(3)・・ﾐ  
 ・ﾈ! ﾐstatingthatgainsareincome,andthestatutorydefinitionofgainsin・・001・・whichﾐ  
 ｰ ・" ﾐrequiresasaleorotherdispositionandwhichcalculatesgainandlossbyassumingﾐ  
 x!X# ﾐthatunrealizedannualgainsandlosseswerenotyettakenintoaccount.Thus,ﾐ  
 @" $ ﾐCode"income"candeviatefromtheeconomics"definition"ofincome.ﾐ  
 #・% ﾐﾌ・4潯erepositivelawdiffersfromcoreconcepts,suchastheSЗТdefinition.ﾐ  
 ・x‑' ﾐThereisnothingillegalaboutsuchdeviations,buttheyattractourscrutinyandﾐ  
 `%@­( ﾐperhapsdemandexplicitjustification.ﾐ  
 (& ) ﾐﾌ・4瑣ﾔ\_ﾔSummarize]・heﾔ\_ﾔrealizationprincipledidnotoriginatewithincometax.Itﾐ  
 ｸ'・+ ﾐhasitsoriginsinbothtrustandbusinessaccounting.In・rust・accounting,changesﾐ  
 (`", ﾐinvalueareallocabletothe"principal"or"corpus"ofthetrust;thevaluechangesﾐ  
 H)(#- ﾐdonotconstitute"income"thatgoestothetrustbeneficiaries.Themetaphoristhatﾐ  
 \*・. ﾐoffruit(toincomebeneficiary)andtree(toremainder).Thus,changesinvalueﾐ  
 ﾘ\*ｸ$/ ﾐcouldnotbeconsideredincomebecauseanyincreaseinvalueincreasedtheﾐ  
 +%0 ﾐcorpus,theremainder.(Thistraditionisabouttounravelintrustlaw,wheretheﾐ  
 h,H&1 ﾐemphasisisshiftingfromincomevs.principaltotheconceptofinvestmentreturnﾐ  
 ﾐandafairallocationthereofamongcurrentandfuturebeneficiaries.)In・inancial・  
 ・ﾈ ﾐaccounting,gainsandlossesinproperty・re・considered"income,"buttheyenterﾐ  
 ｰ・ ﾐintotheincomeaccountonlywhenrealized.Why?Accountingabhorsvaluation,ﾐ  
 xX ﾐbecausealotofshadybusinesspracticesderivefromovervaluingassetsorﾐ  
 @ ﾐundervaluingliabilities.Thebusinessaccountingpremiseisnottogiveﾐ

・ ﾐmanagementtoomuchdiscretionoverthereportingoffactsessentialtooutsiders,ﾐ  
 ﾐ

ｰ ﾐsinceprovidingfairdatatooutsidersuponwhichtheycanrely(shareholders,ﾐ  
 ・x ﾐcreditors)isthegoaloffinancialaccounting.Oncerealizationoccurs,thegainorﾐ  
 `@ ﾐlossisclear.ﾐ  
 (

ﾐﾌ・4澹hytherealizationprincipleintheincometax?Perhapspotential・aluationﾐ  
 ｸ・  
 ﾐandliquidity・problems.Dotheseapplyhere,withexchangeдradedstock?No.Isﾐ  
 ` ﾐitrelevantthatunrealizedgainsandlossesare"temporary"?Notreally,becauseﾐ  
 H(

ﾐwehaveanannualtaxsystem.Evenrealizedgainsandlossescanbetemporaryifﾐ  
 ・ ﾐreinvestedandtherebyplacedatfurtherriskofvaluefluctuation.Notethatﾐ  
 ﾘｸ  
 ﾐﾔ\_ﾔnonneutralitiesﾔ\_ﾔareinevitable,giventhatcertaininvestmentreturnsaretaxedﾐ  
  ﾐcurrently(interest,netrents,dividends)whileunrealizedgainsaren't.Evenifgainﾐ  
 hH

ﾐfromthispropertyistaxedatnominallythesamerateasinterestanddividends,itisﾐ  
 0 ﾐreallytaxedatalowerratesincethetaxbillisdeferred.・eferral・oftaxisveryﾐ  
 ・ﾘ ﾐvaluable;itistantamounttoareductioninthetaxpaid.Therealizationprincipleﾐ  
 ﾀ ﾐproducesotherskewingeffects,affectsbehavior,・tc・・,asdiscussedinthetext.ﾐ  
 ・h ﾐWhereisthebestplacetodrawtherealizationline?Goodexamplewhereoneﾐ  
 P0 ﾐvalueтneutralitynormтhastobesacrificedbecauseofanother・alueтﾐ  
 ・ ﾐﾔ\_ﾔadministrabilityﾔ\_ﾔ・・Whereadministrabilityisn'taproblemт・.g.・・certainexchange・  
 ・ﾀ ﾐtradedstockheldbycertainholdersтtherealizationrequirementhasbeendoneﾐ  
 ｨ・ ﾐawaywith.ﾐ  
 pP ﾐﾌ・4澳onoinclusionduringownership.Whataboutdeductionsduringownership.ﾐ  
 ・ ﾐIsthestockdepreciable?No,noteverythingisdepreciable.First,itmustbeanﾐ  
 ﾈｨ ﾐassetusedinbusinessorheldfortheproductionofincome.・ee・・・67(a)・・Weseeﾐ  
 ・p‑ ﾐthesamelinesdrawnhereaswesawdrawnwithrespecttoexpenses:businessﾐ  
 X‑8­ ﾐandinvestmentpropertyarepotentiallydepreciable,whilepersonalconsumptionﾐ  
 ­ ﾐpropertyisnot.Onceagain,thisistoimplementtheSЗТnotionthatpersonalﾐ  
 ・ﾈ! ﾐconsumptionshouldbeinthetaxbase.Sincestockisheldfortheproductionofﾐ  
 ｰ ・" ﾐdividendincomeandgain,wesatisfythattest.ﾐ  
 x!X# ﾐ・4猯・4澳econd,itmustbethekindofassetthatsufferswearandtearorfromﾐ  
 #・% ﾐobsolescence,・.e.・・must(exante)haveanascertainableusefullife.Stock(andﾐ  
 ﾐ#ｰ& ﾐland,・tc・・)isperpetual,sothestockisnotdepreciable.Thereasonsfortheusefulﾐ  
 ・x‑' ﾐliferequirementwillbemorecleartoyouwhenwetakealookatdepreciationinﾐ  
 `%@­( ﾐmoredetail.Thebottomlineisthatthereisnorealizedlossfortaxpurposesiftheﾐ  
 (& ) ﾐassetisnotawastingasset,apotentiallyinfiniteasset.ﾐ  
 ・ﾐ \* ﾐﾌ・4・.B.・upposeinsteadthatMarkisadentistandpayshisdentalassistantaﾐ  
 (`", ﾐsalaryof$20,000thisyear.Undertaxtheory,thequestionisagainwhetherthereisﾐ  
 H)(#- ﾐanetwealthdecrease.Unlikein1.a.,decreaseinwealth.The$20,000didnotﾐ  
 \*・. ﾐsimplychangeforminMark'shands;it'sgone.The$20,000outlayisnolongeraﾐ  
 ﾘ\*ｸ$/ ﾐ"capitalexpenditure";itisan"expense."Acurrent"expense"istheconceptualﾐ  
 +%0 ﾐoppositeofa"capitalexpenditure":somethingthatwill・ot・produceabenefitthatﾐ  
 h,H&1 ﾐwilllastsubstantiallybeyondtheendofthetaxableyear.Now,isthe"expense"ﾐ  
 ﾐdeductible?Yes;becausetheexpensewasincurredinhisbusiness,itshouldbeﾐ  
 ・ﾈ ﾐdeductibleunderincometaxtheory(forthereasonsdiscussedinconnectionwithﾐ  
 ｰ・ ﾐJaneandSueinProb.1ofthelastchapter),and162allowsdeductionhere.ﾐ  
 xX ﾐExpensesincurredtoproducegrosstaxableincomemustreducethatgrossincomeﾐ  
 @ ﾐifwearetotaxonly"income"andnot"grossreceipts."ﾐ

・ ﾐ・4猯・4瑣ﾔ\_ﾔskip]・upposeﾔ\_ﾔinsteadofbuyingstockthatMarkusedthe$20,000tobuyﾐ  
 ・x ﾐgroceriesoverthecourseoftheyear.Firstquestion,dowehaveacapitalﾐ  
 `@ ﾐexpenditureoranexpense?Anexpense.Secondquestion,isitapersonalﾐ  
 (

ﾐconsumptionexpense(nondeductibleunder262)orabusinessorinvestmentﾐ  
 ・ﾐ

ﾐexpense(deductibleunder162or212)?Thisisanondeductiblepersonalﾐ  
 ｸ・  
 ﾐconsumptionexpenseunder262.Eventhoughthereisanetwealthdecrease,itisﾐ  
 ` ﾐnotdeductible,becausethenetwealthdecreasewasspentinconsumption.ﾐ  
 H(

ﾐConsumptionissupposedtobeinthetaxbaseundertheSЗТconceptofincome,ﾐ  
 ・ ﾐthoughweshallstudysomeprovisionsthatallowdeductionforpersonalexpenses,ﾐ  
 ﾘｸ  
 ﾐsuchasthehomemortgageinterestdeduction,laterinthecourse.・skip]・・・瑣  
  ﾐﾌ・4・.C・・thestockissoldfor$22,000.Isallofthatincome?First,stickwithﾐ  
 0 ﾐconceptualsense.No,because$20,000outofthe$22,000wasalreadysubjecttoﾐ  
 ・ﾘ ﾐtax(byreasonofbeinga・ondeductible・capitalexpenditure).Only$2,000isanﾐ  
 ﾀ ﾐ"increasein"wealth.Ittiesintoneutrality:Don'ttaxthesamedollarsmorethanﾐ  
 ・h ﾐonce,whichwouldtilttheplayingfield.ﾐ  
 P0 ﾐﾌ・4潛nCodeterms,lookatthedefinitionsin・・001・of"gain,""amountrealized,"ﾐ  
 ・ﾀ ﾐand"adjustedbasis."Underthestatute,basisinitiallymeanscost.・・012・・Stressﾐ  
 ｨ・ ﾐthecrucialroleofbasisinanincometax.・uchofthestructuralattributesofanﾐ  
 pP ﾐincometaxdependsontheconceptofbasis・・Basiscomesfromnondeductibleﾐ  
 8 ﾐcapitalexpenditures($20,000).Recoveriesofbasis("capital"inthetaxasopposedﾐ  
 ・ ﾐtotheaccountingsense)cannotbeincome.Theincometaxreachesonly(realized)ﾐ  
 ﾈｨ ﾐnet・ncreases・inwealth.ﾐ  
 ・p‑ ﾐﾌ・4潛sgaingrossincome?Yes.Section・・001ﾔ\_ﾔ(c)ﾔ\_ﾔ・saysgainsrealizedfroma"saleﾐ  
 ­ ﾐorexchange"are"recognized"(included)unlessaspecificCodesectionsaysﾐ  
 ・ﾈ! ﾐotherwise.Section1001ﾔ\_ﾔ(c)ﾔ\_ﾔisredundantwith61(a)(3),whichsaysthatgainsareﾐ  
 ｰ ・" ﾐgrossincome(whetherornotrealizedby"saleorexchange").ﾐ  
 x!X# ﾐﾌ・4澣hegainisa"capitalgain,"becauseitisrealizedfrom(1)the"saleorﾐ  
 #・% ﾐexchange"of(2)a"capitalasset."・ee・capitalgaindefinitionsin・1222・・It'sa"long・  
 ﾐ#ｰ& ﾐtermcapitalgain."Assuch,andassumingnoothercapitalgainsandlossesduringﾐ  
 ・x‑' ﾐtheyear,itissubjecttothemaximumrateof20%,whereasotherkindsoftaxableﾐ  
 `%@­( ﾐincomearesubjecttoratespotentiallyashighas39.6%.ﾐ  
 (& ) ﾐﾌ・4潛nthealternative,itwassoldfor$11,000(amountrealizedis$10,900netofﾐ  
 ｸ'・+ ﾐbroker'sfeeof$100).Nowwehavea"loss."Thefirststepistodeterminetheﾐ  
 (`", ﾐexistenceandamountoftheloss($10,900о$20,000=о$9,100).Wesawthatgainﾐ  
 H)(#- ﾐisﾔ\_ﾔincludableﾔ\_ﾔ,bothconceptuallyandundertheCode.・onceptually・・isthelossﾐ  
 \*・. ﾐdeductible?Yes,it's(1)adecreaseinwealth(2)that'snotconsumption.Howﾐ  
 ﾘ\*ｸ$/ ﾐabouttheCode?Again,therearenoautomaticorcommon・awdeductions.Justasﾐ  
 +%0 ﾐwiththedeductionofbusinessandinvestment"expense,"youmustfindaCodeﾐ  
 h,H&1 ﾐsectionallowingthedeductionofinvestment"losses"ifthislossistobedeductible.ﾐ  
 ﾐA"loss"isnotan"expense"!Rememberthatanexpense(atermofart)isanoutlayﾐ  
 ・ﾈ ﾐthatisnotacapitalexpenditure.A"loss"(alsoatermofart)isdefinedin1001asﾐ  
 ｰ・ ﾐsomethingthatpresupposesasaleordispositionofproperty.(Alossmayalsoﾐ  
 xX ﾐoccurinconnectionwithanon・isposition,butitstillinvolvesproperty.)Therecan'tﾐ  
 @ ﾐbealossunlessbasisexceedsamountrealized.Thereistypicallynooutlayﾐ

・ ﾐinvolvedthatyouaretryingtodeduct,aswithan"expense."Itdealswiththoseﾐ  
 ﾐ

ｰ ﾐchangesinvalueofpropertyduringtheownershipperiodthataren'ttakenintoﾐ  
 ・x ﾐaccountduringownershipbecauseoftherealizationrequirement.ﾐ  
 `@ ﾐﾌ・4澣hedeductibilityofany"loss"isgovernedby・・65・・Tobedeductible,alossﾐ  
 ・ﾐ

ﾐmustbe"sustained,"whichissimilarto(butperhapsbroaderthan)"realized."ﾐ  
 ｸ・  
 ﾐ(Thus,anabandonmentorworthlessnessofanassetgivesrisetoasustainedloss,ﾐ  
 ` ﾐevenabsentasaleordisposition.)Here,wehavearealizedloss;allrealizedﾐ  
 H(

ﾐlossesaresustained,sowedon'thavetoinquireintothenuancesofwhatﾐ  
 ・ ﾐconstitutesa"sustained"loss.ﾐ  
 ﾘｸ  
 ﾐﾌ・4澁orindividuals,allowanceisinitiallygovernedby・・65(c)・・Theygetﾐ  
 hH

ﾐdeductionsonlyforbusinesslosses,investmentlosses,andpersonalcasualtyﾐ  
 0 ﾐlossestotheextentof・165(h・・(studiedlater).Herewehaveinvestmentloss,soitisﾐ  
 ・ﾘ ﾐdeductible.Youcanthinkof165(c)(2)astheanalogto212forlosses.Withtheﾐ  
 ﾀ ﾐexceptionofallowingcertainpersonalcasualtylosses,youseethesameparadigmﾐ  
 ・h ﾐthatwesawwithrespectto"expenses"anddepreciation:Ifitisbusinessorﾐ  
 P0 ﾐinvestment,deductible,ifitisapersonalloss,notdeductible(unlessapersonalﾐ  
 ・ ﾐcasualtyloss,studiedlater).Again,SЗТisseenintheCode.ﾐ  
 ・ﾀ ﾐﾌ・4瑣Questions2&3]・helosscannotexceedbasis.165(b).Noproblemhere,ﾐ  
 pP ﾐsincebasisisgreaterthantheloss.165(b)・axdeductionoflosscan・exceedﾐ  
 8 ﾐpreviouslytaxeddollars・n・theproperty.Ifyougetadeductionforuntaxeddollarsﾐ  
 ・ ﾐ(dollarsnotsupportedbybasis)youwouldgetadoubletaxbenefitfromthesameﾐ  
 ﾈｨ ﾐdollars(exclusioncoupledwithdeductionofthesamedollars).ﾐ  
 ・p‑ ﾐﾌExample:propertyispurchasedfor$20,000,appreciatesto$30,000,andisﾐ  
 ­ ﾐdestroyedbyfire.Thepropertywasnotinsured.Thetaxpayer'sdeductible"loss"isﾐ  
 ・ﾈ! ﾐ$20,000,not$30,000,eventhoughthetaxpayermightbelievethathesufferedaﾐ  
 ｰ ・" ﾐ"loss"inthecolloquialsenseof$30,000.Ifwealloweddeductionofthe$10,000ﾐ  
 x!X# ﾐappreciationthatwasneverincludedinincomebecauseoftherealizationﾐ  
 @" $ ﾐrequirement,wewouldbeallowingadoubledeductionforthesamedollars.Anﾐ  
 #・% ﾐexclusionofdollarscoupledwithadeductionofthosesamedollarsastheeffectofﾐ  
 ﾐ#ｰ& ﾐadoublededuction.Becauseoftherealizationrequirement,thetaxpayerneverﾐ  
 ・x‑' ﾐincludedthe$10,000ofappreciationingrossincome(creatingbasis),sononeofﾐ  
 `%@­( ﾐthatuntaxedappreciationcansupportadeduction.Anotherwaytophrasethisisﾐ  
 (& ) ﾐthat・eductionsmustbesupportedbybasisatsomepoint・・(Andhowdoyoucreateﾐ  
 ・ﾐ \* ﾐbasis?Usuallythroughaninclusioninincome.)ﾐ  
 ｸ'・+ ﾐﾌ・4澹earen'tthrough;thisisalongдermcapitalloss.Section165(f)saysﾐ  
 H)(#- ﾐcapitallossesareallowableonlytotheextentallowedunder1211and1212.ﾐ  
 \*・. ﾐBasically,capitallossesfortheyearareallowedonlytotheextentofcapitalgainsﾐ  
 ﾘ\*ｸ$/ ﾐfortheyearplus$3,000.Thus,here(absentothercapitalgainsandlossesfortheﾐ  
 +%0 ﾐyear)thetaxpayercandeductonly$3,000.Theremaining$6,100becomes(isﾐ  
 h,H&1 ﾐcarriedoveras)apotentiallydeductiblecapitallossforthenextyear(1996),andﾐ  
 ﾐyouapply1211in1996,andsoon.ﾐ  
 ・ﾈ ﾐﾌ・4澣herationaleforrestrictingcapitallossesisthe"selectiverealization"ﾐ  
 xX ﾐproblem.Without1211,taxpayerscouldchoosetoavoidrealizationofgainsbutﾐ  
 @ ﾐtakelosseseveryyear.It'soneoftheproblemswitharealizationrequirement.Thisﾐ

・ ﾐwouldresultinaninaccuratemeasureofchangeinwealth.ﾐ  
 ﾐ

ｰ ﾐﾌ・4潛t'simportanttoattacktheanalysisintherightorder:First,istheregainorﾐ  
 `@ ﾐloss?Second,ifgain,isitﾔ\_ﾔincludableﾔ\_ﾔ(noworlater)?Ifloss,isitdeductibleunderﾐ  
 (

ﾐ165(c)?Third,isitcapitalgainorloss?Fourth,ifyes,whataretheconsequencesﾐ  
 ・ﾐ

ﾐthereof?ﾐ  
 ｸ・  
 ﾐﾌ・4潛n・・.d・・theitemisacarusedinMark'sbusiness.Westillhaveaﾐ  
 H(

ﾐnondeductiblecapitalexpenditureinitially.Butheretheassetqualifiesforﾐ  
 ・ ﾐdepreciation.・ee・167(a).Taxdepreciationisaseriesofdeductionsovertimethatﾐ  
 ﾘｸ  
 ﾐ"useup"theasset'sbasis,accordingtotheapplicablestatutorydepreciationﾐ  
  ﾐschedule.(Theactualtaxdepreciationmethodsarefoundin168plusscatteredﾐ  
 hH

ﾐothersections.)Here,itisstipulatedthattheusefullifeisfiveyears,thestraight・  
 0 ﾐlinemethodistobeused,andthehalfиearconventionapplies.Inyear1(1997),ﾐ  
 ・ﾘ ﾐyoudivide$20,000bytheusefullife(5)(=$4,000)anddivideby2(=$2,000).Inﾐ  
 ﾀ ﾐ1998,thedepreciationdeductionis$4,000.In1999,theyearofdisposition,$2,000ﾐ  
 ・h ﾐofbasisisdeductedasdepreciationunderthehalfиearconvention.ﾐ  
 P0 ﾐﾌ・4澣henrunthroughthegainandlossexercises.Themaindifferenceisthatﾐ  
 ・ﾀ ﾐbasis($20,000)isreducedto$12,000under?1016(a)(2)bytheaggregateﾐ  
 ｨ・ ﾐdepreciationdeductionsof$8,000.Youmustreducebasis,forpurposesofﾐ  
 pP ﾐcomputinggainorloss,bydepreciationdeductions.Otherwise,thetaxpayerwouldﾐ  
 8 ﾐgetdoubletaxbenefitsoutofthesamedollarsinbasis.Thus,taxpayer'srealizedﾐ  
 ・ ﾐandrecognizedgainis$10,000($22,000о$12,000).ﾐ  
 ﾈｨ ﾐ・4猯・4滷ytheway,ifMarkheldontothecarfortenyears,hecoulddepreciateitﾐ  
 X‑8­ ﾐonlyuntilherunsoutofbasis.Thus,aftersixyears(onehalfиear・onventionyearﾐ  
 ­ ﾐforthefirstyear,plusfourfullyears,plusafinalyearinwhichthereisonly$2,000ﾐ  
 ・ﾈ! ﾐofbasisremainingtodepreciate),thebasisiszeroandnomoredepreciationisﾐ  
 ｰ ・" ﾐallowed.Thisresultreliesonthesameprincipleas165(b).Again,can'tdeductﾐ  
 x!X# ﾐmorethanbasis,oressentiallygettingadoublededuction.ﾐ  
 @" $ ﾐﾌ・4潛n・1.e]・・thecarisusedforcommutingandpleasure.Commutinghascertainﾐ  
 ﾐ#ｰ& ﾐbusinessaspects,buttherule(regulationsandcaselawthatisstudiedlaterinmoreﾐ  
 ・x‑' ﾐdetail)isthatcommutingis"personal."Itfollowsthatthecarisnotdepreciable.ﾐ  
 `%@­( ﾐHence,basisstaysat$20,000.Sothegainis$2,000;itisgrossincomeandcapitalﾐ  
 (& ) ﾐgain.NotethatMarkgetsabasisoffseteventhoughtheassetisa"personalеse"ﾐ  
 ・ﾐ \* ﾐone.・.3・・Useofthebasispreventsdoubletaxingthesamedollars.Thatvalueisﾐ  
 ｸ'・+ ﾐsoimportantthatittakesprecedenceovertherulethatpersonalconsumptionﾐ  
 (`", ﾐshouldalwaysbetaxed.IfweweretogiveMarkazerobasisinthecarontheﾐ  
 H)(#- ﾐtheorythatheshouldgetnooffsetagainstamountrealized(ineffectnodeduction)ﾐ  
 \*・. ﾐforthedollarsusedtopurchasethepersonalеsecar,wewouldbetaxinghimtwiceﾐ  
 ﾘ\*ｸ$/ ﾐonthosedollars:oncebydisallowingdeductionofhiscapitalexpenditurewhenheﾐ  
 +%0 ﾐpurchasedthecar,andoncewhenhesolditandhadnobasistooffsethisamountﾐ  
 h,H&1 ﾐrealized.Thatissuchano・othathegetsbasisevenforpersonal・onsumptionﾐ  
 ﾐassets.[Addtochart.]ﾐ  
 ・ﾈ ﾐﾌ・4潘ote,bytheway,thatwhethersomethingisa"capitalasset"withintheﾐ  
 xX ﾐmeaningof1221hasnothingtodowithwhetheritisa"personal・onsumption"ﾐ  
 @ ﾐassetorabusinessorinvestmentasset.Studentsoftengetconfusedonthis.Aﾐ

・ ﾐcapitalassetisdefinedin1221tobe・ny・assetotherthaninventory,certainself・  
 ﾐ

ｰ ﾐcreateditems,andrightstoincomefromservices.Itsaysnothingaboutpersonalﾐ  
 ・x ﾐuseversusbusinessuse.AlsotaketohearttheadmonitioninNote1that"capitalﾐ  
 `@ ﾐexpenditure"hasnothingtodowith"capitalasset,"eventhough,unfortunatelytheﾐ  
 (

ﾐsamewordsareusedinbothinstances.Theyhavenothingtodowithoneanother.ﾐ  
 ・ﾐ

ﾐYousimplyhavetolearnthesetaxtermsintheirownuniquecontexts.ﾐ  
 ｸ・  
 ﾐﾌ・4潛fMarksellsatalossof$9,000($11,000о$20,000),thelossisnotallowableﾐ  
 H(

ﾐunder165(c).(Basisstillpreventsincludingnetamountrealizedasgrossincome.)ﾐ  
 ・ ﾐIt'snotabusinessorinvestmentlossorapersonal"casualty"loss.Thus,inﾐ  
 ﾘｸ  
 ﾐgeneral,lossesonpersonalеseassetsarenotallowed.(Insuchcases,wedon'tﾐ  
  ﾐneedtoreachtheissueofwhetherthelossisacapitalloss.)ﾐ  
 hH

ﾐﾌ・4澣hus,・Note4・・thelossisanetwealthdecrease,butitispersonalandthusﾐ  
 ・ﾘ ﾐshouldbetaxableunderSЗТ,whilethegainisanetwealthaccession,alsoﾐ  
 ﾀ ﾐtaxableunderSЗТ.Withoutunderstandingtheunderlyingnotionof"income,"thisﾐ  
 ・h ﾐresultmightseemillogicalandunfair,wheninfact,itisrequiredunderataxonﾐ  
 P0 ﾐ"income,"properlyunderstood.(Mentionhomeгalelossproposal,whichstemsﾐ  
 ・ ﾐfromfailureofpublicatlargetounderstandwhat"income"means.Tothem,itjustﾐ  
 ・ﾀ ﾐseemsunfairtotaxhomegainтeventhoughitusuallyescapestaxunderrulesﾐ  
 ｨ・ ﾐdiscussedlaterтandnotallowdeductionofhomelosses.)ﾐ  
 pP ﾐﾌ・4潛n・roblem2・・theissueiswhetherthe"fixеp"outlaysare"expenses"orﾐ  
 ・ ﾐ"capitalexpenditures."・ee・Treas.Reg.1.263(a)・(a),(b).・・ftheoutlaysconstituteﾐ  
 ﾈｨ ﾐ"permanentimprovementsorbetterments,"theyareclassifiedas"capitalﾐ  
 ・p‑ ﾐexpenditures."Whattaxresultfroma"capitalexpenditure?Itcreatesbasis.Thus,ﾐ  
 X‑8­ ﾐtheoutlayswouldnotbeimmediatelydeductiblebutwouldbeaddedtobasis.・ee・  
 ­ ﾐTreas.Reg.1.162・:repairsare"expenses."Weknowthetreatmentofexpenses:ﾐ  
 ・ﾈ! ﾐIfbusiness/investment,immediatelydeductible.Cansuchexpensescreatebasis?ﾐ  
 ｰ ・" ﾐNo,thatwouldraisethepossibilityofdoubletaxbenefitsforthesamedollars.Ifﾐ  
 x!X# ﾐpersonal,neverdeductible.Nodeductionnow,andnobasiscreatedtopreserveﾐ  
 @" $ ﾐdeductionforthefuture.ﾐ  
 #・% ﾐﾌ・4潛fthebuildingisusedinbusinessorheldforaninvestment,Cliffwantsthemﾐ  
 ・x‑' ﾐtobe"repairs"ratherthan"capitalexpenditures,"sincebusinessexpensesareﾐ  
 `%@­( ﾐcurrentlydeductible.Thecapitalexpenditurewouldbedepreciableovertheﾐ  
 (& ) ﾐbusinessbuilding'slife,butadeduction・oday・isworthmorethanfuturedeductionofﾐ  
 ・ﾐ \* ﾐthesamedollarsundertimeёalue・f・oneyprinciples.ﾐ  
 ｸ'・+ ﾐﾌ・4潛fthebuildingisapersonalresidence,Cliffdoesn'twanttheoutlaystobeﾐ  
 H)(#- ﾐclassifiedasrepairs,sincepersonalexpensesarenotdeductible(nor,asexpenses,ﾐ  
 \*・. ﾐcantheygeneratedeductionslater).・ee・262(a).Theywouldneverreducethetaxﾐ  
 ﾘ\*ｸ$/ ﾐbaseтever.Iftheoutlaysconstitutecapitalexpenditures,however,theycanbeﾐ  
 +%0 ﾐaddedtotheresidence'sbasisandtherebyreducefuturegain(butnotcreateﾐ  
 h,H&1 ﾐdepreciationorloss).ThisgoesbacktothepointmadeinQ.3,thatwevaluetheﾐ  
 ﾐpreceptthatthesamedollarsshouldnotbetaxedtothesametaxpayermorethanﾐ  
 ・ﾈ ﾐoncesohighlythatwegivebasiscreditforcapitalexpenditurestopersonal・  
 ｰ・ ﾐconsumptionassets,eventhoughpersonal・xpenses・arenotdeductible.Iftheﾐ  
 xX ﾐbuildingislaterconvertedtobusinessuse,hemightevengetdepreciationorlossﾐ  
 @ ﾐdeductionsoutofthe$25,000outlay.ﾐ

・ ﾐﾌ・4潘eedlesstosay,Cliffcan'tsimplymakeanelectiontotreatitasarepairorﾐ  
 ・x ﾐanimprovement,norcanClifffixthetaxresultbycallingtheoutlaya"repair"oranﾐ  
 `@ ﾐ"improvement."Thosearetermsoftaxart;whetheranoutlayisarepairorﾐ  
 (

ﾐimprovementisdeterminedunderlegalcriteriapeculiartothetaxlaw.Thelawofﾐ  
 ・ﾐ

ﾐrepairversuspermanentimprovementisveryconfusedandfact・ound.Whenyouﾐ  
 ｸ・  
 ﾐhaveaquestioncomeup,theonlythingyoucandoistrytoresearchtheparticularﾐ  
 ` ﾐoutlayinquestionandseehowthecourtsandIRShavetreatedsuchoutlays.ﾐ  
 H(

ﾐDifficultline・rawinginvolved.(Givesomeexamplesthatarecontroversialnow:ﾐ  
 ・ ﾐasbestosremoval,environmentalcleanups).ﾐ  
 ﾘｸ  
 ﾐﾌ・4潼ostofthetaxrulesinthischapter(excepttherealizationprincipleandtheﾐ  
 hH

ﾐcapitalgainandlossrules)canbededucedsimplyfromtheconceptofincome.It'sﾐ  
 0 ﾐintheCode,andthelanguageoftheCodeisimportant,butthereisalotoftaxlawﾐ  
 ・ﾘ ﾐyoucanlearnjustbyunderstandingbasicprinciplesтthebasic"structure"ofanﾐ  
 ﾀ ﾐincometax.ﾐ  
 ・h ﾐﾌﾓﾓ