Tax – Professor Faulhaber – Fall 2011

<u>Introduction</u>

I. Introduction
   a. Taxation is the process by which a government transfers resources (a.k.a. money) from the private to the public sector
      i. Individuals often resist sacrificing their private wealth to the public fisc, but the citizenry at large demands that government provide goods and services – all of which ultimately must be financed through taxation
   b. In deciding whom to tax, what to tax, and when, Congress routinely makes fundamental social and economic judgments
   c. The Internal Revenue Code of 1986 imposes all federal internal revenue taxes

II. Overview of the Tax System
   a. Federal Income Tax
      i. Accounts for 51% of federal revenue
         1. Corporate income tax = 9%
         2. Individual income tax = 42%
   b. Federal Excise Taxes
      i. Often based on the quantity of something
      ii. Often routinely collected on a clearly defined product from a small number of taxpayers (often manufacturers)
         1. Ex: pole (strip club) tax; tobacco; liquor
   c. Gift & Estate Tax (i.e., inheritance taxes)
      i. Estate taxes are applied when the estate is transferred *after* death (not when transferred to spouse or charitable organization)
         1. In 2001, the exemption was $675K and the maximum rate was 55%
            a. (lower exemption, higher rate)
         2. In 2009, the exemption was $1M and the maximum rate was 55%
         3. In 2010, NO estate tax due to a sunset provision (but we got rid of the stepped up basis to recap revenue)
         4. In 2011, the estate tax does not apply if the estate is under $5M
            a. After $5M, the rate is 18% - 35%
            b. (much higher exemption, lower rate)
      ii. Gift tax taxes the donor on the gift she makes
   d. Payroll Tax
      i. Accounts for 40% of federal revenue
      ii. Includes Social Security and Medicare taxes
         1. Social Security – employer and employee each pay 6.2% on the first $106K of earned income
            a. So if you make more than $106K, your payroll tax rate overall ends up being lower because you are only paying taxes on up to $106K of income
            b. This year ONLY the employees' rate is 4.2%
         2. Medicare – employer and employee each pay 1.45% on <u>all</u> earned income
      iii. Even though payroll taxes appear to be split evenly between the employer and employee, the employee is actually paying some of the employer's share
         1. This is because we are capitalizing the cost of taxes into wages – so wages go down slightly because the employer has to pay these taxes
      iv. Payroll taxes are only for *earned* income
   e. State & Local Taxes
      i. Sales Tax – collected by vendors at the point of sale
         1. Can learn what a certain state does not think should be taxed
            a. Ex: Massachusetts exempts food, utilities, clothing up to $175, and American flags from sales tax

ii. Income Tax
    1. Massachusetts is the only state that allows rent deduction because of the number of students
iii. Property Tax – tied to the value of the property you own
    1. Often fills in the gap when there is not enough revenue from other sources
    2. Benefits of property taxes are more salient to the local level
    3. State rely more heavily on property taxes when there is NO income and/or sales tax
        a. Ex: New Hampshire has higher property taxes because there is no income or sales tax
    4. Property taxes are harder to avoid
        a. May be able to do so by renting or selling property
iv. Main Source of Revenue
    1. State level – sales tax and income tax
    2. Local level – property tax (primarily imposed on real property and business inventory and equipment)

III. **Tax = Base** (what is actually taxed) **X rate**
  a. Rate is easy to figure out
    i. Currently, the top marginal rate is 35%
      1. 35% rate starts applying at $379,150
        a. Hypo: If A makes $400K, the 35% rate is only applied to the last $20,850 of income
  b. What counts as the base is harder to figure out
    i. If there is nothing in the base, then there are no taxes
  c. Progressive Income Tax → as your income goes up, your tax rate increases
  d. Regressive Income Tax → flat taxes are usually considered regressive because they do not increase as income increases

IV. Taxes in the U.S. are lower as a percentage of GDP than in many other countries
  a. But other countries' spending patterns are also different (esp. with regard to health and education, where the government's share of spending is much higher than in the U.S.)
  b. The U.S. relies more heavily on income and payroll taxes than do others, many of whom use consumption taxes (such as a value added tax) more extensively

V. The composition of the tax base reflects important policy decisions
  a. In general, excise and payroll taxes are usually earmarked to fund specific expenditures
  b. General revenue needs are more likely to be funded by income or consumption taxes

VI. Things to Think About
  a. Every debate about taxation inherently involves a policy debate
    i. There is no normatively neutral way to determine how to tax
  b. Taxation has 2 sides: (1) raising revenue, and (2) spending revenue (i.e., what is the revenue used for)
  c. Taxes have distributional (i.e., who are they giving back to) and behavioral effects
    i. Behavioral effects include changing or incentivizing behavior
      1. Ex: charitable deductions and home mortgage deductions
    ii. Think about whether the provisions are actually achieving these effects
      1. Ex: a cigarette tax could encourage a taxpayer to spend less on groceries than on cigarettes (the opposite effect the tax wanted)
  d. Summary:
    i. Taxes define the relationship of the individual to the state
    ii. In other countries, tax is not used to achieve policy goals the way it is in the U.S.
      1. Examples:
        a. Welfare – EITC drastically increased when welfare ended in the 1990s
        b. Healthcare – the main way we support healthcare is by exempting employer provided insurance from income
          i. Healthcare is tied to your employment because health insurance is supported in the Code

c. Retirement – we do not have a national pension, but we do have Social Security and tax preferred savings accounts (IRAs, e.g.)
d. Definition of Family/Marriage – dependents are explicitly defined in the Code and certain marriages are favored (i.e., equal earners are disfavored, while unequal earners are given certain subsidies)

VII. Themes
- a. Comparative Institutional Analysis
    - i. Why is this in the Code? Why is the Treasury Department dealing with this issue?
    - ii. Are there other institutions that could be dealing with this issue better?
- b. Statutory Interpretation
    - i. The Code is fairly unique because there are so many institutions involved – IRS, legislative staff, Treasury, etc.
    - ii. The Code as a whole is made up by different people and institutions with different interests at different times
        1. Therefore, some sections of the Code are contradictory or inconsistent
- c. Overarching Principles
    - i. Taxing income
    - ii. Progressive rates
    - iii. Favoritism for Christmas tree farmers and flight attendants
    - iv. Provisions that target specific individuals
- d. Ethics and Professional Responsibility
    - i. Tax lawyers have to figure out who they represent
    - ii. Cannot cross the line from helping clients to committing tax fraud

VIII. Tax Terminology
- a. Income Tax = Taxable Income X Tax Rate
    - i. Taxable Income = Gross Income – Deductions
        1. Gross Income = "all income from whatever source derived"
- b. Gain (generally) = the excess of the price at which the taxpayer sold the property over the price at which she purchased the property
    - i. Basis = the portion of the sales proceeds that the taxpayer may recover without incurring tax liability
    - ii. Adjusted Basis = typically the purchase price adjusted upward or downward to reflect subsequent expenditures or tax benefits attributable to the asset
        1. Capital contributions go INTO the A/B
        2. Depreciation deductions come OUT of the A/B
- c. Standard Deduction = a flat amount specified by the Code that varies with marital status, which the taxpayer may deduct regardless of actual expenses
- d. Itemized Deductions = all allowable deductions other than the deductions allowable in arriving at AGI and the personal exemptions
- e. Rates:
    - i. Average Rate = applicable to the taxable income as a whole
    - ii. Marginal Rate = applicable to the last dollar of taxable income
- f. Credit = a direct reduction in tax in the amount of the allowable credit
- g. Deduction = a reduction in taxable income that, in turn, reduces tax liability by the amount of the allowable deduction multiplied by the taxpayer's marginal rate

IX. 1040 Form
- a. Boxes 7-22 → figuring out what counts as gross income
- b. Boxes 23-25 → says AGI, but means "what we take out in order to calculate gross income"
    - i. We use ATL deductions to figure out how much you are actually able to pay
        1. Ex: you may need to spend a certain amount of money just to make your salary, so expenses paid in order to earn gross income are taken out as an ATL deduction
- c. Boxes 33-34 → student loan interest deduction

        i. VERY limited provisions
    d. Line 38 → AGI is finally calculated
    e. Below → BTL deductions
        i. Two Types (either/or):
            1. Standard Deduction: $5,800/single or $11,600/married for 2011
            2. Itemized Deductions: take if they are greater than the standard deduction
                a. Ex: state taxes deduction, home mortgage interest deduction, charitable deduction
                b. Many are meant to create behavioral incentives, BUT these only exist for the people that can take the itemized deduction
    f. Boxes 47-53 & 61-70 → Credits – apply after tentative tax liability is calculated
        i. Two Types:
            1. Refundable
            2. Nonrefundable

X. Credits are generally more valuable than deductions
    a. Value of the Deduction = Deduction X Tax Rate
        i. As your rate increases, the value of the deduction increases
            1. Ex: $2K deduction X 10% rate = $200
            2. Ex: $2K deduction X 20% rate = $400
        ii. Higher Income taxpayers have higher tax rates, so they benefit more from deductions
    b. The difference between refundable and nonrefundable credits only matters if the credit will drop your tax liability below $0
        i. Nonrefundable credits can only be taken to the extent that you have tax liability

XI. Tax Rate
    a. Marginal Rate – the rate that applies to the last dollar of income that you earn
        i. In a progressive system, marginal rates have to be greater than or equal to the average rate
    b. Average Rate – weighted average
        i. To figure out, take the total tax due (by using the marginal rates, like normal) over taxable income
    c. Every year the brackets go up slightly, taking into account the cost of living
    d. Marginal and average rates are the same when you (i) are in the zero bracket, (ii) are in the lowest bracket, or (iii) have tons of income . . . the two extremes

XII. Administration of the Tax System
    a. Organization
        i. IRS – the agency charged with collecting internal taxes
        ii. Commissioner of Internal Revenue – IRS' principal officer, who is nominated by the President and confirmed by the Senate
    b. Treasury Regulations
        i. Administrative interpretation of the Code
        ii. Get *Chevron* deference
        iii. They end up explaining much of the Code
            1. Always check to see if there is a Reg explaining a Code section
    c. Revenue Rulings / Revenue Procedures
        i. Guidance from the IRS (not from the Treasury)
            1. The Commissioner's "official interpretation of the law"
        ii. Binding on the IRS
        iii. Do not get deference in court like Regs do
    d. Private Letter Rulings
        i. Relate only to your specific situation
            1. Have to pay to get one (~$10K)
        ii. May not even be binding on the IRS
            1. Almost always binding on your situation

        2. Can often be binding on other similar situations
    e. How do Cases get into Court?
        i. U.S. has a self-assessment system where taxpayers make the initial determination of their tax liability
            1. Final payment of tax for the year is required with the return, but in most cases, the bulk of the tax liability has already been collected by the IRS through withholding or estimated tax payments
        ii. Criteria for audits are not revealed, but the IRS focuses the bulk of its audit efforts on returns that are likely to produce significant amounts of revenue
            1. Thus the IRS audits a higher percentage of returns of individuals with high incomes
        iii. 1.1% audit rate (so 99% of individuals just file their return with nothing else happening)
            1. If you are audited, you get a 30-day letter to contact the appeals office
            2. If you fail to contact the appeals office or do not resolve the disagreement with them, you get a 90-day letter in which time you must petition the Tax Court
        iv. If you have a deficiency, you have two options:
            1. PAY your taxes/deficiency
                a. Can then go before the U.S. Court of Federal Claims or the U.S. District Court where you are a legal resident
                    i. If "United States" is a party, case started in the District Court
                    ii. Note: May want to pay the deficiency and have the District Court as a forum because they are more likely to hear your case, can forum shop (in the sense that you may want to set a precedent for possible future-repeat problems)
            2. NOT PAY your taxes/deficiency
                a. Can then go before the Bankruptcy Court (if you have other reasons to be there) or the Tax Court (normally where you end up)
                    i. If "Commissioner" is a party, case started in the Tax Court

XIII. Present Value
    a. Idea: A dollar today is worth more than a dollar tomorrow, so you want to hold onto your money as long as possible
        i. Therefore, taxpayers want to wait as long as possible to pay any taxes
    b. Present Value = the amount that one would have to invest TODAY at a specified interest rate in order to have a specified amount AT A SPECIFIED FUTURE DATE
        i. This amount is calculated by discounting the future payment by the rate of return available to the investor over the relevant period
            1. PV = future payment / $(1 + \text{rate of return})^{\text{number of years of deferral}}$
    c. Hypo: Someone offers A $100 today – or – $125 in 2 years, and the interest rate/rate of return is 10%
        i. Future Value of $100 = PV X $(1 + \text{rate of return})^{\text{number of years of deferral}}$
            1. $\$100(1.10)^2 = \$121$
                a. Result: wait for 2 years and take the $125
        ii. Reverse – Future Value is $125
            1. PV = $\$125/(1.10)^2 = \$103.31$
    d. Summary:
        i. We want to accelerate losses because it reduces income now
        ii. We want to push gains to later because we want to keep future value now
        iii. We do not want to pay taxes now if we can push them out 10 years

XIV. Tax Expenditures
    a. Tax Expenditures = revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, preferential tax rate, or a deferral of tax liability
        i. Essentially, it is foregone revenue – money that the government otherwise would have raised

            1. So if something is not counted as taxable income – when it would be income under the H-S or another definition of income – essentially we have created a tax expenditure
      ii. Tax expenditures are to be defined with reference to a normal income tax structure
            1. A provision traditionally has been listed as a tax expenditure if there is a reasonable basis for doing so and the provision results in more than a de minimis revenue loss, which here is a loss of at least $50M over the five fiscal years 2007-2011
      iii. Tax Expenditure Estimates:
            1. Each tax expenditure is estimated separately, under the assumption that all other tax expenditures remain in the Code
            2. Taxpayer behavior is assumed to remain unchanged for tax expenditure estimate purposes
      iv. Remember: Tax expenditures only provide benefits to those paying taxes (unless it is a refundable credit)
b. Two types of government spending:
      i. Direct spending (requires money from some pot of government revenue)
            1. Ex: defense, agencies, state universities, food stamps, section 8 housing
      ii. Tax expenditures (i.e., spending that is taking place by way of forgone revenue)
            1. Ex: home mortgage interest deduction, health care exemption, IRAs, capital gains treatment
c. If a tax expenditure provision were eliminated, Congress might choose to continue financial assistance through other means
d. Almost everything in direct spending can be structured as a tax expenditure
      i. Can increase taxes and therefore revenue and then redistribute through direct spending, *or*
      ii. Can provide preferential breaks in the Code so certain types of people do not have to spend the money
e. A lot of spending can be either direct or a tax expenditure
      i. Sometimes it is easier to have something hidden as a tax expenditure (i.e., tax cut)
      ii. There could be political reasons to choose one over the other
            1. Tax expenditures kind of fit in both spending and tax cuts
                  a. But people respond differently to tax expenditures than they do to tax cuts or spending increases
      iii. Some things we've had for so long one way that it has become the norm

. . . so economically they are similar, but politically they can be presented very differently

f. Stanley Surrey = the originator of the tax expenditure concept
      i. One of his objections to tax expenditures was the way they provided a larger tax benefit to those in higher brackets (i.e., upside-down subsidies)
            1. Because the benefit goes up as your tax rate goes up, the government is forgoing more revenue for the people at the top of the income scale
                        i. "Upside-down" because the way a deduction or exclusion is distributed (i.e. favoring the top), is often the opposite way you'd want/expect it to be distributed
      ii. He argued that once people saw how hidden spending was in the Code (via tax expenditures that favor high income taxpayers), they would shift that spending outside of the Code to direct spending
            1. If we care about something (housing, e.g.), he felt it should be in direct spending
                  a. Because if we were to shape something as a direct expenditure, there are very few situations in which the government would be giving something of a higher value to people at the top of the income scale and a lower value to those at the bottom of the income scale
            2. Institutional Competency – Should the IRS/Treasury really be the ones making housing and welfare decisions?
                  a. By hiding these things in the Code, we are giving them this power

XV. Tax Policy Considerations
  a. Equity/Fairness
    i. Ask:
      1. Who is paying what?
      2. Who should be paying the most?
      3. Should everyone be paying according to their ability to be paid?
      4. Who is being hurt?
      5. Who is being helped?
    ii. Vertical Equity – people who make different amounts of income should pay different amounts of taxes
      1. Idea: If I make more money, I should pay more in taxes
    iii. Horizontal Equity – people who make the same amount of income should be paying the same amount of taxes
      1. Note: Consider when different types of income are taxed differently
        a. Earned income is subject to payroll taxes
        b. Investment income is not subject to payroll taxes

        … but these could be the same amounts, and therefore the different tax liability violates horizontal equity
  b. Efficiency
    i. Distortions – does the tax provision create distortions that would not be there in the absence of the tax provision
    ii. Efficiency is being able to do what you want to do without any distortion
    iii. Ideally, an efficient tax system interferes as little as possible with behavior that would have happened before taxes
      1. In theory, though, this is impossible because all taxes create inefficiencies/tax distortions
        a. Tax incentives are consciously inefficient because they are *trying* to create distortions
          i. Sometimes equity and efficiency point in opposite directions
    iv. Ask:
      1. How have the taxes changed behaviors?
      2. Are the taxes creating distortions that were not there before?
      3. If this is creating a distortion, is it a good or a bad thing?
        a. Is there a benefit to having this inefficiency?
  c. Complexity/Administrability
    i. The Code is inherently complex
    ii. Ask:
      1. Is the Code unnecessarily complex?
      2. Does the Code add complexity that should not be there?
      3. What types of complexity is it creating?
      4. What types of problems come along with complexity?

. . . ideally a tax provision or tax system fulfills all three, but often there is a tradeoff

<u>What is Income</u>

I. Definitions of Income
  a. Haig-Simons' Definition → Income = Consumption + Change in Savings
    i. Haig: "Income is the money value of the net accretion to one's economic power between two points of time"
      1. "Accretion to net worth" suggests an increase in your ability to pay
    ii. Simons: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercises 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"

        iii. H-S definition does not always map perfectly onto the concept of income that the tax system uses
        iv. H-S definition tells us about the *uses* of income, rather than the *sources* of income
    b. The selection of income as the base implies that income should provide a measure of an individual's ability to pay tax and any definition should serve to further that purpose
        i. Generally we think that the H-S definition does a fairly good job at calculating ability to pay
    c. **§ 61(a): Gross Income Defined**: [A]ll income from whatever source derived, including (but not limited to):
        i. § 61(a)(1) – Compensation for services, including fees, commissions, fringe benefits, and similar items
        ii. § 61(a)(2) – Gross income derived from business
        iii. § 61(a)(3) – Gains derived from dealings in property
        iv. § 61(a)(4) – Interest
        v. § 61(a)(5) – Rents
        vi. § 61(a)(6) – Royalties
        vii. § 61(a)(7) – Dividends
        viii. § 61(a)(8) – Alimony and separate maintenance payments
        ix. § 61(a)(9) – Annuities
        x. § 61(a)(10) – Income from life insurance and endowment contracts
        xi. § 61(a)(11) – Pensions
        xii. § 61(a)(12) – Income from discharge of indebtedness
        xiii. § 61(a)(13) – Distributive share of partnership gross income
        xiv. § 61(a)(14) – Income in respect of a decedent
        xv. § 61(a)(15) – Income from an interest in an estate or trust
    d. The broader you make the definition of income, the more you are able to tax
    e. Ex: *Commissioner v. Glenshaw Glass Co.* (U.S. 1955): "Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. Here we have instances of *undeniable accessions to wealth*, *clearly realized*, and over which the taxpayers have *complete dominion*."

II. Compensation for Services [§ 61(a)(1)]
    a. Income does not need to come from an employer
        i. Ex: tips, legal and medical fees, and jury fees are all compensation for services includable in gross income
    b. Income does not have to be cash
        i. Ex: compensation would include stock, notes, property transferred for services, someone paying your taxes, someone paying your child's tuition
    c. Payment must be compensatory in nature (circular)
        i. Focus is the intent – the purpose of actually making the payment
        ii. So not all payments to employees are compensation
    d. Ex: *Old Colony Trust Co. v. Commissioner* (U.S. 1929): the marginal tax rate was really high during this time, so the taxpayer had an incentive to either shield income or figure out a way to not pay taxes; here, the employer paid employee's (president of the company) income taxes; taxpayer argued that this is not compensation because it was never paid to him, but rather went straight to the IRS, and he did not get anything in return, but rather he just did not have to pay his taxes; court rejects the idea that this was a gift because it was compensation for services
        i. Court: The payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor
            1. Payment was compensatory in nature
                a. Employer paid because of the employee's work for them
            2. This result comports with the H-S definition of income because the employer's payment of taxes amounts to a change in savings for the employee
        ii. "Tax on a Tax" Issue → Solution is "Grossing Up"
            1. Take the net income that you want and gross up the salary so what is paid to you on paper is before taxes

            a. Formula: (1 – t) x Gross Income = Net Income
        2. Grossing up is common nowadays
            a. If there is a payment of a tax, it needs to be grossed up
    iii. Tax-Inclusive Base
        1. Federal income tax base is tax inclusive (i.e., the amount of tax is included in the amount of taxable income to which rates are applied)
            a. Ex: A has $1K in income and tax rate is 50%; A pays $500 from the $1K base and keeps the remaining $500K
        2. If federal taxes were deductible (which they are not - § 275), the income tax would be imposed on a "tax-exclusive" basis
            a. Sales tax is a tax exclusive base
                i. Ex: A has a product worth $1K and sales tax is 50%; A pays $500 in sales tax on top of the $1K

e. Stacking Income
    i. Three options:
        1. Stack the bottom half: paying taxes on only company income
            a. Results in the company paying the lowest marginal rate
        2. Stack the middle half: paying a proportion of the employee's total tax equal to the ratio of the company salary to his total income
        3. Stack the top half: paying the difference between the employee's total tax and the tax on his non-company income (*Old Colony*, e.g.)
            a. Results in the company paying the highest marginal rate

f. Winning and Taxes
    i. Ex: Oprah gave away cars that were worth $30K; did not realize this would be taxable to the audience members; decided she would pay the taxes for them – must be gross up
    ii. Ex: Jordan's Furniture gave away free furniture when the Red Sox won the World Series; IRS determined that the refunds were a purchase price reduction/discount/rebate; this is an extreme example of a complete discount
        1. Discounts and rebates are sometimes seen as income – and – sometimes just seen as lower prices

g. Imputed Income → the benefits derived from labor on one's own behalf or from one's own ownership of property (i.e., income that you did not have to earn because you performed a service or provided a good yourself)
    i. Economists generally regard imputed income as income that should be taxed
        1. If you were not a farmer and could not eat food you grow, you would have to buy food and to do this you'd have to earn income, which would be taxable
    ii. Code does <u>not</u> tax imputed income
        1. This creates inequities and inefficiencies, but the practical difficulties in subjecting imputed income to tax make taxation unlikely
            a. Violation of horizontal equity → A works overtime and earns $10, which he uses to pay a dog walker; B leaves work on time and walks her own dog; A and B are in the same economic situation, but A will pay tax on $10 more income than B
            b. Violation of vertical equity → Couple AB – each make $50K, spend $30K on childcare; Couple CD – C makes $100K, D stays home so they spend $0 on childcare; BOTH are taxed on the $100K in income, but AB only has $70K in the bank and CD has $100K
                i. If income was imputed, we would impute $30K of income to D for providing childcare
                ii. We could do the reverse of imputing income and instead not tax the cost of providing childcare to AB – but we don't do this

c. Exclusion of imputed income also produces inefficiencies by causing taxpayers to make economic choices different from those that they would have made in a no-tax world
    i. Ex: some women stay at home rather than enter the workforce
d. Administering a tax on imputed income would be too complex
    i. Conceptual difficulties – privacy concerns, who would monitor?
    ii. Valuation and recordkeeping problems

iii. Courts have been somewhat inconsistent in their treatment of imputed income
    1. Compare: *Morris v. Commissioner* (B.T.A. 1928): the value of farm products consumed by the owners of the farm is not income
        a. With: *Dicenso v. Commissioner* (B.T.A. 1928): the owner of a grocery store must include in income groceries used for home consumption
    2. Sometimes if you sell to yourself (a life insurance policy, e.g.) you have imputed income, and sometimes not

iv. The most significant form of imputed income from property is the imputed rental value of owner-occupied homes
    1. For a while, Britain taxed such income

v. Imputed Income is an example of how we do not have a normatively neutral tax system

III. Gifts

a. **§ 102(a): Gifts and Inheritances**: Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance
    i. What counts as a "gift" can be hard

b. H-S Definition vs. Code
    i. H-S Definition: Donor deducts the cost of the gift from income; Donee includes the cost of the gift in income
    ii. Code: Donor does not deduct the cost of the gift; Donee does not include the cost of the gift
    iii. This is a situation where the H-S definition does not match what we have in the Code
        1. Could be a concern about income shifting (from a high bracket to a low bracket) – which would result in the government losing money
        2. Could be to encourage detached and disinterested giving (since the donor is actually treated worse by the Code's policy decision, but the donee is treated better)

c. Business Gifts – Employer-Employee Relationship
    i. Ex: *Commissioner v. Duberstein* (U.S. 1960): Berman gave Duberstein a Cadillac because Duberstein had been helpful in suggesting customers to Berman – no prior arrangement for compensation and Duberstein did not expect to be paid; Tax Court & SCOTUS (deferred to TC) held that this was income – the car was in a middle ground between compensation and detached and disinterested generosity; the car was either a recompense for past services or an inducement for future services
        1. Court: A gift proceeds from a detached and disinterested generosity, out of affection, respect, admiration, charity or like impulses
            a. This is a fact-intensive inquiry that looks to the donor's intent
                i. Note: Gifts between an employer-employee nowadays is <u>not</u> a fact intensive inquiry because there is no longer a concept of business gifts
        2. Dissent: Wanted a rebuttable presumption for employer-employee relationships that it was compensation
            a. But note that our rule now is much harsher – this presumption is nearly impossible to rebut now if there is an employer-employee relationship
    ii. In *Duberstein*, SCOTUS punted the "business gift" issue to Congress for reasons of institutional competency
        1. Congress was forced to clarify the issue and added §§ 274(b) and 102(c) – and the result is that "business" gifts essentially do not exist anymore

            a. **§ 274(b)**: No deduction shall be allowed under § 162 or § 212 for any expense for gifts if such expense exceeds $25
                i. Essentially, the payor cannot take a deduction on business gifts
            b. **§ 102(c)**: Gifts are income if they are from an employer to an employee
        2. Note: Even with §§ 274(b) and 102(c), it is not clear that the Cadillac would clearly be compensation because Duberstein was not an employee of Berman's
    iii. Summary: Business gifts between employer-employee are almost always income – not gifts
        1. Even if you are really good friends with your employer, almost everything between employer-employee will be treated as compensation
d. Business Gifts – No Employer-Employee Relationship
    i. When there is not an employer-employee relationship, the inquiry is much more fact intensive – really need to question what the compensation is for and what the intent is
        1. Ex: *United States v. Harris*: two young women each received $500K over a period of years from an elderly man; girls argued the money was a gift; government argued the money was; donor passed away so could not figure out intent
        2. Ex: *Milton Peebles*: Peebles wife had an affair with her doctor; when confronted with evidence of the affair, the doctor paid Peebles $25K; Peebles treated it as a gift, but Tax Court found it unlikely that the doctor was making a gift out of detached and disinterested generosity
        3. Ex: *Yang v. Commissioner*: taxpayer received $10,500 from her boyfriend – he claimed it was income to her and deducted it as a business deduction; Tax Court – not wanting to get involved in what this money was for – decided this was a gift
e. Bequests
    i. General Rule: Bequests ≠ Income
        1. Ex: *Wolder v. Commissioner* (2d Cir. 1974): bequests that are a form of compensation for services are includable in income
        2. Ex: *United States v. Merriam* (U.S. 1923): a bequest made to an executor in lieu of compensation was excludable from income
f. Family Support
    i. Family support, like intrafamily gifts, is <u>not</u> included in income (no specific statutory authority for this rule though – just how the IRS treats it)
        1. Why? Administrability concerns & social contract/obligation notion (i.e., if parents don't pay, society will have to)
        2. Equity concerns: one student could have to pay tuition with after tax dollars from a job, while another student can have her family pay for tuition
g. Governmental Support
    i. Generally income from most government benefits and other welfare payments is not included in income
        1. Notion that the government does not want people paying taxes from the money that the government just gave them
        2. But, it is clear that Congress can choose to tax such benefits if it wants
            a. Institutional competency – the IRS is happy to let Congress make social welfare tax decisions, but the IRS does not always want to
            b. Ex: § 85, which includes unemployment compensation in income

IV. Prizes and Awards
a. **§ 74(a): Prizes and Awards**: Gross income <u>includes</u> amounts received as prizes and awards (except as otherwise provided in this § or § 117)
b. **§ 74(b)**: Gross income does <u>not</u> include amounts received as prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement, but only if –
    i. (1) the recipient was selected without any action on his part to enter the contest or proceeding;

ii. (2) the recipient is not required to render substantial future services as a condition to receiving the prize or award (i.e., this is not compensation); and

iii. (3) the prize or award is transferred by the payor to a governmental unit or organization described in § 170(c) pursuant to a designation made by the recipient

1. This is really the only requirement!!

c. **§ 74(c)**: Gross income shall not include the value of certain employee achievement awards – those of tangible personal property for length of service or safety achievements – if the employer's cost does not exceed limits defined in § 274(j) – generally $400

i. If the cost to the employer exceeds the amount allowed, then the employee must include in income the greater of –

1. the excess of the employer's cost over the limitation (but not in excess of the FMV), *or*

2. the excess of the award's FMV over the maximum allowable employer deduction

d. IRS will tax "windfalls" – because you are better off, you will have more ability to pay

i. The value includable in income is the FMV – not the value of the car to you

ii. If you do not actually have any money to pay for the taxes on a prize or award – like a car – then you have to sell the car to pay for the taxes owed

e. Concerns:

i. Valuation – can we accurately value the prize or award?

ii. Liquidity – do you actually have more ability to pay?

f. Ex: Nobel Prize cash prize and gold medal (worth $ if you melt the gold) = income under § 74

i. According to the five American Nobel Laureates in science, who wrote a letter to President Clinton, by taxing the prize, the United States is devaluing it

ii. No liquidity concerns because you can pay the taxes with the cash prize (i.e., do not have to melt the gold medal to pay)

iii. Might have a valuation concern if we do not think that the medal is worth its weight in gold – either because it is more expensive due to what it actually is or less expensive because we question its accuracy or think it was stolen, e.g.

1. Nobel Committee could do what the Oscar Committee does: Oscars are not income because they cannot be sold – if they are, ownership automatically reverts back to the Academy – so there is no FMV

V. Scholarships

a. **§ 117(a): Qualified Scholarships**: Gross income does not include any amount received as a qualified scholarship

i. "Qualified Scholarship" → for "qualified tuition and related expenses" → meaning tuition, fees, books, supplies, and equipment

1. "Related Expenses" ≠ room and board = includable in income

ii. Scholarships are treated more like gifts than prizes and awards because scholarships are generally more limited in the sense that they are not just straight cash that you can do whatever you want with

b. **§ 117(c)**: Any portion of a "scholarship" received for teaching, research, or other services required as a condition for receiving the scholarship is not excludable

i. If services are required then the scholarship is more like a quid pro quo and becomes more like compensation

ii. Ex: Rev. Ruling 77-263: Athletic scholarships are excludable if the scholarships (1) do not require the student to participate in a particular sport, (2) requires no particular activity in lieu of participation, and (3) does not cancel if the student cannot participate

c. SUMMARY: Scholarships ≠ Income, *unless* they are used for unqualified expenses – or – there is is a quid pro quo requirement

VI. Fringe Benefits

a. Fringe benefits are in-kind (i.e., non-cash) compensation

i. Could be income – because they are additional, hidden compensation

    ii. Could <u>not be</u> income – because they are essential to the performance of the employee's job (i.e., required by the employer)

    . . . most fringe benefits fall somewhere in between → they are transferred because the employee has performed services for the employer and thus have a compensatory element, but they also are often for the benefit of the employer

        1. Many fringe benefits are <u>not</u> subject to the income tax under current law – not because they are not income, but because Congress has chosen to treat them specially

b. Why offer fringe benefits?
    i. Could be a way for employers to offer compensation and eliminate some tax consequences for the employee
        1. Employers get to pay less to the employees because the employees would prefer to have non-taxable benefits than taxable income because at the end of the day they have a higher value
            a. While it is true that there is a distortion in favor of non-taxable in-kind compensation, people might not *always* choose over cash compensation
c. Concerns:
    i. Equity
        1. Horizontal: Two taxpayers could be in the same economic situation but be taxed differently
        2. Untaxed benefits are more valuable and often have been more available to employees in higher tax brackets
        3. Untaxed fringe benefits may be disproportionately available depending on industry and occupation
    ii. Efficiency
        1. Failure to tax benefits induces employees to offer, and employees to select, wage and benefit packages very different from those that they would obtain without the tax benefit
        2. If we did not tax any in-kind fringe benefits, we'd end up in an under-the-table bartering society where people would work for food, e.g.
    iii. Administrability
        1. Inherent difficulty in distinguishing in-kind compensation from goods or services related to an employee's work that also provide the employee incidental economic benefits
d. H-S definition of income does not care what form the compensation takes – cash or in-kind – therefore, in-kind compensation is still considered income under H-S
    i. Think: Whether you pay for meals and lodging obviously affects consumption and change of savings in the H-S definition of income . . . but the Code may come out differently (and this could be true for a lot of fringe benefits)
e. Meals and Lodging
    i. Ex: *Benaglia v. Commissioner* (B.T.A. 1937) (pre–§119): meals and lodging provided by employer to employee (manager of 2 deluxe Hawaiian resorts) were <u>not</u> income because employee could not perform his job otherwise; the meals and lodging were not for employee's personal convenience, but rather for the convenience of the employer
        1. **In-kind compensation raises all kinds of valuation concerns** – we do not know whether the FMV really represents the value to the taxpayer, but we still use the FMV for tax purposes (versus figuring out the subjective value for each taxpayer)
            a. Could argue the FMV overestimates the value to him → it is not clear he would have spent this much money on meals and lodging had his employer not required him to live there
            b. Could argue the FMV underestimates the value to him → he lives at a resort hotel in Hawaii – that is pretty sweet

ii. **§ 119(a): Meals or Lodging Furnished for the Convenience of the Employer**: Employee can exclude from gross income the value of meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if –
    1. the meals are furnished on the business premises of the employer, or
    2. the employee is required to accept such lodging on the business premises of his employer as a condition of his employment

iii. Efficiency Concerns:
    1. Employees have an incentive to minimize their taxable income by claiming that their consumption is related to business and for the convenience of the employer
        a. Distortion to characterize things as business versus personal
    2. With a choice between two equal jobs – both with $50K in benefits, but one paying all $50K in cash and one paying $30K in cash and $20K for food and housing – tax consequences might cause you to choose one job over another because you will only be taxed on $30K in income on the second job
        a. Distortion of your preferences

iv. *Benaglia* and § 119 provide a certain subsidy to certain job sectors – those industries where there is an ability to provide meals and housing or require people to stay (hotels, apartment managers, e.g.)

v. § 119 does <u>not</u> apply to cash allowances (or stipends, coupons, vouchers, etc.)
    1. Ex: *Commissioner v. Kowalski* (U.S. 1977): SCOTUS held that cash payments (like a voucher; not an actual in-kind benefit like *Benaglia*) given to state troopers as meal allowances were income because they were undeniably accessions to wealth, clearly realized, and over which troopers had complete control
        a. § 119 covers actual meals furnished by the employer and <u>not</u> cash reimbursements for said meals
            i. Think: We all have to pay for our meals with after-tax income, so it does seem as if there is good reason to limit the § 119 exception in this manner

vi. Note: Even though there is much mention of "convenience of the employer", it is generally mentioned in conjunction with § 119 because § 119 is the law

vii. For examples of other cases to analogize to, see pgs 126-127

f. Business Travel

i. Goal of the Code → To tax overall net income, which is the gross income minus the cost of actually doing business/the cost of what was necessary to make the rest of your income

ii. Focus → Is there a dominant business purpose?

iii. Ex: *United States v. Gotcher* (5th Cir. 1968): Mr. and Mrs. Gotcher took an expense-paid trip to Germany to tour VW factories; argument here is that he was required to go on this trip for business and therefore the cost was necessary to make his income; court held that this <u>was not</u> income for Mr. G, but <u>was</u> income for Mrs. G because she lacked the necessary dominant business purpose
    1. Valuation Q: The trip was $690/each – was it really worth that to each of them?
        a. Could argue that no one wanted to go to Germany in 1959, or that if they did choose to go to Germany they would not have spent their time touring car factories
    2. Incentives: Link trips and vacations to business expenses as much as possible while still retaining a sufficient business purpose (think: industry conferences in fabulous places)
        a. This creates a subsidy for the tourist industry, which benefits from conferences and business trips
        b. This also favors high income taxpayers who are generally the ones able to go on these types of business trips

            i. Upside down subsidy = the value of an exclusion to you is based on your income, and being able to exclude the cost of a trip has a higher value to higher income taxpayers
      3. Relevant Section: § 132(a)(3) – working condition fringe
         a. If you do not know if something your employer is providing to you should be included in income, then figure out what would happen if you had to pay for it yourself
            i. If you can deduct it, then when the employer pays for it, you do not have to include it in income
               1. Deductible to the employee under § 162(a)
            ii. If you cannot deduct it, then when the employer pays for it, you do have to include it in income
         b. Cross-References § 162(a)
   iv. Spouse's Expenses
      1. **§ 274(m)(3)** provides that travel expenses are deductible for a spouse or dependent only if (i) the spouse is an employee of the taxpayer, (ii) there is a bona fide business purpose, **and** (iii) the expenses otherwise would have been deductible
      2. If expenses are not deductible from income, they are included in the income of the employee (not the spouse), but married couples are one single taxable unit, so turns out not to matter all that much
      3. Reg. § 1.132-5(t): Even if the employer cannot deduct the spouse's expenses, the employee can exclude the reimbursement so long as the spouse's presence had a bona fide business purpose
         a. Example of "surrogate taxation"
g. **§ 132(a)**: Gross income shall <u>not</u> include any fringe benefits which qualifies as a
   i. (1) no-additional-cost service
      1. See Reg. § 1.132-2(a)(2): defines "excess capacity services" as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone service
      2. See § 132(j): Nondiscrimination Clause – this fringe benefit cannot only be given to highly compensated individuals
         a. Note that this applies to § 132(a)(1) and (2) ONLY
   ii. (2) qualified employee discount
      1. Qualified if the employee discount does not exceed the gross profit percentage of the price at which the *property* is being offered to customers
         a. See Reg. § 1.132-3 to know what profit margin to apply
      2. Qualified if the employee discount does not exceed 20% of the price at which the *services* are being offered to customers
         a. Code sets a specific percentage because it is harder to pin down the costs and profit margins for the service industries
            i. It is harder to value services – FMV is what the person is charging, presumably, but what is the "wholesale" value of a service?
      3. NO qualified employee discounts on real property
      4. See § 132(j): Nondiscrimination Clause – this fringe benefit cannot only be given to highly compensated individuals
   iii. (3) working condition fringe
      1. Catch-all provision that cross-references §§ 162 and 167
      2. See Reg. § 1.132-5(m) [employer-provided transportation for security concerns] and (n) [product testing]
   iv. (4) de minimis fringe
      1. De minimis: typing of a personal letter by a company secretary, occasionally personal use of the company copy machine, occasional company cocktail parties or

picnics, occasional supper money or tax fare because of overtime, and certain holiday gifts of property with a low FMV

2. Not de minimis: season tickets, regular use of a car for commuting, membership in a country club, life insurance for a spouse or child, weekend use of an employer owned facility (Cape house, e.g.)

v. (5) qualified transportation fringe
   1. Transit passes must not exceed $100/mo.
   2. Parking must not exceed $175/mo.
   3. Bicycle commuting reimbursement is added to incentivize

vi. (6) qualified moving expense reimbursement

vii. (7) qualified retirement planning services

viii. (8) qualified military base realignment and closure fringe

. . . Reg. § 1.132-1(b) defines "employee" for each of these – generally employees, spouses, and dependents

   1. BUT, Reg. § 1.132-1(b)(1) defines "employee" to include parents for purposes of no-additional-cost air transportation

h. Employer-Provided Health Insurance

   i. A fringe benefit – and – one of the biggest tax expenditures in the Code
      1. Employer-provided health insurance constitutes income in the economic sense, but is statutorily excluded from income in the Code as a result of a policy decision
         a. This creates a subsidy for the health insurance industry and for healthcare as a whole
            i. If we do not subsidize and encourage health insurance (compared to other types of salary), we might end up with a society where people spend their salary on things we think less important
         b. § 106 creates a distortion because I may shift my job preferences based on whether my employer contributes to my health insurance or whether I am paying for it entirely (but maybe making more to compensate)
            i. Equity issue too – if two people take home the same amount at the end of the day but the employer is paying for insurance in one situation and the employee (who is making more) pays for it herself in another
         c. Note: Employer-provided health insurance is generally available to full-time employees in larger institutions – generally <u>not</u> offered to employees that are self-employed, part-time, in smaller business, or unemployed
            i. See § 213 discussion for those *not* offered employer-provided healthcare
            ii. And this does shift some people away from being self-employed
         d. Consider: Health insurance is not clearly tied to employment, so this illustrates the policy decision made here
            i. It is not clear that your employer and your health insurance should determine one another

   ii. Cambridge's Same-Sex Stipend
      1. Employer-provided healthcare covers employees, spouses, and dependents
         a. "Spouse" is defined in §3 of DOMA as a person of the opposite sex who is a husband or wife – and this applies to the Code
            i. Because people in opposite-sex marriages are not taxed on the value of health insurance for their spouse, DOMA affects how much people pay (or don't pay) in taxes
               1. In same-sex marriages, you will be taxed on the value of your spouse's health insurance

        2. To make opposite- and same-sex couples equal re: taxes and health insurance, Cambridge is giving stipends to same-sex married public employees to defray the costs of the discriminatory federal tax
            a. Cambridge is essentially grossing up, and then fundamentally paying this money to the federal government based on a policy decision to make the two couples equal
    iii. **§ 106(a): Contributions by Employer to Plan**: Gross income of an employee does <u>not</u> include employer-provided coverage under an accident or health plan
        1. This applies only when the employer pays the health insurance premiums
    iv. **§ 105: Amounts Received under Plan** – applies when the employer is providing health insurance & to the money the health insurance industry pays out to you
        1. § 105(a): Amounts received by an employee through accident or health insurance are included in gross income if they are attributable to contributions by the employer which were not included in the gross income of the employee – or – are paid by the employer
        2. § 105(b): IGNORE § 105(a) if the amounts received are reimbursements for healthcare
    v. **§ 104(a): Compensation for Injuries or Sickness** – applies to the money the health insurance industry pays out to you
    vi. **§ 213** allows deductions for medical and dental expenses paid during the taxable year for the taxpayer, her spouse and dependents
        1. Medical expenses are deductible only if they are not compensated by insurance or reimbursed by employers
        2. BTL deduction – so it only applies to people who have medical expenses that are greater than the standard deduction (when combined with their other itemized deductions)
            a. Can only deduct under § 213 if the medical expenses exceed 7.5% of AGI
                i. At the end of 2012, this will become a 10% floor (but won't apply to people 65 yrs or older for the first three years)
                ii. The floor is intended to disallow deduction for normal medical expenses such as annual physical and dental check-ups and supplies for the medicine cabinet
            b. Remember: <u>People who itemize deductions are those that know how to do so – there is a knowledge threshold and this might raise equity concerns</u>
        3. KEY: We look to § 213 to show how much we favor health insurance provided by an employer (i.e., exclusion from GI vs. deduction from AGI)
    vii. Concerns:
        1. Institutional Competence – Do we think the IRS should be determining what counts as healthcare or a deductible healthcare cost? Are there better institutions to do so?
        2. Equity – Why are large corporations' employees not taxed on healthcare but the self-employer/part-time/unemployed are? What about single vs. married (i.e., if you are single, you may have to stay in a job in order to maintain health insurance)?
        3. Efficiency – What is tying your employment to your health insurance? What does this mean for your ability to move or change jobs or industries?

VII. Constitutionality of Taxation
    a. **General Welfare Clause – Art. 1, § 8** – "The Congress shall have the power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States; but all duties, imposts and excises shall be uniform (i.e., cannot vary state by state or between individuals) throughout the United States"
        i. In order to have a government, we need to be able to raise revenue; therefore, Congress needs to have the power to tax

        ii. Money raised under the General Welfare Clause is much easier for Congress to protect, if challenged . . . but it is also harder to pass (because it is a tax)
b. **Art. 1, § 9, cl. 4** – "No capitation (i.e., like a poll tax – a head count), or other direct, tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken"
c. **Direct Taxation – Art. 1, § 2, cl. 3** – "Representatives and direct taxes shall be apportioned among the several states"
    i. Direct taxes are those directed at individuals (rather than the goods individuals buy), and they must be apportioned
d. **Income Taxation – Sixteenth Amendment** – "The Congress shall have the 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"
    i. Constitutional to tax income
    ii. Income taxes are not apportioned by state population, so different states pay much different income taxes, regardless of the size of their population
e. *Arizona Christian School Tuition Organization v. Winn* (U.S. 2011): Ps are challenging an AZ law that gives tax credits for contributions to school tuition organizations which then use the contributions to provide scholarships to students at private schools – including religious schools; Ps claim standing in their role as taxpayers . . . Establishment Clause case that becomes a standing problem
    i. General Rule: Taxpayers do <u>not</u> have standing based on the mere fact that they are taxpayers
    ii. *Flast* Exception: If the government is spending money on something that allegedly violates the Constitution (religious organizations, e.g.) and the taxpayers can show that their money – which they gave to the government – is being used to fund that, then they are deemed to have standing *as taxpayers* to challenge the spending
        1. In *Flast* cases, there is direct spending that creates a connection between the taxpayer and the religious organization
    iii. Court: Because Ps challenge a tax credit as opposed to a governmental expenditures, they lack standing under *Flast*
        1. Here, a failure to impose a tax does not create a connection between the taxpayer and the religious organization
        2. Essentially, tax credits ≠ government property
            a. Instead, the money goes directly from the individual citizen as a taxpayer to the institution – so the government is not really involved
    iv. Kagan's Dissent: Precedent has never distinguished between tax expenditures and direct handouts
        1. Tax breaks and tax spending result in the same bottom line – government subsidy to a religious organization – so taxpayers should have the same standing regardless of the form of the subsidy
        2. Fears that the majority's position allows the government to hide from Establishment Clause challenges by reframing direct spending as a tax credit
f. Ex: *Thomas More Law Center v. Obama* (6th Cir. 2011): Ps allege that Congress lacked authority under the Commerce Clause to pass the minimum coverage provision, and alternatively, that the penalty is an unconstitutional tax; RESULT: Penalty, <u>not</u> a tax
    i. BEFORE deciding whether a tax is constitutional, first must determine whether it even counts as a tax
    ii. It matters here whether this is a tax or a penalty because
        1. If it is a tax, that means Congress passed it under its taxing power, and it is more likely to be constitutional (more likely to survive if deemed a tax)
            a. If it is a penalty, that must be passed under the Commerce Clause, and there is more stringent scrutiny (less likely to survive if deemed a penalty)
        2. The court must determine whether the Anti-Injunction Act applies, which prohibits federal courts from having subject matter jurisdiction over tax issues until the tax has been collected (which it has not yet been in this case)

iii. Arguments this IS a tax:
    1. Structured and looks like a tax
    2. Going into the Code part of the U.S.C.
        a. Normally we think of things in the Code as a tax
    3. Assessed the same way as other tax penalties – you pay through your taxes
    4. Seems to raise some revenue

iv. Arguments this is NOT a tax:
    1. Congress called it a "penalty"
        a. It is politically harder to pass things under the General Welfare Clause, and if Congress acknowledged that it was not going to be able to pass something as a tax under the General Welfare Clause, then this may mean that it should not be seen as a tax, but rather a penalty
    2. Legislative findings show that Congress was using the Commerce Clause power
    3. Raising revenue was not the purpose

g. Ex: *Murphy v. IRS I* (D.C. Cir. 2006): P was awarded $70K in damages - $45K for emotional distress and $25K for damage to professional reputation; P included damages in income and paid taxes on them; P later filed an amended return seeking a refund; P argued that if the damages are not income – because they are a recovery of capital – then they do not fall under the 16th Amendment … and this is recovery of capital because the damages were only making her whole – not increasing the value of her property (i.e., herself)
    i. Step 1: Under the Code, were the payments income?
        1. § 61 is a broad definition of income
        2. **§ 104(a)(2)**: Gross income does <u>not</u> include the amount of any damages (other than punitive damages) received on account of personal physical injuries or physical sickness
            a. "For purposes of [this] paragraph, emotional distress shall <u>not</u> be treated as a physical injury or physical sickness." ← was passed in 1996 (so up until then, emotional distress was excluded from income)
                i. Emotional vs. Physical Distinction – physical is a lot easier to quantify and it is easier to fudge emotional distress
        3. YES – clear statutory answer that these payments were income
    ii. Step 2: Even if they were income under the Code, is it constitutional to tax them?
        1. § 104(a)(2) is unconstitutional to the extent that it permitted the taxation of compensation for a personal injury (mental distress and loss of reputation), which compensation was unrelated to lost wages or earnings (i.e., not income)
        2. Court looked to *Rayethon* and asked what the payments were in lieu of → the damages were not in place of something that would count as a gain, but rather were awarded to make her whole
        3. Court focused their discussion entirely on the 16th Amendment and argued that these damages were not income because there was not gain or accession to wealth
            a. So since the damages fell outside of the 16th Amendment, they had to be apportioned under Art. 1, § 2, and they were not, so unconstitutional
    iii. Physical Capital Idea → When a laborer works, he gets income – but how much of this income is recovery of capital after a day of labor and how much is gain on top of physical capital? Impossible question to answer . . . Your recovery of capital is your income . . . Basically, we do **<u>not</u>** buy the recovery of capital argument when it comes to human/physical capital because it is too hard to calculate
        1. And if the court believes this is recovery of capital then the award does not count as taxable income [$70K (A/R) - $70K (Basis) = $0 (Gain)]

h. Ex: *Murphy v. IRS II* (D.C. 2007): court decided to re-hear the case en banc
    i. Gross income under § 61 <u>includes</u> compensatory damages for non-physical injuries

            1. When § 104(a) was amended in 1996, must presume that § 61 was to be read to include a non-physical damages award, regardless if it was an accession to wealth
        ii. The tax imposed on an award of damages for non-physical injuries operates with "the same force and effect" throughout the United States, so it is uniform under Art. 1, § 8, cl. 1
    i. Summary:
        i. Constitutional challenges to taxation do not happen often
        ii. Almost always, anything that counts under § 61 as income should be taxable under the 16th Amendment
        iii. Different tax sections that we have do not always map onto the world we have
            1. The distinction between direct and indirect taxes is fuzzy enough that you could argue in one case that something is a direct tax and in the next case that the same tax is indirect
    j. STEPS:
        i. Is this even a tax at all, or is this a penalty?
            1. If it is not a tax, then we are not worried about tax analysis
            2. If it is a tax, Congress is authorized to raise it under the General Welfare Clause, but there are limitations imposed by other amendments/provisions
                a. Indirect Tax – imposed on a good rather than a person – has to be applied uniformly (Art. 1, § 8, cl. 1, *Murphy II*)
                b. Direct Tax – applied to a person – has to be apportioned (Art. 1, § 2, cl. 3)
                c. Income Tax – does not need to be apportioned (16th Amendment)

VIII. Recovery of Capital and Basis
    a. Definitions:
        i. Capital – the amount you put into something
            1. Recovery of Capital = Tax-Free ≠ Income
        ii. Basis – what you put into something (i.e., the cost) – the capital that you are recovering
            1. Basis is not taxable
            2. [Basis only matters for figuring out gain or loss!]
        iii. Adjusted Basis – the new basis to account for any money put in or taken out of the original
            1. Ex: capitalized expenditures, untaxed receipts, certain losses, depreciation
        iv. Gain – the difference between the amount realized and the basis
            1. Gain is taxable income
        v. Loss – the difference between the basis and the amount realized
    b. § 1001(a): Computation of Gain or Loss
    c. **§ 1012(a)**: Basis of property is cost (if you paid cash) – or – the FMV (if you exchanged property or services)
            i. If you exchange goods, the FMV of the property RECEIVED sets your basis
    d. § 1014: Basis of Property Acquired from a Decedent
        i. Stepped-Up Basis – FMV at the time of decedent's death
            1. Incentivizes holding onto assets until you die (versus selling assets before death and leaving the money to the estate)
                a. Code creates a lock-in effect
                    i. People who have the luxury of the lock-in effect are those with a lot of assets – or – people who have assets in the form of pensions or retirement savings (because they do not have to sell things at the end of their lives to maintain their living situation)
        ii. Stepped-Down Basis – FMV at the time of decedent's death
            1. If decedent's basis is $200, but FMV @ time of death is $100, decedent should sell before death to get the benefit of losses (otherwise it is lost)
        iii. Estate Tax Sunset Provision: § 1014(f) – NO stepped up basis after death for people who die after Dec. 31, 2009 [applied *ONLY* for 2010]
            1. The Estate Tax was established in 2001 and set to expire in 2010 and then return in 2011

            a. When you get rid of the Estate Tax that gets rid of a source of revenue
            b. When you get rid of the stepped-up basis that is a source of revenue

  - **e. § 1015: Basis of Property Acquired by Gifts**
    - i. Carryover Basis – basis of the donor
      1. Makes sure that the recipient of the gift will eventually be taxed on the gain that the donor was not taxed on
      2. Recaptures the built in gain that we do not have in the stepped-up basis
      3. Changes whether you sell –
         - a. At a loss → donee's basis is FMV
         - b. At a price between donor's basis & FMV → donee's basis at sale becomes the cash; buyer's basis is the cost (whatever he paid in cash)
         - c. At a gain → donee's basis is donor's basis
  - f. Allocation of Basis
    - i. Where a taxpayer sells less than her whole interest in an asset, it may be difficult to allocate basis to the portion sold and the portion retained
      1. 3 Options: (1) allocate to portion sold; (2) keep to portion retained; (3) something in between
    - ii. Determination of basis can also be difficult where the taxpayer has acquired similar assets at different times
      1. First-In, First-Out → If a taxpayer cannot adequately identify the lot from which the stock (e.g.) sold or transferred was taken, the stock sold will be charged against the earliest lots of such stock acquired by the taxpayer to determine basis and gain or loss
    - iii. In a part-gift, part-sale transfer, the transferor generally can allocate basis to the portion of the transfer that constitutes a sale (and this reduces taxable income)
      1. Reasoning: IRS does not want to be looking at valuation questions between gift-sales between friends
      2. Acting as if this was a full sale – ignoring the FMV
    - iv. We do NOT ignore the FMV when we have a part-gift, part-sale to charity → split the basis PROPORTIONATELY between the sale and the gift
      1. The norm with charity is to donate outright, so we do not want to create incentives to charge a charity
      2. This is a disincentive because some of the basis is shifted to the sale so you will have taxable income
  - g. Ex: *Hort v. Commissioner* (U.S. 1941): issue: whether in computing net gain or loss from income tax purposes a taxpayer can offset the value of the lease cancelled against the consideration received by him for the cancellation; Hort argues that the amount received for cancellation of the lease was capital rather than ordinary income
    - i. Court: The amount received by Hort for cancellation of the lease must be included in gross income
      1. Basically, the payment was merely a substitute for the rent reserved in the lease
    - ii. When might this not be income? If you buy off someone else's lease – might be seen differently (?)

IX. Realization
  - a. Realization Requirement – You are only taxed on gain or loss when you have a realization event (selling, e.g.)
    - i. So *un*realized appreciation is <u>not</u> taxed
    - ii. This is actually seen as a tax expenditures – it is different than a norm and allows you to defer taxes (which means the government is losing out on the opportunity to invest the taxpayer's taxes)
  - b. OPPOSITE = Mark-to-Market – where you recognize gain or loss every year, even if you don't "realize" it

        i. We do not have a mark-to-market system because of administrative concerns (how would you assess this – put property on the market every year?; general administrative burden by not having a realization requirement) – and – concern about the ability of people to pay taxes on things when they are not actually realizing the gain (liquidity concerns)
    c. The realization requirements provides taxpayers with considerable flexibility in the *timing* of taxation of gains and losses
        i. Timing issue – when we figure out when we're taxing the gain
    d. Realization is not just a question of liquidity – there are other concerns
        i. Ex: If you find a diamond ring (i.e., not liquid), that is still a taxable realization event
    e. Concerns:
        i. Equity: horizontal equity concerns
            1. Hypo: H does not work but has a $500K house and in 10 years her house appreciated to $1M so when she sells, she has a gain of $500K; S does not have a house but works for 10 years and makes $50K/yr
                a. They are in the same economic situation (both have $500K), but they were taxed different – S was taxed every year on his income (receipt of income is a realization event); H was not taxed on the gains until she sold in year 10
        ii. Efficiency: distortions and incentives are created
            1. Taxpayers are incentivized to hold onto property until they can ensure the appreciated gains will not be realized/recognized
            2. Encourages people to invest in assets that allow them to defer taxation
                a. Ex: bonds vs. stocks – bonds have payments that occur over the ownership period, while stocks do not have that same type of realization event – if you want to delay realization, then you choose stocks because you will not be taxed on the unrealized appreciation until you sell the stock
    f. Ex: *Cesarini v. United States* (6th Cir. 1970): P purchased a piano and seven years later found $4,467 dollars inside it; Ps claimed that the windfall was not includible in gross income under § 61
        i. Court: This is income – strong statutory support . . .
            1. § 61 defines income broadly – whatever source derived
            2. IRS Rev. Ruling: "The finder of treasure-trove is in receipt of taxable income"
            3. Tres. Reg. § 1.61-14: "<u>Treasure trove constitutes gross income for the taxable year in which it is reduced to undisputed possession</u>"
                a. "Undisputed possession" is fuzzy – but requires a certain awareness
                b. Basically, anything you find unexpectedly – cash in a piano, a diamond ring – is income in the moment you find it (that is the realization event – then there will be another if you sell it)
                    i. So this is an exception to the general rule that realization requires a sale
                c. Note: Treasure trove requires separability – the treasure must have its own value (i.e., no realization event if you think you have a cheap piano and then realize it is actually an expensive one, until you sell it)
    g. Ex: *Haverly v. United States* (7th Cir. 1975): principal receives gratuitous textbooks in the mail (not a gift though because no detached and disinterested generosity), then donates them to the school library, and claims a charitable deduction for $400 – the FMV (deduction is OK under § 170); issue: are the value of the textbooks income?
        i. Court: Income includes all (i) accessions to wealth, (ii) clearly realized, and (iii) over which the taxpayer has complete dominion ← three-part test
            1. Books are an accession to wealth – he has more wealth than if he did not have them
            2. Clearly realized? The Seventh Circuit seems to assume yes, but normally there would only be realized when he sold them

3. Complete dominion – yes because when he donated them, he made clear that they were his to give

ii. IRS is concerned about taxpayers getting double tax benefits: (1) not including something in gross income, then (2) getting a deduction, which reduces your taxable income

1. <u>If you take a tax deduction on something that you have not been taxed on before as income, then this is your realization event – when you establish your complete dominion</u>
2. Tax Symmetry → *if* one side takes something as income, *then* other side can get a deduction

iii. Result: Textbooks are income to him

1. Fairly narrow holding, though, because they are only income *because* he donated them and took a deduction – without first including them in income
   a. If there was no charitable deduction, then there would not be the double benefit issue and the case would have come out differently
      i. Fundamentally, the free books are similar to *Gotcher*'s fringe benefit analysis if there is a dominant business purpose
2. So this is an exception to the general rule that realization requires a sale

h. Baseballs (pg. 158) – Are you taxed on the ball? Is there a realization event when you catch it?

i. Matt Murphy

1. Under *Cesarini*, this would likely be income because treasure trove is taxable in the moment you find it – you do not have to sell/realize it first – and here the baseball was separable from the ticket he bought
   a. **In theory**, *Cesarini* applies to baseballs because it is like a windfall and the moment you catch it, you have taxable income
      i. It is an accession to wealth that increases you ability to pay
2. Under *Haverly*, this might be income – (1) is an accession to wealth, (2) he does have complete dominion, (3) might be clearly realized if we consider his possession and receipt of it realization – but might not be realized if we buy the symmetry event of *Haverly*
3. Under H-S Definition, this is arguably income

ii. Cardinals Groundkeeper who promptly returned the ball to Mark McGwire because it belonged in the Hall of Fame

1. Could argue that it is not income when he donates/returns it because he did not take a charitable deduction (so no tax symmetry issue)
2. Could argue under H-S that he had complete dominion for such a short period of time that he was not in fact better off

iii. Derek Jeter – see class notes if need theories to analogize to

i. <u>Summary: Two basic ways to realize income</u>

i. General Rule:

1. A normal realization event (sale or exchange, e.g.)

ii. Exceptions:

1. Separability / Treasure Trove (*Cesarini*)
2. Symmetry (*Haverly* & when do we tax a baseball)

j. Ex: *Eisner v. Macomber* (U.S. 1920): question about whether a stock dividend is taxable income; dividends are distributions of cash or property granted in proportion to your stock holding; SCOTUS: unconstitutional to tax a true stock dividend (which they consider capital) as income to the stockholder without apportionment

i. Cash Dividends = Distributions of Earnings = Realization Event = Income

1. Idea that she has complete dominion over the cash and can do whatever she wants
   a. So if she was given a cash dividend by legally bound to buy more stock with it, then we might not consider that a realization event

ii. Stock Dividends = Distributions of More Stock ≠ Income

1. This is because your ownership percentage is still the same

            a. So if your ownership percentage is changed, that might count as taxable income under *current* law
        2. Idea that you do not have complete dominion, so you have not realized income yet

X. Transactions Involving Borrowed Funds
  a. Introduction
    i. Borrowing does <u>not</u> count as income to the borrower
      1. The borrower has <u>no</u> deduction when he makes principal payments on the loan
      2. If a third party pays the lender back on the borrower's behalf, that <u>is</u> income to the borrower
    ii. The Lender does <u>not</u> have a deductible loss upon making the loan
      1. The lender does <u>not</u> realize income on the repayment of the loan *principal* (like recovery of capital)
      2. The lender <u>does</u> realize income from *interest* payments (like return on capital)

    . . . Technically it does increase and decrease our abilities to pay during the lending period, but the Code sees it as a wash because of the obligation to repay

    iii. Cancellation of Indebtedness (COD)
      1. General Rule: § 61(a)(12): COD <u>does</u> count as income to the borrower
        a. Ex: If L lends B $100, but later have an arrangement where B only repays L $75 – B has $25 COD income
          i. L gave something to B that was not a gift – but rather, income
      2. Exceptions: § 108: COD does <u>not</u> count as taxable income if –
        a. § 108(a)(1)(A): the discharge occurs in bankruptcy
        b. § 108(a)(1)(B): the discharge occurs when the taxpayer is insolvent (i.e. broke)
        c. § 108(a)(1)(E): if your home mortgage is underwater and the lender comes to an agreement with you regarding the mortgage
          i. Incentive to increase negotiations after the housing crisis
          ii. If we did not have, people might be discouraged from agreeing to a lower indebtedness
        d. § 108(f): the discharge is part of a student loan forgiveness plan
  b. Discharge of Indebtedness
    i. Ex: *Zarin v. Commissioner* (Tax Court 1989): casino was giving petitioner chips on credit – the chips could only be used in the casino and were therefore not equivalent to cash because they were not fungible; at one point he received a credit of $3.5M, treated this as a loan and did not report it as income, but essentially loses it all gambling and owes the casino; casino and petitioner settle for $500K; issue: is the difference between the $3.5M loan and the $500K settlement COD income?; Tax Court: $3M difference **is** COD income
      1. Petitioner's arguments that this was not COD income:
        a. There was no income to him because he lost it all
        b. The opportunity to gamble was not a thing of value the way actual cash income can be internalized
        c. The settlement should be treated as a purchase price reduction – which essentially says that the experience of gambling was worth $3.5M, but then we decided it was only worth $500K so it is just a purchase price reduction
          i. Purchase price reductions are only allowed to be nontaxable income allowed for seller-financing (i.e., when the financing is offered by the seller – the same person is providing the loan and the good)
            1. Raises a valuation question because if you are a seller-financer then you are setting the value yourself – not the market, necessarily – so there is a question as to whether this is an arm's length transaction

ii. Tax Court: Looks to § 108(e)(5) and gets hung up on the "purpose of such property" language because they do not consider the chips here property

d. This type of debt is not enforceable in New Jersey (i.e., the obligation to pay back cannot be enforced), therefore the government should not be able to tax it

i. Tax Court: This does not matter

e. Because he wants to use all of these losses to offset his gain

i. § 165(d): Gambling losses can only offset gambling gains from the same year ← Basketing Regime

1. Itemized deduction, so can only use your gambling losses only to the extent that they exceed the standard deduction

2. Policy: Congress likely does not think gambling is 100% morally upstanding, so we do not want to allow any special preferences

a. Without a basketing regime, there would be a type of income sheltering – where taxpayers could use gambling losses to offset other gains

3. Professional Gamblers cannot take losses if they have net losses, but when they have a net gain, their losses are treated as business deductions (so the basketing regime does not apply to professionals in the same way)

f. Tax Court: Petitioner's losses were in 1980, but his COD income was in 1981 – different taxable years

2. Note: In the Tax Court this case is GOOD law, *but* outside the Tax Court this is BAD law because this case was overturned by the Third Circuit

a. Could argue that the Tax Court was right based on the concept of COD income, which is that you can consume more if you have less debt = accession to wealth

i. Petitioner got $3.5M of enjoyment and he only had to pay $500K for it – so he got $3M of consumption for free

b. Third Circuit held that the $3M did <u>not</u> count as taxable income

i. They adopted his unenforceability argument → COD is not income when the debt itself is unenforceable – if there is no obligation to repay, then cancellation of it does not create income

ii. They adopted his contested liability argument → there is no COD income if the amount was in question – whatever the amount the parties settled on was the actual amount of the debt

iii. They also question whether you can really ever have COD – they view the recalculation between the parties similar to a purchase-price reduction [*but* the law is that COD income exists]

c. Illegal Income

i. Illegal income is still taxable income

1. So stolen money and money from prostitution or drug dealing should be included in taxable income

a. Illegal income is taxed the same as legitimate income – otherwise we would have criminals tax preferred status – and this would violate horizontal equity (i.e., if $50K stolen was taxed differently than $50K earned)

b. We do not want to create an inefficiency and distort people toward certain types of income gathering

        2. Criminals obviously do not like this requirement because they either (a) include the money and incriminate themselves in a way because the IRS would be alerted due to the unaccounted for amount, or (b) not report the income and then get charged with tax fraud (as opposed to being charged for their substantive crime)
    ii. Ex: *Collins v. Commissioner* (2d Cir. 1993): Petitioner borrows $80K, bets this money and loses $38K, at the end of the day he returns $42K to his employer (immediate restitution); this is different than *Zarin* because here petitioner steals the money – there is no mutual lending-borrowing agreement (and any unilateral intention to repay does not transform a theft into a loan)
        1. Embezzlement would not likely count as income under the *Eisner* definition: "gain derived from capital, labor, or both combined, provided it be understood to include profit gained through a sale or conversion of capital assets"
            a. But *Eisner* is from 1920 and the definition of income has been expanded (§ 61; "etc." line on 1040s)
        2. Court uses the *Glenshaw Glass* definition of income: "accessions to wealth, clearly realized, and over which the taxpayer has complete dominion"
        3. Petitioner tries to use *Gilbert v. Commissioner* (2d Cir. 1977) – where the court found a consensual recognition of the obligation to repay despite the absence of a loan agreement – but the court distinguishes the cases
            a. Gilbert did not realize income (and it therefore counted as a loan) because (1) he not only fully intended but also expected with reasonable certainty to repay the sums taken, (2) he believed his withdrawals would be approved by the corporate board, and (3) he made prompt assignment of assets sufficient to secure the amount he owed
                i. This is distinguished from the typical embezzlement cases where the embezzler plans right from the start to abscond with the funds
            b. Collins knew there was a strict policy against stealing/betting and it seemed unlikely that he would be able to pay his employer back $80K
        4. RESULT: Petitioner must include as taxable income all amounts illegally acquired
            a. *But* petitioner may claim a tax deduction for payments he makes in restitution

XI. Effect of Debt on Basis
    a. Leverage = Using debt to buy something
        i. Highly leveraged companies are ones that have a lot of debt
    b. Depreciation = Estimating the lowering in value of the property over the course of its life
        i. Depreciation attempts to be some sort of mark-to-market system → if you fail to track the depreciation accurately over the life of the asset (i.e., if you overestimate depreciation), then you will have to recapture your gains at the time of sale
            1. We might think of this as incentivizing people to exaggerate their depreciation, but this is a policy choice – owners of things like commercial real estate should be able to DEFER their gains and ACCELERATE their losses
        ii. Note: You <u>cannot</u> take more depreciation deductions than what your basis is
            1. Generally when you are depreciating, you want your basis to be higher because a higher basis when you sell means lower taxable gain
    c. Two Types of Borrowing:
        i. Recourse Debt → where the borrower is personally liable for repayment of the debt
            1. Upon default of a recourse debt, the lender can look not only to any asset securing the debt, but also to the borrower's other assets for repayment (i.e., the lender has recourse to your other assets)
        ii. Nonrecourse Debt → where the borrower is not personally liable and the lender can look only to the assets that secure the debt for repayment

            1. Upon default of a nonrecourse debt, the lender can obtain satisfaction of the obligation only from the property securing the debt (i.e., the debt is secured by collateral – the item being paid for)
                a. If, when a nonrecourse debt comes due, the value of the property is adequate to satisfy the amount owed, the lender will be paid in full
                b. If, however, the value of the property is inadequate to satisfy the debt – either because the property declines in value after the loan was made or because the property was overvalued at the time of the loan – the lender, not the borrower, will suffer the economic loss
        iii. DIFFERENCE between the two types of debt only matters on the downside – then we have a shifting of the burden (i.e., recourse – you absorb it / nonrecourse – bank absorbs it)
            1. On the upside, the two have the same result → bank will get the full amount
    d. Ex: *Crane v. Commissioner* (U.S. 1947): taxpayer's husband left her commercial real estate worth the exact amount of the nonrecourse mortgage, which she eventually sold before paying off the mortgage; she has a stepped-up basis – FMV at the time of decedent's death – and she notched it down by claiming depreciation deductions; she has an incentive to heighten her basis – so not to take away the mortgage value – so she keeps the mortgage value in the basis when she is calculating depreciation
        i. <u>RULE</u>: A loan, whether recourse or nonrecourse, is included in the basis of the asset it finances and the amount realized
            1. Recourse and nonrecourse debt will be treated alike
                a. This creates parity between a purchaser who borrows from a bank and pays the seller cash and a purchaser who uses seller financing
        ii. Court agrees with the IRS here because of a **tax symmetry** argument → she got to take the deductions she did by using the full mortgage/FMV amount as the basis – so if she got this loss, she should have to repay that with a gain (so she is recapturing the $100K loss (i.e., deductions) with a $100K gain)
        iii. <u>Incentives after *Crane*</u>: To borrow more – If you can take depreciation deductions by bumping up your basis by including the mortgage in the basis, then there is an incentive for debt-financing
            1. The principal effect of the case was to increase and accelerate the amount of depreciation deductions allowed to owners of property financed from debt
                a. If you could not include the mortgage in the basis, then you could only take depreciation deductions based on the amount you actually put in in cash
        iv. <u>Benefits for Taxpayers</u>:
            1. If the property is eligible for depreciation deductions, including the borrowed amount in basis enables a taxpayer to recover costs that she has not yet paid or assumed directly
            2. If the money for buying the property is borrowed through a nonrecourse mortgage for which the taxpayer has no personal liability, it may be possible for her to recover through depreciation putative acquisition costs for which she may never have to put up any of her own money
            3. Although the amount of the outstanding debt will be included in the taxpayer's amount realized upon an eventual sale (offsetting the earlier depreciation deductions), the taxpayer enjoys the time value of the depreciation deductions
        v. Note re: FN 37: Taxpayer here sold at a gain/upside, so Court did not address recourse vs. nonrecourse mortgage effects . . .
    e. Ex: *Commissioner v. Tufts* (U.S. 1983): partnership took out a $1.8M nonrecourse mortgage and put in $44K of capital contributions (= putting money into the partnership or the actual building; ≠ repayment of the mortgage); FMV at the time of sale was $1.4M; partnership reported a loss of $55K
        i. Disagreement between IRS and partnership is what the amount realized is:
            1. IRS says it is the amount of the mortgage (because *Crane* says to include the full amount of the mortgage in the amount realized)

a. Essentially disregarding the fact that this is nonrecourse and focusing only on the fact that there was a mortgage
i. The full amount of the mortgage was used to figure out the depreciation deductions and was the full amount of the obligation that the partnership took out
1. Symmetry → If you get a tax benefit (i.e., deductions from taxable income), then you have to pay for it at some point (i.e., partnership cannot then try to report a loss)
2. Partnership says it is the FMV (since it was a nonrecourse mortgage and the property went down in value, they are only on the hook for the value of the property – in essence, shifting liability/burden to the lender)
a. Essentially disregarding the fact that it is a mortgage and focusing on the fact that it is nonrecourse
ii. Court (agreeing with the IRS): When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the IRS properly requires him to include in the amount realized the outstanding amount of the obligation – the FMV of the property is irrelevant to this calculation
iii. O'Connor's Concurrence: Bifurcated Approach → separate (1) the ownership and sale of the property and (2) the arrangement and retirement of the loan
1. Property Transaction: purchase price (disregard whether debt or cash) + capital contributions – depreciation – sale/FMV = gain or loss
a. Here, they had a loss
2. Borrowing Transaction: loan received – loan repaid (nonrecourse) = gain/loss
a. Here they had COD income – income in the amount of the difference between the proceeds of the loan and the amount for which the taxpayer is able to satisfy his creditor
f. Summary:
i. *Crane* & *Tufts* approach applies for **nonrecourse** debt
ii. Under a Treasury Reg., the bifurcated approach applies for **recourse** debt
XII. SUMMARY OF: WHAT IS INCOME?
a. When we include or exclude something from income, is it because we are trying to accurately measure income – or – for policy reasons?
b. Do we have equity, efficiency, and/or administrability concerns?

<u>Deductions</u>

I. Introduction
a. Exclusions from gross income and deduction both reduce your taxable income
i. They are both upside down subsidies – both subject to my tax rate
b. Exclusions reduce the overall amount that you will be taxed on – they reduce gross income through adjusted gross income and down to taxable income
c. Deductions are different . . .
i. BTL deductions have <u>limitations</u> that do not apply to exclusions, and therefore BTL deductions may not have the same direct effect that exclusions do
1. **§ 63: Standard Deduction** – $5,800 for 2011
a. If your BTL itemized deductions are greater than the standard deduction, then you will take them . . . otherwise, you take the standard deduction
i. Therefore, itemized deductions only create real benefits when you are way beyond the standard deduction
b. Goals of the SD: (1) Supposed to be a zero bracket amount – so if you only make $5,800, then you should not be taxed on anything; and (2) Trying to serve as a rough estimate for itemized deductions – that is, what many

people would end up taking as itemized deductions, but now they do not have to keep receipts, records, etc.

i. Hard to serve both of these goals at the same time though → because if A has $0 of deductions, A gets the standard deduction; but if B has $4K in itemized deductions, B still only gets the same standard deduction . . . so the SD treats people the same, even though they may have different deductions

2. 2% Floor for Miscellaneous Itemized Deductions - § 67
    a. You can only take miscellaneous itemized deductions to the extent that they exceed the 2% floor
        i. Hypo: $100K AGI; $7K in miscellaneous itemized deductions; 2% of AGI = $2K, so can only take $5K in miscellaneous itemized deductions (which is now less than the SD)
    b. § 67 lists 12 things that are <u>not</u> miscellaneous itemized deductions
        i. So, anything <u>not</u> listed <u>is</u> a miscellaneous itemized deduction
3. Overall Limit on Itemized Deductions - § 68
    a. Certain high income taxpayers are limited in the amount of itemized deductions they can take – so as your income goes above [$166K], you end up slowly losing your ability to take itemized deductions
        i. This phase out worked for high income taxpayers in ways similar to what the SD did for low income taxpayers who were prevented from taking itemized deductions because they were below the SD
    b. As of 2010, this limit does <u>not</u> apply (but it may come back)

ii. ATL deductions are almost the same as exclusions
1. They basically try to make your AGI reflect your real income (i.e., telling what your real income really was, even if your gross income appears higher)
    a. Idea that you should be able to not have to pay taxes on your full gross income if a portion of that was used to make that income
    b. § 62 defines AGI by defining what ATL deductions are
        i. ATL deductions are those necessary for calculating AGI
2. Taxpayers prefer ATL deductions because the BTL deduction limits will not apply

d. Purpose:
    i. Many are necessary to measure income accurately
    ii. Others are not necessary to obtain an accurate measurement of income, but rather are tax subsidies for certain activities or investments

II. "Ordinary and Necessary" Business Expenses

a. **§ 62(a)(1)** - § 162 business deductions are ATL deduction if you as an employee do not incur them (i.e., employer pays or reimburses)
    i. If you as an employee pay for something (and it is not reimbursed), that is a BTL deduction
        1. Why? If the employer is willing to reimburse, that says that is really was a business expense – and vice versa
b. **§ 162(a): Trade or Business Expenses**: There shall be allowed as a deduction all the **ordinary and necessary** expenses paid or incurred during the taxable year in carrying on any trade or business, including (1) a reasonably allowance for salaries or other compensation for personal services actually rendered; (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and (3) rental or other payments [see Code]
    i. § 162 can be an ATL deduction or a BTL deduction (when non-reimbursed)
        1. When it is an ATL deduction, it is a full, immediate deduction (§ 132)
        2. When it is not an ATL deduction it is a miscellaneous itemized deduction (because it is not listed in § 67)
c. **§ 212: Expenses for Production of Income**: There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year (1) for the production or collection of

income; (2) for the management, conservation, or maintenance of property held for the production of income; or (3) in connection with the determination, collection, or refund of any tax

   i. So for § 212(1), you have to have an ordinary business expectation – you cannot shift all of your personal expenses to business expenses
      1. But no real guidance in the Code as to what counts as an income producing expense versus a personal expense
   ii. § 212 is a miscellaneous itemized deduction (because it is not listed in § 67)

d. Ex: *Welch v. Helvering* (U.S. 1933): petitioner made payments to the creditors of a bankrupt corporation in order to strengthen his own standing and credit; petitioner deducted these payments as business expenses under § 162 because otherwise people would not have wanted to do business with him (and bankers advised him to do so); IRS said these payments were capital expenditures to develop reputation and goodwill
   i. Court: We can assume these payments were "necessary" (in the sense that they were appropriate and helpful), but not "ordinary"
      1. While this decision is not helpful in defining "ordinary and necessary," it does opine on the phrase
         a. Ordinary means not extraordinary
            i. "What is ordinary is a variable affected by time and place and circumstance"
               1. So while something may be extraordinary for one person (because it only happens once in a lifetime, e.g.), the question is whether something is ordinary for the industry
      2. Cardozo suggests that petitioner's payments are bizarre or extraordinary, *but* he did get business advice to do this and this situation happened before in petitioner's same state … so we could argue that this is more ordinary than Cardozo thinks it is
         a. Note: A bizarre vs. ordinary distinction could have negative consequences (e.g., a business tries something new/different/unique could be penalized as "bizarre")
      3. Court also discusses business versus personal – the debts paid were those of a bankrupt company (E.I. Welch) and were paid when petitioner was working at a different company (Kellogg)
         a. Maybe there would be more of a business reason if petitioner was paying the debts of his own company
      4. Court also distinguishes business versus capital – and thinks there are more akin to capital expenditures so should be capitalized into the basis of the company
      5. Symmetry → essentially he is repaying loans and trying to take a deduction for repaying a debt – but, if you take a deduction, symmetry requires that at some point someone paid taxes on it . . . petitioner never paid taxes on the COD income because the company was bankrupt
   ii. This decision is not preventing petitioner from making these payments, but is it preventing him from deducting these payments
      1. Idea of Moral vs. Legal Obligations
         a. Legal obligations (i.e., bound to pay) create § 162 business expenses
         b. Moral obligations do not create business expenses
            i. *Unless*, you are Conway Twitty or another country music star → Conway Twitty invested in "Twitty Burger" with 75 friends and paid this off because of a moral obligation – but the court upholds it as a business deduction
               1. Apparently there are a few industries (we only know of country music) where moral obligations are so important to your ability to do your business (i.e., the business of

being a country music star), that they are fully immediately deductible business expenses

e. Ex: *Gilliam v. Commissioner* (Tax Court 1986): artist got in a fight on a plane on the way to a job; his $17K in legal fees are at issue; § 162 says "ordinary and necessary … *for carrying on a trade or business*"
    i. Step (1): Is this even a business expense → Step (2): If it is a business expense, is it "ordinary and necessary"
        1. The legal fees in this case are not even tied enough to petitioner's trade or business to get past Step (1) – too attenuated
            a. With regard to legal fees, courts generally use an "origin of the claim approach" → Did the case arise out of personal activities (should not be a business expense) – or – business (should be a business expense)
            b. Court distinguishes *Dancer v. Commissioner* where petitioner's legal fees, resulting from a car accident, were a business expense because driving was an integral part of petitioner's business – whereas flying, and much less getting into a fight during, are not integral parts of being an artist

III. Salaries
  a. § 162(a)(1) LIMITS 162(a) by requiring that the allowance for salaries be "reasonable"
    i. Why limit salaries?
        1. Concern about income inequality – in the past 20 or 30 years it has increase drastically and the focus is mainly on executive compensation, so Code responded to that
        2. Concern about market failure re: executive compensation – idea that shareholders cannot effectively gauge the value of the CEO
        3. Concern that corporations are representing dividends or gifts as salary
            a. Salary → employer can deduct if reasonable, under § 162(a)(1) / employee includes salary in their income, under § 61(a)(1) [symmetry]
            b. Dividends → employer includes (i.e., pays tax) / employee also includes in income, under § 61(a)(7) [double taxation]
                i. Note: The concern about dividends being hidden as salary only applies when the dividend recipients are the same people receiving salary – so more of a concern in smaller corporations where the shareholders are also employees
                ii. This concern has also changed slightly due to the fact that the dividend tax rate has gone down to 15% (until 2012) – but employers would still rather pay salary since it is deductible
            c. Gifts → employer includes (no business gifts) / employee excludes if detached and disinterested generosity [symmetry]
  b. **§ 162(m): Certain Excessive Employee Remuneration**: NO deduction if the salary for covered employees exceeds $1M – so we have a floor – and corporation can only deduct the first $1M of salary (if reasonable)
    i. This limit sends a signal that the Code does not think it is good to have nonperformance-based compensation over $1M
        1. And this actually had an anchoring effect because as soon as the Code chose $1M, the corporations paying under $1M increased salaries to $1M
    ii. But, this is **<u>only</u>** a limit for publicly held corporations – so closely held corporations or non-corporations escape this
        1. Who else escapes? Athletes, movie stars, doctors, lawyers – anyone not in a publicly traded corporation
            a. Are we OK with this? Could argue we do not have similar shareholder concerns or concerns about market failure

iii. § 162(m)(3)(B): "covered employee" means the CEO or the four most highly compensated employees (other than the CEO, whose salaries are filed with the SEC)
    1. Code defers to Congress's decision as to whose salaries should be reported
iv. § 162(m)(4)(B): NO limitation if the employee received their salary on a commission basis
v. § 162(m)(4)(C): NO limitation if the salary is performance-based
    1. Requires a compensation committee with outside directors and performance goals, but with good lawyers, this is not really much of a limit
vi. The government politically DISFAVORS some groups in the Code by having a lower floor on salary nondeductibility
    1. § 162(m)(5): If your company receipt TARP payments (i.e., government bailout), then your employee compensation is going to be more limited than it would be otherwise
        a. If you have executive compensation above $500K, you lose all deductions over $500K – applies to the CEO, CFO, and the other three highest compensated officers
        b. Concern: If you had to take TARP funding, you should not be paying employees over $500K
    2. § 162(m)(6): If the health insurance provider does not provide a minimum level of care, then it loses salary deductions over $500K for ***all*** health care executives (read: broader than § 162(m) and (m)(5))
vii. A lot of people use § 162(m) as a negative tax expenditure – we are collecting more revenue under § 162(m) than we are under a normal tax system that allows deductions for all salaries – *but*, tax expenditure analysis does <u>not</u> consider negative tax expenditures

c. Solutions for Dealing with Executive Compensation (other than using § 162(m)):
    i. Corporation laws could prevent closely held corporations
    ii. All companies could have compensation consultants
    iii. Dividends and salaries for closely held corporations could be treated the same
    iv. Could have a salary cap (although politically not likely)
    v. Sur tax (tax on income)

    . . . suggests that the Code might not always be the best place to deal with certain issues

d. Ex: *Exacto Spring Corp. v. Commissioner* (7th Cir. 1999): petitioner was paid a salary of $1.3M and $1M in 1993 and 1994, respectively; IRS said "reasonable" is $381K and $400K
    i. Tax Court splits the difference and says "reasonable" is $900K and $700K – but they said they applied a 7-factor test: (1) type and extent of the services rendered; (2) scarcity of qualified employees; (3) qualifications and prior earning capacity of the employee; (4) contributions of the employee to the business venture; (5) net earnings of the employer; (6) prevailing compensation paid to employees with comparable jobs; and (7) peculiar characteristics
    ii. Seventh Circuit does not like the 7-factor test because: it is nondirective; the factors overlap; it does not bear any relationship to the goal of § 162 and limiting salaries to reasonable; leads to arbitrary decision; companies have no predictability; requires the court to set itself up as a superpersonnel department – institutional competency concerns & courts might bring in their own preconceived notions
    iii. Independent Investor Test → Performance based – looking at the rate of return for investors – and basically, as long as the rate of return is better than what the shareholder expected, then the salary is assumed reasonable
        1. Exacto Springs Corp. investors expected a 13% return, but got a 20% return – so petitioner's salary is reasonable under this test
        2. *Cf.*: If we have two comparable companies with the same rate of return and both exceeded the rate of return in the same percentage, but one CEO is paid $100K and the other CEO is paid $10M, the independent investor test says that both of these salaries are reasonable because the rate of return was exceed … but are they?

a. Posner's test may be useful when there is a clear gain re: rate of return, but it does not actually tell us what is *not* reasonable

iv. Note: § 162(m) does <u>not</u> apply because this was a closely held corporation

e. Ex: *Menard v. Commissioner* (7th Cir. 2009): petitioner's compensation was: $157,500 salary, $3M profit-sharing bonus, 5% of Menard's net income bonus equal to $17M; Tax Court thought reasonable compensation was $7.1M – figured out by looking at the CEOs' salaries of Home Depot and Lowes

i. Posner found petitioner's salary reasonable under the Independent Investor Test (and therefore Menard could deduct the full amount as reasonable salary)

1. Posner focused on the fact that petitioner was a hard worker – but this doesn't really play into the independent investor test – which suggests that we need to add a little more to the test → does the CEO work as hard as other employees, has the company grown, etc.

ii. Note: A finding that a salary is unreasonable does not mean that the corporation is disallowed from giving it, but they cannot deduct the full amount from the company's income

iii. Note: § 162(m) does <u>not</u> apply because this was a closely held corporation

f. REASON Court stringent about salaries (*Menard* & *Exacto Spring*)

i. With closely held corporations, there is likely more of a concern about hiding dividends as salary (e.g., Menard was a 50% shareholder)

ii. The salaries involved here were significant – stood out in comparison to competitors

iii. [If you have a closely held corporation, it is possible that there is an ability to shield income from taxes by paying high taxes (so if a company is doing well, income shielding argument is stronger?]

g. Note: Failure to pay dividends is an important, although not conclusive, factor to some courts – they assume that if a corporation is not paying dividends to shareholders then it can be automatically assumed that the salary, which may have otherwise been deemed reasonable, will be deemed unreasonable (*See Charles McCandless v. United States*)

i. *But*, this rule is not great because companies may have very good reasons for not issuing dividends – might want to invest in capital, or might want to hold on to its profits so that shareholders do not have a realization event and are not taxed on the company's increased profits

h. "Deductions are given by the grace of Congress"

i. Deductions are indeed granted by Congress and what Congress gives it can take away

1. But maybe salary seems less by the grace of Congress and more attributable to business expenses (i.e., maybe deductions like clothing deductions are more by the grace of Congress)

a. That is, if we have deductions for salary because it should not be considered income (because income should not be assessed until after we have deducted the cost of earning the income), then Congress is overtaxing in some ways by not allowing the deduction

2. Note that if we accept the idea that deductions are by the grace of Congress, then maybe § 162(m)(5) & (6) make sense – Congress does not want their TARP money being misused, e.g.

IV. Expenses Contrary to Public Policy

a. <u>Tax Penalty</u>: If you do not allow a deduction for something that you would otherwise allow a deduction for

i. The opposite of a tax expenditure because the government is collecting, rather than forgoing, revenue

b. **§ 162(f)**: No deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law

c. Treasury Reg. § 1.162-21: No deduction shall be allowed under § 162(a) for any fine or similar penalty (defined as: **criminal or civil fine**, paid in settlement of the taxpayer's actual or potential liability for a fine or penalty, forfeited as collateral in a proceeding which could result in the imposition of a fine or penalty) paid to – (1) the government, (2) the government of a foreign country, or (3) a political subdivision of any of the above (SEC, e.g.)

    i. § 1.162-21(b)(2): The amount of a fine or penalty does not include legal fees re: defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty. Compensatory damages paid to a government do <u>not</u> constitute a fine or penalty

d. Third Parties
    i. Because § 162(f) prohibits deductions only for fines or penalties paid to a government, damages or payments made to a private party for a violation of law or private rules are deductible
        1. Where, however, the payments to private parties are akin to a fine, deduction has been disallowed – Rev. Ruling 81-151
    ii. Restitution made to the victims of fraud or theft is <u>not</u> deductible where the repayment serves a punitive purpose (*Kraft v. United States*)
        1. So compensatory and paid to the government can be deducted, but if compensatory and paid to a victim cannot be deducted
    iii. A company that makes a court-ordered charitable contribution in lieu of a criminal fine may not take a business deduction under § 162 or a charitable deduction under § 170 – Rev. Ruling 79-148
e. Ex: *Tank Truck Rentals v. Commissioner* (U.S. 1958): petitioner was trying to deduct payments of fines for overweight trucks as ordinary and necessary business expense
    i. Under *Welch*, it seems like the fines would be deductible because of the health and safety concerns – it is not capital (cannot put the cost into basis); it is not personal (company decision); it is not bizarre (other companies were doing this)
    ii. Under *Gilliam*, it seems like the fines would be deductible because this is part of the trucking business – driving through Pennsylvania
    iii. Petitioner argued that these expenses should be deductible under § 162 because:
        1. This is a revenue toll, rather than a fine
            a. PA is making about $2M/yr on these fines
                i. They still want truckers to drive through the state, just want them to pay extra
            b. Note: We do have fines that also raise revenue – sin taxes (on alcohol, cigs, etc.) – in some ways these are seen as somehow punishing things, but they are also raise revenue
                i. If you think of sin taxes are solely focused on the sin itself (i.e., to reduce smoking), then there would be no revenue consequences because the tax would make people stop smoking
        2. Innocent violations would not frustrate state policy – basically a distinction between innocent versus intentional
    iv. SCOTUS: Fines are <u>not</u> deductible
        1. Allowing the fines to be deductible would frustrate the state's purpose of prohibiting these vehicles
            a. Petitioners should not get to reduce the fine by being able to deduct it
                i. If this fine is supposed to punish, and there is some calculation that the fine is supposed to be a deterrent, then if we reduce the fine by allowing a deduction, we would be undoing the calculus that figured out the value of the fine
    v. So this was arguably an ordinary and necessary business expense for them, but it was contrary to public policy, so no deduction
        1. "<u>A finding of '*necessity*' cannot be made if allowance of the deduction would frustrate sharply defined national or state policies proscribing particular types of conduct, evidenced by some governmental declaration thereof</u>"

            a. "The test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction"

f. Ex: *Commissioner v. Tellier* (U.S. 1966): petitioner wants to deduct expenses incurred in his unsuccessful defense of a criminal prosecution for violating securities and mail fraud as ordinary and necessary under § 162; IRS denied the deduction as contrary to public policy – you violated the law and were found guilty, so should not be able to deduct legal fees
    i. Court: Legal fees are deductible as an ordinary and necessary business expense
        1. There can be no question that the payments deducted by the petitioner were expenses of his securities business
            a. Origin of the claim – it was tied to his business (not personal) activities
        2. No public policy is offended when a man faced with serious criminal charges hires a lawyer to help in his defense
            a. Having a lawyer is a constitutional right, so legal fees tied to your trade or business are generally deductible
        3. Notion that if we did not allow a deduction for legal fees that higher income taxpayers or those who pick an expensive lawyer would be subject to higher taxes, and it did not seem right that it would not be based on the actual crime, e.g.
    ii. Note: Legal fees are not punitive like fines
        1. Petitioner's fine imposed at the underlying criminal trial is <u>not</u> deductible - § 162(f)
    iii. "The purpose of the tax law is not to reform men's moral character"
        1. Well, our efficiency concerns definitely change people's behavior
            a. Ex: sin tax – we at least give lip service to the Code trying to reform moral character

g. Ex: *Commissioner v. Sullivan* (discussed in the above two cases): Court allowed a business expense deduction for salaries and rent even though both were illegal under state law (illegal activity related)
    i. If you have an illegal business and you have income from it, you are still taxed – regardless of legality – so it might made sense that the expenses you had to earn this income would be treated the same
    ii. If we did not allow a business deduction for illegal activity, that would be a tax penalty … and maybe we don't see that as a bad thing, but it might discourage people from filing taxes at all for their illegal activity/income

h. Summary:
    i. Deductible (tied to business and not punitive):
        1. Salaries and rents (legal and illegal business)
        2. Bribes and kickbacks, if they are allowed by law (i.e., not very many)
            a. Policy wise, this is saying that if there has been some legal decision to allow these, then we will allow a deduction
        3. Compensatory damages
        4. Legal fees
    ii. Not Deductible (punitive):
        1. Fines or penalties (§ 162(f); *Tank Truck*)
        2. Treble damages for antitrust violations (§ 162(g))
            a. Treble damages are one of the harshest penalties we have, so do not want to reduce that by allowing a deduction
        3. Bribes and kickbacks, if they are disallowed by law (§ 162(c))

V. Lobbying Expenses
    a. In 1962, Congress added § 162(e), which permits deductions for certain types of lobbying expenses and disallows others
    b. In 1993, Congress amended § 162(e) to <u>eliminate</u> the deduction for expenses incurred in lobbying federal or state legislators or certain executive branch officials
        i. Local Exception: Expenses in connection with lobbying local government bodies (e.g., city council or county legislature) remain deductible

            1. Might be a sense that there is not as much money at stake when lobbying a local entity
        ii. De Minimis Exception: If a taxpayer's total in-house lobbying expenditures do not exceed $2K, they are deductible
            1. A congressional decision that this amount of money is not that much of an influence, so we are not as concerned about it
        iii. Indian Tribal Government Exception: § 162(e)(7): An Indian tribal government shall be treated like a local council or similar local governing body
    c. Remember: Lobbying expenses still <u>must</u> be related to your trade or business (i.e., you must have a trade or business, which a family safety group, e.g., would not be deemed to have)
        i. This highlights the personal-business divide
        ii. But the fact that most lobbying is not deductible now, suggests a policy decision to put business and personal lobbying on equal footing (i.e., neither can deduct) – want to remove any sort of distortions that might favor more lobbying on the part of the business community
    d. **§ 162(e)(5)(A)**: If your trade or business is as a lobbyist and someone pays you to lobby for them, then all of your ordinary and necessary business expenses are deductible still under this §
        i. This essentially a savings clause for lobbyists so they can take the ordinary and necessary business expenses deductions that they would otherwise be able to take under § 162(a)
    e. **§ 162(e)(3)**: You cannot deduct your dues to a tax-exempt organization if that money was used or somehow associated with lobbying
        i. A "belts and suspenders clause"
        ii. Idea: Charitable organizations can lose their tax-exempt status if they are engaged in political activities
            1. So if you give money to a charity that turns around and uses it for lobbying, then that is no longer a charitable deduction, but rather a non-deductible lobbying expense
    f. Summary:
        i. Deductible:
            1. Ordinary and necessary business expenses for lobbying to local governments and Indian tribal governments
            2. Ordinary and necessary business expenses for lobbying trades or businesses
            3. Ordinary and necessary business expenses for any type of lobbying under $2K
        ii. Not Deductible:
            1. Personal lobbying of any type
            2. Business lobbying of any type to the federal or state government
            3. Any dues for the above lobbying
    g. Note: Lobbying is a fairly inelastic activity in that it does not seem to be distorted by making it more expensive (i.e., a nondeductible expense)
        i. In this field, taxes are not enough to change behavior because lobbying has actually increased since 1993
    h. Advertising vs. Lobbying
        i. Most advertising is not lobbying, and most lobbying is not advertising – but there is a gray area in there
            1. Lobbying = Nondeductible
                a. Expenses incurred to attempt to influence the general public with respect to legislative matters, elections, or referendums are not deductible
            2. Advertising = Deductible as an ordinary and necessary business expense
        ii. Ex: *Geary v. Commissioner* (9th Cir. 2000): a police officer took his puppet to work in order to improve his relationship with the community, but was not allowed to patrol with the puppet, so he formed a committee to put the issue on the local ballot and advertised in voting materials; he won the vote, but lost the deduction because the advertising was intended to influence the general public

VI. Business/Personal

a. **§ 262**: No deduction shall be allowed for personal, living, or family expenses (except as otherwise expressly provided in this chapter)
    i. No further clarity as to what it means to be a personal expense
        1. Regs for § 262 add some clarity (Code pg. 601)
            a. Ex: Suit for a breach of a promise to marry is an inherently personal suit
    ii. § 262(b): Basic local telephone service to the first telephone line of the taxpayer's resident is explicitly treated as a personal expense
b. Notwithstanding the conceptual difficulties, the Code must distinguish business from personal expenses
    i. If personal expenses could be deducted, personal consumption would be omitted from the tax base; and if business deductions were not allowed, gross income, not net income, would be taxed
    ii. Allowing business deductions for personal consumption produces both horizontal and vertical inequities: Taxpayers with similar incomes have different abilities to obtain these deductions depending on their occupations, while taxpayers with higher income often have more opportunities to obtain these deductions than do people with lower income
    iii. Recently, Congress has responded to what it perceives as "abuses" by imposing restrictions on or disallowing certain deductions
        1. Congress has also limited certain mixed motive expenses in order to raise revenue
c. Various tests for deductibility – pg. 260 – do you want/need?
d. Clothing
    i. Clothing is one of the most personal choices we make – an expression of our personalities – but it is also constrained in many ways by what we do as a job
    ii. Ex: *Pevsner v. Commissioner* (5th Cir. 1980): petitioner worked at YSL and she was required to wear their clothes while working; this is not about a qualified employee discount in § 132; this is petitioner paying for the clothes herself and seeking a deduction for the clothes as an ordinary and necessary business expense; she did not wear the clothes outside of work; she argued that she made much less than the people who normally buy these clothes and she felt that the clothes were a little bit ridiculous for her to wear outside of work
        1. Test: The cost of clothing is deductible as a business expense only if –
            a. (1) it is of a type specifically required as a condition of employment,
            b. (2) it is not adaptable to general usage as ordinary clothing, and
            c. (3) it is not so worn
        2. Tax Court: Clothing is deductible
            a. Thought the second prong should be subjective (rather than objective) and petitioner did not think it was adaptable to ordinary wear (sympathetic to petitioner)
                i. *But* (i) this seems to conflate the second and third prongs and (ii) there were no limits on her wearing these clothes in her everyday life
        3. Fifth Circuit: Clothing is not deductible
            a. The second prong is an objective determination – "no reference is made to the individual taxpayer's lifestyle or personal taste . . . depends upon what is generally accepted for ordinary street wear"
                i. Administratively that is easier and it promotes substantial fairness among the greatest number of taxpayers
                ii. Think: Couldn't "ordinary street wear" vary by age, city, etc.?
    iii. Ex: *Hamper v. Commissioner* (Tax Court 2011): TV news reporter tried to deduct almost everything as ordinary and necessary business expenses – clothing, gym membership (maybe for self defense), magazine and newspaper subscriptions, makeup, hair, nails, professional association dues, meals, entertainment, car, cell phone; she alleged that these things were required for her job, which was a lot about how she looked on TV

1. Problem with these deductions – lots of other people have these same expenses for their jobs (i.e., we all need to wear business appropriate clothing to keep our jobs)
    a. Clothing and other of these items are inherently personal
    b. Internet, e.g., might not just be for work – business and personal are conflated
2. Tax Court found almost everything was <u>not</u> deductible
    a. The cost of wardrobe has generally been considered a nondeductible personal expense pursuant to § 262 (uses the *Pevsner* test)
        i. The general rule is that where business clothes are suitable for general wear, a deduction for them is not allowed – even if petitioner does not wear them outside of work but could have
            1. Such costs are <u>not</u> deductible even when it has been shown that the particular clothes would not have been purchased but for the employment
    b. When the cost of acquiring clothing is deductible, then the cost of maintaining such clothing is likewise deductible as an ordinary and necessary business expense
3. Professional dues can be deducted ***if*** she has substantiation
4. Tax Court imposed an accuracy related payment
    a. So above disallowing the deductions, they hold that she did not even make the effort to figure out whether the items were deductible
        i. Seen as a like-form of tax fraud

iv. Ex: Sarah Palin's clothes, makeup, accessories, etc. paid for by the RNC
1. The RNC could likely deduct this as ordinary and necessary business expenses – they are essentially selling a product and need to present their politicians in a certain way
2. Apparently the RNC lent the items to Palin and then donated them to charity
    a. If they took a charitable deduction, then symmetry tells us that at some point prior they should have been seen as some sort of income/compensation
3. If the items stayed with the Palin family, then we have a business-personal divide issue and need to consult *Pevsner* and *Hamper*
4. Flag pins? This might be a deductible business expense for a presidential candidate, but that is different than from what we'd think for the ordinary person walking around

v. Examples of what the Tax Court <u>has not</u> permitted a deduction for:
1. A welder trying to deduct the cost of his Rocky Wolverine work boots because they were suitable for general or personal use
2. A professional tennis player trying to deduct court shoes because tennis pros can wear tennis shoes off the court
3. A model trying to deduct styling because that provided personal benefits
4. A fiction writer trying to deduction everything as research for his books
5. A writer of a book about legal brothels trying to deduction payments for prostitutes – um, inherently personal (plus he did not have receipts, so unsubstantiated)

vi. Examples of what the Tax Court <u>has</u> permitted a deduction for:
1. A piano soloist required to wear formal attire could deduct his tuxedos
2. A solider whose fatigues cannot be worn off duty
3. Uniforms – like scrubs – are the classic example of clothing as a deductible business expense

e. Transportation
    i. Transportation expenses, such as airfare, cab fare or the cost of operating a car, generally are deductible when the taxpayer is traveling on business – § 162(a)(2)

ii. *But*, the cost of commuting from home to work and back are nondeductible personal expenses
    1. Idea that work is a fixed location and the decision to live beyond walking distance is a personal one
    2. Exception: Additional expenses that may at times be incurred for transporting job-required tools and material to and from work may be deductible business expenses (but you still have to pay for the commuting costs – excess costs due to the tools are deductible)
        a. Requires separability – there has to be a separate expense for the commuting for the work item
            i. Code is creating friction here by making things a little more difficult – if you are willing to jump through the hoops, then you can get the benefit – shows that it really is related to business enough
            ii. Ex: Lawyer has to take documents home – if she takes a cab with the documents that is not deductible, but if she puts the documents in a black car and she takes a cab the black car is deductible
        b. Ex: *McCabe v. Commissioner*: NYC police officer's most efficient route was through a state that did not allow him to carry his gun; court denied the deduction, noting that his additional commuting expenses were not directly connected with the pursuit of his employer's business, but were the result of his personal decision to reside in a remote suburb adjacent to New Jersey
    3. Exception: If you need to be in the car and doing work, then your commuting can be a business deduction
        a. So if you are driving and working the entire time, then it stops being commuting and it starts being a deductible business expense
        b. Ex: *Pollei v. Commissioner*: court held that police officers, who began active patrol when they left home, were engaged in their jobs while driving to and from the station; commuting expenses allocable to that time were deductible

iii. Example of Overtaxation → Overtaxation happens when we end up not allowing deductions for things that may actually be business expenses – that may actually contribute to the production of income
    1. Undertaxation happens when we allow more deductions than we might otherwise allow

f. Food & Lodging
    i. § 162(a)(2): Ordinary and necessary trade or business expenses, including traveling expenses while away from home, are deductible
        1. An employee's unreimbursed travel expenses are dedutible as a miscellaneous itemized deduction and are subject to the 2% of AGI floor of § 67
        2. Travel expenses reimbursed by the employer (as well as those incurred by self-employer individuals) are deductible from gross income under § 62(a)(2)(A)
        3. Overnight Rule: what SCOTUS and the IRS use to interpret § 162(a)(2)
            a. "Away from home" does not include any trip not requiring "sleep or rest" no matter how far the taxpayer travels
                i. Administrability – Bright-line rule which is easier for the Commissioner to determine (i.e., business meal if you stayed overnight, not a business meal if you did not)
                ii. Might be the notion that not spending the night is a personal decisions . . . but imagine that the receipts from the two trips

(overnight & 1-day trip) look exactly the same, except for the hotel

iii. Creates an inefficiency to offset people's preferences – We want people not to be choosing between jobs because of how much travel is involved, but rather, we want them to do whatever is necessary for their work

4. This section does not take into account whether you actually live travelling at all
    a. So it may distort spending and favor people who go on business trips versus those that stay at home (maybe they have to because of kids) – but there is not any clear line here whether people love or hate travel
5. Note: The "lavish or extravagant" exception does not have many teeth – travel expenses are deductible even if you are staying in a 5-star hotel

ii. Ex: *Hantzis v. Commissioner* (1st Cir. 1981): law student tried to deduct the costs of her summer employment in NYC because her home was Boston (where she was from and her husband resided); IRS argued that her home for purposes of § 162(a)(2) was NYC and therefore her costs of traveling to and living in NYC were not incurred "while away from home"; IRS argued that the expenses were not "in pursuit of a trade or business"; Tax Court: deductible business expenses because "home" is Boston and "trade or business" is NYC; First Circuit: not deductible business expenses because NYC was her "home" and there was no real business reason to maintain a "home" in Boston
    1. *Flowers* Rule re: § 162(a)(2): A traveling expense is deductible only if it is (1) reasonable and necessary, (2) incurred while away from home, and (3) necessitated by the exigencies of business
        a. So here, petitioner did not satisfy (2)
    2. Note: If she had a job in Boston that required her to stay in NYC for a few weeks, then the costs incurred by traveling to and living in NYC would be deductible
        a. But you have to have both homes at the same time – you have to have a home from which you are actually leaving to have deductible business expenses (i.e., cannot be a transient with no home base)
            i. Idea: The only time we allow deductible business expenses is when they are repetitive of a cost you are already paying – so we do not allow a deduction for where you must temporarily live if the costs are not adding onto what you would have been paying otherwise

g. Entertainment and Business Meals
    i. Food presents a great business-personal consumption distinction
        1. Arguments For Business Meal Deduction: You are still working – contributing to the business and income-gathering, and we might not necessarily choose to eat with the people and at where the business meal is (i.e., not really a personal choice to sit through a 3-hr dinner with clients)
        2. Arguments Against Business Meal Deduction: (i) It is too hard to distinguish the personal consumption aspect from the business aspect – the business meal is not on top of your personal consumption, but rather just replacing it; (ii) there is an equity concern that higher income taxpayers are generally the ones who get to have business meals, and that only certain types of employees are eligible (i.e., not all); and (iii) if business meals are presumed to be deductible expenses, people might shift to always claim this
    ii. Ex: *Moss v. Commissioner* (Tax Court 1983): petitioner is a partner at a law firm who is trying to deduct his daily business lunch expenses (every single day); lunch was part of the working day – only an 8-person firm so had to go to discuss business
        1. Court: Lunch has too much of a personal aspect – even if we accept that they discussed business, it was part of their working day, and the partnership benefited from the exchange of information

a. *Sutter* Formula: Business meals are deductible where the expense is "different from or in excess of" the personal expenditure the taxpayer would otherwise have made
   i. Meaning, if you do something that was completely different from what you would have done, then you get to deduct the **full** amount of the business meal
      1. NOT: deducting the difference between the normal amount you'd spend and the actual cost
      2. So if it is not different enough, then no deduction at all
   ii. But, to know what is different or excessive, there is a subjective inquiry into the taxpayer's choices, which we do not like to do usually
b. In close cases, § 262 takes priority over § 162
   i. Daily meals are an inherently personal expense, and a taxpayer bears a heavy burden in proving they are routinely deductible

2. *Silba v. Commissioner* & *Cooper v. Commission*: Tax Court allowed deductions for firemen who were required to contribute to a meal fund every day they were on duty, regardless of whether they ate or were event present at the station
   a. But here, taxpayer's situation was both unusual and unique
3. § 119: Limited exception to § 61 allowing an employee to exclude meal amounts if the meal is furnished on the business premises for the convenience of the employer
   a. Petitioner alludes (but cannot rely on since lunch is not on the business premises) to this section and argues that the firm incurred the expense solely for the benefit of its practice and not for the personal convenience of its attorneys
   b. AFTER this case, the law firm ends up having the restaurant come in-house daily and provide lunch → § 119 satisfied
      i. Idea of friction: If you think these meals are so business related that you are willing to do this, then maybe we should give you the business deduction

iii. Note: If your employer *occasionally* provides lunch for you, you do not have to include that in income – we can assume there is a business aspect and permit a deduction
   1. If it is *daily*, then we think of it as replacing your normal meals – too personal
      a. We have a tax avoidance concern if we allow daily meals to be deductible – everyone would be claiming all meals as business meals

iv. Client Meals
   1. Judge Posner thinks it is pretty obvious that going out with clients should be deductible because it is clearly tied to business and it would look strange if you brought your own food – so both you and your client's meal should be deductible
   2. Despite Judge Posner, in theory you are not supposed to be deducting the cost of the client's meal and your meal . . . but, the IRS has said they will not enforce that rule . . . therefore, the real rule, then, is that you can deduct the meal for you and your client (unless we see a clear case of tax avoidance, then we will enforce the rule on the books)

v. § 274: Disallowance of Certain Entertainment, etc., Expenses
   1. § 274(d): Substantiation Required
      a. This § limits the deductibility of otherwise deductible things – so first have to ask whether the item is deductible under any other provision of the Code? (i.e., § 274 does not make anything deductible, must already be deductible before arriving here)
         i. Even if deductible elsewhere in the Code, without substantiation (i.e., receipts) it is not deductible
            1. Concern about tax fraud

b. Before this §, the *Cohan*-rule applied, which was the opposite of a substantiation rule – you only needed to approximate, basically (dangerous, could lead to undertaxation)

2. Congress has flatly prohibited the deduction of certain kinds of entertainment
   a. No deduction may be taken with respect to hunting lodges, yachts, and other entertainment facilities – § 274(a)(1)(B)
   b. § 274(l)(2) limits the deduction for luxury leased skyboxes in sports stadiums rented for more than one event to the sum of the face value of regular box seats for the number of seats in the skybox
   c. No deduction for club dues (if you paid yourself) even if the primary purpose for using the club is furtherance of the taxpayer's trade or business – § 274(a)(3)
      i. *But*, if the employer pays or you are reimbursed under § 132, then the dues are not included in income (essentially a deduction) – this is because when the employer does something that proves a true business purpose

   . . . notion that even if there is a business purpose, the level of personal enjoyment and costs are so high that we are going to limit
3. **§ 274(n): 50% Disallowance**: Amount allowable as a deduction shall not exceed 50% of the amount of such expense or item which would – but for this paragraph – by allowable as a deduction
   a. So despite that the item is deductible elsewhere in the Code, if it qualifies under § 274 as a meal or entertainment expense, we think it is more personal than business, so the deduction is 50% disallowed
      i. And the 50% is a bright-line rule for administrability's sake
   b. This section only applies to the person who is ultimately paying
      i. If the taxpayer is reimbursed for the cost of business meals or entertainment, the 50% limitation applies to the one who makes the reimbursement, not the taxpayer
         1. Taxpayer either includes the reimbursement as income and immediately takes an ATL deduction – or – never includes the reimbursement in income and never takes a deduction
      ii. If the employee is not reimbursed by the employer, the expenses for meals and entertainment are subject to not only the 50% limitation but also the 2% floor of § 67
         1. Reimbursement suggests a true business purpose, so unreimbursed business meals seems a little suspicious

vi. Despite the limitations, the liberal allowance of the deduction for meals and entertainment is in sharp contrast to the restrictions on deduction of many other business-related costs, such as work clothing and commuting

h. Losses
   i. Taxpayers want to deduct losses any time they have income to set off
   ii. Business losses <u>are</u> deductible, *but* personal losses <u>are not</u> deductible – otherwise there would be an incentive to produce all losses as business losses
      1. Losses under § 165 are business losses (i.e., § 162 and 212 losses) incurred in your trade or business . . . even if there is a slim chance of success (think: VCs)
      2. **§ 172: Net Operating Loss Deduction**
         a. Carryback Period – 2 years / Carryforward Period – 20 years
            i. In a way, this is the opposite of a basketing regime
            ii. Any losses that are not subject to a basketing regime can be carried back 2 years to soak up any gains (just file an amended

return), or carried forward 20 years because if there are accurate business losses, you should get time to use them up

b. Shorter carryback period for administrability reasons – the Code changes often so it gets more confusing to file amended returns the farther back you go
c. Longer carryforward period to facilitate losses early create gains later on – early losses are the cost of making the profits in the future (i.e., start-ups)

iii. Gambling Losses
1. Gambling losses are a classic example of a loss that is presumed to involve a component of personal consumption
    a. To prevent taxpayers from using such consumption-related losses to reduce the tax otherwise payable on unrelated income and to permit the deduction of losses only when incurred in business or profit-seeking activities, § 165(d) allows gambling losses to be deducted only to the extent of gambling gains
        i. § 165(d) [wagering losses] is an exception to § 165 [losses] in general
2. Gambling losses still require substantiation (we don't want you collecting tickets from other people and claiming them as your losses)
    a. Gamblers can still rely on the *Cohan*-rule, which permits a deduction based on estimates/approximation where the court believe that an expense was actually undertaken
3. Professional Gamblers → must be involved in the activity with continuity and regularity and with the primary purpose of earning income or profit in order to claim gambling expenses as ordinary and necessary business expenses
    a. So they are treated better than amateur gamblers because they can deduct traveling, etc., expenses
    b. *But*, professional gambling losses are still seen as § 165(d) losses – so still basketed (so no carryback/forward period) and seen as disfavored losses

iv. Hobby Losses
1. **§ 183 – Activities Not Engaged in For Profit –** is another provision designed to restrict the deduction of losses under § 165 to those incurred in the course of a business or profit-seeking activity
    a. § 165(c) requires that losses be incurred in a business or in a transaction entered into for profit
    b. <u>General Rule</u> [§ 183(a)]: No deduction for losses unless the activity is profit-seeking (i.e., no deduction if personal)
    c. <u>Exception</u> [§ 183(b)(1)]: Deductions that would be otherwise be allowable without regard to profit-seeking motive – saying that § 183(a) does not undo any other allowable deductions (e.g., state taxes are deductible without regard to profit-seeking)
    d. <u>Exception</u> [§ 183(b)(2)]: Deductions allowed for non-profit seeking activities if that deduction would otherwise be allowed if you had engaged in for profit (i.e., losses are deductible)
        i. Basketing → hobby losses deductible only to the extent of hobby gains
        ii. Deduction may be limited, however, by the 2% floor (Supp. 23)
        iii. Taxpayer has to have net losses in order for there to be any concerns with a basketing regime limitations
            1. If you have more gambling, e.g., gains than gambling losses, then we do not care if we are in a basketing regime or not because there are no losses to offset

2. **§ 183(d)** – rebuttable presumption that an activity was engaged in with the requisite profit motive if the activity produced profits for 3 out of 5 consecutive years ending with the year in question . . . and this means that you can take your losses for all 5 of those years
    a. (and if you do not meet the rebuttable presumption, look to *Plunkett*'s factors)
    b. Horse Exception – the rebuttable presumption is edited to "2 out of 7" consecutive years
        i. Why? Maybe a lobbying group, maybe an argument that horse breeding has more years of losses to produce two years of gain
        ii. This is just for people doing this as a hobby – <u>not</u> horse breeding as a business, because then we are in § 165
3. Ex: *Plunkett v. Commissioner* (Tax Court 1984): petitioner tries to deduct his losses under § 183 for truck-pulling and mud-racing; Commissioner thinks this is a tax shelter – using losses from one activity to shelter gains from another; Court: looking at the factors, mud-racing was not profit seeking, truck-pulling was profit seeking – greater profit margin, fewer changes for you to lose, and bigger purse when you did win
    a. <u>Standard</u>: Did the individual engage in the activity with the actual and honest objective of making a profit?
        i. Although the taxpayer's expectation of profit need not be reasonable, the facts and circumstances must indicate that the taxpayer had the requisite profit objective
            1. Note that we are only concerned about expectation of profit and the profit margin for hobby losses – not business losses, which lack the hobby/recreation element and are therefore in §165
    b. Factors:
        i. The manner in which the taxpayer carries on the activity
        ii. The expertise of the taxpayer or his advisors
        iii. The time and effort expended by the taxpayer in carrying on the activity
        iv. The expectation that the assets used in the activity may appreciate in value
        v. The success of the taxpayer in carrying on other similar or dissimilar activities
        vi. The taxpayer's history of income or loss with respect to the activity
        vii. The amount of occasional profits, if any, which are earned
        viii. The financial status of the taxpayer
        ix. Whether elements of personal pleasure or recreation are involved

        . . . can look to these factors for other cases, but hobbies are pretty subjective as to the application of the factors
            1. What may be a profit-seeking activity for one taxpayer may not be for another
            2. Taxpayer may have the proper motive one year and have abandoned it in a future year
4. Ex: *Morley v. Commissioner*: court permitted petitioner to deduct the losses from his horse breeding; court talks about how difficult the business was and how he was "never around" . . . but lots of people are "never around" for various reasons so unclear whether this gives any guidance

a. This case seems to be an exception to the norm, influenced likely by the fact that it involved horse breeding, which is a hobby that gets more preferential treatment

5. Concern: Tax Shelters – activities that were unrelated to a taxpayer's primary business activities and that arguably provided a means of securing business deductions for what were in reality personal consumption expenditures
    a. Tax shelters do not always have to be a bad thing – you could have two valid businesses – but it becomes more questionable if the losses seem to be personal and are sheltering your actual income

VII. Capital Expenditures

a. Capitalization → Adding the cost of the item to the value of the asset, rather than expensing the cost of the item
    i. Capitalization does not change your overall gain, but it does change how your gain is recaptured
        1. When you take deductions, you eventually need to recapture them
        2. (If you do not take deductions, you are taxed only on the real world gain)
    ii. You have to capitalize INTO something – so need to ask: "what is this capital expenditure being capitalized into?" – If there is nothing it is capitalized into, then you generally cannot capitalize it

b. Capital expenditures are somewhere in the middle of the business-personal spectrum
    i. They are not purely business because they are <u>not</u> immediately deductible
    ii. They are not purely personal because they will be deductible at some point

c. § 263 specifically DISALLOWS deduction of a "capital expenditure" (i.e., the costs for acquiring or improving an asset)
    i. When an amount must be capitalized, it is added to the taxpayer's basis in the asset with respect to which the expenditure is incurred (capital expenditures are capitalized into the basis of something)
        1. This amount will either be recovered when the asset is sold or over some period of time during which the asset is held, through a series of deductions – depreciation or amortization
    ii. <u>Capital Expenditures: Costs of acquiring or improving a business asset that will last for more than one year</u>
        1. You cannot capitalize a personal asset
            a. Ask: Business or Personal?
                i. Business – next Q
                ii. Personal – no capitalization
            b. Ask: Business or Capitalize?
                i. Business – immediately deductible
                ii. Capitalize – not immediately deductible
                    1. Holding period of 1 yr+? (NOT holding period for CGs)
                        a. Yes – move to next Q
                        b. No – might still capitalize
                    2. Is it a separate and distinct asset? (*Lincoln Savings*)
                        a. Yes – capitalize
                        b. No – move to next Q
                    3. Is there a future benefit? (*INDOPCO*)
                        a. Yes – capitalize
                        b. No – might not capitalize

d. Tax Impact of the Capitalization Requirement
    i. There are three options:
        1. Immediate Business Deduction - § 162
            a. Best option to taxpayers because we are deferring paying taxes and accelerating deductions and losses

b. No capitalization
2. Ratable Depreciation – taking the deduction evenly over the useful life of the asset
    a. Capitalization
3. Recovery on Disposition – waiting until you dispose of the asset at the end of its useful life
    a. Best option for the IRS because taxpayer is paying taxes upfront (time value money for the IRS)
    b. Capitalization

ii. The numbers do not change, but the timing does
    1. We want to DEFER paying taxes (time value money – then we have more money to invest now)
    2. We want to ACCELERATE our deduction and losses

iii. IRS prefers capital expenditures partially because it means they get taxes early and partially because a capital expenditure is likely to be closer to a mark-to-market system (where every year you account for the actual value of an asset you own)
    1. There is some effort in capitalization to get closer to a mark-to-market system
        a. If we do not have a mark-to-market system and we allow an immediate deduction at the start, we end up with undertaxation
        b. Flip: If we wait until the end with no mark-to-market system, we end up with overtaxation

e. **General Rule** (§ 263(a)): Capital expenditures are <u>not</u> deductible expenses
    i. <u>Exceptions</u> (§ 263(a)(A)-(K)): These are things that but for these provisions would be capital expenses, but instead they are treated as deductible expenses
        1. These certain expenses get favorable treatment
    ii. § 263(a) seems to give guidance re: what counts as a capital expenditure . . . but we should ignore it because it is very difficult to figure out what counts – can use the Regs for some guidance
    iii. Expenses that must be capitalized:
        1. Business and real estate
        2. Tangible property
        3. Financial assets
    iv. Two general rules:
        1. Capital expenditures should be for the cost of acquisition of an item or improvement of an item
            a. Why? When we capitalize, we increase the basis because the basis is supposed to get at how much money you put into acquiring or improving something
                i. When you sell the asset, you are not taxed on gains you should not be taxed on (i.e., we do not want to be seen as selling at a gain when we are really selling at what it is worth because of our improvement)
        2. One Year Rule = If the asset is going to produce income beyond the current year, then that expense should be capitalized
            a. This is a guideline, though, rather than a bright-line rule because we cannot always predict what will create income for more or less than one year
                i. Can give guidance if precedent and the Regs are not helpful

f. What Does it Mean to "Acquire an Asset" → Ex: *Woodward v. Commissioner* (U.S. 1970): petitioners tried to deduct litigation fees (lawyer, accountants, e.g.) in connection with appraisal of corporate stock (because minority shareholders disapproved of something and needed to be bought out at the "real value" of the stock) as ordinary and necessary business expenses; IRS disallowed the deduction because the fees represent capital expenditures incurred in connection with the acquisition of capital stock of a corporation; SCOTUS agrees with the IRS

i. If an expense is capital, it cannot be deducted as a business expense under § 162 or § 212
ii. Costs incurred in the acquisition or disposition of a capital asset are clear capital expenditures
1. <u>These costs of acquisition or improvement *include* all of the costs associated with such acquisition or improvement</u>
a. Therefore, these litigation fees are treated as a capital expenditure
i. The idea of something being too attenuated from acquisition is pretty much throw out
1. Because here, the acquisition was never in question – the only question was the valuation of the stock to be paid to the minority shareholders – and if petitioner needed to pay these fees solely to figure out the value of the shares (absent any acquisition concerns) that would be an ordinary and necessary business expense
ii. Origin of the claim (*Gilliam*) – These costs were tied to acquisition of stock
iii. The capital expenditure here will be capitalized into the value of the shares
1. So if they buy the shares for $100K, the $25K capital expenditures will make their basis $125K when they sell the shares

g. Ex: *INDOPCO v. Commissioner* (U.S. 1992): petitioner (formerly National Starch), was the target of a **<u>friendly takeover</u>** by Unilever and incurred significant investment banking and legal fees as well as other acquisition expenses which it sought to deduct as ordinary and necessary business expenses; we have an acquisition and costs related to that, but the question is whether or not the petitioner is realizing any future benefit
i. *Lincoln Savings*: A taxpayer's expenditure that serves to create or enhance a separate and distinct asset should be capitalized under § 263
1. But, SCOTUS did not consider in *LS* the tax treatment of expenditures that did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances
a. So *LS* means 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
2. Bottom Line: Separate and distinct is not the only requirement, but it is considered when determining whether there has been a capital expenditure
a. Generally, if you do acquire a separate and distinct asset, that is enough to deem it a capital expenditure
ii. Here, SCOTUS finds that even if there was no separate and distinct asset, there was realization of future benefit
1. Therefore, the costs of being acquired are treated as capital expenditures
a. <u>RULE</u>: Costs of being acquired in a friendly takeover are capital expenditures
2. Think: This was a friendly takeover which means that petitioner agreed to it after making spending these costs to determine it was a good business decision for them (i.e., that there would be realization of future benefit)
iii. Post-INDOPCO: More costs are capitalized and fewer are immediately deducted – and taxpayers did not like this because they felt deprived of deductions they might otherwise be able to take under *Lincoln Savings*
1. Specifically, salaries and advertising were confusing after this case – both seemed to have the possibility of future benefit so maybe they should be capitalized, but this would cause problems because then you would be adding salaries to basis and slowly ratcheting it down

2. Treasury ended up passing a lot of Regs to deal with post-INDOPCO questions – so look at them
    a. Salaries: Generally still deductible (even though they create future benefit)
    b. Advertising: Almost always deductible
    c. Clarifies the separate and distinct test (pg. 311)

iv. HOSTILE Takeovers → Costs of being acquired in a hostile takeover have been held as deductible as an ordinary and necessary business expense – not capitalized because there is no future benefit aspect in a hostile takeover, no business decision was made to be acquired in this situation

h. **§ 263A**: Statutory source for capitalizing indirect costs (e.g., interest, lawyer or accountant fees)
   i. Codified *Commissioner v. Idaho Power* – a utility company used equipment for the construction of its own facilities and depreciated the equipment over a ten-year useful life (and company would prefer a shorter depreciation period because we want to accelerate deductions)
      1. SCOTUS: Since this equipment was being used to build the company's own building and the building is a capital expenditure, then everything involved with the capital expenditure had to be treated the same – therefore, the equipment had to be included in the adjusted basis of the building, which would be depreciated over its useful life of thirty years
   ii. § 263A tells us that indirect costs, even if they are things you'd normally get to deduct altogether (because they are ordinary and necessary business expenses, e.g.) or depreciate faster, once used for capital expenditures are treated the same as direct costs
      1. And this is true for salaries – in that, if you are paying someone solely to acquire a capital expenditure, then their salary is a capital expenditure (although it normally would not be otherwise)

VIII. Education and Job Seeking Expenditures
   a. Expenses Re: A New Business
      i. Costs of entering a *new* trade or business are always capital expenditures (or personal)
         1. While the costs to maintain an *existing* trade or business are generally deductible (which we'd prefer)
            a. If you are paying for yourself and are not reimbursed, likely deductible under § 162 and subject to the § 67 2% floor
            b. These may end up being capital expenditures – if the expenses are for acquiring something
         2. And this is consistent with the general rule of capitalization– building a new business or a new building are both capital expenditures
      ii. In general, start-up costs or expenditures incurred prior to entering a new business have been required to be capitalized (§ 195(a))
         1. Remember: § 162 – ". . . ***carrying on*** any trade or business . . ." – start-up costs are not for an existing trade or business then
            a. This language is not in § 212, but this limit has been read into § 212, requiring that the business be in existence before a § 212 deduction is allowed
         2. **§ 195(b)(1)(A)(ii)** permits a maximum deduction of $5K for start-up expenses (if expenditures do not exceed $50K – after $50K the deduction starts phasing out)
            a. Beginning 2010: $10K max deduction if expenditures do not exceed $60K
               i. Hypo: $55K start-up costs, so I get a $10K deduction <u>AND</u> under § 195(b)(1)(B) I take $3K/yr for 15 years as a deduction (because the remainder after the initial $10K deduction is allowed as a deduction ratably over the 180-month period)
                  1. <u>Immediate Deduction AND Ratably Depreciate</u>

b. Hypo: $71K start-up costs, I get NO deduction because for every dollar I spend about the phase out limit ($50K or $60K in 2010) I reduce my deduction ($5K or $10K)
    i. BUT, can ratably depreciate over 180 months (?)

3. **§ 195(b)(1)**: Taxpayer are required to make an election under this § — you have to choose a year as the start of the start-up
    a. § 195(c)(2)(A): Treasury Regs will instruct when § 195 applies – when the beginning of a trade or business counts (and when it doesn't because it is a hobby, e.g.) . . . but these Treasury Regs do not actually exist, so there is an open question as to when § 195 kicks in
4. <u>POLICY</u>: Start-up costs are treated differently than expenses for an existing business because if we can easily deduct start-up expenses, people would have an incentive to claim our personal hobbies/consumption as start-up expenses

b. Education
    i. Educational expenses are generally <u>not</u> deductible
        1. Therefore they are seen as personal expenses (because we cannot capitalize them, nothing to capitalize into)
            a. But, there are some exceptions where business expenses are capitalized into the lifetime of the person involved in the business
        2. Nondeductible educational expenses include:
            a. Fulfilling minimum educational requirements (Tres. Reg. § 1.162-5(b)(2))
            b. Qualification for a new trade or business (Tres. Reg. § 1.162-5(b)(3))

            … often these two conflate, but **the Reg has examples to analogize to**
        3. Deductible (under § 162) educational expenses include:
            a. Maintaining or improving skills required by the individual in his employment or other trade or business (Tres. Reg. § 1.162-5(a)(1))
    ii. Ex: *Wassenaar v. Commissioner* (Tax Court 1979): petitioner tries to deduct as an ordinary and necessary business expense the cost of his LLM (tuition, books, meals, lodging, misc.); petitioner tried to argue he was "away from home" (going to school in NY, primary residence in MI), but the court was not having it; petitioner contends that his trade or business was "analyzing and solving legal problems for compensation" (while he worked at the law review and for a firm – not convincing) – or – "rendering his services to employers for compensation" (and if this is going to work, then we lose any distinction between an existing trade or business versus a new trade or business)
        1. Court: Costs are nondeductible personal expenses
            a. Tres. Reg. § 1.162-5(a)(1) – Petitioner's expenses were not incident to the trade or business of practice law, and therefore he was not maintaining or improving the skills of that profession
            b. Tres. Reg. § 1.162-5(b)(3) – Educational expenses are not deductible if the education is part of a program of study being pursued which will lead to qualifying petitioner in a new trade or business
        2. Note: MBAs generally have an easier time deducting their expenses if they were working for a few years before earning their MBA than lawyers
            a. There is no Bar or other exam to pass before entering the business world, so when you get an MBA you are generally just keeping up or maintaining your current job
            b. Lawyers like the idea that we are a profession and the nature of being in a profession is that you can't have been doing this before you came to law school because you need to get a degree and pass the Bar first . . . whatever you were doing before law school (something of a legal nature, e.g.) is not the same as what you will be doing after (i.e., practicing law)
                i. We have barriers to entry into the profession, so cannot deduct the costs of education

1. Note: CLE expenses are likely to be deductible though because you will already be in the profession

iii. Ex: *Sharon v. Commissioner* (Tax Court 1976): petitioner is trying to deduct his undergrad and legal education, home office, licensing for NY and CA Bar, and SCOTUS Bar costs; petitioner alleges that he is in the business of being an attorney and these were all necessary for him to get into the business (a lot of "but for" arguments – but for going to college he could not have gotten into law school …)
   1. Home Office → Not Deductible
      a. Court implies that the home office has to be necessary for work, and his work provided an appropriate office, so a home office was not really necessary
         i. His home office was purely a matter of personal convenience or comfort
      b. Home office deductions are actually pretty hard to get
         i. Need to have a very clear separate room – cannot have kids running through it, cannot use the space for entertaining, cannot use for personal correspondence, etc.
   2. Education Expenses → Not deductible
      a. Education is inherently personal
   3. Bar Review Course → Not deductible
      a. This was a personal expense of entering into a new profession
   4. Continuing as a Lawyer in CA → Not deductible
      a. Passing the Bar in another state is considered a new trade or business (i.e., being a lawyer in another state)
   5. Various Licensing Fees → Not deductible immediately, but capital expenditures that could be amortized over his life expectancy
      a. Petitioner wants to amortize until he is 65 years old (retirement age)
      b. Likely it will be amortized over this lifetime (using life expectancy stats)
      c. Dissent: There is no way to ascertain the reasonable useful life of the asset petitioner acquired through his capital expenditures

iv. Note: There is NO educational expense deduction for travel as education (§ 274(m)(2))

v. Note: Change in duties within a trade or business does not count as starting a new trade or business
   1. Sometimes change in duty is narrowly read (as with saw in *Sharon*)

vi. Generally – Most educational expenses are not deductible
   1. Congress could subsidize education if it wanted to
   2. There is no overall deduction for education expenses because –
      a. Might create a distortion – people might over-purchase education
      b. Could increase the overall cost of education because the deduction might be capitalized into the cost of education
         i. This would happen because if you showed that you were willing to pay $10K after-tax dollars for education and you get a 50% deduction, then they might raise the price of education o $20K after-tax dollars accounting for the 50% deduction … essentially absorbing the cost of the deduction
   3. What do we have to help make education more affordable (i.e., exceptions to the general rule that the cost of education is generally not deductible)?
      a. **§ 222(a)**: A taxpayer may deduct up to $4K for college tuition and related expenses for himself, a spouse, or a dependent
         i. Students who are claimed as dependents on their parents' return are not eligible to take a deduction

            ii. Taxpayers whose AGI exceeds $80K are not eligible to take a deduction
                1. "Cliff Effect" – if you make $79,999 you get a $2K deduction, but if you make $80,000 you completely lose the deduction
                    a. This is a huge effective marginal tax rate
                    b. People who do not make that much different are treated very differently re: § 222 educational expenses
            iii. Taxpayers whose AGI is between $65K and $80K may deduct $2K
                1. Cliff Effect – from <$65K to >$65K
                    a. Huge effective marginal tax rate here, too
            iv. Unlike the deduction for education expenses under § 162, this education does not need to be business-related
        b. **§ 117**: Qualified scholarships are <u>not</u> included in income
        c. **§ 127**: If your employer pays for your education, then you do <u>not</u> have to include that in income up to a certain amount ($5,250)
    c. Job-Seeking Expenses
        i. Rev. Ruling 75-120: Expenses incurred in seeking new employment in the **same** trade or business <u>are</u> deductible under § 162 *if* directly connected with such trade or business
            1. Such expenses are <u>not</u> deductible if an individual is seeking employment in a **new** trade or business
                a. If the individual is presently unemployed, his trade or business would consist of the services previously performed for his past employer if no substantial lack of continuity
            2. Tax Court has held that if substantial differences exist in the tasks and activities of various occupations or employments, then each such occupation or employment constitutes a separate trade or business
    d. Expenses of Seeking Public Office
        i. These expenses are <u>not</u> deductible – so either personal or capital expense
            1. There is some sense that every office you seek is entering a new trade or business
            2. Institutional Competence – Courts want Congress to make the decision, so costs of running for office are not deductible unless Congress clearly states otherwise
        ii. If you are running for re-election, that is likely seen to be within the same trade or business, so should count as an ongoing, ordinary and necessary business expense

IX. Capital Recovery – Depreciation
    a. Principal mechanisms for recovery of capitalized expenditures over a number of years: depreciation; amortization (depreciation for an intangible asset (e.g., IP, the value of a degree)); and depletion
        i. Remember: Recovery of capital is not taxed
    b. Depreciation deductions are allowable because of an underlying sense that there is real world economic depreciation – the value of some things will slowly decrease and this should be captured in the value of the asset as is decreases (rather than waiting until the realization requirement)
        i. Economic depreciation (i.e., the actual decline in value) is hard to measure, so we do not actually measure that way
            1. Our Code has clear rules that ignore what is actually happening re: depreciation, and instead use the tax forms re: depreciation – partly for administrability reasons
        ii. An allocation of costs to the related income is essential to the clear reflection of income
            1. The depreciation deduction is intended to allocate the cost of the machine/asset over the proper period of time
        iii. Depreciation deductions are the most common way to reduce your basis
    c. **§ 167(a): Depreciation**: There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) – of property used in the trade or business, or of property held for the production of income

        i. Depreciation deductions are property (mainly tangible) used for business
            1. If use of the asset is personal, depreciation deductions are unavailable – this is to stay consistent with other parts of the Code (no personal deduction, e.g.)

d. **§ 168** provides a mandatory system of depreciation (MACRS – Modified Accelerated Cost Recovery System) for tangible personal property and real property placed in service in 1981 and subsequent years
    i. "Accelerated" losses (and therefore defer gain) is a policy decision that is good for taxpayers (if they have taxable income to start with)
        1. Accelerated depreciation was codified to help businesses and encourage investment in depreciable assets
    ii. The annual depreciation allowance is applied to the **depreciable base** – this is usually the property's basis (and basis is often cost)
        1. The depreciable base includes any capital expenditures that have been added to basis
            a. The basis is reduced periodically by the amount of allowable depreciation
                i. And the result – adjusted basis – reflects the recovery of the taxpayer's capital investment over time
    iii. Depreciation deductions increase the gain or decrease the loss realized by the taxpayer on disposition
    iv. The depreciation allowance depends on the depreciation rate – which is a function of both the method and the recovery period . . .

e. For § 168(a) – need to figure out the:
    i. Depreciation Method
        1. <u>Straight Line</u>: the cost of an asset is allocated in equal amounts over its useful life
            a. Straight line % is calculated by dividing 100 by the useful life (depreciation period)
                i. Ex: $30K asset depreciated over 5 years – 20%
            b. § 168(b)(3) – straight line method applies to nonresidential real property, residential rental property, railroad grading or tunnel bore … or if the taxpayer elects this method
                i. If you elect this method, you are locked into it
                ii. Might want to elect if: (i) you do not have gains to offset, (ii) you are a public company that wants similar losses every year for the financial statements, (iii) if you are a small company that does not want to have to calculate the declining balance method[, or (iv) you know that you do not want to recover all later on because you will be taxed on it and that might bump you into a new tax bracket?]
        2. <u>Declining Balance</u>: allocates a larger portion of the cost of the earlier years and a lesser portion to the later years
            a. A constant percentage is used, but it is applied each year to the amount remaining after the depreciation of previous years has been charged off
            b. *Double* Declining Balance – doubles the straight line rate – 200%
                i. § 168(b)(1)(B): switch to the straight line method for the first taxable year for which using the straight line method with respect to the adjusted basis will yield a larger allowance
                    1. We do this to make the calculations neater and eventually end up a $0
            c. This method is generally more favorable for the taxpayer because it is accelerated depreciation (as compared to straight line), as long as the taxpayer has gains to offset
    ii. Recovery Period

1. This is the estimated useful life of the asset – because we cannot accurately predict this, we look to § 168 to determine (which generally focuses on class life)
    a. § 168(c) – Applicable Recovery Period
    b. § 168(e) – Classification of Property
2. Hypo: I have two assets that I can accurately predict will last 2 years and 3 ½ years, respectively
    a. Under § 168(e)(1), 3-year property is defined as having a class life of 4 or less years
        i. Therefore, the 3 ½ year asset will be treated better because you will recover the capital before the asset is done being useful
            1. If the useful life of the asset is 2 years, you still have to map the deductions over 3 years
3. § 168(e)(1) tells us that the longer the predicted lifespan of an asset, the more accelerated depreciation you get

iii. **Convention**
1. The convention tells you WHEN you account for something during the year
    a. § 168(d)(1) – for personal property, presumption that the applicable convention is half-year
        i. <u>Half-year</u>: treats all property placed in service during any taxable year as placed in service (or disposed of) on the mid-point of such taxable year
    b. § 168(d)(2) – for real property, the applicable convention is mid-month
        i. <u>Mid-month</u>: treats all property placed in service during any month as placed in service (or disposed of) on the mid-point of such month
        ii. Less wiggle room with this convention
    c. § 168(d)(3) – if you buy more than 40% of your depreciable property in the last 3 months of the year, the applicable convention is mid-quarter
        i. <u>Mid-quarter</u>: treats all property placed in service during any quarter of a taxable year as placed in service (of disposed of) on the mid-point of such quarter
        ii. This is in response to the incentive created by the half-year convention presumption, which is to purchase property late in the year

f. Salvage Value → the amount the taxpayer would expect to recover when he stops using the asset for the production of income
    i. We IGNORE the salvage value limitations and permit the entire cost of an asset to be depreciated (§ 168(b)(4))
        1. This is favorable to taxpayers and allows for accelerated depreciation (since we do not have to take the salvage value into account)

g. Code provides for accelerated depreciation (that which is earlier depreciation than you'd get under the MACRS double declining balance method – because this is accelerated, but it is our normal depreciation)
    i. **§ 179** creates immediate deductions for certain types of property
        1. In 2011, the immediate deduction is up to $500K
            a. So when you pay for something that would otherwise be depreciable property, you can get an immediate deduction for $500K … and we like that because that accelerates our losses and defers our gain
        2. As you go above the specific cap for the certain taxable year, you lose the immediate deduction and shift over to depreciation
            a. In 2011, the cap is $2M
        3. This is an incentive to accelerate purchases now because in the next few years, the ability to take this immediate deduction will be gone

a. So you may choose to front load certain purchases now because of § 179 than you would have done otherwise
   i. This provision is an effort by Congress to increase economic spending (and not necessarily to change the amount spent, but to distort the timing of the expenses)

ii. Congress recently created two new categories of depreciable property – qualified retail improvement property and qualified restaurant property – that can be depreciated over 15 years instead of the usual 39 years for commercial real estate
   1. An effort to provide a stimulus to the economy and favor certain industries

iii. Accelerated depreciation is only valuable if you have something to depreciate against
   1. It is less useful if you do not have gains
      a. Think: How useful is accelerated depreciation then if we do not allow businesses to depreciate all of the losses that they have?

h. Land is <u>not</u> depreciable
   i. Why? Depreciation is based on the notion that we're tracking in some way the actual economic depreciation, and this is not true of land
      1. Land does not wear out or become obsolete – even though we could imagine situations where land can be destroyed and depreciation should be allowed
         a. Some notion that even if the land has lost it use for one purpose (farming, e.g.), it can be useful for something else (buildings, e.g.)
   ii. The purchase price (or other basis) must be allocated between land and buildings in proportion to their respective FMVs
      1. Taxpayers have an incentive to have more of the property's value attributed to the building (generally depreciable) than the land (not depreciable)

i. Ex: *World Publishing v. Commissioner* (8th Cir. 1962): petitioner (WP) wants a deduction for depreciation of a portion of the price it paid when it purchased improved real estate subject to an outstanding lease to the tenant who had built the building on the property; WP paid Smith (original owner) $700K for the property ($400K land, $300 building); lessor is WP, lessee is Farnam; WP is deducting amounts for depreciation for the $300K building (straight line method until the lease ends), but WP is not actually the one who build it – Farnam built it and leased the land
   i. IRS does not think that WP should be taking deductions for the building when WP really only owns the land – that is, when Smith leased the land originally, there was no building, only non-depreciable land
   ii. WP contends that the building reverts to them at the end of the lease, so they have a wasting investment – they will be the ones left with this less valuable asset
   iii. Court: WP *can* take depreciation deductions for the building
      1. The building, as well as the land, was acquired and clearly owned by WP for the production of income
         a. The building is a wasting asset and its complete exhaustion will have been effected before the end of the lease term
   iv. Court does not seem to care whether Farnam is taking deductions
      1. "Each taxpayer has a separate wasting investment which meets the statutory requirements for depreciation
         a. To allow each to recover his own, and separate, investment is not to permit duplication at the expense of the revenues and is not to permit one taxpayer to depreciate another's investment"
      2. What does this tell us?
         a. If both parties are ratcheting down the $300K basis by taking depreciation deductions, then in total they are getting $600K of depreciation deductions – this suggests that the basis is something different than it is
      3. Statutory response: § 167(c)(2): Lessee is NOT able to take depreciation deductions
         a. This case is still good law though because it concerns the Lessor's depreciation deductions

v. Hypo: If WP owns the land and the building and then leases the building, there is no question that they get to take depreciation deductions
    1. If the lessee makes improvements on a building that they have complete control of, they can depreciate the improvements (if they can take the improvements with them at the end of the lease)
    2. *World Publishing* was a mix of the two – WP got the ability to actually deduct for the building because it reverts back to them, even though the lessee was the one who actually built it

j. Antiques
    i. IRS has taken the position that they are not depreciable because they do not have a determinable useful life defined by their physical condition

k. Luxury Cars
    i. § 280F limits the amount of depreciation that can be taken on "luxury automobiles"
        1. The amount that can be taken as a deduction for depreciation in the first year of the recovery period is limited to $2,560

X. Business Interest
    a. **§ 61(a)(4)**: Interest is included in income (to the recipient)
        i. Is it deductible to the borrower/payor?
            1. Currently, deductibility of interest turns generally on the purpose of the indebtedness
                a. **Business Interest** – Interest on indebtedness used to operate a trade or business is a cost to the taxpayer of doing business and thus is deductible like any other business expense (§ 163(a))
                    i. Except in circumstances where interest is required to be capitalized, for example, when allocable to an asset the taxpayer is constructing (§ 263A)
                b. **Investment Interest** – Treated differently than business interest (*infra*)
                c. **Personal Interest** – Generally not deductible (§ 163(h))
                    i. If you are borrowing to fund something that would otherwise not be deductible, then the cost of that borrowing itself should not be deductible
                    ii. Exception: home mortgage interest deduction (*infra*)
                d. **Interest to Earn Tax-Exempt Income** – Congress has limited interest deductions in several of these contexts (*infra*)
    b. **§ 163(d)**: The amount allowed as a deduction for investment interest for any taxable year shall not exceed the net investment income (= total investment income – investment expenses) of the taxpayer for the taxable year
        i. Basketing Regime → interest payments are netted against the already netted investment income
            1. As a result, some legitimate investment interest expenses may not be deductible in the year paid or incurred
        ii. Investment income does not include net capital gains or dividends unless the taxpayer elects to forgo the 15% preferential rate on those items
            1. This rule prevents a taxpayer from deducting investment income at the top ordinary rate to offset income that will be taxed at the lower capital gains or dividend rate (symmetry)
        iii. Trader vs. Investor
            1. For tax purposes, a trader is a person whose actual job is to make money by investing for others
                a. Subject to § 163(a) (because their interest is fully deductible as a business expense)
            2. Investors invest for themselves, making money from the fluctuations in the market
                a. Subject to § 163(d)

3. Ex: *Yaeger v. Commissioner*: two fundamental criteria distinguishing traders from investors are the length of the holding period and the source of the profit
    a. Investors derive profit from the interest, dividends, and capital appreciation of securities
        i. They are primarily interest in the long-term growth potential of their stocks
    b. Traders buy and sell securities with reasonable frequency in an endeavor to catch the swings in the daily market movements and profit thereby on a short term basis
4. § 163(d) can sometimes be more favorable for investors than traders
    a. Normal basketing regimes are limited temporally – in that you can only use the losses against the gains in the same taxable year . . . but § 165(d) does not have such a time limitation
        i. Even though you are limited in the first year, after that, you can use your excess investment interest expenses forever into the future (§ 165(d)(2)) → "leaky basket"
            1. And this is more favorable than § 163(a) because traders are limited by not having an indefinite carryforward period (no basket, but no carryforward)
                a. This is a curious result that permits the taxpayer to deduct more than would have been deductible had the limitations of § 163(d) never been enacted

c. Interest to Earn Tax-Exempt Income
    i. Arbitrage = Making a profit that is not actually based on an increase in economic value
        1. The actual economic value of the asset you are selling is not changing, but rather you are taking advantage of some sort of gap in values
        2. Risk-Free Profit = Where there is actual economic profit of $0 or less
    ii. Tax Arbitrage = Deductions of interest in circumstances where related income is tax-exempt or tax-preferred
        1. Kind of the reverse of tax symmetry because you are using two different rates – the rate you include something at is different than the rate you deduct something at
            a. If you get to deduct your interest at a normal rate, but you are using that interest to pay for something that is producing something that is taxed at a 0% rate, then you have economic gain based entirely on tax difference
        2. Ex: Municipal Bonds – bonds issued by municipalities used to pay for project (and the issuer of the bonds is the borrower, who then agrees to pay a certain interest rate)
            a. § 103: Interest earned on municipal bonds is tax-exempt
                i. So these bonds are treated differently than other types of bonds – the tax preference can likely be attributed to federalism
            b. So if you borrow money in order to buy a tax-exempt municipal bond, you will make more money than you would otherwise entirely because of the Code
                i. In the business world, you did not really do anything – but the in tax world you paid less (i.e. made money) = tax arbitrage
            c. Statutory Fix = § 265(a)(2): If you are borrowing to buy a tax-exempt bond (e.g., municipal bond), you can no longer deduct the interest on the borrowing at the normal rate – it is no longer deductible
                i. § 265(a)(2) was meant to prohibit tax avoidance and arbitrage
                    1. But § 265(a)(2) actually ends up defeating the goals of § 103 (to encourage people to invest in municipalities and

municipalities can pay lower interest rates than they would otherwise)

3. § 163(d)(4)(B) is meant to fix a certain type of arbitrage
    a. (ii): If your investment income creates capital gains and those are taxed at 15%, you cannot deduct the interest for the investment borrowing at your normal rate – instead you deduct at 15% rate
        i. EITHER deduct/include @ 15% or deduct/include @ normal %
    b. One response is a statutory fix, and one response is a judicial fix …

iii. Ex: *Knetsch v. United States* (U.S. 1960): petitioner purchased ten 30-year maturity deferred annuity savings bonds (generally, an installment asset), each in the face amount of $400K and bearing interest at 2 ½% compounded annually; petitioner is paying for the bonds with a note that has a 3 ½% interest rate; Sam Houston is selling petitioner the bonds and loaning him the money = purchase-money debt … valuation concerns; annuities are tax-favored investments because the interest that the annuity earns is not taxed
1. Concern: Petitioner is essentially taking this deduction and borrowing against the increase in value of the annuity, but he is not being taxed on the increase in the annuity bond
    a. This is like tax arbitrage – there was a 0% rate on the increase in the annuity bond, while the rate of the deduction here was almost 90% (his tax rate)
        i. *But* this was all within the letter of the law / Code
2. Court: This is a sham transaction – the transactions did not have a business, or any other real, purpose other than to save money on taxes, and petitioner never had to recapture the money he saved
    a. Saying something is a sham transaction is saying that none of the transaction actually happened
        i. So the entire deduction is disallowed / erased … harsh result
3. Note: Court talks about the 1% spread → anytime there is a spread where you are paying more to borrow than your rate of creating gains, courts will look questionably at the transaction as a sham
4. POST-*Knetsch*: Congress responded to Knetsch's transaction (which was not prohibited by the Code) by enacting § 264(a)(2): No deduction for any amount paid or accrued (i.e., interest) on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract
    a. Congress specifically chose <u>not</u> to make this provision retroactive

iv. Ex: *Goldstein v. Commissioner* (2d Cir. 1966): taxpayer who won $140K in the Irish Sweepstakes paid 4% interest to borrow money with which she purchased Treasury notes yielding annually about 1.5% interest income payable over a number of years; taxpayer prepaid interest in the year she won the Sweepstakes and tried to deduct that prepayment; although the taxpayer paid more interest than she would earn, the tax savings from, in effect, spreading the Sweepstakes winnings over a number of years would have made the transaction profitable --- there was a negative spread – the rate she is actually receiving interest at is lower than the rate she is paying interest at
1. Court: No "sham", but disallowed the interest deduction on the grounds that there was no purposive reason – no business purpose, other than the securing of a deduction (i.e., motivated entirely by tax avoidance)
    a. What petitioner did was entirely permissible by the Code … until the court stepped in and looked at her subjective mindset for entering into the transaction
    b. Allowing the deduction would encourage transactions that have no economic utility and that would not be engaged in but for the system of taxes imposed by Congress

v. Other Judicial Remedies (Ex-Post):

1. Sham (*Knetsch*): Determining that the transaction itself is a fiction – did not actually happen
2. Economic Substance Doctrine: If a transaction is lacking in objective economic substance, a court after the fact can declare that the entire transaction did not exist for tax purposes
    a. If you are profiting only from arbitrage and not from an increase in economic value, that transaction inherently lacks economic substance
        i. ***But***, by itself, arbitrage is not necessarily a bad thing (although a court may come in and say otherwise in some situations)
    b. This judicial doctrine was codified by § 7701(o) – need both subjective business purpose & objective economic substance
3. Substance Over Form Doctrine: If the form of the transaction itself creates tax benefits, but the substance is really tax avoidance, the court may focus on the substance over form
    a. What is the taxpayer trying to benefit from in the Code? What is the taxpayer trying to avoid?
4. Business Purpose: If a transaction is lacking subjective business purpose, a court after the fact can declare that the entire transaction did not exist for tax purposes

<u>. . . underlying all of these is a question of institutional competency</u>
    a. Do we really want courts determining that something violates the spirit of the Code or tax law? Court imposing their own judgment …
    b. Do we want the court to act like a superpersonnel department (*Exacto*)?
    c. Remember: These judicial remedies deem a transaction that is legal under the Code (within the letter of the law) impermissible

XI. Recovery of Business Losses
  a. Ex: *Cottage Savings v. Commissioner* (U.S. 1991): CS cannot just sell these devalued mortgages outright because FHLBB requires them to report their losses and that would cause them to go out of business; FHLBB said that CS need not report losses associated with mortgages that are exchanged for substantially identical mortgages held by other lenders – and this was to generate tax losses while not substantially affecting the economic position of CS; issue: does a financial institution realize tax-deductible losses when it exchanges its interests in one group of mortgage loans for another lender's interests in a different group of mortgage loans?; § 165: have to ***realize*** a loss
    i. What FHLBB did was regulatory arbitrage – something that did not count as a loss in one regulatory scheme (FHLBB) counts as a loss in another regulatory scheme (Code)
    ii. Transaction: CS owned mortgage pool 1 with a face value of $6.9M but a FMV at the exchange of $4.5M; exchanged for mortgage pool 2 with a FMV of $4.5M at the exchange =$2.4M in losses
        1. Note: This transaction took place at the end of the year (12/30/80), so the IRS will look suspiciously at it
    iii. Court looks to § 1001(a) – in order to realize a loss, need a sale or other disposition of property
        1. There is no sale here, so need to determine whether the exchange is a "disposition of property"
            a. IRS: Not because there needs to be a material difference, which requires a difference in economic substance – There is no realization event here because the exchange was of things that are not different
                i. And the Court agrees that an exchange of property only gives rise to a realization event under § 1001(a) if the properties exchanges are materially different
            b. SCOTUS: <u>Properties are "different" so long as their respective possessors enjoy legal entitlements that are different in kind or extent</u> (meaning that the question is not whether there is a different economic substance)

i. The exchange included things with different legal entitlements (i.e., the mortgages were secured by different properties), so there was a realization event here where CS ***realized*** losses, and CS can take the business loss deductions
    1. This case does end up making it easier to ***realize*** losses (or gains)

iv. Note: *Cottage Savings* applies to gains and losses
    1. Question: Is this a disposition? (not: Is this a gain or loss)

v. POST-*Cottage Savings*: People reacted negative to this case because SCOTUS made it easier to realize things – all you need is different legal entitlements to be an actual disposition (so what might have seemed like an exchange of exactly the same thing before might be considered a change in legal entitlements and result in a disposition)
    1. Concern (esp. with debt modifications) that the case made is so easy to realize a loss or gain on that things that were not previously considered realization requirements and this would negatively affect business
        a. Ex: If I have a nonrecourse mortgage for $300K and the house goes down in value to $200K; if the bank is deciding whether or not to renegotiate the loan to reflect this change, is their willingness to do going to be affected by *CS*?
            i. Banks will likely be less flexible because just by changing the terms of the mortgage in this situation would be enough to force the bank to recognize a loss, and banks do not want to be realizing losses when renegotiating mortgages (and this is change from pre-*CS* where a realization was not deemed to occur unless there was a "material modification")
    2. IRS responded to these fears that CS created a hair trigger test for realization on the modification of debt instruments by issuing regulations defining what constitutes a "significant modification" of a debt instrument such that the parties are deemed to have exchanged a modified instrument for the original debt

b. Ex: *Fender v. United States* (5th Cir. 1978): petitioner was trying to create a loss to offset the capital gains from another transaction by selling unrated Bender Bonds (hard to sell on the market because they were unrated and the value was low because interest rates went up); petitioner sold the bonds to Longview Bank, in which he had a 40% interest (avoiding § 267's related sale rule by reducing his ownership <50%), on 12/26 and reported a $106K loss for each of the trusts; 42 days later (avoiding the 30-day limitation in § 1091) he buys the bonds back; IRS does not think this is a bona fide loss because he sold it – got the loss – quickly bought back
    i. Treasury Reg. § 1.165-1(b): Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss
    ii. Was this a full sale where petitioner lost control over these bonds between the sale and repurchase?
        1. Taxpayer had sufficient influence over the bank to remove any substantial risk that the trusts would be unable to repurchase the bonds and thus eliminate the apparent loss on the sale to the bank
            a. Taxpayer controlled 40% of the bank's stock – largest single block
            b. It appears that the bank would not have agreed to the transaction absent a special relationship with petitioner – these bonds were unrated and were of a maturity that the bank did not normally purchase
            c. Bank would have had a hard time selling these bonds to a buyer other than the taxpayer
        2. Could argue, though, that the taxpayer assumed more risk than the court acknowledged
            a. The bank was a regulated bank, so if someone wanted to buy these bonds at a better rate than the taxpayer, the bank would have to sell to them

iii. Court: The transaction and resulting losses are disallowed (as if the transaction – which was not disallowed by the Code at the time – never happened)
    1. The taxpayer had sufficient dominion over the bank to ensure that the apparent loss would be recaptured through a repurchase
        a. Court putting its own judgment on whether there was risk or not
    2. The sole purpose of the transaction was to create a tax loss (i.e., no other reason to sell the bonds)
    3. Taxpayer did not in substance experience the loss that is necessary for a deduction under § 165 – no bona fide loss

c. Loss Harvesting: When you have deductions from one activity that you are trying to use to offset gain/income from another activity
    i. *Cottage Savings* – losses were real, so loss harvesting was acceptable/successful
        1. <u>NEED REAL, ECONOMIC LOSSES</u>
    ii. *Fender* – no real economic loss because this was not actually a real/full/bona fide sale, so unsuccessful loss harvesting (even though he was not in violation of the Code §§ 267 or 1091)

d. <u>Several provisions of the Code are designed to PREVENT the deduction of losses in circumstances where a loss has not actually been realized</u>
    i. **§ 267: Transactions Between Related Taxpayers**: Disallows deductions for losses from sales or exchanges of property, whether direct or indirect, between certain related people, such as family members or corporations and their majority (more than 50%) shareholders
        1. The seller's loss generally is lost permanently because the purchaser's basis for computing loss when he sells the property is his cost
            a. If, however, he ultimately sells the property for a gain, the purchaser can increase his basis for determining gain by the seller's disallowed loss (§ 267(d))
        2. Hypos:
            a. Dad buys something in 2005 for $1K, and sells to Son in 2011 for $700 – Dad's desired loss is $300
                i. § 267 – No deduction allowed for Dad (permanent disallowance of loss)
            b. Son later sells the item for $600 (i.e., at a loss) → A/R $600 – Son's Basis $700 = $100 Loss … which he CAN take
                i. § 267 permanently disallows losses when the second party sells at a loss
            c. Son later sells the item for $1,200 (i.e., at a gain) → A/R $1,200 – Son's Basis $1,000 = $200 Gain
                i. § 267 does not permanently disallow losses when the second party sells for a gain . . . because his gain is offset by Dad's disallowed loss (reflected in the Son's basis)
    ii. **§ 1091: Wash Sales**: Disallows a loss from a sale preceded or followed by a purchase of *substantially identical securities* (including options) within a 30-day period
        1. § 1091(d): When the loss is disallowed, the basis of the stock purchased is that of the stock sold, plus any additional amount paid on the repurchase, so that losses are DEFERRED, <u>not</u> lost forever
            a. Code wants to prevent wash sales because they look like you are trying to harvest a gain or loss by selling it momentarily for tax purposes and then getting it right back
            b. But we treat wash sales better than related party transactions because: (i) we can imagine that there might a good reason to have a wash sale, and (ii) there is more potential for tax avoidance with related parties
        2. § 1091 does not apply to gains nor does it apply if the securities are not "substantially identical"

a. At year end, a taxpayer can sell a bond that has declined in value and purchase a similar bond from another issuer -- § 1091 will not prevent deduction of the loss because the issuers are not the same

iii. **§ 1211: Limitation on Capital Losses**: Capital losses are deductible by individuals only to the extent of capital gains plus $3K of ordinary income

1. **§ 1212**: Any capital losses not allowed in the current year may be carried forward indefinitely by individuals

XII. Personal Interest

a. **General Rule**: § 163(h): Personal interest is <u>not</u> deductible (with a few exceptions)

i. Pre-1986, all personal deduction was deductible (with a few exceptions)

1. If I pay for something with before-tax income = I can deduct the cost of what I'm paying for = tax-preferred

a. What I am paying for is a fully deductible expense because the money I am using to pay for it is not subject to my tax rate (I take out the money before I figure out my rate)

ii. Now, if I take out a personal loan and pay for personal expenses, I am paying with after-tax income because it is not deductible

b. Horizontal Equity Violation Concern: A & B both have $20K in the bank and both get a 10% payout each year; both will get a car for $20K and thus end up with $0 – so in the same real world economic situation, but will be treated differently in the tax world

i. A: Buys the car with $20K cash – so no interest income (she spent all the money in the bank) and no interest expense (she did not take out a loan)

1. A has no taxable income

ii. B: Borrows $20K to buy the car – so he has interest income of $2K (earned from the money in the bank) and interest expense of $2K (to pay interest on the loan)

1. B has $2K of taxable interest income, and because the loan is personal he cannot deduct the $2K interest expense

iii. PRE-1986, the concern about horizontal equity allowed more personal interest to be deductible

iv. POST-1986, the view is that B used the borrowed money for something personal, and therefore the indirect cost of making this personal consumption choice should also be personal (and not deductible)

c. Personal interest is defined by omission to include any interest that is <u>*not*</u>: (a) interest paid or incurred in connection with a trade or business), (b) investment interest, (c) interest that would be deductible in connection with a § 469 passive activity, (d) qualified residence interest, (e) interest on certain deferred estate tax payments

i. Interest on an income tax deficiency is personal interest (even where the income subject to the deficiency arose in a trade or business)

d. **Exceptions**:

i. Home Mortgage Interest Deduction – § 163(h)(2)(d): Qualified residence interest <u>is</u> deductible (= acquisition indebtedness or home equity indebtedness)

1. Acquisition Indebtedness → a mortgage

a. § 163(h)(3)(B)(ii): $1M Limitation – the acquisition indebtedness can go up to $1M and then the amount you are deducting as interest is tied to the acquisition indebtedness amount

i. As interest rates go up or down, the deduction could be affected

b. § 163(h)(4)(A)(II): Taxpayers can deduct the interest on their acquisition indebtedness for a (1) vacation home

i. $1M limit still applies, whether you have 1 or 2 homes – so in the aggregated, cannot exceed $1M

ii. We do not hear a lot about policy reasons for having a second home (or if there are, whether they strengthen or weaken the policy behind allowing this deduction as a whole in the first place)

                1. Perhaps if we did not allow this deduction people's behavior would be distorted in choosing one home versus two
        c. Policy: Encouraging home ownership
            i. Why? Home ownership encourages investment in something that creates actual wealth (now and for future generations) and locks people into where they live (i.e., less transient community)
    2. Home Equity Indebtedness → taking the value of your home to secure a loan for something else (could be personal) – borrowing against the increasing value in your home
        a. § 163(h)(3)(C)(ii): $100K Limitation
    3. To be qualified residence interest (acquisition or home equity indebtedness) the debt <u>must</u> be secured by the residence
        a. Under this §, a home is an asset that produces tax-deductible interest
    4. Code showing preference for different kinds of taxpayers – home owners vs. renters – because the home mortgage interest deduction is forgone revenue for the government
        a. A home is an asset that produces tax deductible interest
        b. You can argue whether or not this is a good thing – to favor home owners over renters
            i. Pros: American dream aspect; greater stability; creating wealth in a way that other consumption does not; being able to deduct this interest might be able to bump someone into the ability to own a house who would not otherwise be able to
            ii. Cons: Upside down subsidy – favors higher income taxpayers; racial breakdown of home ownership; being able to deduct this interest might not actually make people buy homes who would not otherwise be able to buy – it might make it more expensive for people who were otherwise going to buy a home (notion of capitalizing the deduction in the cost of homes)
        c. You can argue whether or not a tax expenditure is the best way to deal with this
            i. Could target certain types of taxpayers
            ii. Could have a direct expenditure
            iii. Could make rent deductible in order to make renters' situation better (MA allows up to a $3K deduction)
ii. **Interest on Education Loans – § 221**: Certain taxpayers may take an ATL deduction for up to $2,500 of interest paid on education loans
    1. The indebtedness must be incurred to pay for college expenses for the taxpayer, her spouse, or a dependent
    2. Section 221(b)(2): The deduction is phased out for single taxpayers with income of $50K - $65K and married taxpayers with income of $100K - $130K
    3. If a person who is not legally obligated to do so (e.g., mom) pays the interest on behalf of the taxpayer who owes the interest (e.g., child), the payor is treated as making a gift to the recipient, who then is treated as paying the interest and gets the deduction
        a. Recipient is essentially seen as the indirect payor
        b. Why? Concern about income shifting – we do not want wealthy people to get to deduct and then have the poor person have to include it in income
    4. Because this is an ATL deduction, suggests that the Code thinks for some taxpayers who are below a certain income level that this is a cost of them making income – it is contributing to their ability to earn income

a. *But*, if you make over \$65K, the Code is essentially saying that it was not a cost of making your income

XIII. Casualty Losses

a. **§ 165(c)(3)**: Taxpayers can take deductions for personal losses arising from "fire, storm, shipwreck, or other casualty, or from theft"

   i. Casualty → something that is **"sudden and unexpected"** that leads to you losing some value … but what counts as "sudden and unexpected"?

      1. Allowed Deduction:

         a. Ex: *Kielts*: diamond lost from a ring because the ring suffered a strong blow on one side

            i. Court noted that absent willfulness, negligence has no bearing on whether a casualty has occurred

               1. Need intention or gross negligence – otherwise we'd allow everyone to create their own shipwrecks and get losses at the end of the year (loss harvesting ex.)

         b. Ex: *White*: taxpayer irretrievably lost a diamond in her gravel driveway while shaking her hand in pain after a car door was slammed on it – sudden and unexpected, not due to deliberate or willful actions

         c. Pine beetle infestation (apparently fast-moving)

      2. Disallowed Deduction:

         a. Ex: *Keenan*: a wife wrapped her diamond ring in a tissue and placed it on the nightstand; husband went to throw all the used tissues away and flushed the ring down the toilet – not sudden or unexpected

         b. Ex: *Stevens*: duck-hunting taxpayer was denied a deduction for the loss of a ring that fell into the water while he was retrieving a decoy

         c. Rat or termite infestations (apparently slow-moving)

         d. Advanced warning that animals might behave in a particular manner

      3. Do bed bugs count?

         a. Yes: they force you to throw everything out, we don't always know they are there, might be unforeseeable

         b. No: there are lot of articles about them, so might be foreseeable

   ii. Only uninsured casualty losses exceeding \$100 are taken into account (§ 165(h)(1))

   iii. Deductions for casualty and theft losses equal to casualty and theft gains are deductible from gross income

      1. Excess casualty losses are limited to the amount that exceeds 10% of AGI and are deductible only as itemized deduction

         a. The 10% floor ensures that only large and uninsured losses are deductible

b. STEPS:

   i. Was there a "casualty" – sudden and unexpected – that caused physical damage?

      1. Courts may be more stringent in defining "other casualties" than those specified in the statute

   ii. Was the damage covered by insurance?

      1. "Casualty gain" – If the damage was covered by insurance and you get paid more than the FMV of the damaged property

         a. Ex: Basis \$1K, FMV now \$5K, FR pays \$5K = \$4K casualty gain

   iii. What was the value of the damage?

      1. Treasury Reg. § 1.165-7(b): Amount of loss shall be the lesser of either (i) the FMV immediately before the casualty reduced by the FMV immediately after the casualty – or – (ii) the adjusted basis

      2. It is necessary to disallow a loss deduction for unrealized gains in order to prevent the double benefit that otherwise would result since the gain was never taken into income

        3. Treating the loss as an occasion for both the realization of gain and the deduction of the entire value of property would have the same effect in such circumstances as limiting the deduction to basis
        4. The amount of a casualty loss must be reduced by insurance of any other recovery
            a. If at the end of the taxable year in which the casualty occurs, there is a reasonable prospect of recovery, the taxpayer is not permitted to take a deduction
    iv. Is each damaged item over the $100 limit (that applies 2010 – on)?
    v. Is the aggregate of the damage (including only those items that exceed $100) more than the 10% of AGI floor? Net gain & loss, then apply 10% floor (if insurance covered all, will net $0)
c. The suddenness and physical damage requirements can be viewed as backstops to the realization requirement (i.e., no deduction for decline in value until the loss is "realized") and depreciation (i.e., no depreciation deduction for ordinary wear and tear for personal use property) rules
    i. A casualty deduction for anything less than a sudden event involving physical damage would circumvent these other limitations
d. Theft
    i. Theft losses are deductible in the year of discovery
        1. You actually have to prove that it was a theft
            a. This requirement is sufficient to remove the requirement that it be sudden and unforeseeable (do <u>not</u> look at suddenness or foreseeability)
    ii. Valuation – use whichever is LOWER:
        1. Difference in the FMV at the time of the loss compared to what is left after the theft
        2. Adjusted basis (gift = carryover basis)
        3. Hypo: A paid $10K for ring; A donates ring to B w/ FMV at time of gift is $12K; ring stolen from B w/ FMV at that time was $25K → (1) difference in FMV: $25K - $0 (no ring, so no value) = $25K / (2) A/B is $10K (basis of the donor), which we use because otherwise B would take a $15K benefit she was never taxed on
            a. If insurance paid B more than $10K, B would have a casualty gain
            b. B's AGI $50K, 10% floor = $5K, so B can only take $5K deduction – but this is BTL, so B will choose the standard deduction
    iii. We do not want you to have a realization event at the same time (??)
e. The deduction for casualty and theft losses may seem at odds with the policy of disallowing personal losses, but the allowance may be motivated by ability to pay considerations – therefore floors and limits are imposed in order to better reflect ability to pay
    i. The loss or expense is considered to be largely beyond the taxpayer's control and not the result of a personal consumption choice
    ii. Because the Code only wants to allow the deduction in cases where the loss affects your ability to pay, there are floors and other limits imposed
        1. Code wants to create enough friction before you are eligible for these loss deductions that you will have a greater incentive to pay for insurance
            a. Some regard the widespread availability of casualty insurance as adequate protection and would repeal the casualty loss deduction

XIV. Taxes
a. § 164 permits deductions for the amount of certain tax payments to states, localities, and the federal government
    i. In allowing deduction of state and local income and property taxes without regard to profit seeking, § 164 constitutes an exception to the general rule of § 262 that no deductions from income are allowed for "personal, living, or family expenses"
    ii. Taxes not related to business or investment activity must be deducted from AGI
        1. BTL deduction – so only available to taxpayers who itemize
        2. Deduction for income and property taxes is <u>not</u> subject to the 2% AGI floor in § 67(b)(2) – so this is not a *miscellaneous* itemized deduction

b. Some taxes cannot be deducted whether incurred in a personal *or* a profit-seeking context → federal income tax, employee's SS taxes, and estate, inheritance and gift taxes imposed at the federal, state, and local levels (§ 275)
    i. Employer CAN deduct the cost of SS taxes paid for employees (seen as a business expense); Employee CANNOT deduct his own SS taxes (seen as future personal consumption – paying for retirement)
c. Taxes that are deductible *only if* incurred in connection with trade, business, or investment activity → federal excise taxes, custom duties, stock transfer taxes, gasoline tax, and licensing fees
    i. Gasoline tax for personal use is not deductible because it is a commuting cost (i.e., an indirect cost of a personal expense)
d. State and Local Property Taxes
    i. Generally deductible if they are ad valorum – (i) based on the value of the property, (ii) imposed on an annual basis, and (iii) in respect of personal property
        1. Another benefit of homeownership (along with the home mortgage interest deduction)
    ii. Rev. Ruling 79-180: Tenants cannot deduct payments of property taxes passed along to them by their landlords as provided by a state statute
e. State and Local Income Taxes
    i. Generally deductible
    ii. Taxpayers in states without an income tax, can deduct state and local sales taxes
        1. Unless you live in NH which has neither
    iii. State income tax is in some ways a reverse of federalism – the federal government is giving a subsidy to the state
        1. When you deduct your state income taxes, you end up paying more taxes to the federal government (than you would have otherwise)
            a. So the more you pay in state taxes, the less you pay to the federal government

XV. Medical Expenses
a. § 213 allows deductions for medical and dental expenses paid during the taxable year for the taxpayer, her spouse, and dependents
    i. BTL Deduction – 7.5% AGI Floor
        1. If your medical expenses are above the 7.5% floor, you get to deduct the excess amount
        2. If your medical expenses do not exceed the 7.5% floor, then you do not get a deduction
            a. Floor is meant to exclude normal medical expenses – such as annual checkups and medicine cabinet supplies
        3. Floor to be increased in 2013 to 10% (unless you are over 65 yrs old, in which case you have the 7.5% floor for 3 more years)
    ii. Medical expenses can be deducted only if they are not compensated by insurance or reimbursed by employers
b. What counts as a medical expense (§ 213) versus a personal expense (§ 262)?
    i. § 213(d) defines "medical care" – diagnosis, cure, mitigation, treatment, prevention of disease, transportation/travel expenses, etc.
    ii. Treasury Reg. § 1.213-1(e)(1)(iii): glasses, seeing eye dog, artificial teeth and limbs, wheelchair, crutches, an inclinator or an air conditioner which is detachable from the property and purchased only for the use of a sick person, etc.
    iii. *Id.*: A capital expenditure which is related only to the sick person and is not related to permanent improvement or betterment of property, if it otherwise qualifies as a medical expense, shall be deductible
        1. Ex: wheelchair ramps are deductible – IRS has decided that they do not increase the value of the home (so do not even have to figure out whether the ramp did indeed increase the value)

a. Rev. Ruling 87-106 (pg. 456) lists expenditures that normally do not increase the value of a home

iv. *Id.* & Rev. Ruling 87-106: A capital expenditure for permanent improvement or betterment of property which would not ordinarily be for the purpose of medical care (within the meaning of this paragraph) may, nevertheless, qualify as a medical expense to the extent that the expenditure exceeds the increase in the value of the related property, if the particular expenditure is related directly to medical care
   1. Ex: elevator – if the elevator installation cost $1K and increases the value of the home by $700, the $300 difference is a deductible medical expense
      a. If the expenditure does not increase the value of the home, then the entire cost of installation qualifies as a deductible medical expense

v. Pools: (i) Is the taxpayer actually using it for medical care – did the doctor prescribe a pool; (ii) How much is the pool increasing the value of the home (see elevator example); and (iii) Is there a community pool nearby – because if there is, taxpayer can likely deduct the cost of transportation to the pool and the membership
   1. Look out for any personal, rather than medical, motivations

vi. § 213(d)(2): Lodging (not lavish or extravagant under the circumstances) while away from home primarily for and essential to medical care is deductible if there is no significant element of personal pleasure, recreation, or vacation in the travel away from home
   1. Limited to $50/night per individual
   2. So even with a doctor's recommendation, if there is a significant amount of personal pleasure, no deduction (e.g., stress-free vacations)

vii. An expenditure that is merely beneficial to the general health of an individual is NOT a deductible medical expense
   1. Ex: gym membership for someone above their idea weight or even if diagnosed as obese = personal expense
      a. Deductible only if it is for the treatment of a specific disease (§ 213(d)(1)(A))
      b. "Prevention" in § 213(d)(1)(A) is actually very narrow – needs to be prevention for a specific, doctor identified disease

viii. § 213(b): Medicine and drug costs are *only* deductible if it is a prescribed drug or is insulin
   1. *Cf.*: OTC heat patch is probably deductible as a medical supply – not a medicine or drug)

ix. Psychiatric treatment is generally deductible
   1. IRS says that marriage counseling is not deductible because inherently personal

x. Drug and alcohol abuse treatment have been held deductible

xi. Medical marijuana – not a deductible (even if legal in the state because it is a controlled substance for purposes of federal law)

xii. Vasectomy – deductible

xiii. Legal abortion – deductible

xiv. In vitro – generally deductible if it is a medical necessity

xv. Gender reassignment surgery – the part that is medically necessary will be deductible, but the cosmetic surgery that accompanies it will not be deductible

xvi. Cosmetic surgery (voluntary, solely focused on appearance) – not deductible
   1. But, if there is an actual medical purpose, then could be deductible
      a. Ex: breast reconstruction after a mastectomy and laser eye surgery so glasses need not be worn

xvii. Breast pumps – now a deductible medical expense
   1. At one point, though, the IRS denied a deduction and there was an uproar
      a. IRS argued that a breast pump was a replacement for food, and food is a personal, nondeductible expense … so if we allow a deduction for accessories that help you make food, then there is a slippery slope

c. Theme Re: What Counts as a Medical Expense → Doctor's approval

i. Institutional deference – the IRS defers to doctors regarding what constitutes a medical expense (*unless* there is some aspect of personal pleasure, recreation or vacation involved)

d. Medical vs. Business Deductions

i. Some things can be deductible as business deductions, rather than medical expenses, and are therefore not subject to the 7.5% AGI floor

1. Ex: payments by blind employees to readers for services relating to the employees' work; amounts paid by the handicapped for travel, meals and lodging, and for companions for their business trips

XVI. Charitable Deduction

a. Requirements (§ 170(c)): To qualify as a charitable organization, charity must be –

i. Created or organized in the U.S.;

1. Generally <u>no</u> deduction if you donate outside the U.S. (but some exceptions)

ii. Organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

1. Can have pretty broad goals and count as a charitable organization
2. Religious organizations make up 33% of donations; Education is the second largest

iii. No part of the net earnings of which inures to the benefit of any private shareholder or individual; and

1. Bar on Private Inurement = An effort to prevent you from masking something that is not charitable as a charitable organization (e.g., creating a charity to fund your own education and getting a deduction)
2. Organization must be deemed to count as a valid organization for receiving a charitable contribution

a. Ex: *Free Fertility Foundation v. Commissioner* (Tax Court 2010): taxpayer created a non-profit corporation to provide his sperm free to women who requested it; court did not consider whether the donation of sperm was a donation of property or services; court said the foundation did not qualify as a charity because the class of taxpayer's beneficiaries was not sufficiently large to benefit the community as a whole – some concern about private inurement here

i. ASK: Is this really for charitable purposes, or is it creating a private benefit that we do not want to create a deduction for?

iv. Which is not disqualified for tax exemption under § 501(c)(3) by reason of attempting to influence legislation, and which does not participate in any political campaign on behalf of any candidate for public office

1. Ex: Preacher preaching about politics would be DQ'd for tax exemption under § 501(c)(3)

… Code wants to ensure that organizations really are charitable organizations

b. Once you've determined something qualifies as a charitable organization, § 170 allows a deduction for a transfer by an individual or a corporation of cash or, in some cases, the FMV of property transferred, but not for a contribution of services

i. BTL deduction – but <u>not</u> subject to the 2% floor because <u>not</u> a miscellaneous itemized deduction

ii. Individuals generally are allowed a charitable contribution deduction of no more than 50% of AGI (§ 170(b))

1. Congress wants to incentivize charitable giving, but does not want taxpayers to be able to eliminate their tax liability entirely due to the charitable deduction
2. And 50% of AGI is the overall cap

a. So can give 30% of AGI to a private foundation and 20% to a public charity … but cannot give 30% of AGI to a private foundation and then 50% to a public charity

iii. A corporation's charitable deduction is limited to 10% of its taxable income
    1. Code is more concerned about corporations being incentivized to donate large chunks of money to lower taxable income

iv. Certain gifts of appreciated property are limited to 30% of AGI (§ 170(b)(1)(C))
    1. Ex: If A buys something for $1K and it has increased to $2K, A gets the full benefit of the current/new FMV when A donates – so charitable deduction will be $2K because A can donate the unrealized appreciation – but A is limited to 30% of AGI
        a. Lower limit so A cannot cash in all of her unrealized appreciation, never get taxed on it, and get a deduction
    2. So there is an incentive to donate assets with unrealized appreciation (to avoid being taxed on it), but this limit curtails the incentive a bit

v. Charitable contributions to private foundations (e.g., Ford or Gates Foundation) are limited to 30% of AGI (§ 170(b)(1)(B))
    1. We have a concern about private inurement with private foundations because no matter the limits, there is some aspect of that going on
        a. Donors to private foundations are generally the few wealthy families that make up the foundation, so we are concerned that if they have their own foundation and get the benefit of the charitable deduction then they will just shift their income
            i. The limit is much more about symbolizing the concern because limiting the deduction to 30% of AGI from 50% really does not seem too limiting
    2. *Cf.*: Public charities depend on donations from a wide swath of people (rather than a handful of individuals)

c. What Constitutes a Church? Churches have special status in the tax law, which is generally more favorable than that of other charitable organization or even other religious organizations
    i. Code does not define the term "church", but the IRS has listed 14 factors to be considered (e.g., existence of a regular congregation)

d. Why Have a Charitable Deduction?
    i. It is not really clear – seems obvious thought that the Code is saying that charities are good
        1. Government is willing to forgo some of its revenue to make it cheaper to donate to charity (i.e., for those people who would do it otherwise) and/or to incentivize charitable giving (i.e., for those people who would not donate otherwise)
            a. These are two different behavioral responses, and it is not clear which one was Congress's goal
        2. We can also imagine that the charitable deduction does not increase charitable giving at all, but rather makes it more preferable

e. § 170 can be thought of as a tax expenditure – the government is forgoing revenue

f. Debate about whether charitable contributions count as personal consumption
    i. Could be that the choice to give to a charity is itself a form of consumption
    ii. Could be that the amount donated to charity will not be consumed by the taxpayer
        1. Some people argue that rather than thinking of it as a tax expenditure, we should think of the charitable deduction as an accurate accounting of income
            a. That is, we do not think the charitable deduction ever counted as your own income – and if you really think this, then the deduction should be ATL
                i. So if you think the charitable deduction should be an ATL deduction, the theory that supports that is that it is not actually consumption

g. Does the charitable deduction create a distortion?
    i. Yes: It affects people who would not have otherwise donated
    ii. No: Regardless of the donation, people will donate

h. Does the charitable deduction create inequity?

        i. Yes: Because it is an upside down subsidy (the higher your rate, the more value you get), higher income taxpayers have more of an incentive to donate because it clearly blocks out their income
            1. Also, people higher on the income scale are more likely to get the benefit of the deduction because they are more likely to itemize (rather than take the standard deduction)
        ii. No: Lower income taxpayers generally do not have the same types of fluctuations
    i. People on the lower end of the income scale empirically donate larger percentages of their income
        i. But the actual value of it is much lower than that from the higher end of the income scale
    j. Once we've assumed that the charitable deduction is here to stay (which is probably true despite recent attempt to eliminate) –
        i. ASK: Whether or not the charitable deductions that we are granting would otherwise be a nondeductible expense (i.e., whether this is an otherwise nondeductible expense that is being recharacterized or hidden as a deductible expense)
        ii. ASK: Whether or not the amount you are deducting is actually the correct value
            1. When you are deducting the amount of your donation, the amount should be the FMV of the item at the time of donation
                a. Cf.: Treasury Reg. § 1.170A-1(h)(4): A taxpayer may not treat an estimate of the value of goods or services as their FMV if the taxpayer knows, or has reason to know, that such treatment is unreasonable
                    i. Ex: during Yankees stadium construction someone buried a Red Sox jersey to curse the Yankees; jersey was subsequently discovered an auctions on eBay for $175K with proceeds going to charity; winning bidder was told that anything above $715 was deductible as a charitable contribution … good advice?
            2. You CANNOT donate your services to charity – volunteering is not deductible
                a. But the costs of volunteering are deductible (e.g., costs of transportation, if you pay an employee to help)
                b. People value their time and services differently and the Code does not want a sliding scale of deductibility for doing the same service
                c. Also a concern about people volunteering for the wrong reason only to offset income
            3. § 170(f)(8): Substantiation Requirement
                a. **For gifts of $250 or more**, taxpayer must provide a written contemporaneous statement from the charity that includes information as to whether goods or services have been provided to the donor in exchange for the gift, and an estimate of their value
                b. **For gifts of cash**, regardless of size, the taxpayer must have a bank record or a written record from the donee showing the date and amount of the contribution
        iii. Ex: *Hernandez v. Commissioner* (U.S. 1989): taxpayer tried to deduct as charitable contributions payments made to branch churches of the Church of Scientology in order to receive services known as "auditing" and "training"; taxpayer tries to make arguments that a quid pro quo analysis is inappropriate under § 170 when the received benefit is purely religious
            1. Court: NO deduction because there was a quid pro quo – in return for taxpayer's money he received an identifiable benefit
                a. Quid pro quos are generally disfavored in the tax world if you are supposed to be making a deductible charitable donation
                    i. Code does not want you getting something back for your charitable donation
                    ii. Code does not want charitable donations to be an exchange for services

… this is straight up personal consumption

2. Dissent: Disagree because the IRS cannot constitutionally be allowed to select which religions will receive the benefit of its past rulings
    a. Lists examples of situations where a taxpayer has donated to a religious organization and gotten in return someone fairly specific (above and beyond the benefits of religion in a general sense)
        i. Therefore, IRS' application of the quid pro quo standard here discriminates against the Church of Scientology
    b. Valuation concern because there is no real market value for these types of services
        i. With seller-pricing, because there is no free market for these services that cannot be offered outside of the Church, there is a question about valuation accuracy
            1. This is something like an intangible religious benefit
3. POST-*Hernandez*: IRS came to a separate agreement with the Church of Scientology and now payments like these are deductible charitable donations
    a. Congress' responded within § 170(f)(8)'s substantiation requirement → In providing a receipt a donor should not if only "intangible religious benefits" where received, which are defined as a benefit "provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context"
    b. *Hernandez* is still good law (interestingly, not for the parties themselves though) – but it really stands for the idea that you cannot get a charitable deduction for a quid pro quo

k. Courts have increasingly supported the notion that a deductible charitable contribution should meet the *Duberstein* test ("detached and disinterest generosity") for gifts (i.e., not getting anything in return)
    i. Sports Tickets
        1. *Duberstein* gift analysis has been used to combat fundraising tactics that encourage giving for motives that could hardly be classified as "disinterested generosity"
            a. Essentially a quid pro quo concern – donate to the organization to get sports tickets
        2. Code allows an 80% deduction whenever a contribution makes the donor eligible to obtain sports tickets (§ 170(l))
            a. Underlying idea is that 20% of your donation is actually some sort of payment for ticket eligibility and 80% can count as the charitable aspect
    ii. Education
        1. Concern here is essentially quid pro quo – donate with the anticipation of economic benefit
        2. Rev. Ruling 83-104 lists factors to determine whether there is quid pro quo or detached and disinterested generosity (See pg. 445)

XVII. Retirement Benefits

a. <u>Annuities</u> → an investment asset that provides streams of payments that often relate to a person's life expectancy
    i. Annuities are generally to provide money if you die late and need money because you outlived your savings
    ii. The amount you pay for an annuity is the present value of the stream of future payments
        1. This upfront money, as it sits, accrues interest and this allows the annuity to increase in value and pay out over the course of the annuity
            a. § 72 (and *Knetsch*): <u>Not</u> taxed on accruing interest until it is actually distributed
                i. So annuities are tax-preferred

iii. Most annuities are life annuities (as opposed to a fixed term)
    1. Seller will use a table of average life expectancies to decide what you should pay for an annuity
        a. The amount of the premium will be determined by (1) the individual's life expectancy and (2) the return the insurance company expects to receive from investing the premium
            i. The amount actually received by the individual will depend on how long he lives
    2. Die BEFORE the predicted life expectancy: mortality loss because the individual did not recover all of his capital
        a. § 72(b)(3)(A): Individual gets a deduction on his final tax payment for the excess of capital recovery that he did not end up collecting
        b. Mortality Losses = Full Deduction
    3. Die AFTER the predicted life expectancy: mortality gain because his capital is fully recovered at the end of the life expectancy
        a. The only way to prevent a mortality gain is to cap the exclusion ratio at zero
            i. § 72(b)(2): Once you recover all of your basis for a life annuity, you are then going to be taxed on the full payout
        b. Mortality Gains = Taxed Fully

iv. For tax purposes, the individual has income to the extent he receives more than he paid for the annuity
    1. The investment in the annuity is, in effect, his "basis," which is recoverable as annuity payments are received
        a. What portion of each payment is treated as tax free recovery of basis and what portion is the taxable return on investment?
            i. § 72 provides for pro rata recovery of basis (i.e., a portion of each annuity payment is treated as recovery of investment and a portion is treated as a taxable return)
                1. The entire amount that is expected to be received under the annuity is compared to the amount paid for the annuity
                    a. A ratable portion of each payment received is excluded from income in an amount expected to restore the capital in full when the final payment is received
                    b. The amount excluded is determined by the "exclusion ratio," where the numerator is the investment in the contract and the denominator is the expected return
            ii. Historical Treatment – Recover all of the basis first and then the rest is taxable income, so you are taxed later on your income than you would be under § 72
                1. More preferential than § 72
            iii. Bank Account Treatment – Accelerated income realization compared to § 72
                1. Less preferential than § 72

b. <u>Life Insurance</u> → insurance against dying too early – so not insuring yourself, but providing benefits to your beneficiaries
    i. Individual puts in money and it accrues value, but does not pay out until death
        1. Premium changes based on your life expectancy (higher premiums if a greater likelihood of dying)

ii. Life insurance generally consists of a pure insurance element (investment) and a savings element (return on investment) [pg. 175]

iii. Life insurance proceeds are <u>not</u> includable in the beneficiary's gross income [§ 101(a)] → tax-preferred treatment

   1. This is regardless of the amount of gain that may be involved

      a. Therefore, the interest earned on savings through life insurance, or any other return on the taxpayer's investment, and the portion of proceeds representing the amount covering the life insurance risk, are free of income tax if received by reason of the death of the insurance

iv. Unlike annuities, mortality gains and losses on life insurance are ignored

v. Two Types:

   1. Term Life Insurance = a bet on dying – so not necessarily an investment

      a. Not that common because the premium increases based on your life expectancy (higher if older/greater likelihood of dying)

      b. Premium (Basis) is never actually recovered if you outlive the term

   2. Whole Life Insurance = you pay the same exact amount for your entire life (straight line/flat level)

      a. Tax preferred treatment for people who want to save for their heirs and have no taxation on any investments accrued

         i. Tax preferred whether it is your investment or return on investment

vi. If you terminate your life insurance (a tax preferred investment vehicle) – so the payout is not at death but at some point earlier – the amount of the life insurance policy is not included in income § 101, but only the pure insurance amount (i.e., the amount that is equal to the insurance portion) ??

vii. Upside down subsidy – because it is an exclusion from income, there is more benefit the higher you are on the income scale

viii. Summary: As a practical matter, taxpayers are not taxed annually on the investment income earned under a life insurance contract, even when amounts are withdrawn prior to death

   1. Thus, whether realized through death or through surrender of the policy during the lifetime of the insured, interest earned on savings in life insurance receives favorable treatment under the income tax relative to the earnings on many other forms of saving

c. <u>Deferred Compensation</u> → Compensation that is paid later (likely after you retire)

   i. Compensation may be deferred to provide employees income during retirement and, in some cases, so that employees will be taxed on income after retirement, when they may be in lower tax brackets

   ii. A tax-preferred savings vehicle to incentivize people to save in ways they might not have done otherwise

      1. Code's way of making sure that people supplement their SS

   iii. Employer Contributions

      1. Qualified Plans & Nonqualified Plans

         a. Both types are treated better than pure salary, but employers would vastly prefer a qualified plan

            i. Salary: Employer – deductible § 62 / Employee – includes § 61

            ii. Qualified: Employer – deductible now (like salary) / Employee – only include in income when you get the distribution

               1. Favorable tax treatment

            iii. Nonqualified: Employer – cannot deduct until the contribution is actually distributed to you (i.e., retirement) / Employee – only include in income when you get the distribution

            1. Surrogate Taxation: If the employee is not going to get taxed on it until later, then the employer cannot deduct until later (some effort at symmetry/matching)
      b. In order to be qualified, the employer needs to meet certain requirements – most set out by ERISA
         i. Two important requirements:
            1. Cannot be discriminatory
               a. Cannot just favor the highly compensated employees because we care about lower income employees saving more
            2. Vesting Requirement
               a. If a plan vests, you get to take your benefits with you (i.e., you do not lose the retirement savings you earned while at the company)
                  i. We do not want to disincentivize people from getting new jobs
               b. All benefits have to vest within 7 years (so benefits have to be fully vested within 7 years so you can take them with you?)
      c. Both have penalties for early withdraws
   2. Defined Benefit & Defined Contribution Plans
      a. Defined Benefit: Employee is guaranteed to get a certain benefit when they retire (could be a fixed amount or a percentage)
      b. Defined Contribution: Employee is not guaranteed any amount of money when they retire, but rather promised that every year your employer will put in a fixed amount of money
      c. The preference for one over the other depends on who bears the burden of a market shift
         i. Market UP
            1. Employee: Defined Contribution Plan – employer will have to put the same amount each year, so the benefit of the market increase goes to the employee
            2. Employer: Defined Benefit Plan – here, the employee gets the same amount at retirement no matter what, so the employer benefits if the market shifts up
         ii. Market DOWN
            1. Employee: Defined Benefit Plan – employee does not want to worry about what the employer puts in being worth less
            2. Employer: Defined Contribution Plan
iv. Employee Contributions (employees putting aside their own contribution)
   1. 401(k)
      a. Version of a CODA (cash or deferred arrangement) – Employees are allowed to make their own contributions to retirement savings plans in lieu of receiving cash salary and, by doing so, achieve tax savings
         i. Employee chooses the amount of her salary that she wants to take out pre-tax and put into a 401(k), and this contribution is not included in income until it is distributed
            1. All employee money, just a timing issue re: receipt and taxation
      b. 401(k) vs. Savings Account
         i. 401(k)
            1. Employee's Contribution: Excluded from income

2. Distribution: Included in income
ii. Savings Account
1. Contribution: Included in income (this is after-tax income)
2. Distribution (i.e., the interest): Included in income (and this inclusion happens over the course of your life, not just at retirement)
a. Double taxation (not in the sense that the same money is being taxed twice, but that you are subject to taxation twice) – the principal you put in is after tax income (i.e., has already been taxed) and when you earn interest income that is taxed as well
3. Benefit: Can take money out whenever – whereas the retirement plans generally have penalties for taking money out before retirement
c. When an employer matches your 401(k) contribution, they treat that like salary
2. IRAs
a. Traditional:
i. Contribution: Deduct contribution (reduces your taxes now)
ii. Distribution: Include later
b. Roth:
i. Contribution: Do not deduct contribution (no benefit of deduction now)
ii. Distribution: Not included in income (even at the time of distribution)
1. Never taxed on the gain – only taxed when you contribute
c. Have to make certain predictions and policy judgments to choose which type
i. If your tax bracket is higher now than when you think you'll retire and receive the distribution, then you want a traditional IRA because you are not worried about being taxed in the future
ii. If you think your bracket is lower now, then you want a Roth IRA
iii. If you think our tax rates will go down as a whole, then you may want the traditional IRA (and vice versa)
d. IRA contributions are generally capped for both types
e. Generally, taxpayers who withdraw savings from an IRA before retirement are subject to a penalty
i. But this penalty may not apply to withdrawals to pay medical expenses, health insurance premiums, or education expenses

<u>Capital Gains and Losses</u>

I. History and Rationale
a. Capital gains (or losses) are gains (or losses) from a sale or exchange of capital assets that you hold for over one year
b. Capital gains DO NOT include earned income and salary (so can contrast with this)
c. Capital gains do not exist anywhere else other than tax world
i. Capital gains are essentially own tax system
1. Rates fluctuate differently than any other tax rates – and historically, the treatment of capital gains has changed pretty consistently
a. Maximum rate on capital gains for 2011 → 15% (§ 1(h)(1)(C))

            i. If you are normally in a 10% or 15% ordinary income bracket, then your capital gains rate is 0% (used to be 5%)
        b. Maximum rate on ordinary income for 2011 → 35% (Code pg. 636)

d. Ideal Tax Planning → If I have gains and losses, I'd prefer the gains to be capital and the losses to be ordinary
    i. Conversion = Opportunity to convert ordinary income/gains TO capital gains, and to convert capital losses TO ordinary losses

e. Calculating Rates
    i. FIRST: Need to realize your gain or losses (so, need a realization event)
        1. Broad general realization requirement = "sale, exchange, or other disposition (§ 1001)
        2. Capital gains realization requirement = "sale or other exchange" (§ 1222)
            a. That means that any "other disposition" is automatically ordinary
    ii. SECOND: Is the gain or loss capital or ordinary?
        1. § 1221 – What is a capital asset?
            a. If it is a capital asset, then need to figure out . . .
    iii. THIRD: If capital, is it a short term or long term capital asset?
        1. Look to the holding period:
            a. Short Term = 12 months (365 days) or less
            b. Long Term = longer than 12 months
    iv. FOURTH: Netting out separately the short term gains and losses – and – netting out separately the long term gains and losses
        1. If short-term gains exceed short-term losses, there is a net short-term gain
        2. If short-term losses are greater, there is a net short-term loss
    v. FIFTH: Net the short term gain or loss against the long-term gain or loss
        1. If the net short-term capital gain exceeds net long-term capital losses, the excess short-term gain is taxable in full as ordinary income
            a. (but are still considered short term capital gains even though the preferential rate does not apply)
        2. If the net long-term gain exceeds the net short-term capital loss, the excess ("net capital gain") is taxed at the preferential capital gains rate
        3. When the taxpayer has both a net short-term gain and a net long-term gain, the former is taxable in full as ordinary income, and the latter is subject to the favorable rate
        4. Where the losses exceed the gains, the excess capital loss offsets up to $3K of ordinary income each taxable year
            a. Any excess not allowed in one taxable year is carried forward indefinitely until it is completely utilized
                i. The losses carried over keep their character
                    1. For the purpose of determining the character of the losses carried over, any short-term losses are deemed to offset ordinary income *before* long-term losses

f. Corporate Taxation
    i. Capital gains and losses are calculated the same way, but corporate taxpayers are taxed differently
        1. There is **no** rate difference between ordinary income and capital gains for corporations (rates in § 11)
        2. Capital losses are only deductible to the extent of capital gains (no leaky basket)
            a. Corporations are permitted a 3-year carryback and a 5-year carryforward of capital losses to be used against past or future capital gains
                i. Each amount carried back or forward is treated as a short-term capital loss

ii. The corporation forfeits losses not used within the permissible period

g. Reason for Preferential Rate: Promote investment
   i. The idea is to harness distortion – use the tax system to push people into investing in things they might not otherwise
h. Who Benefits?
   i. Capital gain rates generally benefit taxpayers with high income and very high income
      1. One reason is because wealth of this type is generally distributed there
      2. Most people below the high income cut-off have money from earned income, and we know that is not capital gains
      3. Some people do not have the flexibility to determine whether or not they have something that creates a capital gain or loss because they may not be able to wait for the 12-month holding period)
   ii. The effect of having a preferential treatment for high income people is that it creates a subsidy and lowers their effective tax rate
      1. Very top of the income scale (top 400 taxpayers) have an effective tax rate of 17% (despite their 35% statutory tax rate) – and this low effective rate is because so much of their income is from capital gains
         a. This undoes some of the progressivity of our tax system
i. Arguments Re: Preferential Rate
   i. For:
      1. Capital gains are not really income – and this is because capital gains are not recurring and sometimes they simply reflect changes in interest rates (rather than a change in actual value)
         a. If we really think this argument is compelling, then we should change our entire tax system
            i. Including only recurring items in income would conflict with the notion that the income tax base should reflect differences in people's ability to pay tax, even where one person's greater ability is due to a windfall or other extraordinary event
      2. Alleviate bunching – the realization rule forces a taxpayer to report in the year of the asset's sale capital gains that have accrued over a period of years, and thus the gain on the sale may be subject to a higher marginal rate than would have applied had the gains been reported each year as they accrued
         a. Idea of bunching is that if you sell all of your assets in one chunk, then you might be bumped into the top tax rate (i.e., end up being taxed more than if you had spread the sales out)
         b. Opponents think a better solution would be to permit the taxpayer to allocate the gain or loss realized to the number of years the asset has been held and compute the tax liability on that fraction at the appropriate marginal rate (mark-to-market idea)
      3. Taxation of capital gains on corporate stock is double taxation
         a. But capital gains treatment is not single taxation, just a more preferential rate
         b. If this is a serious problem, the best response is probably figuring out how to get rid of double taxation entirely – rather than having capital gains rate as some type of solution
      4. Disincentive to risk taking – taxing capital gains at a full ordinary income rate would make investors less willing to make risky investments because the tax reduces the expected return
         a. But, capital gains treatment is not limited to risky investments

5. Disincentive to savings – capital gains rate will encourage people to save more and to save in certain ways (i.e., not just in a savings account, which has a form of double taxation)
6. Lock-in – to avoid the taxation of the gain on appreciated assets, taxpayers will refrain from selling assets, even when market conditions otherwise would favor sales (i.e., the realization requirement encourages lock in so we should make it cheaper to sell)
    a. This reduces liquidity, impairs the mobility of capital, and may lead to broader fluctuations in market prices
        i. A preference for capital gains reduces the tax barriers to economically-motivated shifts in investments by encouraging realization
    b. Realization requirement alternative? Mark-to-market

ii. Against:
1. A dollar of capital gain is the same as any other dollar of economic gain, so should be treated the same
2. Capital gains treatment is very complex
    a. But administrability is not the most compelling argument because most things in the Code are hard to administer
3. Capital gains preference creates too much inequity – primarily benefits high-bracket taxpayers
    a. Idea that if it is really only the top of the income scale that gets this benefit, then we should not be giving a preferential rate
    b. But, it is not only the capital gains system that creates this (e.g., the realization requirement favors people who can choose to dispose of something or not)

iii. A lot of the reasons for and against capital gains treatments are actually criticisms of the Code as a whole
1. So, if you care about some of these concerns, the better way to deal with them is to change the Code as a whole, rather than dealing with the concern only in the treatment of capital gains

j. Note: Capital expenditures and capital assets and NOT the same thing, despite similar names

k. Note: In 2003, the 15% preferential rate was extended to dividends as well
    i. *But*, dividends are actually ordinary income (i.e., <u>not</u> capital gains) – just taxed at a 15% rate / the capital gains rate

II. What is a Capital Asset?

a. <u>TO QUALIFY FOR FAVORABLE CAPITAL GAINS TREATMENT, A TRANSACTION MUST</u>:
    i. Involve "property" that is a "capital asset,"
    1. MUST fall into § 1221(a)
    a. "Property"? Fruit (ordinary income) or tree ("property")?
    2. MUST NOT fall into § 1221(a)'s exceptions
    ii. The property must be transferred in a "sale or exchange," and
    1. More limited than a realization requirement
    iii. The minimum holding period (12 months) must be met

b. § 1221 defines capital asset broadly to include all property held by the taxpayers, **NOT** including . . . the general statutory exceptions (i.e., ordinary income taxed at your normal rate):
    i. <u>§ 1221(a)(1)</u>: The stock in trade or inventory of a business, or property that is held primarily for the sale to customers in the ordinary course of a trade or business
        1. Inventory Exception: If an asset is held primarily for use in your trade or business or for sale to customers, then the sale of the asset creates ordinary income
        2. Purpose: To distinguish profits and losses "arising from the everyday operation of a business" from those resulting from changes "in value accrued over a substantial period of time"

3. Ex: *Malat v. Riddell* (U.S. 1966): petitioner contends that his intention was to develop and operate apartments on the land; IRS contends that there was a "dual purpose" of developing the property for rental purposes or selling, whichever proved to be the more profitable – thinks § 1221(a)(1) is satisfied here; case is interpreting the meaning of "**primarily**"
    a. SCOTUS: "Primarily" means "of first importance" or "principally"
        i. Not a lot of guidance
    b. A lot of people were concerned that "primarily" meaning "principally" – rather than "substantially" as the IRS wanted – would change what counted as capital gains . . . but not much has changed
    c. When you have dual purpose ownership or transactions, different courts are going to look at them differently
        i. Some will say that if at any time you wanted to sell, then the primary purpose is sale to customers
        ii. Others will say look to whether sale was your overall purpose
        iii. The outcome will depend on how narrowly the court looks at the primary purpose (i.e., days before the sale – when clearly sale was the primary purpose – or years before the sale)

ii. <u>§ 1221(a)(2)</u>: Depreciable or real property used in a trade or business
1. This § is affected by § 1231, whose principal effect is to characterize net gain on sales of depreciable or real property used in a business as capital gain and net losses on sales of such assets as ordinary losses – more preferential treatment than capital gains treatment [§ 1231 – always ordinary losses]
    a. § 1231 is for quasi-capital assets and have the best possible treatment
        i. Not limited to sales or exchanges – can include "other dispositions"
        ii. Christmas tree farmers fall under this § and get the ideal treatment
2. Because § 1231 is so favorable, we have recapture provisions
        i. § 1245 recaptures as ordinary income amounts that otherwise would be treated as capital gain under § 1231
        ii. § 1245 (applies mainly to machinery) + § 1250 (applies to real estate) end up recapturing the depreciation expenses at a different rate (once depreciation recaptured, preferential rate)
            1. § 1250 is more favorable than § 1245 because it applies the ordinary rate to some of the recapture and then applies a rate between the ordinary and capital gains rate)

iii. <u>§ 1221(a)(3)</u>: Literary or artistic property held by its creator, unless the creator of a musical composition or a copyright in musical works elect to treat it as a capital asset
1. Eisenhower Amendment: If you are an artist or creator of something, you are not going to get capital gains treatment of the asset – and people who are receiving the asset from the artist are not going to get capital gains treatment
    a. We do not have the same lock-in or realization requirement concerns with artists
        i. Sense underlying this that the distortion of the tax system are not strong enough to discourage artists from selling their work
    b. This only applies to the creator of the art and the family and friends
        i. Collectors who sell art can have capital gains
    c. Does NOT apply to patents – investors can get capital gains treatment
2. Interplay with the Charitable Deduction → Generally under § 170 the charitable deduction amount is the FMV, however, § 170(e) limits this – when appreciated

property is donated the charitable deduction is reduced by the amount of gain that would have been ordinary gain

a. **If you have CAPITAL gains, you get the full amount of the deduction**
    i. **But if you have ORDINARY gains (under § 1221(a)(3)), you do not get the full amount of the deduction (because of § 170(e))**
b. Hypo: 2 artworks with FMV $1K each
    i. Artist:
        1. Basis: $50 – what she put into it
        2. Gain: $950 – treated as *ordinary*
        3. Deduction if Donated (w/o § 170(e)): $1K
        4. § 170(e) Deduction: $50
            a. Reduces the amount of the otherwise permitted deduction of the FMV by the amount of gain, if recognized, that would be ordinary income
    ii. Collector:
        1. Basis: $500 – cash he put into it
        2. Gain: $500 – treated as *capital*
        3. Deduction if Donated (w/o § 170(e)): $1K
        4. § 170(e) Deduction: $1K
c. Notion that you cannot deduct services, so the $950 of gain for the artist is based partially on reputation and it was his own services
    i. We also have some valuation questions – artist's valuation might not actually be the real world FMV

iv. <u>§ 1221(a)(4)</u>: Accounts of notes receivable acquired in the ordinary course of the taxpayer's trade or business
    1. If you have assets that are inventory, and you sell that inventory in exchange for something else that you hold onto, the thing you receive in exchange is also going to be treated as inventory

v. <u>§ 1221(a)(5)</u>: U.S. government publications received from the government at a price less than that which the general public is charged
    1. This § was added because various members of the government were getting these publications free or at a reduced price, then donating them, and then getting the full value of the deduction
    2. § 170(e) also reduces the value of a deduction for government publications if legislators got them at a discount
        a. Code does not want you to get the full value of a deduction that you did not ever pay for

vi. <u>§ 1221(a)(6)</u>: Commodities derivative financial instruments held by commodities derivative dealers
    1. This should seem easy – if you are a dealer and holding something for customers, then the instrument should be ordinary income – but this § was added to clarify that dealers ARE in the inventory exception

vii. <u>§ 1221(a)(7)</u>: Identified hedging transactions under rules provided in regulations (i.e., business hedges)
    1. Risk management business hedges vs. Investment business hedges → taxpayer has to identify on the day that they enter into the hedge that it is a business hedge – has to **earmark** as ordinary income
    2. Dicta: § 1256 – certain hedging transactions must be mark-to-market (i.e., the opposite of a realization requirement), but this only applies to those hedges that do not require ordinary treatment – so whether or not something qualifies under § 1221 actually affects whether or not the realization requirement applies (in this instance)

viii. <u>§ 1221(a)(8)</u>: Supplies regularly consumed by the taxpayer in the ordinary course of the trade or business
    1. Supplies linked to your trade or business – the inventory – then ordinary treatment

. . . § 1221(a)'s exclusions are intended to produce *ordinary income treatment* for proceeds from everyday business activities and from personal labor – and – *capital gains treatment* for investment gains

c. Ex: *Bramblett v. Commissioner* (5th Cir. 1992): both the partnership and the corporation have the same owners and the same ownership percentages – muddies an otherwise OK transaction (i.e., partnership holds onto land for a lengthy holding period and for investment, and then the corporation is developing and selling primarily for customers); corporation never pays the interest back to the partnership – only the principle after their sales to customers (suggests something questionable is going on, because no arms length transaction allows you to not pay the interest); $7M of gains at issue here – capital or ordinary?; if this is a sham, then the companies should be treated as one holding company for purposes of gain and loss and definitely no capital gains treatment
    i. <u>*Bramlett* Factors</u>: (1) nature and purpose of the acquisition of the property and the duration of ownership; (2) extent and nature of the taxpayer's efforts to sell the property; **(3)** number, extent, continuity, and substantiality of the sales******; (4) extent of subdividing, developing, and advertising to increase sales; (5) use of a business officer for the sale of the property; (6) character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) time and effort the taxpayer habitually devoted to the sales
        1. FACTORS to determine: ordinary course or investment activity?
    ii. Court: NO sham
        1. Partnership is holding the land for investment, so capital & corporation is correctly treating things as ordinary – but it gets to deduct the cost of the land at an ordinary rate, so these owners are really taxed only at the capital gains rate (their ordinary tax rate might have been 20%??)
        2. Court finds a business purpose to have the corporation – as a middleman, essentially, between the partnership and customers
            a. The corporate structure has legal ramifications and incorporation can shield you from liability
    iii. TAKE-AWAY: Judicial doctrines are applied differently by different courts
        1. Sometimes just having a change in structure is enough to change how courts look at something
        2. Also, the same assets held by different entities can be treated differently
            a. Here, the same plot of land was held by the same people yet for one entity it counted as a capital asset and for the other ordinary income

d. Stocks
    i. Taxpayers holding stocks can be divided into three types:
        1. Dealers – generally sell stock to customers and work on commission
            a. § 1221(a)(1) treats dealers as having ordinary income – stocks are like inventory held for sale to customers
            b. § 1236 permits securities dealers to receive capital gains treatment on securities they **earmark** as investment assets, but then they are locked into that treatment, so dealers generally do not do this because they have the risk of losses
        2. Traders – somewhere in between (often sell a lot of stock, like dealers, but earn money based on changes in the market, like investors)
            a. Generally treated for capital gains purposes as if they are investors because they make money off the fluctuations in the market . . . but it is not always clear that they should get investor treatment

3. Investors – invest for their own purposes (often sell less stock, and make money more on changes in the market)
    a. Generally seen as having capital gains – gains from something other than selling to customers

ii. Court might look to the *Bramblett* factors – frequency and substantiality of sales being the most important (went through factors in class notes)
    1. Courts suggest that numerous sales that extent over a long period of time are more likely to have occurred in the ordinary course of business, while sales that are few and isolated are more likely to have resulted from investment activity
    2. Most of the factors seem to focus on the effort you are expending and the professionalism
    3. Note: These factors do not necessarily support the purposes of capital gains treatment
        a. One instance where the purposes do not always match up to the rules we end up applying
        b. Ex: If we are not going to give capital gains treatment to dealers who are selling the largest number of assets, then that seems to undermine our concern about bunching

iii. Ex: *Marrin v. Commissioner*: court refused to permit a former securities trader to treat any of his loss on stock sales as ordinary because he was trading for his own account (and he wanted this because he had losses); petitioner had a full-time job, but he spent 40 hrs/wk researching trades; court found that petitioner's activities did not rise to the level of a trade or business
    1. Note: It is possible that courts look more critically on claims for ordinary treatment for losses than ordinary treatment for gains

iv. 2 and 20 Formula → Management fee is 2% of the amount invested (the full amount managed), and 20% is gains over the predetermined benchmark (i.e., carried interest – the increase in value)
    1. The 2% is taxed as ordinary income, and the 20% is taxed at the capital gains rate
        a. The 20% could be seen as salary, but this formula and its treatment are still used

e. Ex: *Corn Products v. Commissioner* (U.S. 1955): CP is concerned about the price of corn going way up – more than they agreed to, so they end up buying futures contracts = derivative contracts based on the price of commodities, a fixed agreement to purchase or sell an asset (i.e., you are tied to the price you agreed to buy or sell at); 1940 – profit of $700K in corn futures, 1941 – loss of $100K; CP wants this to be an investment/capital asset – arguing that the futures contracts were separate and apart from their manufacturing business (i.e. purpose)

   i. Hedging transactions are essentially risk management – if I am investing in one direction, I can hedge that investment by adding another investment that is going in the opposite direction
       1. If I have a long position in something, I also want an off-setting short position in the same asset
           a. The difference between them is that the up and downsides are treated differently
               i. Long downside – maximum downside risk is $0 (the floor for a long position is usually the amount you put in) / Long upside – infinite amount
               ii. Short downside – infinite amount / Short upside – capped on the upside at what you put in

   ii. *Bramblett* factors suggest that CP might be more like an investor than a dealer – they do not actually seem to be doing this as part of their business – no office, only a small number, not putting effort into selling

iii. SCOTUS: This is NOT capital … despite the fact that the transaction does not fit within the literal language of the statutory exceptions (§ 1221(a)(1)-(5) only at the time of this case)
    1. 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
    2. Since this section is an exception from the normal tax requirements of the Code, the definition of a capital asset must be narrowly applied and its exclusions interpreted broadly

iv. Taxpayers with LOSSES like this decision – Taxpayers with GAINS dislike this decision
    1. Until *Arkansas Best*, taxpayers saw this case as a benefit because when they had gains they would claim they were capital, but if they had losses they would claim them as *Corn Products* losses (i.e., ordinary)

f. Ex: *Arkansas Best v. Commissioner* (U.S. 1988): issue: whether capital stock held by petitioner is a capital asset as defined in § 1221 regardless of whether the stock was purchased and held for a business purpose or for an investment purpose; AB purchased stock in a bank in 1968 and sold almost all of it in 1975 – but in 1972 things start to look bad for the bank; Tax Court classifies 1968-1972 as capital and 1972-1975 as ordinary; Appellate Court says everything is subject to capital loss treatment because we only look at the asset; AB had losses, so wanted ordinary income treatment
  i. SCOTUS: Taxpayer's motivation in purchasing an asset is irrelevant to the question whether the asset is "property held by a taxpayer (whether or not connected with his business)" and is thus within § 1221's general definition of "capital asset" → stock here falls within § 1221(a) and not into any of the exceptions → capital treatment
    1. *CP* accepted that § 1221(a) was a broad statement, but then it broadened § 1221(a)(1) to mean if it is in any way related to your business … but did not affect § 1221(a)
      a. *AB* narrows the broad reading of inventory – making it harder to have ordinary income than after *CP*
    2. We conclude that CP is properly interpreted as standing for the narrow proposition that hedging transactions that are an integral part of a business' inventory-purchase system fall within the inventory exclusion of § 1221
  ii. Taxpayers with GAINS like this decision (because *AB* made it easier to have capital treatment than *CP*) – Taxpayers with LOSSES do not like this decision

g. POST-*CP* and POST-*AB*, Congress added three exceptions → § 1221(a)(6)-(8) (*supra*)

III. What is "Property"?
  a. **§ 1221(a)**: "[T]he term 'capital asset' means ***property*** held by the taxpayer (whether or not connected with his trade or business) . . ."
    i. ASK: When is something just a stream of payment (i.e., ordinary income), and when it is so much like property that it is treated as capital?
  b. Introduction
    i. Conversion → changing the character of an asset – easiest when there are substitutable assets
    ii. Generally capital treatment is supposed to go to occasional sales of property, rather than recurring payments
    iii. Things we know get ORDINARY treatment: rent, dividends (even though taxed at a different rate), and interest payments
    iv. Things we know get CAPITAL treatment: land (*Bramblett*), stocks, and bonds
    v. Fruit vs. Tree Analogy → Tree (capital) is the full asset that is producing the ordinary income, while the fruit (ordinary income) is something that is being produced by something else, more recurring)
      1. POLICY: Maybe our concerns about bunching, etc., do not apply to the fruit, but might more convincingly concern the tree itself
    vi. *Hort-Lake* Line of Cases

1. *Hort* (payment by the lessee for the cancelled lease) – ordinary income because it was a substitute for future ordinary income, like rent
2. *Lake* (payment in exchange for assigning rights to future oil payments) – ordinary income because money for the right to the future payments is like a substitute for ordinary income; the payment itself would have been ordinary, so the payments for the payments are ordinary

vii. *McAllister* (sale of a life interest in a piece of property) – capital because the life interest is a capital asset

c. Ex: *Lattera v. Commissioner* (3d Cir. 2006): "property" at issue is the right to 17 remaining lottery payments; lottery payments are ordinary income in the year they are received; petitioners contend that this has become property because they have held the right for more than one year
   i. (Traditional) Substitute-For-Ordinary-Income doctrine holds that lump-sum consideration substituting for something that would otherwise be received at a future time as ordinary income should be taxed the same way
      1. Third Circuit thinks this is too simplistic and applies their own version (adding steps 2 and 3) – if you accept the traditional doctrine then every capital asset is fundamentally a substitute for ordinary income
   ii. Court: Ordinary income → (1) no clear family resemblance; (2) vertical carve out; (3) right to earned income
      1. Ordinary treatment not because this falls within the exclusions of § 1221(a) but because earned income never even makes it into capital gains land under § 1221(a) – not a capital asset because there was never a sale or exchange of property
         a. *CP* is already within § 1221(a), so would not necessarily tell us anything about this case; *AB* might tell us that you broaden the definition of a capital asset, but probably not so broad to include this . . . this is the case before we get to the analysis from those cases
   iii. <u>Court's Substitute-for-Ordinary Income Analysis</u>: (APPLY FOR STREAMS OF INCOME/PAYMENTS)
      1. **Family Resemblance Test**
         a. Determine whether the asset is like either the capital asset category (e.g., stocks, bonds, or land) or like the income items category (e.g., rental or interest income)
            i. Essentially analogizing to the things that are clearly accepted as capital assets or ordinary income
               1. It is not that they are ALWAYS capital assets, but they could be
               2. The list of ordinary assets are NEVER capital assets though
         b. If the asset does not bear a family resemblance to items in either of those categories, move on to the other factors
      2. **Type of Carve Out**
         a. Horizontal (only part of the right you own/fruit) – ordinary income treatment presumably applies
         b. Vertical (entire interest in the property/tree) – look to the character of the asset factor
      3. **Character of the Asset**
         a. Right to Earned Income – ordinary treatment
            i. Notion that the income has already been earned and the holder of the right to this income only has to collect it
         b. Right to Earn Income – capital gains treatment
            i. Notion that the holder of such right must do something further to earn the income because mere ownership of the right to earn income does not entitle the holder to income

        ii. Ex: Patents are capital assets
        iii. Ex: Stocks are capital assets, but I could argue that I am not doing much more than the Latteras if I just sit back and wait for to earn income if Apple does well
    iv. Court rejects the simplistic view (but same result as here) that the *Maginnis* court took to a similar payment because their analysis might result in a change of character just because of the change in value
        1. *Maginnis*' Test: (1) Was there an investment in the property? (2) Was there an accretion to wealth?

d. Ex: *Commissioner v. Ferrer* (2d Cir. 1962): petitioner sells a series of rights under various contracts re: "Moulin Rouge"; his first round of contracts gives his rights, his second round provides for various forms of compensation; petitioner argues for capital treatment because the second contract's payment were tied to his performance (i.e., if he just stopped showing up, no $); IRS argues that this is just salary presented as something different, so ordinary income; § 1221(a)(1) does not apply here because then petitioner would have to be deemed to be in the trade or business of selling his rights under contracts to customers (court dismisses this idea quickly)
    i. Court breaks up the payment into three parts to determine treatment, and then remands to the Tax Court to figure out what portion of the payment is allocated to each part (so petitioner will argue that all of the payment was for the first two parts – that that is where the entirety of the value was)
        1. Surrender of the "lease" of the play
            a. Court: Looks to the Eisenhower Amendment but determines it does not apply because petition is not the creator, so the lease is capital (different than *Hort* because instead of being cancellation of a lease and payment back, this is the lessee selling the entire right onto someone else)
        2. Negative power (i.e., petitioner's right to prevent disposition of the movie when he still has rights to the play)
            a. Court: Capital asset
        3. 40% of the proceeds of the play and the movie, if the movie had come after the play
            a. Court: Ordinary income
    ii. The policy reasons behind capital gains treatment does not really explain the difference between the treatment for (1) & (2) and (3) . . . we see a divide between the rationale for preferential treatment and what is actually getting it

e. KEY: Have to fit into § 1221(a) before you even consider whether the exceptions apply (and courts approach this very differently)
    i. *Ferrer* divided out different rights in a bundle of rights to find the some were ordinary and others were capital – and this was somewhat based on whether equitable relief (i.e., state law) was tied to them … so this is good if you think capital gains treatment should be tied in some way to state law
    ii. *Lattera* looked at the family resemblance test, carve outs, and right to earn vs. earned income
    iii. *Maginnis* looked at the underlying investment and whether there was an accretion of wealth

f. ASK: Is something a capital asset?
    i. If there is a statutory answer, then you have an answer
    ii. If there is no statutory answer, then look to the rationales behind capital gains treatment – would capital gains treatment in this situation respond to these concerns (bunching, inflation, encouraging investment)?

IV. Preferential Treatment WITHOUT Being a Capital Asset

a. **Dividends** – taxed at the capital gains rate, but they are considered ordinary income

b. **§ 1202: Preferential treatment of qualified small business stock** – to incentivize certain investments
    i. An individual can exclude 50% of the gain on the sale or exchange of a qualified small business stock held for at least 5 years

1. Includable portion is taxed at a max rate of 28%, so the maximum effective tax rate on the gain is 14%
2. If you acquired the stock in late 2010 or early 2011, you can exclude ALL gain

ii. Individual must have acquired the stock at its original issuance (on the ground floor)

iii. To be qualified, company must (i) be relatively small (net worth $50M or less), (ii) at least 80% of its assets must be used in the conduct of an active trade or business during substantially all of the taxpayer's holding period, and (iii) the business conducted by the corporation must be something other than one where one of the principal assets of the business is the reputation of one or more of its employees

1. Business <u>cannot</u> involve banking, insurance, leasing, financing, investing, farming, or operating a hotel or restaurant

V. Nonrecognition of Gain or Loss

a. **<u>NOT</u>** necessarily limited to capital gains

b. <u>General Rule</u>: **§ 1001(c)**: Realization events are recognition

i. *But*, there can be a realization event that does not lead to recognition (i.e., taxing the gains or losses)

c. <u>Exception: Like Kind Exchange</u>: **§ 1031(a)**: **No** gain or loss shall be recognized on the exchange of 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

i. Basic Idea: Instead of selling one asset and using the money from the sale to buy another asset, you just exchange the two assets

ii. **RATIONALE** for this being a nonrecognition event:

1. **Liquidity** – no liquidity is created by this transaction, so you have nothing to pay your taxes with if you are taxed on gains
   a. Note: We do <u>not</u> have this same concern with losses because there is no concern about not being able to pay taxes with losses (i.e., no gains)
2. **Valuation** – we assume no recognition because there is a valuation concern because you did not go onto the market to figure out the worth/price, BUT we also assume that when you exchange things they have the same value
3. **Equity/Fairness** – some sense that if you have basically the same investment, you should not be viewed as having changed your assets that much; but, if you have a change in your holding, then we might recognize
4. **Lock-In** – we do not necessarily want the tax system changing the decisions you would otherwise make for a good business purpose – if we have high enough tax rates, that might encourage people to hold onto assets even when it is not otherwise a good business decision

*********LOOK to these purposes when trying to figure out whether something counts as a nonrecognition event . . . liquidity and valuation probably being the most important*********

iii. Hypos re: Taxable Event?

1. A bought shares of stock of Texaco for $10K; A swaps them for shares of stock of Exxon worth $60K → Taxable Event
   a. § 1031(a)(2)(A): We do <u>not</u> grant nonrecognition treatment to exchanges of stocks, bond, or notes
      i. Looking at the rationales: (i) still liquidity concerns, unless you say that stocks are so easily traded that that is a factor; (ii) no valuation concerns because easy to value; (iii) maybe we want to treat people who sell and trade their stocks the same; (iv) probably still a lock-in concern
   b. Texaco and Exxon are SIMILAR businesses, but they are <u>not</u> the SAME business – and the fact that they are fundamentally different interests in completely different corporations affects the treatment of stocks (in addition to the rationales)

2. B bought X Farm for $10K and has held it as an investment; B swaps X Farm for Y Farm, worth $60K → NOT a Taxable Event, if Y Farm is also held for investment
    a. Rationales: liquidity concern; valuation concern (at least more so than with stock)
3. C bought M Farm for $10K and has held it as an investment; C sells it for $60K and uses the proceeds to buy N Farm the next week → Taxable Event (she realizes and recognizes cash; not a like kind exchange)
    a. Cash changes everything – once it comes into the transaction, nonrecognition treatment is off the table
        i. Cash is the most liquid thing we have
        ii. Transaction has now gone into a market – so we know the FMV
        iii. No major lock-in concern since C was clearly willing to sell
        iv. There is an amount of discretion that C has once he has cash and that changes the concern since there is not a direct property-for-property exchange
    b. Holding periods in § 1031 are not related to how long you can hold onto cash, but rather are for earmarking like kind exchanges, etc.
4. D bought S Farm for $10K and has used it in his farming business; D swaps it for a fleet of tractors worth $60K that he will also use in his farming business → Taxable Event
    a. Not like kind (real vs. personal property) – D sold his farm and got something back completely different, he just happened to do it with the same purchaser/seller

iv. **§ 1031 Like Kind Exchange Requirements**:
1. You must have held the property for productive use in a trade or business or for investment
2. Property must be of like kind – <u>cannot</u> fall into one of § 1031(a)(2)'s exceptions
    a. Asset classes do not always determine whether something is like kind, but it can be a good hint (e.g., exchanging a computer for a printer is not a taxable event, but exchanging an airplane for a bus is a taxable event)
        i. Treasury Reg. § 1.1031(a)-2(b)(2): General Asset Classes
    b. § 1031(e): Exchanges of livestock of different sexes are NOT like kind exchanges – they have completely different functions and markets
3. Need an exchange – <u>cannot</u> just sell the original property for cash and turn around and buy a like kind piece of property
    a. Cash entering the transaction is enough to undo any nonrecognition that would have otherwise applied
        i. So we can have two very similar looking transactions, with very different treatment if cash is involved
        ii. Friction – if you want § 1031 treatment, then you are willing to structure the transaction so that cash does not leak into it

v. Rev. Ruling 82-166: Does an exchange of gold bullion held for investment for silver bullion held for investment qualify for nonrecognition of gain under § 1031(a)?
1. Rationales: (i) liquidity concern because no cash; (ii) we have a gold and silver exchange, so maybe less of a valuation concern, but the concern is still valid when something is not traded on a market but rather between two people; (iii) probably would not make the exchange if you knew you would get taxed, so lock-in concern; (iv) re: equity, trading gold for silver seems to leave the taxpayer in the same position (both commodities, precious metals, used in jewelry) . . . but the uses of each are different (gold is an investment in itself whereas silver is an investment in industrial economies)

2. IRS: This is NOT a like kind exchange because of the completely different purposes on the market (even though taxpayer was holding both for investment)

vi. Treasury Reg. § 1.1031(a)-1(b): The words "like kind" have reference to the nature or character of the property and not to its grade or quality

vii. Ex: *California Federal Life Insurance v. Commissioner* (9th Cir. 1982): petitioner exchanged Swiss francs for U.S. double eagle gold coins, only afforded the gold coins their face value, and then claimed a substantial capital loss (i.e., they put in $43,500 and what they got was only worth $3,500, so they are claiming a $40K loss); in trying to devalue what they got, they look to § 1001(b) and argue that the coins were money and not property (because cash has a basis of its face value); petitioner also argues that this is a nonrecognition event because there was a like kind exchange of collectible currency (but the Swiss franc is actual currency, not collectible)

1. Petitioner points to a Reg re: real property that says if any real estate is involved, improved or unimproved is immaterial to the question of whether something is a like kind exchange – basically saying that if the exchange of city real estate for a farm in the country (i.e., two very different things) is a nonrecognition event, then this exchange should qualify for nonrecognition treatment as well
    a. Court does not find this compelling
    b. It is easier to get nonrecognition treatment for real property vs. personal property – (i) liquidity concerns are greater; (ii) some subjective valuation issues; (iii) maybe a life stages issue (i.e., where it is best for you to live changes); (iv) coins are an objective valuation
2. Court: This is NOT a like kind exchange
    a. Actual currency is essentially an investment in an economy, whereas collectible currency is for actual investment

viii. Ex: *Jordan Marsh v. Commissioner* (2d Cir. 1959): this is a sale in lease out = you sell something and then immediately become the lessee; question as to whether this counts as a full sale or whether it is so close to being a sale-for-sale that it is essentially an exchange; petitioner does not want like kind treatment because the properties were sold at a loss, which petitioner wants to deduct

1. IRS viewed this, in substance, as an exchange of a fee interest for a long term lease and uses Treasury Reg. § 1.1021(a)-1(c), which says that a leasehold of more than 30 years is the equivalent of a fee interest
2. Court: Transaction was a full sale – <u>not</u> an exchange
    a. Petitioner here, by its unconditional conveyances to a stranger, did more than make a change in the form of ownership: it was a change in the quantum of ownership – notion that there are different rights that accompanying owning property versus being a lessee
3. Liquidity Rationale: When there are losses, we do not have the same liquidity concerns that support nonrecognition
    a. If you have a gain and we are going to tax you on the gain, there is the concern that you do not have the cash to pay the taxes if you just had a like kind exchange … but with losses, there are no taxes to pay, generally

ix. **KEY**: For like kind exchanges, look to the Regs – they often have specific lists

d. <u>Exception: Involuntary Conversion</u>: **§ 1033**: Provides for nonrecognition where property is compulsorily or involuntarily converted (e.g., by theft, destruction, or condemnation) and is replaced with property that is "similar or related in service or use"

i. Nonrecognition is *mandatory* where there is a direct conversion of property

ii. Nonrecognition is *optional* where the taxpayer receives cash and then buys the replacement property

iii. § 1031 vs. § 1033: Under § 1033 –

1. The replacement property must be "similar or related in service or use" as opposed to "like kind"

a. This is definitely broader than § 1031, but is not unlimited
b. Some sense that we are going to look more favorably because we do not think there is much tax planning going on if your property involuntarily burnt down
2. If cash is received, the taxpayer generally has two years in which to find replacement property
3. If cash is received, the taxpayer may choose to recognize gain
a. So the losses are recognized, but you can elect what to do with the gain
i. We do not want to them to have to recognize gains, if there are any, if it was simply a replacement of the destroyed property
4. Losses are recognized – conversion into property applies only to nonrecognition *gain*
a. We do not think you are being harmed if you are forced to recognize losses from an involuntary conversion

e. Boot & Basis
i. If the basis does not change, then you are eventually going to recapture any gain or loss that you did not recognize
1. But if the basis changes, then you lose that gain or loss forever
ii. "Boot" is money or other property that is transferred as part of the like kind exchange
1. If the transaction is a § 1031 like kind exchange, it will still qualify for nonrecognition despite the boot, but if there is gain, it is recognized to the extent of the boot (§ 1031(b))
a. So the amount of gain that is recognized is the lesser of the amount of gain realized or the amount of the boot
iii. EQUATION: A/B of A + Gain Recognized = A/B of B (Substitute Basis) + Boot
1. Boot is recognized only to the extent of gain
2. You ARE taxed on any gain RECOGNIZED, but that is it
3. If you have boot, but you did not recognize any gain, you will actually have a lower substitute basis to eventually recapture any income you would have because of the boot

f. **Exclusion of Gain from Sale of Principal Residence: § 121(a)**: Gross income shall NOT include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more
i. This is very preferential treatment
1. With nonrecognition events, you are not taxed on gain or loss at the realization event, but you eventually will be – so you are deferring taxation until later
2. With § 121, there is <u>no</u> deferral, you are just <u>never</u> taxed
ii. Gain is limited to $250K for single taxpayers and $500K for married taxpayers
1. So if you have gain of $150K – not taxed on it; if you have gain of $350K, only taxed on the excess $100K
iii. In theory, § 121 can only be used every two years
iv. This section does <u>not</u> require reinvestment of the gain in another principal residence
v. This section is an attempt to encourage home ownership
1. There is also some sense that most people who sell their principal residence will use that money to buy another principal residence, so it should be treated similar to a like kind exchange
a. But, they cannot use § 1031 because the first requirement is that the property must be held for productive use in your trade or business or for investment

WHO IS A TAXPAYER

Marriage

I. Focus: WHO is taxed, rather than WHAT is taxed
    a. In a progressive tax system, WHO is taxed determines what rates apply and how much tax is paid

II. Treatment of married couples and the family unit does not always map well onto real life
    a. Some marital units, pool their assets, but others do not
    b. Some marital units see the unit as a tax avoidance, but others do not
    c. Some marital units see children as a tax avoidance, but others do not

III. Marriage Penalty (and Bonus): As a marital unit you are taxed more, when compared to each individual in the marriage unit being taxed as single (so not compared to any single person, but you two as single people)
    a. So the penalty does not affect ALL married couples – but generally those where the spouses make similar amounts (i.e., dual earning households) … or very low income people who receive the EITC
    b. A marriage bonus (i.e., their combined taxes will decline if they marry) is generally in situations where one taxpayer in a couple earns substantially more than the other (OR single earner households)

IV. The marriage penalty/bonus is the result of Congress choosing two out of three possible elements in our tax system: progressive rates and equal treatment of marital units that are similarly situated (third element forgone = equal treatment of individuals unaffected by changes in marital status) ← **Impossibility Theorem**
    a. Why does this matter?
        i. Congress is creating financial incentives or penalties depending entirely on who you marry, which is a very personal choice
        ii. Congress claims to be pro-marriage, but this says is that Congress is pro-certain-types-of-marriage
            1. Congress has a huge penalty to low income taxpayers who decide to get married
            2. Congress has a bonus when two people with substantially different incomes get married
        iii. This does create real incentives that change our labor supply in that the D's of the world (second income earners) have a real disincentive to enter the labor market based entirely on the Code and how their income will be taxed because they are married
            1. This is the definition of inefficiency – when the Code discourages workers who would otherwise enter the workforce

V. The validity of a marriage for federal tax purposes is usually a matter of state law
    a. Taxpayers are not free to argue that they are not married, so long as the state of the marriage considers it valid
        i. MUST file as married if marriage is valid at both the federal and state level
            1. Ex: *McCarty*: taxpayers learned of the marriage penalty after their valid marriage in Fuji and tried to argue the marriage was only symbolic; court: marriage is valid, so cannot claim you are unmarried
            2. If you are in a common law marriage that IS recognized by the state, then the federal government will respect that for tax purposes
                a. This means that federal law WILL defer to state law re: what counts as marriage *except* with regard to same sex couples
        ii. CANNOT file as married if marriage is not valid at both the federal and state level
            1. Same sex couples generally cannot file tax returns jointly
                a. Even if the state has recognized same sex marriage, for purposes of federal law, DOMA defines marriage as only heterosexual
                b. Think: Heterosexual couples might end up suffering a marriage penalty, and because of DOMA, same sex couples who would have suffered a marriage penalty are not because they are not deemed legally married for federal law purposes
            2. By having mandatory community property treatment of married couples and same sex couples, California has managed to change the treatment of married couples (gay and straight) – because both are not getting federal tax treatment due to the fact that it is a community property state – so federal law is deferring to state law

re: community property treatment (i.e., all property is the marital unit's and you each have access to 50%) . . . NOT because federal law is recognizing same sex couples as married

b. Ex: *Druker v. Commissioner* (2d Cir. 1982): petitioners thinks that the income tax structure unfairly discriminates against working married couples in violation of the Equal Protection Clause of the Fourteenth Amendment (because they were subject to the marriage penalty); petitioners filed their returns applying the tax tables for single people
    i. Court: We do not doubt that the "marriage penalty" has some adverse effect on marriage, but the tax rate structure of § 1 places no direct legal obstacle in the path of persons desiring to get married – so petitioners were deprived of no constitutional right
        1. Petitioners cannot just announce that they are not married, when they legally are

VI. Imputed Income → Not income that you earn, but income that we think you could be taxed on because if you went into the market for the service you would be taxed on that
    a. So maybe we should not be treating AB and CD the same because they are not similarly situated, assuming D provides childcare
        i. Ways to Respond to Imputed Income:
            1. Not tax D's income on however much it would cost to pay for childcare
            2. Make the cost of working deductible – could claim that childcare for AB is a business deduction under § 162 because it is a cost of earning their income (this is NOT the law)
            3. § 21: Provides a credit for childcare and other care giving costs, but capped at a pretty low level
                a. The fact that this is a credit has symbolic value – not treating the cost of childcare as a deductible expense, but we are in many ways treating it better (but not putting it into the category of being necessary to earn income)

VII. Section 1: Tax Imposed
    a. § 1(a): Married individuals filing jointly
    b. § 1(b): Heads of households – unmarried individuals with a household (§ 2(b))
        i. Some exceptions, but generally single parent status
        ii. This status will be the same or worse than marital status (but never better)
    c. § 1(c): Single
    d. § 1(d): Married filing separately
        i. Will NOT avoid the marriage penalty by filing under this §
        ii. Harshest rates – more restrictive/less favorable than if you'd stayed single
            1. Inherent financial prohibition against filing under this §
        iii. As a general rule, married taxpayers file separately only when they are so estranged from one another that they do not wish to sign a joint return (because there is joint and several liability) – or – when separate filing enables one spouse to exceed the 7.5% AGI floor for medical deductions

VIII. Why Treat Married Couples Differently? (pg. 472)
    a. Income Pooling – Income should be aggregated for tax purposes regardless of how it is actually earned because married couples are economic units; Costs of Children; Imputed Income; Costs of Working – Idea that there are greater costs in earning two incomes than in earning one

IX. Family/Children
    a. Those who favor taxing the consolidated income of a family unit emphasize that the ability of parents to pay taxes differently depending on whether their children have income of their own
        i. The parents' obligation to provide food, clothing, and other items of support for their children may well decrease as the children's own earnings increase
        ii. Without taxation of the family unit, parents have incentives to shift investments to the children
    b. Proposals for a family unit of taxation have been criticized for placing a burden on parents to account for the babysitting and paper route earnings of their children

        i. Some have argued that family taxation might create a disincentive to productive employment among the children of wealthy families because the earnings of a rich child with a paper route would be taxed move heavily than would the earnings of a poor child with a paper route
   c. **Kiddie Tax: § 1(g)**: Net unearned income of children under the age of 19 as well as children over 18 but under 24 who are full-time students is taxed at their parents' top marginal rate, regardless of the source of the unearned income → Disincentive to shifting income
        i. "Net *un*earned income" = unearned income in excess of the child's standard deduction plus the amount of allowable deductions that are directly connected with the production of the unearned income
        ii. If the parents do not have any income or do not have as high of a tax rate as their child (e.g., famous child stars), then the children with *earned* income (i.e., not gifted income) can file individually at their own higher rate so their parents will not be taxed on that income
            1. But then they cannot be claimed as dependents by their parents
   d. How can we account for the cost of having children (i.e., paying for their support)?
        i. One way: Personal Exemption = $3,700/person
            1. Married filing jointly = 2 PEs; with four children = 6 PEs
            2. Sense that it is some amount of money that you need to live on
                a. So if you have several dependents, then you should have a higher zero bracket amount (i.e., a higher amount that you should not be taxed on)
                    i. PE counts for all dependents (including elders if they are not claiming themselves and you are providing some amount of support)
        ii. Could increase the PE – apply some calculation re: how much it actually costs to raise children of certain ages
        iii. § 21: Childcare and Care Giving Credit (*supra*) – but capped at a pretty low level
        iv. [See Low Income Taxpayer Section, *infra*]
   e. Hypo: (using rates from pg. 636)
        i. A (single with no children)
            1. Marginal Rate @ $35K: 25%
            2. If income is $50K: 25%
        ii. B (single with 1 child)
            1. Marginal Rate @ $35K: 15% - so head of household status is making B's treatment more favorable than A (i.e., having a child means B has better treatment than A)
            2. If income is $50K: 25%
        iii. C (married with 1 child)
            1. Marginal Rate @ $35K: 15%
            2. If income is $50K (assuming C's spouse provides childcare and has no income): 15% - the lowest marginal tax rate, even though B also has 1 child and is less likely to have someone caring for the child at home for free
                a. If B made a $1 more of income, .25 cents would go to the government, whereas only .15 cents of C's extra $1 will go to the government
                b. A lower tax rate does suggest a lower ability to pay, but here it does not seem as if B does in fact have more ability to pay than A
                c. Policy → Congress wants to support people with children, but has created more of a benefit to a married person with a child (maybe this is an incentive to get married)

X. Take-Away: People can have very different tax treatments based on very personal decisions (e.g., who you marry, when you marry, when you have a child, whether you have a child)

<u>Divorce</u>

I. Rev. Ruling 76-255: For tax purposes, when is someone treated as divorced or married (heterosexual couples only):

a. Generally the determination of whether an individual is married is made as of the close of the taxable year
    i. An individual shall be considered as married even though living apart from the individual's spouse unless legally separated under a divorce decree or separate maintenance
b. When there is a death, you do not look at the last day of the taxable year, but rather the day before the death to determine filing status
c. If a couple married couple has filed a joint tax return in one year and gets the marriage annulled in the next year, they will need to file an amended return for the previous taxable year
    i. Annulment is essentially saying it was a sham marriage, so we do not legally see it as ever having occurred
d. Sham Divorce Doctrine → look at the intent as to why the couple got married, divorced, re-married
    i. If the true nature of the divorce tax avoidance, then we will treat you as married
        1. And this is true even if the divorce is legally real – so we can question this analysis, but it is how it works
            a. Think: Even if this divorce was for tax purposes, it was legal, so if one of the parties had died before they got remarried, it is unlikely that the other party would get benefits as if they were married
    ii. This is only if you keep getting divorced right around the time you need to determine your filing status for tax purposes so you can benefit from being single

II. Property Transfers Arising from Divorce: (1) Alimony, (2) Child Support, (3) Property Settlements) . . . important to distinguish because they get different treatment
a. Alimony
    i. Alimony ***if***: (1) in cash rather than property or services; (2) not earmarked by the parties as nondeductible to the payor and nontaxable to the recipient (i.e., if on good terms, parties can elect pre-1940s treatment, but does not happen very often because if alimony does what it is supposed to go, recipient will be in a lower bracket than payor); (3) parties do not live in the same household if they are legally divorced or separated; (4) there is no liability for any payment after the death of the recipient (alimony is for support and you do not need support after death); and (5) payments do not constitute child support
        1. § 71(a): Recipient INCLUDES the alimony payment
            a. Treated like salary/income to the recipient
        2. § 215(a): Payor DEDUCTS the alimony payment
            a. ATL deduction – so anyone who pays alimony gets the benefit of the deduction, regardless of how many itemized deductions they have
                i. Alimony has its own line on the 1040 – some decision by the IRS that it is important enough that people know they should be deducting and including, respectively
        3. 1940's Treatment: Recipient does not include (treated like a gift); Payor does not deduction (because like personal consumption/choice)
            a. Which treatment – deduction/inclusion or nondeduction/exclusion – better reflects the abilities of the former spouses to meet their tax liabilities?
    ii. Payments are deductible as alimony only if made pursuant to a court decree or a written separation agreement
b. Child Support
    i. Recipient does <u>not</u> include
        1. We want the money going to support the child, not to be paying taxes
        2. So recipient has an incentive to classify something as nonincludable child support
    ii. Payor does <u>not</u> deduct
        1. This makes sense because beyond the personal exemption, parents do not get to deduct the cost of caring for their children
        2. So payor has an incentive to classify something as deductible alimony

iii. § 71(c) differentiates child support from alimony → If payments are tied to the life of the child in some way (e.g., attaining a specified age, marrying, dying, graduating), then they look like child support and we will treat them as such
   1. In the real world, the payments are more conflated than in the Code and can be hard to distinguish though (esp. in lower income brackets) – can argue something is alimony because the ex-spouse is getting indirect benefits (i.e., by paying the rent and heat), or can argue it is all for child support because the child needs shelter and heat

iv. § 71(c)(3): If the payor fails to pay alimony and/or child support, if years later he starts paying lump sums, the payments will first be treated as child support payments until the back sums are paid, only then to be treated as alimony
   1. We do not want the payor to be able to deduct the payments right away – this is like a penalty to B

c. Property
   i. A property settlement is essentially a division of family savings (i.e., marital property)
      1. So if you have a forced division of family savings, Code is not going to take that – will treat as a gift – NO deduction and NO inclusion (§ 1041)
   ii. § 71(f) contains a limitation to prevent the parties from structuring a property settlement to qualify as alimony
      1. "Front loading alimony payments" is actually a property transfer disguised as alimony
      2. If there are excess alimony payments, the payor shall INCLUDE the amount of such excess payments in gross income beginning in the 3rd post-separation year, and the recipient shall be allowed a DEDUCTION in computing AGI for the amount of such excess payments beginning in the 3rd post-separation year
         a. "Excess payments" means more than a $15K difference between alimony payments in Y1 & Y2 and Y2 & Y3
         b. So if payor got to deduct more than the Code thinks he should, § 71 cleans that up in Y3
            i. Sense that by Y3 we will have a better understanding as to what is going on re: property settlement vs. alimony?
               1. Note: If parties agree to frontload for 3 or 4 years, then they can get around § 71(f) . . . but we do not think this is as much of a property settlement if you can amicably agree to do this (so not raising the same concerns that we may have if one of the parties did not agree or if one of the parties need the alimony or property settlement)
   iii. **General Rule: § 1041(a)**: No gain or loss shall be recognized on a transfer of property between spouses during marriage or as an incident to divorce
      1. Recipient's basis is ALWAYS Payor's basis – it is as if nothing happened (so this treatment differs from normal gift treatment)
         a. Ex: A bought house for $250K; at divorce house has FMV $500K; when B gets the house, B's basis is $250K – carryover basis
            i. If B sells house when FMV is $600K, B has to recognize the full $350K gain (because B is the one that made the choice to sell)
               1. And this means that A is never taxed on the unrealized gain when the property is transferred at divorce – idea of forced conversion: divorce is not a realization event re: property settlements
         b. Ex: A bought house for $250; at divorce house has FMV $100K; B's basis is still $250K

III. Antenuptial Agreements

a. Ex: *Farid-Es-Sultaneh v. Commissioner* (2d Cir. 1947): in Dec. 1923, petitioner's ex-husband gave her shares while he was still married to someone else; in Jan. 1924, he gave her another transfer of shares; married in May 1924 – signs a prenup agreeing that the stock was a gift, yet also an exchange for releasing her dower and other marital rights in exchange for his profit to marry her plus the gift of stock (at the time her marital rights were worth ~$33M); divorced; 1938 she sells the stock for $230K – and she wants her basis to be high so she has less gain to recognize; she claims a basis of $120; IRS claims her basis is $2K alleging this was a gift so carryover basis
    i. Court: Basis is $120K
        1. Court finds that this was a sale – there was some sort of exchange
            a. If this was a real sale, then he should have been taxed on the $118K of gain (if his basis was $2K and he was selling it for $120K)
    ii. Consider that she got the stock before she had a marital right to give up
    iii. Arguably this was a sale of something that was worth $33M (i.e., her 1/3rd of his income), that both parties are saying was worth a lot less – either $2K or $120K (and if there really was a sale of something worth $33M but a basis of $2K or $120K, then he should have reported a gain)
    iv. If these are her marital rights to begin with, then perhaps we think they should not change based on who she is with – notion that she sets the value
        1. It is possible that the actual valuation of what she gave up (i.e., her marital rights) was exactly what he priced it at because it was contingent on him marrying her – notion that he sets the value

b. *Davis* Rule: If someone gives something up in release for marital claims, then the person paying will recognize gain, but not loss, on that sale – so that does become a realization event
    i. Idea: If one spouse is willing to give up something of value, we think our legal system should protect the spouse entering the marriage, so the other spouse should have to pay taxes on the gain
    ii. Does NOT exist anymore, replaced by § 1041

c. **§ 1041**: <u>Transfers within a marriage and as an incident to divorce are nonrecognition events</u>
    i. No taxation as if it were a sale or exchange
    ii. Dicta: § probably would not have applied in *Farid-Es-Sultaneh* because that was a transfer made prior to marriage pursuant to an antenuptial agreement

<u>Assignment of Income</u>

I. <u>CONCERN</u>: Shifting Income . . . so think about when deciding whether an assignment is successful!!
    a. One of the reasons we are concerned with who counts as a marital/family unit – because we are concerned about income shifting within the units (e.g., § 1(g))
        i. One reason we have married filing jointly is to disincentivize income shifting within the marital unit – because both members have the same aggregate income/tax bracket
    b. Often involves explicit assignments of income
        i. Imagine A has a 50% bracket and B has a 10% bracket: If A wants to give B $100 (if a normal transfer, this is AFTER-TAX money for A), then A has to earn $200 – after taxes, left with $100, which A transfers to B; A is left with nothing, B is left with $90 (if taxable income) or $100(if gift)
        ii. Imagine A is not taxed on the $200 and the $100 is an assignment of income (instead of a transfer): A still transfers the $100, but A is only taxed on the remaining $100 – after, taxes left with $50; B is going to be taxed, but going to have $90 at the end of the day
            1. The government losses out on this assignment of income – in comparison to the normal transfer situation (ex. of whipsawing the government)

II. Basic Rules:
    a. <u>Earned income is taxable to the person who earns it</u>
        i. Who is the "earner"?
            1. Pure earned income is salary, so seems easy enough to determine, but then we have cases like *United States v. Scott* where a businessman put his wife on the

payroll despite the fact that she did nothing to earn it – court determined that it was clearly the businessman's earned income, so even though it never actually reached him (because went straight to her), he was the beneficial owner

b. <u>Income from property is taxable to the owner of the property</u>
    i. Who is the "owner"?

III. Income from Services

a. Ex: *Poe v. Seaborn* (U.S. 1930: in community property states, each spouse was taxable on one-half of community income, even if it was earned solely by one of the spouses
    i. Did not apply in *Lucas* because not a community property state
b. Ex: *Lucas v. Earl* (U.S. 1930): PRE-joint filing, so petitioner and wife are filing separately; petitioner signed a binding contract with his wife to give her 50% of his income, so he did not want to be taxed on all of it; he did earn all of this income, but he also had a binding contract to give 50% up so could argue that he did not have full ownership of that 50% - he did not get the benefit of consumption
    i. Court: Petitioner is taxed on the **full** amount of his earned income, even though he only had a legal right to 50% of it – a failed assignment of income
        1. Court thinks that there is some tax avoidance here, but the contract is from 1901 and there was no income tax then – therefore, there had to be non-tax reasons for this contract
            a. Maybe he had some incentive to protect his wife, or maybe she brought a lot of property into the marriage and this contract evened things out, or maybe this was just a prenup
        2. Court briefly makes a fruit-tree analogy, and this is actually used quite often to deal with assignments of income → you have to assign the entire tree (right to earn income) over to someone else, and not just the fruit (right to earned income) . . . and here the tree is him or his labor, which is impossible to shift
    ii. <u>General Rule: Anticipatory assignments of income before you actually earn that income are not recognized for tax purposes</u>
        1. Earned income is taxed to those who earn it, regardless of whether someone else has a legal right to the income
        2. Anticipatory assignments of income when there is some sort of **family relationship** between the parties will be looked at much more closely than a **legal or business** transaction (which are generally respected)
            a. *Lucas*' general rule does <u>NOT</u> apply to (1) partnerships or (2) *Giannini* cases
                i. 50/50 Partnerships are taxed 50/50, regardless of how much each person actually earned for the partnership (e.g., 90% vs. 10%) – this is a business contract that will be respected
                ii. Ex: *Commissioner v. Giannini* (9th Cir. 1942): taxpayer was the president of a large corporation and told the board he would no longer accept any salary and that the board should do something worthwhile with the money; taxpayer's salary ended up going straight to a scholarship fund; court finds that the taxpayer has no taxable income because it was never beneficially received by the taxpayer – he never had any control over it
                    1. Distinction between *Giannini* and *Lucas* is not very compelling, but some sense that (a) Giannini gave up the whole tree when he gave up entire control – never had the opportunity to undo the assignment – whereas Earl might have had the possibility to undo the assignment; and (b) *Giannini* was a business transaction, whereas *Lucas* involved a contract between married taxpayers
                        a. Seems to come down to control
    iii. Tax results petitioner could not achieve by contract routinely are achieved today by married couples through the use of joint returns

c. Education & Assignment of Earned Income
    i. Normally we pay for education with AFTER-tax income
    ii. Ex: *Armantrout v. Commission*: taxpayer's employer made payments to a trust to fund college expenses for his children; court ends up taxing petitioner, even though allegedly the money was for his children, because this payment is just additional compensation (like when someone pays your taxes, counts as income)
    iii. Ex: *Saunders v. Commissioner*: petitioner was the majority shareholder and only doctor of a professional corporation engaged in the practice of medicine; after *Armantout*, the corporation amended its educational benefit plan to provide for loans (which would be almost inevitably be forgiven) rather than scholarships to petitioner's children; so the person earning the income was also the one assigning it; court ends up taxing petitioner – this was income because there was no valid debtor-credit relationship
    iv. Ex: *Teschner v. Commissioner*: petitioner entered a contest in which only people under 17 yrs old were eligible to win prizes and designated his daughter to receive the prizes; court: successful assignment of income – not taxable to the assignor (father), taxable to the assignee (daughter) – contest rules forbid father from receiving any prize, so he could not have won if he did not assign – he never had control because he was not actually permitted to win

d. Rev. Ruling 74-581: This is a successful assignment of income → amounts received for services performed by a faculty member or a student of the university's school of law under the clinical programs and turned over to the university are not includible in the recipient's income
    i. Without this Rev. Ruling they would be taxed on the income and then would get to deduct it (maybe under § 162 or § 170, but both are more limited than not ever including it at all)
    ii. IRS has recognized that amounts that would otherwise be deemed income are note, in certain "unique factual situations"
        1. Clinical professors are "unique factual situations"
        2. Ex: Statutory legal fees received by attorneys for representing indigent defendants are not includible in gross income where the attorneys, pursuant to their employment contracts, immediately turn the fees over to their employer, a legal aid society
        3. Ex: The amount of the checks received by a physician from patients he has treated in the hospital by which he is employed full-time, which checks he is required to endorse over to the hospital, is not includible in his gross income
            a. But, doctor earning the money in private practice – not a valid assignment of income
        4. Ex: Fees received from *private* professional practice by faculty members of a university's school of medicine are includible in gross income even though under the contracts of employment such fees are required to be turned over to the school
    iii. Religious Orders (not in Rev. Ruling): Can have a successful assignment of income if the whole purpose of the assignment is to go to the full religious order, but if the person making the payment is really assigning the income for the benefit of an individual (e.g., a nun) then that will be unsuccessful
        1. Concern: there are people who create their own church and then assign their income to the church, but the church's whole purpose is to pay for their living expenses – therefore, we look closely at assignments of income to religious organizations to ensure benefits are actually going to a legit organization
        2. Question of control – do you retain control over where the money goes?

e. Other Assignment of Income Attempts:
    i. Ex: *Hundley v. Commissioner*: taxpayer entered into an agreement with his father to share equally any bonus he might receive for signing a professional baseball contract – amount was to compensate his father for coaching and acting as his agent; court held that the bonus payments to the father were includable in gross income, but that the father was entitled to a full business expenses deduction under § 162

ii. Ex: *Allen v. Commissioner*: bonus payment to a player's mother was NOT deductible since she had nothing whatsoever to do with her son's development as a baseball player
iii. Ex: *Jones v. Page*: petitioner contracted with Warner Brothers to make a series of golf films in exchange for $120K and 50% royalties; before he made the film, he contracted to sell his services to his father for 6 years at $1K/yr and transferred his rights under the WB contract to his father; court held that the payments from WB were taxable to petitioner because contract with father was deemed to be for tax avoidance purposes

f. KEY: Pretty hard to shift your income (and thus avoid taxation) if you (1) earned it and (2) retained any control over it
   i. An unsuccessful assignment of income does NOT mean that you cannot do it, it just means that you will first be taxed on it so the income transferred will be AFTER-tax

IV. Income from Property

a. Fruit and tree analogy works better here
   i. If you just shift the income from property, you'll be taxed
   ii. If you shift the entire property, you won't be taxed on the property or the income
b. Carve Outs → If you have a *vertical carve out*, we will respect that as an assignment of income; if instead you maintain control such that you only shift a *horizontal carve out*, we will not respect that assignment of income
c. Ex: *Blair v. Commissioner* (U.S. 1937): petitioner assigned his children his beneficiary interest in his father's trust; petitioner did not assign the entire trust, but he did assign something that has its own rights and remedies (i.e., the entire beneficial interest) – and it was assigned without reservations
   i. Court: Assignments are valid – the assignees thereby become the owners of the specified beneficial interests in the income and they are taxable rather than the petitioner
      1. Petitioner was not seeking to limit the assignment so as to make anything less than a complete transfer of the specified interest of the petitions as the life beneficiary of the trust
      2. Because this is so much of a real property right (i.e., more than just a right to payments), this beneficial interest itself can be deemed its own piece of property (i.e., the trust and the beneficial interest were their own trees)
         a. And this was a full carve out of this real property with real rights and remedies – that petitioner retained NO control over (i.e., he cannot get back from his children)
d. Ex: *Helvering v. Horst* (U.S. 1940): petitioner detached interest coupons from a bond and gave to his son – and he does this one at a time right before the interest is due (so his sons would not have the risk of whether the bond would reach a point of paying interest) … seem more like the fruit (i.e., the coupon is income from the property/bond)
   i. Court: Unsuccessful assignment of income – petitioner is taxed on the entire value (the bond and the interest payments) because his ownership of the bond allows him to CONTROL who gets the coupon payments
      1. Court also discusses these coupons being a gift – essentially saying that he was giving his son these coupons out of the goodness of his heart – and this matters because gifts have a carryover basis, but the court ends up treating this less favorably than if it was a gift – treating it as if petitioner had earned that income and had a realization event
   ii. Dissent: Each coupon is its own negotiable instrument and you have complete control over it and a certain amount of risk (i.e., if the issuer fails and cannot pay the interest, the coupon is valueless)
   iii. POST-*Horst*: § 1286 now provides that where a taxpayer disposes of unmatured coupons or the naked bond, the basis of the bond is allocated between the retained portion and the sold portion
      1. This is essentially a rejection of the idea underlying *Horst*, which is that the bond can only have one holder
         a. Now you can split the holding of a bond

        2. This is an <u>exception</u> to the general principles that underlie ***Horst*** – <u>if you are trying to just transfer the income, you are not transferring enough</u>
    e. Lottery → Seems like ticket = property & if you have winnings = income from property
        i. Ex: *Riebe v. Commissioner*: ticketholders made an oral assignment of a 2/3rds interest to member of his family – after the ticket was selected but before the sweepstakes; court held that all proceeds were taxable to the ticketholder – unsuccessful assignment of income – oral agreement did not seem legally binding enough
        ii. Ex: *Braunstein v. Commissioner*: taxpayers transferred their interest in a sweepstakes ticket to a trust for their children two days before the drawing; court: successful assignment of interest – if you set up a trust to receive income that you win, then we see that as legally binding and you giving up control
    f. Joe Paterno Article: Not a problematic assignment of income because it is post-1948 and it is within a marriage so they are joint filers

V. KEY: Look at where the CONTROL rests – if you assign complete control/dominion over something, that is more likely to be respect than if you retain some control
    a. Are you able to determine what happens to the income? Are you able to retract this assignment?

<u>Low-Income Taxpayers</u>

I. Provisions meant to help low and medium income taxpayers:
    a. Standard Deduction – if you make below $5,800 you are in a zero bracket
        i. No phase out for the SD, so it is not targeted at anyone specifically
        ii. Roles: (1) Create a certain zero bracket amount & (2) Essentially act as a replacement for itemized deductions
    b. Personal Exemption - $3,700 (§ 151)
        i. Roles: (1) Represents an amount spent on support that is unavailable to pay taxes & (2) Raises the zero bracket amount
        ii. Applies for you, your spouse, and any dependents (qualifying child or relative)
            1. If you are married with three kids, you have around a $28K zero bracket amount ($18,500 + standard deduction)
            2. If you are divorced and have custody, then you can take the qualified child's deduction
            3. To claim a child (and get their PE), taxpayer does <u>not</u> need to provide at least 50% of the dependent's support (we do not want to disincentivize accepting help from grandparents, etc.)
            4. A "qualifying relative" can be an individual with no familial relationship with the taxpayer (e.g., taxpayer was able to claim two grandkids of a "friend" who lived with her)
                a. Taxpayer <u>must</u> provide at least 50% of the qualified relative's support to claim their PE
                    i. Sometimes elderly people who get SS, Medicaid, etc. might not receive over 50% of their support from the taxpayer
            5. Weird: If an individual's parents decline to claim an individual as a qualifying child, another taxpayer may claim that individual as a qualifying child *if* that taxpayer's AGI is higher than the AGI of either of the child's parents
        iii. No phase out for last year, this year, next year (and maybe forever)
            1. Prior phase out (until 2010)→ as your income increased, you lost part of the PE amount & by the time you got to $225K you lost the entire PE
                a. A phase out means that the PE was targeted at lower income taxpayers
            2. If there is a phase out, that means the your effective marginal tax rate, despite what the statute says your rate is, is higher because with every dollar you earn over the phase out starting income, you lose a little piece of your PE, which means you pay more in taxes
    c. Child Tax Credit - $1K (§ 24(a)), in addition to the PE

   i. The credit is refundable to the extent of 15% of the taxpayer's earned income in excess of $3K
   ii. A taxpayer with earned income of less than $10K who owes no taxes gets NO credit
   iii. There is a phase out

d. Earned Income Tax Credit
   i. § 32 provides a credit to low income taxpayers *who have earnings*
      1. Refundable credit (can get $ back from gov't)
      2. Not eligible if you had no earnings – we want you to have earned income (cannot just have wealth, interest income)
         a. Making work pay idea → we want to encourage people who might not have clear tax incentives to work to work and earn income so they are eligible for EITC
   ii. Largest poverty reduction program in the U.S.
      1. EITC became a lot stronger in the 1990s as Clinton was getting rid of welfare as we know it – it was filling a gap → a credit meant to replace direct expenditures to low income taxpayers
         a. Meaning that poverty reductions used to be a direct expenditures – welfare – but is now administered through the Code as a tax expenditure
      2. Has been supported on both sides of the aisle because it requires earned income
      3. 15% of Americans are living below the poverty line
         a. Poverty line in 2001 for a family of 4: $22,350
      4. In 2009, 27M American tax-filing families received a reduction in taxes under the EITC (and more were eligible, but calculating the EITC is confusing)
   iii. In theory, EITC provides negative tax rates → If every dollar that you make actually ends up increasing your **tax credit**, then every dollar you make actually ends up reducing the amount of taxes you owe
   iv. Amount of EITC → Credit is a percentage of earned income, with both the credit percentage and the earned income varying with the number of children (# of kids max'd at 3)
      1. The credit increases as earned income increases until it hits a maximum amount, and then is phased out by a percentage of the income exceeding the phase-out amount
      2. Max credit for a single taxpayer with no kids: $457
      3. Max credit for single taxpayer with 3 kids: $5,666
   v. (Huge) Marriage Penalty → created by the phase-outs
      1. Max credit for married taxpayer with 3 kids: $5,666
         a. You essentially lose one of the EITC deductions if you get married
      2. Ex: A (2 kids, $15K): $5,036 EITC; B (2 kids, $15K): $5,036 EITC; AB (4 kids, $30K): $3,862 EITC
         a. $6K federal incentive NOT to get married
            i. Congress did <u>not</u> explicitly want this to happen, but it is
      3. If A or B stopped working, they would be entitled to $5,666 EITC (but at the end of the day, still less money from earned income, but more money from gov't)
         a. May be enough incentive for low income second-earners to not enter the workforce, and save money by providing childcare (imputed income), and getting a higher EITC
      4. If you want to make sure there is no marriage penalty, double the amount that is available if you are a married taxpayer with children
   vi. Marriage Bonus (Sometimes) → applies to the CD's of the world, where one person works and one does not
      1. Ex: C (no kids, $15K): No EITC; D (2 kids, $0K): No EITC; CD (2 kids, $15K): $5,036 EITC
         a. Could argue CD needs less of a credit if we presume D provides childcare

vii. We might assume that people will not shift decisions because of the EITC, but interesting, some of the most informed taxpayers are those that receive the most EITC → If you are right on the cusp of losing your EITC, studies show that these people end up being very informed about the (dis)incentives . . . so this is actually a congressional behavioral incentive that has actual weight

II. Shaviro Article: Effective Marginal Tax Rates on Low-Income Households
   a. Statutory marginal tax rate = 35% (max)
   b. Effective tax rate = your average tax rate
   c. Effective marginal tax rate = how much, regardless of what your statutory rate is, you actually end up changing your tax burden based on one earned dollar more
      i. This means that if you lose some credit or benefit by making this extra dollar, then you may change your taxes by a significant amount
      ii. If you look at all of the phase-outs that apply to low income taxpayers, at certain points they have extremely high effective marginal tax rates – sometimes over 100%
         1. Ex: federal income tax through its positive marginal tax rates; EITC; federal payroll taxes; state and local income, sales, excise, and property taxes; welfare benefits under TANF; food stamps; Medicaid; and federal housing subsidies (these are ALL directly or indirectly income-conditioned)
            a. TANF, food stamps, and federal housing subsidies are DIRECT EXPENDITURES that play into effective marginal tax rates
         2. If you earn $10 more and you lose an offsetting $10 benefit, that would be a 100% increase for that extra $10 earned
         3. Extreme phase outs are the cause of these extreme marginal tax rates
            a. EITC is generally a smooth phase out, but other benefits are step phase out lines, so taxpayers could fall off the cliff
   d. If phase-outs are the problem, how do we alleviate?
      i. If we just do not have any, that means ALL taxpayers will get the benefit
      ii. Could get rid of the programs, so nothing to phase out – but most people think it is better to just deal with the phase-outs than eliminate entirely
      iii. We could harmonize the benefits so that the phase-outs do not continually affect taxpayers – so mesh them more compelling rather than piecemeal application – but at some point, there is still a phase-out to deal with
      iv. Could eliminate the phase-out (i.e., everyone eligible), but increase the marginal tax rates as income increases about certain points to take into account that people above a certain income do not need the EITC (so the marginal tax rate will offset the benefit) – notion that the higher statutory marginal tax rate will not be as extreme as the higher effective marginal tax rate
         1. Problem: Politically, we like that the EITC is very targeted at a certain type of taxpayer – very specific income limits – so Shaviro contends there is an illusion that if you have aid for low income taxpayers it should be limited to them only (and this illusion could be part of the problem phase-outs are creating)

III. CBO Article: Effective Federal Tax Rates Under Current Law, 2001 to 2014
   a. Effective tax rates are average tax rates
      i. Economists generally argue that marginal tax rates are what people distort their preferences based on – *but* think of your own behavior: it could change based on rough estimates (i.e., average tax rate)
   b. Table of Effective Tax Rates by Quintiles (1/5th) – not based on income but the number of taxpayers
      i. Negative effective tax rates for the lowest quintile (bottom 20%) with the EITC when they are only paying income taxes – but paying payroll taxes are sufficient to offset the negative value the EITC creates
         1. Payroll taxes do not have a zero bracket amount (e.g., SS & Medicaid) and they also apply at the bottom of the income scale and phase out past $100K

ii. Key: You do not actually learn a lot by knowing the taxes paid by the bottom or top quintile because we do not know what income inequality is underlying the numbers (need a lot more data)

<u>Innocent Spouse Relief</u>

I. PROCEDURE – how the IRS raises the revenue that taxpayers owe

II. <u>RULE</u> (§ 6013(d)(3)): Couples filing jointly are jointly and severally liable for *everything* on the return, and for anything that is not on the return by could/should have been (extends to underpayments and deficiencies too)
   a. Policy: IRS and Tax Court want to set a higher standard for taxpayer self-education and communication of finances

III. <u>EXCEPTION</u>: **Collection Due Process: § 6330: Notion and Opportunity for Hearing Before Levy**
   a. You have the right to defend yourself/opportunity to be heard because the IRS takes your property
      i. It is after you've been given notice that you have a right to a hearing under §§ 6330 or 6320 that you can raise the innocent spouse relief defense or arrange for an offer-in-compromise
         1. **Offer-in-Compromise**: Taxpayer offers to pay a certain amount in lieu of paying their full actual tax liability, and the IRS accepts OICs because they often have a hard time collecting taxes owed – it is a judgment call that it would be less expensive to accept an OIC than go to court
            a. Equity – IRS has some sense that this is an effective equitable relief in that requiring you to pay over what you can in an OIC would be inequitable
            b. ***<u>But</u>***, when we think about equity, are we looking at (i) the individual's own situation – ***or*** – (ii) are we comparing them to all the other individuals who had that same tax liability and did pay it
   b. Tax Gap Idea: There is a gap between the amount of tax that should be collected and that actually is collected
      i. Part of this is due to the fact that the IRS is unable to go after every taxpayer
      ii. Sometimes the gap is because people are legitimately not able to pay (but then we have OIC)
      iii. Most of the tax gap is because people are not listing things that should have been on the return (i.e., direct tax avoidance/evasion)
      iv. If there is a large tax gap, that means the rates for taxpayers who are paying have to go up (to compensate)
   c. AFTER a CDP hearing, you can appeal to the Tax Court if you still have a deficiency

IV. <u>EXCEPTION</u>: **Innocent Spouse Relief: § 6015: Relief from Joint and Several Liability on Joint Return**
   a. § 6015(b): Essentially remove liability from the innocent spouse in certain situations
   b. § 6015(c): Allows the IRS to recalculate the liability so the innocent spouse owes less
   c. § 6015(f): Equitable Relief – If you meet the facts and circumstances test, then you are declared innocent and release from joint and several liability
   d. Before 1998, ISR existed in a much more limited form – no § 6015(f) equitable relief – many cases required that the innocent spouse signed the return under fraud or duress (needed a direct causal connection)

. . . both EXCEPTIONS are not often granted remedies – are essentially stopgap measures: once we've determined under the Code that you own a certain amount of taxes, we have these stopgap measures if you still cannot pay

V. Ex: *Estate of Aylesworth* (Tax Court 1955): 1948-1951 returns at issue (joint returns start in 1948); seems as if husband was reporting income from a venture other than his primary business and was claiming petitioner as an employee, among other deductions that seem suspect; petitioner argues duress because she only signed the last return because he attacked her and then filed for divorce
   a. Factors Relevant to the Tax Court: petitioner stayed with her husband through the abuse (but let's remember this was the 1950's); she did not file a separate return; she did not disavow her signature; she benefited – in that they lived a lavish lifestyle and they got a marriage bonus starting in 1948 (but we could argue that HE is benefitting because she likely had no tax liability when single)

            i. Although it is questionable that husband paid petitioner a salary and listed her as an employee, that does not lead to tax avoidance since they are married with an aggregate income
    b. Court: Petitioner's signature was not procured by duress or fraud, so she is jointly and severally liable (entirely liable in this instance)
            i. Note: She has access to his estate, so maybe this is not as unjust as it could be
    c. Continued instances of limited ISR allowance that we see in this case eventually leads to the passage of § 6015(f) – notion that the direct causal relationship should not have to be shown with regard to signing the return

VI. Ex: *McGhee v. Commissioner* (Tax Court 2010): petitioner's wife was embezzling money from her employer, which he claims to have no knowledge of, and he seeks ISR; note that the wife keeps the embezzled money, which counts as income and she will be taxed on the illegal income; petitioner seeks relief under § 6015(b) or § 6015(f); **NO** relief under § 6015(b) because assertion of a tax deficiency is a prereq; **NO** relief under § 6015(f) because does not meet the safe harbor conditions and then fails the facts & circumstances test
    a. A taxpayer who does not qualify for relief under § 6015(b) or (c) may nevertheless be relieved from joint and several liability if, taking into account all the facts and circumstances, it would inequitable to hold the taxpayer liable for any unpaid tax or deficiency
            i. <u>Threshold Conditions</u> (must meet to even be considered for ISR under § 6015(f)): (1) requesting spouse must have filed a joint return for the taxable years for which relief is sought; (2) requested relief must not have been available to the requesting spouse under § 6015(b) or (c); (3) requesting spouse applied for relief no later than 2 years after the date of the IRS' first collection activity; (4) no assets were transferred between spouses as part of a fraudulent scheme by them to hide income or avoid tax; (5) nonrequesting spouse did not transfer disqualified assets to the requesting spouse; (6) requesting spouse did not file or fail to file the return with fraudulent intent; and (7) the income tax liability from which the requesting spouse seeks relief is attributable to an item of the individual with whom the requesting spouse filed the joint return
                1. Petitioner SATISFIES these
            ii. <u>Safe Harbor Conditions</u> (if met, along with threshold conditions, will get ISR under § 6015(f)): (1) On the date of the request for relief, the requesting spouse is no longer married to, or is legally separated from, the nonrequesting spouse; (2) on the date the requesting spouse signed the joint return, the requesting spouse did not know or have reason to know that the nonrequesting spouse would not pay the income tax liability; and (3) the requesting spouse will suffer economic hardship if relief is not granted
                1. Petitioner DOES NOT satisfy (1), so move onto the multi-factor test
            iii. <u>Facts & Circumstances Test</u>:
                1. Marital Status
                    a. Seems to be an important factor here – if you are staying with the guilty spouse, we do not see this as an innocent spouse situation because you are both benefitting from the money
                2. Nonrequesting Spouses' Legal Obligation to Pay Pursuant to a Divorce
                    a. Does guilty spouse have a legal obligation to pay the tax liability?
                3. Abuse
                    a. Does not have to be causally linked to signing the return
                4. Health Problems
                    a. Expensive, and may explain why one spouse was not as aware as the other as to what was going on
                5. Compliance with Federal Tax Laws
                    a. Has the innocent spouse otherwise been compliant?
                6. Economic Hardship
                7. Significant Benefit**
                    a. Innocent spouse has to prove they received NO significant benefit
                8. Knowledge or Reason to Know**

a. Here, tax returns were filed after civil and criminal suits against petitioner's wife had been filed
b. The fact that you knew means you were complicit – so even if you do not benefit, if you knew and were complicit, NO ISR
c. We put the onus on the innocent spouse to look closely enough into the other spouse's monetary situation to see if the life you are living is tied to the money you are claiming on the joint return – so if you are claiming the same amount on returns, but suddenly going on more cruises or getting more expensive gifts, that is suspect

VII. Ex: Carol Ross Joynt: petitioner's husband was running a very clear tax fraud scheme through his restaurant business – he was claiming all of his personal deductions as business deductions and the money he withheld as an employer (which was owed to the IRS) he kept for himself or gave to special employees; at his death, he owes $3M in tax liability
  a. IRS Arguments: marital status – married; significant benefit – lavish lifestyle; less economic hardship – she inherited his estate; knowledge – she should have known (sophisticated, college-educated, he told her he was being audited but not to worry); "well the tax accountant prepared the return" is not an excuse we want to set a precedent for – you actually need to look yourself; the restaurant business was operating at a loss on the reports, so maybe she did not actually think her lavish lifestyle was within their means
  b. Petitioner Arguments: she did not handle the finances or look at the bank statements (which McGhee admittedly did); abuse claims – this might have prevented her from looking into the finances more; he owned the business long before she knew him, so maybe she is not as sophisticated as the IRS suggests; despite operating the restaurant business at a loss, there were inheritances, so she could have assumed those supported her lavish lifestyle
  c. Result: ISR granted

<u>Alternative Minimum Tax (§§ 55 – 58)</u>

I. **Original Purpose**: Ensure that everyone pays a minimum amount of federal income tax

II. **Idea**: Many Code provisions are designed to encourage specified expenditures and activities rather than accurately measure a taxpayer's economic income, and as a result, a taxpayer may owe little or no taxes even though he has a substantial amount of income
  a. Congress has long believed, however, that some income tax should be imposed on all taxpayers whose economic income reflects a substantial ability to pay taxes, and has been concerned that the public will regard the income tax as unfair if high income individuals pay no income tax
    i. This, the Code imposes a minimum tax on those taxpayers who have used income tax exclusions, deductions, or credits to reduce their tax below a specified minimum level

III. **AMT is a response to 2 congressional (sometimes inconsistent) goals**:
  a. Code is supposed to be raising revenue in a progressive manner
  b. Code attempts at places to create behavioral distortions and achieve various policy goals
    i. And this can sometimes undo the progressive goal
      1. Response: AMT – safety net of minimum taxes

IV. AMT is its own parallel, separate tax land (like capital gains)
  a. Essentially a second tax system with a LOWER rate and a BROADER base (§§ 55 – 58)
    i. Broader base means that we do not allow the same number of loopholes, exceptions or deductions that we have in the normal tax system
      1. "Rate X Base" – base is what matters, not rate
    ii. Because of the broader base, the rate can be lower and raise the same amount of revenue
      1. AMT Rate: 26-28%

V. Calculation:
  a. **Normal**: GI – ATL = AGI – ((BTL or SD) + PE) = TI X Rate = TTL – Credits = Tax Due
  b. **AMT**: TI + Tax Preferences = AMTI – Exemptions = Net AMTI X Rate = Tax Due
    i. TI is the SAME in the normal and AMT calculations

ii. Tax preferences are things like deductions, exclusions, credits, or some other reduction of GI under the normal tax system that is added back in under AMT
iii. Exemptions: 2010 - $72,450 married/$47,450 single; in 2011 - $74,450/$48,450
    1. This is like a zero bracket amount for your AMT
    2. These phase out level starts at $150K married/$112,500 single
        a. As your AMTI goes over those income levels, you start to lose your exemption (i.e., you are taxed on more of your AMTI)
            i. By the time you hit $440K married/$303K single, you have a zero-zero bracket amount – the income after which you have no more exemption so your AMTI is the same as your Net AMTI
                1. Relatively slow phase out period
                2. Exemption phase out numbers are based on your AMTI, not your GI
    3. If you want to target something at high bracket taxpayers, you want to have a higher exemption – and you keep that exemption higher for longer to make sure it is the highest bracket taxpayers that are paying

c. PAY the <u>higher</u> of your normal tax due or AMT due
d. Note: Almost everyone should be calculating their AMT – some high taxpayers escape it and some low taxpayers are subject to it
    i. Sense that if under the normal tax system you are only taking the SD and 1 PE and you are single with $48K in income, you are probably fine
e. Corporate AMT → Exemption: $40K & Rate: 20%

VI. Tax Preferences
a. If they are just equal to the BTL or SD plus the PE, then AMTI would just be AGI; if they are just ALL of your deductions, then it would just be GI . . . but neither are the case, rather they are a collection of various ATL, BTL, credits, etc. – and a policy decision has gone into determining whether a tax preference goes back in for purposes of calculating AMT
b. Tax Preferences and Adjustments for Individual AMTI:
    i. Qualified Small Business Stock – ex. of a tax preference that is much more complicated to calculate than just adding back in what you deducted
        1. 7% of the gain excluded from the sale or disposition of qualified small business stock is a tax preference – but recall that 50% of the gain on the sale of the stock of certain small businesses that is held for more than 5 years is excluded from income
    ii. Depreciation – less accelerated than in the normal system (different %s)
        1. Need to figure out the difference between what you deducted in the normal tax and what you would deduct under the less accelerated version to determine the tax preference
    iii. Itemized Deductions
        1. Medical expenses can be deducted but only to the extent they exceed 10% AGI floor (as opposed to the 7.5% for normal tax purposes)
        2. NO deduction for state and local taxes or on real or personal property
        3. Miscellaneous itemized deduction that are subject to the 2% floor are NOT deductible at all
        4. Interest on home equity loans is generally NOT deductible (exception if used on home improvements?)
        5. *But*, home mortgage interest deduction is ALLOWED (i.e. do NOT add back into AMT)
            a. Along with all other itemized deductions that are not listed in §§ 55-58 and are not miscellaneous (e.g., charitable deduction)
    iv. PE and SD – not allowed in calculating AMTI
    v. Also: Tax-Exempt Interest; Percentage Depletion; Intangible Drilling Costs; Circulation Expenditures; Research & Experimental Expenditures; Mining Exploration & Development Costs; Pollution Control Facilities; Incentive Stock Options (pg. 785 & 787); Tax Shelter Farm

Losses; Passive Activity Losses; Long-Term Contracts; Net Operating Loss Deduction . . . a lot of the tax preferences we add back in are not the big ones we think of – fairly targeted tax preferences

c. AMT is essentially closing loopholes from the normal tax system, but what does it mean when we decide that some loopholes are tax preferences and others are not – some are necessary for calculating income and others are not? If so, why is the home mortgage interest deduction necessary for calculating income (i.e., not a tax preference)?

VII. AMT is quite unpopular because:
  a. You have to calculate your taxes twice
  b. The number of taxpayers subject to the AMT has increased dramatically
    i. SD and PE are added back in, so if you are married with ten kids, your relatively high zero bracket amount under a normal tax system and that drops your taxes due significantly – not so in the AMT
    ii. Bush Tax Cuts could bump you into the AMT (if the tax cuts, that you may have supported, reduce your income enough)
    iii. AMT is not indexed for inflation (i.e., the exemption amounts will not increase automatically) and thus in the last decade, as people's income increased slightly with inflation, fewer taxpayers have been automatically exempt from the AMT
      1. SD is indexed for inflation and this important because as there is greater inflation, your purchasing power is reduced slightly – so you want to be slightly increasing your zero bracket amount as everyone's income goes slightly up
      2. Response: Congress has passed a "patch" every year – a stopgap measure – by which Congress gives new numbers each year (rather than indexing for inflation)
        a. People do not think a patch is as good as indexing because it requires congressional action, and if they do not act the exemption reverts to a lower number (i.e., it is worth less)
    iv. As the AMT expanded to include more non-preference items, such as state income taxes or nonrefundable personal credits, it affected more middle-class taxpayers (a group that Congress did not originally intend to be AMT filers)
      1. And this is because as state and local taxes increase, you are more likely to fall into the AMT just because of where you live (if in a high tax state)
        a. Note: The deduction for state and local taxes is the single largest tax preference item – nearly 60% of AMT revenue is attributable to the loss of the deduction by those who pay AMT
  c. Really politically charged – so even though passed by Congress, not loved by Congress

VIII. Repeal AMT?
  a. Congress does support progressive income tax, to the extent that is what we have, so if it is possible that people are using loopholes to escape tax liability, then we do need some kind of stopgap measure
  b. AMT is a huge source of revenue with widespread impact on the tax planning of high-income individuals
    i. It not only raises revenue paid as a minimum tax, but also serves to increase the regular income tax paid by taxpayers who limit their use of preferences or deductions to avoid triggering the AMT
  c. Brookings Institution study suggests that repealing the AMT would actually cost more money than if we were to repeal the income tax (i.e., gov't would lose more revenue)
    i. Notion that the people who pay the AMT now (approx. 4M) pay so much more under the AMT than they would under the normal tax system that shifting them back there would cost the government a lot of revenue
      1. So beyond any fairness and equity concerns, the AMT is a major source of revenue
        a. We'd have to raise a lot of revenue elsewhere

IX. Modify AMT?

a. If we wanted to make it simpler, could try to match up the tax preferences more – but this would probably not be very popular
b. We could look at why the AMT has not actually succeeded in having as much progressivity as we might like it to have
    i. Ex: Charitable deduction is NOT a tax preference in the AMTI calculation, and because high income taxpayers donate to charity a lot, some high income taxpayers might not fall into the AMT
    ii. Ex: Capital gains are still taxed at the preferential rate under the AMT, so if you are trying to target high income taxpayers but still allow preferential treatment for capital gains that might explain some progressivity failure
    iii. Note: Changing preferences in the AMT may reflect back on what you think about the normal Code
        1. Ex: If you think that the home mortgage interest deduction should or should not be a tax preference, that reflects back to what you think about the home mortgage interest deduction being in the normal Code
c. Could raise the exemption amount (to make sure middle income people are not under AMT) and raise the AMT rates (to raise the same revenue despite less people being included)

X. AMT Only?
a. We'd likely raise more revenue, but there is a concern that we would not be allowing a lot of the tax preferences we currently have – that would undo a lot of the policy judgments we've made

XI. Consumption & Income Taxes Article (pg. 780-82)
a. U.S. income tax has never been either a pure-income based or a consumption-based tax, but rather a hybrid that exempts to varying degrees many forms of consumption, savings, and investment
    i. Proponents of consumption taxes believe that an income-based tax distorts economic behavior by creating a preference for current over future consumption because it double taxes savings
        1. They would oppose any limitation – including a minimum tax – on the use of tax preferences, especially those related to investment activity, because such limitations reduce desired savings and investment incentives and the neutrality between current and future consumption
    ii. Proponents of income-based taxes disagree with consumption taxes because they are not progressive (equity/fairness)
b. Dicta: Difference between H-S definition of income and our income tax is that we are not a pure consumption income tax

XII. AMT Concerns:
a. Administrability → we sacrifice simplicity in order to achieve some sort of equity
    i. Complicate tax planning because have to calculate twice, do not know whether you will be subject, could be subject one year and not the next …
b. Equity → AMT is supposed to improve equity (although does not always achieve this)
    i. Ex: A makes $50K and B makes $500K, if B pays less taxes than A = violation of vertical equity
    ii. Could change the exemption amount to address equity concerns by excluding or including more people
c. Efficiency → any minimum tax blunts the incentive effects of tax preferences
    i. People are encouraged to structure their income so they are paying enough taxes in the normal tax system to avoid AMT
        1. Double-Level Distortion: (1) distortions under the normal Code & (2) another level of distortions because you are worried about the AMT
    ii. For many people, the AMT dulls all the distortions in the normal Code
        1. We may think this is a good thing because we see behavioral distortions as inherent inefficiencies

            2. We may think this is a bad thing because we've created the behavioral incentive for a reason and then the two systems clash in terms of what we want the taxpayer to do
        iii. Creates a distrust in the tax system

XIII. Summary:
   a. AMT essentially magnifies a lot of the debates about what the base is/should be for the normal Code (e.g., how you define income, should we have capital gains rates)
      i. So even if you have an easy or flat rate (e.g., 9-9-9), if you cannot agree on what the base includes and excludes, then you still have a lot of the same open questions
         1. BASE matters, not RATE
   b. Not very popular, but unlikely to go away because it raises a lot of revenue

<u>TAX SHELTERS AND TAX LAWYER ETHICS</u>

<u>Tax Shelters</u>

I. Basic Idea: Trying to create excess losses to shelter gains, when we can argue that economic losses does not actually exist
   a. Examples we've seen: *Knestch* (trying to shelter his income by incurring a large number of losses; could be seen as a tax shelter because he was not going to get any annuity payments until he was 90 yrs old; there was an interest spread; and the annuities paid out at a lower interest than his borrowing) & *Cottage Savings* (could be seen as a tax shelter, but court did NOT strike it down)

II. Two Types:
   a. Retail – generally marketed to individual taxpayer professionals (e.g., doctors) who have high income they want to shield
      i. 1986 – Code shut down retail tax shelters due to the passive loss rules: If you have losses from passive activities – that do not actually involve risk on your part – you cannot use them against your active gains
   b. Corporate – not necessarily engaged in by individuals, but targeted at corporations and high net worth individuals

III. Ex: *ACM Partnership v. Commissioner* (3d Cir. 1998): partners end up contributing $200M, which it used to buy $180M of Citicorp notes (short term debt instruments); after four days they sell the notes for $140M in cash and $40M in installment debt – each installment will be calculated "LIBOR X Notional Principal Amount"; LIBOR is the London Interbank Offering Rate – a variable rate that changes with the market … so the installment is contingent on the value of LIBOR; Notional principal amount is what is being used to calculate the payouts over six years with the $40M target amount; looks like the partnership is trying to break even and does not have a potential for profit (pre-tax considerations)
   a. ACM relies on § 453, which establishes a general rule for contingent installment sales (treats like annuities re: basis recovery) → If you have an installment sale, you divided the basis ratably over the number of years that the installment sale is scheduled to occur across and then you recover that basis every year
      i. Basis Recovery: $18,300 is the basis you put in & $50K are the payouts
         1. Exclusion Ratio (annuities): $18,300 / $50K = $366 (basis recovery for each payout, with the remainder of the payout being taxable income)
         2. Ratable (installment sales): $18,300 / $50K = $366
      ii. § 453 was enacted initially to respond with accelerating basis, but ACM is happy to spread the basis over the installment period
      iii. <u>ALL</u> within the letter of the law
         1. § 453 required some contingency, which was the variable LIBOR
            a. And here, LIBOR actually did go down, so ACM ended up losing about $6M of *real* economic loss (and since ACM could not control LIBOR that suggests that there was actually a certain amount of risk here)
   b. This transaction depends on § 1212(a), which permits a corporate taxpayer to carry back a capital loss to offset capital gains recognized within the preceding three years – gains are from the previous year when Colgate sold a subsidiary, so needed to carry back the losses from this tax shelter to offset

c. Court (Tax Court & 3d Cir.): This is a corporate tax shelter (i.e., the purchase and sale of the Citicorp notes) that lacks economic substance so the entire transaction (and its losses) is disallowed
    i. *Cottage Savings* is inapposite – losses were allowed there because there were different legal entitlements, which suggests economic substance
        1. <u>But</u>, could have argued that under *CS* ACM should have been seen as having economic purpose – Colgate used the $40M cash for a valid reason (to buy up its own debt)
d. Dissent: Economic substance doctrine is essentially a smell test and this should not be enough to disallow the transaction
    i. ACM, like all taxpayers, has the absolute right to decrease or to avoid the payment of taxes so long as that goal is achieved legally

IV. Arguments AGAINST:
    a. Corporate tax shelters reduce the corporate tax base (i.e., loss of revenue), raising the tax burden on other taxpayers (if we think that we have a fixed amount of spending)
    b. Corporate tax shelters breed disrespect for the tax system
    c. A view that well-advised corporations can and do avoid their legal tax liabilities by engaging in these tax-engineered transactions may cause a "race to the bottom"
    d. Piecemeal legislative remedies complicate the Code
    e. Significant resources, both in the private sector and the government, are currently being waste on this uneconomic activity
        i. Incredibility inefficient because these resources could be put to much better use
    f. Inefficient – a corporation is distorting their behavior solely because of the Code
    g. Fairness – most people do not have access to corporate tax shelters, so there is an equity issue between individuals & corporations and lower income taxpayers/smaller corporations & higher income taxpayers/larger corporations

V. Arguments FOR:
    a. It is just good business to reduce your taxes so that you are paying the minimum amount that you are legally allowed to pay (not a fiduciary duty though)
        i. Corporate social responsibility to do so and then use the savings/money for whatever is in your good business judgment? (could argue it is a corporate social responsibility to no reduce taxes by such an egregious amount)
            1. It may even be necessary if all of your competitors are doing it
    b. Voluntary tax cut – if we think tax cuts are good for the economy, then tax shelters are reducing the amount of money the corporation pays and this is keeping the money in the hands of someone other than the government
    c. Strategically, tax shelters play a part in the creation of the Code by showing where the holes are
        i. So in *ACM*, court could have allowed the transaction (admittedly losing revenue for the government for a few years) and said its Congress' job to fix the Code going forward to disallow this type of transaction

VI. Hard to craft a definition of "tax shelters" because many of these transactions are based on a literal reading of the Code or a regulation to obtain tax benefits that were not intended by Congress
    a. A serious question is whether taxpayers should be able to rely on the literal language of the Code

VII. The tax system itself is clearly at some fault as well because as the Code has become more and more complex, it has become less coherent, less understandable, and more open to manipulation
    a. Even when Congress responses to abuses, it often does so in broad-brush ways that open the door to additional abuses
    b. There are structural aspects of the Code that invite creative tax planning

VIII. Common Characteristics:
    a. Lack of economic substance – tax shelters are "deals done by very smart people that, absent tax considerations, would be very stupid"
    b. Inconsistent financial accounting and tax treatment (i.e., of the shelter item)

c. Many recent shelters have relied on the use of "tax-indifferent" parties – such as foreign or tax-exempt entities – who participate in the transaction in exchange for a fee to absorb taxable income or otherwise deflect tax liability from the taxable party
d. Marketing activity – promoters often design tax shelters so that they can be replicated multiple times for use by different participants
e. Confidentiality – prevents expropriation by others and protects the efficacy of the idea by preventing or delaying discovery by the IRS
f. Corporate tax shelters often involve contingent or refundable fees in order to reduce the cost and risk of the shelter to the participants
g. Corporate tax shelters carry unusually high transaction costs
h. Low audit rates might encourage

IX. <u>One Response to Tax Shelters</u>: **Judicial Doctrines**:

a. Economic Substance: objective economic substance (did the transaction offer an opportunity for pre-tax profit) **– and –** subjective business purpose (other than tax avoidance)
    i. Might argue this is the court replacing the business judgment of the corporation with theirs – and that raises a question of institutional competency
    ii. When courts apply after-the-fact doctrines, they are themselves applying a normative judgment and deciding that even though we have ex-ante statutes, we should have ex-post rules additionally
    iii. CODIFIED: § 7701(o) – so now it *is* an ex-ante rule, but has the force of an ex-post standard because it can only be applied ex-post by a court
        1. Congress' approval of this judicial doctrine – but leaves it up to courts when to apply it
        2. Used to be a disjunctive test (or), now it is a conjunctive test (and) → need *both* objective economic substance and subjective business purpose for the transaction to be respected
            a. Code seems to suggest some sort of profit motive outside of just taxes – as long as the predicted profit is significant – might be enough to have economic substance
            b. Note that since business purpose is a subjective determination, it is an open question as to what qualifies
b. Business Purpose
c. Sham Transaction – if the transactions actually have no economic significance other than the expected tax benefits, they will be deemed a sham and are ignored (as if they never happened)
d. Substance Over Form – used to deny the tax consequences that would flow from the formal transaction, substituting the consequences that would flow from the economic substance of the transaction
e. Step Transaction – notion that a transaction with three steps may produce better tax results than a transaction with two steps, even though they end up in the same place, so a court will link together the interdependent steps, rather considering them in isolation, so that tax liability is based on the results of the entire transaction

. . . many of these doctrines are conflated, and no matter which one is applied, the court will use a judicial doctrine to strike the transaction down
    i. These all still exist, but we may see a shift towards the economic substance doctrine since it is now an actual part of the Code
f. OPPOSITION TO –
    i. The doctrines themselves add confusion – no predictability if the court will apply (i.e., Code could say yes, but court still says no)
        1. *But*, some argue this uncertainty is a good thing because if we have rules that are too clear, people will always find the edges and the IRS will also be a step behind – so this gray area may scare people away from the edges
    ii. Judicial doctrines might give courts power that you do not think they should have

            1. *But*, some argue this is a good thing because courts can look beyond the actual transactions at the facts
      iii. Doctrines are not very clearly defined

X. Another Response to Tax Shelters: **Statutory Response**:
   a. Exactly what the IRS did in 1986 when they closed down retail tax shelters
   b. Pros: Code is a statute, so there is more guidance than judicial doctrines
   c. Cons: Code is always one step behind

XI. Penalties
   a. Taxpayers
      i. Because going after taxpayers buying tax shelters is not always feasible (i.e., gov't does not know who they are and we have low audit rates), the Code imposes reporting requirements
      ii. **§ 6707A:** Imposes a penalty on taxpayers who fail to disclose "reportable transactions" (and this is regardless of whether the transaction is OK or not): (i) "listed transactions" and those with substantially similar consequences (and the IRS can keep adding to this list, which is easier to do than changing the Code); (ii) confidential transactions (so if you are trying to hide it, you need to report it); (iii) transaction with contractual protection (i.e., those where fees with respect to the transaction are contingent on achieving the intended consequences); (iv) excessive loss transactions that result in a deductible loss exceeding $10M; (v) transactions involving assets with holding periods of 45 days or less and a tax credit exceeding $250K
         1. IRS is not saying that the transactions themselves create any liability, but even if it is a totally legit transaction, just by not reporting it, you are going to have a penalty – and this hopefully reduces the involvement in problematic transactions
      iii. **§ 6662A:** Imposes a significant penalty on understatements with respect to reportable avoidance transactions, which are listed transactions and reportable transactions with a significant tax avoidance purpose
         1. If the taxpayer adequately discloses the transaction, the penalty is 20%; if not adequately disclosed, 30%
         2. Penalty can be WAIVED *if* the taxpayer had reasonable cause and acted in good faith (i.e., they disclosed, had substantial authority for the position taken, and had a reasonable belief that the treatment was "more likely than not" correct – so if someone else told them it was the right thing to do)
            a. Incentive: To shift liability to a lawyer that will give you such an opinion – and this is why the Code has to apply liability to secondary participants (e.g., lawyers & promoters – the people that have knowledge)

      . . . these reporting requirements and understatement penalties in many ways encourage taxpayers to shift their liability to some professional

   b. Promoters & Advisors
      i. **§ 6111** requires a "material advisor" with respect to a reportable transaction to notify the IRS with details about the transaction
      ii. **§ 6112** requires material advisors to maintain a list of the names of all persons for whom the advisor provided advice with respect to reportable transactions
   c. Tax Practitioners & Return Preparers
      i. **Circular 230** provides standard for "covered" opinions and other written advice
         1. If audited, a written opinion will shift liability away from the taxpayer under § 6662A, to the law firm
         2. PRE-Cir. 230, law firms would write opinion letters that were contingent on the *assumption* that there was business purpose (either a flat assumption or because client told us) . . . but the whole idea of whether or not something will stand is whether there is business purpose, so you should not be able to assume the conclusion on which the entire decision rests

a. Could argue that making assumptions is the only thing lawyers – not trained in whether a transaction has a subjective business purpose – can do, so maybe it is wrong for the rules to place the onus on the lawyer

3. Cir. 230 requires that opinion writers take certain steps if it is to be used as penalty protection: for example, must use reasonable efforts to identify and ascertain the facts and to determine which facts are relevant – can no longer assume relevant facts, such as the existence of business purpose
4. Incentive: to give ORAL advice, or claim that written advice is not actually "written advice" (with a Cir. 230 disclosure)

ii. **§ 6694(a): Understatement of Taxpayer's Liability by Tax Return Preparer Due to Unreasonable Positions**: Imposes a penalty equal to the greater of $1K or 50% of the income derived by the preparer where the preparer did not have substantial authority for the position

1. Sliding scale of liability depending on the possibility of success
   a. "More Likely than Not" – need something greater than 50% chance of success if challenged (hard to meet)
      i. If the position is not disclosed, and it is a tax shelter, you need to satisfy the more-likely-than-not standard
   b. "Substantial Authority" – need around 40%
      i. If the position is not disclosed, but it does not deal with a tax shelter or a reportable transaction from § 6707A, you need substantial authority
   c. "Reasonable Basis" – need around 25%, so not likely it would withstand scrutiny, but not laughable
      i. If the position is disclosed, only need a reasonable basis

   … all relatively vague and the percentages are hard to determine
2. For a while, § 6694 had different standards than § 6662 – if you were a taxpayer, you only needed to have substantial authority to escape a penalty, but if you were the preparer, you need to be more-likely-than-not sure that the transaction would survive
   a. Good Incentive: Preparer will look more thoroughly at the transaction to avoid liability, so maybe this creates a more effective more-likely-than-not standard
   b. Reverse Incentive: Client and lawyer have conflicting incentives – lawyer will start at 51% authority, even if representing their client to the fullest extent might mean going to 40% authority, and client will know that they can engage in transactions that the lawyer will get in trouble for (burden shifting)
   c. FIX: § 6694 has been amended so that the taxpayer and the preparer penalties utilize the same standards and have the same incentive to disclose

iii. Note: To be considered a "return preparer", you do <u>not</u> have to have prepared the entire return

d. Civil Fines and Criminal Liability
   i. We need criminal liability because otherwise complying with the rules would just be an economic calculation
   ii. When thinking about WHO is going to jail, consider whether it is the right individual (promoter? lawyer? taxpayer?)
   iii. Might want to distinguish between tax avoidance (within the letter of the law, but IRS/court says it is not allowed) – and – tax fraud/evasion . . . maybe it makes the most sense to have criminal penalties only for the latter

XII. **KEY (1)**: Concept of efficiency, which is the idea that there is not a distortion that would not exist but for the Code

a. Inefficiency is when a set of laws create distortions that are to avoid or respond to the legal system
    i. Lawyers are inefficiencies – and this is not necessarily a bad thing – but what it means is that if there was not a legal system as a whole, people would not have to change their behavior to avoid the legal system
    ii. Sometimes you can argue that people still would not do something that laws forbid because of a moral obligation

XIII. **KEY (2)**: NO normatively neutral way of looking at tax (and this is just one example)
  a. Whenever you are talking about tax, you are implicitly talking about what tax revenue is used for – so the big picture is looking at the role of the government
    i. If you think government spending is wasteful, then you think differently about the tax system as a whole

<u>Tax Lawyer Ethics</u>

Real World vs. Legal vs. Tax Lawyer Ethics

I. Real world ethics want you to undo your favoritism towards your family and friends and treat everyone similarly

II. Legal ethics are trying to undo real world ethics to a certain extent in that you have to treat clients better than you might in the real world
  a. More than just applying common sense

III. Tax ethics are different even than legal ethics because some conflicting obligations only exist for tax lawyers – this is because we are in an adversarial system, but we are dealing with the IRS which is both our adversary and serving as a tribunal itself
  a. Ex: If you are representing a client that is clearly misstating income on his return, you must advise the client to report the income, but you CANNOT disclose that information to the government
    i. You may have to withdraw, but this can be a red flag to the government (which is different, though, than explicitly alerting them to the problem)
  b. Ex: If you are representing a client that is settling with the government and the settlement agreement is more favorable to the client because of information that the government does not know, you do NOT have a duty to and should not tell the government this extra information – this is a purely adversarial situation
    i. If there were fraud or a misstatement involved, then you would have an obligation – but it has to be pretty egregious
  c. Ex: If you are involved in an IRS proceeding and the IRS seems unaware of a material fact that would actually make it less likely to engage in something, you do NOT have a duty to reveal that information – the IRS is <u>not</u> a "tribunal" for the purposes of MRPC
    i. Your obligation changes as you go up the appeals system though – if you make it to an actual tribunal, then you have a legal obligation to disclose

IV. **Concerns**: Trust – you generally trust your superiors/employer; Confidence – you may second guess yourself if everyone else is going along with it; Job Security/Reputation

<u>Tax Policy</u>

I. Despite claims that we have an income tax system, our base is different than pure net income – we have a hybrid income tax with a base that is both broader and narrower than pure net income
  a. People are overtaxed and undertaxed compare to a pure income tax

II. Possible Bases: income, consumption, wealth, wages
  a. And we actually do tax all of these, just the last three outside the Code

III. Why Tax Income?
  a. Complexity: Can be looked at three ways
    i. Rule Complexity – problems of understanding and interpreting the law
      1. This is not necessarily a bad thing, but if it prevents people from paying taxes or causes people to distrust the tax system, then complexity in and of itself is a problem

ii. Transactional Complexity – arises when taxpayers organize their affairs to minimize taxes, which is essentially inefficiency in action
    1. Complex transactions are not necessarily bad, but they can be if the extra layers are hiding something
iii. Compliance Complexity – encounter in trying to comply with the law (this is the real complexity concern)
iv. Complexity is something used to argue against the income tax, but that is not a strong argument because complexity will exist regardless of the base (so complexity does not argue in favor of any base)

b. Efficiency: An efficient tax interferes as little as possible with people's economic behaviors (although tax expenditures and tax penalties are actually designed to be inefficient and create congressionally desirable distortions
    i. Income as a base is not any more or less inefficient than other bases
    ii. Efficiency has a lot to say about specific tax provisions

c. Equity: Real reason we tax income
    i. We want to tax people only to the extent of their ability to pay
    ii. Other bases: consumption taxes are generally argue to be inequitable because lower taxpayers spend a larger percentage of their income on consumption; wage taxes are inequitable; wealth taxes might be more equitable, but there is some sense that we want to focus not on who has money but who earns it
    iii. Equity supports a progressive income tax – vertical equity
        1. Even though within our income tax we have things that undo progressivity – ex: upside down subsidies, which are regressive
        2. AMT is an attempt to restore equity

IV. Code tries to **BOTH** accurately measure income – *and* – create incentives to achieve policy goals
    a. To figure out which one, look at what the Code allows you to deduct
        i. Accurately measure income: ordinary & necessary business expenses deduction, perhaps some healthcare expenses (i.e., need to be healthy to earn income), casualty and theft losses
            1. If necessary to calculate net income → ATL
        ii. Policy goals: perhaps some healthcare expenses (i.e., we treat self-employed individuals completely different), accelerated depreciation (i.e., does not map onto the real world, but is an incentive to invest in certain assets), home mortgage interest deduction, state and local income taxes – policy preference to giving federal assistance to the states and localities
            1. Sometimes the Code taxes more than your net income (i.e., when it chooses to not let certain items be deductible that seem like they should otherwise be) – negative tax expenditures/tax penalties: § 162(m) and *Tank Truck Rentals*
            2. If to achieve a policy goal → BTL generally, sometimes with limits

MISC.

- Historically, income tax rates were very different
  - So consider the year because your feelings about a case may change if the tax rate was 95% vs. 35%
- Tax Court judges are appointed to 15-year terms and the court cannot exercise powers held by the District Court, such as transferring a case to another forum
- Remember our concerns (equity, efficiency, administrability) – do they help explain why a decision was made?
- Always think about whether a provision is creating a subsidy for certain types of industries
- Always think about whether a provision is creating any (dis)incentives
  - Ex: if § 132(a) only reimbursed for T-passes and bikes, this would favor people who do not drive and therefore incentivize not driving
- Fringe Benefits → LOOK to the examples in the Regs are argue by analogy
- Re: fringe benefits – pg. 119 – IRS announced that it will not assert that a taxpayer has gross income because he has received or used frequent flier miles attributable to business travel
- § 152 defines "dependents"
- Remember tax symmetry → overall policy goal to have transactions be tax-symmetrical (we do not want over or undertaxation)
- Corporations vs. Individuals re: Income Tax
  - BTL deduction limits are for individuals only; Corporations only have to calculate gross income and subtract their deductions
- One reason we generally have basketing regimes is to prevent loss harvesting (i.e., trying to get losses from one area and using them against ordinary income)
  - Basketing regimes do not allow cross-pollination
  - Basketing regimes are better than no deduction at all
- Ex Ante vs. Ex Post
  - Entire Code is ex ante
  - Judicial doctrines/standards are ex post (e.g., economic substance, business purpose, sham)
- " … bears to …" in the Code essentially means there is a RATIO
- Deductions → we have an ability to pay notion in what we allow to be deductible (e.g., casualty and theft losses), but many deductions are really policy decisions (e.g., home mortgage interest deduction to favor home ownerships, or state income tax deduction for federalism reasons)
- Rather than having a tax expenditure, could Congress use a direct expenditure? Probably. Would it be better?
- Consider: Code is made up of a lot of small, explicit, piecemeal policy decisions (versus being one big, comprehensive policy decision as a whole)
- Phase outs & cliffs create extremely high effective marginal tax rates at the margins
- Capitalizing your expenditure is a way to calculate your income over several years (rather than only at disposition)