**Tax Outline**

1. **#GROSS INCOME**

**A. Benefits in Kind**

**[In General]**

**§ 61(a):** “gross income means *all income from whatever source derived*,” whether money, property, or services.

* **Non-monetary Income** 🡪 taxed at its fair market value.
  + That is not the only way one could imagine taxing fringe benefits. They could be taxed at cost to the employer, or at the amount that the employee would otherwise have spent (e.g., employee might have bought a Chipotle burrito for $7 if the employer had not taken her out to dinner for $150), or the employee’s subjective evaluation of the benefit she received (e.g., that dinner was worth about $40 to the employee even though her employer paid $150).
* [Determining Price – Middle Ground] *Turner v. Commissioner* (1954) (Randomly won non-sellable cruise tickets to South America for two. Transferred to four cheaper tickets to different country [visiting family]. Issue: how much are the tickets worth for taxing income?)
  + Court made up middle ground number of $1,400.
    - Argument for taxpayer: they would have never purchased tickets in first place. $2,200 is too much. $520 is subjective value.
    - Counter: logistical nightmare, and strong incentive to understate subjective value.
  + MD: makes objective market value assessment attractive.
* [Paying Taxes For Officers] *Old Colony Trust co. v. Commissioner* (Company passed policy to pay taxes for its officers. Issue: are the taxes paid by the company “income” to Mr. Wood.)
  + Taxes paid by company ***is*** taxable income. Problem of infinite taxation?
    - **Method to determine income:** difference between what the total amount of his tax would be, including his income from all sources, and the amount of this tax when computed upon his income excluding such compensation or salaries paid by this company.
    - MD: why using difference? To include tax-bracket issues. Trying to make sure Mr. Wood gets reimbursed at highest marginal rate. Stacking income on top of all other income.
    - **Solution to infinite taxation: *grossing up income***. Net = Gross (1 – tax rate).
      * Tax inclusive description: Tax is 33% (applied to gross).
      * Tax exclusive description: Tax is 50% (tax relative to net).
* [Marginal Rate v. Average Tax Rate]
  + **Marginal Rate –** tax rate you face on your last dollar of income.
  + **Average tax rate** – total taxes / total income. E.g. guy pays 10% on first 3k, but 20% on last 2k, so pays MTR of 20%, but ATR of 14%.
    - What if there was one 25% tax bracket with $3k deduction? All have MTR of 25%.
      * 2k – get $250 back (-$100k) w/ ATR of -12.5%
      * 3k – get 0. w/ ATR of 0%
      * 5k – pay $500 w/ ATR of 10%.
      * 10k – pay $1750. w/ ATR of 17.5%
      * 30k – pay $6,750 w/ ATR of 22%.
  + **Tax Bracket –** range of income for which a given rate applies.
  + **Deductions** are a way to change tax rates and shift burdens.
* Quick Review
  + Furniture Store that gave furniture for free if Red Sox won World Series.
    - Court said not income, but store discount.
    - Counter position: game show winnings or gambling. You bought sofa and lottery ticket 🡪 winnings are taxable.
  + $90 net / 25% 🡪 Gross = $120. 33% = TER.
  + For ***average tax rate***, tax actual amount of tax paid in each bracket, add together, and divide by entire income.

**[#Fringe Benefits]**

* [Problems] - If the tax system did not account for these benefits, employers would be able to compensate employees entirely (or nearly entirely) in non-taxable benefits, or to pay a combination of income and benefits that would allow the employee to severely underreport his or her income in order to be taxed at a much lower rate.
  + (1) *Complexity*
    - Hard to draw line between in-kind compensation and goods/services related to an employee’s work that also provide incidental economic benefits.
    - Hard to value certain things. Basic rule is *fair-market value* (but see *Turner*).
  + (2) *Equity*
    - Two taxpayers in the same “economic position” could be taxed differently.
    - E.g. Work at Google w/ $10k monthly income and pay $2k in rent. If Google offers to pay rent, but only pays you $8k monthly income, Google pays the same, but you walk away with more (pay less taxes; gov picks up the bill).
      * **Problems:** not everyone get these benefits—less wealthy companies or unsalaried users. Benefits most in ppl in highest tax bracket → save a higher % b/c pay a higher % of taxes. And allows higher-income folks to evade paying “fair share” of taxes and co-opt lower marginal tax rates intended for households with lower income.
  + (3) *Efficiency*
    - Failure to tax benefits induces employers to offer, and employees to select, wage and benefits packages very different from those that they would have obtained w/o tax benefits.
    - *Benaglia v. Commissioner* (1937) (Guy who owned luxury hotels in Hawaii was put up with wife in suite of rooms. Issue: are rooms “entirely for the convenience” of employer, thus not taxable?)
      * FMV: $8k. PV (personal value to Benaglia): $2k. Cost (to resort): $1k. B’s alternative housing: $1.6. Hotel pays $6k plus room/board.
      * Resort might strike deal with B for $1,500 (both get value).
      * **At 40%, the taxes push the cost outside the zone where both benefit**. Hotel changes to offer $7k ($6k plus $1k for cost of room). B gets $2,600 left over instead of $400 with prior contract and taxes.
        + **Problem:** Hotel and B is worse off (not trading), but society is worse off b/c taxes are less well off → **deadweight loss**.

However, not all “freebies” that employees received from their employers are taxable fringe benefits.

* [#Meals & #Lodging]
  + **§ 119: Meals or lodging** furnished to **employee, his spouse, and his dependents**, pursuant to employment that the employer gives for its ***own convenience*** (which may incidentally benefit the employees) are NOT taxable.

**§ 119(a):** Meals or lodging furnished “for the convenience of the employer” are excluded from gross income if

1. the meals are furnished on the employer’s business premises, or
2. the employee is required to accept lodging on the employer’s business premises as a condition of employment.
   * + (1) For meals → furnished ***on the business premises*.** This puts a practical limit on what the employer’s “convenience” can mean: it applies to situations in which the employee cannot (or would be less productive if she did) leave the place of work to get her own food. There exists a great deal of tension between the existing cases that define which meals are “for the convenience of the employer.”
       - *Commissioner v. Kowalski* (Supreme Court 1977): New Jersey state troopers must pay taxes for reimbursed meals that they ate in roadside restaurants.
       - *Christey v. United States* (8th Cir. 1988): State Troopers can deduct the cost of meals eaten at highway-adjacent restaurants under § 162.
       - *Sibla v. Commissioner* (9th Cir. 1980): Firefighters not taxed for meals paid by employer and prepared at fire station that they themselves planned and cooked.
       - Consider: Google campus? Gourmet cooking and snacks for free on-site. Is coffee a meal? What constitutes business premises?
       - What does furnished mean? E.g. police stopping and diners and getting reimbursed. Problem: food not being directly provided by employer. E.g. seamless web for law firm associates.
     + (2) For lodging → employee is required to accept such lodging on the business premises of his employer ***as a condition of his employment***.
       - Trying to distinguish between conditions of employment versus income in kind. What constitutes “convenience for employer”? Want programmers to program, or trying to lure employees away from Apple.
     + (b)(1) **Contract or State statute NOT determinative**.
     + (d) **For educational institutions**, on-campus lodging can be non-taxable even if it is NOT a “condition of employment,” but must pay tax on the lesser of (i) or (ii) divided by the amount of rent paid by the employee for the lodging.
       - (i) 5% of appraised value of “qualified campus lodging,” or
       - (ii) average rental paid by individuals for comparable lodging provided by the educational institution.
       - Drew Faust’s house? “Qualified campus lodging” = located on, or in proximity of, a campus… Is her house close enough?
       - (2) Exception in cases of inadequate rent (gets complicated)
   * \*\*The “convenience of the employer” test is flexible: if the ***majority of the benefit*** is for the employer, but the employee gets some benefit, it is still generally excludable from taxable income.
     + *Benaglia v. Commissioner* (B.T.A. 1937) (Hotel manager lived at luxury hotel for approximately half the year and ate his meals there. Issue: are rooms/meals “for the convenience of the employer”?)
       - For convenience 🡪 NOT as a form of compensation (“even though it may relieve him of an expense which he would otherwise bear”).

* [#Other Fringe Benefits]

**§ 132(a):** Exclusions from gross income:

1. No-additional-cost service (132(b))
2. Qualified employee discount (132(c))
3. Working condition fringe (132(d))
4. De minimis fringe (132(e))
5. Qualified transportation fringe (132(f))
6. Qualified moving expense reimbursement (132(g))
7. Qualified retirement planning services (132(m))

* **§132(b) No-additional-cost benefit:** If the employer wants to give its employees a benefit that will not cost it any additional money, the employee is not taxed on the amount of that benefit. Needs to not add a “substantial cost” to employer AND the service is offered in the ordinary course of the line of business.
  + E.g. Free airplane flights employees if seats are empty. Issue: how long before can you determine that there is no foregone revenue? What is substantial?
  + **§ 132(c) Qualified employee discount:** employee discounts are “qualified” if:
    - For *sale of property*: discount isn’t bigger than the employer’s profit share (that is, the employer doesn’t lose money when they employee buys with her discount); or
    - For *sale of services*: discount isn’t more than 20% of regular price.
    - No-additional-cost benefit and qualified employee discount can only be excluded if they are available to a ***wide cross-section of employees***.
  + **§ 132(d): Working condition fringe:** property or service that the employee could take as a deduction under § 162 if the employee paid for it herself (example: buying a uniform for work is deductible, or the employer can buy it for the employee).
    - This is a way to get around the limit on itemized deductions (potentially).
    - *Goucher*: If taxpayer had paid for his own trip to Germany to see VW manufacturing facilities, he could have deducted it as a business expense; thus, VW paying for his trip is excludable.
  + **§ 132(e) De minimis fringe:** benefit so small that it would be unreasonable to account for it. Needs to be “occasional.” If *de minimis* 🡪 employer can deduct in full.
    - Employer-run eating facilities qualify as *de minimis* if located on/near business premise AND revenue from eating facility equals/exceeds direct operating costs.
  + **§ 132(f) Qualified transportation fringe:** Transportation benefit provided by employer, including “qualified parking,” transit passes (bus passes), “qualified bicycle commuting reimbursement,” and transportation provided in a “commuter highway vehicle” that is used principally to drive employees to and from work.
    - Parking needs to be at/near business premises. Commuter highway vehicle must have capacity for at least 6 persons (not including driver) and at least 80% of expected mileage of vehicle must be incurred in transporting employees to/from work (taxi/limo does not count).
    - Benefit capped at certain $ amount (varies year to year).
  + **§132(g) Qualified moving expense:** moving expenses paid for or reimbursed by employer (not including payment or reimbursement of expenses deducted in the last taxable year).
  + **§ 132(m) Qualified retirement planning services:** retirement planning services for an employee and spouse.
    - (2) Benefit is excludable when provided to highly compensated employees only if they are also available to the other employees “normally provided education and information regarding the employer’s qualified employer plan.” Does NOT apply to tax prep, accounting, legal/brokerage services related to RP.

**§ 106(a):** Gross income of an employee does NOT include employer-provided coverage under an accident or health plan.

* **§ 105:** Excludes from GI amounts empoyees receive from their employers as ***reimbursements for medical expenses*** and the value of services emploees receive under an employer-proved health care plan.

*Policy Considerations: Impact of § 106/tax-free healthcare plans*

* **Expensive for USFG**
* **Inefficient**
* **Incentivizes “big” (lots of coverage) plans**
* **Incentivizes overconsumption of healthcare**
* **Equity concerns**
* But cannot favor highly compensated individuals.
* When an employer covers her employees’ health insurance coverage, into a health savings account, or reimbursements for prescribed drugs or insulin. This does not mean that the employer has to “pay” for the coverage: employer-provided healthcare means that the coverage is provided through the employer, even though the employee pays for the cost of her coverage. In other words, if an employee “buys” her health care through her employer,*she pays for it with before-tax income*.
* This exception provides a huge incentive for employer-provided health insurance and functions as a smaller scale incentive for “pooling” health care costs 🡪 spreads risk and costs and thus solves the big adverse selection problem. This exclusion however is hugely expensive for the federal government: it adds up to $200-300 billion in foregone revenue each year (approximately 10% of federal government revenues).
* Making insurance plans tax-exempt also incentivizes inefficient behavior; that is, it encourages taxpayers to buy plans that would not be “worth it” in pre-tax income.
* Ultimately, this incentivizes insurance companies to offer bigger and more comprehensive plans. People buy more insurance coverage than they need or would want to buy if they were paying in after-tax income, since it is basically discounted (you get to buy in pre-tax dollars). Then, everyone uses the health insurance coverage that they have – getting MRIs when they don’t need them, etc. This overconsumption of healthcare raises the costs of healthcare for everyone, because even (relatively) healthy people are demanding expensive healthcare procedures.
* This also raises an **equity concern**: the highest discount here is given to the taxpayers in the highest bracket, who have the most expensive healthcare plans. It is the opposite of a progressive tax rate: it gives a biggest subsidy to the people with the most money.

**§ 107:** In the case of a **minister of the gospel**, gross income does NOT include:

1. Rental value of a home furnished to him as part of his compensation; or
2. Rental allowance paid to him as part of compensation (to extent it is used to rent/provide home and does not exceed fair rental value of the home, including furnishings, utilities, garages, etc.

* **§ 125 Cafeteria Plans:** When an employee offers a benefit that only some employees can use (maybe they don’t need parking because they live next door, or they don’t eat meals on-premises because of a dietary restriction, etc.), they can offer employees to take extra cash salary in lieu of the benefit.

**§ 125: Cafeteria Plans**

1. Except in (b), no amount shall be included in the gross income of a participant of a cafeteria plan solely because, under the plan, the participant may choose among the benefits of the plan.
2. Does NOT apply to (1) *highly compensated participants* and (2) *key employees*.

* The extra cash salary *is taxed*, meaning that choosing a non-taxable benefit is net better for an employee *if* she values the benefit at a value that is at least equal to the pre-tax fair market value of the benefit (or, the discounted value of the benefit calculated in post-tax dollars).
* Avoids the problem of “constructive receipt” of a taxable benefit that the employee does not use.
  + **Constructive receipt:** person gets value b/c employee had choice (?) → employer takes away first option to eliminate decision → ppl get mad b/c they don’t want fringe benefits → everyone gets $35.

**[#Imputed Income]**

* In defining “gross income,” § 61 includes monetary and non-monetary income; however, it does not include **“imputed income”**: that is, internalized value that, if not for the property or work of the taxpayer, would otherwise (a) cost money that would be paid to someone else’s income and/or (b) have to be earned as additional taxable income to pay for (a).

*Example 1*:

*Policy Considerations for Imputed Income:*

**Inefficiency**

**Inequity**

A and B each have $100,000 available, tax rate of 40%, interest rate of 10%. Assume they both rent housing and pay $1,000/month in housing costs - $12,000/year.

A invests $100,000 in a bond ($10,000/year in taxable income, for total of $6,000). Pays $12,000/year in rent.

B buys a house for $100,000 and pays no rent. “Imputed income” is the “extra” $12,000/year that he does not have to pay in rent (in other words, could imagine that B has bought property and is “renting” it to herself – so that she is still paying the $12,000, but she is paying it to herself, and the “receiver self” is receiving income of $12,000).

Thus, the lack of imputed income incentivizes internalizing costs by buying a home, doing one’s own housework/childcare, etc. (because a stay-at-home-parent’s domestic work is not taxed as “income” for the household).

*Example 2*:

A has an hourly wage of $200/hour. Professional housepainters cost $150/hour. If A does not paint his house himself, he can work for an additional hour during that time. The tax rate is 40%

A’s taxable income after one hour is: $120, which is less than the professional housepainters will cost. Thus, A will elect to paint the house himself, forgoing $200 in pre-tax income, even though it is the **less economically efficient** choice.

**B. Recovery of Capital**

**[Introduction To #Basis]**

* When a capital asset pays off, it is “recovered.” It is defined by the sense that the taxpayer has “gained” something. In a sense, one could refer to all income as “recovery of capital,” in that income involves the monetization of some resource available to a taxpayer. If someone is earning a salary, for example, she is monetizing her human/mental energy/time investment in her work (and she may be monetizing educational investments that she made previously, if the work, like lawyers’ work, is one that required or is aided by previous schooling).
  + [Adjusted Basis] *Inaja Land Co. v. Commissioner* (The land was bought in 1940 for $100. Because of some work that was done nearby that degraded the environmental quality of the land, the owner sued the polluters and settled for $20 in 2003. In 2005, the owner sold the land for $120. The owner’s gain was $40.)
    - This can be understood the following way: 2003 lawsuit payout ($20) was a compensation for some part of the bundle of rights that was lost because of the pollution, so the owner’s basis went down to $80. Thus, when it sold for $120, the owner’s gain was $40.
    - Or, we can tax the $20 as a one-time payment, and then tax the $20 realization at the end.
  + **The longer you hold on to $$ (defer taxes) = the more $$ you have.** The **value of deferral** is equal to the value of having tax-exempt interest or, in other words, a tax-exempt savings account. How valuable this is varies with the **tax rate** and the **rate of interest**.

*Example*:

Income: $100; interest rate: 10%; tax rate: 40%

|  |  |  |
| --- | --- | --- |
|  | Year 1 | Year 2 |
| 1 (basic example) | $100 (income)  -$40 (tax) = $60 | $60 (in bank)  +$6 (interest)  -$2.4 (tax) = $63.60 |
| 2 (tax-exempt savings) | $100 (income)  - $40 (tax) = 60 | $60 (in bank)  +$6 (tax-exempt interest) = $66 |
| 3 (defer tax payment on income) | $0 (all income to bank) | $100 (income)  +$10 (interest)  -$44 (tax) = $66 |

* Depending on how you characterize a gain and its relationship to the owner’s basis (e.g., was that payout a recovery of basis), there are **vastly different tax consequences**. Characterizing all capital recovery as recovery of basis is unlikely to be successful, but it would be the most taxpayer-friendly way to interpret a sale (because **deferring taxes lets the taxpayer take advantage of the time value of money**). Taxing gains as they accrue ***(“accrual method”***) would be the least taxpayer-friendly. The middle ground (the ***“realization method”***) apportions recovery of basis proportionally with gain as a percentage of capital recovered.

*Example 1*:

Year 0: Invest in 100 shares of stock worth $100/share.

Basis: $10,000

Year 1: Stock rises to $120/share; sell 50 shares for $6,000.

Basis: could be $4,000 (recover basis first); gain $0

Basis: could be $5,000 (sold half of shares); gain $1,000 (“Realization”)

Basis: could be $6,000 (value of remaining stock); gain $2,000 (gain first) (“Accrual”)

Year 2: Stock rises to $140; sell final 50 shares for $7,000

*Example 2*:

*Nixon* case: Richard Nixon buys 2 parcels of land in California. For the first 27 acres (which includes coastal property), he pays $1.4 million; for the last 3 acres (of non-coastal land), he pays $100K. (total original investment: $1.5Million)

He sells 24 of the non-coastal acres for $1.249 million, and tries to claim that it is “recovery of basis.”

If all acres were priced the same, they would each have cost $50K. However, when he bought the additional 3 non-coastal acres, they were only worth $33K.

By trying to price the sale as “recovery of basis,” he would have avoided paying taxes on the appreciated land until he sold the coastal acres, presumably for a much higher amount - or died, and his heirs would inherit the property at fair market value.

\*\*Court rejected Nixon’s characterization. Found that there was gain and that Nixon needs to allocate land sold to original land.

**[#Damage Payments]**

**§ 104(a):** Gross income does NOT include:

1. **Workmen’s compensation payments** for personal injuries or sickness;
2. **Damages** for personal *physical* injury or sickness (other than punitive damages);
3. Accident or health **insurance payments** for personal injury or sickness;
4. **Pension or disability payment** for Armed Forces; and
5. **Disability income** attributable to injuries incurred as a “direct result of a terroristic or military action.”

* [Two Types Of Damages]
  + **Physical Damages (non-taxable):** e.g. Uber hits guy 🡪 recovery and lost wages excludable.
    - Punitive damages ARE included (taxable). Why? Not being paid to return basis to person.
    - If physical damage is ***voluntary*** 🡪 included (taxable).
  + **Emotional Damages (taxable):** Emotional distress, lost wages, defamation, etc. E.g. Crimson writes defaming article 🡪 emotional recovery and lost wages included.
    - However, medical expenses ARE excluded. And mental damages for WWII were excluded.
    - *Why draw distinction?* (1) Some notion of **return to basis**. You have (market value) basis in your body, so your lost wages is seen as non-taxable return to basis. Mental basis is roughly zero. (2) **Imputed income** interpretation 🡪 other people’s use of limbs are not being taxed, so it would be unfair to tax your loss of limbs now.
      * *Does this distinction matter?* Juries can account for taxes when awarding damages.
* [Asymmetry In Treatment Of Damages]
  + (1) Involuntary physical (***excludable***) & involuntary mental (***non-excludable***) damages.
  + (2) Voluntary physical & voluntary mental damages are ***non-excludable***.
* [Business Damages] *Raytheon Production Corp. v. Commissioner* (RCA pays Raytheon a settlement of $410K. Raytheon claims that $60k of the payment is for destruction of its patents (and future income associated with them), and $350k is non-taxable return of capital [lost goodwill])
  + Court refuses to find that the $350 is recovery of basis without a demonstration that Raytheon had that much basis. ***Damages should be taxed based on what they are “in lieu” of*** 🡪 taxpayer must establish this basis.
    - MR: Odd. Why does the burden of proof lie with them? Changed later in the code to shift burden onto the State. Damages needed to be associated with basis. Also, pay attention to distinction between value of a business and future income of a business.
  + Replacing **good will** 🡪 NOT taxed. Replacing **lost profits** 🡪 taxed. Excess recovery over amount of capital lost 🡪 taxed.

**[#Annuities]**

**§ 72(a):** Unless it falls under an exclusion, gross income *includes* amount received as an annuity under an **annuity**, **endowment**, or **life insurance contract**.

**§ 72(b):** **“Gross income”** does NOT include the part of the annuity payment equal to the investment-to-return ratio.

* **§ 72 Annuities:** Exclude from each year the **same *ratio*** of payment as the total payment / total value of contract. Basically, spread the tax payment evenly over every year.
  + E.g. 10k (year 1) x 15,200 / 20k (see below).
* [Example] Annuity Contract
  + Year 1: 10k
  + Year 2: 10k.
  + How much are you willing to pay? At 20%, $15,277.78
  + How will you tax this?
    - Under **§72** → ((20k-15,200)/2) x 33.3% = per year tax payment ($799.2).
    - Return to Basis Approach → 20k-15,200) x .33 = pay tax at end ($1598.4)
      * Year 1: RoB (10k); TI (0); Tax (0)
      * Year 2: RoB (5,200); TI (4,800); Tax (1,600).
      * Under this approach, the government is giving you an interest-free loan, especially is valuable if interest rates are high.
    - Self-Annuitize (like putting it into the bank). Lend $15,200 to insurance company.
      * Year 1: 15,200 x .2 = 3040. RoB (6,960); TI (3,040); Tax (1013)
      * Year 2: RoB (8,210); TI (1,648); Tax (587)
* [Example 2] Life Insurance Policy (Annuity Until Death)
  + ***Live beyond?*** After pre-determined life expectancy 🡪 entirety of monthly payments will be taxable income (because basis has been recovered).
  + ***Die early?*** The basis that has not been recovered can be deducted on last tax return.
* **Deferred annuity:** A person may buy an annuity in advance, for payment after she turns a certain age (e.g., invest $50,000 in an annuity that will begin to pay out at age 65). The person can get the years in which there is no payment tax free (the exclusion ratio will be based on the initial investment, though).
  + Exaggerates the “interest-free loan period” of annuities.

**[#Life Insurance]**

**§ 79(a):** Gross income includes life insurance provided by an employer to the extent that the cost exceeds $50k and the amount paid by the employee.

**§ 101(a):** Life insurance payouts from death are not taxable unless they fall into an exception (such as that for annuities).

* **§ 101 Certain Death Benefits:** Death benefits are NOT taxable. Seems like a tax-free slot machine (anomalous). Argument that 101 is “right” is that there’s a lot of ppl buying life insurance that are not getting anything back, so it evens out (is correct) ***on the aggregate***.
  + 101 is exploited by wrapping tax-saving mechanism around it.
  + Premium *should* be going up every year b/c your risk of dying is increasing, but it stays level. Thus, you’re overpaying when you’re young, then underpaying when you’re old 🡪 savings that are paid early to fund later payments = ***savings account attached to life insurance***.
    - Question: how much savings is going on in relation to life insurance?
    - Extreme form = fund everything early on and then have ability to take out money.

**C. #Realization**

**[In General]**

* In **realization**, you have ***deferred income*** 🡪 gains are not taxed when they are earned, but when they are “realized,” i.e. turned into cash. E.g. stocks raise each year, and you get “gain,” but you don’t count income until you sell. How is this justified?
  + **Administrative** – Complicated to administer. Hard to determine value each year, and stocks rise and drop.
    - Counter: we do much more complicated stuff; not clear why we can’t do it here. We don’t seem to worry about this when determining income.
  + **Liquidity/Fairness** – you don’t have the $$ to pay taxes until you sell.
    - Counter: they can just sell it or borrow against the asset.
  + **Valuation** – how to determine value of unsold assets?
    - Counter: look, at least for stocks, it’s easy to determine value. Re-counter: markets are stupid/irrational.
* [Narrow/Old Income Definition] *Eisner v. Macomber* (Issue: whether stock dividend is income.)
  + **Stock dividend is capital increase**, NOT income. **Income:** gain derived from capital, from labor, or from both combined. Capital is *source of income*, but NOT income itself (income is “from capital”, not growth or increment of capital). Needs to be ***something of exchangeable value*** ***proceeding from*** the property, severed from the capital (need separation). Income is “realized” when it is picked off the tree (notion of separation). Dividends in kind—increased stock—remains with company.
    - “Essential and controlling fact is that the stockholder has received nothing out of the company’s assets for his separate use and benefit.
  + **Brandeis Dissent:** cash dividends are treated differently (non excludable), but they’re essentially the same as stock dividends.
    - Cash dividend: give $$ to shareholders.
    - Stock Dividend: increased number of shares.
    - Share Repurchase: take increase in cash and buy up shares in market.
      * Economically speaking, the above three are exactly the same. The value is earned when assets are increase, the above three are just paper shuffling.
  + MD: but in stock dividend, there is no increase in capital….(only the # of stocks doubled). See notes.
    - *Takeaway*: notion of income that is much more precise.
* [Expands Income Definition] *Cesarini v. United States* (P bought piano for $15 and found $4,467. Issue: is found cash taxable income?)
  + Cash ***is*** taxable. Except as otherwise provided, **gross income** means ***all income from whatever source derived***. Also, IRS 1.61-14 says treasure trove = income.
  + MR: does this really makes sense under def. of income under Eisner. Also, why is cash found (taxable when found) different than a diamond that is found (taxable when sold)?
    - (i) very sharp departure from *Eisner v. Macomber*. Big expansion of what is income.
    - (ii) Think about realization. Why is cash different than a diamond ring?
    - (iii) Intro to treasure trove.
* [Income If Deductible] *Haverly v. United States* (Principle receives free sample textbooks [worth $400]. Donates books to library and takes tax deduction for charitable donation. Issue: are books “income”?)
  + **Yes.** Value of textbooks is taxable income. ONLY relevant when taxpayers are taking double tax benefits (taking deduction). When ***tax deduction is taken*** for the donation of unsolicited samples → gross income.
    - **Rule:** Intention of Congress “to use the full measure of its taxing power” and “to tax all gains except those specifically exempted.” Language of 61 encompasses ALL “accessions to wealth, clearly realized, and over which the taxpayers have *complete dominion*.”
  + MD: tricky to see why original donation to principle is not a realization event, but it is when principle gives to library. Pretty incoherent. But keeps us away from gifts.
    - Very different view of income than Eisner.
* **§ 1014** **Basis of property acquired from a decedent:** When you inherent property, the **basis of the property** is the fair market value of the property at the ***date of the decedent’s death***. (**Step-Up Basis on Death**).
  + MD: what happens to all that gain?? Escapes taxation.
  + Policy Considerations
    - **Cons:** encourages generational wealth accumulation. Decentivizes ppl to work hard (ppl just live off of inheritance).
      * Efficiency: encourages ppl to hold onto ownership instead of using capital. Ties up money and resources → prevents ppl from liquidating and diversifying → raises risk portfolio (holding onto assets long).
    - **Pros:** prevents ppl being forced to break up family businesses. Inefficient liquidation

**[Discount Obligations]**

*Types of bonds*:

* **Simple #bond:** Pay money for a bond, and, at the end of the bond’s term, the bond will pay out in the same amount for which you bought it. In the intervening years, it will pay out interest each year.
  + Pay tax on interest that you receive in the year that you receive it.

*Example*:

Invest $100 in a three-year simple bond, interest rate at 20% (v. good market), tax rate 40%.

Year 0: -$100 (into bond)

Year 1: $20 (interest), -$8 (tax liability) = $12

Year 2: $20 (interest), -$8 (tax liability) = $12

Year 3: $20 (interest), -$8 (tax liability) = $12, $100 (return bond)

Total post-tax gain: $36 (60-24)

Total tax liability: $24; marginal rate = 40%

* **Original Issue Discount Bond (#OID):** The bond only pays out after its term has expired (“yield to maturity”). As it produces interest, that interest is re-invested and itself produces interest. So, after its term is up, the bond has a higher value than a simple bond of the same amount.
  + These bonds are not as good for borrowers, since the borrowers cannot deduct the value of the payments for the years before the bond is paid. However, if the borrower is a non-taxable entity (like a state or local government, or a university), then an original issue bond is no more or less beneficial than a simple bond.
  + Pay tax each year according to that year’s “return” that would otherwise be paid (as if it is being realized, then re-invested in the bond). Looks like a total departure from realization.

*Example*:

Invest $100 in a three-year OID bond, interest rate at 20% (v. good market), tax rate 40%.

Year 0: -$100 (into bond)

Year 1: [$20 interest] (not paid); -$8 (tax liability) = -$8

Year 2: [$24 interest] (not paid); -$9.6 (tax liability) = -$9.6

Year 3: [$28.8 interest], -$11.52 (tax liability), $100 (return bond)

Total post-tax gain: $43.68 (72.8-29.12)

Total tax liability: $29.12; marginal rate = 40%

**[Capital Gains]**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Deferral Problem** | *Undeferred* | | *Deferred* | |
| TR: 50% Interest: 10% | Year 1 | Year 2 | Year 1 | Year 2 |
| Pre-Tax Revenue | 100 | 55 | 100 | 110 |
| Taxes | 50 | 2.5 | 0 | 55 |
| Year-End Total | 50 | **52.5** | 100 | **55** |

* Four ways to think about #**deferral problem**
  + (i) Kind of like getting *interest-free loan* from the government.
  + (ii) Analogize to a *reduction in tax rate*.
  + (iii) Government becomes *investment partner*. Gov = owner/co-investor in deferral.
  + (iv) *Exempting return* on the after-tax deferred amount.

**D. Motivation**

**[#Gifts]**

* **Gifts** are *generally excludable* from income (at donee level), but NOT to the extent that they produce additional income.

**§ 1015:** Basis shall be the *same as it would be in the hands of the donor* or the last preceding owner by whom it was not acquired by gift (**carry over basis**), EXCEPT that if such basis is greater than the fair market value of the property at the time of the gift, then for the purposes of ***determining loss*** the basis shall be the such fair market value.

**§ 102(b):** **Interest income** from gifts and inherited property ***is*** ***included*** in gross income.

**§ 102(c):** Gifts from employers to employees *are* (generally) included in gross income.

**§ 274(b):** Gifts are NOT deductible by the giver.

**§ 1014(a)(1):** Basis in inherited property is (generally) the fair market value of the property at the *time of inheritance*.

**§ 102(a):** Gifts and inherited property are NOT included in gross income.

* + **Business-related gifts** are generally *not excludable*(because they are considered not considered “gifts”). A **gift** is given with ***“detached and disinterested generosity.”***
  + **“Carryover basis”:** when a gift is given, the recipient has the same basis in the gift that the giver had.
    - BUT: **“step up basis”** at death ((§ 1014(a)(1)) 🡪 so you may permanently avoid taxation on gain.
* **§ 1015 Basis of Property:** if we didn’t discount it to fair market value 🡪 allow people to shift loss and take advantage by the creation of a market for losses (tax benefits).

|  |  |  |  |
| --- | --- | --- | --- |
|  | **A** | **B** | **C** |
| **1916 Purchase** | $30k | $30k | $30k |
| **1923 Gift** | $15k | $15k | $15k |
| **1925 Sale** | $50k | $10k | $25K |
| **Gain?** | $20k | 0 | 0 |
| **Loss?** | 0 | $5k | 0 |

* [Interest Payments Taxable] *Irwin v. Gavit* (Inheritance pot of money. Three generations. The grand-daughter is meant to get all of it someday, but she’s too young, so father gets interest income from pool of cash. When daughter turns 21, she gets pot [won’t get taxed]. Issue: is father’s interest gains income?)
  + **Yes.** Interest payments ***are*** taxable income, but “corpus” is not. Same as §102.
    - MD: it looks wrong because the Donor gifted all the interest streams to the father. But the interests streams have NOT been taxed yet; only the pot of $$ has been taxed. Need to tax it at *least once* 🡪 tax interest streams. Pot is like **OID** (costs $62k now). Interest stream is like **annuity** (costs $38k now). If buy OID & annuity 🡪 50k gets taxed by donor. If set up like *Irwin* 🡪 same amount is taxed, but only one person is being taxed. It seems odd, but is the “right answer” b/c the same amount is being taxed.
  + Example in Notes. Way to think about it. If parent keeps money 🡪 stream is taxable, but the corpus is not. Or, stream is annuity, and corpus is bond (split the asset up front). In remainder trust, you’re splitting the asset in year five = double dipping (count both corpus AND income from corpus as gift).
* [Intention Of Giftor] *Commissioner v. Duberstein & Stanton* (Two cases: Berman gives Duberstein Cadillac b/c D helped him out with getting customers. Directors of church voted resigning comptroller “gift” of $20k. Issue: are these gifts?)
  + **Test:** whether something is a gift is based on ***intention of giftor***, as determined by jury looking at the totality of the facts. “Most critical consideration…is the transferor’s ‘intention.’” Triers of fact are in best position to determine “detached and disinterested generosity.” ***Wide open consideration***.
  + **Frankfurter Dissent:** presumption against gifts by employers (as non-taxable). Majority approach will lead to chaos and inconsistency.
    - Government wants detailed test that involves *who* the giftor is (business v. private persons).
  + On remand, comptroller gets gift, and Berman doesn’t.
  + End up in **§102(c) – (a)** shall not exclude from gross income any amount transferred by or for an ***employer to, or for the benefit of, an employee***

**[#Prizes And Awards]**

* **Rational:** If prizes were not included as gross income 🡪 employers incentivized to give “prizes,” not salary. And same thinking as *Glenshaw Glass*—wealth has become available to the taxpayer.

**§ 74(a):** Prizes and awards *are included* in gross income.

* + Exception: if the prizewinner ***donates it to charity***, did not agree to ***render future services***, and did not take ***any action to enter contest/be considered*** 🡪 there is no tax (§ 74(b)).

**[#Scholarships And Fellows]**

* **§ 1117(a)**: Need to be *candidate for a degree* at an educational organization.

**§ 127:** Certain educational assistance programs for employees are NOT included in gross income.

**§ 117:** “Qualified scholarships” (used for tuition) are NOT gross income.

* + Why do we do this? Encourages schools to give $$ to students.
  + Inequities introduced? If you pay for school with work, or borrow, you pay with after-tax income 🡪 scholarships get break. How to solve problem?
    - Treat as an investment. When would you take as deduction? If you take now, then not very valuable b/c you’re not making any $$ as a student. We could treat as long-term investment and let you deduct over time. (We don’t do this).
* **§ 117 (b):** Also worried about *how* you spend $$--tuition and related fees, books, equipment, etc, is NOT taxed, but $$ for room and board and amounts paid for teaching (§ 117(c)) *are* taxed.
* **§ 117 (c):** Exclusion does NOT apply if scholarship is compensation for services, such as teaching/research. Athletic scholarships are not covered here.

**[#Social Welfare Payments]**

**§ 85(a) Unemployment compensation:** In the case of an individual, gross income *includes* unemployment compensation.

* Support provided by family members, like intrafamily gifts, is NOT included in gross income. It has also been the longstanding policy of the IRS to *exclude* form income most government benefits and other welfare payments.

**E. Competing Claims and Offsetting Liabilities**

**[#Discharge of Indebtedness]**

**§ 108(a):** Discharge of indebtedness is NOT included as gross income if it is discharged as part of a Title 11 bankruptcy proceeding, occurs when the taxpayer is insolvent, the debt is “qualified farm indebtedness,” the debt is “qualified real property business indebtedness” (except for C corporations), or the debt is “qualified principal residence indebtedness” discharged before 01/01/14,

**§ 61(a)(12):** Creation of a loan is NOT a taxable event for either the lender or the recipient, but discharging the debt ***is*** a taxable benefit to the recipient.

* **Loan payments** are NOT income 🡪 do not change taxpayer’s net worth.
  + We could count loans as income and then when we pay back as deductions. We don’t do this. Why?
    - Want ppl to borrow? Invest in economy? And its not an ascension to wealth 🡪 not any wealthier b/c you owe the $$ back
  + Loan forgiveness is problematic, especially in the family setting. Forgive debt could be characterized as a gift?
    - E.g. get MRI, can pay $5k, so hospital says pay $1k 🡪 income? Could say purchase price reduction. Problematic, b/c negotiated *ex-post*, did bill for $5k.
    - E.g. Marth gives Desai $50k b/c he’s struggling 🡪 Desai goes bankrupt. Income? § 108(a) EXCLUDES when taxpayer is insolvent, but shall not exceed the amount taxpayer is insolvent. What does this mean? **Insolvent:** excess of liabilities over fair market value of assets. If Desai had $10k, then § 108(a) would only cover $40k.
      * Policy: liquidity? Only what ppl to be taxed on money they can pay?
* [Bond Repurchase] *United States v. Kirby Lumber Co.* (K issued bonds for $12m. Later in year, purchased some bonds back with difference of $137,521.30. Issue: is the difference taxable gain?)
  + **Yes**. Essentially got to keep $$ they were going to have to pay back (“saved” by buying back liabilities at lower price) 🡪 taxable income.
    - (Balance sheet example).
* [Gambling Debt Forgiveness] *Zarin v. Commissioner of Internal Revenue* (Gambler runs up $3.4m in debt; settles for $500k.)
  + Taxable income = $2.9m.
    - DP: Just a *price reduction*. NOT a loan, but just an opportunity to gamble 🡪 bought chips, and we understood that they’re *not worth $3.4m* (compulsive gambler, casino knew he’d lose it).
      * MS: Problematic b/c we could characterize all types of things as purchase price reduction.
    - And does it matter that NJ would NOT have enforced the debt against D? ***Yes, overruled on this basis.*** Is the discharge of unethical/illegal loans (like payday loans) for less than their face value income?
  + **Dissent:** never was a loan, b/c both parties knew he’d *never pay it back*.

**[#Illegal Income]**

* [Stolen Money Taxable] *Collins v. Commissioner* (Employee at racetrack placed horse bets w/o paying for them. He won $$, but was net behind. Issue: is $$ he stole taxable income?)
  + **Yes.** Larceny of any kind is taxable income. Gambling loss is *irrelevant* and does not offset D’s gain in form of gambling opportunities. Only a loan with its attendant ***“consensual recognition”*** of the obligation to repay is NOT taxable.
    - Could not have intended to repay the $$ b/c it was *3x his annual salary*. MD: but could characterize it this way.
  + The fact that gain arises out of illegal activity does NOT result in exclusion from income. *United States v. Sullivan*
  + Nor is producing business/tax records self-incriminating under the 5th Amendment. *Couch v. U.S.*

**F. Tax Expenditures and the Concept of Income**

**[Tax Exempt Interest]**

**§ 103 Interest on #State and local bonds:** Gross income does NOT include interest on any State or local bond.

* **§ 103:** Allows State and local governments to pay lower tax rates of interest on their debt (compared to corporate bonds).
  + Incentive to buy state/local bonds? MD: Not really. If corporate is 10%, then TE Bond will only be 6%. Incentive is the same. All that is happening is ***transfer of $$ from fed to state*** (basically Federal spending program).
  + Story gets complicated by *varied tax rate*. TE Bond % needs to go up to get lower-rate payers into the market 🡪 some benefit will go to highest tax rate investors = *wealthy ppl get chunk of subsidy* (regressive distributive mechanism) 🡪 **leakage**.
    - **Markets are pinned down by last person who is lured in.**
    - Solve problem by eliminated TE bonds, and have Fed give $$ to state?
  + **Provision against arbitrage** – solves problem of tax-exempt orgs (Harvard, States) from borrowing at tax-exempt and re-investing.
    - How to detect arbitrage? Hard to trace.
  + **Another problem:** *rent out* tax-exempt status to Google (incentive to build is Mass) 🡪 restricted.

*Example*:

Taxable bond of $100; interest rate of 10%; tax rate is 40%

Year One: $100 bond; $10 interest; $4 tax = $6 gain

Tax-exempt bond of $100; interest rate of 6%

Year One: $100 bond; $6 interest (no tax) = $6 gain (investor is indifferent between this and taxable bond at 10%; state or local government can pocket the 4%)

* **Solutions?**
  + Offer tax-exempt bonds with varying interest rates depending on the investor’s tax bracket.
    - This would *decrease the liquidity* of a state or local government’s bonds, since they couldn’t all be traded together.
  + Eliminate the state and local government tax-exempt bond and allows the federal government to give money to state and local governments.
    - People generally dislike the creation of federal spending programs.
  + Create one taxable bond (at the lowest level) and allow a (refundable) taxable credit

**[Tax Expenditure Budget]**

* **“Tax expenditures”** refers to the amount of revenue that the federal government has *foregone* by allowing exclusions, deductions, or credits. As far as their effect on the federal budget is concerned, tax expenditures and federal spending programs are indistinguishable.
* [Example]
  + 10 ppl. Income: $1k each. GDP: $10k. Tax: 15% 🡪 $1,500.
  + If person X makes hoodies, and there are **spillover benefits**, we exempt X from taxes. But if we want to do in revenue neutral way 🡪 (A) tax others more = 9 ppl at 16.7% (GDP: $1,500). (B) 10 ppl at 16.7% (GDP: $1667), then Gov spends $167 on X.
    - X is indifferent between (A) and (B). But in (B) 🡪 *government is bigger*.
    - (A) is ***tax reduction*** and (B) is ***tax expenditure***. (A) allows you to say politically, “I cut taxes.” (even though they’re exactly the same). (A) likely leads to more spending b/c it doesn’t seem like spending.

**[Concept Of Income]**

* **Haig-Simon definition**: “Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and end of the period in question.” 🡪 **Income = consumption + change in wealth** (land appreciates or $$ in bank, i.e., savings).

**[Alternative Tax Bases]**

* Traditionally, the “base” of taxes is **income** (see above). But there may be other bases that are better. Taxes are always in *reference to something*. How else could be tax? Three guiding lights: (1) Efficiency; (2) Equity; (3) Complexity.
  + **Poll (head) tax:** very efficient 🡪 wouldn’t distort purchasing decisions at all. Super simple (easy to calculate). Equitable 🡪 everyone taxed the same.
    - **Cons:** Ignores ability to pay. Huge boon to rich (regressive).
    - Impulse to tie to “ability to pay” 🡪 income; wealth; consumption; wages. Tricky though b/c *imperfect* 🡪 ability to pay is tied to underlying skillset/human capital and hard to get at.
  + **“Benefit” tax:** Charged according to the extent you benefit from government service. E.g. “user fee” for road use. Calculable. “Fair”.
    - **Cons:** Ability to pay/regressive (but maybe could exclude under a certain income). Would severely limited public facilities (need enough buy-in to fund lots of projects). Biggest problem 🡪 ***Allocation***.Benefits like national security are non-excludable and non-rival.
  + **Wages tax:** Administrable. Avoids games with the investment market to avoid taxes. Incentives savings.
    - **Cons:** Allows wealthy to avoid taxes (encourages accumulation). Burdens working class.
  + **Wealth tax:** (U.S. does have estate/property tax, but other countries have a much more explicitly wealth-based tax system). Actually takes into account what people have. Avoids weird avoidance games.
    - **Cons:** Tax multiple times?
  + **Income Taxation (amount of consumption + amount saved):** Considers the amount you actually end up with in a given year. (Note: this requires some concept of realization).
    - **Cons:** *Essentially penalizes savings*. Also ignores non-monetary benefits (e.g. free time or self-satisfaction) unless imputed income is taken into account (e.g. laborer who works 50 hrs/wk for $10/hr and computer programmer who works 10 hrs/wk for $50. Pay same taxes, even tho the latter has higher ability to make more and instead chooses leisure time.
  + **Consumption Tax:** Incentivizes savings (by removing the “cost” of deferred consumption by taxing savings in income tax). Avoids over-taxing (taxing income, then taxing interest on income). Could design a progressive consumption.
    - **Cons:** Regressive in regard to fixed costs (poor less likely to have savings). Difficult to classify some savings (housing/cars savings or consumption?).
    - E.g. 50% tax rate. 10% interest rate. YR 1 – earn $100 (none in YR 2). How much do we get to eat if we eat everything in year one (1) or eat everything in year two (2).
      * Income tax 🡪 (1) $50 (2) $52.5
      * Consumption tax 🡪 (1) $50 (2) $55
      * Wage tax 🡪 (1) $50 (2) $55
    - **Pros:** Above, see that income tax *encourages consumption earlier*. Tilts toward consuming today. Who cares? Well, maybe savings is good. AND captures black market activity. AND more representative of “well off”? Consumption captures utility more than how much I earn (b/c some ppl hate their job).
      * Consumption tax is like an income tax which you ***defer until you consume***.
    - **Problem:** entrenches wealth. Poor have to consume more of income, and wealthy can save. Counter: it’s all going to get consumed at *some point*. But ***can’t get progressive tax*** in basic retail sales tax. Retailer becomes tax collector. Problem if retailer is corrupt.
    - MD: You *don’t have to do* a retail tax 🡪 do **value-added tax** (solution to problem of evasion [ppl not reporting sales] and issues of progressivity).
      * **VAT:** collect tax at each stage of production, and retailer only has to pay the difference between tax collected and tax paid at the previous level. Reduces incentive to cheat and is self-enforcing. And then calculate consumption by taking income – savings (solves progressive taxation problem).
        + Ideal Tax rate? (see notes). Basically results in bell curve of taxation b/c of the trade-off between increasing revenue and decreasing incentives to earn income. The further you go along, the incentives still increase, but you’re remaining benefit (on everyone that earns more) decreases.

1. **#DEDUCTIONS**

**§ 262:** There is *no* general deduction for personal, living, or family expenses.

* **General Rule:** Courts often state that deduction should be ***narrowly construed*** 🡪 “an income tax deduction is a matter of legislative grace and the burden of clearly showing the right to the claimed deduction is on the taxpayer.”
* **Why deductions?** 
  + (1) Direct Activity
  + (2) Try to identify “real income.”
* **Deductions v. Credits**
  + **Deductions:** Reduces your tax base at the amount of the deduction.
  + **Credit:** Reduces the *amount of tax* you pay.
    - E.g. 20% tax. Income: $100k. $10k deduction 🡪 $18k taxes = $72k remaining. $2k credit 🡪 $18k taxes = $72k remaining.
  + They’re different b/c deductions are same for ALL ***tax rates*** (ends up being like subsidy for wealthy—higher rates = higher subsidy b/c value of subsidy is value of the rate). Credits are differentat ***different tax rates***.
* **Deduction v. Exclusion** 
  + Different b/c there are *limits on deductions* 🡪 e.g. deductions can’t exceed more than 5% of income (drives a wedge between deductions and exclusions). Typically aren’t limits on exclusions, and not generally enumerated.
  + Also, exclusions are NOT reported (based on the idea that some forms of income are not “income,” while deductions are “income” that should not taxed b/c of how $$ is spent.)
* E.g. Domestic Production Deduction (DPD) – deduction that used to be a credit for exports, but WTO held it illegal.
  + 199 – can deduct up to 9% of domestic production activity (anything that is manufactured in U.S.). In effect, the real only exceptions are retail sales.
  + If 9% is deductible, and tax rate is 35%, then on that class of activities 🡪 tax rate reduced to 31.5%

**A. Profit-Seeking Expenditures**

**[“#Ordinary And Necessary” Business Expenses]**

* Case law is about negotiation ***boundaries***:
  + [Deductible Business Expenses] **§ 162:** all the **“ordinary and necessary”** ***expenses*** paid or incurred during taxable year, including
    - (1) a **reasonable allowance** for salaries or other comp for personal services actually rendered;
    - (2) **traveling expenses** (including meals/lodging other than lavish/extravagant amounts) while *away from home* in the pursuit of trade/business.
    - (3) **rentals/other payments** required to be made for continued use/possession of property to which taxpayer has not taken title or in which he has no equity.
  + [Deductible Individual Expenses for Production of Income] **§ 212:** all the **“ordinary and necessary” *expenses*** paid/incurred during taxable year
    - (1) for the **production/collection** of income;
    - (2) for **management/maintenance/conservation of property** held for the production of income;
    - (3) in connection with the **determination, collection or refund** of any tax.
      * E.g. managing investment portfolio, repairs on rental property, coin-collecting. Any expenses to produce income that doesn’t rise to the level of a business.
  + [ND Individual] **§ 262:** No deduction shall be allowed for personal, living, or family expenses.
    - NEVER deductible.
  + [ND Business] **§ 263 Capital expenditures:** No deduction for [long-term expenses…sort of]
    - New buildings or permanent improvements or betterments made to increase the value of any property or estate. Not applicable to…(bunch of exceptions).
      * CAN deduct in deprecation expense.
* [Necessary, But Not Ordinary] *Welch v. Helvering* (Welch paid debts of bankrupt company in order to improve his reputation and credit standing. Issue: deductible from income?)
  + **No.** Court should be *slow to override* what individuals think is “necessary,” (***wide latitude for first prong***) but this expense is NOT “ordinary” 🡪 investment in capital expenditures, an outlay for the development of reputation and good will (§ 263). Ordinary does NOT mean that payments must be habitual or normal in the sense that the same taxpayer will make them often (e.g. one-time lawyer fees). **Ordinary = expense for a particular purpose is common and accepted** (unique for individual, but not for community).
    - **“Necessary”** does NOT mean essential, but appropriate and helpful for business.
  + If payer incurs expense due to a moral obligation, then no deduction. *Friedman v. Delaney*
* [Not Connected, So Not Ordinary] *Gilliam v. Commissioner* (Professor flew to Memphis for teaching gig; got kicked off plan b/c he acted bizarrely and tried to deduct associated legal fees as business expense.)
  + NOT ordinary expenses (§ 262). “**Ordinary** has the connotation of ***normal, usual, or customary***. To be sure, an expense may be ordinary though it happen but once in a taxpayer’s lifetime. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved *(business specific*). One of the extremely relevant circumstances is the ***nature and scope*** of the particular business out of which the expense in question accrued.”
    - **NOT** ordinary for people in such trades or business to be involved in altercations on airplanes. Altercation and legal fees did not further Gilliam’s trades or business.
* [Example]
  + Google 3-year server farm. (see notes). 🡪 **Inefficiency**. B/c of capitalization, Google won’t invest in the server farm.
* [#Salary] *Exacto Spring Corp v. Commissioner* (Exacto paid it’s CEO, cofounder, and principle owner $1.3m and $1m in ’93 and ’94 [and deducted it as business expense]. IRS thought this excessive and Tax Court found the maximum reasonable compensation would be $900k and $700k. Issue: reasonable compensation?)
  + **Yes.** ***Indirect market test*** 🡪 ratio between CEO salary and corporations rate of return. Higher the ration, the harder to prove she is overpaid. If RoR higher than expected, salary is presumptively reasonable. AND salary was *approved by shareholders*.
    - Underlying problem: disguising dividends as compensation. CEO was BOTH owner and manager. Problem occurs in any small business. Can get $$ by (1) salary (***deductible***) or (2) dividend (***NOT deductible***) 🡪 incentive to funnel $$ into “salary.”
    - **Posner:** Indirect market test is market-based, easy to measure, and tied to CEO purpose.
  + **Problems:** what is a reasonable return? How are you to measure return? 🡪 market fluxuates, so any one year is problematic.
  + **§ 162(m):** [third way to solve problem]. No deduction for salaries about $1m in publicly held corporations.
    - (4) Exception for **commission basis** compensation 🡪 ***stock options*** or bonuses based on company earnings. (162m correlated to rise in CEO pay in ‘90’s).
* [Expenses Contrary To Public Policy] *Commissioner v. Tellier* (Tellier deducted legal expenses for unsuccessfully defending a fraud allegation. Issue: “ordinary and necessary”?)
  + **Deductible**. Federal income tax is a tax on income, NOT a sanction against wrongdoing. Not allowed ***only*** where the allowance of a deduction would “frustrate sharply defined national or state policies proscribing particular forms of conduct.” Further the “policies frustrated must be national or state policies evidenced by some *governmental* declaration of them.” Finally, the “test of nondeductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.” Present case falls outside this rule. No PP is offended when man hires lawyer to defend criminal allegations 🡪 basic right of criminal.
    - Deductions may be allowed by specific legislation 🡪 deductions are “matter of grace.” Would amplify penalty of certain actions.
  + MD: *Tellier* basically saying “be cautious about making public policy decisions with income taxation.”
* [#Fines And Penalties]
  + **§ 162(f):** No deduction for *any fine or similar penalty* paid to government for violation of any law.
  + Fines for overweight trucks were NOT “ordinary and necessary” b/c they would undermine state weight limit policy. *Tank Truck v. Commissioner*
* [#Lobbying]
  + **§ 167(e):** No deduction for
    - (A) influencing legislation,
    - (B) participation in, or intervention in, any political campaign,
    - (C) any attempt to influence the general public with respect to elections/referendums/legislative matters, or
    - (D) any direct communication with a covered executive branch official in an attempt to influence official action.
      * BUT expenses for local lobbying ***are*** deductible.
  + MD: Examples of tax code becoming non-neutral; ***deviation from neutrality***. Removing incentive or penalizing? 🡪 negative tax expenditure (raising $$ through the tax code).

**[#Capital Expenditures]**

* [Thinking About Tax Deferral]E.g. YR0: -250; YR5: 750; 40% tax rate; 50% return.
  + **Interest Free Loan:** If capitalize and delay deduction 🡪 **30% return**. (250 gain, minus 100 in tax).
  + **Tax Forgiveness:** Expense immediately and deduct 🡪 $200 in tax savings. YR0: -300 YR5: 450 (750 – 300 in tax). 50% return on investment. *Equivalent to exempting amount from tax* BUT amounts are different.
  + **Immediate Deduction—Yield Exemption Equivalence:** Gross up initial investment and immediately deduct 🡪 YR0: -833 investment + 333 tax = -500 YR5: 1,250 return – 500 tax = 750. **50% return**. *Essentially not taxing returns*.
* **#Expensing:** immediately deducting full amount.
* **Capitalization:** spreading deduction over a period of time.
* [Capitalize Or Expense?]
  + Certain categories are routinely ***capitalized*** 🡪 expenditures to purchase an asset, including financial assets, such as stocks/bonds, real estate, tangible personal property, such as machinery and equipment, and intangible assets, such as contracts and patents. Also includes costs of constructing an asset (building). Also, costs incurred in raising capital by issuing debt or stock or reorganizing or costs of entering new trade/business.
  + **General idea:** expenditures that produce income *beyond the current taxable year* = capitalized.
    - Can be tricky, so courts ask whether the *immediate or long-term benefits* dominate. Also weight the admin costs of capitalization vs. expensing.
    - Courts are also more willing to allow deduction of recurring rather than nonrecurring expenditures.
* [Origin Of Claim] *Woodward v. Commissioner* (Shareholders voted to indefinitely extend charter; minority shareholder dissented, which triggered the majority needing to buyout the minority share. Litigation ensued to determine share price. Majority deducted legal expense, claiming they were “ordinary and necessary expenses paid for the management, conservation, or maintenance of property held from the production of income.” IRS said they were capital expenditures associated with acquiring stock.)
  + **Capital expenditures**. ***All acquisition or disposition costs should be capitalized***, including brokerage, legal, accounting fees and similar costs. **Rule**: whether the ***origin of the claim*** is in the process of the acquisition/disposition itself. NOT based on “purpose.”
    - Long recognized that acquisition/disposition costs are capitalized.
    - Transaction costs do NOT include in-house employee compensation.
* [Future Benefit] *INDOPCO Inc. Commissioner* (National Starch was target of friendly acquisition and incurred significant investment banking and legal fees which it sought to deduct as expense)
  + **Capital expenditure**. ***Future benefit*** is important in determining whether or not to capitalize. Need not be creating a separate and distinct asset (rule for some courts prior to INDOPCO).
  + MD: Can quickly get into a world where *everything* arguably has future benefits (e.g. salaries, advertising) and thus needs to be capitalized. **Post-INDOPCO problem:** loose language suggests there is a ***presumption*** of capitalization.
* [Overrule (?) INDOPCO] **§ 263:** In the absence of a ***separate and distinct asset***, capitalization is NOT required unless the type of asset is listed in the regulation.
  + **Separate and distinct asset** means “a property interest of ascertainable and measurable value in money’s worth that is subject to protection under applicable law and the possession and control of which is intrinsically capable of being sold, transferred or pledged…separate and apart form a trade or business.”
    - E.g. advertising and in-house costs are considered expenses even though have future benefit. MD: mostly for administrative reasons. But this does raise a distinction between “outside” v. “internal” expenditures (see notes p.292-293).
* **Revenue Ruling 2001-4** (#airplane maintenance)
  + ***“Just maintain”*** and has ***“not materially gained in value or useful life”*** [keeping it in *ordinarily efficient operating condition*]🡪 DEDUCT.
    - MD: does this make any sense? How you can do maintenance without adding value or extending life? Some notion of original expectation.
  + ***“Capital improvements”*** that replace, alter, improve, or add that ***appreciably prolong*** the life of the property, ***materially increase its value***, or make it ***adaptable to different use*** *🡪* CAPITLIZATION.
* [Exceptions]
  + **§ 179:** taxpayer may elect to expense, with $$ limitations 🡪 *part of stimulus that targets small business* (encourage investment).
    - **(b)** Limitations. **Targets small business**, caps by time and size. MD: creates problem with acceleration or postponing investments when windows come back.
  + **§ 263:** Capital expenditures don’t apply to mines, R&D, soil/water conservation, fertilizer, removing barriers for elderly/handicaps, etc.
  + **§ 263A:** Exception for post-INDOPCO world 🡪 *non-deductible* (capitalize) for labor that goes into real/tangible property and production of goods for sale = **inventory production costs**. E.g. macbook air moving down the production line. Recover expenses when goods are sold (included in COGS). This includes costs of repairing machinery.
    - (h) Exempts capitalization for **authors, photographers, and artists**. Why? Like R&D, it is underprovided. Or it is too cumbersome to calculate capitalization.
  + MD: every time we provide exceptions to encourage investment, we are moving away from strict income tax system and move towards a consumption tax.

**[CAPITAL RECOVERY PROVISIONS]**

* [#Losses] – **general problem 🡪** give incentive to manufacture losses.
  + **§ 165:** loss = change in wealth. Two problems: (1) when is the loss realized? 🡪 must be *sold, exchanged, or disposed*; (2) manufactured losses 🡪 (i) swap assets with family members/related parties (*Fender*; **§ 267**); (ii) sell and buy right back (**§ 1091**)
    - Can solve problem by basketing losses within certain categories, e.g. gambling. Or think about losses in terms of trade/business v. personal (**§ 165(c)** 🡪 don’t want ppl to mix and match ordinary losses and capital losses. Why? Ordinary tax rates are higher, so you want to count capital losses as ordinary losses.).
    - (b) **Amount of Loss**. Amount of loss is the *adjusted basis of the property* and must be offset by insurance.
    - (c) **Personal Losses.** Losses limited to those incurred in trade/business or for-profit transactions or arising from fire, storm, shipwreck, “other casualty,” or theft.
    - (g) **Worthless Securities**. If any security that is capital asset becomes worthless, loss shall be treated as one that is from “sale or exchange.” **Worthless** is *objective* 🡪 when they actually become worthless, NOT when taxpayer thinks they’re worthless.
  + **§ 267:** Disallows loss in self-dealing relationships (laundry list in (b)). Prevents you from claiming losses you still maintain constructive control.
    - Get to keep that value of loss for some future realization event.
    - (b) Relationships: family members, any entity where person owns more than 50% of outstanding stock, a grantor and fiduciary of trust, etc.
    - E.g. see notes. **(d)** does not apply to losses (e.g. father sells to daughter, ignore loss. Daughter then sells on market, and only gets loss directly from sale, not including loss from father to daughter). For *gains* 🡪 basis is the value the father bought asset. Also disallowed loss when father sold to daughter.
  + **§ 1091:** Have to wait 30 days before you can buy back. Prevents ppl from gain $$ from loss if they still want to maintain asset (e.g. still believe in stock).
    - Loss is gone forever.
    - What is basis at rebuy? **(d)**
  + **§ 1211(b):** Losses from sales/exchanges of capital assets are allowed *only to the extent* of capital gains. $3k limit.
  + [Change In Legal Rights] *Cottage Savings Ass’n v. Commissioner* (Cottage wants to deduct lost in value of mortages. Swapped similar assets with another company. IRS argued losses were not realized, just switched apples for apples. Issue: was swap a “disposition of property”)
    - **Yes.** IRS argues to think about “materially different” only if they differ in economic substance. **§ 1001(a)** is much less demanding 🡪 properties are “material different” so long as their respective possessors enjoy ***legal entitlements that are different in kind or extent***.
      * IRS argument: no realization if you have substantially similar thing at the end of the day. Counter: how do you pin down “economic substance.”
      * Marshall pros: easier to discern/force “legal entitlements” standard (e.g. different homes are different legal rights). Problems: is every dinky change in legal rights going to be associated with a realization event? Can lead to sham transactions.
  + [“Bona Fide” Loss] *Fender* *v. U.S.* (F tried to get around **§** 267 50% rule and **§ 1091** 30-day timeline. Court comes up with broader notion of “loss.”)
    - NOT a genuine or “bona fide” loss. ***Substance and not mere form governs***.Taxpayer never was exposed to substantial risk that bonds would not be able to be repurchased. Court needs to think substantially about risk exposure.
* [#Bad Debt] – ppl try to structure investments so losses are ordinary (not capital), and if you have gains, they’re capital (and not ordinary). See notes.
  + **§ 166:** Bad business debt (acquired/created as part of trade/business) is deductible in full as an ordinary loss, and a partially worthless business debt can be deducted to the extent charged off by the taxpayer on his books.
    - Worthless *nonbusiness* bad debt can only be deducted as a short-term capital loss (3k limit under **§ 1211**), and partially worthless nonbusiness debt *cannot* be deducted.
    - ***Dominant motivation*** for the bad debt must be business-related. *U.S. v. Generes*
    - ***Investment-related*** debts are NOT “business debt.”
* [#Depreciation] – trying to capture some notion of net income. How to account for decrease in value of asset over time. We can’t do it perfectly, so we do approximations. Need to decide (1) Method; (2) Lifetime; (3) Salvage value.

**§ 167 Depreciation:** There shall be allowed as a deduction a reasonable allowance for exhaustion, wear and tear (1) of property used in the trade/business, or (2) of property held for the production of income.

* + **MACRS:** depreciation schedules based on category of asset—applies to tangible personal and real property.
  + **Intangibles** 🡪 straight-line deprecation over 15 years (**§ 197**)
  + **§ 168:** uses MACRS and year amount based on asset category.
    - For *salvage value* (amount taxpayer expects to recover when he stops using asset) 🡪 don’t worry about it. Assume its zero. Advantage to taxpayer.
      * **What happens when you sell asset?** Treat difference between depreciated basis and resell value as ordinary gain *up to original basis* 🡪 then anything above is capital gain = **recapture**.
      * Salvage value at zero b/c of time value of money. We recapture the gain, but you get to deduct more, earlier.
    - *Method* 🡪 up front steep depreciation (“200 percent declining balance method”) and then switch to straight-line method once you *earn more money*.
      * E.g. 100k; 5-year life.
        + Yr 1: 40k (20k [1/5 of 100k] x 2 🡪 **double declining method**) = 60k
        + Yr 2: 24k (**DD**)/15k (**SL**) = 36k (went with DD)
        + Yr 3: 14,100/12k = 21,600 (went with DD)
        + Yr 4: 8,600/10,300 = 10,800. (went with SL)
  + **§ 179:** permits taxpayer to deduct immediately $25k of the cost of certain tangible business property.
    - Often used as a stimulus, aimed at small business, as raised to $500k as part of stimulus package.
* [#Depletion] – trying to match to underlying value, and value is not necessarily linked to time (e.g. if you let mine sit, it’s arguably worth the same now as in 5 years).

**§ 263(c):** “Intangible drilling” and development costs in the case of *oil and gas wells* can be deducted (*expensed*) instead of capitalized in the year that they are made.

**§ 611:** Taxpayers can take a depletion deduction for depletion in case of *mines, oil and gas wells, other natural deposits, and timber*.

* + **Cost depletion:** estimates the total amount of natural resource in the property and allows deduction of its cost in proportion to each year’s extractions. E.g. $100k for 100k tons 🡪 deduct $1 for every ton.
    - Problem: have to agree on how much is in the land.
  + **Percentage depletion:** allows the deduction of a specified percentage of the gross income from the property year after year w/o regard to the recovery of cost. Used for *mines, wells, and other natural deposits* (**§ 613**).
    - Solves problem of estimating amount of resources.
    - Permits a taxpayer to *deduct more than the actual cost* 🡪 subsidy for activities to which it applies (stimulus to natural resource exploration and development). E.g Uranium 🡪 22%.
      * Solution? Allow deduction until you earn back basis. OR use **negative basis** 🡪 count as capital gain when asset is sold.
    - E.g. Buy land for 20k; earn 50k/year for 10 years, then sold for 4k.
      * Real world gain: 484k (-20k + 500k + 4k)
      * Tax world gain: 404k (500k – 100k + 4k)

**B. The Business/Personal #Borderline**

**[In General]**

* If we allowed personal expense to be deductible, what would be left? *Only savings*. If don’t deduct business expenses 🡪 end up taxing *gross business income*. Some business expenses have little or no personal connection, but most personal expenses can be linked, at least tenuously, to business (e.g. morning coffee helps employees be focused). Unwarranted business deduction would permit taxpayers taxpayers to finance personal consumption with pre-tax dollars. ***How to draw line?***
  + **Underlying motivation/benefits**
  + **Allocating expenses as percentage/Fraction** (274n)
  + **Categorical distinction** (e.g. commuting, child care)
  + **Line drawing tests** (*Pesner* 🡪 clothing useful in other settings?)
* [#Clothing Expenses] *Pevsner v. Commissioner* (Taxpayer was manager at clothing boutique and expected to wear store clothing at work. Clothes were suitable for general purpose, but T stated she did NOT wear clothes outside work. Issue: deductible ordinary and necessary business expense?)
  + **No.** Rule for clothing expenses is that cost is deductible as business expense *only* if: (1) the clothing is of a type ***specifically required*** as a condition of employment, (2) it is NOT adaptable to ***general usage*** as ordinary clothing, and (3) it is not so worn. (2) is an ***objective*** test (“*what is generally accepted*”) 🡪 T lifestyle/personal taste are irrelevant.
* **The Inherently Personal Standard.** Some expenses are so “*inherently personal*” that courts disallow deductions.
  + Payments by a businessman to a minister for business and personal advice based on prayer.(*Trebilcock*)
  + Cost of athletic equipment CPA bought to build up stamina needed for tax practice. (*Kelly*)
* [#Child Care] – Policy rationales? (1) Allows single parents/women to enter workforce; (2) Encourage ppl to have kids 🡪 societal stability, balanced demographic; (3) Child are norm, NOT base case (so not personal decision). Courts have found that having a child is “inherently personal” and therefore NOT a deductible expense. However, there are the following:
  + **§ 21:** *credit* (ignores tax rates) for childcare services based on phased out percentage based on income (though stops phasing out at 20%). Maximum for two or more dependents is **$6k** (**$3k** for one dependent).
    - “Applicable percentage” = 35% reduced 1 percentage point for each $2k by which taxpayer’s adjusted gross income for the taxable year exceeds $15k. $6k for couples.
    - E.g. 15k – 35%, 6k, 2,100; 35k – 25%, 6k, 1,500; 500k – 20%, 6k, 1,200.
    - Problem: disincentive ppl to earn more money?
  + **§ 129:** *exclusion* up to **$5k** (better for higher income earners and not limited by income or subject to deduction caps)of income for employees if use employer-administered care plan. Flexible spending account. NOT employer provided care. But a plan sponsored by the employer.
    - Higher income earners like **§ 129**.

**[#Travel And Moving Expenses]** – key is ***“away from home”*** (does not include any trip NOT requiring “sleep or rest”).

**§ 162(a) Trade or business expenses:** Deduction allowed for all ordinary and necessary trade/business expenses paid/incurred…including (2) *travel expenses* (including meals/lodging other than amounts which are lavish/extravagant under circumstances) while away from home.

* **Commuting.** Commuting is NOT deductible (categorical restriction). Personal decision where you live, and work location is fixed.
  + However, transportation expenses (air fare, taxi, cost of car) generally deductible when *traveling on business* (e.g. traveling from one city to another or cab from law firm to courthouse).
  + Exception to commuting rule for “additional expenses that may at times be incurred for transporting job-required tools and material to and from work.” (*Fausner*)
  + Commuting expenses ARE deductible if traveling to temporary work location *outside* the metro area wherever taxpayer lives/works.
  + If employer pays for an employee’s commuting expenses 🡪 payments constitute gross income.
* **§ 217 #Moving Expenses:** Deduction for reasonable expenses of moving personal goods and traveling (no meals) if:
  + Move more than 50 miles from former principal place of business or, if NONE, residence.
  + Work a job for at least 39 weeks at employer in next yr OR 78 weeks in next 2 yrs (latter includes self-employment).
  + ALL moving expenses deductible under § 217 provided move 50 miles AND have some sort of job on the other end. Doesn’t matter who pays (employer reimbursement or you personally).
* [Away From Home] *Hantzis v. Commissioner* (HLS student tried to deduct NY summer expenses while working at a law firm b/c husband stayed in Boston. Issue: “away from home” in “pursuit of trade/business”?)
  + **No.** Only a taxpayer who lives one place, works another and has business ties to ***both*** is in the ambiguous situation that the temporary employment doctrine is designed to resolve. *Trade or business*did NOT require P to maintain home in Boston. Visits were all for personal reasons (no business justification).
    - **“Home”** is *principle place of business.* Where you are rooted for income producing.
  + ***Temporary vs. Indefinite*** – **§ 162(a)** provides that the taxpayer is not treated as being temporarily away from home if the period of employment exceeds one year.
  + If taxpayer has no home, there is no deduction. (*Wirth*)
  + ***Mixed Personal-Business Trips*** – If trip is for mixed business/personal reasons, travel costs are deductible *only* if the trip is ***primary*** for business purposes. Relative amount of time spent on business matters is important, but not determinative.

**[#Entertainment]**

* **§ 274:** No deduction allowed unless it is ***“directly related”*** or, in case of an item directly preceding/following a ***“substantial and bona fide business discussion*** (including business meetings at convention)” and “associated with the active conduct of the taxpayer’s trade or business.”
  + **(a)(3) Membership dues** are NOT deductible.
  + **(h)** If **convention, seminar, or similar meeting** is held *outside North America area*, no deduction allowed unless established that meeting is “directly related” and reasonable for the meeting to be held there. Gov takes into account purpose, activities, residences of attendees, and “other relevant factors.”
  + **(k)** For **business meals**, need to be not lavish or extravagant, and the taxpayer needs to be present.
  + **(n)** Only 50% of expenses are deductible. BUT if de minimis food/beverages 🡪 employer can deduct 100% (n)(2)(B).
* [Regular Co-Worker Lunches] *Moss v. Commissioner* (Chicago law firm paid for daily business lunch. Moss deducted his share of lunch as “ordinary and necessary” business expenses. Issue: are meals deductible?)
  + **No.** Lunches were personal. If personal living expense is to qualify under **§ 162**, taxpayer must show that it was “different form or in excess of that which would have been made for personal purposes.” **Daily meals** are an ***inherently personal expense***, and taxpayer bears heavy burden in proving they are routinely deductible. Has to be an *unusual and unique expense*.
    - Mere fact that work time is given over the noon hour does not covert the cost of daily mails into a business expense.
  + *The Client’s Meal.* Legislative history indicates that a business meal is “directly related” to the active conduct of trade/business if (1) taxpayer has more than a general expectation of deriving income or specific business benefit; (2) the taxpayer engaged in business discussions during or directly before or after the meal or entertainment; AND (3) the principal reason for the expense was the active conduct of the taxpayer’s trade/business.
    - Taxpayer *can* deduct reasonable cost of his own meal when eating with a client.

**[#Home Office Expenses]**

* **§ 280A:** NO deduction allowed for a “home office.” Exceptions…
  + **(c)(1):** Deduction allowed if item is allocable to a portion of the dwelling unit which is exclusively used on a regular basis—
    - **(A)** as the *principle place of business* (used exclusively and regularly for *substantial admin/management activities*);
    - **(B)** as a place of business which is used by *patients, clients, or customers*; or
    - **(C)** in case of a *separate structure* which is NOT attached to the dwelling unit.
  + Does NOT apply if TP is an employee unless it is maintained for the convenience of the employer.
* *Popov v. Commissioner* (Popov was a professional violinist who practiced in living room of 1-bedroom apartment. Claims its for her exclusive use [claimed daughter was not allowed to play in room]. Issue: deductible?)
  + **Yes. Two primary considerations:** (1) the ***relative importance*** of the activities performed at each business location and (2) ***time spent*** at each place. Here, (1) is inconclusive, but (2) falls in P’s favor 🡪 deduction allowed. Space was exclusively used as her principal place of business.
    - MD: really hard to shoehorn your way into **§ 280A**.

**[#Gambling Losses And #Hobby Expenses]**

* **§ 165(d):** wagering losses are deductible *only* to the extent of gains.
  + MD: ppl will argue that gambling is trade or business (games of skill). Mixed success in courts. Professional gambler engages in **“trade or business”** if “involved in continuity and regularity” and with the primary purpose of earning income or profit (*Groetzinger*).
  + Most frequently litigated issue is adequacy of taxpayer’s proof of losses. Gamblers who have inadequate records try to rely on the *Cohan* rule which permits a deduction based on estimates where the court believes that an expense actually was undertaken.
* **§ 183:** If activity is engaged in *not for profit* 🡪 no deduction.
  + **(d) Presumption.** Look back at last 5 years, and if there is gain from 3 of those years, presumed to be *for profit*.
* [Hobby For Profit] *Storey v. Commissioner* (Storey, a law firm partner, made a documentary about husband’s band. Issue: primary motive pleasure or profit?)
  + Need to decide *which motivation is dominant*.**Nine factor test:** (1) manner in which the taxpayer carried on the activity, (2) the expertise of the taxpayer of his advisers, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that the assets used in the activity may *appreciate in value*, (5) the success of taxpayer in carrying on other similar or dissimilar activities, (6) the taxpayer’s history of income or loss with respect to the activity, (7) the amount of occasional profits, if any, which are earned, (8) the financial status of the taxpayer, and (9) whether elements of personal pleasure or recreation are involved.
    - MD: trying to get at *underlying motivations*.

**[#Education]**

* **§ 222:** deduction for tuition and related expenses up to $4k/year (drops to $2k if over $65k income, then drops completely at $80k).
* **§ 127:** Employer-provided educational expenses are deductible up to $5,250.
* **§ 25A Hope and Lifetime Learning credits:** credit w/ limitation. Hope is partially refundable; lifetime non-refundable.
  + **(b) Hope Scholarship Credit:** Credit allowed for up to $1k in tuition for 2 taxable years (subject to phase-out).
    - **(i)** Increased to $2k fro ’08-’18.
  + **(c) Lifetime Learning Credit:** Credit equal to 20% of qualified tuition and related expenses as does not exceed $10k.
* *General Self-Improvement*. Undergrad degrees generally not deductible b/c they are minimum requirement for many businesses and contain a large element of personal consumption.
* *General Education Deduction*. Taxpayer may deduct up to $4k for college tuition and related expenses for himself, a spouse, or a dependent.
  + MR: why don’t we capitalize all this stuff? It clearly yields benefit over time. But administrative mess, and we like education?
* *Travel Expenses.* No deduction for travel as education (e.g. traveling in Europe visiting art museums to improve skills as art teacher).
* [Continuing v. Qualifying] *Wassenaar v. Commissioner* (Law student went straight into tax LLM after JD. Worked a little during law school, and tried to argue he was engaged in “analyzing and solving legal problems for compensation.” Issue: education to continue trade/business or prior to?)
  + **Not deductible**. Hadn’t passed bar so not yet engaged in practice of law. Education NOT deductible if “part of a program of study being pursued by P that will lead to qualifying him in ***new*** trade or business.” Must be established at time the educational expenses are incurred and bear ***direct and proximate relation*** to trade/business. NOT sufficient that P’s education is *helpful* in performance of performance but must be ***proximately related*** to such skills.
    - MD: discourages switching careers.
    - Expenses are incurred *prior to* beginning a trade/business are NOT deductible.

**[#Job Seeking]**

* **Revenue Ruling 75–120:** Expenses incurred in *seeking new employment* in the ***same*** trade or business ARE deductible under **§ 162** if directly connected with such trade or business as determined by all objective facts/circumstances. (NOT deductible if seeking new trade/business).
  + 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. (*Davis v. Commissioner*)
  + Vice President is a “unique position” and a new trade/business. (*Rockefeller*)

**C. Personal Deductions**

**[#Interest]**

* **§ 163:** Interest expense ***is*** deductible EXCEPT for personal interest (departure from what we used to do).
  + ***Business Interest***. Cost of doing business and is thus deductible like any other business expense.
  + ***Investment Interest***. Deduction of interest allocable to investment property is limited to **net investment income** 🡪 total investment income less investment expenses. (called **basketing**)
    - **Basketing:** matching investment interest deduction with investment income (interest isolated to investment gain). Prevents taxpayer from claiming ordinary gain interest.
      * Problem investment basketing fixes 🡪 mismatch between cap gains and interest deduction AND you get to take deductions before you have to pay interest on gains.
    - Distinction between business or investment interest is important b/c business interest is *fully deductible* and interest deduction is *limited* to the amount of investment income.
  + ***Personal Interest***. NOT deductible. Defined as interest that is not (a) business interest, (b) investment interest, (c) passive activity interest, (d) “qualified residence interest”, or (3) certain deferred estate tax payments.
  + ***Home Mortgage Interest***. Deductible, and major exception to personal interest disallowance. Not deductible for loans above $1m.
    - MD: really widespread tax incentive worth a lot for $$$.
* **§ 221** **Interest on educational loans:** capped at $2,500 and phased out.
  + (b)(2) $2,500 is reduced by (AGI over $50k / $15k) x $2,500.
  + \*\*Need to know *why* we have phase-outs and the *costs* of a phase out.
* **Tax Arbitrage (§ 265):** Says cannot deduct interest from debt that is used to invest in tax-exempt instruments. Trying to prevent transactions with no economic justification other than avoid taxes (pre-tax economic impact is negative, but post-tax impact is positive). E.g. borrow at 8%, buy corporate bond @ 6%. Doesn’t look economically sound, but after tax (deduct interest at 8%) makes $$. After tax rate on loaned $$ is really 4.8%. Tax arbitrage is inefficient.
  + MD: is this good policy? Allowing these transaction would increase demand for state/local bonds, which result in windfall for highest tax bracket (b/c state bond would have to be priced at lower-income tax bracket payers).
  + In corporate setting, expensing is tantamount to 0% tax rate on that asset. If you can borrow and deduct interest, then there is an effective *negative tax rate* on asset. BUT if disallowed interest deduction, you would create non-neutrality between rich corporations and poor corporations. The **original sin** is the imputed income, interest free bond, and expensing option.
    - Trying to take a lot of things that look inappropriate and fix with disallowing interest deductions. MD: original sin was how you treated asset, not how financing works. Makes you think hard about debt. Two views: (1) borrowing is dodgy, opportunistic (interest deduction disallowance a lot about this); (2) debt is fundamentally democratizing and fabulous 🡪 poor ppl are put on level playing field with rich people (*should* provide interest deduction). This makes thing look anomalous, like *Knetsch*, but problem is with underlying asset, not with financing.
    - There would be no tax arbitrage if there were no tax-favored assets.
* [Economic Substance] *Knetsch v. United States* (K buys $4m worth of annuity savings bond @ 2.5% for $4.004m @ 3.5%. Paid with $4k in cash and $4m loan note [secured by policy, so they could take $4m bond back]. K pre-paid interest of K $140k. K then gets $99k of future value of the bond. K then pays another payment interest of $3,465. K then deducted the two interest payments from taxable year. Does it again in year 2. Issue: can K deduct interest?)
  + Loan is a ***sham*** (simply a façade) 🡪 cannot deduct. NO ***commercial economic substance*** to the transaction.K’s transaction did “not appreciably affect his beneficial interest except to reduce his tax.” (Effectively only getting $43/month).
    - Insurance is up $90k, but K’s value of his interest is tax rate x interest. If K has tax rate > ~30%, then worth it.
  + **§ 7701:** Transaction shall be treated as having **economic substance** only if
    - (A) the transaction changes in a *meaningful way* (apart from Fed income tax effects) the taxpayer’s economic position, and
    - (B) the taxpayer has *substantial purpose* (apart from tax effects) for entering into such transactions. (Have to do it for profits)
      * MD: this provision helped fund ACA.

**[#Taxes]**

* **§ 164(a):** Permits deductions for tax payments to ***state and local governments*** (both real and property taxes).
  + For personal property, the tax must be (1) based on the value of the property, (2) imposed on an annual basis, and (3) must be on personal property.
  + For many taxpayers, deduction for state and local income taxes is their largest deduction.
  + MD: under what theory is this right? It’s *double taxation*! Unfair. Response: but we’re getting different services at state and fed level. Or, we’re trying to find out *net income* 🡪 it’s a cost, so NOT part of income. Response: it’s not a cost, but consumption (mere purchase of a service) 🡪 you get benefits from public services, which is “income” to you.
    - MD: by granting deduction (which we do), we’re basically saying it’s a cost, and the taxes are worthless (so not income). Creates a whole bunch of *distortions* 🡪 incentive for state/local gov. to overtax (raise taxes). And services are provided that wouldn’t be otherwise. Basically, when a state raises taxes, part of that burden is placed on fed gov = out of state taxpayers (**“tax exporting”**).
    - Deductions benefits itemizers 🡪 primarily higher income folks. State/local deduction, 75% goes to ppl who make >75k.
  + MD: why don’t we deduct federal taxation? Spiral into no taxes? Like *Old Colony*, it would frame fed taxes as tax-inclusive or tax-exclusive.
    - Ultimately, it’s a ***transfer to the states***. Part of our federalism. We do (1) block grants; (2) tax free state/local bonds; and (3) deduct state/local taxes.
    - Disproportionately benefits ppl wou live in areas that provide a lot of services (rich, coastal states).
* **International Tax:** Income taxes of a foreign country, subject to certain limitations, may be allowed as a ***credit*** against domestic income tax liability INSTEAD of deduction. **§ 163(b)(3)** 🡪 foreign income is taxed at the *higher of the foreign or domestic rate*.Original options:
  + (1) Worldwide system v. territorial system. (we do former)
  + (2) How to provide relief of WW system? Deduction v. credit. (we do latter)
  + (3) Unlimited credit—reimbursement for higher foreign rates v. limited credit. (we don’t do former—would be subsidizing foreign countries)
  + (4) Deferral. When do we tax? Should be same fiscal year, but we tax *when you bring $$ back* 🡪 deferral (valuable). Leads to corp holding $$$ off shore and weird capital allocation.
    - Most other countries don’t have this system 🡪 **inversion**. Couple years ago said sham transaction, so corp stopped doing **merger inversions**.

**[#Casualty Losses]**

* **§ 165(c)(3):** allows deductions for personal losses arising form “fire, storm, shipwreck, or other casualty, or from theft” NOT compensated by insurance or otherwise.
  + Minimum loss of $100.
  + Limited to the amount that exceed 10% AGI, and only on itemized (only large and uninsured losses are deductible).
  + Reduced by insurance or any other recovery. Also not recoverable if taxpayer fails to file insurance claim.
  + Courts have said that “other casualty” losses are only losses that are ***sudden*** AND ***unforeseen***. (E.g. allowed casualty when diamond ring was lost due to “fairly strong blow” on one side of ring.)
    - “Sudden” – don’t want normal wear/tear becoming deductible.
      * Necessary, but not sufficient. Mere decline in value is NOT enough if no physical damage (e.g. O.J. Simpsons neighborhood declines in value).
      * E.g. can turn on how quickly termites works.
    - “Unforeseen” – might have *opportunity to mitigate impact*?
      * E.g. advanced warning that animals might behave in certain manner precludes deduction, like squirrels. Same for slow-moving pests (rats, carpet beetles).
      * E.g. damage due to heavy rainfall not deductible b/c t was foreseeable weather condition.
    - MD: dilute incentive to get insurance? Fed becomes co-insurer (limiting losses) 🡪 fix this by making insurance premium deductible.
  + *Public Policy Limitation.* Entitled to deduction if casualty results from negligence, but NOT if it is *intentional or gross negligence*.
  + *Theft Losses.* Deductible in the year of discovery*.*
* **Valuation of Loss.** Limited to the *lesser* of the fair market value before the casualty minus the fair market value after the casualty or the property’s adjusted basis. Why? Never realized gain.
  + E.g. Car is destroyed. Paid $20k for car, but work $8k 🡪 deductible loss is $8k (remaining $12k is viewed as consumption).
  + E.g. Painting stolen. Worth $75k and purchased for $30k 🡪 deductible loss is $30k (remaining $45k represents untaxed appreciation).

**[#Medical Expenses]**

* **§ 213:** allows deduction for medical/dental expenses during taxable year for taxpayer, spouse, and dependents.
  + Deductible only if they are NOT compensated by insurance or reimbursed by employers.
    - Critical pieces of private insurance: (1) Premium; (2) Deductible; (3) Copay.
    - **§** **213:** (1) no premium; (2) deductible = 10% above AGI; (3) copay is 1-tax rate (e.g. if tax rate is 40%, your copay is 60% of costs). As insurance policy, you will try to consume not a lot and be price sensitive b/c of copay. But it gets weird with employer-provided healthcare deduction 🡪 incentive to get $$$ plans w/ low deductible. Health savings plan tries to reverse this, by providing incentive for high deductible plans.
  + Deductible only to extent they exceed 10% of AGI (>65 at 7.5% floor)
    - MD: gives big insurance to have *low deductible plan* b/c insurance is subsidized 🡪 leads to low price sensitivity and ppl using more healthcare than they need. Solved by HSA (health savings account)—puts incentive in for large deductible plans and, what ACA did, by taxing “Cadillac plans” (low deductible plans).
    - Also created penalties in ACA, plus a credit once insurance is purchased.
  + **(d)(1):** “**medical care**” includes amounts paid for the diagnosis, cure, mitigation, treatment, or prevention of disease, or for the purpose of affecting any structure or function of the body.
    - “Merely beneficial” to general health is NOT an expenditure of medical care.
    - Any expenditure attributable to *personal motivation* is NOT medical care (e.g. architectural or aesthetic compatibility with the related property, like an enclosed pool).
    - Must be ***essential element*** of treatment and must not be incurred for ***nonmedical reasons***. (*Jacobs v. Commissioner*) (taxpayer tried to deduct lawyer fees for divorce recommended by psychiatrist)
    - Expenses of treatment to combat alcohol and drug abuse have been held deductible.
    - Cosmetic surgery is generally not deductible and reimbursements from such surgery from an employer-funded medical plan are not excludable from gross income.
    - Transportation (and sometimes meals) *primarily for* and *essential to* medical care is deductible.
    - MD: this idea changes over time, e.g. gender-reassignment surgery.
  + **(b):** drug or medicine must be a “prescribed drug” or insulin.
  + **(d)(9):** Cosmetic surgery is generally NOT deductible. Defined as “improving patient’s appearance and does not meaningfully promote the proper function of the body or prevent or treat illness or disease.”

**[#Charitable Contributions]** – weird category b/c not taxed at *either level* (at donee [tax-exempt orgs] or at donor [deductible] level)

* **§ 170:** charitable contributions *are* deductible. This does NOT include any money given to tax-exempt orgs.
  + **(b)** limited to *50%* AGI. And corporations are limited to 10% of income.
    - (A) And NOT any tax-exempt orgs (provides list). If NOT to (A) charities 🡪 limited to 30% AGI.
    - (B) Other contributions – concerns private foundations where the worry is ppl giving to their own orgs.
  + **(e)** Basis gets *adjusted upward* for deduction (donor was never taxed on gain, and is never taxed 🡪 huge gain).
    - Tries to curb it a little by saying you can only deduct adjusted basis if it ***would have produced OI***(TP personally created property) or ***bought < 12 mo.’s ago***. And charitable foundation cannot sell it within the year.
      * If it *would have produced long-term k gains* 🡪 only deduct basis if it is tangible property and the donee’s charity use of property is unrelated to org.’s charitable purpose. If outside this rule, and long-term k gain, limited to 30% AGI.
    - Also, justified by saying that contribution wouldn’t be taxed anyway if passed onto children (step up in basis at death), so it was never going to be taxed anyway.
  + **(l)** Donor’s deduction is limited to 80% of contribution for boxes at stadiums/preferred seating tickets.
  + Cannot get charitable deduction for buying something. **Services are NOT deductible**.
  + **Problem:** to what degree were they going to give anyway? Worried about giving rich ppl windfall. W really want to know if the benefit *encourages charitable giving*. Key question: does it change behavior?
    - Ppl with highest tax rate has highest incentive to give (deductions are valuable).
* **§ 173:** get *full unrealized gain* in donating property (i.e. taxpayer deducts the fair market value of the property and not the taxpayer’s basis in property).
  + The taxpayer is not considered to have realized any gain at point of donation 🡪 gain is lost to tax system.
* *Why allow deductions?* 
  + Against: Form of consumption (get warm glow or name on University building) and therefore deduction is inappropriate. And like gifts, *someone* should be taxed. We don’t allow deduction for gifts. We *could* tax beneficiaries 🡪 problematic administratively and are low-income people. Also, very inefficient 🡪 subsidizes gifts ppl would have given anyway.
  + For: Efficiently encourages gifts. Look to *motivation* 🡪 NOT consumption or savings.
* [Quid Pro Quo] *Hernandez v. Commissioner* (Scientology payments for “auditing” were deducted as charitable giving. Issue: is this a “charitable contribution”?)
  + **No.** Congress intended to differentiate between unrequited payments to qualified recipients and payments made to such recipients in return for goods or services 🡪 ***quid pro quo***. Here, the contribution is inherently *reciprocal in nature*.
    - D argued that should be deductible because it is “purely religious” in nature. **Court punts**.
  + **O’Conner Dissent:** *singling out Scientology!* Lots of quid pro quo contributions that are allowed, e.g. pew rents, public reading rights for Jews. No way to draw line, and court never does.
  + MD: IRS effectively caves afterward and allows deduction. But quid pro quo logic is how we now think about charitable giving in a lot of contexts outside religion.
    - Gives ppl incentives to skew budgets and re-label costs as “charitable contributions.”

**[#Legal Fees]**

* **§ 212(3):** Deduction allowed “in connection with the determination, collection, or refund of any tax.”

1. **COMPUTATION OF TAX**

**A. The Tax #Rates, AGI, and Taxable Income**

Two pieces to think about:

* *(1) What are the rates?* **§ 1**.
  + If not pegged to inflation 🡪 “bracket creep” – rates go up over time.
  + E.g. 0 - $18k 🡪 10%
    - $18-74k 🡪 $1,800 + 15%
    - $74-151k 🡪 $10,313 + 25%
    - (all the way up to $465k [top bracket]) 🡪 $129,900 + 39.6%
  + Progressive? Yes, average tax rate is increasing. But not as progressive as it used to be (70-90% in ‘50’s and ‘60’s). But this doesn’t say anything about how populous each bracket is 🡪 (top bracket used to have *only John Rockefeller*; now has 10x more people). AND ignores distribution of wealth over time 🡪 the rich have seen % gains greater than average.
    - Top 1% now has a lot of people 🡪 ***loud and powerful***, which makes it hard to raise taxation.
* *(2) What does that rate apply to?* Take gross income (**§ 61)** 🡪 then take above-the-line (**§ 61a**) and get adjusted gross income (AGI) [reference point for lots of tax statutes] (**§ 62**) 🡪 then take below the line (**§ 63c,d**). But, need to then consider exemptions (**§ 151**).
  + 🡪 leads to **taxable income**. Which we then fudge by limiting exemptions/deductions.
  + **Above the line deductions** (**§ 62a**) – “above the line” b/c it helps us arrive at adjusted gross income. Tend to profit-seeking deductions (e.g. IRA, moving expenses).
  + **Below the line deductions** (**§ 63c**)– take deductions AND exemptions *after* you arrive at AGI. Tend to be more personal deductions. E.g. interest, charitable, etc. Two options: (1) *itemize* or (2) take *standard deduction*.
    - Rich, high local/state taxpayers itemize.
    - (2) Provides administrative simplicity and progressive (reduces tax base and *creates zero bracket* for earners <$12,600).
* **Personal Exemption Phase-out (PEP):** Exemptions are phased out at certain income levels (**§ 51**). Begins at ~$310k and totally phases out at ~$432k.
  + Reduce deductions by 3% x excess of AGI over some floor. Basically a stealth tax increase.
* **PEASE § 68:** Lose itemize deductions are certain income level (phasing out deductions). Aimed at below the line (*itemized*) deductions. Deductions reduced by the lesser of
  + (1) 3% of excess of AGI over applicable amount ($300k), or
  + (2) 80% of amount of the itemized deductions otherwise allowable for such taxable year.
    - E.g. AGI of $800k w/ $100k deductions. Add 3% of $500k (AGI over $300k) = $15k and add to taxable income = $715k, so taxes at 40% are $286k instead of original $280k.
  + E.g. AGI of $900k. Now only $82k of deductions. Taxable base is now $818k 🡪 taxes are $327,200.Thus, marginal tax rate is 41%.

**B. Minimum Tax on Tax Preferences**

* **Alternative Minimum Tax (AMT) § 55:** alternative tax system (in addition to regular tax, so parallel), designed to make sure rich pay their “fair share.” Sort of a check or backstop on tax system. **Tentative Minimum Tax – Regular Tax.**
  + **Tentative minimum tax:** taxable excess x 26% or 28%.
    - Taxable excess: AMTI (income w/o exemptions and deductions) – exemption amount.
  + MD: instead of creating alternative system, why don’t just get ride of deductions/exemptions?
  + E.g. 175k income (current cutoff: $83,400) w/ bunch of deductions = tax base of 100k 🡪 17k in taxes. Is this right number?
    - AMT: 175k. All deductions disallowed except charitable given and mortgage interest (20k in deductions). Do you get kids/spouse exemptions? No. = 155k tax base – 83.4k (AMT exemption amount) = 72k x 26% (deduction amount) 🡪 18,500k (tax you end up paying).
  + BUT, 83.4k reduction is phased out starting at 158k (25 cents of every extra dollar you make).

**C. Personal Tax Credits**

* **Earned Income Tax Credit (EITC) § 32** – welfare reform that “rewards work.” Eligible taxpayer receives a credit against his tax liability that is the amount of a percentage of his earned income for the year.
  + Provides ***refundable credit*** that *increases* w/ income to reward ppl making income (see notes). Benefits remain consistent at certain income level, then are phased out to avoid bad incentives with crazy high marginal tax rates (credit *increases* 🡪 then *flat* 🡪 then *decreases*). But don’t want it too phased out because it becomes crazy $$$.
    - Benefits significantly higher with at least one qualifying child.
  + E.g. make $10k. For 2 children 🡪 40%, so EITC is $4k.
    - Make $15k. Still 40%, but over statue amount (~14k, so take 40% of this, and get about $5.2k credit [maximum EITC]).
    - Make $25k. Over the phase out amount of $18k. Get $5.2k, then reduce by (phase percentage, 21% x amount you went over phase out amount [in this case, $7k] = $1,400) = $3,800.
    - Make $40k. $5.2k - $4k = $1.2k.
      * Marginal tax rate from $25k to $40k increases b/c you loose $2.6 EITC (basically a tax on the $15k in increased income).
* **Credit for Elderly/Disabled:** Individuals who are 65+ or who are permanently and totally disabled may qualify for a credit of 15% of their income up to a specified maximum (**§ 22(a)**).

1. **CHOICE OF TAXPAYER**

**A. The Taxable Unit**

**[#Marriage]**

* **Example:** Income >100k (high tax rate); 50-100k (medium); 0-50k (low)
  + A: single 100k
  + B: couple, one makes $100k, the other none.
  + C: couple, both make $100k.
  + D: couple, one makes $200k, the other none.
    - *Japanese system* (what we used to have)
      * A = M. B = M. C = M. D = M for both in *community property state*, but H and none in *common law state*. 🡪 creates incentive for states to go to CP state AND C & D have different tax rates (**couple non-neutrality**), so dual-income couples are penalized.
    - *Income splitting* (think about unit together, and split income; change b/c of pressure of CP states)
      * A = M. B = both get L. C = both M. D = both M. But leads to **marriage non-neutrality** (if marry, tax rate decreases).
    - *Current system*: tax rate for singles is capped so as to be relatively close to couples (A = L). But this penalizes *married people w/ dual-income earners* = **marriage penalty** (pay more tax than couple would if they had remained single or obtain divorce).
      * Doesn’t affect standard deduction, but DOES affect EITC.
      * **Marriage bonus:** where one taxpayer earns significantly more than the other, their combined taxed will decrease.
  + Trying to preserve *couple neutrality* and *marriage equality*, but CANNOT co-exist with progressive tax system. Could solve this problem with a flat tax. Marriage is like *Old Colony* stacking income.
    - MR: we end up massaging brackets to minimize effects, but can’t get rid of problem We could also achieve progressivity w/o problematic rates with big refundable credits.
* [Marriage Penalty] *Druker v. Commissioner* (Couple challenges marriage penalty. Issue: equal protection rights violated?)
  + Drukers NOT deprived of any constitutional right. Balancing of policies (*legislative issue*), and impossible to design progressive tax regime in which all married couples of equal aggregate income are taxed equally and in which an individual’s tax liability is unaffected by changes in marital status.
    - Congress had no “invidious intent” to discourage or penalize marriage.

**[#Divorce]**

* **§ 71 Alimony & Child Support:** Alimony payments are deductible to *payer*, and taxable to *receiver* as long as (i) the payments are in cash rather than property/services; (ii) the parties do not earmark payments as nondeductible to the payer and nontaxable to the payee; (iii) the parties do not live in same household; (iv) there is no liability for any payment after the death of the payee; and (v) the payments do NOT constitute child support.
  + BUT under certain conditions, parties can elect to reverse tax treatment (shifts non-valuable deduction).
    - MR: Gives incentive to pay alimony and be generous. And kind of like gifts, where we’re trying to make sure its tax at one place.
    - **Alimony:** payments made pursuant to court degree or written separation agreement.
  + **(c)** **Child support** is taxed in *opposite way* (taxed at payer, deductible for receiver).
    - Statute treats as nondeductible child support any amount that will be reduced (i) upon the occurrence of events relating to the child specified in the divorce instrument, such as marriage, graduation from school, or attiment of a certain age/income level or (ii) at a time “clearly associated” with such an event.
* **§ 1041 Property Settlements:** NO gain or loss (***realization***) is to be recognized on any transfer of property between spouses or on a transfer incident to divorce between former spouses. Basis is ***carried over*** 🡪 NO **realization**.
  + And losses are allowed (*full* carry-over basis), where in **gifts** it is disallowed.
    - MR: more worried about game playing with gifts, but still some that occurs in divorce property allocation.
  + Transfer is treated as incident to divorce if it occurs within one year after marriage ceased or if it is related to the cessation of the marriage.
* [Pre-Marriage Exchange And Basis] *Farid-Es-Sultaneh v. Commissioner* (Before marriage, husband gives fiancée stock “in case he dies before marriage.” At marriage, gives more stock and fiancée signs pre-nup. Gov. argues stock is gift, thus basis is transferred. W argues it was exchange for her dower rights. Issue: what is basis of stock?)
  + NOT a gift, but a valid exchange 🡪 gets FMV for basis. Her interest in husband’s property was fair consideration for stock, and she performed terms of contract.

**B. #Assignment of Income**

* **Two Basic Principles:** (1) *earned income* is taxable to the person who earns it and (2) *income from property* is taxable to the owner of the property.
* [Income From Services] *Lucas v. Earl* (Lawyer signed contract with wife than any income he gets is split jointly with is wife. Issue: is Earl taxed for whole of property?)
  + *Important reasoning:* In general, ***cannot assign income*** to someone who did not earn it. “We think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from *that which they grew*.
    - For labor income 🡪 *donor* is taxed. Straight-forward. But what about property or capital?
      * *Blair* – if capital, and property, taxed at donee level.
      * *Horst* – tough middle ground (more like Blair or Earl?). Court said bond coupons are like *Earl* (but overturned by statute). But principle is still relevant, e.g., patent royalties probably income and like *Earl*.
* [Property Income – Tree] *Blair v. Commissioner* (Trust was created by Blair, with one half of income to go to widow and other half to son [and whole after widow died]. After widow died, son assigned part of interest to children. Issue: is the assignment of the trust interest prohibited “assigning income”? Is this *Lucas v. Earl* 🡪 transferring fruit to children off his own tree? Or was the property transferred?)
  + Trust interest is property (*tree*), NOT income (*fruit*). It was ***assigned w/o reservation*** 🡪 complete transfer of property (tax liability attaches to ownership, and son become owner of equitable interest in corpus of the property).
  + MR: If income 🡪 *donor* is taxed. If property 🡪 then in world of gifts, and taxed at *level of donee*.
* [Property Income – Fruit] *Helvering v. Horst* (Father gave negotiable bond coupons to children. Issue: is this a transfer of income?)
  + **Yes.** Transfer of income, NOT property. Father was still enjoying the “fruits of his labor or investment” (enjoyment of economic benefit) by giving the interest to his son. “The power to dispose of income is the equivalent of ownership of it.”
    - Overturned by statute. Bonds now considered *property* and traded with independent legal rights.
* ***Horst v. Blair?***
  + *Blair* gave away everything (tree)
  + *Horst* “carved out” rights (held onto the tree).
    - AND *Blair* was a more substantial transfer 🡪 big v. small slice.

**C. Other Arrangements**

* **§ 7872 #Interest Free Loans:** Generally precludes the use of interest-free or low-interest loans (below applicable federal rate) between employers/employees (disguise compensation), high-income/low-income family members (exploiting progressive tax rate), and corporations/shareholders (disguising dividends). ***Forgone interest*** *is* 
  + **(A)** transferred from the lender to the borrower (and not characterized in any way), then
  + **(B)** retransferred from the borrower to the lender as interest (*interest income payment* for lender, and *interest deduction* for borrower).
* **Example:** Parents lend $11,000 to the kids (at an interest free rate) when interest rate is 10%.
  + This is a gift loan. The provision says that the forgone interest shall be treated as (A) transferred from the lender to the borrower and (B) retransferred by the borrower to the lender as interest.
  + So, treated as transferred from parents to kids and then retransferred from kids to parents as interest.
  + The first transfer, the gift to the kids, isn’t taxed under § 102(a), and the parents don’t get a deduction.
    - The retransfer is treated as interest.
      * It’s income to the parents under § 61.
  + Say the kids invest the money in the bank and get the 10%.
    - The kids are taxed on the interest received under § 61.
    - If they do this, they could get a deduction for the implicit interest payment above because this is investment income.
  + If the kids don’t invest this money, the family could get hurt on both sides because they kid aren’t getting to deduct their implicit interest payment.

1. **WHEN IS AN ITEM TAKEN INTO ACCOUNT?**

**A. Gains and Losses on the Disposition of Property**

**[#Constructive Realization]**

* **Example:** Jack Dorsey. $100 of Square stock. What could he do?
  + Could sell it 🡪 but creates realization event and bad for taxes.
  + Borrow against stock. Issue: is this a realization event? You’re effectively monetizing wealth and allowing you to consume.
  + Swap 🡪 doesn’t have to pay taxes and reduces his risk exposure to Square stock. Issue: is this a realization event?
  + Short stock 🡪 allows him to get $$ w/o “selling”, w/o paying taxes, and reduces risk of Square stock dropping. Issue: is this a realization?
* **§ 1259 Constructive Realization:** If there is constructive sale of an appreciated financial position—
  + (1) taxpayer shall recognize gain *as if* such position were sold, assigned, or otherwise terminated at its fair market value on date of constructive sale.
    - **Rationale:** prevent short sales against the box and similar maneuvers.
  + **Constructive sale:** short sale of same or ***substantially identical property***, offsetting notional principle contract (agree with someone to give return of stock in exchange for other returns—like you sold stock and invested in something else), futures or forward contract (eliminated risk exposure), or any transition that has ***substantially same effect*** as previously listed transactions.
    - E.g. Is shorting Alibaba stock when owning Yahoo “substantially identical property”? Probably yes, b/c economic exposure is eliminated.
    - If you introduce some risk or level of uncertainty into futures contract does it mean it is not constructive sale? Attempt to work around.
    - **Call Options:** right, not obligation, to buy stock in future.
    - **Put Option:** right, not obligation, to sell stock in future.
      * If you own put option, eliminates risk of stock decrease. Is this a realization event? Not clear. Can you preserve risk if you buy put option a little below current stock price? AND, don’t have to pay any $$ if you sell an equivalent call option to someone else. 🡪 *is this a realization event? How big does zone of risk need to be?*

**[#Deferred Payments]** – Parties agree to sell a piece of property, and buyer pays over time. May happen because of information asymmetries (seller thinks he knows more than buyer), risk allocation, buyer needs time to get money, or parties may value liquidity differently. Deferred payments raise a question of how to account for recovery of basis versus taxable gain when the price will continue to rise into the future.

* **Three ways to treat deferred payments:**
  + (1) “Open Transaction” (*Burnett v. Logan*) – taxpayer doesn’t know how much he will realize (still has underlying exposure). Initial payments are return of basis. *We don’t do this.*
  + (2) “Closed Transaction” – series of set payments over X years. Installment sale. Take present FMV of payments and tax. *We don’t do this* (liquidity and uncertainty concerns).
  + (3**) § 453 installment method** – Typically permits sellers to defer payment of tax by spreading the gain over a number of years, treating a portion of each payment as gain and a portion as a recovery of the taxpayer’s basis in the property. Like *exclusion ratio for annuities* and OID bond. Two things going on 🡪 (i) allocation basis; and (ii) taking care of underlying interest accruing.
    - **Example:** Sells property today ($5k basis) in exchange for $10k to be paid in 3yrs (interest free). Gain will be $5k in 3 yrs.
    - **Problem:** Seller is basically lending money to buyer by selling w/o interest. BUT, the system taxes interest differently → ordinary income vs. capital gains which are lower.
    - **Solution:** Split $5k between capital gains and ordinary income via amortization.
      * Take the PV of a $10k payment in 3 yrs → $7,514 (i = 10%)
      * Convert the AR to $7,514 – (that gives us a $2,514 capital gain)
        + Leaves $2,476 to recover in interest payments
      * Then collect interest payments compounding:
        + 1st yr → owes $751 – ($7,514 + $751 = $8,265)
        + 2nd yr → owes $826 – ($8,265 + $826 = $9,091)
        + 3rd yr → owes $909 – ($9,091 + $909 = $10k)
        + Total interest payments = $2486 → $5k is total gain
    - **If Deferral Allowed:** $5k capital gain, $0 interest. **Instead:** $2,514 cap gain, $2,486 interest.

**[#Nonrecognition]** – Sometimes tax system will not recognize gain that has occurred, e.g., when taxpayer exchanges property for something o the same kind (no gain or loss). This does not apply to fungible property, like stock.

* **§ 121 Exclusion of gain from sale of principle residence:** Single $250k; couples $500k that you *redeploy* into another primary residence within two years. During previous 5 year period, taxpayer owned/used residence for periods aggregating 2 years or more.
* **#Like-kind Exchanges**
  + Why would exchange of like-kind assets qualify for non-recognition? Classic liquidity story 🡪 you have not cashed out. And we want the mobility of capital, don’t want taxes to gum up work. And it saves gov from calculating value of asset (complicated).
  + **§ 1031:** Taxpayers keep their original basis in a *like-kind transaction*. If cash payment is included, receiver of payment is *taxed*, and basis is increased to maintain total untaxed gain. Non-cash boot is counted as gain and allocated to basis at FMV.
    - **RULE: Basis = Old Basis + Gain – Loss – Money Received.**
  + E.g.
    - Seller: MV 100; Basis 10.
    - Buyer: MV 100; Basis 20.
    - How to calculate basis? ***Keep basis the same*** (want to prevent gaming and preserve gain [simply delaying]).
  + ***What is “like kind”?*** NOT different stock. Has to basically be **real property**. Refers to nature of property rather than its grade or quality.
    - When real estate is swapped, outstanding mortgage is treated like cash received and recognized as boot.
    - For multi-party exchanges, IRS focus on whether parties *intended* an like-kind exchange and where it was part of a *single integrated plan*.
    - **§ 1031(e):** Livestock of different sexes are NOT like kind.
  + What of properties that are slightly different in value? (*Boot*)
    - Seller: MV 115; B 10.
    - Buyer: MV 100; B 20. Trades property + $15.
    - Seller gets taxed on $15, and basis stays at 10 (15 of original 105 gain has been taxed, so you maintain 90 left of gain). Buyer’s basis rises to 35. ***Make sure total untaxed gain remains the same***.
  + E.g. (notes) – conceptually, allocating 50 of basis over to boot and being taxed on it, and keeping remaining 25 gap between basis and value of new property (accounts for original 75 gain).
* **§ 1033 Involuntary Conversions:** Permits nonrecognition of gain resulting from *involuntary conversions*, such as a where property is taken by eminent domain or destroyed by fire or other casualty.
  + Taxpayer must used the proceeds to acquire “property similar or related in service or use,” or in the case of real estate, acquire “like kind” property.

**B. Leverage and Deferral**

* *Recourse v. Non-Recourse Debt*
  + **Recourse borrowing:** borrower is personally liable for repayment. Lender can go *beyond property* (has “recourse”).
  + **Non-recourse borrowing:** borrow is NOT personally liable. Lender can only *look to assets* to secure debt payments. No downside loss for borrower.
* [Recourse And Nonrecourse The Same] *Crane v. Commissioner* (Crane inherits property with FMV of $250k with non-recourse debt of $250k [real world value = 0). C takes $29k in deductions and then sells property for $2500. Claims $2500 gain, arguing “equity basis” [basis was 0, then had $2500 gain]. IRS argues basis was $250k [including mortgage], which was reduced to $221k via deductions. AR was $252,500. Issue: what is basis?)
  + Recourse and nonrecourse debt will be treated alike 🡪 loan from either type is ***included in basis of asset***. C’s basis is $2,500 gain plus the value of the outstanding mortgage (C obtained an economic benefit from the purchaser’s assumption of mortgage identical to benefit conferred by the cancellation of personal debt 🡪 taxable economic benefit).
    - Adopted IRS view of C’s tax liability, but ended up allowing taxpayers with property held by nonrecourse debt to deduct depreciation (a substantial benefit 🡪 *time value of money*) by holding basis to the entire property despite the fact that they had not actually paid for it and would escape personally liability.
      * *Crane* served as the foundation of tax shelter investments based on increasing the amount of tax deferred through borrowing or “leverage.”
    - **FN 37:** Court reserves the question of whether a taxpayer that sells a property for less than the value of the nonrecourse debt is subject to the same rule (as “a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage”) (addressed in *Tufts*).
* [Extends Crane] *Commissioner v. Tufts* (Builder buys 1.852m property, funded by full nonrecourse loan. Added 44k of capital contributions. Takes over course of life 440k in depreciation deductions [adjusted basis of 1.456k]. FMV of property when sold = 1.4m [decline in value and worth less than nonrecourse loan]. B walks away from non-recourse loan and claims loss of 55k [AR = 1.4m]. Comm’r determined deficiency of $400k capital gain. Issue: nonrecourse loan included in basis?)
  + **Yes.** Nonrecourse liability shall be treated as a true loan 🡪 it is included in BOTH basis (so that values of the asset is properly depreciable to the borrower) and its assumption by another is included in the ***amount realized*** (so that he recognizes gain when the loan is forgiven or assumed by another). It ***does not matter*** if FMV of property is less than the outstanding mortgage (“mortgagor received the loan proceeds tax free and included them in his basis on the understanding that he had an obligation to repay the full amount”). When obligation is cancelled 🡪 mortgagor is relieved of responsibility to repay = realizes value to that extent within the meaning of 1001(b).
    - Must treat the basis and amount realized symmetrically; if the amount of the outstanding mortgage is not included in the amount realized, then the buyer would have received tax-free benefits.
  + **O’Conner concurrence:** The transactions should be split 🡪 separate loss and cancellation of indebtedness.
* One may NOT capture the tax benefits of deprecation by ***inflating the purchase price*** of a nonrecourse loan asset (owner had no intention of paying). *Franklin v. Commissioner*
  + “To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is *presently reasonable* from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price.”
* **Revenue Ruling 1.001-2:** Adopts O’Conner for ***recourse loans*** 🡪 split transaction into twofold event consisting of (i) a sale of the asset itself for its actual market value (capital rates apply), and (ii) use of the constrictive proceeds to satisfy taxpayer’s debt (ordinary income rates apply).

**C. Annual Reporting**

**[The Taxable Period]**

* An annual system is fine. Need not be on a per-project basis. *Burnet v. Sanford & Brooks Co.*
* **§ 172 Net Operating Loss Deduction:** Loss in any given year can be *carried back* 2 years and *carried forward* 20 years. This rule is ***only for corporations***, NOT individuals.
  + **(c) Net operating loss:** is the excess of deductions allowed over gross income.
* Section provided to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. Without 172, tax code would favor businesses with steady income streams, would be unreflective of overall economic ability to pay, and stimulates capital investment by encouraging taxpayers to take risk in speculative or cyclical ventures.

**[#Accounting Methods]**

* **Cash Method Accounting:** items ordinarily are included in income in the year in which *they are received*, and items are deducted in the year in which *they are paid*.
  + Most taxpayers and many small businesses do this. Also, because it affords opportunities to obtain tax deferral when payment is not received in the year services are performed, many service companies (account and law firms) also used this.
  + Problems? Simple, but many think it fails to measure income accurately when taxpayer’s activities are complex.
* **Accrual Method Accounting:** think about underlying economic activity. Items included in income in the year in which *they are earned*, regardless of when they are received, and items are deducted in year in which *they are incurred*, regardless of when they are paid.
  + Most businesses use this. If have inventories and sell merchandise 🡪 must use accrual method (**§ 471**).
  + Problems: issue with liquidity, but thought to be more accurate.

**[Inventories]**

* *Most important for long-term, non-perishable assets.* Why? For gross income, need to determine **cost of goods sold** 🡪 comes from value of inventory.
* **FIFO:** *First in, first out*.
  + Advantageous for ***tax purposes*** when prices are rising 🡪 depresses income and is tax advantageous
* **LIFO**: *Last in, first out.* 
  + Advantageous for ***showing profits*** when prices are rising. Also, if prices are volatile 🡪 LIFO is more consistent (smooth characterization) b/c it matches recent prices with recent sales.
    - You can pick either, but you ***have to be consistent***.
    - MD: *not* the norm to make private reporting and tax reporting the same. Outlier. In most other settings 🡪 two separate worlds of reporting. This is corporate governance problem 🡪 should be fixed.

**D. Deferred Compensation**

* **Non-Qualified Plans:** employee gets inclusion (in income) and employer gets deduction *at same time*.
  + ***No gap*** 🡪 minimal tax benefits. BUT can have benefit if employer has 0% tax rate, then employee can have investment grow tax free (employer pays no tax when he puts it into account, and employee doesn’t pay tax until it’s taken out). No tax benefit if employee/employer tax rate is the same.
* **Qualified Plans:** employer takes deduction *now*, and employee gets inclusion *upon retirement*.
  + ***Gap*** 🡪 tax benefit of deferral.
  + Required to be non-discriminatory 🡪 ratio of pension benefits to salary has to be the same across different compensation level (can’t just do it with high earners).
    - More valuable to wealthier b/c they save more. W/o non-discriminatory, then no big incentive to give benefit to lower income.
  + *Benefits v. Contribution Plans*. Benefits plan is old school pension plan (pays pension based on last year’s salary). Contribution plan is employer makes contribution today, and employee gets whatever $$ is returned after retirement.
    - Contribution plan increasingly popular.
  + E.g. (see notes)
* **IRA:** if you do not have an employer-provided plan, IRA mimics what you would have (e.g. self-employed person gets same benefits). Look a lot like defined contribution.
  + Get deduction *now* and get inclusion *at retirement*.
  + Beneficial if your tax rate decreases over time (once you retire).
* **Roth IRA:** included *at point of entry*, and *no* tax at distribution.
  + Beneficial if your tax rate will increase over time, or if tax rates will go up in general.
    - And Roth is more *forgiving* = more flexibility to tap into $$ before retirement for certain activities.
  + If your tax rates stay the same you will be *indifferent* between Roth and Traditional IRA.
* *Would you want to convert an IRA to a Roth?* If you pay tax at conversion with *outside sources* 🡪 you don’t reduce principal amount and stuff more $$ into IRA. Grows tax free inside the IRA, so end up with more $$ if you left outside money outside IRA to grow on its own, then taxed.

1. **#CAPITAL GAINS AND LOSSES**

**A. History and Mechanics**

* Preferential K gain treatment base on ***net gains*** (**§ 1222**). **Short-term K gains** do NOT get preferential treatment. *Only* **net long-term K gains**. **§ 1222** mechanics:
  + (1) Identify long-term and short-term losses & gains.
  + (2) Net long-term & short-term losses & gains separately.
    - If have LT & ST k gains 🡪 preferential rate for LT. OI rate for ST.
    - If have LT gain & ST loss 🡪 LT – ST = ***net gain*** that gets preferential rate.
      * You need a net K gain to get preferential rate.
      * Netting procedure allows you to get some preferential K gains treatment for some short-term gains (short-term gains that offset short-term losses).
    - If have LT loss & ST loss 🡪 offset ordinary income up to $3k.
      * Short-term losses are more valuable b/c can be used to reduce short-term gains and, through netting, allow more long-term gains to get preferential treatment.
* Why are we drawing distinction between short-term and long-term?
  + (1) “Stability” – overcomes *short termism* in investing.
  + (2)Want to separate professional investing (income) vs. true investing.
* **Rates**
  + Capital gains are lower than ordinary income. Three rates that relate to OI 🡪 *progressivity* for capital gains.
    - 0% if you are in 10-15% OI range.
    - 15% if in 15-39.6% OI bracket.
    - 20% if in >39.6% bracket.
  + Separate rates for *certain classes of property*:
    - 25% for real estate.
    - 28% for collectibles.

**B. #Rationale**

* *Encourage Risk-Taking:* have to assume there is insufficient amount of risk going on. Why would this be the case? Individuals aren’t factoring in societal benefits 🡪 ***underprovided***. E.g. research & development.
  + Government becomes ***co-investor*** 🡪 encourages more risk. Gov takes part in gains AND losses (assumes losses are fully usable). But we limit ability to use losses, so incentive to risk-take goes away. Why are we so worried about losses? People could strategically realize losses 🡪 sell asset that loses value and keep asset that gains in value. ***We care about losses as consequence***.
* *Political Economy:*tax system is captured by wealthy who benefit from lower rate.
* *Encourage realization (avoid lock in):*induce people to realize gains and pay taxes 🡪 if wait ‘til death, then get step-up basis. Loss of revenue. Also, you’re locking in assets 🡪 holding onto too long and capital could be put to better use.
* *Bunching:* by taxing gains, at one point, that accrue over a long time 🡪 taxing at higher rate than would have otherwise.
* *Inflation:*purchasing power has not increased, but you’re taxing rise anyway.
* *Double taxation of corporate earnings* (**most salient today**): taxed two places 🡪 taxed at entry corporate level, and then at shareholder level with dividends. Why is this a problem? Equity? Bigger reason: distribute through stock buybacks or income by pass-through form (business split themselves up to avoid entity-level taxation). How to solve this?
  + (i) exempt shareholders (but progressive enough?). (ii) deduction for dividends at corporate level. (iii) credit for shareholder for corporate taxes paid.

**#Statutory Requirements**

* **§ 1222:** “Long term capital gain” means gain from (i) ***sale or exchange*** of a (ii) ***capital asset*** (iii) ***held for more than 1 year***.
* **§ 1221 Capital asset defined:** the term “capital asset” means property held by taxpayer (whether or not connected with his trade or business), but does not include—
  + (1) stock in trade or other property that would be properly included in inventory or property held by taxpayer primarily for sale to customers in the ordinary course of his *trade or business*;
  + (2) depreciable property or real property used in *trade or business* (fixed by **§ 1231**);
  + (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by:
    - (A) a taxpayer whose personal efforts created such property.
    - **Rationale:** it’s your job to create these items, so ordinary income. Don’t want ppl re-categorizing labor income as k income.
    - But patent income *is* k gains (**§ 1235**).
  + (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into;
  + (8) supplies of a type regularly used or consumed by taxpayer in his *ordinary course of trade/business*.
  + *Other Exceptions:* 
    - **§ 1202 Partial exclusion for gain from certain small business stock:** gross income shall not include 50% of any gain from the sale or exchange of qualified small business stock held for more than 5 years.
    - **§ 1245:** if you dispose of asset for more $$ than its depreciated value 🡪 difference is taxed as ***ordinary income*** up to original basis. Logic stops when this difference exceeds depreciation amount.
    - **§ 1231:** allows real and depreciable property (land, buildings, machinery, fixtures) used in trade/business to *yield K gain* when there is net gain and *ordinary income* when disposed of at net loss.
      * Still need to be held for 1 year and does NOT apply to inventory or other property held primarily for sale to customers, copyrights, etc.
      * You get best of both worlds. Rooted in wartime efforts to sell assets.
* [Futures Not K Assets] *Corn Products Refining Co. v. Commissioner* (CP buys corn and manufactures corn products. Buys corn futures to protect against corn price rising [locks in price]. If prices rise, sell futures as k gain and buy pricey corn but report diminished OI. If prices drop, use futures to buy corn and avoid higher OI. CP argued it was capital-asset transactions [investing in corn]. Issue: are futures k assets?)
  + **No.** Definition of K asset must be narrowly applied and its exclusions interpreted broadly (court concedes futures don’t fall into language of statute). Futures NOT “separate and apart from its manufacturing operation,” but “vitally important to company’s business as form of insurance.” Congress intended profits and losses ***arising from everyday operation of a business*** be considered as ordinary income or loss rather than k gain or loss. K assets = transactions in property which are NOT the *“normal source of business income.”*
    - *Disaster for IRS* 🡪 decision was repeatedly invoked to treat k losses as ordinary, but rarely used to treat k gains as ordinary. Opposite of problem in *Corn Products*. Limited by *Arkansas Best* (said futures were part of inventory) and addressed specifically be **§ 1221(a)(7)**.
* [Limiting Corn Products] *Arkansas Best Corp v. Commissioner* (Holding company buys shares of bank stock. Lost a bunch of $$ when sold stock and claimed as OI under *Corn Products* “business purpose.” Issue: fall under *Corn Products*?)
  + **No.** Exceptions are exclusive, and motivation in purchasing assets is irrelevant. . Court re-writes *Corn Products*, says it stands “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**.”
    - Solves inventory problem, but leaves question: *what is “capital asset”?*

**[What Is “Capital Asset”?]** – raises big problem of trying to distinguish between property/capital (valued at future income) and income.

* [Substitute For Income] *Hort v. Commissioner* (1927 father of Hort negotiates lease 25k/yr w/ IT. 1928 father gives property to H. 1933 IT negotiates to cancel lease and pays $140k to H. H reports loss of $21k [implies basis of $160k]. IRS argues rent $$ is OI. Issue: is $140k OI or K gain?)
  + **Ordinary income.** Just a pre-payment of future OI (“*essentially a substitute* for rental payments”). Immaterial that petitioner chose to accept an amount less than strict PV of unmatured rental payments, rather than engage in litigation (just relieved of duty to pay tax on some part of lease).
    - MD: what is this thing that Hort thinks he has a loss on? Commitment to pay above-market rate 🡪 ***valuable***. H thinks he has two things 🡪 the property AND the lease.
    - MD: if he had acquired the lease in ’32 🡪 lease *way* above market, so really valuable. In 1928, lease was at market and thus had FMV (basis) *of zero*.
* *Commissioner v. P.G. Lake, Inc.* (Oil/gas company indebted to President for $600k. P cancelled debt in exchange for oil payment rights in oil field worth the same amount. Lake argues its long-term property interest that it sold. Commissioner said it sold future income, so OI. Issue: is cancellation of debt OI or long-term K gain?)
  + **OI**. About ***function***, NOT form. Lump sum was *essentially a substitute*. Didn’t sell anything (conversion of capital investment). Consideration was paid for the right to receive future income, NOT for an increase in the value of the income-producing property (not appreciation, just substitution). **Steps:**
    - **(1)** is there any conversion going on? No.
    - **(2)** easy to determine value.
    - **(3)** no increase in value.
* [K Asset As Equitable Interest] *Commissioner v. Ferrer* (Ferre enters into contract with Author of Moulin Rouge for [1] lease of play; [2] negative right to block production of movies; [3] 40% of any movie made. Then F enters into contract with movie producer, Huston, in which F won’t make play and gets [1] time compensation for acting, $109k, and [2] participation fee, $152k. Commisioner argues all OI. Issue: is $152 OI or K gain?)
  + **Remand to allocate $152k between three parts of contract.** Thinks about what “property” is a deep way, and decides that for three parts of original contract:
    - [1] K gain. Property. Equitable interest.
    - [2] K gain. Property. Equitable interest.
    - [3] OI. No equitable interest, just an option.
      * MR: not clear that 3 is different than 1 and 2. If F made play, then he would have received ordinary income. Maybe he contributes capital asset between two contracts by giving up right to make play?
* [New Test] *Lattera v. Commissioner* (Laterra wins lottery in ’91. 26 years of yearly payment of $370k [valued at $9.6m]. 9 years later, L sells for $3.4m, argue it is K gain. Issue: OI or K gain?)
  + **K gain**. Rejects “substitute-for-ordinary-income doctrine” 🡪 (1) is there underlying investment? And (2) is there accretion in value? Instead, lays out **“family resemblance” test**:
    - **(1)** Determine whether asset is like either the ***“capital asset”*** category (e.g. stocks, bonds, or land) or like ***“income items”*** category (e.g. rental income or interest income). If you’re in between 🡪
    - **(2)** Look at ***nature of the sale*** (what type of carve out?). If horizontal carve-out 🡪 assumed OI. If vertical carve-out 🡪 then we look to:
    - **(3)** ***Character of asset factor***. If sale is a lump-sum for right to *earned* income (income has already been earned and holder of right only has to collect it) 🡪 OI. If lump sum for right to *earn* income (holder of right must *do something further* to create value) 🡪 K gain.
  + MR: does any of this coincide with why we give preferential treatment in the first place? Not really.

**Universal Policy Concerns**

* **Equity:** is it fair (treating similar situated people the same)?
* **Liquidity:** can TP pay?
* **Incentives/Efficiency:** what economic/behavioral effect will this rule have? Act in ways she would not have?
* **Administrability:** will it work?