Institution **Harvard Law School**
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Count(s)	Word(s)	Char(s)	Char(s) (WS)
Section 1	**1713**	**7712**	**9385**
Section 2	**1395**	**6247**	**7626**
Section 3	**962**	**4609**	**5560**
Total	**4070**	**18568**	**22571**

Answer-to-Question-_1_

Part 1:

The first questions is whether this is actually a prize or whether this is really a qualified scholarship/employer assistance programs under §§ 117 and 127 respectively.

~S's Taxes~

Prize: S will not want this to be considered a prize. If it is a prize it is included in S's gross income unless it meets the requirements in §74(b). It was received (supposedly) for educational achievement but we don't know if the mother or S herself entered S for the prize. If she did not there is the question of whether S will have to render substantial future service. There may be some stipulation on what she has to do in school to keep scholarship but that is not service to the company. Finally, S will not want this to be considered a prize because she does not want to give the 100k away to a charity, etc. Paying tuition to a non-taxable entity is almost surely not "giving way" the money.

Employer Educational Assistance Program: S will also not want this to be education assistance. Exclusion of such assistance is capped at $5,250, so the remaining amount would be considered income and taxed at the ordinary rate.

Qualified Scholarship: S wants this to be a scholarship but qualified scholarships are excludible only for tuition and related expenses. Though, this is likely the bulk of the cost. Therefore, S will likely have to argue that it is a scholarship for the tuition but income for the room and board.

Under 1(g) S will be taxed at the mother's rate on any unearned income to the daughter if she is younger than 18 or still receives more than half of her support from her parents (Kiddie Tax). So, any amounts not excludible will be stacked on the parents income and taxed at the appropriate rate.

~Employer's Taxes~

Presumably paying for education for an employee or an employees spouse or dependent would be a form of compensation and thus deductible under § 162 as and ordinary & necessary business expense. Eyebrows might to raised about no one being taxed on these amounts because they are deducted for the employer and excluded from the recipient but this is not terribly uncommon (see § 132) and is done to create incentives for employers to offer such programs (but all benefits really accrue to the employers).

Part 2:

~E's Taxes~

Under § 119 E may be able to exclude the cost of any such meals from his gross income. He eats them on the employer's premises, they are provided by the employer, the only question is, whether they are for the convenience of the employer. We do not consider the fact that the employee has a choice when assessing this (§ 119(a)(1)). The fact that there is a cafeteria may indicate that this final prong is met but more facts would be needed.

This could also be excluded under § 132(e) as the eating facility is on the premises, so long as the revenue derived is equal to or greater than the operating costs. Fictional revenue can be created if § 119 is satisfied because such free meals are considered to have been paid for at the value of the operating costs. Below you will see that the employers will want E to exclude under § 132(e).

~Employer Taxes~

The employer will have to capitalize any costs (except 5k reduced by any amount spent above 50k) before active trade or business has begun. It looks like it has begun now though because employees are there.

Under § 162 the employer can deduct such expenses for meals as O&N but § 274(n)(1) reduces that deduction to 50%. But, if expenses are excluded as a de minimis fringe (§ 132(e)) then the (n)(1) exclusion does not apply. The employer should set up his business model such that no one is taxed on such meals if possible by having them be excluded under § 132(e) and then deducting them under § 162 + § 274(n)(2)(b).

Part 3:

~Greenacre~

The grandson will receive a carryover basis from the grandfather (15k) but because there is a loss, if the grandson were to sell it the basis will be the FMV at the time of the transfer (neither the grandfather nor the grandson could realize a loss on the gift). As such, the grandson should hang on to it until it appreciates in value and then sell it, at

which time it would likely get capital gains, maybe even § 1231 promised land treatment if the real property has been held for more than year. (tolling continues if the basis remains the same).

The grandfather has no realization event, no loss no gain, the property is simply transferred.

~Bank Account~

The question of the account and the interest is a horst/blair question. The account itself is definitely property. The interest payments do not look like a carve out (horst) because the grandson also has the tree and the grandson would certainly have an equitable interest (blair) in the interest payments and could get an injunction against the bank if they were messing things up (but depends on state law). So, because the whole tree has been given (to use the horticultural metaphor), the interest will be taxed to the grandson, not the grandfather.

Part 4:

This is on all-fours with *Farid*. First, A will be taxed on her income from movie making under § 61 as ordinary income (unless she is paid in assets then probably capital gains).

Second, if the transfer happens before the marriage (as in *Farid*) *Farid* will govern but if they wait to make the transfer until after the marriage then § 1041 governs. This is not a like kind exchange because the assets are not similar enough (comparisons are

broad for real property but not so much for other assets). If Farid, then S's basis in the portfolio would be its FMV of $1m. As in *Raytheon* it would be difficult to assess the basis in the potential rights to A's assets as her spouse so a basis of zero would likely be assumed (burden is on the TP to show otherwise, ¶ 7491). Due to this zero basis and unlike Farid, there may be taxable gain to S. The Court in Farid did its analysis post hoc. If there is 1m in gain to S, it is unclear whether it will be taxed as OI or CG. It is unclear what is substitutes for under Hort (probably some assets, some cash), the equitable rights are also unclear without knowing what is being substituted and the relevant state law (Ferrer). They could simplify the whole process by just doing this after the marriage (see below) but then S will not get the step-up basis. But being taxed for $1m doesn't sound great either. If S can get the exact outcome as in Farid, he should go for it but it is unclear if the IRS would let that happen now.

If § 1041 controls, there will be a carryover basis and no gain or loss will be recognized by either S or A.

Part 5:

First, D will be able to deduct any interest paid over the length of this loan under § 163 (business loans).

Second, it looks like he is angling to take advantage of *Tufts*/O'Connor depending on whether this is a recourse or non-recourse loan. It looks like it might be recourse because the facts indicate that he might be only able to partially satisfy the debt but both analysis may be pertinent.

FMV #1 - 4m

Initial Loan - 3m

Personal Investment - 1m

Depreciation Deductions - 900k

Loan Repayment - 600k

FMV #2 - 400k

The real world loss for D would be 1.6m because he invested 1m and repaid 600k of the principal. Crane fn. 37 was rejected because it was an attempt to take both the borrowers and Lender's losses and apply them to the borrower as a deductible loss (though you can still see this in the property portion of O'Connor's analysis).

***Tufts*: Non-Recourse**

The AR under tufts is 2.4m (loan minus any repayment). D's basis is the full cost (FMV of loan when it was received, personal investment minus any depreciation), 3.1m. This means that D's present loss is 700k but his overall loss, taking into account the depreciation he has taken, is 1.6m, the same as his real world loss. The present loss, because it came form a depreciable property (under § 167), will likely get promised land treatment under § 1231, and can be deducted as an ordinary loss (§ 165). As this is the analysis under non-recourse, the bank can take a 2m deduction for partial bad debt (§ 166), the amount of that loss is gone forever and can't be retrieved.

O'Connor: Recourse

This is where the lender wants to be. The first part of this bifurcated analysis is the asset, the second part is the liability:

~Asset~

The AR is 400k (FMV of the property when surrendered). The basis is the same as under Tufts, 3.1m, meaning there is present loss on the asset of 2.7m. This loss, as above likely falls under § 1231 and therefore is fully deductible as an ordinary loss.

~Liability~

The AR is the same as Tufts, 2.4m. The basis is the FMV of the property when surrendered, 400k. The present GAIN will be 2m for D. This will be taxed as ordinary income, forgiveness of indebtedness (unless he is insolvent, but there is no indication that this is the case).

It turns out that when you add the 2m gain and the 2.7 "capital" loss you get 700k loss, just like under Tufts. O'Connor used a different system because capital assets and debt forgiveness are taxed differently but this is not the case when there is a loss on the property side of her analysis and that property is depreciable, or real property that has been held for one year (§ 1231). It makes her analysis superfluous.

That being said, in this case the lender can go after D's other assets and try to reclaim that 2m. If he is insolvent or cannot otherwise pay, they can still deduct this as a partial bad debt under § 166.

Answer-to-Question-_2_

~Offer #1~

This is a fascinating problem because it implicates the Hort line of cases but the income substituted for would be **UN**taxed if received by Phelps in 5 years. To determine if it the payment of 5m today will be taxed as capital gains, it is important to not that a legal right to restitution may not be property under § 1221 (even though it is read broadly, *Arkansas Best*). If it were it might also be excluded under "similar" to a property interest like copyright, or patent under § 1221(a)(3) and thus might fall out of that section. For these perplexing questions we use the Hort line of cases and the horticultural reference (am I the only one that thinks it is funny that Hort adopted the **Hort**icultural reference for the distinction between CG and OI?).

Hort/Lake: This is a lump some for a future payment that, if not for § 139F would be taxed as OI. The fact that it would be excluded under § 139F probably has little bearing and so would be seen as a replacement OI. The problem is the substitution principle under *Ratheyon* coupled with the view of human capital implicated in PL 107-16 § 803. If the rationale for excluding the amount is that the basis in being imprisoned is equal to any restitution received then he probably shouldn't be taxed for these lump sums either. Additionally, if human capital is property under § 1221 then it should be a replacement for capital gains. It is unclear, likely it would be OI because he electing to

receive the money early.

Ferrer: Though it depends on state law, there is likely an equitable interest in right to receive restitution. He could get an injunction against the law firm if they were purposely destroying his cases or if they were litigating without his consent. It is tricky though because he could also just be paid the 10m in damages. Again, depending on the state law, he would likely have an equitable interest and therefore would be taxed as capital gains.

Lattera: The family resemblance test is little help, a right to receive restitution doesn’t look like stock. As to the carve-out, it looks like this is a vertical division, the whole tree is being transferred over. The three step test could stop here but if the court didn’t, the question would be is it earned income or a right to receive future income. It is earned income, the litigation isn’t earning it, his false imprisonment did. Therefore, there could be conflicting outcomes under this test (full tree at the carve-out and OI as to the character of the asset). This will probably not be the test used by the Ct (unless this occurs in the 3d cir) because the court was desperate here, using a student note to try to solve the problem. Hard cases make bad law.

Overall, i think it is more likely that this lump sum will be taxed as OI. Under this offer is also looks like Phelps would still have to pay the legal fees. If that is the case under Tellier he would not be able to deduct them because seeking restitution for a personal offense is almost certainly not “profit-seeking activity.” But if the wealthy individual pays the legal fees then she would likely be able to deduct them as purchasing

his right to restitution is an investment, one which would allow him to deduct such fees under §§ 162/212.

A could be seen as investing 5m with the potential of doubling his profit in 5 years. If he hold the interest for that long, he will likely be able to get longterm capital gains. Any loses on this right to receive the restitution will only be deductible under § 1211 (only to the extent of other capital gains) because such a right is not depreciable/real property and does not qualify under § 1231. She runs a risk of a loss but a 5m gain taxed at a measly 20% isn't bad. The big question is whether § 139F carries over to A (or if he sells it to someone else, to another holder of the right, see below), making this gain non-taxable. The provision itself seems to indicate that it must be held by the individual himself to recover but the assignment to A may not change the tax consequences. If that is true, A needs to pay more than 5m.

If A sold his interest in the money to someone else, any money received would likely be taxed as Capital Gains under all three tests. Under Hort it would be replacing a capital asset that is used as an investment, under Ferrer, there would almost certainly be a right to an injunction (again, subject to relevant state law), and under Lattera, the three-step test would probably end at step 1 because the right to receive the restitution has a "family resemblance" to other investment assets.

There is also the possibility that A could make a like kind exchange with another investment asset but we would need more facts for that. Generally, it wouldn't change anything for A and the other party because gains and losses aren't recognized (as long as

no boots are involved). It would just change who held the interest.

The law firm is in good shape, it will get paid either way. Such payments will be taxed as OI (i don't know partnership tax so i will leave it there).

~Offer #2~

This offer is completely different than the one above. Instead of selling the interest, Phelps is receiving a loan which is not taxable in the present because of the offsetting liability to repay. The interest rate is at market so there is no § 7872 problem. Because it is non-recourse Phelps is able to hedge, if no money comes back he gets to walk away. He just has to pay the relatively higher interest rate reflective of a non-recourse loan (which may be substantial.

The interest on this loan is personal interest which is non-deductible under § 163(h), unless there is an exception for qualified residence, but that is not what is happening here (though if he bought a home with the money, it would make that personal interest deductible, he is just capped at $1m for the home).

B could sell the loan to someone else, banks and other financial institutions do it all the time. In such case, as above, the loan is an investment asset and any amount received would be taxed as capital gains (unless like kind exchange, from which not gain/loss is recognized, as above).

While Phelps has the protection of non-recourse loan, allowing him to walk away, B gets a lot of interest income (taxed as OI) in the meantime and has the option of taking a partial bad debt deduction (§ 166) if this whole thing goes south.

~Recommendation~

Mr. Phelps is unlikely to have any other money available to as he is a convicted (albeit pardoned) felon. Both offers give him money now but offer #2 is the superior option. There is no tax on the loan and, while he probably won't get any deductions under § 163(h), there is no income to take such deductions against. He is also protected against the possibility of not getting anything in the law suit because he can walk away from the debt if he loses. The only real downside is the he would have to pay the legal fees as well (they could, possibly, be paid by A in offer #1).

Offer 1 would require Phelps (very likely) to pay taxes now on money that otherwise would be tax free, and relinquish all right to the money. Under Offer #2, Phelps would still get to keep something probably approximating 4-5m even after paying his debts.

I recommend Phelps take Offer #2, that way he has some money for current expenses etc. If he chooses to take offer #1, i recommend getting A to pay the legal fees (as they would be deductible to him anyway) and, if the excludability of § 139F carries over, to pay at least 6m instead of just 5, as not being taxed is worth at least 2m to him (at 20% CG rate) and as much as 4m (at a 39.6% ordinary rate).

Answer-to-Question-_3_

This question gets at the heart of the purpose/role of above the line and below the line deductions. What is the line? What does it do? If, for example, the standard deduction is about a basis living expense, it should be above the line. If it is about administrability it is located appropriately below the line. But AGI does not appear to be about preserving to the taxpayer the minimum subsistence as it includes § 162 deductions, their inclusion seems more about creating incentives than about subsistence. The original rationale for adjustments was to encourage and incentivizes profit-seeking expenses, to help business grow. Understood in that light, the inclusion of union dues may be consistent with the original rationale.

Constitutionality:

There is no question, given the case law that the granting of a deduction for union dues at all is a matter of congressional grace. There is no constitutional right to such a deduction and therefore no requirement that any legislation be passed. The money used to pay such dues is after-tax dollars, there has been a realization event and thus can be constitutionally taxed under the 16th amendment (*Eisner*).

Fairness:

Giving an above the line deduction for union dues would remove the § 67 itemized

deduction floor. This would primarily benefit low to middle income individuals because they are the ones that primarily are part of unions and such individuals are far less likely to itemize in the first place; they likely take the standard deduction. As such, it is unlikely to affect wealthier taxpayers as generally aren't part of unions.

This will go a small way to granting a deduction that actually helps the indigent more than the wealthy as deductions, by their nature are more beneficial to those be taxed at a higher rate. The only caveat here is how many people it would help in reality: if these individuals are generally taking the standard deduction there is a chance that there is no income to deduct against. In which case, a refundable credit would be more valuable (but would create very different incentive. But, given that the unions are asking for this, it seems fair to say that there would be a significant group of union worker that would benefit.

Economic Efficiency:

There is little question that giving an above the line deduction would increase the incentives to join a union because the cost of joining such a union would decline (assuming union workers have taxable income to deduct against). On the other hand, it is possible that this would be similar to allowing § 162 deductions for § 132 fringes; the benefits disproportionately accrue to the union and union leaders, not to the workers.

In the 162/132 context, a business gets to deduct the cost of the fringe and then gets to offer less in the way of cash compensation because the benefit is not taxed to the employee. This means that the employee is getting roughly the same compensation in a

different form, the government is receiving less revenue and but the employer get to deduct a the same rate but decrease compensation. All of the benefits of the § 132/162 relationship accrue to the business, it is like a government subsidy.

That same may be true here. If an above the line deduction is given, the union can charge more in union dues, getting more revenue. They may not raise them all the way to zero out the benefit to the worker but the difference between the old union dues and the new union dues is an indirect subsidy from the federal government.

Like deducting state and local taxes under § 164, this may be a good way to hide the ball politically (which I won't discuss further) and may be consistent with the incentives that Congress wants to create. If Congress wants to increase union membership and give a subsidy to the unions without passing a bill saying just that, this would be an effective way to do so.

Administrability:

This legislation would not be impractical. It would not be difficult to have the Unions send to the IRS paper work saying how much union dues were or even to give a list of the individuals who paid. This could be readily compared to the tax returns of the workers in case of an audit and would require little extra work. Moreover, if the onus was on the unions to prepare and keep these records, most of the increase in paperwork, etc. could be shifted to the unions, with the IRS getting involved only in rare cases (the lower and middle classes are rarely audited).

Additionally, as mentioned above, this would be consistent with the original intent of adjustments. It doesn't undermine the § 67 itemized limit because these individual would not have been able to deduct and § 63 still functions just as well, with just a little more congressional grace for unions.

Recommendation:

As a revenue raising matter, this is a poor choice. It isn't that the government will have pay out but that it will stop taking in the amounts equal to all union dues. It may not make sense to have union dues be part of itemized deductions at all because they are primarily paid by non-wealthy taxpayers and itemized deductions are taken primarily but the more well-off portion of the tax base. Therfore, in order to make the deduction for union dues more consistent with §§ 62, 63, and 67, subject to congress's interest in creating these incentives, I recommend that either the union dues deduction be moved above the line or removed altogether. Either of these approaches make the tax treatment of union dues, as such, more consistent with the rest of the IRC's statutory scheme and rationales.