### Taxation

1. Four major policy questions:
   1. Fairness – Who does this benefit?
   2. Administrability – How does it interact with other provisions? Will it complicate, or simplify?
   3. Efficiency – What incentives does it create, and for who?
   4. Constitutionality – Does Congress have the power to tax it as income?

### Income

1. §61 defines gross income as “all income from whatever source derived”, and gives a non-exclusive list of categories that might fall into income
   1. Identical to 16th Amendment; at what point (if any) does §61 violate Constitutional principles?
      1. §280(E) restricts deductions for any expenses (except COGS) in connection with drug trafficking, and courts have not found any constitutional problems – can “income” under the 16th Amendment mean *gross* income?
         1. Ability to deduct COGS is explicit attempt to preclude constitutional challenge
   2. Income from *all* sources is taxed, unless the taxpayer can point to a specific exemption – *Cesarini* (Cash found in used piano)
      1. Income is taxable in the year in which it is reduced to “undisputed possession”
2. Should taxable income reflect market value or intrinsic, personal worth (*Turner* – trades cruise tickets won on a game show)
   1. Tax Court essentially splits the difference here – when should this be permitted?
   2. What other criteria to use? Fairness? Efficiency? Do valuation difficulties trump other concerns?
   3. IRS usually argues for fair market value – purely practical, or actually desirable?
3. Whether imputed income should be taxed is largely an academic debate
   1. Not taxing imputed income creates inequality and inefficiency since individuals make different choices than they would in a no-tax world (investments in home ownership rather than factories, working capital; lower paying job with more vacation)
   2. Concerns include limiting principles, administrability (including valuation), and liquidity
4. Taxpayer has burden of production in disputing ordinary tax liability – the IRS bears burden on penalties and fees. After production is met, burden shifts to opposite party - §7491
   1. Burden only shifts if significant reporting requirements are met, challenging entity has net worth of less than $7 million – as a result, burden shift very rarely occurs
5. Tax expenditures are revenue losses attributable to favorable tax provisions in the IRC

“Normal income”

Tax expenditures

Haig-Simon Income –  
 consumption + change in net worth

IRC Income

* 1. Requires a definition of a full, “normal” income – how is this possible?
  2. Haig-Simon income views any actual changes in economic position (regardless of realization)

1. The two most common perspectives for taxation are income and consumption
   1. Income taxes reduce value of future consumption, encouraging spending *now.* Consumption taxes penalize current consumption, encouraging saving
   2. Income tax proponents tend to emphasize fairness (more likely to capture people’s ability to pay) while consumption tax advocates emphasize economic efficiency
      1. Mill argues consumption is more fair because it penalizes individuals who remove goods from the societal pool for individual consumption
   3. Due to exemption-deduction equivalence, a consumption tax can simply be viewed as an exemption of all capital income – therefore, the equivalent of a wage tax
   4. U.S. taxes are actually hybrids of income and consumption taxes
2. An employer’s payment of income tax counts as additional income that must be taxed (*Old Colony Trust*)
   1. Leads to practice of “grossing up” incomes under formula of Gross = Net / (1 – tax rate)
3. Gross income **does not** include interest on state and local bonds (§103)
   1. Essentially a wealth transfer from DC to state governments – money the federal government would have collected in taxes goes to state/local because they can offer bonds with a lower pre-tax return (since tax will be 0)
   2. Huge benefit to higher-income individuals, since tax-free bond rates usually must cater to individuals *not* in the highest tax brackets to generate sufficient revenue– the additional return the highest-income individuals generate is a windfall
   3. Arbitrage bonds (bond proceeds are invested in higher returning assets) **are** taxable - §148
   4. Non-qualified private activity bonds **are** also taxable
      1. Private activity bonds may fall within the 501(c)(3) exception if all property to be provided through the bond’s proceeds will be owned by a governmental unit or a 501(c)(3) organization - §145
   5. U.S. savings bond interest is tax-exempt if used to pay college expenses (tuition and fees) - §135
      1. Contains both a ratio cap (if tuition is only 70% of bond interest, only 70% of interest is excludable) and a dollar cap (full benefit until $40k, benefit disappears by $55k)

#### Non-Cash Benefits

1. Fringe benefits create problems with equity, efficiency, and complexity
   1. Creates problems of deadweight loss, if market value and subjective values are unequal – taxes might create incentives to make different choices than in a tax-free world
   2. Tend to be available to wealthy (also more beneficial – marginal tax rate is higher)
   3. Congress takes different approaches in various Code provisions: all-or-nothing (meals & lodging); dollar caps (transportation); percentage caps (education lodging); or taxing the employer unless certain conditions are met (gyms)
2. ALWAYS ask what Congress’ intended outcome is – what incentives are being created?
3. Why not assume all fringe benefits (other than working condition fringes) are part of the bargain between employers and employees and include FMV in income?
4. Congress could also disallow the employer’s deduction for providing the fringe benefit, rather than tax each individual employee
   1. Economic benefit will not be taxable to a recipient when payment of expenses serves a legitimate business purpose (*Gotcher* – trip to Germany had overarching business purpose)
5. Travel expenses for spouses require that spouse also be an employee, serve a legitimate business purpose, and the expenses would have otherwise been deductible - §274(m)(3)
6. Gross income **does not** include meals and lodging provided by the employer for the employer’s convenience **if** meals are furnished on the employer’s business premise or employee is required to accept such lodging on the employer’s business premise – §119(a)
   1. Attempts to ensure employers aren’t benefitting by furnishing meals rather than upping salary
      1. Meals are provided for employer’s convenience only if there is a substantial noncompensatory purpose
         1. Generally, on-call requirement establishes that lodging/meals are for employer’s convenience
         2. All meals were furnished for employer’s convenience if more than one-half of employees to whom meals are provided were for the employer’s convenience
   2. “Meals” requires an in-kind transfer, not cash *to purchase* meals (*Kowalski* – state troopers)
      1. However, troopers might be able to deduct the cost of meals they were required to eat at highway-side restaurants under §162 (*Christey*)
   3. Semi-harsh rule: meal is either entirely deductible, or not at all
   4. Spouses and dependents’ meals are included for administrability reasons
   5. The lodging portion of §119 is a functional, not spatial, test (*Adams* – home owned by company and lived in by executive served business functions, therefore excludable)
      1. Exception that’s not really an exception for qualified campus lodging – gross income **does not** include the value of such lodging to an employee, **except excess of**: §119(d)
         1. 5% of the appraised value over rent paid ($1 million condo – 0 rent payment = taxable income of $950 k) *or*
         2. Average rentals paid by individuals other than employees or students for comparable, institutionally provided lodging over rent paid
7. Gross income **does not** include employer-provided health coverage - §106
   1. Deduction for out-of-pocket medical expenses to extent that costs exceed 10% of AGI - §213(a)
   2. Gross income **does not** include amounts received under workmen’s comp, damages received (other than punitive) on account of personal physical injuries or physical sickness, or amounts received through health insurance for personal injuries or sickness - §104(a)
      1. However, gross income **includes** amounts received by an employee through a health plan if those amounts were attributable to contributions/payments by the employer **that are not reimbursements**
      2. Gross income **does not** include payments from the employer for the permanent loss of a member/disfigurement of the taxpayer
   3. Damages received for emotional distress **are** taxable under §104(a)
   4. Under *Raytheon*’s matching principle, nonphysical injury to professional reputation should be taxable, but nonphysical injury to personal reputation should not (no tax on personal “brand”). Does this stretch §61’s definition of income beyond constitutional limits (taxing unrealized gain)?
   5. Policy justifications for excluding physical injury damage awards are:
      1. Taxing compensation for pain and suffering is offensive
      2. A recovery for expenses should not be taxed
      3. Recoveries for non-taxable items should be tax-free
      4. Lost wages should be untaxed so the victim will be in the position he would have been had there been no injury (assumes damages are paid on an after-tax basis)
         1. Under *Raytheon*, lost wages should be taxed based on what they are replacing – in this case, *income* from wages!
      5. There should be no tax on recoveries of human capital
         1. The basis of the pre-injury body is the amount of damages received (see *P.L. 107-16* – no taxation for Nazi restitution payments)
   6. Limits taxpayer’s ability to take something out of the tax base twice – damages cannot be excluded *while* simultaneously deducting medical expenses
   7. Taxes can expand size of an economic sector based on whether certain expenses are deductible (see employer-provided health care!)
   8. Employer-provided life insurance **is** taxable income **if** employer pays for more than $50k of coverage and employer pays more than employee (only marginal benefit is taxed) – §79(a)
      1. Gross income **does not** include proceeds of a life insurance contract - §101(a)(1)
         1. If a life insurance policy is surrendered not because of death, proceeds that exceed the cost of the policy are taxable

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|  |  | **Premium** | **Recovery** | **Incentive to provide coverage?** |
| **Medical** | *Employer-Provided* | Not income - §106 | Not income if for medical care – §105(b) | YES |
| *Individual-Provided* | Deductible, but only after 10% of AGI  (*high* bar) – §213 | Not income -  §104(a)(3) | Not really |
| **Accident** | *Employer-Provided* | Not income - §106 | Not income -§§104(a)(3), 105(c) | Yes, but  severely limited |
| *Individual-Provided* | Premium purchased with after-tax dollars and no deduction | Not income - §104(a)(3) | No |

1. Gross income **does not** include any of the following fringe benefits under §132:
   1. No additional-cost services
      1. Service provided to employee **if** service offered for sale in ordinary course of business *and* no substantial additional costs (including foregone revenue) incurred - §132(b)
      2. Includes employees, spouse/dependents, and employee’s widow(er) for flights - §132(h)
         1. If employee is living, employee’s parents may fly tax-free
         2. If employee is dead, employee’s spouse’s parents may *not* fly tax-free
         3. Can employee’s spouse’s parents ever fly free? AW – ambiguous, so maybe yes
   2. Qualified employee discounts
      1. Cannot exceed the gross profit percentage (of all property, or a reasonable classification thereof), or greater than 20% off the cost of services offered to customers - §132(c)
   3. Working condition fringes
      1. Any property or services provided to an employee that, if paid for, would have been deductible under §162 or §167
      2. Requires a substantial noncompensatory business purpose
      3. No meaningful distinction between frequent flyer miles and employer-paid airplane flights – should frequent flyer miles be taxable?
   4. De minimis fringes
      1. Any property/service the value of which is so small as to make accounting for it unreasonable/impracticable
      2. An employee eating facility is a de minimis fringe if located on/near employer’s business premises, and the facility’s revenue normally equals/exceeds direct operating cost
         1. Employers prefer de minimis fringe over §119 exclusion. De minimis fringes aren’t subject to §274(n)(1)’s 50% limit – these meals are *fully* deductible
   5. Qualified transportation fringes
   6. Qualified moving expense reimbursement
      1. Any reimbursement of expenses that, if incurred by the employee, would have been deductible as moving expenses under §217
   7. Qualified retirement planning services
   8. On-premises gym passes are specifically exempted from income - §132(j)(4)
      1. The cost of operating an on-premises gym is not deductible to an employer (§274(a)(1)(B) unless the gym is to be used primarily for the benefit of employees other than highly compensated employees (§274(e)(4)
2. Other items specifically excluded from gross income:
   1. Qualified tuition reduction - §117(d)
      1. Note that exemption can be limited by non-discrimination measures - §117(d)(3)
   2. Value of a home furnished to a minister of the gospel – §107
   3. Amounts received as benefits of a cafeteria plan - §125(a)

#### Basis

1. The basis of property is its cost (§1012(a)), and the gain/loss from a transaction is calculated as the “amount realized” – “cost” - §1001(a) – (b)
   1. Amount realized is equal to cash received plus fair market value of any property received
   2. FIFO governs cost basis of assets acquired at different times
   3. Basis must be allocated in a reasonable way (*Nixon* example – allocate basis across non-coastal and coastal land, since some of the land has an impliedly higher basis)
   4. Damage payments are analyzed under the replacement’s tax structure – if payment replaces lost profits, it is normal income. If it is recovery of capital, it is a taxable gain
      1. Business goodwill is present capital, not a future gain. However, there is a rebuttable presumption that goodwill has a basis of 0 (*Rayethon* – damage payments for antitrust violation is still taxable)
      2. Consistent with §7491’s burden scheme
2. There are three conceptualizations of the benefits of tax deferral: 1) Interest free loan (paying tax later instead of now), 2) Present value reduction of tax liability, and 3) Exemption equivalence (deferral is equivalent to the exemption of interest income). Formula is PV = FV / (1+r)n
   1. Three conditions for exemption equivalence to hold:
      1. Applicable tax rate remains constant
      2. Deduction produces an immediate tax savings equal to the taxpayer’s marginal rate multiplied by the deduction
      3. Tax savings can be invested at a return equal to the original investment
3. Gross income includes any amount received as an annuity, but the principal is exempted from tax under the exclusion ratio- §72(b)(1)
   1. Annuities are taxed if life expectancy is exceeded, once principal is entirely recovered (taxable mortality gain)
   2. If unrecovered principal remains at death, the unrecovered principal is deductible on a final tax return (deductible mortality loss)
4. The basis of inherited property is fair market value at the time of decedent’s death - §1014(a)(1)
   1. Gains on property passed on through inheritance will *never* be taxed! Creates incentives to borrow against an appreciated asset, spend it, die, and leave children to pay off debt by selling asset (with its new basis at FMV!)
   2. Exclusion of taxable income at death only applies to returns on capital – *not* labor - §691(a)

#### Realization

1. The requirement that income must be realized before being taxable has three animating concerns: 1) Administrability, 2) Valuation problems, and 3) Lack of liquidity
2. When a taxpayer displays intent to exercise complete dominion over unsolicited samples, the value of the samples is gross income – *Haverly* (principal donates sample textbooks, claims charitable deduction)
   1. Claiming the charitable deduction is the realization event in this case
   2. Animated by double-dipping concerns – getting tax benefits without associated income increase
3. Under *Eisner v. Macomber*, the severance of capital from income is the touchstone for income realization

Value of company Stock dividend Choice of cash & stock dividend Cash dividend

**Constitutional Line**

* 1. Defines income as “the gain derived from capital, or labor, or from both combined”
  2. Only SCOTUS case holding 16th Amendment did not grant power to tax a type of income
  3. Similarly, capital gains aren’t taxed until realized because income isn’t severable from investment
  4. Bright-line principle of *Eisner* has slowly eroded
     1. *Kirby Lumber* taxes on cancellation of indebtedness – doesn’t fall into labor or capital
     2. *Glenshaw Glass* redefines income as “all gains except those specifically exempted”
     3. *James* held that all unlawful gains are taxable

1. An exchange of property gives rise to a realization event only if the properties are “materially different” – *Cottage Savings* (exchange of bundled mortgage securities gave rise to recognizable losses)
   1. Material difference mean that property gives owner different legal entitlements than they had
2. Income **includes** Original Issue Discount (OID) (excess of bond’s redemption value over issue price) §1272
   1. Is taxability of OID constitutional under Eisner? Where is the severability/realization?
      1. Might be due to guarantee of eventual payment – it is a more sure thing than equities
   2. Getting the calibration is important here, due to the presence of nontaxable entities. If OID is taxed on realization, lenders have an advantage. If taxed on total gain pro rata, tax payments are accelerated, and lenders have a disadvantage. In either case, nontaxables can fill the gap
   3. Gain realized by repurchasing bonds at less than par value is taxable income – *Kirby Lumber*
      1. Income is *more* than gain from capital or labor
      2. Reverse method of calculating gain – amount borrowed must be a “liability basis”

#### Atypical Income (Gifts, Prizes, Scholarships, Discharge of Indebtedness, Illegal Income)

1. Gross income **does not** include the value of property inherited by gift or inheritance - §102(a)
   1. However, income from property received by gift (or where the gift is such income) **is** included in gross income - §102(b)
      1. A gift of interest income is taxable to recipient, since the interest itself would be taxable if it were not gifted – *Irwin v. Gavit*
         1. SCOTUS realizes temporal division is a way to defer tax liability and disguise income as capital appreciation
   2. Reflects a choice to tax the donor rather than the donee, largely for administrability reasons
   3. Employers cannot give gifts to employees and have gifts be non-taxable - §102(c)
      1. However, if a gift is taxable under §102(c), it is deductible for the employer under §274(b)! Only *one* person will be taxed for the gift
      2. The “gift” might still be excludable under some other provision, *and* still be deductible by the donating corporation!
   4. Can Treasury’s proposal to reform inheritance tax be constitutional under *Eisner*? Doesn’t it impose a tax without a realization event or severance of capital and income?
2. The definition of a gift is a fact sensitive inquiry – *Duberstein* (gifted Cadillac to acquaintance that frequently referred business to car dealer)
   1. Transferor’s intent is most critical inquiry, but objective determination of gift is also necessary
      1. Congress rejects the result and passes §102(c) and §274(b), but these provisions only apply in employer-employee relationships. *Duberstein* is still good law for gifts from companies to non-employees
3. The basis of property acquired by gift is the basis it had under the last non-donative owner
   1. However, if basis is greater than FMV at time of the gift, then for the purpose of determining loss the basis is FMV - §1015(a)
      1. Prevents donor from gifting tax loss to donee – gains may be shifted, but losses may not
   2. When a transfer of property is partly a sale and partly a gift, transferor has a gain to the extent that his amount realized is greater than his adjusted basis; no loss is possible – Reg. §1.1001-1(e)
      1. However, if the transfer is to a nontaxable entity, ratio of amount realized to FMV determines new adjusted basis – sale for 50% of FMV leads to a 50% reduction of basis
4. Gross income **includes** prizes and awards **unless**: §74(a)
   1. Prize is for religious, charitable, scientific, educational, artistic, literary or civic achievement;
   2. Recipient was selected without any action to “enter”
   3. Recipient is not required to render substantial future service as a condition to receiving the prize
   4. Prize is donated to a governmental unit or charitable organization
      1. This loophole can be used to avoid limits on charitable deductions by getting it excluded from income in the first place
5. Gross income **does not** include qualified scholarships - §117(a)
   1. Employers may provide educational assistance up to $5,250 **not included** in income - §127(a)
      1. Is this fair? Borrowers and working students pay tuition out of after-tax dollars…why are scholarships given preferential treatment?
         1. Possible solution is increasing basis for borrowers and working students
      2. Example of social interference through tax policy – incentivize “beneficial” activites
6. Note what SCOTUS did in *Kirby Lumber* – Amount Realized – Liability Basis = Taxable Income
   1. Discharge of indebtedness is only taxable if there is a net gain – *Deadbeat Dad* hypo (immediately after child support order, net worth decreases by $100k – immediately after statute of limitations, net worth goes back to original amount, so no taxable gain)
   2. A number of exceptions to the *Kirby Lumber* rule in §108 – most notably, government simply prepares to take tax later by decreasing basis (not below 0) in taxpayer’s remaining property
      1. Any discharge in excess of amount of insolvency is taxed - §108(a)(3)
      2. Basis reduction occurs in the year after the year in which discharge occurs - §1017(a)
   3. Gross income **does not** include any amount of student debt that is forgiven by reason of participation in an educational institution’s program to encourage students to take jobs within a governmental unit or a charitable organization - §108(f)
      1. LIPP does not fall into this definition, since it provides compensation for low-paying private sector jobs! HLS must therefore create two programs – one where indebtedness discharge is not taxed, and another where HLS grosses up to help graduates pay for the taxes they will incur because of their debt forgiveness
7. Gambling loans are income – credit is extended to provide “opportunity to gamble” – a valuable asset
   1. However, opportunity to gamble is *not* property for purchase price reduction of §108(e)(5)
   2. Legal enforceability of an obligation to repay is not determinative of taxability – receipt of valuable consideration is
      1. However, under contested liability doctrine, the settlement amount becomes the assumed amount of the disputed debt
   3. Gambling losses are only deductible to the extent of gains from gambling transactions - §165(d)
      1. Winnings might not be the only way to obtain taxable “gains?”
      2. Gamblers cannot rely on the *Cohan* rule, allowing approximation of the expenses incurred to determine deductible losses, since §274 explicitly requires adequate reporting of entertainment expenses
   4. Distinguished in *Collins* (employee granted himself credit to gamble on horse races)
      1. The taxable gain is the misappropriation of the employer’s property. Once the money is stolen, what the thief *does* with the money is inconsequential to tax analysis
         1. A taxpayer has received income when she “acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition”– *James*
         2. Critical inquiry is whether obligation to repay was “consensually recognized” – if obligation was so recognized, it is likely only a non-taxable loan
            1. Does this lead to unfairness, since the taxation of stolen funds usually leads to decreased recovery for the victim?

### Deductions

1. All ordinary and necessary business expenses are deductible - §162(a)
   1. Ordinary and necessary expenses for the production of income, maintenance of property held for income or tax filing preparation are deductible - §212
   2. “Ordinary” and “necessary” are given meaning by judge’s common experience - *Welch* (payments made to please former company’s creditors were capital expenditures to build brand, not expenses)
      1. Goal is to tax only *net* income, not gross
      2. Necessary only means “appropriate and helpful”
      3. Ordinary means a normal and regular part of business (but might happen only once) – *Gilliam* (litigation expenses from airplane fight during business trip not ordinary)
         1. Litigation expenses’ deductibility turns on the origin of the claim – if claim originates from profit-seeking activity, it is deductible
         2. Since “ordinary” is defined by reference to others in the industry, is there an unfair disadvantage to innovators?
      4. What work does “ordinary and necessary” do? Does this cut the number of deductible expenses, or simply express a presumption towards taxation?
         1. If there are “extraordinary business expenses”, doesn’t the ordinary/necessary restriction lead to double taxation?
2. No deduction is allowed for personal, living or family expenses - §262
3. No deduction is allowed for any amount paid for new buildings or permanent improvements that increase a property’s value - §263
   1. Although creation of a separate and distinct asset may be sufficient, it is not a necessary condition to require capitalization - *INDOPCO*

#### Profit-Seeking Expenses

1. §199 grants a 9% tax rate deduction for selected industries that keep production in the U.S.
   1. Limited to ½ of employee wages to force continued use of employee labor
   2. Applies to things manufacture, grown, produced or extracted in the U.S.
      1. **Does not** include sale of food/beverages prepared at a retail establishment
   3. Congressional intervention to move production away from foreign countries
2. §162(m)(1) sets the maximum deductibility for employee salary at $1 million
   1. Concern is that companies might be stuffing dividends (normally taxable to both the company and recipient) into salary (deductible to company and only taxed to the individual) into salary
   2. §162(m)(4)(C) eviscerates this limit by excluding remuneration earned by virtue of hitting performance targets, subject to reporting requirements
   3. Posner shifts question of excessive executive compensation from market comparisons to an “independent investor test” – if an investor is happy with executive’s actions in increasing company value, high compensation is *presumptively* reasonable – *Exacto*
      1. Tax Court still prefers a 7-factor test of the reasonableness of the compensation
3. Illegal bribe to government officials (or bribes to an official of a foreign government that would be illegal under FCPA) **are not** deductible - §162(c)(1)
   1. Bribe to a citizen that subjects the payer to state criminal liability (as long as law is generally enforced) is **also not** deductible - §162(c)(2)
   2. Fines or other penalties paid to a government for violation of law **are not** deductible - §162(f)
      1. Although the rationale seems to be that allowing deductibility would dilute their effect, the math does not bear out this assertion – disallowing deduction actually makes the fine *heavier* than we might want it to be
      2. The income tax is not supposed to be a sanction against wrongdoing – there is no explicit “public policy” exception to §162 – *Tellier* (expenses for unsuccessful defense of securities fraud are deductible)
         1. Why is §280E focused solely on drug trafficking – under current law, expenses for bullets in my assassination business are deductible!
4. Costs of influencing legislation or participation in a political campaign **are not** deductible - §162(e)(1)
   1. Exceptions for local council legislation (zoning), de minimis in-house expenses (less than $2,000)
   2. Looks like a hidden tax on consumers because lobbying occurs (increased costs are passed on to consumers), but constitutional because deductions are legislative grace
5. Any non-compensated loss sustained during the year **is** deductible - §165(a)
   1. Individuals may only deduct losses incurred in trade/business, losses incurred in any transaction entered into for profit, and losses arising from fire, storm, shipwreck or other casualty - §165(c)
      1. Individual losses are limited since we assume losses are due to consumption of the asset
   2. Any loss arising from theft is deductible in the year the taxpayer discovers the loss – §165(d)
   3. A loss arising from a security’s worthlessness is realized when the taxpayer believes in good faith that it has become worthless – *Boehm*
   4. Losses arising from the sale/exchange of property between certain individuals (family members, commonly owned corporations/trusts, etc.) **are not** deductible - §267
      1. However, if the loss is not allowed to the transferor, and the transferee later sells the property at a gain, gain only recognized to extent it exceeds the previous loss - §267(d)
         1. This is an asymmetrical treatment of losses – family gets benefit of first loss if eventually sold for a gain, but only second loss if eventually sold for a loss
   5. No loss is recognized if substantially identical stocks are purchased/sold within 30 days
      1. New basis = basis of sold stocks + (price of new stocks – price at which old stock sold)
      2. Only bona fide losses are allowable – no elevation of form over substance – *Fender* (neither §1041 nor §267 applies, but court still doesn’t allow deduction)
   6. For individuals, capital losses are only allowable to the extent of capital gains, plus either $3,000 or the excess of such losses over such gains
      1. Necessary to discourage people from realizing losses but not gains – however, this also hurts people that are *only* losing
6. Any debt which becomes worthless within the taxable year **is** deductible - §166(a)
   1. Dominant motivation for the bad debt must be business-related - *Generes*
   2. For an individual, worthless nonbusiness debts (debts not associated with a trade or business) **are only** deductible as a loss from the sale/exchange of a capital asset held for not more than one year (thus subject to capital loss limit of §1211(b))
      1. Individuals are undertaxed because normally, personal losses are not deductible *at all*

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|  | **Business** | **Profit-Seeking** | **Personal** |
| **Expenses** | § 162 - “Ordinary & Necessary” | § 212 - Deduction for production and collection of income | §262 - No Deduction |
| **Losses** | § 165(c)(1) - Deduct for losses incurred in trade or business | § 165(c)(2) - Deduct for losses incurred in profit-seeking activity | § 165(c)(3) - No deduction for personal losses unless casualty |
| **Bad Debts** | § 166(a) - Deduct for bad business debts | § 166(d) - Nonbusiness debts deductible as capital loss subject to § 1211(b) | § 166(d) - Nonbusiness debts deductible as capital loss subject to § 1211(b) |

#### Capital Expenses

1. Expensing is more beneficial than capitalizing expenditures due to benefits of tax deferral – *see page 5*
   1. However, capitalization *might* be more beneficial if there is no income to deduct against this year
2. §179 allows small businesses to expense some purchases of capital equipment rather than capitalize them
   1. Subject to dollar caps (expanded to encourage investment during financial crisis)
3. Costs associated with a capital asset purchase are notdeductible – *Woodward* (appraisal fees for stock purchase should be lumped in with the rest of the capital acquisition expenses)
   1. The standard to be applied is an origin of the claim
      1. Two exceptions to rule that expenses of facilitating a transaction must be capitalized – de minimis and employee compensation
         1. Although the employee compensation exception was made out of administrative necessity, it creates a *huge* incentive to create in-house purchasing jobs, since those costs are immediately deductible
         2. Bush & Obama administrations issued regulations allowing immediate deduction of in-house costs of acquiring intangible & tangible assets, respectively. This creates a large incentive for no one to make things and use in-house purchasing departments whose costs can be immediately deducted
      2. However, general rationale of *Woodward –* costs associated with capital expenditures must still be capitalized – still applies in manufacturing contexts
4. Direct costs of property (and allocable indirect costs) must be capitalized - §263A(a)
   1. Numerous exceptions, including Christmas trees (hiding behind four layers of negation) and creative expenses of writers, photographers and artists
5. The receipt of benefits beyond the tax year are an important consideration in whether expenses are deductible or must be capitalized – *INDOPCO*
   1. Created so much uncertainty that IRS published guidance on what expenses must be capitalized
   2. The IRS has tried to severely limit the impact of *INDOPCO* by allowing deductions for a number of expenses that produce future benefits (advertising, in-house purchase facilitation, etc.)
      1. Effort to produce certainty has led to promulgation of *very* fact-specific revenue rulings (Rev. Rul. 2001-4 – 3 different plane repair scenarios)
         1. If an expenditure 1) adapts an asset for a new or materially different use, 2) significantly prolongs the asset’s useful life, or 3) materially adds to the asset’s value, it should be capitalized. Otherwise, it is a deductible repair
         2. If costs are part of a general plan of rehabilitation, all costs are capitalized
         3. Costs *may* be split between capitalized and deductible in some scenarios
      2. §7421 restricts the ability of individuals to force the IRS to collect someone else’s taxes – so the IRS’ move away from *INDOPCO* is probably *never* subject to judicial review
6. Start-up expenses **are not** deductible unless less than $5,000 (deduction is phased out between $50k and $55k) – all excess is amortized over 15 years - §195
   1. Start-up expenses are only deductible if they would be deductible for an existing business
   2. Capital expenditures cannot be deducted, even as a start-up cost - §195(c)
7. Non-taxpayer created goodwill and other intangibles are amortized over 15 years - §197
   1. Incentivizes creation of my own goodwill, since advertising costs are immediately deductible
8. Depreciation deduction reduces basis of property used in business or held for income production - §167
   1. §168 generally allows double-declining method, unless 150% method or straight-line is called for
      1. Straight-line can be elected for any asset class
         1. Straight-line *must* be used for tax-exempt property, or property based in a foreign country - §168(g)
            1. Limits (but doesn’t completely destroy) incentive have tax-exempt entities rent capital assets from taxable entities at low cost while taxable reap accelerated depreciation benefits
      2. Congress’s choices in shortening applicable asset lifetime creates an effective decrease in tax rate in the shadows – no political accountability!
   2. Salvage value is always 0, and the half-year convention (any asset placed in service during the year is “placed in service” at the halfway point of the year) is followed - §168
      1. If purchased in last quarter, use the mid-quarter convention
   3. Land is not depreciable
   4. Should antiques count as a depreciable asset? (IRS says no, Tax Court sometimes says yes)
      1. Test is whether property is subject to exhaustion, wear and tear, or obsolescence
   5. Leases have a limited lifetime and thus could be treated as a depreciable asset (as long as it isn’t a self-created asset) – *World Publishing*
      1. This is not the rationale used by the *World Publishing* court. There, the court simply allowed both the lessor and lessee to depreciate the building, even though the building’s useful life would end before the lease expired
   6. Congress can add “bonus” depreciation to spur investment in capital assets if necessary - §168(k)
9. Depletion is appropriate for mines oil/gas wells, other natural deposits, and timberland - §611
   1. Depletion allowance is calculated as a percentage of the gross income from the property (“percentage depletion” as opposed to “cost depletion” which estimates the total resource and deducts based on the proportion actually extracted in a given year)
      1. Might lead to a depletion deduction in excess of basis, which means that there is significant under-taxing
   2. Intangible drilling/development costs are immediately deductible - §263(c)

#### Business/Personal Borderline

1. Congress has imposed restrictions on business/personal expenses in response to perceived abuses – taxpayers with higher income usually have more opportunities to obtain favorable deductions (that are also more valuable due to higher marginal tax rate)
   1. Due to lack of statutory clarity, courts and IRS create various tests to determine deductibility. No overarching theme; examine precedent/regulations to determine which standard should apply
      1. There are some expenses “so inherently personal” that no deduction is allowed (religious services, prostitution (even though book was to be written about it))
   2. Consider difficult comparison between working condition fringe benefits (benefits that would be deductible by an employee under §162) and expenses *actually* deductible under §162 – what result if there is a mismatch (i.e., expense not deductible under §162 but probably would not be included in income as a working condition fringe)?
      1. Tax Court says a deduction isn’t allowable if employee was entitled to reimbursement and didn’t seek it
2. The cost of clothing is deductible as a business expense only if: (*Pevsner*)
   1. The clothing is not of a type specifically required as a condition of employment
   2. It is not adaptable to general usage as ordinary clothing
   3. It is not worn as ordinary clothing
   4. These tests are *objective*, not subjective
      1. Administrative necessity, fairness to multiple taxpayers who, although in similar situations, have different tax results, wins out
   5. Although uncertain, the easiest (only?) way to get a clothing deduction is for an official uniform
3. §21 grants a tax credit for expenses for household services or the care of a dependent
   1. Reg. §1.21-1(d)(3) seems to bleed these two categories together – household services only qualify if some of them are done for the dependent
      1. Credit is phased out – falls from 35% of expenses to 20%. Subsidy stays flat for all income levels above a certain amount. Does this reach the intended demographic?
   2. Expenses eligible for credit also subject to hard cap of $3k for 1 dependent and $6k for 2 or more
      1. Expenses eligible for credit are limited to individual (or spouse’s) earned income
   3. The credit is also nonrefundable – if there is not enough tax due, the credit goes to waste
      1. This credit does not really help low-income people *at all*
   4. §129 offers even more help – gross income **does not** include amounts received from an employer for dependent care assistance (below $5,000), subject to §21’s spousal earnings limits
4. Except as provided in §132(a)(6), gross income **includes** payment/reimbursement for expenses of moving from one residence to another which is attributable to employment - §82
   1. §132(g) allows moving expenses to be reimbursed if deductible under §217
      1. §217 allows deductions for moving expenses incurred in connection with the commencement of work at a new principal place of work
         1. Limited to reasonable expenses for moving household goods and traveling (including lodging, but not meals) to the new residence
         2. Employee must remain working in the same area for a certain time after moving and must have moved more than 50 miles
   2. Expense of commuting from home to work is generally **not** deductible
      1. However, additional expenses incurred for transporting required tools to/from work **are** deductible to the extent that they represent cost above what the employee would ordinarily pay to commute by that same means of transportation
      2. Expenses of commuting to a temporary work site outside the metropolitan location whether the taxpayer leaves and normally works **are** deductible
      3. If taxpayer commutes to a temporary worksite and home is not normal workplace, commuting expenses are deductible, regardless of distance
         1. Temporary employment requires definite employment term of less than 1 year
      4. If taxpayer’s residence is principal place of business, taxpayer may deduct commuting expenses between residence and another work location
5. §162(a)(2) allows deductions for travelling expenses while away from home in pursuit of trade or business
   1. Traveling expenses are only deductible if they are 1) reasonable and necessary, 2) incurred while away from home, and 3) necessitated by the exigencies of business – *Flowers*
      1. If a trip is for mixed business and personal reasons, travel costs are deductible only if the trip is primarily for business purposes – cf. *Gotcher*
   2. “Away from home” requirement means that if a trip does not require overnight accommodation, no expenses for meals are deductible
      1. Reflects a point on the spectrum between accuracy and administrability
      2. Why are meals or lodging ever deductible? At the very least, taxpayer would have had to pay for food at home out of after-tax dollars anyway
      3. If a meal is eligible for deduction, only 50% of the cost may be deducted - §274(n)(1)
         1. Employer can take full deduction if employee can exclude the meal as a de minimis fringe under §132(e)
         2. Employer can also take full deduction if it is a reimbursement under §82
      4. Not required for flight (ordinary & necessary under §162(a)); just for otherwise personal expenses, like meals and lodging
   3. Allowance of a deduction under §162(a)(2) turns on the reason for maintaining two homes – if personal, “home” is the place of employment, and no deduction is allowed. If it is for business, “home” is the residence, and the deduction is allowed – *Hantzis*
      1. Without duplicative living expenses, there simply is no “home” under §162 – traveling circus employee
      2. Congressperson’s home is their home district, but only $3,000 of living expenses in D.C. are deductible - §162(a)
6. **No** deduction is allowed for entertainment, amusement or recreation expenses, **unless**: §274(a)(1)(A)
   1. There is more than a general expectation of deriving business benefit
   2. Business discussions either during or immediately following the expensed event
   3. Principal reason for expense was active conduct of business
      1. Although occasional lunches to improve social cohesion might have been deductible, daily lunch to discuss business, though ordinary & necessary, was not deductible – *Moss*
   4. Subject to significant reporting requirements in §274(d)
   5. No deductions for lavish/extravagant business meals, or if taxpayer (or employee) isn’t present for meal - §274(k)
   6. Conventions must meet necessity requirements to be held outside the North American area, and geographic limitations if they will be on cruise ships - §274(h)
   7. The cost of skyboxes is only deductible to the extent of normal stadium seating - §274(l)(2)
   8. No deductions for membership/dues for a club - §274(a)(3)
7. No deduction with respect to use of a dwelling used as residence, unless a portion of the residence is exclusively used on a regular basis as the taxpayer’s principal place of business, a place of business used by clients in dealing with the taxpayer or (if a separate structure), if used in connection with the taxpayer’s business - §280A(c)
   1. A home office is the taxpayer’s principal place of business under two factors: 1) the relative importance of the activities performed at each business location, and 2) the time spent at each place – *Popov* (music studio in a violinists’ one-bedroom apartment living room)
   2. “Principal place of business” includes a place used by taxpayer for business’s administrative activities if there is no other fixed location where taxpayer conducts such activities
   3. §280A(g) includes a de minimis exception for rental income – if less than 15 days, neither deduction nor income
      1. Can Extreme Home Makeover use this as a tax evasion strategy?
8. Losses from activities not engaged in for profit (hobby losses) **are not** deductible. The only deductions allowed are those permitted outside §183, and losses to the extent income exceeds the deductions allowed - §183
   1. If an activity makes a profit for three of five years, it is presumed to be “for profit” - §183(d)
      1. This is a pro-taxpayer, objective test that is not hard for hobbyists to meet since they can manipulate cash flows to create profit in a needed year
   2. Whether an activity is for profit is highly fact-specific, turning on 9 distinct factors – *Storey*
9. Deductions for educational expenses **are** allowed under §162, if two separate tests are met: (*Wassenaar*)
   1. The educational expenses cannot qualify the taxpayer for a new field of employment
      1. Minimum education requirements (such as bachelor’s degree) are generally not deductible because they “qualify” the taxpayer for a new job
      2. Law students generally fail on this test; MBAs usually pass
   2. Educational expenses must maintain/improve skills necessary to taxpayer’s current employment
   3. Compare income exclusion for educational expenses (§§127 (employer contributions), 135 (Income from U.S. savings bonds)) with deduction for tuition - §222
      1. §222 contains hard dollar limits – past a certain point, no deduction is allowed
         1. Example of a particularly egregious “cliff effect” – one additional dollar destroys the entire deduction
      2. §25A includes two tax credits, the American Opportunity Credit (first four years of undergrad) and the Lifetime Learning Credit
         1. Election to take either credits invalidates §222’s education expense deduction
      3. §529 accounts provide tax-free interest and distributions to students if proceeds are used for college expenses
10. Expenses incurred in seeking new employment within the same trade/business **are** deductible under §162
    1. Expenses **are not** deductible if employment is sought in a new trade/business – *Rev. Rul. 75-120*
    2. If unemployed, old trade/business applies if there is not a substantial lack of continuity
    3. Payments to individuals for reimbursement of travel expenses associated with job interviews **are not** includible in gross income – *Rev. Rul. 63-77*

#### Personal Deductions

1. Deductions tend to benefit the wealthy (who actually have sufficient income to take advantage of deductions) and have the assets that are capable of deductions (mortgage interest, etc.)
2. §163(a) permits a deduction for interest, but this is largely limited by subsequent sections
   1. Deductibility of interest *increases* value of accelerated consumption by making it more profitable for me to borrow before I receive payment and deduct interest from future tax liability
      1. Personal interest in particular is severely limited because Congress is concerned about incentives for (not) saving that interest deductibility creates
      2. If interest income is taxed, should deduction be allowed for “negative” interest income?
         1. Also achieves horizontal equity for people who consume out of their own assets or those who borrow against those assets
   2. How is it possible to trace which purposes borrowed money is being used for? Money is fungible!
   3. Deduction for investment interest is only deductible up to the amount of investment gains (but may be carried forward indefinitely) - §163(d)
      1. Investment income does **not** include dividends or capital gains (unless taxpayer elects to have capital gains taxed as ordinary income)
      2. If a business consists solely on investing, interest expenses are fully deductible
   4. There is no deduction for interest incurred for personal reasons - §163(h)
      1. Any interest for a debt not allocable to a trade or business is personal interest
      2. Exceptions for home equity loans (capped at $100k) and mortgages for two residences (capped at $1 million)
         1. According to 9th Circuit, $1 million cap applies per mortgage, *not* per person
         2. Mortgage insurance premiums may also be treated as mortgage interest, subject to a phase out from $100k to $110k
         3. This is a *huge* benefit for wealthy individuals who can afford to own their own homes (in addition to imputed income, property tax deduction, etc.)
      3. Interest on educational loans is deductible (up to $2,500 per year) - §221
         1. Ratio-based phase out if AGI is between $50k and $65k (adjusted for inflation)
   5. Business interest is deductible as an ordinary & necessary expense under §162
      1. Interest must be capitalized on assets built by the taxpayer with a long useful life or long construction time - §263A(f)(1)
   6. No deduction for interest incurred to purchase tax-exempt bonds - §265(a)(2)
      1. Congress *could* repeal §265(a)(2) and eliminate the windfall of tax-exempt bonds for high taxpayers, since all taxpayers who could would try to take advantage of the negative tax rate, increasing demand and lowering interest rates on the bonds
      2. Taxpayer can get a negative tax rate by combining interest deduction with a 0 tax rate
      3. Tax arbitrage might also be possible if the immediate expensing of an asset is permitted
      4. All other tax-exempt income (scholarships, etc.) *also* disallowed under §265(a)(1)
3. Courts invented economic substance transaction to address perceived “sham” transactions that only served as tax dodges – *Knetsch*
   1. Expanded in *Goldstein* to cover non-sham transaction with sole purpose of tax avoidance/deferral
      1. Or did *Goldstein* simply redefine a sham transaction as one where there is no realistic opportunity for profit?
   2. In order to avoid the economic substance doctrine, a transaction must: §7701(o)
      1. As a threshold matter, court must make the determination that the doctrine applies, using the *Knetsch/Goldstein* framework
         1. Courts can get around this requirement any time they want!
      2. Assuming economic substance doctrine applies, a transaction must:
         1. Meaningfully change taxpayer’s economic position (apart from tax effects)
            1. Present value of economic benefits can indicate a change in economic position if substantial compared to present value of tax benefits
         2. Have a substantial purpose *other than* income tax effects

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Tax-exempt bonds** | **Home** | **Depreciable Assets** | **Investment Income** | **Construction Period Interest** |
| **Income (less than full taxation)** | Interest from bonds is exempt | Imputed rental income excluded | Accelerated depreciation | Deferred Gain | Deferred income from construction |
| **Deduction of Interest** | No deduction | Fully deductible | Fully deductible | Deduction limited to gains | Interest capitalized if  no income yet |
| **Treatment of Tax Arbitrage** | Disallowed | Allowed | Allowed | Disallowed | Disallowed |

1. Taxes associated with asset purchases generally must be capitalized, but state and local income and property taxes may be deducted - §164
   1. Reflects a theory that local taxes are a cost of doing business, properly exempted as not income?
   2. Deductibility of state/local taxes benefit wealthy *again* since poor don’t pay federal taxes, and wealthy individuals have a higher marginal tax rate leading to lower effective state tax rate
2. Casualty losses are limited to uninsured losses of more than $100 and must exceed 10% of AGI - §165(h)
   1. Loss must be sudden, unexpected, violent or unusual and not something you can guard against
      1. Helps get around realization (loss can’t be deducted until realized) and depreciation requirements (ordinary wear and tear on personal property is nondeductible)
   2. If casualty gains exceed casualty losses, excess is taxed as capital gain
      1. Deduction on personal property is limited to FMVpre-casualty – FMVpost-casualty *or* basis
   3. Is this a recognition of deduction of net worth (and presumed inability to pay) or a subsidy?
      1. If it’s a subsidy, it’s a strange one – since it’s a deduction, it benefits wealthy taxpayers
      2. But that creates disincentive to buy insurance, since the government will insure you
         1. High limits (only deductible past 10% of AGI) eliminates this disincentive
   4. Losses from for-profit transactions, even if not connected to a trade/business, are deductible - §165(c)(2)
3. Medical expenses not compensated by insurance and that exceed 10% of AGI **are** deductible - §213
   1. Limited to prescription drugs and insulin – cosmetic surgery costs are not included unless necessary to promote proper function of the body or prevent/treat disease
   2. Capital expenditure may be a medical expense if it has a primary purpose of medical care – *Rev. Rul. 87-106*
4. Charitable contributions are deductible under §170 up to a limit of 50% of AGI, but donations to a subset of charities are only deductible up to 30% (§170(b)(1)(B))
   1. Corporate charitable contributions are only deductible up to 10% of taxable income - §170(b)(2)
      1. What is the rationale behind the charitable contribution deduction? If it is a subsidy, why are there limits?
         1. We don’t want taxpayers to avoid all liability
      2. Why isn’t it a credit? Especially if we want to encourage lower-income people to give to charities since we’re concerned that wealthy and poor people give to different charities
         1. This may be doubly harmful, because §170 is only deductible if deductions are itemized (unlikely for poorer taxpayers)
         2. But rich people tend to give more to charity anyway
   2. Although the contribution may only be given to a specific set of donees (§170(c)), the gift can be restricted to make sure that a specific person will be the recipient of the gift
   3. A contribution is not deductible if it is a quid pro quo – *Hernandez* (scientologist contribution)
   4. There are a number of rules that alter a charitable contribution’s deductibility if the gift is an appreciated asset
      1. The amount of the charitable contribution will **always** be reduced by the amount of **non**-long term capital gain the donor would have realized if sold at FMV - §170(e)(1)(A)
      2. The amount of a charitable contribution will be reduced by the amount of **long-term** capital gain the donor would have realized if sold at FMV **if** donation is: §170(e)(1)(B)
         1. Tangible, personal property
            1. Unrelated to the charitable organization’s purpose
            2. Related to org.’s purpose but discarded by donee within the year
         2. To a private foundation
         3. A gift of other intangibles/taxidermy
      3. All other property with long-term capital gain (real property, securities, etc.) get a double benefit – neither donor nor donee will be taxed on appreciation of asset
         1. Charities that receive donations from wealthy individuals argue that the double benefit is necessary – otherwise, wealthy people will just not donate and realize a stepped-up basis when they die
         2. If capital gain property not within (e)(1)(B) is donated, total amount of deductible contributions is limited to 30% of AGI - §170(b)(1)(C)(i)
      4. Only gifts of capital – NOT labor – are deductible (i.e., if artist donates painting, no capital asset, therefore no double benefit)
   5. Bargain sales to charities of appreciated property result in gain proportional to amount realized over FMV – if property is sold for 50% of FMV, 50% of basis is used, and the rest is taxed as gain
   6. 80% of the contribution is allowable as a deduction if contribution is to an educational institution that allows donor generally unavailable opportunity to purchase tickets to sports events - §170(l)

### Computation of Tax

1. There are four basic justifications for a progressive income tax structure:
   1. Essential to taxation based on ability to pay
   2. Deliberate mechanism for reducing economic inequalities
   3. Equalize overall tax burden by offsetting effects of more regressive taxes (federal payroll taxes, state/local sales taxes, property taxes, etc.)
   4. Benefits of government expenditures may increase progressively with income
2. §62(a) provides a list of expenses that may be deducted “above the line” in calculating AGI. They include (but are not limited to): trade/business deductions, losses from sale/exchange of property, alimony, moving expenses (§217), education loan interest (§221), education expenses (§222), HSAs (§223)
   1. Employee business expenses may be deducted above the line if reimbursed by employer – unreimbursed expenses must be itemized deductions
      1. *Huge* pressure for employers to reimburse expenses, especially because below-the-line business expense deductions will *also* be subject to the 2% floor
3. Standard deduction is a tool for administrative convenience and simplicity – adjustment of rate schedule
4. Itemized deductions are those **not** included in above-the-line deductions and personal exemptions
   1. Miscellaneous itemized deductions only allowed if they exceed 2% of AGI - §67(a)
      1. Exceptions to 2% floor include (but not limited to): Interest, taxes, casualty/theft losses, charitable contributions, medical/dental expenses - §67(b)
   2. Subject to a phase out of 3% of excess of AGI over a specified threshold up to maximum of 80% of itemized deductions - §68(a)
      1. Medical/dental expenses, investment interest deductions, and casualty/theft losses are not subject to the phase out - §68(c)
      2. Phase outs act as a kind of “bonus tax” on wealthy taxpayers – makes it difficult to know what the actual tax rate is
5. Personal deductions are subsidies for those with only subsistence income – especially with children
   1. Family size is only taken into account when considering the number of personal exemptions – should family size be changed to an “above-the-line” deduction?
   2. Personal, spouse and dependent exemptions are also all phased out upon reaching §68 threshold at 2% per $2500 over threshold- §151(d)(3)
6. §1411 places an additional Medicare tax (3.8%) for if AGI is greater than threshold amount on net investment income or AGI above threshold
   1. Attempts to place a burden on capital income that already exists on labor income
7. AMT was designed to ensure that people could not credit/deduct themselves out of tax liability
   1. Due to lack of inflation adjustment, AMT now hurts many more middle-class individuals than intended, but Congress can’t change it because it is such a huge revenue source
   2. Rates are lower (26% before $175k, 28% after) but base is broader (fewer deductions) - §55(b)
      1. Depreciation deduction is reduced to 150% declining method - §56(a)(1)(A)(ii)
      2. No miscellaneous itemized deductions (§67b), no qualified housing interest deduction, no state/local tax exemptions, and no standard deduction/personal exemptions - §56(b)
   3. For corporations, AMT rate is 20% above exemption amount
8. Three broad categories of tax credits: status, credits for certain purchases, and working credits
   1. Earned income credit (EIC) increases with earned income, then decreases according to a phase out percentage. The phase out amounts are adjusted for inflation §32
      1. Amount of credit increases for 1 and 2+ children – currently has a temporary credit percentage increase for 3+ children
      2. Originally used as a way to reduce the burden of payroll taxes on the working poor – now primarily seen as insuring a minimum subsistence level for poor workers
   2. Similar to the EIC, §21 provides a credit designed to encourage individuals to work outside the home by crediting dependent care expenses
   3. §22(a) provides a rarely used credit for the elderly and/or disabled
   4. §24 creates a partially refundable child credit (in addition to standard deduction) of $1k per child, subject to a threshold phase out amount
      1. Stresses ability to pay (people with children unlikely to be able to pay significant taxes)

### Taxpayer Choices

1. The “marriage penalty” is constitutional as an unavoidable consequence of a progressive tax – *Druker*
   1. Mathematically impossible to have graduated tax rates and have all married couples pay the same tax, so the Congress’ compromise is the best we can do
   2. Marriage penalty technically only impacts couples where both spouses make similar amounts of money – if one makes substantially more than the other, there is actually a “marriage bonus”
2. The determination of whether an individual is married is made at the close of the taxable year
   1. If spouse dies, determination is made as of date of death
   2. Tax court looks to substance, not form – marriage “cruises” where marriage occurs on December 30 and divorce on January 2 do not qualify taxpayers for married rate
3. Gross income includes amounts received as alimony but **does not** include child support payments - §71
   1. A deduction **is** allowable for alimony paid during the tax year - §215(a)
   2. Parties *can* swap these rules (so that payor pays taxes and payee does not) to lower overall tax
   3. §71(b) contains list of requirements for alimony payments
4. No gain/loss on a transfer of property between spouses (or former spouses, if incident to divorce) - §1041
   1. Property is treated as if acquired by gift, and the basis is the transferor’s basis
   2. Transfer is incident to the divorce if it occurs within 1 year after the date on which the marriage ceases or if it is related to the cessation of the marriage
   3. Note the lack of loss qualification (see in §1015) – spouses *can* transfer losses to each other
   4. Prenuptial transfers of property do not qualify as gifts, so FMV at time of transfer is transferee’s new basis – *Farid-Es-Sultaneh*
      1. Court doesn’t think through logical implications of the result here – the transferor spouse did not realize a gain from “sale” of stock, but transferee gets stepped-up basis
      2. This does *not* control transfers of appreciated property *within* the marriage relationship - §1041 governs there
5. §1(g)’s “kiddie tax” is a large step to taxation based on family (rather than individual) income
   1. Taxes child’s unearned (*not* earned) income over a threshold amount of at parent’s tax rate
      1. Transferor’s identity is irrelevant – if Grandma gives grandchild a bond, Dad is taxed on coupon
   2. If child’s tax rate is higher, §1(g)(1)(A) taxes the child. If not, (1)(B) taxes the parent
6. “Anticipatory arrangements” cannot be used to escape tax liability – *Lucas v. Earl* (transfer of ½ of salary to wife does not mean he is only taxed on his portion)
   1. Similar to *Love or Money* – promise to pay ½ of prize money does not remove tax consequences. Full tax bill falls on the one who “earned” the money, and the “gift” is not subject to income tax!
   2. If income from labor/services can be turned into property (i.e., a painting or manuscript), it *can* be shifted to another person
7. There are two ways to make a distinction between gifts of property and gifts of income (gifts of property are not taxable to the donor, gifts of income are)
   1. Was there a horizontal carve-out (was the gift of *all* the property, or only a part)?
      1. This division was found in *Helvering v. Horst* – father’s gift of bond coupons while retaining ability to collect principal was inadequate severance of “fruits” from “tree”
         1. §1286 has overruled specific outcome of *Horst* – basis is now allocated between naked bond and coupons
   2. Does the donee now have an equitable interest (able to get an injunction for ownership)?
      1. This transfer of equitable ownership was found in *Blair* – assignment of trust income through trustee created a new beneficial owner, so the assignor was exempt from tax
         1. If donor gives *entire* property (tree + fruits), tax falls on donee
            1. If only one donee is present, *Blair* controls
            2. If more than one donee is present, *Gavit* controls to avoid ability to remove fruit from tax base through temporal division

However, if property and income are split at the same time, both donees are taxable

* 1. Is this coherent, since the value of property is just discounted value of future payments?

1. §7872 eliminates the tax benefit for low- or no-interest gift or demand loans – interest is imputed at the applicable federal rate and taxed to both the lender and borrower
   1. Could lead to double taxation (imputed interest received by lender, imputed benefit of no interest received by borrower)
      1. But if used in the correct context (i.e., employer lends money to employee for house payments), tax consequences can zero out (EMPLOYER – interest is deductible salary, repayment is interest income. EMPLOYEE - initial transfer is not taxable as loan, mortgage interest is deductible)
   2. Term loans occur when the amount loaned exceeds the PV of all payments to be made under the loan – the applicable federal rate is employed to calculate OID
2. Income of decedent not includable in decedent’s last tax return is included as recipient’s income – §691(a)
   1. If employer owes decedent at death, taxable to estate/recipient (labor income), BUT property bequests result in stepped-up basis. Tax code treats labor and capital differently

### Transaction Timing

1. Constructive sales of appreciated financial positions result in realized gain as if the position were terminated at FMV on the date of the constructive sale. After the constructive sale, future gain/loss may also be taken into account, and the holding period runs from the date of the constructive sale - §1259
   1. Is this permissible under the 16th Amendment? It’s essentially taxation without realization event!
   2. No regulations for put and call combinations (i.e., collars with a long put and short call)
2. Income from an installment sale is computed under the installment method – proportional allocation of gross profit to the total contract price is recognized as income - §453
3. The entire amount of gain or loss is recognized, except as otherwise provided - §1001(c)
   1. §121 exempts the gain from the sale/exchange of property used as a taxpayer’s principal residence, if used as such for 2 of the past 5 years – capped at $250,000 ($500,000 for joint filers)
   2. **No recognition of gain/loss on exchange of like-kind property if used in trade or business or held for investment - §1031(a)**
      1. **If an exchange includes “boot”, the value of the “boot” is recognized as gain, but no additional loss shall be recognized FOR RECIPIENT - §§1031(b), (c)**
      2. **New basis = Old basis (on like-kind property *and* boot given) + gain/loss recognized –cash received**
   3. If property is involuntarily converted into similar property, no gain is recognized - §1033(a)
      1. If the property is involuntarily converted to money used to purchase replacement property, no gain is recognized except to the extent that the amount realized on the conversion exceeds the cost of the new property
      2. No gain is recognized for insurance proceeds to replace unscheduled personal property
   4. Gain from the sale of securities that are rolled over into a specialized small business within 60 days is not recognized - §1044

#### Leverage & Deferral

1. Nonrecourse liability is treated like a true loan – it is included in the basis, and the assumption of the liability by another is included in the amount realized – *Commissioner v. Tufts*
   1. O’Conner’s concurrence is adopted for recourse lending, and bifurcates the economics of the property and the liability (Reg. §1.1001-2(a))
      1. Invokes *Crane* to find that the purchase price (FMV on date of acquisition) is the basis in the property, and the FMV on the date of disposition is the amount realized. The amount borrowed is the basis in the liability, and the amount realized is the amount of indebtedness that is cancelled
      2. **Allows different kinds of income (capital gains, ordinary income) be treated differently**
   2. Although negative basis could reach the right result, it might be more complex because it requires taxpayers to track both depreciation *and* his equity investment in the asset
   3. *Tufts* calculations:

* Property acquired for = 100,000 (borrowed non-recourse)
* Depreciation deductions = 60,000
* Principal repayments = 20,000
* Property worth 50,000 surrendered to lender
* Real World: Taxpayer’s gain = -20,000 + 0 = (20,000)
* Bank’s gain = -100,000 + 20,000 + 50,000 = (30,000)

|  |  |  |  |
| --- | --- | --- | --- |
|  | Tufts Majority | O’Connor | |
| Amount Realized | 80,000 (Liability – Repayment) | **Property**  50,000  (FMV of Property @ Surrender) | **Loan**  80,000 (Liability – Repayment) |
| -Basis | 40,000  (Property – Depreciation) | 40,000  (Property – Depreciation) | 50,000 (FMV of Property @ Surrender) |
| Gain/Loss | 40,000 | 10,000 | 30,000 |
| TAX CONSEQUENCES: Today | 40,000 | 40,000 | |
| Past | -60,000 | -60,000 | |
| TOTAL | -20,000 | -20,000 | |

* 1. *Crane* n. 37 has the same calculation as O’Conner’s Property section – but this doesn’t lead to a correct reflection of reality when the purchaser is upside-down in investment

1. This rule allows taxpayers to get basis without putting their own money into an investment – it is an opportunity to defer tax payments, creating a *huge* loophole for tax shelters
   1. *Estate of Franklin* is a runaround the IRS tries to squash – no depreciation unless buyer can show that purchase price has a reasonable relationship to FMV – otherwise, buyer makes interest payments without hope of gaining equity in the “investment”
   2. Tax shelters’ effectiveness can be limited in three ways:
      1. Alternative minimum tax
      2. §465 limits deductions to the amount actually at risk
      3. §469 limits deductions to “active” business participants

#### Annual Reporting

1. Taxes are assessed annually as an arbitrary (but necessary) bright line for receipt of tax revenues – *Burnet v. Sanford & Brooks*
   1. Resolved by §172’s loss carryback/forward provisions
      1. Allows carryback of 2 years and carryforward for 20 years
         1. Entire amount is carried to the earliest year to which the loss can be carried
      2. Only applies to business losses – personal exemptions, etc. cannot be carried
      3. Modern justification as diminishing impact of large income variability from year to year
   2. The “transactional approach” argued for in *Burnet* is partially revived in §111 – gross income does **not** include amounts deducted in previous years if deduction didn’t reduce tax
      1. If benefit was received, we’ll “undo” it in later transaction – but see §1341
   3. §1341 also allows a deduction if an item *was* included in gross income because it appeared that the taxpayer had a right to the property, and it later becomes known that such right did **not** exist
      1. Takes into account potential change in tax rate to make sure treatment is “fair”
      2. Limited to deductions in excess of $3,000
2. Cash and accrual methods of accounting present different problems in tax treatment
   1. The purpose of accrual accounting is to *never* overstate income – valuable for financial reporting, unnecessary (and even counterproductive?) for tax purposes
      1. Most large firms are *required* to use the accrual method - §448
      2. Can cause liquidity problems (if revenue is required to be recognized before cash is received), time value of money advantage (by deducting amounts to be paid in the future today)
   2. Cash method has had to adapt somewhat to limit flexibility to report income whenever is most convenient – mostly accomplished through “constructive receipts”
   3. “All-events test” moves accrual taxpayers closer to cash accounting method - §461(h)
      1. Economic performance must have occurred *with respect to liabilities*, defined as:
         1. When services are provided to the taxpayer by another
         2. When property is provided to the taxpayer by another
         3. When the taxpayer uses property
         4. As the taxpayer provides property or services to another
3. LIFO leads to lower closing inventory costs (assuming inflationary environment), higher COGS, and therefore lower taxes and variability
   1. Few adopters due to requirement to match financial reporting inventory system with tax computation system (§472(c)). Concern is depressed stock prices due to lower earnings in the period immediately after switch from FIFO to LIFO
   2. Closing inventory and taxable income move together, so firms try to understate closing inventory

#### Deferred Compensation

1. Qualified pension plans can be either defined contribution or defined benefit – DC plans shift risk from employers to employees
   1. 2015 annual contribution limit to DC is $53,000, but DB annual benefit limit is $210,000
2. Employees can also contribute to IRAs, but contributions are only deductible to a limit of $5k
   1. Deduction is phased out between $80 and $100k (for joint filers, $50 to $60k for singles)
3. Decision to convert from a Roth to a traditional *might* depend on expectations of future tax rates – lower tax rates in the future might indicate value of a traditional account
   1. A conversion to Roth is *worse* for the government, and only beneficial to the taxpayer if there are assets *outside* the account used to finance the conversion from taxable assets to non-taxable

### Capital Gains

1. Capital gains rates vary based on a taxpayer’s ordinary income bracket, whether the capital gain is short-term or long-term, and source of gain
   1. Capital gains rate if ordinary income is taxed below 25% tax rate = 0%
      1. If ordinary income is taxed below 39.6% tax rate = 15%
      2. If ordinary income is taxed at 39.6% tax rate = 20%
   2. If capital gain from sale of small business stock, 50% excluded (5 year holding period) - §1202(a)
   3. Collectibles are almost certainly subject to 28% rate if ordinary income is taxed at/above 25%
   4. Corporations capital gains and ordinary income rates are identical – *no* preferable treatment
2. Computation of capital gains taxes:
   1. Net short-term gains and long-term gains
      1. If short-term gains are larger than long-term losses, gains are taxed as ordinary income
      2. If long-term gains are larger than short-term losses, gains are taxed as capital gain
      3. If both short-term gains and long-term gains are present, short-term gain is taxed as ordinary income and long-term gain is taxed as capital gains
      4. Short-term losses offset ordinary losses before offsetting long-term capital gain
         1. If short-term loss exceeds long-term gain in year 1, a short-term loss in year 2 is permitted - §1212(b)(1)
         2. If long term loss exceeds short-term gain in year 1, a long-term loss in year 2 is permitted
      5. Capital losses are given an indefinite carryforward, but may only be deducted to the extent of capital gains plus $3,000 - §1211(b)
         1. Corporate capital losses are only deductible to the extent of capital gains
   2. Remove all “special items” to arrive at adjusted net capital gain
      1. Adjusted Capital Gain = Net Capital Gain – Collectibles - §1250 gain – qualified dividends
3. There are four primary rationales to justify the differential treatment of capital gains and ordinary income
   1. Bunching (prevents proceeds from sale of capital asset from being taxed at higher marginal tax rate than they would have been had the gains been taxed each year, as they accrued)
      1. One-year holding period requirement doesn’t make much sense if this is the rationale – needs to be longer
   2. Inflation (decrease in purchasing power of investment through inflation justifies lower tax rate)
      1. This rationale isn’t supported by the one-year inflation requirement either
      2. Also a weaker rationale since some (but not all) other aspects of the income tax system are indexed for inflation
   3. Encouraging investment (leads to lower tax rates than simply stuffing money in a bank account)
   4. Discourage lock-in effect (we need to encourage realization through the use of a lower tax rate)
      1. §1001’s definition of gain is *broader* than §1222 (“sale or disposition” and “sale or exchange”, respectively). Makes sense because there is no need to encourage realization on receipt of insurance proceeds when lightning strikes my house
4. Holding period is extended for exchanged property if new property has same basis in taxpayer’s hands as property exchanged
   1. Involuntary conversion under §1033 is an exchange of property converted for property acquired
5. §1221 lists several categories of property that are *not* capital assets and therefore ineligible for capital gains treatment
   1. Property which would properly be included in the taxpayer’s inventory, or held by taxpayer primarily for sale to customers - §1221(a)(1)
      1. Not necessary to offer tax incentives to carry on ordinary business by selling inventory!
      2. The definition of “capital asset” should be applied narrowly, and the list of exceptions should be construed broadly – *Corn Products*
         1. *Arkansas Best* clarifies that “capital asset” is interpreted *broadly,* but *Corn Products* involved a broad construction of the inventory exception
         2. Specific result in *Corn Products* was also addressed through (a)(7), which eliminated hedging transactions from capital gains treatment
   2. Property used in a trade/business subject to allowance for depreciation (or real property) – (a)(2)
      1. This kind of property gets treatment under §1231 (the promised land of taxation) – if gains exceed losses, capital gain. If losses exceed gains, ordinary losses!
         1. Subject to recapture (to the extent of depreciation deductions) under §1245
            1. So, property bought for $100,000, depreciated to $40,000 and sold for $300,000 would have $60,000 taxed as ordinary income and $200,000 taxed as capital gain
         2. Real property is subject to recapture under the similar provisions of §1250
   3. Copyright, literary, musical, or artistic composition held by a taxpayer who (or for whom) the property was made – (a)(3)
      1. Also includes a taxpayer who has carryover basis – this taxpayer’s gain will be taxed as ordinary income. If gain is from some other transfer (stepped-up basis), capital gain
         1. Thus, no double benefit of charitable giving under §170(e) of an appreciated asset donated by the artist – there is no long-term capital gain!
      2. §1221(b)(3) contains a carve-out for self-created musical works – they get capital gain treatment! – §170(e) rejects this carve-out
      3. A sale of a patent is the sale/exchange of a capital asset for individuals (not corporations) - §1235
   4. If an entire business is sold, the assets must be individually identified and determined if they should be included as ordinary income, capital gains, or §1231 treatment
6. What is the dividing line between sale of *property* and sale of *income from property*?
   1. Is the distinction even coherent, since the value of property is simply the discounted value of expected future cash flows?
   2. In *Hort,* Supreme Court tries to create a “substitute for income test.” Sale of property merits capital gains treatment, but sale of income from property is treated as ordinary income. *P.G. Lake* comes to the same conclusion on substantially the same reasoning
      1. Elevates substance over form, as is typical in *many* tax cases
      2. Echoes concerns *Gavit*’s concern about allowing temporal divisions to frustrate tax code
   3. *Ferrer* rejects *Hort*’s substitution test and focuses instead on “equitable ownership” to determine what is taxed as capital gain and what is taxed as ordinary income
   4. *Lattera* employs a three-step process: family resemblance test, identifying the type of carve-out (giving up “some” or “all” of asset as in *Horst*), and a to-be-earned/earned income test