Chapter 2. Recovery of Basis

A. Computation of Gain:

1. Suppose T purchases 10 shares of X Corp. stock for $50 per share. Subsequently, T sells one share for $60. How much income does T have?
    a. T ought to have $10 of income. Look first at §61 defining gross income. In particular, gross income includes "[g]ains derived from dealings in property." §61(a)(3).
    b. "Gain" is defined in §1001(a) to be the excess of "amount realized" over "adjusted basis." (Loss is also defined in §1001(a).)
    c. "Amount realized" is defined in §1001(b) to be the sum of money received plus the fair market value of any property received. Here, the amount realized is $60. (Quaere: is it fair to say that amount realized equals the fair market value of the property sold?)
    d. "Adjusted basis" is defined in §1011 to be "basis" as defined in §1012 (or other relevant section) as adjusted under §1016. Adjustments under §1016 include upward adjustments for additional investment and downward adjustments for depreciation, depletion, amortization or other cost-recovery deduction. Here, there are no §1016 adjustments, so the adjusted basis of the share of stock equals cost, or $50.
    e. Therefore, gain equals $60 - $50, or $10.
2. Suppose T then trades his remaining 9 shares of X Corp. stock for 9 shares of I.B.M. stock selling for $60 per share.
    a. Does T have gain? Since amount realized includes the fair market value of property received, amount realized here is 9 times $60, or $540. Since adjusted basis is 9 times $50, or $450, there is a gain of $540 - $450, or $90.
    b. Should T have taxable income? Most would say "yes" on the theory that T has received an accession to wealth; i.e., his ability to consume has increased. Yet, it was not the sale that produced the accession.
    c. To see this, consider T's economic position if he had not traded the X Corp. shares but rather had held on to them. Had he chosen this route, there would be no sale or other disposition of property and hence no taxable gain. Yet, T has received an accession to wealth because stock bought for $50 per share is now worth $60 per share. In other words, the accession to

wealth is the appreciation in the X Corp. stock and not the exchange of that stock for I.B.M. stock.

d. Is T really better off once the X Corp. stock goes up in value? Of course! If the stock is trading on a market, the increased ability to consume is obvious. (Note that if T chooses to hold the stock rather than sell it, he is choosing not to consume. That is okay but should not affect T's tax liability because an income tax is imposed on *ability* to consume rather than actual consumption.) Even if there is no ready market, T is better off if the fair market value of the X Corp. stock really is $60 per share. (If, though, it will cost T $10 per share to find a buyer, the X Corp. stock is worth less than $60 per share.)

3. Should T be taxed when the X Corp. stock appreciates even if T does not sell or otherwise dispose of the stock? In theory, yes: the appreciation is an accession to wealth, and vertical equity requires that T be taxed whenever there is an accession to wealth. Nevertheless, administering such a system would be difficult: all assets would have to be valued each year. For marketable securities, this could be done. But what about all other assets such as land, homes, cars and jewelry. That a taxpayer has no taxable income on the mere appreciation of property is called the *realization* doctrine. Similarly, when an appreciated asset is converted into some new form (such as into cash or I.B.M. stock), we say that the gain has been *realized*.

   a. Jargon: When a taxpayer disposes of appreciated property, we say that the taxpayer's gain has been *realized.* Thus, §1001(a) defines when gain and loss are realized. Usually, realized gains must be included on the taxpayer's return as income, but sometimes Congress allows the taxpayer to defer that gain until later. If a realized gain must be included on the taxpayer's return, we say the gain must be *recognized.*

   b. Thus, §1001(c) provides the rule that all realized gains must be recognized unless otherwise provided by Congress. That is, all gains from dispositions of property as defined in §1001(a) must be included on one's tax return except as otherwise provided by Congress.

4. In general, a disposition of property should not produce an accession to wealth: unless one party to an exchange is deceived, defrauded or incompetent, equal values should be traded. Do not make the mistake of saying that there is no taxable gain if the value of what is given up equals the value of what is received: to account for the realization doctrine, the proper comparison is the *basis* of what is given up with the *value* of what is received.

5. Suppose Congress eliminated the realization doctrine for stocks, so that stocks would be valued each year and any increase in value would

be includible even without a disposition. How would this affect adjusted stock basis?

a. Suppose T purchases one share of stock on January 1, 1995, for \$50.00, and assume that this share of stock is worth \$60.00 on December 31. T will then report \$10.00 on her return.

b. Suppose the share of stock continues to climb in value, and T sells it for \$64.00 on April 1, 1996. How much gain should T have as a result of that sale? T purchased the share of stock for \$50.00, and ends up with \$64.00. Thus, T has made a profit of \$14.00. T reported \$10.00 of income in 1994, so T should have \$4.00 of gain on the disposition. That is, T's adjusted basis in the share must have been \$60.00 when it was sold.

c. This makes sense: T paid \$50.00 for the share, so T's (initial) basis equals \$50.00. §1012. When the stock is appreciates to \$60.00, we are assuming that T is taxed on that appreciation. To ensure that T is not taxed on that appreciation twice, we must increase T's adjusted basis in the share to reflect the income just reported.

d. Another way to say this is that basis is the amount you've already paid tax on, so when you include income, your basis in some asset must increase dollar for dollar. (Similarly, if you report a loss, basis must decrease dollar for dollar.)

e. Often, we will try to determine the tax consequences of some exchange of assets. The rule above can be restated as follows: your aggregate basis in the new assets received in the exchange will equal the aggregate adjusted basis in the assets given up, plus any gain recognized and minus any loss recognized. For shorthand, I sometimes say that new basis equals old basis plus gain recognized and minus loss recognized. **Know this rule!**

B. Taxation of Cash Dividends and Stock Dividends:

1. Cash Dividends:

a. Suppose that T keeps his 10 shares of X Corp. stock and a dividend is declared and paid by X Corp. equal to \$1.00 per share. Does T have income? Yes. §61(a)(7).

i. Note that there is taxable income although there is no "gain" (because there is no disposition of property). Gain is not the only kind of income.

ii. Should T's adjusted basis in his shares change as a result of the dividend? No. (On the other hand, if the dividend had been received tax-free, there would have to be a downward basis adjustment.)

b. What effect will the dividend have on the value of T's shares? Presumably the shares will decrease in value by \$1.00 per share. Thus, the positive value of the dividend to T is just offset by the decrease in share value. Just as gain can be realized without an accession to wealth *at that time*, so, too, dividend income can be received without an accession to wealth *at that time.* Indeed, a corollary to the realization doctrine might be that income is includible when value changes form rather than when first received.

c. So where is the accession to wealth implicitly taxed via the dividends? When the corporation made a profit, the value of T's shares went up. That increase in value remains untaxed to T until there is a disposition by T of his shares.

d. Suppose T purchased only one share (for $50.00), and suppose further that the dividend to T consists not of $1.00 in cash but instead of an ashtray worth $1.00. Assuming the value of this dividend is taxable, T's post-dividend aggregate basis must increase by $1.00. Prior to the dividend, T owned one share of stock with adjusted basis of $50.00. Now, T owns the same share of stock and an ashtray. T's combined adjusted basis in the stock and the ashtray must equal $51.00. Congress has provided in a section we will not look at that dividend property takes a basis equal to fair market value. Under this rule, T takes a basis in the ashtray of $1.00, leaving T's adjusted basis in the stock at $50.00 (because we know T's total basis must equal $51.00).

2. Stock Dividends:

a. Suppose that X Corp. declares a dividend payable in X Corp. stock. That is, each shareholder of X Corp. stock gets one additional share for each share held. (Such a dividend is called a "stock dividend.") If T receives 10 shares of X Corp. as a result of a stock dividend, should T be taxable?

i. If T's 10 shares are worth $10.00 per share prior to the stock dividend, then his 20 shares will be worth $5.00 per share after. The stock dividend, in other words, does not make T any richer. Rather, it divides his investment in the corporation among more shares without affecting the aggregate value.

ii. Has the value of T's shares undergone a change in form sufficient to justify taxation? We tax cash dividends, but cash is quite different from stock. Should we tax T on the stock dividend when the form of his investment changes from 10 shares of X Corp. stock to 20 shares of X Corp. stock?

iii. Note that if we *do* tax T, the taxable amount will be $50 (10 shares at $5.00 each). We have no reason to believe that X Corp. has earned that much since T purchased his X Corp. shares. Indeed, X Corp. might not have earned any profit since T bought his shares. The income that T would report by reason of the stock dividend is thus not based on any true accession to wealth. When T sells his shares, he will report a loss because the basis of the shares remains high even though the value is low. (The basis of his original 10 shares will remain at $10.00 per share, and T's basis in his new 10 shares will be $5.00 per share. Why?) The taxable loss without true economic loss will just offset the prior income without gain.

iv. If the stock dividend is not taxable to T, then his basis in the original 10 shares must be allocated, after the stock dividend, among the original 10 shares and the new 10 shares. Why?

v. For your information, stock dividends sometimes are taxable and sometimes are not. See §§305(a), 305(b). If the dividend stock is not taxed, the basis of the old shares is allocated among the old and new shares in proportion to relative fair market values. §307(a).

C. Express Nonrecognition Provisions:

1. Taxable Exchanges:

a. Recognition of Income or Loss: Suppose a taxpayer owning Blackacre exchanges Blackacre for Whiteacre. In the absence of any special provision, this exchange will be taxed under §1001 as a disposition of property. Accordingly, the taxpayer will recognize gain (or loss) in an amount equal to the excess of the amount realized over the taxpayer's adjusted basis in Blackacre. But what will the taxpayer's basis be in newly-acquired Whiteacre?

b. Basis: Under §1012, a taxpayer's basis in purchased assets is cost. But what is the cost in an exchange? This answer can be seen to be correct in a number of ways.

i. First, the exchange of Blackacre for Whiteacre is equivalent to the sale of Blackacre for cash, followed by the purchase of Whiteacre for cash. Had this been done, clearly the taxpayer's basis in Whiteacre would be its fair market value, since that is the amount of cash paid.

ii. Second, we use the term "basis" to mean the taxpayer's investment in an asset; that is, that amount of receipts that can be received tax-free. Accordingly, whenever a taxpayer recognizes a dollar of income, the taxpayer's adjusted basis in *some* asset must be increased by the same dollar to avoid taxing the same income twice. (Similarly, recognition of a deductible loss must reduce adjusted basis.) Thus, the basis of property acquired on an exchange should equal the adjusted basis of the property transferred plus any gain recognized on the exchange. Thus, new basis = old basis + gain. Since gain = amount realized - old basis, we have that new basis = old basis + [amount realized - old basis], or new basis = amount realized. This is the fair market value basis rule, because amount realized is defined to be the fair market value of the property received. See §1001(b).

2. Statutory Overview of §1031:
   a. PLR 200203033 (p. 267): This PLR concludes that a perpetual conservation easement (a "PCE") is of like-kind to a fee interest in real estate. A PCE is a contractual restriction on the use of property, limiting the use of the subject property predominately in its natural, scenic, historical, agricultural, forested, or open space condition. Thus, the owner of the PCE has only the legal right to enforce the use restrictions, and the grantor of the PCE retains the underlying property subject to the use restrictions. The PLR emphasizes that a PCE is an interest in real estate. Quaere: what does that mean and why is it important?
   b. Qualifying Property:
      i. Used in the taxpayer's trade or business or held for investment.
      ii. The properties must be of "like-kind."
      iii. The properties must be "real estate."
   c. Taxation:
      i. No gain or loss if exchange is solely like-kind.
      ii. Gain and loss can be recognized if you give-up non-like-kind property.
      iii. Gain but not loss can be recognized if you receive non-like-kind property. See §1031(b),(c).
      iv. Basis in the acquired property is determined under §1031(d). That section produces a fair market value basis less the amount of gain deferred.
3. Examples:
   a. Page 229, part (b):
      i. Are the farms of like-kind? See Reg. §1.1031(a)-1(b).
      ii. Under §1031(a), no gain is recognized.
      iii. Under §1031(d), the basis of the new farm equals \$10,000 - 0 + 0, or \$10,000.
   b. Greenacre is exchanged for Purpleacre plus cash of \$200,000 when the relevant adjusted bases and values are:

	Basis	Fair Market Value
Greenacre	**$500,000**	**$800,000**
Purpleacre	**200,000**	**600,000**

i. First consider the taxpayer who gives up Greenacre and receives Purpleacre plus the cash.

(A) The *gain realized* equals the amount realized minus the taxpayer's adjusted basis in the property given up; i.e., $800,000 minus $500,000, or $300,000.

(B) Under §1031(b), the *gain recognized* is limited to the value of the boot received, or $200,000. Thus, of the $300,000 gain realized, $200,000 is recognized and $100,000 is deferred.

(C) Under §1031(d), the taxpayer's basis in the property received equals the basis of the property given up - cash received + gain recognized - loss recognized, or $500,000 - $200,000 + $200,000 - $0, or $500,000. This amount is also equal to the fair market value of the like-kind property received [$600,000] less the gain deferred [$100,000]. Why?

(D) Note that the analysis would be the same if the taxpayer had not received cash but instead had taken out a loan of $200,000, secured by Greenacre because transferring *away* a loan is treated as receiving cash with which to pay off the loan. Reg. §1.1031(b)-1(c). Note that the basis rule of §1031(d) (final sentence) properly treats the transfer of a liability in the same way.

(E) *If the boot received had been property rather than cash (for example, if the taxpayer had received $200,000 in diamonds), the analysis would be only slightly different.* Under §1031(d), the total basis would now be $700,000 rather than $500,000 (because no cash is received), but then of that $700,000, $200,000 is immediately allocated to the diamonds under the second sentence of §1031(d). Thus, the like-kind property still takes a $500,000 basis.

(F) If the boot furnished by the taxpayer had been appreciated or loss property, then the taxpayer will recognized that gain or loss on the boot given up because the transaction will be bifurcated into a 1031 exchange (of the real estate) and a 1001 exchange (of the boot given up), and the latter exchange is fully taxable. See Reg. §1.1031(d)-1(e).

ii. Next consider the other taxpayer, the one who gives up Purpleacre plus cash to get Greenacre. As a conceptual matter, the transaction should be bifurcated into an exchange described §1031(a) (Purpleacre for three-quarters of Greenacre) as well as a purchase (of one-quarter of Greenacre). From this perspective, the transaction is tax-free. The regulations combine the two transaction into a single transaction (see the example in Reg. §1.1031(d)-1(e)) but the result is the same.

(A) The *gain realized* equals \$800,000 minus \$400,000 (this being the basis of the real estate plus the cash), or \$400,000.

(B) Under §1031(a), the *gain recognized* equals \$0 (because no boot is *received*).

(C) Under §1031(d), the taxpayer's basis in Greenacre is \$400,000 - \$0 + \$0 - \$0, or \$400,000. (Do not forget that the first term equals the basis of *all* property given up. In this example, that equals the basis of Purpleacre plus the cash.) Once again, the taxpayer's basis in the property acquired equals the fair market value of the property received less any gain deferred.

iii. Suppose that Greenacre's basis had been \$710,000 rather than \$500,000. How would your answers change to part (i) above?

(A) The gain realized would be only \$90,000.

(B) Under §1031(b), the gain recognized is so much of the gain as does not exceed the value of the boot received. That amount is \$90,000. To be sure, there is \$200,000 of boot, but you cannot recognize more gain that is realized! The rule of §1031(b) can thus be restated as forcing recognition equal to the *lesser of* the gain realized or the value of the boot received.

(C) Under §1031(d), the new basis equals \$710,000 - \$200,000 + \$90,000 - \$0, or \$600,000. This is the fair market value of the property received, as it should be because no gain was deferred.

c. Redacre is exchanged for Blueacre plus $50,000. Consider the taxpayer who receives Blueacre plus cash of $50,000.

	Basis	Fair Market Value	Liability
Redacre	**$500,000**	**$800,000**	**$150,000**
Blueacre	**200,000**	**600,000**	**-0-**

i. How much gain is realized on the exchange? The amount realized equals $800,000, composed of $600,000 as the fair market value of Purpleacre, $50,000 of cash received, and $150,000 of debt released (see the last sentence of §1031(d)). Since the taxpayer's adjusted basis in Redacre is $500,000, the realized gain equals $300,000.

ii. Since the taxpayer has received actual (cash) boot as well as constructive (release of debt boot), §1031(a) does not apply. However, §1031(b) does apply, and it provides that gain is recognized but only to the extent of the boot received. Since the taxpayer received $50,000 of cash and $150,000 of constructive cash, the amount of boot received equals $200,000 under §1031(b), so that amount of the gain is recognized.

iii. The taxpayer's basis in Blueacre equals $500,000 (the adjusted basis of the property given up) - $200,00 (the amount of actual and constructive cash received) + $200,000 (the amount of gain recognized), or $500,000. Thus, the taxpayer's basis in Blueacre is $100,000 below its current fair market value, and that difference is precisely the amount of gain deferred under §1031(b).

4. Deferred Exchanges Under Reg. §1.1031(k)-1

a. Overview: While most deferred exchanges are also three-party exchanges in which property the relinquished property is first transferred to a qualified intermediary (a "QI"), the identification and receipt rules apply to all deferred exchanges alike, whether two-party or three party.

b. Identification of Replacement Properties: The transferor must identify potential replacement properties within 45 days of the transfer of the relinquished property. In general, if the identification rules are not satisfied, then any replacement property will be treated as not of like-kind and so the transaction will be taxable.

c. Receipt of Replacement Property: The taxpayer must receive the replacement property within the earlier of (1) 180 days after transfer of the relinquished property and (2) the due date of the taxpayer's return (including extensions).

d. Actual and Constructive Receipt of Boot: Any actual or constructive receipt of disqualifying property will cause the transaction to be taxable. Constructive receipt occurs if the taxpayer has an unrestricted right to obtain property, even if the taxpayer ultimately does not exercise that right. If a QI were treated as an agent of the taxpayer, then receipt of cash by the QI would be treated as receipt by the taxpayer, thereby disqualifying the transaction. The detailed regulations of QI's are intended to make clear what a QI can and cannot do to avoid such agent status. Note: what if the contract with the QI can be modified?

D. Gifts:

1. Donee's Exclusion Under §102:

a. *Commissioner v. Duberstein* (p. 144):

i. Why do we care whether some receipts are "gifts"? Because "gifts" are excludible from gross income under §102(a).

ii. What is a "gift" within the meaning of §102(a)?

(A) Absence of contract consideration not determinative. See p. 147.

(B) Look to donor's motive (p. 147): "A gift in the statutory sense . . . proceeds from a 'detached and disinterested generosity.'"

(C) How does §102(c)(1) affect the *Stanton* case? Can it apply to a payment to a retiring worker's surviving spouse?

iii. Note 2b (p. 150): The enactment of §102(c)(1) eliminates the possibility that a transfer from an employer to an employee will be treated as a gift except with respect to certain employee achievement awards. Is §102(c) overbroad? What if members of one's family are also one's employees?

iv. Are tips paid to waiters and waitresses gifts under §102? No. How about "tokes" paid to dealers by lucky card players? Not gifts. *See Olk v. United* States (Note 1, at p. 160). Why? If a §102 "gift" cannot be made out of guilt, is a charitable contribution a gift?

b. Should gifts be includible in the income of the recipient?

i. Suppose that I earn $100 in wages and spend that money on a housekeeper. I will have taxable income on the wages without an offsetting deduction. That is appropriate since I have spent the wages on consumption of housekeeping services. Note that the housekeeper will also be taxed on $100 of income. Has there been a wrongful double taxation of the $100? No: the housekeeper should be taxed again since in his hands there is a second cycle of earning and consumption. That is, funds should be taxable each time they are received and consumed (or saved), even if one taxpayer's consumption is a second taxpayer's earnings.

ii. Suppose that instead of paying the housekeeper, I give the $100 to a friend (as a "gift") and my friend hires a housekeeper. Since I get no deduction for a gift, the funds constituting the gift were includible to me when earned. If we made the gift a taxable receipt to my friend, then it would be taxed again even though there has been a single cycle of consumption (or do you consider the making of a gift a "consumption" of happiness).

iii. Note that an alternate approach is possible: allow the donor a deduction for gifts and make the gift taxable to the donee. Why is this approach not followed? When we come to a general discussion of the attribution issue, reconsider this question. For the most part, donors are in higher brackets than donees. Thus, current law taxes the gift to the higher bracket taxpayer. Since in fact it is the donor who first had the discretionary use of the funds, that does not seem inappropriate.

c. *Taft v. Bowers* (p. 165):

i. Issue: Can the donee be taxed on appreciation which accrued prior to the gift?

ii. Holding: Yes.

iii. Would it make sense for a donee to refuse a gift because of the potential income tax consequences? No, since even a zero carry-over basis will leave some after-tax dispositional gain for the donee to enjoy.

d. Notes (p. 167):

i. Note 1: Be sure you understand why *both* C and L are taxed.

ii. Note 2: Remember that either the donor or the donee must pay tax on all of the asset appreciation. If we decide not to tax the donee, then by default we have chosen to tax the donor. So, is it fair to tax the donor on any of the asset appreciation, when it is the donee who in fact will get the cash? A carry-over basis rule for gifts simply forces the cash-rich donee to pay the tax.

iii. Note 4: This note suggests the alternate possibility, namely that of taxing the donor on accrued appreciation.

e. Questions (p. 171):

i. Question 1: (a) A sale for $3500 produces a gain of $2500, while (b) a sale for $1500 produces a gain of $500.

ii. Question 2: (a) A sale for $2,500 produces a gain of $500; (b) a sale for $500 produces a loss of $500; and (c) a sale for $1,500 produces no taxable gain or loss.

iii. Hypo: If Father gives Daughter stock with an adjusted basis of $1000 at the time of the gift, then the following chart gives the gain (or loss) recognized to Daughter upon disposition for fair market value.

Fair Market Value at Gift	Fair Market Value at Sale	Gain (Loss)
1500	1500	500
1500	1200	200
1500	900	(100)
900	1500	500
900	800	(100)
900	950	none

iv. The effect of this rule is that accrued losses cannot be shifted. To be sure, accrued losses can be used to offset future gain, but the accrued loss cannot be claimed by any taxpayer other than the donor. *See generally* Reg. §1.1015-1(a)(2).

v. Question 3:

(A) Make a gift of the asset to Ana so that the gain will be reported by her (in a low bracket).

(B) Sell the asset, then make a gift of the sale proceeds. That way, the loss will be fully reportable by Ernesto in his high tax bracket.

(C) If Ernesto needs money soon, make a gift of the asset so that the gain will be taxed at Ana's low rate. If Ernesto does not need either the asset or the cash, make a gift of the cash and keep the asset, avoiding all taxation until the asset is sold in the distant future. (Note that this alternative trades deferral for a reduction in rates, because when the asset is sold, it will be taxed to Ernesto.)

(D) Sell the stock with a basis of $120,000 now, then give the sale proceeds to Ana. This accelerates the recognition of a taxable loss (which is good) and allows the loss to be claimed by the high-bracket taxpayer (also good).

(E) To answer this question, do not forget that all unrealized gain and loss is lost at death. Accordingly, an elderly taxpayer should hold appreciated assets until death and should sell loss assets prior to death. By the way, I did not consider the possibility of *borrowing* against the value of Ernesto's assets. For elderly taxpayer's who own appreciated assets but who need money to live on, borrowing can get them cash in hand without the recognition of income.

E. Claims in Property Divided Over Space and Time:

1. Spatial Divisions :

a. Suppose that you buy Blackacre for $15,000 and later sell half of it for $10,000. Should you have gain on the sale? Sure, since presumably half of your basis is properly allocable to the half you have retained.

b. What if the left half of Blackacre was worth $10,000 when you bought it and the right half was then worth only $5000? Your basis should be allocated in proportion to fair market values at time of acquisition, so that you have no gain or loss if you sold the left half and a gain of $5,000 if you sold the right half. Reg. 1.61-6(a); *see also* Reg. §1.1011-2(b).

2. Sophisticated Non-Temporal Divisions:

a. *Inaja Land Co. v. Commissioner* (p. 96):

i. Facts: The taxpayer purchased land for $61,000. Thereafter, the City of Los Angeles began dumping foreign material in a stream that ran through the taxpayer's land. The taxpayer sued the City and settled for a payment of $50,000 for past damage and for giving the City the right to continue dumping. That right is called an "easement."

ii. Issue: Is any part of the $50,000 settlement taxable? *Held*, full exclusion as a return of capital. Why did the court refuse to allocate more than $11,000 of the taxpayer's basis to what remained of the land (i.e., to the land burdened by possible pollution)?

b. Can *Inaja Land* be characterized as a sale of an undivided interest in land? Suppose you sell someone the right to park their car on your driveway? Must we allocate your basis in land plus house between your driveway and everything else? Surely a jury could make such an allocation. Should we require it to do so?

c. Note 3 (p. 98): If the land is subsequently sold for 25,000, the taxpayer should have a gain of $14,000 (assuming the taxpayer initially received $50,000 tax-free for the easement).

3. Transfers at Death

a. Transferee's Basis: Under §1014, the basis of property acquired from the estate of a decedent is equal to the fair market value of the property at the time of the decedent's death. The effect of this rule is to eliminate all unrealized gain in such property from the tax base. While in theory the rule of §1014 might also apply to step-down the basis of loss property held until death, in practice that almost never happens. Why?

b. Income in Respect of a Decedent: Income that has been *earned* but not yet included by the decedent prior to death will not be excluded by reason of §1014 because of the application of §691. As a general rule, IRD is earned income of a decedent that was not includible to the decedent prior to death because of the decedent's method of accounting (we will cover methods of accounting later).

4. Temporal Divisions:

a. Consider the following. G dies, leaving $100,000. A is left a 9 year income interest paying $8000 per year, the fair market value of which is $50,000. B is left the remainder, also worth $50,000.

i. At the end of year 1, A receives a check for $8000. Should that amount be fully taxable? A will argue that his basis in the "property" he received (that being a 9 year income interest) is equal to its fair market value as of the date of G's death. See §1014. Since that amount is $50,000, and since A will receive a total of $72,000 over the 9 years, he should have total income of only $22,000 over that period. In other words, of the $72,000 he will receive, A wants to treat $50,000 as a return of basis.

ii. How should that $50,000 basis be allocated among the 9 years. We might allocate it ratably over the nine years, thereby allowing A to exclude ($50,000 divided by 9, or) $5,540 per year. On the other hand, we might let A exclude the first $50,000, and then include everything else. The text proposes an alternate method which taxes A as if he invested his bequest in a savings account paying 8% per year. Thus, in year 1 A has $4000 of interest income, while in year 2 A has interest income of only 8% of $46,000, etc.

iii. Note the implications of this to B — his bequest had an initial fair market value of only $50,000, yet when it becomes possessory in 9 years, it will be worth $100,000. He should have $50,000 of income over the 9 years.

b. *Irwin v. Gavit* (Supplement): At issue is whether a taxpayer receiving an income interest as a bequest has a non-zero basis in it (as argued above). The Supreme Court held that the taxpayer had a zero basis in the income interest, apparently on the theory that an income interest is not "property" under §1014 or under §102(b)(1), a result now codified in §1001(e). Note that the opinion in Gavit seems to emphasize that the devise could not exempt what would be income to the decedent had not death occurred but did not seem to contemplate the possibility that the remainderperson should be taxed.

c. The effect of the *Irwin v. Gavit* rule is to over-tax the income beneficiary and under-tax the remainderman. Can this rule be abused? Sure. For example, devise an income interest to a charitable organization and the remainder to a grandchild.

F. Recovery of Loss and Deduction:

1. The Loss Deduction: Certain losses are allowed as a deduction under §165(a).

a. But what is a "loss" within the meaning of this section?

i. A loss from the disposition of property is defined in section 1001(a).

ii. The term "loss" is also used in connection with a specific transaction to mean the excess of deductions from the activity over income from the activity. See, e.g., §§465(d), 469(d)(1).

iii. The term "loss" in §165 is broader than these two other meanings. Note that §165(g)(1) does not define a worthless security as giving rise to a loss but rather assumes such worthlessness creates a loss. Losses for purposes of §165 are defined (sort of) in Reg. §1.165-1(b) and must be evidenced by "closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year." The partial destruction of property by fire or other natural disaster, the abandonment of property, and the worthlessness of property have all given rise to loss deductions.

b. How is the amount of the loss determined? Note in *Zakon* that no loss was allowed for the goodwill. Why? See Reg. §1.165-1(c)(1). Suppose a taxpayer purchases investment property for $100, the property increases in value to $180, and then the property declines in value to $150 as the result of a closed a completed transaction that generates a loss. What is the amount of the taxpayer's deduction under §165(a)? Is there a less taxpayer-friendly alternative rule that the regulations did not adopt? Note that computation of the loss amount can require a precise definition of the "property" that has been lost. For example, suppose a taxpayer purchases improved real estate (i.e., land and a building). If the building is destroyed, is the amount of the deduction limited to the taxpayer's adjusted basis in the real estate (land plus building) or in the improvements alone? See Reg. §1.167-(b)(2).

c. Basis Adjustment: Basis must be adjusted downward to the extent of any casualty loss claimed. See §1016(a)(1).

d. Worthless Securities: As we will see, capital gains and losses arise from the “sale or exchange” of a capital asset. Section 165(g) provides that a security becomes worthless without disposition of the security generates an immediate loss and that loss is a “capital” loss. Capital gains and losses are covered later in the semester.

e. Bad Debts: Worthless debts not represented by a security are covered by §166, and this provision applies even if a debt becomes only partially worthless. Nonbusiness bad debts are treated as short-term capital losses under §166(d)(1) while business bad debts generate an ordinary deduction.

f. *Rev. Rul. 2009-9* (p. 460): Note that the deduction for personal theft losses has been eliminated. But this Ruling also speaks to the timing of loss recognition. Note that a theft loss is treated as arising in the year it is discovered (which may be long after the theft was committed). Reg. §§1.165-8(a)(2), 1.165-1(d).

2. The Tax Benefit Rule:

a. *Alice Phelan Sullivan Corp. v. United States* (Supplement):

i. Facts: In prior years, the taxpayer had contributed real estate to charitable organizations. Deductions were taken (see §170) totaling $8706.73, producing an aggregate tax benefit of $1877.49. (From these two numbers, we conclude that the taxpayer's average tax rate was approximately 22%.)

ii. Issue: How much income does the taxpayer have on account of return of the properties?

iii. Arguments:

(A) Government: Include the full amount of the prior deduction in current income; i.e,, include $8706.73.

(B) Taxpayer: Add $1877.49 to current tax liability.

(C) Is there a difference? Yes, because tax rates have increased.

iv. Holding: For the government.

v. Why was the taxpayer not required to include the fair market value of the properties in income? When a specific item is recovered, we try to return to the status quo ante (i.e., to the position before the transaction). To do so, we should merely include the prior deduction.

b. Section 111:

i. Inclusionary Aspect: A "recovery" of an item previously deducted constitutes gross income.

ii. Exclusionary Aspect: To the extent that the prior deduction of an item did not offset taxable receipts, the subsequent recovery is not taxable. Look to the prior year and determine if losing some or all of the deduction would have increased taxable income for that year.

iii. Note: to the extent a prior deduction gave rise to a Net Operating Loss ("NOL") that has not yet expired, the deduction is treated as having given rise to a tax benefit. In general, deductions arising out of profit-seeking activity can give rise to an NOL while personal deductions (such as the charitable deduction) do not. See §172.

3. Recovery of Loss:

a. *Clark v. Commissioner* (p. 100):

i. Facts: The taxpayer overpaid his tax liability for 1932 by $19,941.10 because of the negligent advice of his tax advisor. In 1934, the tax advisor paid the taxpayer $19,941.10 to compensate him for this loss.

ii. Issue: Is the $19,941.10 taxable?

iii. Holding: No, since he did not deduct the overpayment of his taxes. In effect, he had an undeducted basis in his claim against his tax advisor, and the payment of $19,941.10 did not exceed this basis. That is, he had a basis in the claim arising from the overpayment, and so his receipt from the tax advisor was no more than a return of that basis.

iv. In what sense is that case the "opposite" of *Alice Phelan Sullivan Corp*? In both cases, the taxpayers were simply getting what they should have had in the first place. However, the taxpayer in *Alice Phelan Sullivan Corp.* had taken a deduction in the earlier year whereas the taxpayer in *Clark* had not.

b. Hypothetical (p. 104) (This hypothetical assumes that personal casualty losses are deductible. It is useful as an exercise in the tax benefit rule):

i. Problem 1: No to part (a). As to part (b), did the loss arise from "fire, storm, shipwreck or other casualty, or from theft?" If the wallet was found and kept by some passerby, then arguably the loss resulted from theft (larceny by a finder). In any event, the loss limitations in §165(h) will reduce the deductibility by $100, see §165(h)(1), and then subject the remaining $200 to a threshold of 10% of Tom's adjusted gross income, see §165(h)(2), so that if Tom's A.G.I. equals or exceeds $2,000, no loss will be allowed.

ii. Problem 2: There was no mistake in 2000, so no amendment is appropriate. The tax benefit rule will require income recognition in 2001.

iii. Problem 3: No income under *Clark*. Is this fair?

iv. Problem 4: This "new" $300 must be included in income.

v. Problem 5: Since the statute of limitations has not run by 2001, he could file an amended return for 2000 claiming the deduction, and then include the money in his 2001 income. Surely no taxpayer would do that, since it so much easier to not file an amended return and then exclude the income. The issue becomes much tougher when he finds the income in 2005, since the statute of limitations forbids filing an amendment. Is excluding the income consistent with the statute of limitations?

G. Current Expense vs. Capital Expenditure:

1. Statutory Overview:

a. Section 162 allows a deduction for all "ordinary and necessary" expenses incurred by a taxpayer in his trade or business. Section 212 allows a similar deduction for amounts spent for the production of income. Yet, section 263 specifically provides that "[n]o deduction shall be allowed for [a]ny amount paid . . .

for permanent improvements or betterments made to increase the value of any property or estate." Is there a conflict?

b. Over the long run, will the obligation to capitalize some cost instead of deducting it immediately affect the total amount of taxable income a taxpayer will report? No: it will only affect the timing of the income.

c. As a theoretical matter, should capitalization ever be required? Suppose you can rent a truck for use in your business at an annual rent of $2000. You can also purchase it outright for $6340. If the truck will have a useful life of 4 years, which should you do? In what way is the purchase similar to purchasing a 4-year annuity to fund four years of rental payments. (Note: the discounted value of a four-year income stream of $2,000 per year is $6340, assuming a 10% discount rate.)

d. How should advertising by Sears be taxed? How about employees' salaries?

e. Examples Under Reg. §1.263(a)-2:
   i. Suit to quiet title? Add to basis of land.
   ii. Architect's fee? Add to cost of building.
   iii. Commissions paid to buy stock?

2. *INDOPCO, Inc. v. Commissioner* (Supplement 1992): The Supreme Court held that an expenditure must be capitalized if it provides a long-term benefit without regard to whether that benefit attaches to a particular identifiable asset. This result makes sense: if an expenditure will help produce income beyond the close of the taxable year, some (or all) of the cost should be capitalized and recovered later.

   a. Costs Associated with a Corporate Acquisition: The expenditures at issue in *INDOPCO* were incurred by the target corporation in a friendly takeover. What about other, similar expenses?
      i. Acquiring corporation's expenditures in a successful acquisition: Pretty clearly should be capitalized as the cost of the stock acquired (if stock is acquired) or as part of the assets acquired (if assets acquired directly). However, part of the cost of the acquisition might be allocable to goodwill, and newly-enacted §197 provides for the amortization of intangibles over 15 years.
      ii. Acquiring corporation's expenditures in an unsuccessful acquisition: Probably should be expensed just like costs invested in other failed business ventures.
      iii. Target corporation's expenditures in a failed acquisition: If the target corporation defeated the acquisition, then the expenditures probably should be

capitalized on the theory that they were incurred to attract a more valuable suitor or otherwise were incurred to increase the long-term value of the target's stock. But if the acquisition failed to go through because of some regulatory difficulty or because the acquiring corporation ultimately could not proceed, the target's expenditures might be expensed as costs associated with a failed business venture.

iv. A recent case involved the target's expenditures in a hostile takeover. Because the takeover ultimately was successful, these expenditures incurred by the management of the target to prevent the takeover arguably were wasted and therefore deductible. Nonetheless, the court held that the expenditures had to be capitalized, citing *INDOPCO*. One fact that the court emphasized was that the target management's hostility to the initial takeover offer ultimately resulted in a higher price.

v. Regulations under section 263 were issued which largely undermine the reasoning of *INDOPCO*. See the discussion on pp. 501-502 and the casebook update. As this discussion makes clear, the current regulations seem to be little more than specific relief provided to specific industry concerns.

b. Suppose a business purchases a one-year fire insurance policy on July 1. Can it deduct the entire cost of the policy? Conceptually the cost should be recovered in part in the current year and in part in the next taxable year because the policy will have value in each of those two taxable years. *See Commissioner v. Boylston Market Ass'n*, cited at page 422. Despite this, it long has been the rule that expenditures producing assets whose useful lives will not extend *substantially* beyond the close of the taxable year can be expensed in full, and this has been interpreted to mean that so long as the asset will fully waste during the current or next taxable year, the cost of the asset is an expense.

3. *Encyclopedia Britannica v. Commissioner* (p. 416):

a. Facts: The taxpayer hired an independent firm to do the preliminary research and writing for publication of "The Dictionary of Natural Sciences." At issue was the tax treatment of the payment to the independent firm.

b. Analysis:

i. According to the court, what is the joint object of §§162 and 212? See p. 417 ("to match up expenditures with the income they generate").

ii. How does the taxpayer treat the salaries of its editor/employees? It deducts them. How do authors treat their various expenses related to their writing? They usually deduct them, although the reason for that rule is less than clear. See p. 417-18.

iii. According to this court, what does "ordinary" in §162 mean? See p. 419 (that an expense is not highly unusual nor properly capitalizable). Should recurring expenses be immediately deductible?

iv. Suppose a power company hires a contractor to build a power plant. The plant takes 6 years to build and will produce power for 40 years. The contractor buys a truck to use in the construction of the plant. The truck will last 4 years. Over what period should the contractor amortize (or depreciate) the cost of the truck? Assuming that the contractor gets partial payments as he goes along, I think 4 years is correct. If the power company builds the power plant itself and buys a truck to use in construction, over what period should it amortize the cost of the truck? 40 years. See the discussion of *Commissioner v. Idaho Power Co.* (1974), at p. 418 and p. 419.

(A) In *Idaho Power*, the depreciation of the truck should not begin until construction of the power plant is completed and power is generated. This is consistent with the goal of matching expenses with the income the expenses will produce.

(B) What if a taxpayer incurs, prior to the start of its business, some expenses that would otherwise be ordinary and necessary expenses? For example, consider the pre-opening advertising expenses incurred by an apartment rental complex. Such costs are not deductible under §162 because when incurred the taxpayer was not yet in a trade or business. Under §195, these start-up expenditures must be capitalized and recovered over a period of at least 60 month.

H. Repair and Maintenance:

1. Theory: When should repairs be capitalized? Consider a taxi driver who purchases a new cab for $10,000. If he averages 30,000 miles per year and the new cab is good for about 120,000 miles, over what period should he depreciate the cab? 4 years.

a. However, the tires on the cab wear out every year. Should he be allowed to allocate some of the cost of the cab to the tires and then deduct that amount entirely in the first year? Should he be allowed to deduct the cost of new tires as he buys them each year?

b. Water pumps last about 60,000 miles and cost $100 new. How should he depreciate the cost of the water pump? If we do not allow him to depreciate the water pump separately, but we do let him deduct the new one in 3 years, how is he taxed?

c. When should mass assets be subdivided? When some major component has a useful life significantly shorter than the overall asset. *E.g.*, the elevator in a building.

d. Congress once authorized "component depreciation" allowing a single piece of property to be divided into distinct components for depreciation recovery. That has been repealed but asset segregation analysis has developed as a new field in an attempt to recapture much of the benefit of component depreciation. The IRS has not yet challenged asset segregation but has indicated that it is unhappy with the effort and is considering a challenge.

e. See Reg. §1.162-4.

2. *Midland Empire Packing Co. v. Commissioner* (p. 425):

a. Facts: The taxpayer lined its basement with concrete to prevent oil from a neighboring refinery from seeping in. At issue was whether the cost of that project was deductible under §162 or must be capitalized and depreciated.

b. Holding: Deductible. Why was the lining a "repair" of the building rather than an improvement of it? Suppose that the need for the concrete lining had been recognized from the start and the taxpayer had constructed the lining along with the building? One way to explain the result in this case is to say that the deduction is a substitute for the loss deduction that should be allowable under section 165. But that denies the proper tax treatment to someone who sustains a loss but elects not to rebuild and is overly favorable to a taxpayer who rebuilds a low-basis asset. Perhaps the court is trying to say that the act of rebuilding serves as proof of the loss.

c. Suppose the nearby refinery was tortuously spilling oil, and Midland Empire had sued for a permanent injunction. If the refinery had built the lining, how should it have treated the cost? What if the refinery had settled such a law suit by paying Midland Empire $5000?

d. Note: there is no conceptual line between a deductible repair and a capitalizable improvement. For example, replacing one roof shingle is deductible while replacing an entire roof is capitalizable. But a roof in nothing but a lot of shingles. Where is the line? Two shingles? Twenty? Two-hundred?

3. *Revenue Ruling 94-38* (discussed on pp. 431): A taxpayer incurs three types of expenses: (1) costs to replace previously contaminated soil; (2) costs to construct a ground-water treatment plant; and (3) daily monitoring expenses. The Services rules that items (1) and (3) are deductible while (2) must be capitalized. Note that (1) represents costs of producing income in the past (CERLA liability is imposed on past behavior) while the costs in (3) will be incurred as income is produced. Only (2) represents in investment that will help the taxpayer produce income over a long period unless the treatment plant is better described as remediating past pollution (as 1), in which case this part of the Ruling is difficult to defend.
4. *Revenue Ruling 2004-18* (p. 480): This Ruling concludes that costs deductible under Rev. Rul. 94-38 may still need to be capitalized under §263A for those taxpayers subject to the full-cost accounting rules of that section. Is this a correct decision? At least in the abstract, yes: §263A was added to the Code to provide that certain costs other deductible should be capitalized into the cost of inventory. However, to the extent that the costs at issue increased profits *in the past,* it seems to be that current expensing should be permitted.
5. *Norwest Corp. v. Commissioner* (Supplement):
    a. Facts: As part of a general building remodeling costing approximately $7 million, the taxpayer discovered asbestos material in the walls and paid almost $2 million for its removal. The remodeling expenses were capitalized by the taxpayer but the costs of asbestos removal were deducted. The Commissioner argued that the asbestos removal expenditures must also be capitalized. *Held*, for the government.
    b. Analysis: The Court seemed to accept the taxpayer's assertion that the cost of asbestos removal, if done separately, would deductible. The court went on to say that because the removal was done as part of a larger, admittedly capitalizable renovation, it should for tax purposes be treated as part of the renovation and so capitalized. While it is hard to understand why such a major, long-term benefit as asbestos removal should be expensed under any circumstances, insofar as this opinion suggests that things done together will be aggregated and treated as one large (usually capitalizable) item, it probably is following what many courts do.

I. Rent vs. Purchase:
1. *Starr's Estate v. Commissioner* (Supplement):
    a. The taxpayer agreed to pay $1240 per year for 5 years for a custom sprinkler system. The taxpayer would have an option

to renew at a cost of $32 per year. Did the court, by ignoring the fact that the sprinkler company would own the system out-right in 10 years, tax the taxpayer on a transaction that did not occur? Not really, since it was reasonable to assume that the sprinkler company would not repossess the system. Further, even if we recognize the company's legal right to possess, the fact remains that the taxpayer wanted to deduct over a 5 year period what in fact was (almost) 10 years worth of rent.

b. Did the taxpayer anticipate losing the sprinkler after 10 years? If it had, how should it have been taxed? If not, was the court's decision correct? Is there much difference?

c. Suppose the useful life of the system was 10 years. Was the transaction a "sale" or a "lease"? Is there any non-tax difference? Should taxation turn on the label? Will it?

2. Note 4 (p. 488): If interest of $1240 is paid over 5 years, why is the first year's interest component $393 rather than one-fifth of $1240, or $240? Because the amount of the outstanding debt decreases each year.

J. Depreciation and the Investment Tax Credit:

1. Theory:

a. Why should some assets be depreciable?

i. Recall the economic definition of income: income equals consumption plus change in net worth. To fully apply this definition, all assets would have to be valued each year. Because of the realization doctrine, we ignore market appreciation and loss until disposition.

ii. Some assets are "wasting" assets in the sense that, even if market values do not change, the value of the asset will decrease. Keeping true to the realization doctrine, how should such wasting assets be taxed? We should allow a recovery of part of the asset's cost each year; that is, we should allow the inevitable decrease in value to be reflected in a deduction.

iii. Why do income-producing assets sometimes inevitably decline in value? The current fair market value of an income producing asset is the discounted value of the income stream that the asset is expected to produce.

iv. What should the amount of the depreciation deduction be? Fair market value of asset (at beginning of taxable year) minus fair market value of asset (at end of taxable year), assuming that the fair market value is based on discounted income stream but ignores fluctuations in market values.

b. Computation of Depreciation Deduction:

i. Straight-Line Income Production:

Year	Income	PV_0	PV_1	PV_2	PV_3	Deduction
1	100	90.91				68.30
2	100	82.64	90.91			75.13
3	100	75.13	82.64	90.91		82.64
4	100	68.30	75.13	82.64	90.91	90.91
		316.98	248.68	173.55	90.91	316.98

(A) This chart sets forth the decreasing annual fair market value of an asset expected to produce $100 of income per year for 4 years. The initial fair market value of the asset is $316.98. Its fair market value after one year drops to $248.68, and that diminution ($68.30) is the amount of the proper depreciation deduction in year 1. As this chart indicates, the depreciation deduction starts small and grows larger.

(B) This chart is based on two key assumptions. First, I have assumed a 10% annual discount factor. Second, I have assume that the asset has a constant income producing capacity. The next example modifies the second assumption.

ii. Accelerated Depreciation:

Year	Income	PV_0	PV_1	PV_2	PV_3	Deduction
1	110.87	100.79				79.24
2	103.25	85.33	93.86			79.25
3	95.08	71.44	78.38	86.44		79.24
4	87.18	59.42	65.50	72.05	79.25	79.25
		316.98	237.74	158.49	79.25	316.98

(A) This example also considers the depreciation of an asset costing $316.98 and having a useful life of 4 years. However, the asset is no longer assumed to produce $100 per year. Rather, it produces more income in the earlier years. Thus, it wastes faster and so the depreciation is faster. I have selected the income values each year in such a way as to produce (very nearly) straight-line depreciation. Once again, salvage value is assumed zero.

(B) By making the rate of income production even faster, one could further accelerate the depreciation schedule. On the other hand, by assuming an increasing rate of income production, we could slow down the depreciation. What assumptions should be made about the rate at which income producing assets produce income? Does it vary asset-by-asset? Can all assets be classified into a few major groups having similar characteristics?

2. Practice:

a. Introduction:

i. Possible Permutations: To change the system of depreciation, one or more of the following changes must be implemented.

(A) The total amount of depreciation allowable could be modified. For example, salvage value could be deliberately underestimated.

(B) The time over which the depreciation is claimed could be changed. For example, the useful life could be deliberately underestimated.

(C) The rate at which the depreciation is claimed may be modified. For example, the rate at which income is produced could be deliberately accelerated, thereby allowing depreciation in excess of economic loss (in the early years).

b. Prior Law: Depreciation Under §167:

i. Useful life determined by ADR range, that being a useful life slightly shorter than true economic life.

ii. Total depreciation equals cost less salvage value.

iii. For intangible property, only straight-line (ratable) depreciation allowed. For tangible property, faster depreciation rates used. §167(c) (repealed). Most intangible property now is covered by §197.

c. Pre-2018 Law — MACRS Under §168:

i. Useful Lives:

(A) Now called "recovered period" to emphasize that depreciation schedules no longer are tied to economic realty, all assets are divided into 9 classes. See §168(e)(1)-(2). Note that the definitions in §168(e)(1) deliberately define recovery periods shorter than useful lives.

(B) The recovery periods for each class of property are specified in §168(c).

ii. Recovery Rates:

(A) The cost of (depreciable) real-estate is recovered over the applicable period using straight-line (i.e., ratable) cost-recovery. §168(b)(3).

(B) Short-lived assets are recovered using the 200 percent declining balance method, §168(b)(1), thus producing twice the straight-line amount in the first year.

(C) Longer-lived assets are recovered using the 150 percent declining balance method. §168(b)(2).

iii. First-Year Conventions:

(A) In general: Most property is treated as if placed in service in the middle of the year, thereby producing only one-half the expected cost-recovery deduction in the first year. See §§168(d)(1), 168(d)(4)(A).

(B) Real Estate: As to real estate, the first year cost-recovery deduction is prorated for the actual months of service, with the property treated as if placed in service at the middle of the month. See §168(d)(2), 168(d)(4)(B).

(C) Anti-Front Loading: If a taxpayer places substantial (40%) of his non-real estate depreciable property in service in the last quarter of the taxable year, then the mid-year convention is not used. Instead, a mid-quarter convention is used. See §§168(d)(3), 168(d)(4)(C).

iv. Salvage value is assumed to be zero. §168(b)(4).

v. Expensing in Lieu of Depreciation: Up to $500,000 of the cost of depreciable property can be expensed in lieu of MACRS. See §179. This advantage applies to tangible, depreciable property as well as improvements to real estate, see §179(d)(1), and is phased out as the amount of such property purchased by the taxpayer during the year exceeds $2,500,000, see §179(b)(2).

d. Current Law: Congress expanded the definition of "bonus depreciation" for "qualified property" to the extent it now swallows the more general rule. See §168(k). Now, the cost of qualified property can be fully expensed in the year of acquisition, §§168(k)(1), 168(k)(6), where "qualified property" generally means property other than real estate and other assets having a depreciable life extending beyond 20 years, §168(k)(2). Some shorter-lived assets also qualify for bonus depreciation.

3. Depreciation Recapture Under §§1245 and 1250:
   a.. Introduction:
      i.. When an asset is sold at a gain, the amount realized necessarily exceeds the taxpayer's adjusted basis in the asset. Ordinarily, a taxpayer who acquires an asset buys it, producing a cost basis to the taxpayer under §1012. Thus, basis and fair market value begin equal. If the fair market value exceeds the adjusted basis when the asset is sold, either the fair market value went up or the adjusted basis went down (or some combination of each).
      ii.. For example, suppose T purchases a printing press for $100,000 and holds it for 4 fours. During those years, assume the taxpayer is entitled to claim depreciation of $30,000. Thus, the taxpayer's adjusted basis will be $70,000 after 4 years. If the taxpayer then sells the printing press for $120,000, there will be a taxable gain of $50,000. Of that gain, $30,000 is attributable to the reduction in the taxpayer's basis caused by the depreciation and the remaining $20,000 is attributable to a true increase in the value of the asset.
      iii. Should all of the gain qualify as preferential capital gain? The first $30,000 of gain is not attributable to an increase in the value of the property but is merely a tax pay-back of the depreciation deductions, deductions which offset ordinary income without limitation.
      iv. The primary role of §§1245 and 1250 is to recharacterize as ordinary income gain attributable to a decrease in adjusted basis rather than to an increase in asset value. However, these sections can have greater effect, sometimes forcing the recognition of ordinary income when, but for these sections, all gain would be deferred by reason of some specific deferral provisions. Any gain recognized or recharacterized under §§1245 or 1250 is referred to as "recapture" because such gain is depreciation recaptured.
   b. Basic Provisions of §1245:
      i. Section 1245 applies to all depreciable assets other than real estate. See §§1245(a)(3).

ii. Under §1245(a)(a)(1), gain from the disposition of §1245 property is taxable as ordinary income to the extent the gain does not exceed the depreciation taken. Thus, all depreciation is recaptured when §1245 property is disposed.

iii. Complete Preemption: To the extent §§1245 says it applies to a particular transaction, it does so without regard to any other provision. §1245(d). Accordingly, whenever an asset is sold and not all the gain realized is recognized at ordinary rates, §§1245 and 1250 must be considered.

iv. Exceptions: Some transactions are not covered by §1245(a)(1) because of specific exceptions contained in §§1245. See §1245(b). In particular, §1245 does not apply to gifts and or to devises, and it usually applies to nonrecognition transactions only to the extent that boot is received and gain would be recognized even in the absence of depreciation recapture.

c. Basic Provisions of Section 1250: Section 1250 recaptures gain from the disposition of depreciable real estate at ordinary rates but only that gain arising from depreciation claimed in excess of straight-line depreciation. Because the real estate, in general, can be recovered only ratably, section 1250 has little current application. However, some real estate placed in service in the early 1980's might be captured by section 1250 along with any real estate that qualifies for special tax treatment because it is located in a specially designated disaster zone or is a special type of property (such as lease-hold improvements) made during specific time periods. *See, e.g.,* § 168(k).

4. Goodwill, Intangibles and §197

a. Application of §197: Section 197(a) authorizes straight-line cost recovery for "amortizable section 197 intangibles" over a 15-year statutory life.

i. Note that the 15-year recovery period applies even if the useful life of the asset is fixed and shorter. For example, suppose a taxpayer purchases a copyright with 8 years remaining. The cost of that copyright is recovered ratable over 15 years. Similarly, the cost of a covenant not to compete is recovered over 15 years even if it lasts for only two or three years.

ii. Note that amortizable section 197 intangibles are considered, for all purposes, as depreciable property. §197(f)(7).

iii. Definition of Section 197 Intangible: Section 197(d) defines the term "section 197 intangible" to include most intangibles.

iv. Definition of Amortizable Section 197 Intangible: Under Section 197(c)(1), amortizable section 197 intangibles include all section 197 intangibles held in connection with profit-seeking activity. However, those section 197 intangibles described in §197(d)(1)(A), (B), or (C) are not treated as amortizable *if self created* unless created in connection with the acquisition of a trade or business. Note also that the costs incurred in *INDOPCO* are not amortizable because they were incurred in connection with a *tax-free* acquisition. See §197(e)(7).

b. *Welch v. Helvering* (p. 433):

i. Facts: The taxpayer had been an officer of the family corporation engaged in the grain business. It went bankrupt and the taxpayer became an independent contractor purchasing grain on commission. The taxpayer began to repay the corporation's debts that had been discharged in bankruptcy.

ii. Issue: The Commissioner asserted that the amounts repaid had to be capitalized, while the taxpayer sought a current deduction.

iii. Based on *INDOPCO*, should the repayments have been capitalized? What was the taxpayer's trade or business while the corporation was alive? Were the amounts spent on repayment primarily used to improve his personal reputation or his business reputation? If the latter, was it to improve his business reputation or to acquire a business reputation? Does it matter?

iv. Justice Cardozo seems to confuse the capital/ordinary line with the personal/business line. Why? Is there a personal component to the debt repayment? What if the taxpayer had paid the debts anonymously?

c. Education:

i. *Carroll v. Commissioner* (p. 467): A police officer took general college courses at night, consistent with police policies. *Held*, that the course satisfies the taxpayer's employer does not establish that the course maintains or improves skills used in the taxpayer's trade or business. Deduction disallowed.

ii. *Kopaigora v. Commissioner* (p. 469): This case is about the definition of a “trade or business” within the meaning of Reg. §1.162-5. The taxpayer changed employers but not he used his skills in the same way for both employers. Held, that the cost of his education was deductible because it maintained or improved skills used in his current trade or business and did not qualify him for a new trade or business.

iii. Regulation §1.162-5 provides a series of objective tests on the costs associated with education.

(A) The costs of education are not deductible if:

(1) The education simply meets the minimum educational requirements for the taxpayer's current trade or business. For example, T has a temporary apprentice certificate to cut hair and works as a barber. T takes 20 hours of schooling to qualify for a permanent hair cutting license. The costs of the 20 hours of schooling are not deductible.

(2) The education qualifies the taxpayer for a new trade or business. Of course, what constitutes a new trade or business is subject to dispute. For examples, see Regs. §1.162-5(b)(3) (e.g., classroom teacher to principal is not a change of trade or business). Any state licensed profession presumably will constitute a distinct trade or business. Note that no part of an education is deductible if the program of study as a whole will lead to qualification for a new trade or business.

(B) To be deductible, education must:

(1) Maintain or improve skills used in the taxpayer's current trade or business; or

(2) Meet express requirements imposed on the taxpayer for continuing in his current trade or business.

(3) Note that an employer's willingness to reimburse the employee for the costs of certain education does not establish that the education maintained or improved skills used by the taxpayer in his current trade or business. On the

other hand, mandatory CLE is deductible under (ii).