

## Chapter 2: Recovery of Investment

### A. Computation of Gain and Loss: Taxation Under the Code

Suppose individual T purchases a share of X Corp. stock for \$50 and subsequently sells the share for \$60. How much income does T have because of the sale? The answer obviously is \$10, and that is both the sensible answer and the answer that the Code generates. To see how we get that answer under the Code, start at section 61.

Section 61 defines gross income, and in section 61(a)(3), gross income includes “[g]ains derived from dealings in property.” Note also that the list of includible items in section 61(a) is nonexclusive: that is, gross income can include items that are not included on its list. And note also that items that are described in section 61(a) may not constitute gross income to the extent “otherwise provided.”

“Gain” from dealing in property is defined in section 1001(a) to be the excess of “amount realized” over “adjusted basis.” Loss also is defined in section 1001(a), and we will return to that definition later.

“Amount realized” is defined in section 1001(b) to equal the sum of (1) the amount of money received by the taxpayer plus (2) the fair market value of any property received by the taxpayer. Section 1001(b) thus defines “amount realized” to be the total value received by T; in our case, that is the \$60 of cash. Note that the amount realized would not change if T had received \$60 in the form of non-cash property or partly in the form of cash and partly in the form of non-cash property. That is, amount realized is defined so that it is independent of the form of the value received.

“Adjusted basis” is defined in section 1011 to be “basis” as defined in section 1012 (or other relevant provision) as adjusted by the rule in section 1016. Basis in section 1012 is the original cost of the property being sold; that is, the cost of the asset to the seller of the asset being sold. Additional basis rules are provided in other Code sections for methods of acquisition other than purchase. For example, there is one rule for property acquired by gift<sup>1</sup> and another for property acquired from a decedent.<sup>2</sup> The Code is full of basis rules, and we will look at several of them throughout this course. In our example, the stock was purchased for \$50, and so T’s basis equals \$50.

Basis as determined by the taxpayer’s method of acquisition is then adjusted under the rules of section 1016. Adjustments in section 1016 include, for example, upward adjustments for additional investment (a taxpayer who purchases a car and then has it painted can increase basis in the car by the cost of the painting) as well as downward adjustments for depreciation, amortization, and similar cost-recovery deductions. Here,

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<sup>1</sup> Section 1015, covered later in the course.

<sup>2</sup> Section 1014, covered later in the course.

there are no adjustments under section 1016 so that the taxpayer's adjusted basis remains at cost of \$50.

Now that we know amount realized equals \$60 (cash received) and that adjusted basis equals \$50, we can compute the gain under section 1001(a) as the excess of \$60 over \$50, or \$10. Note that when computing gain (and loss), the word "excess" generally means "minus," so that, for example, the excess of \$80 over \$20 equals \$60. In particular, do not think the phrase "excess of A over B" calls for division (because of the word "over"): when the Code says "excess," it is telling you to do a subtraction.

The word "excess" is not exactly the same as "minus." What is the excess of \$30 over \$40? If you did a subtraction, you would get negative \$10. But the Code never uses negative numbers! Because \$30 is smaller than \$40, we say there is no excess of \$30 over \$40. Put another way, the excess of \$30 over \$40 is zero.

### **1. Gain: The Underlying Economics and the Realization Doctrine**

Reconsider our taxpayer T but now assume T purchases a single share of X Corp. stock for \$500, and suppose T exchanges that share for a piece of real estate worth \$600. What is T's gain?

We know that T's amount realized equals \$600 and we know that T's adjusted basis under §1011 equals \$500 (we again are assuming there are no adjustments under section 1016 so that T's "adjusted basis" equals T's "basis" under §1012). Accordingly, T's gain under §1001(a) equals the excess of \$600 over \$500, or \$100.

Having determined that this exchange by T generates taxable income of \$100, let us now ask whether this exchange *should* generate \$100 of taxable income to T. Assuming that taxable income should measure accessions to wealth, does the exchange by T of the X Corp. stock for the real estate make T richer?

The answer is no. To be sure, T started with \$500 of cash (used to purchase the X Corp. stock) and ended up with property worth \$600 (the real estate). And just as surely, \$600 is more than \$500. But immediately prior to the exchange, presumably the X Corp. stock had increased in value to \$600 (if not, then why is the prior owner of the real estate willing to part with \$600 of value to get it?). Assuming that parties dealing at arm's length always exchange equal values, then an exchange by such parties *never* makes either richer or poorer since, by assumption, they get the same value they give.

Then why does the Code tax "gain" as defined in section 1001(a)? Although nothing in the Code directly says so, the mere appreciation (or diminution) in the value of property does not generate gain or loss to the owner of the property. This is worth repeating: with limited exceptions,<sup>3</sup> mere appreciation or diminution in value of property does not trigger taxation on that appreciation or diminution. This is called the "realization doctrine" and is understood to be latent in the taxation of gain under section 61(a)(3) and 1001(a). Not

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<sup>3</sup> One important set of exceptions are the original issue discount ("OID") rules, covered later in the course.

until there is some event of disposition – called a “realization event” – does the tax system capture any change in value. Any change in value in property prior to an event of realization is called “unrealized” gain or loss.

Not all realized gains and losses are immediately taken into account by our tax system: note that the definition of gross income in section 61(a) is limited by the phrase “[e]xcept as otherwise provided in this subtitle.” Tax items that are taken into account are said to be “recognized.” So, “recognized” gains are realized gains that are not excluded by statute from immediately taxable.

## **2. Mark-to-Market Taxation**

Suppose the realization doctrine were eliminated so that taxpayers would have to report as income the fair market value increase, if any, of assets held on the last day of the taxable year. For example, if T purchases a share of stock in 2018 for \$50 and on December 31, 2018, that share is worth \$60, T must report \$10 of income on her return even if she continues to hold the share. This is called “mark-to-market” taxation because each asset is valued (that is, “marked”) to market values at the end of each year. With very limited exceptions, we have never had a mark-to-market system of taxation.

Assume T then sells the stock – bought for \$50 and on which she has already been taxed on \$10 at the end of 2018 -- for \$64 on April 1, 2019. How should she be taxed on that sale? We know that she started with \$50 and ends up with \$64, so there should be \$14 of total income taxable to T. She already reported \$10 of gain on her 2018 tax return, leaving only \$4 of gain to be taxed on the sale. That is, her adjusted basis at the time of the sale should not be her original cost basis of \$50 but rather \$60. When T includes the \$10 of gain at the end of 2018, her adjusted basis must increase by the amount of the gain recognized to ensure that she is not taxed a second time on the same increase in value. Because adjusted basis is the amount you can receive tax-free (recall the definition of gain in section 1001(a)), inclusion of income must increase adjusted basis in some asset. Put another way, when a taxpayer engages in a transaction or series of transaction, new basis at the end of transaction must equal adjusted basis at the beginning of the transaction plus any gain recognized (and minus any loss recognized). Note that this rule is not limited to mark-to-market taxation; rather, it must be true even in a realization-based system such as the US income tax. *It is perhaps the single most important rule in all of income taxation.*<sup>4</sup>

## **3. Computation of Loss**

Section 1001(a) defines both gain and loss from the disposition of property. While gain is defined as the excess of amount realized over adjusted basis, loss is defined as the excess of adjusted basis over amount realized. Note, though, while section 61 generally provides that all realized gain are includible in gross income (that is, realized gain are recognized, see §1001(c), except to the extent some provision provides otherwise), losses do not

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<sup>4</sup> There is an exception to this fundamental rule arising when a taxpayer holding appreciated or loss property dies. We will come to this exception shortly.

reduce gross income. Rather, only deductions reduce gross income, and so a loss will produce a tax benefit only if the loss is treated as deductible. Section 165 (discussed later) provides that some but not all losses are deductible, and even as to those losses that are deductible under section 165, there are additional hurdles that must be negotiated before such deductions can be claimed by a taxpayer on the taxpayer's return. One word of warning: while the term "loss" is defined in §1001(a) as the excess of amount realized over adjusted basis, it is defined in other provisions in other ways.<sup>5</sup> When you see the term "loss" in a provision, it is important to ascertain the precise meaning of the term in the specific context.

#### **4. Taxation of Cash Dividends and Stock Dividends**

##### *a. Cash Dividends*

Suppose T purchases one share of X Corp. stock for \$50 and sometime thereafter X Corp. declares and pays a \$1.00 per share cash dividend. Does T have income? Yes: see §61(a)(7).

What value should the dividend have on the value of T's share? Immediately prior to the dividend, T had a claim on the corporation's assets. Immediately after, T still has a claim on the corporation's assets but now those assets have been reduced by reason of the dividend. For example, suppose there are 10 shares of X Corp. stock outstanding, and suppose that X Corp. had assets worth \$500 immediately prior to the dividend so that T's share was worth 10% of \$500, or \$50. Immediately after the dividend, X Corp. has assets worth only \$490 (because \$10 has been distributed to the shareholders), so that T's 10% interest is now worth only 10% of \$490, or \$49. The dividend does not affect T's wealth but only changes a bit of its form from \$50 in the form of stock to \$49 in stock and \$1 in cash.

How does the taxable stock dividend affect T's basis in the one share of stock? It doesn't! Prior to the stock dividend, T owned one share of X Corp. stock. Immediately after the stock dividend, T owned the same share as well as \$1 in cash. Because T included \$1 in income, T's adjusted basis must go up, but that only means that T's *aggregate* adjusted basis must increase by \$1. Cash is never directly assigned a basis but the income tax rules always assume that cash has an adjusted basis equal to face value. Accordingly, the \$1 of cash has an implicit basis of \$1, and because T's aggregate basis must equal \$51 (\$50 prior to the stock dividend plus the \$1 of taxable income), T's adjusted basis in the stock must remain at \$50.

Continuing with this example, T now has a "built-in" loss in T's share of X Corp. stock. If T were to immediately sell the share for its fair market value of \$49, T would recognize a loss of \$1 under section 1001(a) (adjusted basis is \$50 while amount realized would be \$49). Assuming the loss is deductible, T would recognize no net gain or loss for the year as the \$1 income from the dividend and \$1 deductible loss offset one another.

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<sup>5</sup> E.g., §465(d).

Suppose that the dividend had been paid not in cash but rather in property worth \$1, say in an X Corp.-logo pen. Assuming the value of the pen is includible in income (it is), T again reports \$1. But what is T's adjusted basis in the share of X Corp. stock? Now, there are multiple possible answers.

We know that T's aggregate adjusted basis must equal \$51 because of the taxable dividend. One possibility is that the pen is allocated \$1 of basis, leaving \$50 for the share of stock. Another possibility is that the pen is allocated \$0 of basis, leaving \$51 for the share of stock. So long as the basis allocated to the pen and the basis allocated to the share of stock equals \$51, Congress can allocate the \$51 aggregate basis however it desires.<sup>6</sup>

*b. Stock Dividends*

Now suppose that instead of the cash dividend, X Corp. declares and pays a stock dividend, giving each shareholder one additional share of stock for each share already owned (usually called a "1 for 1" stock dividend). Should that stock dividend be taxable?

The stock dividend does not make T any richer: where T owned one of 10 shares, T now owns 2 of 20 in the same corporation. But of course the cash dividend also did not make T richer, and it *was* taxable. The cash dividend changed the form of T's wealth, and in a realization-based income tax, change of form generally is when tax liabilities are imposed. Did the stock dividend change the form of T's wealth?

Barely. T's wealth remains in the form of T Corp. stock, but now the number of shares (but not percentage ownership) has doubled. Is that enough to justify taxation? Congress has determined it is not.<sup>7</sup> Given that decision by Congress, what is T's basis in the new share and what is T's adjusted basis in the old share?<sup>8</sup>

*Notes*

1. *Fair Market Value – Introduction:* The phrase "fair market value" appears in many Code sections besides §1001(b). The Supreme Court has held that "[f]air market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable

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<sup>6</sup> This is not a course on corporate taxation, but for the curious: the pen takes a stock basis of \$1 under §301(d).

<sup>7</sup> Again, this is not a course on corporate taxation, but for the curious: the answer can be found in §305(a), but one really must master all of §305 to reach that result. Section 305 will be covered in your corporate tax class.

<sup>8</sup> Because the stock split is not a taxable event, aggregate basis in the stock must remain unchanged though it now must be allocated among 20 shares rather than 10 shares. As a result, each share has an adjusted basis of \$25. Of course, Congress could provide that all the basis remains with the old shares, giving each new share a basis of \$0. Or it could provide that all the basis flows to the new shares, leaving nothing for the old shares. The actual statutory answer to this allocation of basis question will be covered in your corporate tax class.

knowledge of relevant facts.”<sup>9</sup> An identical definition is found in the Estate Tax regulations.<sup>10</sup>

2. *Fair Market Value – Some Problems:* In most jurisdictions, consumer retail purchases trigger a sales tax. Suppose, for example, that T purchases a new automobile for a stated price of \$30,000 upon which a state sales tax of 6% (or \$1,800) is imposed. Is the fair market value of the automobile the \$30,000 received by the seller or the \$31,800 paid by the buyer? A similar issue arises when purchases trigger sales commissions. Note that it does not matter who nominally pays the commission: whether paid by the buyer or the seller, the amount paid by the buyer will exceed the amount received by the seller. One way to resolve this problem is by treating the buyer as paying and the seller as receiving the purchase price including the commission and then treating the seller as paying the commission to the broker or taxing authority. This technique of recasting one hard-to-analyze transaction into a series of easier-to-analyze transactions is commonly used in tax practice.<sup>11</sup> As we shall see later in this course, the tax consequences of a seller paying a commission is easy to determine.

In the computation of gain under section 1001(a), the transferor’s gain is defined as the amount of cash received plus the fair market value of any property received. What if it is difficult to value the property received? If the parties are dealing at arm’s-length, then the value of what is received equals the value of what is given so that “amount realized” must equal the fair market value of the property given up.

For example, suppose two individuals who are about to marry one another sign a prenuptial agreement in which spouse X relinquishes all claims on the property of spouse Y in exchange for P Corp. stock having an adjusted basis in the hands of spouse Y of \$85,000. This transaction should be taxable to spouse Y on the excess, if any, of the value *of the marital rights* relinquished by spouse X over the adjusted basis of the P Corp. stock (which is \$85,000). But how should such marital rights be valued? *If* it is fair to treat the two parties as dealing at arm’s length (an uncertain assumption at best in this context), then we can treat the fair market value of the marital rights as equal to the fair market value of the P Corp. stock (which might be easy to value). *United States v. Davis*, 370 U.S. 65 (1962) (transfer in the context of divorce). How should spouse X be taxed?

3. *Fair Market Values in Multiple Asset Exchanges:* Suppose I sell to a stranger both my house and my car in a single transaction for \$525,000. Because we assume that strangers deal at arm’s length, we assume that the fair market value of my house plus the fair market value of my car equals \$525,000. Now suppose that the sales agreement provides that the buyer is paying \$500,000 for the house and \$25,000 for the car. Can we be sure, given their arm’s-length dealing, that the house really is worth \$500,000 alone while the car really is worth \$25,000?

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<sup>9</sup> *United States v. Cartwright*, 411 U. S. 546 (1973).

<sup>10</sup> Regs. §20.2031-1.

<sup>11</sup> Recall the principle of horizontal equity discussed in Chapter 1.

We cannot. Both the buyer and seller are economically indifferent to the allocation of the sale price between the two assets. If, for example, the buyer believes the house is worth \$490,000 and the car is worth \$35,000, the two combined remain worth the agreed-upon price of \$525,000. Indeed, not only do we not know that the price allocation in the contract represents their true valuation of each asset separately, but we do not even know that the two parties share the same valuation for either asset considered separately. All we do know – assuming they are dealing at arm’s length – is that the total value given up by one side of the exchange equals the same total value given up by the other side.

Why might the parties have specified a purchase price allocation in their sale contract? Suppose the seller’s taxes are independent of the allocation but the buyer’s tax treatment of the transaction will be better if more value is ascribed to the car. Given the seller’s indifference, presumably the seller will not care how the purchase price is allocated between the assets and so will accept whatever the buyer proposes, even if the seller recognizes the buyer has inflated the value of the car at the expense of the house. To ensure the buyer cannot use this technique to inappropriately reduce her taxes, it will be up to the Commissioner of Internal Revenue to ferret out the truth and tax the buyer properly. In one context, Congress has attempted to resolve this issue by demanding consistency between the parties, presumably based on the idea that the parties will have adverse tax positions, and this should force them to accurately value individual assets in a multiple asset transaction.<sup>12</sup> What assumptions underlie this approach?

## **B. Nonrecognition Provisions**

### **1. Like-Kind Exchanges Under Section 1031**

#### *a. Simultaneous Exchanges*

Section 1031(a)(1) provides nonrecognition for certain exchanges. To fall within §1031(a)(1), a taxpayer must (1) exchange real estate for real estate, (2) the properties must be of “like-kind,” and (3) each property must be held for investment or for productive use in a trade or business. In addition, the property transferred by the taxpayer cannot have been held primarily for sale. §1031(a)(2). The property transferred by the taxpayer is called the “relinquished” property and the property received by the taxpayer in the exchange is called the “replacement” property. Note that when §1031(a)(1) applies to an exchange, neither gain nor loss is recognized on the exchange.

Until the Tax Cut and Jobs Act of 2017, like-kind property included more than just real estate. Now, the statute is limited to real estate, and section 1031(a)(1) continues to apply only when the relinquished real estate and the replacement real estate are of “like-kind.” Reg. §1.1031(a)-1(b) provides that

“[t]he words “like kind” have reference to the nature or character of the property and not to its grade or quality. . . . The fact that any real estate

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<sup>12</sup> See §1060.

involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale.”

While the definition of like-kind real estate is very broad, not all real estate is of like-kind to all other: real estate located within the United States is not of like-kind to real estate located outside the United States. §1031(h)(1).<sup>13</sup>

If a taxpayer engages in a §1031(a)(1) exchange, the taxpayer’s basis in the replacement property is determined under the first sentence of §1031(d). While the rule in that sentence seems unnecessarily complex, note that it applies to more transactions than just those described in §1031(a)(1). The rule starts with the taxpayer’s adjusted basis in the relinquished property and then adds and subtracts certain numbers. In the context of an exchange described in §1031(a)(1), all those numbers equal zero. Accordingly, the taxpayer’s basis in the replacement property equals the taxpayer’s adjusted basis in the relinquished property.

#### *Notes*

1. *Exchanges with Boot*: It is a rare case when taxpayers are willing to exchange property of like-kind and the properties are of precisely equal value. Usually, the properties will have different values and the parties will have to “true up” the values. This can be done in either of two ways. First, one party could add additional value to the exchange, usually cash but sometimes other property. Second, the other party could borrow against the more valuable property, so that when the property is transferred, the new liability goes with it, reducing the net value transferred.

Consider the following exchange: Taxpayer X owns Greenacre, used in X’s trade or business, having an adjusted basis of \$500,000 and a fair market value of \$800,000. Taxpayer Y owns Purpleacre, held by Y for investment, having an adjusted basis of \$200,000 and a fair market value of \$600,000. Both assets are located in the United States. X and Y exchange their real estate, with Y also contributing \$200,000 to the exchange.

The taxation of X is determined under §1031(b). Under that provision, if a taxpayer receives nonqualifying property in addition to qualifying like-kind property, the taxpayer recognizes her realized gain to the extent of the value of the other property. For example, if the realized gain is \$10,000 and the value of the nonqualifying property is \$8,000, then the taxpayer recognizes \$8,000 of her gain. If, though, the realized gain equals \$10,000 and the value of the nonqualifying property equals \$18,000, then the taxpayer recognizes gain of \$10,000 because that is all the gain that is realized on the exchange. Nonqualifying property, whether cash or anything else, often is called “boot.”

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<sup>13</sup> If this provision is not included in your abridged copy of the Internal Revenue Code, see <https://www.law.cornell.edu/uscode/text/26/1031>.



Returning to X, X's realized gain on the exchange is \$300,000 because X's amount realized equals \$800,000 (the amount of cash received plus the value of the property received) while the adjusted basis of the property given up equals \$500,000. Because X receives boot of \$200,000 (all in the form of cash received), X recognizes \$200,000 of the \$300,000 realized gain. §1031(b).

What is X's basis in Purpleacre immediately after the exchange? Under the first sentence of §1031(d), that basis equals \$500,000 [adjusted basis of relinquished property] minus \$200,000 [amount of cash received] + \$200,000 [amount of gain recognized] - \$0 [amount of loss recognized], or \$500,000.

X now owns Purpleacre with basis of \$500,000 while the property has a fair market value of \$600,000. Thus, X has a built-in gain of \$100,000 in Purpleacre. Recall that X recognized only \$200,000 of X's realized \$300,000 gain on the exchange. The \$100,000 realized gain that was not recognized on the exchange is preserved in the new property by giving it a basis below its fair market value. That is, X's built-in gain in Purpleacre is the gain that went unrecognized on the exchange. In this way, §1031 ensures that it operates only to *defer* gain rather than to *exempt* it.

### Problems

P-1. X owns Greenacre with adjusted basis of \$500,000 and fair market value of \$800,000. Y owns Purpleacre with adjusted basis of \$200,000 and fair market value of \$600,000. X exchanges Greenacre for Purpleacre plus cash of \$200,000. How much gain does X realize on the exchange? How much gain does X recognize on the exchange? What is X's basis in Purpleacre?

P-2. Reconsider problem 1 but assume that X receives \$200,000 in diamonds rather than cash. How do your answers change?

P-3. Reconsider the facts of problem 1. How much gain does Y realize on the exchange? How much gain does Y recognize? What is Y's basis in Greenacre?

P-4. Reconsider the facts of problem 2. What are the tax consequences to Y, assuming Y's adjusted basis in the diamonds is \$170,000? Assuming Y's adjusted basis in the diamonds is \$210,000?

P-5. How do your answers to the questions in problem 1 change if X's adjusted basis in Greenacre is \$710,000 rather than \$500,000?

P-6. P owns Redacre with adjusted basis of \$500,000, fair market value of \$800,000, and encumbered by a debt of \$150,000. Q owns Blueacre with adjusted basis of \$200,000 and fair market value of \$600,000. P exchanges Redacre for Blueacre plus cash of \$50,000, and Q takes Redacre subject to the existing liability. How much gain does P realize? How much gain does P recognize? What is P's basis in Blueacre?

*b. Deferred and Three-Party Exchanges*

Consider a taxpayer who wishes to purchase real estate for development of a shopping center or an apartment complex. Even though this taxpayer is willing to pay a reasonable price for the land, the owner may be unwilling to sell because the seller is unwilling to trigger recognition of gain. The seller might be willing to engage in a like-kind exchange, but the buyer only has cash. What can they do?

A standard technique is to use a deferred, three-party exchange. The owner of the real estate (i.e., the seller) transfers the property to the party having the cash (i.e., the buyer) and the buyer transfers the cash to a third party who will hold the cash for the benefit of the seller. This third party is called a “qualified intermediary” (or “QI”) and cannot be an agent, relative or employee of the buyer.<sup>14</sup> Failure to follow the rules in this regulation may cause the seller to be treated as in constructive receipt of the cash, and actual or constructive receipt of any consideration other than like-kind property vitiates possible tax-free characterization.

Once the cash is deposited with the QI, the seller goes shopping for replacement real estate which the QI will purchase with the escrowed funds and that will be titled directly in the seller’s name. Note that it is not unusual for the seller to identify multiple potential assets because real estate transactions do not always close. In addition, there is nothing to prevent the seller from adding additional cash to the transaction to acquire replacement property worth more than the relinquished property.

*Notes*

1. *Timing Rules.* Section 1031(a)(3) imposes two timing rules on deferred exchanges. First, the replacement property must be identified within 45 days of transfer of the relinquished property. §1031(a)(3)(A). Second, the replacement property must be received by the transferor by the earlier of (1) 180 days after transfer of the relinquished property and (2) the due date of the transferor’s tax return that covers the transfer of the relinquished property. §1031(a)(3)(B). Property that is not identified within the identification period will not be considered as like-kind even if ultimately received by the transferor. Similarly, property not received within the replacement period will not be considered as being of like-kind.

2. *Use of a Qualified Intermediary.* Why do taxpayers use qualified intermediaries? In theory, the seller could transfer the real estate to the buyer and then have the buyer purchase replacement property on behalf of the seller as the buyer identifies appropriate real estate? But sellers fear that once the real estate has been transferred to the buyer and the buyer has not yet paid anything for the property, the buyer may abscond with the assets. Use of a QI as an escrow agent allows the seller to rely on the credit worthiness of the QI (often an affiliate of a bank or law firm) rather than on the buyer.

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<sup>14</sup> See Reg. §1.1031(k)-1(g)(4).

## 2. Involuntary Conversions Under Section 1033

If property (not limited to real property) is involuntarily converted (that is, taken or lost such as by condemnation, fire or natural disaster) and the owner receives funds with which to purchase replacement property, gain that otherwise would be recognized on the conversion can be deferred to the extent the proceeds are invested in property "similar or related in service or use to the property so converted." §1033(a)(2)(A). Section 1033 is similar to section 1031 with "involuntary conversion" replacing "like-kind." Note that there is again a time limitation -- here it is 2 years -- on the period during which the reinvestment can be made to preserve the deferral of gain. §1033(a)(2)(B)(i). The basis rule in §1033 is written in different language than the rule in §1031(d) but yields the same result. See §1033(b)(2).

## 3. Implicit Nonrecognition

### **Cottage Savings Assn. v. Commissioner**

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**499 U.S. 554 (1991)**

JUSTICE MARSHALL delivered the opinion of the Court.

The issue in this case is whether a financial institution realizes tax-deductible losses when it exchanges its interests in one group of residential mortgage loans for another lender's interests in a different group of residential mortgage loans. We hold that such a transaction does give rise to realized losses.

#### **I**

Petitioner Cottage Savings Association (Cottage Savings) is a savings and loan association (S & L) formerly regulated by the Federal Home Loan Bank Board (FHLBB). Like many S & L's, Cottage Savings held numerous long-term, low-interest mortgages that declined in value when interest rates surged in the late 1970's. These institutions would have benefited from selling their devalued mortgages in order to realize tax-deductible losses. However, they were deterred from doing so by FHLBB accounting regulations, which required them to record the losses on their books. Reporting these losses consistent with the then-effective FHLBB accounting regulations would have placed many S & L's at risk of closure by the FHLBB.

The FHLBB responded to this situation by relaxing its requirements for the reporting of losses. In a regulatory directive known as "Memorandum R-49," dated June 27, 1980, the FHLBB determined that S & L's need not report losses associated with mortgages that are exchanged for "substantially identical" mortgages held by other lenders. The FHLBB's acknowledged purpose for Memorandum R-49 was to facilitate transactions that would generate tax losses but that would not substantially affect the economic position of the transacting S & L's.<sup>15</sup>

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<sup>15</sup> [Is it appropriate for a federal regulator to promulgate a rule with the intended purpose of allowing its regulated entities to generate tax deductions without having any meaningful effect of their economic positions? – ed]

This case involves a typical Memorandum R-49 transaction. On December 31, 1980, Cottage Savings sold "90 participation interests" in 252 mortgages to four S & L's. It simultaneously purchased "90 participation interests" in 305 mortgages held by these S & L's.<sup>16</sup> All of the loans involved in the transaction were secured by single-family homes, most in the Cincinnati area. The fair market value of the package of participation interests exchanged by each side was approximately \$4.5 million. The face value of the participation interests Cottage Savings relinquished in the transaction was approximately \$6.9 million. See 90 T.C. 372, 378-382 (1988).

On its 1980 federal income tax return, Cottage Savings claimed a deduction for \$2,447,091, which represented the adjusted difference between the face value of the participation interests that it traded and the fair market value of the participation interests that it received.<sup>17</sup> As permitted by Memorandum R-49, Cottage Savings did not report these losses to the FHLBB. After the Commissioner of Internal Revenue disallowed Cottage Savings' claimed deduction, Cottage Savings sought a redetermination in the Tax Court. The Tax Court held that the deduction was permissible. See 90 T.C. 372 (1988).

On appeal by the Commissioner, the Court of Appeals reversed. 890 F.2d 848 (CA6 1989). The Court of Appeals agreed with the Tax Court's determination that Cottage Savings had realized its losses through the transaction. See *id.* at 852. However, the court held that Cottage Savings was not entitled to a deduction because its losses were not "actually" sustained during the 1980 tax year for purposes of 26 U.S.C. 165(a). See 890 F.2d, at 855.

Because of the importance of this issue to the S & L industry and the conflict among the Circuits over whether Memorandum R-49 exchanges produce deductible tax losses, we granted certiorari. We now reverse.

## II

Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer "realizes" the gain or loss. The realization requirement is implicit in 1001(a) of the Code, 26 U.S.C. 1001(a), which defines "[t]he gain [or loss] from the sale or other disposition of property" as the difference between "the amount realized" from the sale or disposition of the property and its "adjusted basis." As this Court has recognized, the concept of realization is "founded on administrative convenience." *Helvering v. Horst*, 311 U.S. 112, 116 (1940). Under an appreciation-based system of taxation, taxpayers and the Commissioner would have to undertake the "cumbersome, abrasive, and unpredictable administrative task" of

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<sup>16</sup> By exchanging merely participation interests, rather than the loans themselves, each party retained its relationship with the individual obligors. Consequently, each S & L continued to service the loans on which it had transferred the participation interests and made monthly payments to the participation-interest holders. See 90 T.C. 372, 381 (1988).

<sup>17</sup> [The face value of the transferred participation interests presumably equaled Cottage Savings's adjusted basis in the participation interests. This would be the case, for example, if Cottage Savings Had been the original lender on the underlying loan. – ed]

valuing assets on an annual basis to determine whether the assets had appreciated or depreciated in value. See 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts* § 5.2, p. 5-16 (2d ed. 1989). In contrast, "[a] change in the form or extent of an investment is easily detected by a taxpayer or an administrative officer." R. Magill, *Taxable Income* 79 (rev. ed. 1945).

Section 1001(a)'s language provides a straightforward test for realization: to realize a gain or loss in the value of property, the taxpayer must engage in a "sale or other disposition of [the] property." The parties agree that the exchange of participation interests in this case cannot be characterized as a "sale" under 1001(a); the issue before us is whether the transaction constitutes a "disposition of property." The Commissioner argues that an exchange of property can be treated as a "disposition" under 1001(a) only if the properties exchanged are materially different. The Commissioner further submits that, because the underlying mortgages were essentially economic substitutes, the participation interests exchanged by Cottage Savings were not materially different from those received from the other S & L's. Cottage Savings, on the other hand, maintains that any exchange of property is a "disposition of property" under 1001(a), regardless of whether the property exchanged is materially different. Alternatively, Cottage Savings contends that the participation interests exchanged were materially different because the underlying loans were secured by different properties.

We must therefore determine whether the realization principle in 1001(a) incorporates a "material difference" requirement. If it does, we must further decide what that requirement amounts to and how it applies in this case. We consider these questions in turn.

Neither the language nor the history of the Code indicates whether and to what extent property exchanged must differ to count as a "disposition of property" under 1001(a). Nonetheless, we readily agree with the Commissioner that an exchange of property gives rise to a realization event under 1001(a) only if the properties exchanged are "materially different." The Commissioner himself has, by regulation, construed 1001(a) to embody a material difference requirement:

"Except as otherwise provided . . . the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property *differing materially either in kind or in extent*, is treated as income or as loss sustained."

Treas. Reg. 1.1001-1 (emphasis added).

Because Congress has delegated to the Commissioner the power to promulgate "all needful rules and regulations for the enforcement of [the Internal Revenue Code]," 26 U.S.C. 7805(a), we must defer to his regulatory interpretations of the Code so long as they are reasonable, see *National Muffler Dealers Assn., Inc. v. United States*, 440 U.S. 472, 476-477 (1979).

We conclude that Treasury Regulation 1.1001-1 is a reasonable interpretation of 1001(a). Congress first employed the language that now comprises 1001(a) of the Code in 202(a) of the Revenue Act of 1924, ch. 234, 43 Stat. 253; that language has

remained essentially unchanged through various reenactments. And since 1934, the Commissioner has construed the statutory term "disposition of property" to include a "material difference" requirement. As we have recognized, "Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law." *United States v. Correll*, 389 U.S. 299, 305-306 (1967), quoting *Helvering v. Winmill*, 305 U.S. 79, 83 (1938).

Treasury Regulation 1.1001-1 is also consistent with our landmark precedents on realization. In a series of early decisions involving the tax effects of property exchanges, this Court made clear that a taxpayer realizes taxable income [499 U.S. 554, 562] only if the properties exchanged are "materially" or "essentially" different. See *United States v. Phellis*, 257 U.S. 156, 173 (1921); *Weiss v. Stearn*, 265 U.S. 242, 253 -254 (1924); *Marr v. United States*, 268 U.S. 536, 540 -542 (1925). Because these decisions were part of the "contemporary legal context" in which Congress enacted 202(a) of the 1924 Act, and because Congress has left undisturbed through subsequent reenactments of the Code the principles of realization established in these cases, we may presume that Congress intended to codify these principles in 1001(a). The Commissioner's construction of the statutory language to incorporate these principles certainly was reasonable.

## **B**

Precisely what constitutes a "material difference" for purposes of 1001(a) of the Code is a more complicated question. The Commissioner argues that properties are "materially different" only if they differ in economic substance. To determine whether the participation interests exchanged in this case were "materially different" in this sense, the Commissioner argues, we should look to the attitudes of the parties, the evaluation of the interests by the secondary mortgage market, and the views of the FHLBB. We conclude that 1001(a) embodies a much less demanding and less complex test.

....

[W]e find no support for the Commissioner's "economic substitute" conception of material difference. According to the Commissioner, differences between properties are material for purposes of the Code only when it can be said that the parties, the relevant market (in this case the secondary mortgage market), and the relevant regulatory body (in this case the FHLBB) would consider them material. . . .

Moreover, the complexity of the Commissioner's approach ill-serves the goal of administrative convenience that underlies the realization requirement. In order to apply the Commissioner's test in a principled fashion, the Commissioner and the taxpayer must identify the relevant market, establish whether there is a regulatory agency whose views should be taken into account, and then assess how the relevant market participants and the agency would view the transaction. The Commissioner's failure to explain how these inquiries should be conducted further calls into question the workability of his test.

Finally, the Commissioner's test is incompatible with the structure of the Code. Section 1001(c) of Title 26 provides that a gain or loss realized under 1001(a) "shall be recognized" unless one of the Code's nonrecognition provisions applies. One such nonrecognition provision withholds recognition of a gain or loss realized from an exchange of properties that would appear to be economic substitutes under the Commissioner's material difference test. This provision, commonly known as the "like kind" exception, withholds recognition of a gain or loss realized "on the exchange of property held for productive use in a trade or business or for investment . . . for property of like kind which is to be held either for productive use in a trade or business or for investment." 26 U.S.C. 1031(a)(1). If Congress had expected that exchanges of similar properties would not count as realization events under 1001(a), it would have had no reason to bar recognition of a gain or loss realized from these transactions.

## C

Under our interpretation of 1001(a), an exchange of property gives rise to a realization event so long as the exchanged properties are "materially different" - that is, so long as they embody legally distinct entitlements. Cottage Savings' transactions at issue here easily satisfy this test. Because the participation interests exchanged by Cottage Savings and the other S & L's derived from loans that were made to different obligors and secured by different homes, the exchanged interests did embody legally distinct entitlements. Consequently, we conclude that Cottage Savings realized its losses at the point of the exchange.

....

## IV

For the reasons set forth above, the judgment of the Court of Appeals is reversed, and the case is remanded for further proceedings consistent with this opinion.

So ordered.

[Justice Blackmun, in an opinion joined by Justice White, concurs in part and dissents in part.]

### *Note*

1. *The Cottage Savings regulation.* In response to the Supreme Court's decision in *Cottage Savings*, the Treasury promulgated a regulation detailing when the modification of a debt instrument (usually a corporate note or bond) must be treated as an exchange and when the modification may be ignored.<sup>18</sup> When the modification must be treated as an exchange, both the debtor and the debt holder are treated as if the old debt instrument was cancelled in exchange for a new debt instrument having the modified terms. Such a deemed exchange can be taxable to either or both parties.

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<sup>18</sup> Reg. §1.1001-3. This regulation is available on the Cornell web site.

This regulation both defines what constitutes a “modification” and when such a modification is considered “significant.” In general, only significant modifications are treated as exchanges. A significant modification includes more than a de minimis change to the interest rate or term of the obligation as well as a change in the identity of the debtor (such as, for example, the substitute of a subsidiary corporation for its parent). However, most changes to the terms of a debt interest are not treated as modifications if they occur pursuant to the terms of the debt instrument itself. For example, if the interest paid on a debt instrument changes in response to specific market conditions such as an increase or decrease in a benchmark interest rate, the change is not considered to be a modification.

#### 4. Gifts

##### a. Exclusion

### **Commissioner v. Duberstein**

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**363 U.S. 278 (1960)**

MR. JUSTICE BRENNAN delivered the opinion of the Court.

These two cases concern the provision of the Internal Revenue Code which excludes from the gross income of an income taxpayer "the value of property acquired by gift." They pose the frequently recurrent question whether a specific transfer to a taxpayer in fact amounted to a "gift" to him within the meaning of the statute. The importance to decision of the facts of the cases requires that we state them in some detail.

The taxpayer, Duberstein, was president of the Duberstein Iron & Metal Company, a corporation with headquarters in Dayton, Ohio. For some years the taxpayer's company had done business with Mohawk Metal Corporation, whose headquarters were in New York City. The president of Mohawk was one Berman. The taxpayer and Berman had generally used the telephone to transact their companies' business with each other, which consisted of buying and selling metals. The taxpayer testified, without elaboration, that he knew Berman "personally" and had known him for about seven years. From time to time in their telephone conversations, Berman would ask Duberstein whether the latter knew of potential customers for some of Mohawk's products in which Duberstein's company itself was not interested. Duberstein provided the names of potential customers for these items.

One day in 1951 Berman telephoned Duberstein and said that the information Duberstein had given him had proved so helpful that he wanted to give the latter a present. Duberstein stated that Berman owed him nothing. Berman said that he had a Cadillac as a gift for Duberstein, and that the latter should send to New York for it; Berman insisted that Duberstein accept the car, and the latter finally did so, protesting however that he had not intended to be compensated for the information. At the time Duberstein already had a Cadillac and an Oldsmobile, and felt that he did not need another car. Duberstein testified that he did not think Berman would have



sent him the Cadillac if he had not furnished him with information about the customers. It appeared that Mohawk later deducted the value of the Cadillac as a business expense on its corporate income tax return.

Duberstein did not include the value of the Cadillac in gross income for 1951, deeming it a gift. The Commissioner asserted a deficiency for the car's value against him, and in proceedings to review the deficiency the Tax Court affirmed the Commissioner's determination. It said that "The record is significantly barren of evidence revealing any intention on the part of the payor to make a gift. . . . The only justifiable inference is that the automobile was intended by the payor to be remuneration for services rendered to it by Duberstein." The Court of Appeals for the Sixth Circuit reversed. 265 F. 2d 28.

The taxpayer, Stanton, had been for approximately 10 years in the employ of Trinity Church in New York City. He was comptroller of the Church corporation, and president of a corporation, Trinity Operating Company, [that] the church set up as a fully owned subsidiary to manage its real estate holdings, which were more extensive than simply the church property. His salary by the end of his employment there in 1942 amounted to \$22,500 a year. Effective November 30, 1942, he resigned from both positions to go into business for himself. The Operating Company's directors, who seem to have included the rector and vestrymen of the church, passed the following resolution upon his resignation: "BE IT RESOLVED that in appreciation of the services rendered by Mr. Stanton . . . a gratuity is hereby awarded to him of Twenty Thousand Dollars, payable to him in equal instalments of Two Thousand Dollars at the end of each and every month commencing with the month of December, 1942; provided that, with the discontinuance of his services, the Corporation of Trinity Church is released from all rights and claims to pension and retirement benefits not already accrued up to November 30, 1942."

The Operating Company's action was later explained by one of its directors as based on the fact that, "Mr. Stanton was liked by all of the Vestry personally. He had a pleasing personality. He had come in when Trinity's affairs were in a difficult situation. He did a splendid piece of work, we felt. Besides that . . . he was liked by all of the members of the Vestry personally." And by another: "[W]e were all unanimous in wishing to make Mr. Stanton a gift. Mr. Stanton had loyally and faithfully served Trinity in a very difficult time. We thought of him in the highest regard. We understood that he was going in business for himself. We felt that he was entitled to that evidence of good will."

On the other hand, there was a suggestion of some ill-feeling between Stanton and the directors, arising out of the recent termination of the services of one Watkins, the Operating Company's treasurer, whose departure was evidently attended by some acrimony. At a special board meeting on October 28, 1942, Stanton had intervened on Watkins' side and asked reconsideration of the matter. The minutes reflect that "resentment was expressed as to the 'presumptuous' suggestion that the action of the Board, taken after long deliberation, should be changed." The Board adhered to its

determination that Watkins be separated from employment, giving him an opportunity to resign rather than be discharged. At another special meeting two days later it was revealed that Watkins had not resigned; the previous resolution terminating his services was then viewed as effective; and the Board voted the payment of six months' salary to Watkins in a resolution similar to that quoted in regard to Stanton, but which did not use the term "gratuity." At the meeting, Stanton announced that in order to avoid any such embarrassment or question at any time as to his willingness to resign if the Board desired, he was tendering his resignation. It was tabled, though not without dissent. The next week, on November 5, at another special meeting, Stanton again tendered his resignation which this time was accepted.

The "gratuity" was duly paid. So was a smaller one to Stanton's (and the Operating Company's) secretary, under a similar resolution, upon her resignation at the same time. The two corporations shared the expense of the payments. There was undisputed testimony that there were in fact no enforceable rights or claims to pension and retirement benefits which had not accrued at the time of the taxpayer's resignation, and that the last proviso of the resolution was inserted simply out of an abundance of caution. The taxpayer received in cash a refund of his contributions to the retirement plans, and there is no suggestion that he was entitled to more. He was required to perform no further services for Trinity after his resignation.

The Commissioner asserted a deficiency against the taxpayer after the latter had failed to include the payments in question in gross income. After payment of the deficiency and administrative rejection of a refund claim, the taxpayer sued the United States for a refund in the District Court for the Eastern District of New York. The trial judge, sitting without a jury, made the simple finding that the payments were a "gift," and judgment was entered for the taxpayer. The Court of Appeals for the Second Circuit reversed. 268 F. 2d 727.

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The exclusion of property acquired by gift from gross income under the federal income tax laws was made in the first income tax statute passed under the authority of the Sixteenth Amendment, and has been a feature of the income tax statutes ever since. The meaning of the term "gift" as applied to particular transfers has always been a matter of contention. Specific and illuminating legislative history on the point does not appear to exist. Analogies and inferences drawn from other revenue provisions, such as the estate and gift taxes, are dubious. The meaning of the statutory term has been shaped largely by the decisional law. With this, we turn to the contentions made by the Government in these cases.

*First.* The Government suggests that we promulgate a new "test" in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. We reject this invitation. We are of opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory

framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. The cases at bar are fair examples of the settings in which the problem usually arises. They present situations in which payments have been made in a context with business overtones—an employer making a payment to a retiring employee; a businessman giving something of value to another businessman who has been of advantage to him in his business. In this context, we review the law as established by the prior cases here.

The course of decision here makes it plain that the statute does not use the term "gift" in the common-law sense, but in a more colloquial sense. This Court has indicated that a voluntary executed transfer of his property by one to another, without any consideration or compensation therefor, though a common-law gift, is not necessarily a "gift" within the meaning of the statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716, 730. And, importantly, if the payment proceeds primarily from "the constraining force of any moral or legal duty," or from "the incentive of anticipated benefit" of an economic nature, *Bogardus v. Commissioner*, 302 U. S. 34, 41, it is not a gift. And, conversely, "[w]here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it." *Robertson v. United States*, 343 U. S. 711, 714. A gift in the statutory sense, on the other hand, proceeds from a "detached and disinterested generosity," *Commissioner v. LoBue*, 351 U. S. 243, 246; "out of affection, respect, admiration, charity or like impulses." *Robertson v. United States*, *supra*, at 714. And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor's "intention." *Bogardus v. Commissioner*, 302 U. S. 34, 43. "What controls is the intention with which payment, however voluntary, has been made." *Id.*, at 45 (dissenting opinion).

The Government says that this "intention" of the transferor cannot mean what the cases on the common-law concept of gift call "donative intent." With that we are in agreement, for our decisions fully support this. Moreover, the *Bogardus* case itself makes it plain that the donor's characterization of his action is not determinative — that there must be an objective inquiry as to whether what is called a gift amounts to it in reality. It scarcely needs adding that the parties' expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter.

....

*Second.* The Government's proposed "test," while apparently simple and precise in its formulation, depends frankly on a set of "principles" or "presumptions" derived from the decided cases, and concededly subject to various exceptions; and it involves various corollaries, which add to its detail. Were we to promulgate this test as a matter of law, and accept with it its various presuppositions and stated consequences, we would be passing far beyond the requirements of the cases before us, and would be painting on a large canvas with indeed a broad brush. The Government derives its test from such propositions as the following: That payments by an employer to an

employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment's being a deductible business expense; that a gift involves "personal" elements; that a business corporation cannot properly make a gift of its assets. The Government admits that there are exceptions and qualifications to these propositions. We think, to the extent they are correct, that these propositions are not principles of law but rather maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated in explaining their factual determinations. Some of them simply represent truisms: it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift. Others are overstatements of possible evidentiary inferences relevant to a factual determination on the totality of circumstances in the case: it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the "gift" exclusion; nor does it draw any distinction, in terms, between transfers by corporations and individuals, as to the availability of the "gift" exclusion to the transferee. The conclusion whether a transfer amounts to a "gift" is one that must be reached on consideration of all the factors.

Specifically, the trier of fact must be careful not to allow trial of the issue whether the receipt of a specific payment is a gift to turn into a trial of the tax liability, or of the propriety, as a matter of fiduciary or corporate law, attaching to the conduct of someone else. The major corollary to the Government's suggested "test" is that, as an ordinary matter, a payment by a corporation cannot be a gift, and, more specifically, there can be no such thing as a "gift" made by a corporation which would allow it to take a deduction for an ordinary and necessary business expense. As we have said, we find no basis for such a conclusion in the statute; and if it were applied as a determinative rule of "law," it would force the tribunals trying tax cases involving the donee's liability into elaborate inquiries into the local law of corporations or into the peripheral deductibility of payments as business expenses. The former issue might make the tax tribunals the most frequent investigators of an important and difficult issue of the laws of the several States, and the latter inquiry would summon one difficult and delicate problem of federal tax law as an aid to the solution of another. Or perhaps there would be required a trial of the vexed issue whether there was a "constructive" distribution of corporate property, for income tax purposes, to the corporate agents who had sponsored the transfer. These considerations, also, reinforce us in our conclusion that while the principles urged by the Government may, in nonabsolute form as crystallizations of experience, prove persuasive to the trier of facts in a particular case, neither they, nor any more detailed statement than has been made, can be laid down as a matter of law.

*Third.* Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the data of practical human experience, and the multiplicity of relevant factual elements, with their various

combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

This conclusion may not satisfy an academic desire for tidiness, symmetry and precision in this area, any more than a system based on the determinations of various fact-finders ordinarily does. But we see it as implicit in the present statutory treatment of the exclusion for gifts, and in the variety of forums in which federal income tax cases can be tried. If there is fear of undue uncertainty or overmuch litigation, Congress may make more precise its treatment of the matter by singling out certain factors and making them determinative of the matter, as it has done in one field of the "gift" exclusion's former application, that of prizes and awards. Doubtless diversity of result will tend to be lessened somewhat since federal income tax decisions, even those in tribunals of first instance turning on issues of fact, tend to be reported, and since there may be a natural tendency of professional triers of fact to follow one another's determinations, even as to factual matters. But the question here remains basically one of fact, for determination on a case-by-case basis.

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. Where the trial has been by a judge without a jury, the judge's findings must stand unless "clearly erroneous." . . .

*Fourth.* A majority of the Court is in accord with the principles just outlined. And, applying them to the *Duberstein* case, we are in agreement, on the evidence we have set forth, that it cannot be said that the conclusion of the Tax Court was "clearly erroneous." It seems to us plain that as trier of the facts it was warranted in concluding that despite the characterization of the transfer of the Cadillac by the parties and the absence of any obligation, even of a moral nature, to make it, it was at bottom a recompense for Duberstein's past services, or an inducement for him to be of further service in the future. We cannot say with the Court of Appeals that such a conclusion was "mere suspicion" on the Tax Court's part. To us it appears based in the sort of informed experience with human affairs that fact-finding tribunals should bring to this task.

As to *Stanton*, we are in disagreement. To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a "gift." To be sure, conciseness is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give no revelation of what the District Court's concept of the determining facts and legal standard may be. . . . While the standard of law in this area is not a complex one, we four think the unelaborated finding of ultimate fact here cannot stand as a fulfillment of these requirements.

. . . .

*It is so ordered.*

*Questions*

Q-1. *Duberstein* provides the definition of a “gift.” Why do we care?

Q-2. What is the definition of a “gift” for purposes of §102?

Q-3. When a patron leaves a tip for a retail worker, can the worker exclude the tip under §102? What if the patron leaves money with a note that says the following? “Thank you for providing good service to me. In appreciation of your efforts, I chose to make this tax-free gift to you.” What if the note reads: “While the service today wasn’t the best, I think you’re really cute”?

Q-4. Can an employer make a gift to an employee? See §102(c)(1). What if the employee is the employer’s child? Note that §102(c)(1) requires an employer/employee relationship and so does not apply to payments to independent contractors.

Q-5. Should gifts be includible in the income of the donor? Should they be deductible by the donor? Should a gift be an event of realization for the donor?

*b. Transfer of Unrealized Appreciation*

**Taft v. Bowers**

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**278 U.S. 470 (1929)**

MR. JUSTICE McREYNOLDS delivered the opinion of the Court.

....

Abstractly stated, this is the problem:

In 1916, A purchased 100 shares of stock for \$1,000, which he held until 1923, when their fair market value had become \$2,000. He then gave them to B, who sold them during the year 1923 for \$5,000. The United States claim that, under the Revenue Act of 1921, B must pay income tax upon \$4,000, as realized profits. B maintains that only \$3,000 -- the appreciation during her ownership -- can be regarded as income; that the increase during the donor’s ownership is not income assessable against her within intendment of the Sixteenth Amendment.

....

The only question subject to serious controversy is whether Congress had power to authorize the exaction.

....

If, instead of giving the stock to petitioner, the donor had sold it at market value, the excess over the capital he invested (cost) would have been income therefrom and subject to taxation under the Sixteenth Amendment. He would have been obliged to share the realized gain with the United States. He held the stock -- the investment -- subject to the right of the sovereign to take part of any increase in its value when separated through sale or conversion and reduced to his possession. Could he,

contrary to the express will of Congress, by mere gift enable another to hold this stock free from such right, deprive the sovereign of the possibility of taxing the appreciation when actually severed, and convert the entire property into a capital asset of the donee, who invested nothing, as though the latter had purchased at the market price? And, after a still further enhancement of the property, could the donee make a second gift with like effect, etc.? We think not.

In truth, the stock represented only a single investment of capital -- that made by the donor. And when, through sale or conversion, the increase was separated therefrom, it became income from that investment in the hands of the recipient subject to taxation according to the very words of the Sixteenth Amendment. By requiring the recipient of the entire increase to pay a part into the public treasury, Congress deprived her of no right and subjected her to no hardship. She accepted the gift with knowledge of the statute and, as to the property received, voluntarily assumed the position of her donor. When she sold the stock, she actually got the original sum invested, plus the entire appreciation and out of the latter only was she called on to pay the tax demanded.

The provision of the statute under consideration seems entirely appropriate for enforcing a general scheme of lawful taxation. To accept the view urged in behalf of petitioner undoubtedly would defeat, to some extent, the purpose of Congress to take part of all gain derived from capital investments. To prevent that result and insure enforcement of its proper policy, Congress had power to require that, for purposes of taxation, the donee should accept the position of the donor in respect of the thing received. And, in so doing, it acted neither unreasonably nor arbitrarily.

....

There is nothing in the Constitution which lends support to the theory that gain actually resulting from the increased value of capital can be treated as taxable income in the hands of the recipient only so far as the increase occurred while he owned the property. And *Irwin v. Gavit*, 268 U. S. 161, is to the contrary.

The judgment below is

*Affirmed.*

#### *Notes*

1. *The donee's basis.* A donee's basis in gifted property is determined under the first sentence of §1015(a). With one important exception, the donee's basis is set equal to the donor's adjusted basis in the gifted property. This rule ensures that any unrealized appreciation in the transferred property will be recognized if and when the property is sold by the donee. Had *Taft v. Bowers* come out the other way, any unrealized appreciation in gifted property would escape taxation forever. When property is transferred from one taxpayer to another and the recipient's basis is determined by reference to the adjusted basis of the transferor, we say the recipient takes a "transferred basis" in the property. §7701(a)(42). A "transferred" basis is one type of "substitute basis." §7701(a)(42).

Another term for substitute basis is “carryover basis,” and we sometimes say that the recipient “steps into the shoes” of the transferor.

2. *The kiddie tax.* Because §102 allows a high-bracket donor to transfer unrealized appreciation to a lower-bracket family member, it offers multiple opportunities for tax minimization. For example, a parent might gift appreciated property to a child with the understanding that the property will be sold and the proceeds used to pay for the child’s tuition. Congress has responded to this and similar perceived abuses of the tax system by enacting the “Kiddie Tax,” now found in §1(j)(4). While we will not cover the details of this provision, its basic operation is to tax unearned income (that is, income not generated by labor) of certain children at a tax rate that approximates the rate applicable to their parent’s rate. The children covered by this provision are specified in §1(g)(2).

3. *The donee’s basis in loss property.* If you read the first sentence of §1015(a) closely, you will see that the basis for determining a subsequent loss by the donee is not strictly a carryover basis. While Congress is willing in many provisions to allow one taxpayer to report income that accrued to another taxpayer, Congress is much less willing to allow one taxpayer to report a loss that accrued to another taxpayer. To test your understanding of the special loss rule in §1015(a), work the following problem.

*Problem*

P-7. Father owns stock with an adjusted basis of \$1,000. Father makes a gift of this stock to Daughter when it is worth the value specified in the first column of the chart below. Daughter subsequently sells the stock for the amount specified in the second column below. Compute the gain or loss to Daughter for each of the six possibilities, ignoring the possible application of the Kiddie Tax.

Fair Market Value <u>At Gift</u>	Sale <u>Price</u>	Gain <u>(Loss)</u>
1500	1500	
1500	1200	
1500	900	
900	1500	
900	800	
900	950	

**C. Claims in Property Divided Over Space and Time**

**1. Spatial Divisions**

Suppose X purchases Blackacre for \$15,000 and subsequently sells half of it for \$10,000. Does X have a gain on the sale? The answer depends on the portion of X’s adjusted basis that can be allocated to the portion that X sells. Current regulations provide that “[w]hen a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts.” Reg. §1.61-6(a). Equitable apportionment requires that the basis be allocated among the several parts in proportion



to relative fair market values at the time of acquisition. *Id.* (example 2). So, for example, to answer the Blackacre question at the start of this paragraph, we need to know the relative value of the half sold as compared with the relative value of the half retained as of the date that X acquired the property. Reg. §1.1011-2(b). In practice, this often requires taxpayers to hire experts to do a *retroactive valuation*; that is, to determine the value of assets as of some date in the past.

## 2. Sophisticated Non-Temporal Divisions

### **Inaja Land Co. v. Commissioner**

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**9 T.C. 727 (1947), acq. 1948-1 C.B. 2**

....

The issue is whether petitioner received taxable income of \$48,945 under a certain indenture of August 11, 1939, whereby it granted the city of Los Angeles, California, certain easements over its land and settling all claims arising out of the release of foreign waters from the city's Mono Craters Tunnel project. Certain facts have been stipulated and are so found. Facts found other than those stipulated are found from the evidence.

#### **FINDINGS OF FACT.**

....

On or about January 26, 1928, petitioner acquired approximately 1,236 acres of land in Mono County, California, together with all water and water rights appurtenant or belonging thereto, at a cost of approximately \$61,000. This property was located along the banks of the Owens River, which flows through and over petitioner's land, involved in this controversy. . . .

Petitioner's purpose in acquiring its properties was to operate a private fishing club thereon, with incidental rental of its properties for grazing livestock. It has conducted these activities since the time of its incorporation to date.

....

The Department of Water and Power of the City of Los Angeles, a municipal corporation, is responsible for the construction, operation, and maintenance of the water supply of that city. On or about September 25, 1934, the Department of Water and Power commenced the construction of Mono Craters Tunnel in Mono County (the west portal of this tunnel being in Mono Basin and the east portal being in the Owens River Drainage Basin.) . . .

Prior to the settling of the rights of petitioner and the city of Los Angeles by the execution of an indenture dated August 11, 1939, except as hereinafter stated, the city was not possessed of, and had not acquired, either by way of condemnation, prescription, user, grant or license, any right to divert, release, or suffer the release of waters into the Owens River in such a manner that such waters would flow through or over petitioner's lands, or to deposit or permit the deposit of foreign matter in or

to pollute the Owens River as it flowed through petitioner's land; nor had the city compensated petitioner in respect to these matters. Petitioner had not given the city any release or acquittance with respect thereto, except for the period from November 12 to December 2, 1935, when petitioner gave the city a revocable license to "dump" waters into the river, and the city engineer was given permission to enter on petitioner's lands for the purpose of making surveys. . . .

The adjusted basis of petitioner's properties was more than \$50,000 on January 1, 1939. Disregarding the sum in controversy, no event occurred in 1939 which would cause or require the adjusted basis of these properties to be reduced below \$50,000 for the taxable year involved.

. . . .

#### **OPINION.**

*LEECH, Judge:*

The question presented is whether the net amount of \$48,945 received by petitioner in the taxable year 1939 under a certain indenture constitutes taxable income under section [61(a)], or is chargeable to capital account. The respondent contends: (a) That the \$50,000, less \$1,055 expenses incurred, which petitioner received from the city of Los Angeles under the indenture of August 11, 1939, represented compensation for loss of present and future income and consideration for release of many meritorious causes of action against the city, constituting ordinary income; and, (b) since petitioner has failed to allocate such sum between taxable and nontaxable income, it has not sustained its burden of showing error. Petitioner maintains that the language of the indenture and the circumstances leading up to its execution demonstrate that the consideration was paid for the easement granted to the city of Los Angeles and the consequent damage to its property rights; that the loss of past or future profits was not considered or involved; that the character of the easement rendered it impracticable to attempt to apportion a basis to the property affected; and, since the sum received is less than the basis of the entire property, taxation should be postponed until the final disposition of the property.

The recitals in the indenture of August 11, 1939, indicate its principal purpose was to convey to the city of Los Angeles a right of way and perpetual easements to discharge water upon and flood the lands of petitioner, in connection with the water supply of the city. Among its covenants are reciprocal releases by the respective parties. The respondent relies heavily on the language of the release by petitioner as grantor, contained in paragraph (A) of the indenture, which is set forth in full in our findings of fact. We think the respondent places too much emphasis upon the release provision of the indenture. It is usual and customary in agreements of this character to incorporate a provision for the release and discharge of any possible past, present, or future claims and demands. The mutuality of the releases indicates the purpose was precautionary and protective rather than descriptive and in recognition of asserted claims and demands. Paragraph (e) of the indenture recites that "a dispute has arisen between the parties hereto wherein Grantor claims that it has been and is being damaged by reason of the discharge into said Owens River \* \* \* of foreign waters, and

that such damage will continue henceforth \* \* \*." The character of the damage is not specified or otherwise indicated. The record reveals, through the testimony of petitioner's officers and its attorneys who carried on the negotiations culminating in the agreement, that no claim for damages for lost profits or income was ever asserted or considered. Of primary concern was the fact that, if the city were permitted to continue interference with petitioner's rights as riparian owner, the city might acquire, by prescription or user, the right to direct foreign waters into the Owens River, flooding petitioner's lands and interfering with its fishing rights by polluting the stream. The threat of an injunction suit was to protect petitioner against the city acquiring such rights without making proper compensation therefor. The evidence does not disclose any claim for or loss of income. . . . We conclude that petitioner has satisfactorily established that the \$50,000 it received in 1939 was consideration paid by the city for a right of way and easements and for resulting damages to its property and property rights.

....

Upon this record we have concluded that no part of the recovery was paid for loss of profits, but was paid for the conveyance of a right of way and easements, and for damages to petitioner's land and its property rights as riparian owner. Hence, the respondent's contention has no merit. Capital recoveries in excess of cost do constitute taxable income. Petitioner has made no attempt to allocate a basis to that part of the property covered by the easements. It is conceded that all of petitioner's lands were not affected by the easements conveyed. Petitioner does not contest the rule that, where property is acquired for a lump sum and subsequently disposed of a portion at a time, there must be an allocation of the cost or other basis over the several units and gain or loss computed on the disposition of each part, except where apportionment would be wholly impracticable or impossible. *Nathan Blum*, 5 T.C. 702, 709. Petitioner argues that it would be impracticable and impossible to apportion a definite basis to the easements here involved, since they could not be described by metes and bounds; that the flow of the water has changed and will change the course of the river; that the extent of the flood was and is not predictable; and that to date the city has not released the full measure of water to which it is entitled. In *Strother v. Commissioner*, 55 Fed. (2d) 626, the court says:

\* \* \* A taxpayer \* \* \* should not be charged with gain on pure conjecture unsupported by any foundation of ascertainable fact. See *Burnet v. Logan*, 283 U.S. 404; 51 S.Ct. 550, 75 L. Ed. 1143.

This rule is approved in the recent case of *Raytheon Production Corporation v. Commissioner*, *supra*. Apportionment with reasonable accuracy of the amount received not being possible, and this amount being less than petitioner's cost basis for the property, it can not be determined that petitioner has, in fact, realized gain in any amount. Applying the rule as above set out, no portion of the payment in question should be considered as income, but the full amount must be treated as a return of capital and applied in reduction of petitioner's cost basis. *Burnet v. Logan*, 283 U.S. 404.

Reviewed by the Court.

*Decision will be entered for the petitioner.*

*Questions*

Q-6. Why did the court not require an equitable apportionment between the interest sold and the interest retained? Are you persuaded by the court's argument?

Q-7. If Inaja Land Co. subsequently sells the land for \$35,000, will it recognize a gain or a loss? Of how much?

Q-8. How would the outcome in this case have been different if Los Angeles had paid not \$50,000 but rather had paid \$80,000?

Q-9. What does "Reviewed by the Court" at the end of the opinion mean? What does "acq. 1948-1 C.B. 2" in the case citation mean?

**Raytheon Production Corp. v. Commissioner**

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**144 F.2d 110 (1st Cir. 1944)**

MAHONEY, Circuit Judge.

This case presents the question whether an amount received by the taxpayer in compromise settlement of a suit for damages under the Federal Anti-Trust Laws is a non-taxable return of capital or income. . . .

The original Raytheon Company was a pioneer manufacturer of a rectifying tube which made possible the operation of a radio receiving set on alternating current instead of on batteries. In 1926 its profits were about \$450,000; in 1927 about \$150,000; and in 1928, \$10,000. The Radio Corporation of America had many patents covering radio circuits and claimed control over almost all of the practical circuits. Cross-licensing agreements had been made among several companies including R.C.A., General Electric Company, Westinghouse, and American Telephone & Telegraph Company. R.C.A. had developed a competitive tube which produced the same type of rectification as the Raytheon tube. Early in 1927, R.C.A. began to license manufacturers of radio sets and in the license agreement it incorporated "Clause 9", which provided that the licensee was required to buy its tubes from R.C.A. In 1928 practically all manufacturers were operating under R.C.A. licenses. As a consequence of this restriction, Raytheon was left with only replacement sales, which soon disappeared. When Raytheon found it impossible to market its tubes in the early part of 1929, it obtained a license from R.C.A. to manufacture tubes under the letters patent on a royalty basis. The license agreement contained a release of all claims of Raytheon against R.C.A. by reason of the illegal acts of the latter under Clause 9 but by a side agreement such claims could be asserted if R.C.A. should pay similar claims to others. The petitioner was informed of instances in which R.C.A. had settled claims against it based on Clause 9. On that ground it considered itself released from the agreement not to enforce its claim against R.C.A. and consequently, on December 14, 1931, the petitioner caused its predecessor, Raytheon, to bring suit against R.C.A. . . .

In the spring of 1938 . . . the Raytheon affiliated companies began negotiations for the settlement of the litigation with R.C.A. In the meantime a suit brought by R.C.A. against the petitioner for the non-payment of royalties resulted in a judgment of \$410,000 in favor of R.C.A. R.C.A. and the petitioner finally agreed on the payment by R.C.A. of \$410,000 in settlement of the anti-trust action. R.C.A. required the inclusion in the settlement of patent license rights and sublicensing rights to some thirty patents but declined to allocate the amount paid as between the patent license rights and the amount for the settlement of the suit. The agreement of settlement contained a general release of any and all possible claims between the parties.

The officers of the Raytheon companies testified that \$60,000 of the \$410,000 received from R.C.A. was the maximum worth of the patents, basing their appraisal on the cost of development of the patents and the fact that few of them were then being used and that no royalties were being derived from them. In its income tax return the petitioner returned [i.e., reported] \$60,000 of the \$410,000 as income from patent licenses and treated the remaining \$350,000 as a realization from a chose in action and not as taxable income. The Commissioner determined that the \$350,000 constituted income on the following ground contained in the statement attached to his notice of deficiency: "It is the opinion of this office that the amount of \$350,000 constitutes income under § 22(a) of the Revenue Act of 1936. There exists no clear evidence of what the amount was paid for so that an accurate apportionment can be made as to a specific consideration for patent rights transferred to Radio Corporation of America and a consideration for damages. The amount of \$350,000 has therefore been included in your taxable income."

....

Damages recovered in an antitrust action are not necessarily nontaxable as a return of capital. As in other types of tort damage suits, recoveries which represent a reimbursement for lost profits are income. The reasoning is that since the profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner.

Damages for violation of the anti-trust acts are treated as ordinary income where they represent compensation for loss of profits.

The test is not whether the action was one in tort or contract but rather the question to be asked is "In lieu of what were the damages awarded?" Where the suit is not to recover lost profits but is for injury to good will, the recovery represents a return of capital and, with certain limitations to be set forth below, is not taxable.

....

But, to say that the recovery represents a return of capital in that it takes the place of the business good will is not to conclude that it may not contain a taxable benefit. Although the injured party may not be deriving a profit as a result of the damage suit itself, the conversion thereby of his property into cash is a realization of any gain made over the cost or other basis of the good will prior to the illegal interference. Thus A buys Blackacre for \$5,000. It appreciates in value to \$50,000. B tortiously

destroys it by fire. A sues and recovers \$50,000 tort damages from B. Although no gain was derived by A from the suit, his prior gain due to the appreciation in value of Blackacre is realized when it is turned into cash by the money damages.

....

Since we assume with the parties that the petitioner secured the original Raytheon's assets through a series of tax free reorganizations, petitioner's basis for the good will is the same as that of the original Raytheon. As the Tax Court pointed out, the record is devoid of evidence as to the amount of that basis and "in the absence of evidence of the basis of the business and good will of Raytheon, the amount of any nontaxable capital recovery cannot be ascertained." 1 T.C. 952. Cf. *Sterling v. Commissioner*, 2 Cir., 1937, 93 F.2d 304.

Where the cost basis that may be assigned to property has been wholly speculative, the gain has been held to be entirely conjectural and not taxable. In *Strother v. Commissioner*, 4 Cir., 1932, 55 F.2d 626, affirmed on other grounds, 1932, 287 U.S. 308, 53 S. Ct. 150, 77 L. Ed. 325, a trespasser had taken coal and then destroyed the entries so that the amount of coal taken could not be determined. Since there was no way of knowing whether the recovery was greater than the basis for the coal taken, the gain was purely conjectural and not taxed. Magill explains the result as follows: "as the amount of coal removed could not be determined until a final disposition of the property, the computation of gain or loss on the damages must await that disposition." *Taxable Income*, pp. 339-340. The same explanation may be applied to *Farmers' & Merchants' Bank v. Commissioner*, supra, which relied on the *Strother* case in finding no gain. The recovery in that case had been to compensate for the injury to good will and business reputation of the plaintiff bank inflicted by defendant reserve banks' wrongful conduct in collecting checks drawn on the plaintiff bank by employing "agents who would appear daily at the bank with checks and demand payment thereof in cash in such a manner as to attract unfavorable public comment". Since the plaintiff bank's business was not destroyed but only injured and since it continued in business, it would have been difficult to require the taxpayer to prove what part of the basis of its good will should be attributed to the recovery. In the case at bar, on the contrary, the entire business and good will were destroyed so that to require the taxpayer to prove the cost of the good will is no more impractical than if the business had been sold.

....

The decision of the Tax Court is affirmed.

#### *Question*

Q-10. Why did this case come out differently from *Inaja Land*? Note that *Inaja Land* cited *Raytheon* with approval.

### **3. Transfers at Death**

Section 102(a) excludes from a recipient's income not only gifts but also bequests, devises, and inheritances. Further, the recipient's 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.<sup>19</sup> §1014(a)(1). The effect of these rules 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?

In contrast, 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. Such income, called “income in respect of a decedent” (usually abbreviated “IRD”) generally 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). The most important example of IRD is deferred compensation such as amounts in Individual Retirement Accounts, 401(k) accounts, and other pension arrangements.

#### 4. Temporal Divisions

Consider the following: G dies, leaving \$100,000 in bonds paying 8% (\$8,000) per year in interest. By the terms of G's will, A is entitled to receive the interest payments for 9 years, and after that the bonds go to B. Thus, A has a nine-year *term interest* while B has the *remainder interest*. Between A and B, they together own the entire bond, and that means their interests are together worth \$100,000 (the value of the bonds). But what is each interest worth separately?

If we use 8% as the appropriate discount factor, then A's interest is worth  $\$8,000/1.08 + \$8,000/1.08^2 + \$8,000/1.08^3 \dots + \$8,000/1.08^9$ , or about \$50,000. B's interest is worth  $\$100,000/1.08^9$ , or about \$50,000. Thus, the present values of the two interests in the bonds are about the same. Of course, the form that each interest takes is different: A will receive \$8,000 per year for 9 years while B will receive \$100,000 in nine years. But it turns out (using a discount rate of 8%) that the present value of A's term interest approximately equals the present value of B's interest.<sup>20</sup>

What basis should each beneficiary take in her interest in the bonds? Under §1014, we know that someone who receives property by devise, bequest or inheritance takes a basis equal to the fair market value of the property as of the date of the decedent's death. Following that rule would give both A and B a basis of \$50,000. Note that while their interests are very different, the values of their interests are the same, and section 1014 turns on the *value* of property received through the estate of a decedent. Further, we know that under the Haig-Simons definition of an income tax, it is value and not the form

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<sup>19</sup> There can be times when an alternative valuation date is used. See §1014(a)(2)-(4). We will not concern ourselves with such alternative valuation dates. They usually are discussed in a course covering the federal estate and gift taxes even though they are relevant to income tax issues.

<sup>20</sup> Alternatively, we could use an after-tax discount rate. For example, if there is a single tax rate of 40%, then the after-tax discount rate would be 60% of the pre-tax return of 8%, or 4.8%. Using this discount rate would change the relative values of the two interest – the term interest would be worth about \$33,400 and the remainder would be worth \$66,600 – but the combined values remain \$100,000.

of the value that should determine tax consequences, a rule codified in the definitions of gain in §1001(a) and of amount realized in §1001(b).

Let's focus first on A. If A's basis equals \$50,000 while A will receive \$72,000 as a result of the devise (9 payments of \$8,000 each), then A should recognize a total of \$22,000 over the 9 years. This raises the familiar question of basis allocation over time: we could, for example, treat A as having gross income each year of \$8,000 but then allow A an annual deduction of one-ninth of A's basis of \$50,000 (or an allowance of about \$5,556 each year for the nine years). Or we could allow A to treat the initial payments as a return of capital until A's basis has been exhausted, so that A would not have income until the seventh payment is received. We will look more closely at the proper allocation of basis over time later in this Chapter.

Now consider B. If B's basis in the device also equals \$50,000, and because we know what B will receive \$100,000 in a lump sum in nine years, then B should recognize \$50,000 (\$100,000 amount realized less \$50,000 basis) over the nine years. How should that income be reported by B? It may seem as if the realization doctrine demands that B not be taxed until B's remainder becomes possessory (that is, in year nine), but we shall see later that the modern understanding of the realization doctrine tells us that B should be taxed each year on the anticipated increase in the value of B's remainder, so that B should be taxed each year until, after 9 years, B has included exactly \$50,000 in income. That is, B should be taxed as if B received \$50,000 immediately and then put that money into a savings account paying 8% interest per year for nine years.<sup>21</sup>

The method described above for taxing A and B is consistent with the words of the statute in section 1014 and ensures that like taxpayers are taxed alike. Alas, it is not the law.

### **Irwin v. Gavit**

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#### **268 U.S. 161 (1925)**

HOLMES, J. delivered the opinion of the Court.

This is a suit to recover taxes and penalties exacted by the Collector under the Income Tax Act of October 3, 1913 . . . .

The question is whether the sums received by the plaintiff under the will of Anthony N. Brady in 1913, 1914 and 1915, were income and taxed. The will, admitted to probate August 12, 1913, left the residue of the estate in trust to be divided into six equal parts, the income of one part to be applied so far as deemed proper by the trustees to the education and support of the testator's granddaughter, Marcia Ann Gavit, the balance to be divided into two equal parts and one of them to be paid to the testator's son-in-law, the plaintiff, in equal quarter-yearly payments during his life. But on the granddaughter's reaching the age of twenty-one or dying the fund went over, so that, the granddaughter then being six years old, it is said, the plaintiff's interest could not exceed fifteen years. The Courts below held that the payments

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<sup>21</sup> This suggests A should be taxed as if A received \$50,000 immediately and then purchased a nine-year annuity paying \$8,000 per year. The taxation of annuities can be found in §72.



received were property acquired by bequest, were not income and were not subject to tax.

The statute in Section II, A, subdivision 1, provides that there shall be levied a tax "upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States." If these payments properly may be called income by the common understanding of that word and the statute has failed to hit them it has missed so much of the general purpose that it expresses at the start. Congress intended to use its power to the full extent. . . . The language quoted leaves no doubt in our minds that if a fund were given to trustees for A for life with remainder over, the income received by the trustees and paid over to A would be income of A under the statute. It seems to us hardly less clear that even if there were a specific provision that A should have no interest in the corpus, the payments would be income none the less, within the meaning of the statute and the Constitution, and by popular speech. In the first case it is true that the bequest might be said to be of the corpus for life, in the second it might be said to be of the income. But we think that the provision of the act that exempts bequests assumes the gift of a corpus and contrasts it with the income arising from it, but was not intended to exempt income properly so-called simply because of a severance between it and the principal fund. .

..

The Courts below went on the ground that the gift to the plaintiff was a bequest and carried no interest in the corpus of the fund. We do not regard those considerations as conclusive, as we have said, but if it were material a gift of the income of a fund ordinarily is treated by equity as creating an interest in the fund. Apart from technicalities we can perceive no distinction relevant to the question before us between a gift of the fund for life and a gift of the income from it. The fund is appropriated to the production of the same result whichever form the gift takes. Neither are we troubled by the question where to draw the line. That is the question in pretty much everything worth arguing in the law. *Hudson County Water Co. v. McCarter*, 209 U.S. 349, 355. Day and night, youth and age are only types. But the distinction between the cases put of a gift from the corpus of the estate payable in instalments and the present seems to us not hard to draw, assuming that the gift supposed would not be income. This is a gift from the income of a very large fund, as income. It seems to us immaterial that the same amounts might receive a different color from their source. We are of opinion that quarterly payments, which it was hoped would last for fifteen years, from the income of an estate intended for the plaintiff's child, must be regarded as income within the meaning of the Constitution and the law. It is said that the tax laws should be construed favorably for the taxpayers. But that is not a reason for creating a doubt or for exaggerating one when it is no greater than we can bring ourselves to feel in this case.

*Judgment reversed.*

#### *Notes*

1. *Justice Holmes and the Gavit Opinion.* Justice Holmes wrote several foundational tax opinions, and they justly are famous for their flowery language and use of metaphor. It is

less clear if the reasoning underlying his opinions can withstand scrutiny. In *Gavit*, Justice Holmes draws a clear line between “property” and “income from property,” and only property is covered (he says) by §1014. Now that we treat property as a bundle of sticks, the distinction between property and income seems much less clear. Indeed, Justice Holmes seems to say that the remainder beneficiary was devised the entire property, yet we know that only a portion of the value of the property is reflected in the remainder interest. Giving the remainder-beneficiary a basis equal to the value of the remainder *when it becomes possessory* flies in the face of the statute. Is it possible that Justice Holmes intended that the remainder-beneficiary receive basis equal to the initial value of the remainder and the term-beneficiary receive no basis at all? If so, basis is lost as compared with devising the corpus entirely to one beneficiary or the other. Does the statute support that outcome?

2. *The Codification of Irwin v. Gavit*. Section 1001(e) largely codifies the holding of *Irwin v. Gavit*. Note, though, that §1001(e) does not actually say that the term-beneficiary gets no basis from the devise but rather that whatever basis she gets cannot be used in determining gain or loss from disposition of the term interest. That raises the question whether the term-beneficiary is entitled to amortize her basis against the receipts of the term interest, and it leaves open the question of how much basis is given to the remainder-beneficiary.

Regulation §1.1014-4 (called the uniform basis regulation) resolves the questions left open by *Irwin v. Gavit* and §1001(e). Under this regulation, the basis arising under §1014 is the same (i.e., is “uniform”) regardless of how interests in property are divided. In the bond example above, that means there is \$100,000 of basis to be shared among A and B because there would be \$100,000 of basis if the bonds were left outright to either one (or to someone else). Thus, as a technical matter, A and B in this example each take a basis of \$50,000 assuming that is the fair market value of each devise. However, this regulation further provides that as the value of B’s interest grows over time, basis shifts from A to B so that at the end of A’s term interest, B has the full \$100,000 of basis and can receive the bonds free of tax. Reg. §1.1014-4(b). The effect of this rule is to ensure that if B sells her remainder interest prior to maturity, there will not be a phantom loss allowable to B that otherwise would arise by giving her the full \$100,000 basis immediately.

Note that while A’s basis starts at \$50,000 and declines over time as required by the uniform basis rule, A cannot use any of that basis upon disposition of the term interest. §1001(e); Reg. §§1.1014-1(b)(1), 1.1001-1(f)(1). There is, however, one exception: if B and A each sells their interest in the bonds in a single transaction, A can use what basis she has against her sale proceeds and B similarly can use her basis against her sale proceeds. §1001(f); Reg. §1.1001-1(f)(3).

Can A use her share of the uniform basis by amortizing it over the life of the term? No: that is the holding of *Irvin v. Gavit*, a holding that has never been reversed by the Court, by Congress, or in regulations.

3. *Exploitation of Irvin v. Gavit*. Whenever the tax rules exalt form over substance (as did the Supreme Court in *Irvin v. Gavit*), there is an opportunity for well-advised taxpayers to

exploit the loophole created by the mistake. For example, suppose you have a client who anticipates leaving \$100,000 at death, and the client wishes to split that value between a taxpaying relative and a tax-exempt charity. While the client could devise \$50,000 outright to each beneficiary, a tax-advantaged plan is to devise a term interest worth \$50,000 to the charity and the remainder (necessarily also worth \$50,000) to the relative. While the charity will get no basis and so will have taxable income each year of the full amount received, because the charity is not a taxpayer, that income is meaningless. The relative, on the other hand, was devised property worth \$50,000 that eventually will be worth \$100,000 without any imposition of tax. The rule of *Irvin v. Gavit* gives all the basis to the remainder-beneficiary and denies any basis to the term-beneficiary and thereby under-taxes the remainder-beneficiary and over-taxes the term-beneficiary. When the two beneficiaries are in very different tax positions, this leads to tax reduction without any reasonable justification.

4. *Irvin v. Gavit and Gifts*. While *Irvin v. Gavit* arose in the context of a death-time transfer, the same issue arises if a gift is made in the form of divided interests. In the bond hypothetical, suppose the transfer by G was made while G was still alive, with A again getting a term interest in the bonds and B getting the remainder. G's total (i.e., uniform) basis would carry-over from G under §1015, but the allocation of that basis would be subject to the same issues that were addressed in *Irvin v. Gavit* and in §1001(e) as well as the uniform basis rule. Note that §§1001(e)(1), 1001(e)(2), Reg. §1.1014-4 and Reg. §1.1001-1(f) apply equally to death-time transfers and lifetime transfers.

5. *Irvin v. Gavit and Purchases*: None of the rules discussed in the notes above apply to purchasers of term interests. A purchaser of a term interest takes a cost basis under §1012, and that basis can be amortized over time or used to offset subsequent sale proceeds. This should be another reminder that something is very wrong with the holding of *Irvin v. Gavit* because the basis to a devisee is the same as the basis to a purchaser: purchasers, at least when they are dealing at arm's length, pay fair market value, and that yields under §1012 the same basis as provided by §1014.

#### D. Recovery of Loss and Deduction

##### 1. The Loss Deduction

Section 165 provides a deduction for certain losses. What is a loss within the meaning of §165? It certainly encompasses losses from dealings in property as defined in §1001(a), but it is broader than that. Read §165(g)(1) closely. This provision speaks to losses arising from a worthless security. Note that when a security becomes worthless, there is not yet a loss within the meaning of §1001(a) because there has not been a "disposition."<sup>22</sup> Congress could provide that a security becoming worthless shall be treated as a sustained loss, but that is not what §165(g) says: section 165(g) says that *the loss* resulting from a security becoming worthless shall be treated as the loss from the sale or exchange of a

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<sup>22</sup> See Reg. §1.165-4(a): "No deduction shall be allowed under §165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or other cause."

capital asset. Thus, §165(g) *assumes* there is a loss resulting from the worthlessness of a security: the function of §165(g) is to specify that this loss is treated as resulting from the sale or exchange of a capital asset (which affects whether the loss is treated as an ordinary loss or a capital loss<sup>23</sup>).

The regulations under §165 provide a definition of the type of loss that is allowable for purposes of §165(a). That definition provides: "To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and . . . actually sustained during the taxable year." Reg. §1.165-1(b). See if you agree with how this definition is applied in the following case and ruling.

**Zakon v. Commissioner**

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**7 B.T.A. 687 (1927)**

FINDINGS OF FACT

The petitioner is an individual, residing at Roxbury, Mass. In 1911 he purchased for \$11,000 from one Harding, in the City of Boston, a liquor license of the fourth class, which gave him the right to sell liquor in bottles in any quantity. Harding continued in business under this license until April 1, 1911. During April, 1911, the license was transferred to petitioner by the license board of Boston and he began doing business under the license May 1, 1911. The purchase price did not include any stock or fixtures and, upon acquiring it, the business was moved to a new and different location and fixtures and improvements were installed by the petitioner at a cost of more than \$2,500.

Under the law of the Commonwealth of Massachusetts the number of liquor licenses issued in the City of Boston was limited to 1,000. The license board of Boston had limited the number to 984. Such licenses were issued annually, on May 1, upon payment of the yearly fee, which varied from 1911 to 1919 from \$12,000 to \$14,000. It was the practice of the license board of Boston to issue annual licenses only to the holders of old licenses unless refused for cause. If the holder of a license sold or transferred such license to another acceptable party, the transferee had a preferred status before the license board as the holder of such license. This practice made such licenses valuable and they commanded high prices from persons desiring to go into the liquor business. On March 1, 1913, the license of the petitioner had a fair market value of over \$11,000. The license continued to have a substantial value until after January 1, 1919.

Petitioner continued in the liquor business, renewing his license annually until June 30, 1919, when he was forced to discontinue on account of prohibition legislation. He thereupon procured a license for selling 2 3/4 per cent beer in bottles. This business

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<sup>23</sup> See §1221(1)-(4) providing that capital losses arise from the sale or exchange of capital assets. We will cover the capital gain and loss provisions later in the semester.

was discontinued in October, 1919, when it was determined that sale of such beer was unlawful.

#### OPINION

It appears that in 1911 and prior thereto the number of liquor licenses which might be issued in the City of Boston was limited by the laws of Massachusetts to not more than 1,000 and that such number might be further limited by the licensing board of the City of Boston in its discretion. This board did limit the number to 984 and refused to issue any larger number. While such licenses were issued annually, expiring on May 1 of each year, it was the established custom of the board to issue such annual licenses to the holders of licenses for the previous year. The holders of any license might transfer it to another, to whom a new license would be issued by the license board, if the purchaser were found to be acceptable by the board. Under such circumstances the holder of such a license had an asset which had a value entirely separate and distinct from the right to conduct the business of a liquor dealer for the remainder of the year for which such license was issued. The courts have recognized that such value existed and constituted property rights. . . .

In 1911 the petitioner purchased such a license to operate in the City of Boston from one Harding, paying therefor \$11,000. The transfer was made to the petitioner in April, 1911, at which time the annual license had less than one month remaining. The petitioner never operated under such annual license but, by reason of its ownership, was enabled to secure the annual license under which he began operations on May 1, 1911. These facts conclusively show that the \$11,000 was not paid by the petitioner to Harding for the right to operate during the remaining period which the annual license had to run but was paid in order that the petitioner might be placed in a position where he could thereafter secure annual licenses by payment of the prescribed fee. This intangible right which appertained to the ownership of the annual license continued in the petitioner through 1913 and on March 1 of that year had a value in excess of the amount paid in 1911.

It is the claim of the petitioner that the March 1, 1913, value of his license was \$35,000 and that on that date his business had a good will value of \$10,000, all of which were destroyed in 1919 as the result of prohibition legislation. He contends that in computing his net income for 1919 he is entitled to a deduction of such March 1, 1913, value either under the provisions of section 214(a)(4) or of section 214(a)(8) of the Revenue Act of 1918, which subsections provide for the deduction of:

(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise if incurred in trade or business.

(8) A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence.

The last-quoted provision of the Act indicates that it is intended to care for losses of capital which took place over a longer period than the taxable year. There is nothing in the record in this case which would indicate that there was any exhaustion, wear and tear, or obsolescence of either the license or the good will prior to the taxable year involved. In fact the testimony here is to the contrary. It all indicates that any loss or damage which was sustained by this petitioner occurred in the year 1919. We therefore conclude that the taxpayer has not brought himself within subparagraph (8) of section 214 of the Act, quoted above.

It does appear, however, that the taxpayer sustained a loss in 1919 which he is entitled to deduct under the provisions of subparagraph (4) of the section of the Act quoted above. The deduction, however, is not measured by the March 1, 1913, value as contended by the petitioner, but is limited to the actual loss sustained. The license cost the petitioner \$11,000 in 1911. In 1913, it had a value in excess of that amount. In 1919, it became worthless. The taxpayer sustained a loss of \$11,000 which is deductible in 1919. The good will, however, appears to have cost the taxpayer nothing and . . . there is no deductible loss on account of that item.

*Decision will be entered on 15 days' notice, under Rule 50.*

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**Revenue Ruling 84-145****1984-2 C.B. 47****ISSUE**

Has a domestic commercial air carrier, subject to the regulations of the Civil Aeronautics Board (CAB), sustained a deductible loss under section 165 (a) of the Internal Revenue Code because of a devaluation of its route authorities resulting from the enactment of the Airline Deregulation Act of 1978.

**FACTS**

The taxpayer, a commercial air carrier, is engaged in the interstate and international transportation of passengers, mail, and property. The taxpayer is subject to the Federal Aviation Act of 1958, as amended, (the Act), which regulates the economic aspects of air transportation. The Act established the CAB and granted it authority to issue regulations that govern interstate and international air transportation. Pursuant to this authority, the CAB granted taxpayer the rights to service several cities. These rights were represented by route authorities.

In order to obtain a route authority to service a particular geographic location, the taxpayer had to apply to the CAB. The CAB would issue a permanent certificate authorizing the whole route or any part of the route authority covered by the taxpayer's application, if it found the taxpayer fit, willing, and able to perform the transportation properly and to conform to the law, rules, regulations, and requirements of the CAB and if it found that the transportation was required by the

public convenience and necessity. The application of this standard to the taxpayer and other carrier applicants resulted in the CAB granting a limited number of route authorities to any one destination. The application process was highly competitive, and the taxpayer typically incurred considerable expense in its efforts to prevail in the awarding of a route authority.

Rev. Rul. 56-600, 1956-2 C.B. 171, and Rev. Rul. 67-113, 1967-1 C.B. 55, require air carriers to keep the costs they incur in the acquisition and development of air routes in separate capital accounts. These costs remain capitalized until the routes are abandoned. In the years prior to 1979, the taxpayer capitalized the costs it incurred in obtaining permanent air route authorities from the CAB.

The Deregulation Act changed the standards the CAB used to grant route authorities. The air transportation offered by a carrier no longer needed to be required by the public convenience and necessity. Under the new standard, the air transportation needed merely to be consistent with the public convenience and necessity. However, from the date of enactment until December 31, 1981, when the new standard became fully effective, carriers in order to obtain new route authorities were still obligated to obtain certificates issued by the CAB authorizing the carrier to fly the routes. Under the Deregulation Act, as fully effective after December 31, 1981, most of the CAB's control over domestic routes terminated.

When the Deregulation Act became fully effective on December 31, 1981, the exclusiveness of route authorities considerably lessened because restrictions on entry into a particular market was significantly reduced. Under the new law, commercial air carriers must still obtain the CAB's permission to operate in a specific market, but they are no longer required to show anything other than that they are not unfit to provide the service. Thus, it is now relatively easy for all commercial air carriers to obtain route authorities from the CAB. In the instant situation, although the taxpayer continued its normal operations, the value of its route authorities declined substantially because its right to operate in a particular market was affected by the potential for increased competition for other commercial air carriers.

#### LAW AND ANALYSIS

Section 165 (a) of the Code provides that there shall be allowed as a deduction any loss sustained during the taxable year and not compensated by insurance or otherwise.

Section 1.165-1 (b) of the Income Tax Regulations provides that to be allowable as a deduction under section 165 (a) of the Code, a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and actually sustained during the taxable year. Only a bona fide loss is allowable.

In *Reporter Publishing Co., Inc. v. Commissioner*, 201 F.2d 743 (10th Cir. 1964), the court held that the taxpayer, a newspaper publisher, did not sustain a deductible loss

as a result of a decision of the Supreme Court of the United States that held that the by-laws of the Associated Press, which granted the taxpayer an exclusive right to Associated Press services in its community, violated the Sherman Anti-Trust Act. Although the value of the membership in the Associated Press was reduced because of the Supreme Court's decision, it was not eliminated because the taxpayer retained the same rights to receive all the services it received before the decision.

In *Consolidated Freight Lines v. Commissioner*, 37 B.T.A. 576 (1938), *aff'd*, 1011 F.2d 813 (9th Cir. 1939), the lowest court denied a deduction for the cost of certificates of convenience and necessity that a motor carrier claimed had no value because a new law was enacted that repealed the monopolistic characteristics of the old law under which the certificates were issued. The United States Court of Appeals for the Ninth Circuit held that a monopoly was not granted by the certificates but rather sprang from the provisions of the old law. The certificates were merely a means by which a carrier might take advantage of the monopoly that was conferred by the statute. The monopoly, not the certificates themselves, was the thing destroyed by the repeal of the old law.

In the instant situation, the taxpayer did not sell or abandon as completely worthless its route authorities. Although the value of its route authorities was substantially reduced after the Deregulation Act became law, the mere diminution in value of the operating rights does not constitute the elimination or abandonment of a completely worthless asset. In addition, there was no closed and completed transaction fixed by identifiable events because the taxpayer's operating rights remained unchanged even though more competition was introduced.

#### HOLDING

A commercial air carrier subject to the regulations of the CAB did not sustain a deductible loss of its capitalized costs under section 165 (a) of the Code because of the devaluation of its route authorities that resulted when the Deregulation Act became fully effective on December 31, 1981.

#### Notes

1. *When is an Economic Loss Established?* The taxpayer in *Zakon* suffered an economic loss when prohibition rendered obsolete his city license to sell alcohol. Similarly, the taxpayer in Revenue Ruling 84-145 suffered an economic loss when deregulation of the airline industry rendered largely irrelevant the taxpayer's CAB route certificate. Yet, the economic loss in *Zakon* was allowed as a deduction while the economic loss in Revenue Ruling 84-145 was not. Why the difference?

The rights granted to the taxpayer in *Zakon* were countermanded by enactment of prohibition. As a result, not only did the taxpayer suffer an economic loss but the rights granted by the city license were eliminated. Thus, prohibition eliminated the taxpayer's



rights to serve alcohol and was the identifiable event that fixed the amount of the taxpayer's loss as required by Reg. §1.165-1(b).

In Revenue Ruling 84-145, the taxpayer's rights to fly specific routes covered by the CAB license were unaffected by deregulation. To be sure, the value of the CAB license declined because deregulation meant that any qualified carrier could obtain a similar route license (prior to deregulation, the number of carriers permitted to fly a specific route were limited to minimize competition). As a result, while the value of the taxpayer's rights declined substantially, the rights themselves remained unchanged. That is, there was no change to the rights themselves (the taxpayer could continue to fly the routes) but the value of those rights was diminished.

Other events giving rise to a loss deduction include natural disasters such as fires, thefts and abandonments.<sup>24</sup>

2. *What is the Amount of a Deductible Loss?* If a loss arises by reason of the disposition of property, then the amount of the loss under §1001(a) is the amount of the taxpayer's adjusted basis in the property in excess of the amount realized. In particular, if the amount realized is \$0, the amount of the loss is the taxpayer's adjusted basis in the property. Even when there is no disposition within the meaning of §1001(a) (such as in the case of abandonment of property), the measure of the loss is the same. See Reg. §1.165-1(c)(1).

Consider the following example. Taxpayer L owns property with an adjusted basis of \$1,000 and a fair market value of \$5,000, and that property is lost (perhaps by fire) within the meaning of §165. While the taxpayer's economic loss equals \$5,000, the taxpayer's deductible loss equals only \$1,000. Does this make sense?

Yes, and it's all about the realization doctrine. The \$4,000 unrealized gain or loss in L's investment is irrelevant to the tax system until we have some realization event, and when that occurs the only relevant amount is the value of the investment at that moment. So, for example, if a taxpayer purchases an investment for \$500 and subsequently sells it for \$500, the taxpayer has no gain or loss without regard to how the investment's value may have changed while the taxpayer held it.

Alternatively, suppose L had made two investments, each costing \$1,000. One of the two investments increased in value to \$5,000 and then was lost while the other investment doubled in value (from \$1,000 to \$2,000) and then was sold. L now has \$2,000, the same amount L started with. As a result, L should have no net taxable income, and since we

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<sup>24</sup> E.g., *Hubinger v. Commissioner*, 36 F.2d 724, 726 (2d Cir. 1929).

know L's taxable income from the second investment is \$1,000, it must be the case that L's taxable loss from the other investment also equals \$1,000.<sup>25</sup>

Finally, suppose that the tax system actually gave L a deduction of \$5,000. Using a 40% tax rate, that makes L's deduction worth \$2,000. It would be peculiar that a taxpayer could double her investment (from a \$1,000 investment to a deduction worth \$2,000) by losing an asset.

Recall in *Zakon* that the court awarded a loss to the taxpayer equal to the taxpayer's cost invested in the liquor license but it refused to award a deduction for the value of the taxpayer's goodwill because "[t]he good will . . . appears to have cost the taxpayer nothing and . . . there is no deductible loss on account of that item." This is another example of limiting a taxpayer's deductible loss to adjusted basis.

Suppose a taxpayer purchases a rental house and then a fire destroys the garage. If the taxpayer's adjusted basis in the house (including the garage) immediately prior to the fire is \$400,000, the value of the house and garage immediately prior to the fire is \$850,000, and the value of the house immediately after the fire is \$760,000, what is the amount of the taxpayer's loss deduction?

The taxpayer's economic loss on these facts is \$90,000 (\$850,000 less \$760,000), and the regulations provide that the deduction for partial destruction of property is the lesser of the economic loss (here, that is \$90,000) and the taxpayer's adjusted basis in the property (here, that is \$400,000), Reg. §1.165-7(b),<sup>26</sup> so that the deduction equals \$90,000. As a result of this deduction, the taxpayer's adjusted basis in the property declines by \$90,000, from \$400,000 to \$310,000. §1016(a)(1). Note, though, that we are treating the house and the garage as a single asset. You can imagine circumstances in which a court might make a taxpayer equitably apportion her basis of \$400,000 between the house and the garage, and then the maximum loss allowable would be the adjusted basis of the garage at the time of fire. For an example of such an allocation issue, see Reg. §1.165-7(b)(2)(i).

The results described above accurately represent the law as it stands today, but you should be troubled by those results. Recall the facts of the hypothetical fire: the value of the property declines from \$850,000 to \$760,000 while the taxpayer's adjusted basis in the property is only \$400,000. Thus, the economic loss simply reduces the unrealized appreciation in the property. Since that unrealized appreciation has not yet been taxed and is not taxed because of the fire, why is any loss deduction allowed at all? One might expect that on the partial destruction of property, no loss would be allowed except to the

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<sup>25</sup> A taxpayer who starts with \$2,000, invests it, and then ends up with \$2,000 must have no net income or loss from the investment activity. This is an example of the principle of horizontal equity.

<sup>26</sup> Note that while this regulation addresses the deduction for personal casualty losses in §165(c)(3) that has been all but eliminated by §165(h)(5) until 2026, the regulation cited in the text applies to both profit-seeking activities as well as to personal casualty losses, Reg. §1.167-7(a)(1).

extent the value of the property declines both as compared with its pre-casualty value and the taxpayer's adjusted basis. On the facts of the hypothetical, that means no deduction would be allowable unless the fire reduced the value of the building (now lacking a garage) below \$400,000. For example, if the post-fire value of the house is \$395,000, then the taxpayer would be allowed a deduction of only \$5,000 because that is the diminution in L's after-tax invested value.

3. *When Can a Deductible Loss Be Claimed?* A deductible loss under §165 can be claimed only in the year in which the loss is sustained. Reg. §1.165-1(d). So, for example, the loss allowed in *Zakon* was reported in the year in which prohibition became the law of the land. While this rule makes sense, it would impose a significant burden on taxpayers who suffer a loss by reason of theft because thefts often go undiscovered for years. Accordingly, Congress has provided that theft losses are to be claimed not in the year that the theft was committed but rather in the year the theft is discovered. §165(e).

4. *Personal Losses.* Losses allowed by §165(a) are limited to losses incurred in connection with profit seeking activities, §165(c)(1)-2(c), as well as non-profit-seeking losses (so-called "personal losses") that occur in a federally declared disaster area, §§165(c)(3), 165(h)(5). Historically, those personal losses described in §163 (usually called "casualty losses") also were allowed albeit subject to two reductions. See §165(h)(1) (per loss reduction of \$100), 165(h)(2) (annual aggregate reduction equal to 10% of the taxpayer's adjusted gross income). As part of the 2017 Tax Act, Congress eliminated the deduction for most personal casualty losses until 2026. See §165(h)(5). When such losses again become allowable in 2026, the two limitations described above will again apply.

#### *Questions*

Q-11. Suppose an investor purchases a rental home in an upper middle-class neighborhood. Shortly after the purchase, a grisly murder generating significant publicity takes place next door, substantially reducing the market value of the investor's rental unit. Can the investor claim a loss deduction as a result of the decline in market value of the home? What if the murder took place in the rental home itself?

Q-12. Suppose a taxpayer suffers a loss from an asset that is covered by insurance, but the taxpayer declines to report the loss to her insurance company (perhaps out of fear that the policy will be cancelled). Can the taxpayer claim the loss as a deduction?

## 2. The Tax Benefit Rule

### **Alice Phelan Sullivan Corp. v. United States**

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**381 F.2d 399 (Ct. Cl. 1967)**

COLLINS, JUDGE:

Plaintiff, a California corporation, brings this action to recover an alleged overpayment in its 1957 income tax. During that year, there was returned to taxpayer two parcels of realty, each of which it had previously donated and claimed as a charitable contribution deduction. The first donation had been made in 1939; the second, in 1940. Under the then applicable corporate tax rates [18 and 24 percent respectively], the deductions claimed (\$4,243.49 for 1939 and \$4,463.44 for 1940) yielded plaintiff an aggregate tax benefit of \$1,877.49.

Each conveyance had been made subject to the condition that the property be used either for a religious or for an educational purpose. In 1957, the donee decided not to use the gifts; they were therefore reconveyed to plaintiff. Upon audit of taxpayer's income tax return, it was found that the recovered property was not reflected in its 1957 gross income. The Commissioner of Internal Revenue disagreed with plaintiff's characterization of the recovery as a nontaxable return of capital. He viewed the transaction as giving rise to taxable income and therefore adjusted plaintiff's income by adding to it \$8,706.93—the total of the charitable contribution deductions previously claimed and allowed. This addition to income, taxed at the 1957 corporate tax rate of 52 percent, resulted in a deficiency assessment of \$4,527.60. After payment of the deficiency, plaintiff filed a claim for the refund of \$2,650.11, asserting this amount as overpayment on the theory that a correct assessment could demand no more than the return of the tax benefit originally enjoyed, i.e., \$1,877.49. The claim was disallowed.

This court has had prior occasion to consider the question which the present suit presents. In *Perry v. United States*, 142 Ct. Cl. 7, 160 F. Supp. 270 (1958) (Judges Madden and Laramore dissenting), it was recognized that a return to the donor of a prior charitable contribution gave rise to income to the extent of the deduction previously allowed. The court's point of division -- which is likewise the division between the instant parties -- was whether the "gain" attributable to the recovery was to be taxed at the rate applicable at the time the deduction was first claimed or whether the proper rate was that in effect at the time of recovery. The majority, concluding that the Government should be entitled to recoup no more than that which it lost, held that the tax liability arising upon the return of a charitable gift should equal the tax benefit experienced at time of donation. Taxpayer urges that the *Perry* rationale dictates that a like result be reached in this case.

The Government, of course, assumes the opposite stance. . . .

A transaction which returns to a taxpayer his own property cannot be considered as giving rise to "income" . . . . Yet the principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. . . . The only limitation upon that

principle is the so-called "tax-benefit rule." This rule permits exclusion of the recovered item from income so long as its initial use as a deduction did not provide a tax saving. . . . But where full tax use of a deduction was made and a tax saving thereby obtained, then the extent of saving is considered immaterial. The recovery is viewed as income to the full extent of the deduction previously allowed.<sup>27</sup>

Formerly the exclusive province of judge-made law, the tax-benefit concept now finds expression both in statute and administrative regulations. Section 111 of the Internal Revenue Code of 1954 accords tax-benefit treatment to the recovery of bad debts, prior taxes, and delinquency amounts.<sup>28</sup> Treasury regulations have "broadened" the rule of exclusion by extending similar treatment to "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years . . . ."

Drawing our attention to the broad language of this regulation, the Government insists that the present recovery must find its place within the scope of the regulation and, as such, should be taxed in a manner consistent with the treatment provided for like items of recovery, i.e., that it be taxed at the rate prevailing in the year of recovery. We are compelled to agree.

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Ever since *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359 (1931), the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured. "It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation." 282 U.S. at 365. To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates. And absent specific statutory authority sanctioning a departure from this principle, it may only be said of *Perry* that it achieved a result which was more equitably just than legally correct.

Since taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income. We therefore sustain the Government's position and grant its motion for summary judgment. *Perry v. United States*, *supra*, is hereby overruled, and plaintiff's petition is dismissed.

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<sup>27</sup>The rationale which supports the principle, as well as its limitation, is that the property, having once served to offset taxable income (i.e., as a tax deduction) should be treated, upon its recoupment, as the recovery of that which had been previously deducted. . . .

<sup>28</sup> [Section 111 has been amended since this case was decided.]

## Notes

1. *The Litigants' Positions.* The taxpayer and the government agreed that the taxpayer had to recognize income as a result of the reacquisition of the properties. Their dispute was over how much tax had to be paid. What was the government's position? What was the taxpayer's position? Neither party argued that the taxpayer should include in income the value of the reacquired properties as of the date of the reacquisition. What was the holding of the court?

2. *Recovery and Pre-Tax Offset.* This case exemplifies the *inclusionary aspect* of the tax benefit rule. When a taxpayer claims a deduction based on some assumption about the future and the future then turns out in a manner inconsistent with that assumption, the inclusionary aspect of the tax benefit rule unwinds the prior deduction by requiring the taxpayer to include the amount of the prior deduction in current income. Note that this inclusion unwinds the prior deduction in a *pre-tax sense*: if tax rates have changed, the burden of the inclusion can be less than or more than the benefit of the prior deduction. How could the deduction be unwound in a post-tax sense?

3. *The Exclusionary Aspect of the Tax Benefit Rule.* It is possible that a deduction is claimed but produces no tax benefit to the taxpayer because there was no income for the deduction to offset. To the extent this occurs, a subsequent recovery of the prior deduction should not be includible because of the absence of a tax benefit from the deduction, a result now codified in §111. For example, if a taxpayer claimed a loss deduction under §165(a) of \$100,000 in a year in which the taxpayer's income otherwise was only \$80,000, a subsequent recovery of the deductible amount (perhaps because the taxpayer qualified for a court-awarded settlement fund) would be includible only to the extent of \$80,000, the amount of the deduction that offset taxable income. If the subsequent recovery were only \$50,000, then the inclusion amount would be \$30,000. Note that if a such a deduction arose in connection with the taxpayer's trade or business, it would give rise to a net operating loss under §172, and if that NOL remains alive at the time of the recovery, the deduction is treated as offsetting income (even though the NOL might expire unused sometime in the future). §111(c).

## Problem

P-8. In year 1, T incurs a deduction of \$100,000 in a year in which the taxpayer's gross income equals only \$80,000. Assume the excess deduction of \$20,000 does not contribute to a net operating loss under §172. In year 2, T recovers \$45,000 of the prior deduction. In year 3, T recovers \$50,000 of the deduction. How much income does T report in years 2 and 3 under the tax benefit rule?

### 3. Recovery of Loss

#### **Clark v. Commissioner**

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**40 B.T.A. 333 (1939), acq. 1957-1 C.B. 4**

LEECH: This is a proceeding to redetermine a deficiency in income tax for the calendar year 1934 in the amount of \$10,618.87. The question presented is whether petitioner

derived income by the payment to him of an amount of \$19,941.10, by his tax counsel, to compensate him for a loss suffered on account of erroneous advice given him by the latter. The facts were stipulated and are so found. The stipulation, so far as material, follows:

\* \* \* \* \*

3. The petitioner during the calendar year 1932, and for a considerable period prior thereto, was married and living with his wife. He was required by the Revenue Act of 1932 to file a Federal Income Tax Return of his income for the year 1932. For such year petitioner and his wife could have filed a joint return or separate returns.

4. Prior to the time that the 1932 Federal Income Tax return or returns of petitioner and/or his wife were due to be filed, petitioner retained experienced tax counsel to prepare the necessary return or returns for him and/or his wife. Such tax counsel prepared a joint return for petitioner and his wife and advised petitioner to file it instead of two separate returns. In due course it was filed with the Collector of Internal Revenue for the First District of California. \* \* \*

5. Thereafter on or about the third day of February, 1934, a duly appointed revenue agent of the United States audited the aforesaid 1932 return and recommended an additional assessment against petitioner in the sum of \$34,590.27, which was subsequently reduced to \$32,820.14. This last mentioned sum was thereafter assessed against and was paid by petitioner to the Collector of Internal Revenue for the First District of California.

6. The deficiency of \$32,820.14 arose from an error on the part of tax counsel who prepared petitioner's 1932 return. The error was that he improperly deducted from income the total amount of losses sustained on the sale of capital assets held for a period of more than two years instead of applying the statutory limitation required by Section 101 (b) of the Revenue Act of 1932.

7. The error referred to in paragraph six above was called to the attention of the tax counsel who prepared the joint return of petitioner and his wife for the year 1932. Recomputations were then made which disclosed that if petitioner and his wife had filed separate returns for the year 1932 their combined tax liability would have been \$19,941.10 less than that which was finally assessed against and paid by petitioner.

8. Thereafter, tax counsel admitted that if he had not erred in computing the tax liability shown on the joint return filed by the petitioner, he would have advised petitioner to file separate returns for himself and his wife, and accordingly tax counsel tendered to

petitioner the sum of \$19,941.10, which was the difference between what petitioner and his wife would have paid on their 1932 returns if separate returns had been filed and the amount which petitioner was actually required to pay on the joint return as filed. Petitioner accepted the \$19,941.10.

9. In his final determination of petitioner's 1934 tax liability, the respondent included the aforesaid \$19,941.10 in income.

10. Petitioner's books of account are kept on the cash receipts and disbursements basis and his tax returns are made on such basis under the community property laws of the State of California.

\* \* \* \* \*

The theory on which the respondent included the above sum of \$19,941.10 in petitioner's gross income for 1934, is that this amount constituted taxes paid for petitioner by a third party and that, consequently, petitioner was in receipt of income to that extent. The cases of *Old Colony Trust Co. v. Commissioner*, 279 U. S. 716 ; *United States v. Boston & Maine Railroad*, 279 U. S. 732 , are cited as authority for his position. Petitioner, on the contrary, contends that this payment constituted compensation for damages or loss caused by the error of tax counsel, and that he therefore realized no income from its receipt in 1934.

We agree with petitioner. The cases cited by the respondent are not applicable here. Petitioner's taxes were not paid for him by any person—as rental, compensation for services rendered, or otherwise. He paid his own taxes.

....

[S]o long as petitioner neither could nor did take a deduction in a prior year of this loss in such a way as to offset income for the prior year, the amount received by him in the taxable year, by way of recompense, is not then includable in his gross income. *Central Loan & Investment Co.*, 39 B. T. A. 981 .

Decision will be entered for the petitioner.

#### *Notes*

1. *Receipts: Taxable and Not.* The court held in *Clark* that the taxpayer's receipt of damages from his tax attorney was not taxable income. Receipts are (a) taxable income, (b) return of capital (i.e., recovery of basis), or (c) excludible by reason of a specific statutory provisions (such as §§102 or 1031(a)). There was no exclusionary provision at issue in *Clark*, so the holding of the case was that the payment was a return of capital. Did the taxpayer own an asset with positive adjusted basis that was exchanged for the payment? A refund of overpaid federal income taxes is not includible in taxable income. How is this case different?



## Questions

Q-13. Suppose an employee embezzles funds from his employer, is caught, and repays the embezzled funds. Does the employer have income from the repayment?

Q-14. Suppose a restaurant employee has her tip income stolen. Upon hearing of the theft, the owner of the restaurant gives the employee a \$200 bonus. Does the bonus constitute taxable income to the employee? (The employee cannot exclude the bonus under §102 as a gift because of §102(c).)

### **E. Current Expense or Capital Expenditure**

We know that an income tax taxes profits rather than receipts, and for transactions in property, the measure of income is gain (or loss) as defined in §1001(a) (a comparison of amount realized and adjusted basis). But not all profits are generated by dispositions of property. Many taxpayers generate their income through the provision of services, and for such taxpayer section 1001(a) has no direct application. And even for those taxpayers who deal in property, there may be other costs that do not easily translate into the calculation described in §1001(a). For example, the salary of the president of Google plainly is a cost of Google that must be taken into account in determining Google's profit, but it is hard to see how it should be factored into Google's computation of "gain." Similarly, if GM borrows funds to use in its production and sale of automobiles, the cost of those funds – the interest – must be subtracted from GM's receipts to measure properly its taxable income.

Section 162 is the principal statutory provisions authorizing a deduction for the various costs incurred by a taxpayer in profit-seeking activity. Expenditures described in §162 generally are called "expenses," and it is called "expensing" when an expenditure can be deducted in full as the expenditure is made.<sup>29</sup> If *some or all* of an expenditure cannot be deducted immediately, then we say the cost must be "capitalized." Of course, an expenditure that is expensed does not increase the taxpayer's adjusted basis in any asset: the expenditure cannot offset includible receipts in the future (that is the job of adjusted basis) because the immediate deduction for the expenditure offsets receipts in the current year. Thus, using adjusted basis against amount realized in §1001(a) as well as immediate expensing under §162 are two different ways of recovering (i.e., using) the cost of an asset.

Section 162(a) imposes two obvious limitations on business expenses: they must be "ordinary" and they must be "necessary." Recall that deductions in an income tax must not be used for consumption or for savings. The two requirements in §162(a) draw these two lines. "Necessary" has come to mean that the expenditure is appropriate and helpful in carrying on the taxpayer's trade or business. Many common expenses are necessary in this sense such as wages paid to employees and rent paid on business assets. Some expenditures are less obviously necessary such as business trips to conventions at luxury

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<sup>29</sup> Technically, as the expenditure is "paid or accrued." The difference between "paid" and "accrued" turns on the taxpayer's method of accounting and will be considered in detail later in the course.

resorts or near remote family members. We will cover such dual-purpose expenditures later.

“Ordinary” within the meaning of §162(a) means the expenditure is not a component of savings or investment. That is, the financial benefits arising from the expenditure are short-term rather than long-term. We sometimes say that an “ordinary” expenditure is a *current expense*.

The two limitations imposed by §162(a) are reinforced by two additional Code provisions. Section 262 provides that “no deduction shall be allowed for personal, living or family expenses” (except as otherwise provided). This reinforces the “necessary” limitation in §162(a). Similarly, §263 provides that no deduction shall be allowed for “new buildings or for permanent improvements or betterments made to increase the value of any property,” thereby reaffirmed the “ordinary” limitation in §162(a).

#### *Questions*

Q-15. How should the cost of weekly advertising by *Best Buy* be treated for tax purposes?

Q-16. How should an architect’s fee be treated when paid for the design of a building that the taxpayer then constructs?

Q-17. How should a taxpayer treat commissions paid to brokers for buying and selling shares of publicly-traded stock?

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While the meaning of “ordinary and necessary” in §162(a) seems clear, one of the early and most cited cases in tax law muddied the water considerably.

#### **Welch v. Helvering**

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**290 U.S. 111 (1933)**

MR. JUSTICE CARDOZO delivered the opinion of the Court.

The question to be determined is whether payments by a taxpayer, who is in business as a commission agent, are allowable deductions in the computation of his income if made to the creditors of a bankrupt corporation in an endeavor to strengthen his own standing and credit.

In 1922, petitioner was the secretary of the E. L. Welch Company, a Minnesota corporation, engaged in the grain business. The company was adjudged an involuntary bankrupt, and had a discharge from its debts. Thereafter the petitioner made a contract with the Kellogg Company to purchase grain for it on a commission. In order to reestablish his relations with customers whom he had known when acting for the Welch Company and to solidify his credit and standing, he decided to pay the debts of the Welch business so far as he was able. In fulfillment of that resolve, he made payments of substantial amounts during five successive years. . . .The Commissioner ruled that these payments were not deductible from income as ordinary and necessary expenses, but were rather in the nature of capital

expenditures, an outlay for the development of reputation and goodwill. The Board of Tax Appeals sustained the action of the Commissioner (25 B.T.A. 117), and the Court of Appeals for the Eighth Circuit affirmed. 63 F.2d 976. The case is here on certiorari.

....

We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful. *McCulloch v. Maryland*, 4 Wheat. 316. He certainly thought they were, and we should be slow to override his judgment. But the problem is not solved when the payments are characterized as necessary. Many necessary payments are charges upon capital. There is need to determine whether they are both necessary and ordinary. Now, what is ordinary, though there must always be a strain of constancy within it, is nonetheless a variable affected by time and place and circumstance. "Ordinary" in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. Nonetheless, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. *Cf. Kornhauser v. United States*, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times, there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.

The line of demarcation is now visible between the case that is here and the one supposed for illustration. We try to classify this act as ordinary or the opposite, and the norms of conduct fail us. No longer can we have recourse to any fund of business experience, to any known business practice. Men do at times pay the debts of others without legal obligation or the lighter obligation imposed by the usages of trade or by neighborly amenities, but they do not do so ordinarily, not even though the result might be to heighten their reputation for generosity and opulence. Indeed, if language is to be read in its natural and common meaning, we should have to say that payment in such circumstances, instead of being ordinary, is in a high degree extraordinary. There is nothing ordinary in the stimulus evoking it, and none in the response. Here, indeed, as so often in other branches of the law, the decisive distinctions are those of degree, and not of kind.

One struggles in vain for any verbal formula that will supply a ready touchstone. The standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.

The Commissioner of Internal Revenue resorted to that standard in assessing the petitioner's income, and found that the payments in controversy came closer to capital outlays than to ordinary and necessary expenses in the operation of a business. His ruling has the support of a presumption of correctness, and the

petitioner has the burden of proving it to be wrong. Unless we can say from facts within our knowledge that these are ordinary and necessary expenses according to the ways of conduct and the forms of speech prevailing in the business world, the tax must be confirmed. But nothing told us by this record or within the sphere of our judicial notice permits us to give that extension to what is ordinary and necessary. Indeed, to do so would open the door to many bizarre analogies. One man has a family name that is clouded by thefts committed by an ancestor. To add to this own standing he repays the stolen money, wiping off, it may be, his income for the year. The payments figure in his tax return as ordinary expenses. Another man conceives the notion that he will be able to practice his vocation with greater ease and profit if he has an opportunity to enrich his culture. Forthwith the price of his education becomes an expense of the business, reducing the income subject to taxation. There is little difference between these expenses and those in controversy here. Reputation and learning are akin to capital assets, like the goodwill of an old partnership. *Cf. Colony Coal & Coke Corp. v. Commissioner*, 52 F.2d 923. For many, they are the only tools with which to hew a pathway to success. The money spent in acquiring them is well and wisely spent. It is not an ordinary expense of the operation of a business.

....

The decree should be

*Affirmed.*

#### *Notes*

1. *What Was the Court's Holding in Welch?* The government argued in *Welch* that the expenditures at issue in were not "ordinary" because they were made to improve the taxpayer's business reputation: "We may assume that the payments to creditors of the Welch Company were necessary for the development of the petitioner's business, at least in the sense that they were appropriate and helpful." But as Justice Cardozo observed, not all "necessary" expenditures are "ordinary." Because any improvement to the taxpayer's business reputation would provide a long-term financial benefit, the cost to improve the taxpayer's business reputation must be capitalized rather than expensed. But if the expenditure was made to improve the taxpayer's personal reputation (and that of his family), then perhaps the expenditure was personal rather than "necessary" to the taxpayer's trade or business. What was the Court's holding?

2. *Justice Cardozo's Personal History.* Justice Cardozo established his reputation as a great jurist while on the New York Court of Appeals (the highest court in New York) and then was appointed to the United States Supreme Court. He never married and seems to have had no hobbies. It appears he devoted his life to the law.

His father, Albert Cardozo, was a judge on the Supreme Court of New York (the general trial court in New York). Albert Cardozo was tainted by a corruption scandal while on the bench and resigned in disgrace. It is possible that Justice Cardozo dedicated his professional life to restoring his family's reputation. Reread *Welch v. Helvering* and see if you can find any part of Justice Cardozo's personal history in the opinion.

Justice Blackmun delivered the opinion of the Court.

In this case we must decide whether certain professional expenses incurred by a target corporation in the course of a friendly takeover are deductible by that corporation as ordinary and necessary" business expenses under §162(a) of the federal Internal Revenue Code.

I

Most of the relevant facts are stipulated. Petitioner INDOPCO, Inc., formerly named National Starch and Chemical Corporation and hereinafter referred to as National Starch, is a Delaware corporation that manufactures and sells adhesives, starches, and specialty chemical products. In October 1977, representatives of Unilever United States, Inc., also a Delaware corporation (Unilever), expressed interest in acquiring National Starch, which was one of its suppliers, through a friendly transaction. National Starch at the time had outstanding over 6,563,000 common shares held by approximately 3700 shareholders. The stock was listed on the New York Stock Exchange. Frank and Anna Greenwall were the corporation's largest shareholders and owned approximately 14.5% of the common. The Greenwalls, getting along in years and concerned about their estate plans, indicated that they would transfer their shares to Unilever only if a transaction tax-free for them could be arranged.

Lawyers representing both sides devised a "reverse subsidiary cash merger" that they felt would satisfy the Greenwalls' concerns. Two new entities would be created—National Starch and Chemical Holding Corp. (Holding), a subsidiary of Unilever, and NSC Merger, Inc., a subsidiary of Holding that would have only a transitory existence. In an exchange specifically designed to be tax-free under §351 of the Internal Revenue Code, Holding would exchange one share of its nonvoting preferred stock for each share of National Starch common that it received from National Starch shareholders. Any National Starch common that was not so exchanged would be converted into cash in a merger of NSC Merger, Inc., into National Starch.

In November 1977, National Starch's directors were formally advised of Unilever's interest and the proposed transaction. At that time, Debevoise, Plimpton, Lyons & Gates, National Starch's counsel, told the directors that under Delaware law they had a fiduciary duty to ensure that the proposed transaction would be fair to the shareholders. National Starch thereupon engaged the investment banking firm of Morgan Stanley & Co., Inc., to evaluate its shares, to render a fairness opinion, and generally to assist in the event of the emergence of a hostile tender offer.

Although Unilever originally had suggested a price between \$65 and \$70 per share, negotiations resulted in a final offer of \$73.50 per share, a figure Morgan Stanley found to be fair. Following approval by National Starch's board and the issuance of a favorable private ruling from the Internal Revenue Service that the transaction would

be tax-free under §351 for those National Starch shareholders who exchanged their stock for Holding preferred, the transaction was consummated in August 1978.

Morgan Stanley charged National Starch a fee of \$2,200,000, along with \$7,586 for out-of-pocket expenses and \$18,000 for legal fees. The Debevoise firm charged National Starch \$490,000, along with \$15,069 for out-of-pocket expenses. National Starch also incurred expenses aggregating \$150,962 for miscellaneous items—such as accounting, printing, proxy solicitation, and Securities and Exchange Commission fees—in connection with the transaction. No issue is raised as to the propriety or reasonableness of these charges.

On its federal income tax return for its short taxable year ended August 15, 1978, National Starch claimed a deduction for the \$2,225,586 paid to Morgan Stanley, but did not deduct the \$505,069 paid to Debevoise or the other expenses. Upon audit, the Commissioner of Internal Revenue disallowed the claimed deduction and issued a notice of deficiency. Petitioner sought redetermination in the United States Tax Court, asserting, however, not only the right to deduct the investment banking fees and expenses but, as well, the legal and miscellaneous expenses incurred.

The Tax Court, in an unreviewed decision, ruled that the expenditures were capital in nature and therefore not deductible under §162(a) in the 1978 return as "ordinary and necessary expenses." *National Starch and Chemical Corp. v. Commissioner*, 93 T.C. 67 (1989). The court based its holding primarily on the long-term benefits that accrued to National Starch from the Unilever acquisition. *Id.*, at 75. The United States Court of Appeals for the Third Circuit affirmed, upholding the Tax Court's findings that both Unilever's enormous resources and the possibility of synergy arising from the transaction served the long-term betterment of National Starch." *National Starch and Chemical Corp. v. Commissioner*, 918 F. 2d 426, 432-433 (1990). In so doing, the Court of Appeals rejected National Starch's contention that, because "the disputed expenses did not create or enhance . . . a separate and distinct additional asset," see *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345, 354 (1971), they could not be capitalized and therefore were deductible under §162(a). 918 F. 2d, at 428-431. We granted certiorari to resolve a perceived conflict on the issue among the Courts of Appeals.

## II

Section 162(a) of the Internal Revenue Code allows the deduction of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." In contrast, §263 of the Code allows no deduction for a capital expenditure—an amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate." The primary effect of characterizing a payment as either a business expense or a capital expenditure concerns the timing of the taxpayer's cost recovery: While business expenses are currently deductible, a capital expenditure usually is amortized and depreciated over the life of the relevant asset, or, where no specific asset or useful life can be ascertained, is deducted upon dissolution of the enterprise. See §§167(a) and 336(a); Treas. Reg. §1.167(a). Through provisions such as these, the Code endeavors

to match expenses with the revenues of the taxable period to which they are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. See, e.g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1, 16 (1974); *Ellis Banking Corp. v. Commissioner*, 688 F.2d 1376, 1379 (CA11 1982), cert. denied, 463 U.S. 1207 (1983).

In exploring the relationship between deductions and capital expenditures, this Court has noted the familiar rule" that an income tax deduction is a matter of legislative grace and that the burden of clearly showing the right to the claimed deduction is on the taxpayer." *Interstate Transit Lines v. Commissioner*, 319 U.S. 590, 593 (1943); *Deputy v. Du Pont*, 308 U.S. 488, 493 (1940); *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934). The notion that deductions are exceptions to the norm of capitalization finds support in various aspects of the Code. Deductions are specifically enumerated and thus are subject to disallowance in favor of capitalization. See §§161 and 261. Nondeductible capital expenditures, by contrast, are not exhaustively enumerated in the Code; rather than providing a complete list of nondeductible expenditures," *Lincoln Savings*, 403 U.S., at 358, §263 serves as a general means of distinguishing capital expenditures from current expenses. For these reasons, deductions are strictly construed and allowed only as there is a clear provision therefor." *New Colonial Ice Co. v. Helvering*, 292 U.S., at 440.

The Court also has examined the interrelationship between the Code's business expense and capital expenditure provisions.<sup>5</sup> In so doing, it has had occasion to parse §162(a) and explore certain of its requirements. For example, in *Lincoln Savings*, we

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<sup>5</sup>See, e.g., *Commissioner v. Idaho Power Co.*, 418 U.S. 1 (1974) (equipment depreciation allocable to construction of capital facilities is to be capitalized); *United States v. Mississippi Chemical Corp.*, 405 U.S. 298 (1972) (cooperatives' required purchases of stock in Bank for Cooperative are not currently deductible); *Commissioner v. Lincoln Savings & Loan Assn.*, 403 U.S. 345 (1971) (additional premiums paid by bank to federal insurers are capital expenditures); *Woodward v. Commissioner*, 397 U.S. 572 (1970) (legal, accounting, and appraisal expenses incurred in purchasing minority stock interest are capital expenditures); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970) (consulting, legal, and other professional fees incurred by acquiring firm in minority stock appraisal proceeding are capital expenditures); *Commissioner v. Tellier*, 383 U.S. 687 (1966) (legal expenses incurred in defending against securities fraud charges are deductible under §162(a)); *Commissioner v. Heininger*, 320 U.S. 467 (1943) (legal expenses incurred in disputing adverse postal designation are deductible as ordinary and necessary expenses); *Interstate Transit Lines v. Commissioner*, 319 U.S. 590 (1943) (payment by parent company to cover subsidiary's operating deficit is not deductible as a business expense); *Deputy v. Du Pont*, 308 U.S. 488 (1940) (expenses incurred by shareholder in helping executives of company acquire stock are not deductible); *Helvering v. Winmill*, 305 U.S. 79 (1938) (brokerage commissions are capital expenditures); *Welch v. Helvering*, 290 U.S. 111 (1933) (payments of former employer's debts are capital expenditures).

determined that, "to qualify for deduction under §162(a), an item must (1) be 'paid or incurred during the taxable year,' (2) 'be for carrying on any trade or business,' (3) be 'an expense,' (4) be a 'necessary' expense, and (5) be an 'ordinary' expense." 403 U.S., at 352. See also *Commissioner v. Tellier*, 383 U.S. 687, 689 (1966) (the term "necessary" imposes only the minimal requirement that the expense be appropriate and helpful' for the development of the [taxpayer's] business," quoting *Welch v. Helvering*, 290 U.S. 111, 113 (1933)); *Deputy v. Du Pont*, 308 U.S. 488, 495 (1940) (to qualify as ordinary, "the expense must relate to a transaction of common or frequent occurrence in the type of business involved"). The Court has recognized, however, that the decisive distinctions" between current expenses and capital expenditures are those of degree and not of kind," *Welch v. Helvering*, 290 U.S., at 114, and that because each case turns on its special facts," *Deputy v. Du Pont*, 308 U.S., at 496, the cases sometimes appear difficult to harmonize. See *Welch v. Helvering*, 290 U.S., at 116.

National Starch contends that the decision in *Lincoln Savings* changed these familiar backdrops and announced an exclusive test for identifying capital expenditures, a test in which creation or enhancement of an asset" is a prerequisite to capitalization, and deductibility under §162(a) is the rule rather than the exception. We do not agree, for we conclude that National Starch has overread *Lincoln Savings*.

....

*Lincoln Savings* stands for the simple proposition that a taxpayer's expenditure that serves to create or enhance . . . a separate and distinct" asset should be capitalized under §263. It by no means follows, however, that only expenditures that create or enhance separate and distinct assets are to be capitalized under §263. We had no occasion in *Lincoln Savings* to consider the tax treatment of expenditures that, unlike the additional premiums at issue there, did not create or enhance a specific asset, and thus the case cannot be read to preclude capitalization in other circumstances. In short, *Lincoln Savings* holds that the creation of a separate and distinct asset well may be a sufficient but not a necessary condition to classification as a capital expenditure. See *General Bancshares Corp. v. Commissioner*, 326 F. 2d 712, 716 (CA8) (although expenditures may not resul[t] in the acquisition or increase of a corporate asset, . . . these expenditures are not, because of that fact, deductible as ordinary and necessary business expenses"), cert. denied, 379 U.S. 832 (1964).

Nor does our statement in *Lincoln Savings*, 405 U.S., at 354, that "the presence of an ensuing benefit that may have some future aspect is not controlling" prohibit reliance on future benefit as a means of distinguishing an ordinary business expense from a capital expenditure. Although the mere presence of an incidental future benefit—some "future aspect"—may not warrant capitalization, a taxpayer's realization of benefits beyond the year in which the expenditure is incurred is undeniably important in determining whether the appropriate tax treatment is immediate deduction or capitalization. Indeed, the text of the Code's capitalization provision, §263(a)(1), which refers to "permanent improvements or betterments," itself envisions an inquiry into the duration and extent of the benefits realized by the taxpayer.



### III

In applying the foregoing principles to the specific expenditures at issue in this case, we conclude that National Starch has not demonstrated that the investment banking, legal, and other costs it incurred in connection with Unilever's acquisition of its shares are deductible as ordinary and necessary business expenses under §162(a).

Although petitioner attempts to dismiss the benefits that accrued to National Starch from the Unilever acquisition as "entirely speculative" or "merely incidental," Brief for Petitioner 39-40, the Tax Court's and the Court of Appeals' findings that the transaction produced significant benefits to National Starch that extended beyond the tax year in question are amply supported by the record. For example, in commenting on the merger with Unilever, National Starch's 1978 Progress Report "observed that the company would benefit greatly from the availability of Unilever's enormous resources, especially in the area of basic technology." App. 43. See also *id.*, at 46 (Unilever provides "new opportunities and resources"). Morgan Stanley's report to the National Starch board concerning the fairness to shareholders of a possible business combination with Unilever noted "that National Starch management feels that some synergy may exist with the Unilever organization given a) the nature of the Unilever chemical, paper, plastics and packaging operations . . . and b) the strong consumer products orientation of Unilever United States, Inc." *Id.*, at 77-78.

In addition to these anticipated resource-related benefits, National Starch obtained benefits through its transformation from a publicly held, freestanding corporation into a wholly owned subsidiary of Unilever. The Court of Appeals noted that National Starch management viewed the transaction as swapping approximately 3500 shareholders for one." 918 F. 2d, at 427; see also App. 223. Following Unilever's acquisition of National Starch's outstanding shares, National Starch was no longer subject to what even it terms the "substantial" shareholder-relations expenses a publicly traded corporation incurs, including reporting and disclosure obligations, proxy battles, and derivative suits. Brief for Petitioner 24. The acquisition also allowed National Starch, in the interests of administrative convenience and simplicity, to eliminate previously authorized but unissued shares of preferred and to reduce the total number of authorized shares of common from 8,000,000 to 1,000.

....

### IV

The expenses that National Starch incurred in Unilever's friendly takeover do not qualify for deduction as ordinary and necessary" business expenses under §162(a). The fact that the expenditures do not create or enhance a separate and distinct additional asset is not controlling; the acquisition-related expenses bear the indicia of capital expenditures and are to be treated as such.

The judgment of the Court of Appeals is affirmed.

It is so ordered.

### Questions

Q-18. A taxpayer purchases raw land for the purpose of constructing a skateboard park. In constructing the park, the underlying land is graded in such a way that water runs onto a neighboring parcel. That water invades a building on the neighboring parcel, and the owner threatens to sue. In response, the taxpayer pays to establish a drain around the skateboard park to keep the water from invading neighboring parcels. Is the cost of the drain immediately deductible under §162(a)?

Q-19. What if the drain were constructed by the taxpayer on the neighbor's property?

Q-20. The capitalization rules apply to corporate and noncorporate taxpayers alike. How should the costs of corporate mergers and acquisitions be treated in the following circumstances? In each fact pattern, the acquiring corporation desires to merge with or otherwise acquire the target corporation, and the target corporation may desire the acquisition (a friendly acquisition) or be opposed to it (a hostile acquisition).

a. The acquiring corporation's legal, accounting, and related costs in a successful acquisition.

b. The acquiring corporation's legal, accounting, and related costs in an unsuccessful acquisition.

c. The target corporation's legal, accounting and related costs in a failed acquisition that was successfully resisted by the target corporation.

d. The target corporation's legal, accounting and related costs in an acquisition that was mutually desired but failed because of regulatory disapproval.

e. The target corporation's legal, accounting, and related costs in an acquisition that the target fought but which nevertheless occurred over the target's objection?

#### 1. **Repair and Maintenance**

#### **Midland Empire Packing Co. v. Commissioner**

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**14 T.C. 635 (1950), acq. 1950-2 C.B. 3**

*ARUNDELL, Judge:*

The issue in this case is whether an expenditure for a concrete lining in petitioner's basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under section [162(a)] of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section [165(a)] of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss.

....

It will be seen from our findings of fact that for some 25 years prior to the taxable year petitioner had used the basement rooms of its plant as a place for the curing of hams and bacon and for the storage of meat and hides. The basement had been entirely satisfactory for this purpose over the entire period in spite of the fact that there was some seepage of water into the rooms from time to time. In the taxable year it was found that not only water, but oil, was seeping through the concrete walls of the basement of the packing plant and, while the water would soon drain out, the oil would not, and there was left on the basement floor a thick scum of oil which gave off a strong odor that permeated the air of the entire plant, and the fumes from the oil created a fire hazard. It appears that the oil which came from a nearby refinery had also gotten into the water wells which served to furnish water for petitioner's plant, and as a result of this whole condition the Federal meat inspectors advised petitioner that it must discontinue the use of the water from the wells and oilproof the basement, or else shut down its plant.

To meet this situation, petitioner during the taxable year undertook steps to oilproof the basement by adding a concrete lining to the walls from the floor to a height of about four feet and also added concrete to the floor of the basement. It is the cost of this work which it seeks to deduct as a repair. The basement was not enlarged by this work, nor did the oilproofing serve to make it more desirable for the purpose for which it had been used through the years prior to the time that the oil nuisance had occurred. The evidence is that the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary. It is true that after the work was done the seepage of water, as well as oil, was stopped, but, as already stated, the presence of the water had never been found objectionable. The repairs merely served to keep the property in an operating condition over its probable useful life for the purpose for which it was used.

While it is conceded on brief that the expenditure was "necessary," respondent contends that the encroachment of the oil nuisance on petitioner's property was not an "ordinary" expense in petitioner's particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of "ordinary" for, as stated in *Welch v. Helvering*, 290 U. S. 111, "ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. \* \* \* the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. *Kornhauser v. United States*, 276 U. S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part." Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain

sections of the country it must be a common experience to protect one's property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

....

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations.

In our opinion, the expenditure of \$4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner's alternative contention that the expenditure is deductible as a business loss, nor need we heed the respondent's argument that any loss suffered was compensated for by "insurance or otherwise."

*Decision will be entered under Rule 50.*

#### *Notes*

1. *The Midland Empire Reasoning.* The court in *Midland Empire* allowed the taxpayer to deduct the cost of constructing a concrete lining to its basement on the theory that "the expenditure did not add to the value or prolong the expected life of the property over what they were before the event occurred which made the repairs necessary." But why is that the relevant test? The expenditure surely made the property more valuable than it was immediately prior to construction of the concrete lining. Why did the court use a different comparison date? More generally, the expenditure will produce a long-term benefit to the taxpayer. Under *INDOPCO*, that should require capitalization. Of course, *Midland Empire* was decided long before the Supreme Court rendered its *INDOPCO* opinion.

2. *The Repair Regulations.* Treasury promulgated in 2012 regulations covering repair and maintenance expenditures. Those regulations provide that "[a] taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts are not otherwise required to be capitalized."<sup>30</sup> Additional regulations further provide that an expenditure must be capitalized as a "betterment" to property if it "[a]meliorates a material condition or defect that either existed prior to the taxpayer's acquisition of the unit of property or arose during the production of the unit of property, whether or not the taxpayer was aware of the condition or defect at the time of acquisition or production."<sup>31</sup> This rule largely codifies the holding in *Midland Empire* although it makes

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<sup>30</sup> Reg. §1.162-4.

<sup>31</sup> Reg. §1.263(a)-3(j)(1)(i); see also Reg. §1.263(a)-3(j)(iv)(A).

clear that a taxpayer cannot avoid capitalization simply by showing that the condition necessitating the expenditure, though existing prior to acquisition of the property, was unknown to the taxpayer at the time of acquisition.

3. *Reconsidering Midland Empire*. It is impossible to square the *Midland Empire* result with *INDOPCO*: if an expenditure is made to produce a long-term benefit, then the cost of the expenditure must be capitalized. The tax bar waged a dogged and ultimately successful war against the Court's holding in *INDOPCO*, and the final regulations promulgated in response to that case – often called the *INDOPCO* regulations – represent a significant victory for the anti-*INDOPCO* forces.<sup>32</sup>

4. *Loss Deduction as Compared with Repair Deduction*. Could the taxpayer in *Midland Empire* have claimed a loss deduction under §165 for the diminution in value of its building that occurred when the oil started seeping? Recall that a loss deduction requires that the loss “be evidenced by closed and completed events.” Reg. §1.165-1(b). If the oil problem itself is not sufficient to establish the loss, might the repair satisfy the requirement of a “completed event[]”? Is there any practical difference between claiming a loss deduction under §165 and a repair deduction under §162(a), given that under general contract law principles diminution in value cannot exceed cost of repair? Consider the possibility that the building in *Midland Empire* had been fully depreciated?

#### Question

Q-21. Suppose a business purchases a one-year fire insurance policy in the middle of its taxable year (say, July for a corporation that uses the calendar year as its taxable year). How should the cost of the policy be treated, assuming it is a necessary expenditure. What if the policy lasts for two years rather than for only one?

#### Revenue Ruling 94-38

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#### 1994-1 C.B. 35

#### ISSUE

Are the costs incurred to clean up land and to treat groundwater that a taxpayer contaminated with hazardous waste from its business deductible by the taxpayer as business expenses under section 162 of the Internal Revenue Code, or must they be capitalized under section 263?

#### FACTS

X, an accrual basis corporation, owns and operates a manufacturing plant. X built the plant on land that it had purchased in 1970. The land was not contaminated by

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<sup>32</sup> See, e.g., Reg. §1.263(a)-3(i)(3) (examples 2 and 3).

hazardous waste when it was purchased by X. X's manufacturing operations discharge hazardous waste. In the past X buried this waste on portions of its land.

In 1993, in order to comply with presently applicable and reasonably anticipated federal, state, and local environmental requirements ("environmental requirements"), X decided to remediate the soil and groundwater that had been contaminated by the hazardous waste, and to establish an appropriate system for the continued monitoring of the groundwater to ensure that the remediation had removed all hazardous waste. Accordingly, X began excavating the contaminated soil, transporting it to appropriate waste disposal facilities, and backfilling the excavated areas with uncontaminated soil. These soil remediation activities started in 1993 and will be completed in 1995. X also began constructing groundwater treatment facilities which included wells, pipes, pumps, and other equipment to extract, treat, and monitor contaminated groundwater. Construction of these groundwater treatment facilities began in 1993, and the facilities will remain in operation on X's land until the year 2005. During this time, X will continue to monitor the groundwater to ensure that the soil remediation and groundwater treatment eliminate the hazardous waste to the extent necessary to bring X's land into compliance with environmental requirements.

The effect of the soil remediation and groundwater treatment will be to restore X's land to essentially the same physical condition that existed prior to the contamination. During and after the remediation and treatment, X will continue to use the land and operate the plant in the same manner as it did prior to the cleanup except that X will dispose of any hazardous waste in compliance with environmental requirements.

#### LAW AND ANALYSIS

Section 162 generally allows a deduction for the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Even though a particular taxpayer may incur an expense only once in the lifetime of its business, the expense may qualify as ordinary and necessary if it is appropriate and helpful in carrying on that business, is commonly and frequently incurred in the type of business conducted by the taxpayer, and is not a capital expenditure. *Commissioner v. Tellier*, 383 U.S. 687 (1966); *Deputy v. du Pont*, 308 U.S. 488 (1940); *Welch v. Helvering*, 290 U.S. 111 (1933). Section 162 has been applied to allow business expense deductions for the costs of removing and disposing of waste materials produced in a taxpayer's business. See *H.G. Fenton Material Co. v. Commissioner*, 74 T.C. 584 (1980).

Section 263 generally prohibits deductions for capital expenditures. Section 263(a)(1) provides that no deduction shall be allowed for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of any property. Section 263(a)(2) provides that no deduction shall be allowed for any amount expended in restoring property or in making good the exhaustion

thereof for which an allowance has been made in the form of a deduction for depreciation, amortization, or depletion. Section 1.263(a)-1(b) of the Income Tax Regulations provides that capital expenditures include amounts paid or incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Section 1.263(a)-2(a) provides that capital expenditures include the cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.

....

Through provisions such as section 162(a), section 263(a), and related sections, the Internal Revenue Code generally endeavors to match expenses with the revenues of the taxable period to which the expenses are properly attributable, thereby resulting in a more accurate calculation of net income for tax purposes. Moreover, as the Supreme Court has specifically recognized, the “decisive distinctions [between capital and ordinary expenditures] are those of degree and not of kind,” and a careful examination of the particular facts of each case is required. *Welch v. Helvering*, 290 U.S. at 114; *Deputy v. du Pont*, 308 U.S. at 496. In determining whether current deduction or capitalization is the appropriate tax treatment for any particular expenditure, it is important to consider the extent to which the expenditure will produce significant future benefits. See *INDOPCO, Inc. v. Commissioner*, 112 S. Ct. at 1044-45.

The groundwater treatment facilities constructed by X have a useful life substantially beyond the taxable year in which they are constructed and, thus, the costs of their construction are capital expenditures under sections 263(a) . . . .

Under these facts, X's soil remediation expenditures and ongoing groundwater treatment expenditures (i.e., the groundwater treatment expenditures other than the expenditures to construct the groundwater treatment facilities) do not produce permanent improvements to X's land within the scope of section 263(a)(1) or otherwise provide significant future benefits. Under the facts of this ruling, the appropriate test for determining whether the expenditures increase the value of property is to compare the status of the asset after the expenditure with the status of that asset before the condition arose that necessitated the expenditure (i.e., before the land was contaminated by X's hazardous waste). See *Plainfield-Union Water Co. v. Commissioner*, 39 T.C. 333, 338 (1962), nonacq. on other grounds, 1964-2 C.B. 8. X's soil remediation and ongoing groundwater treatment expenditures do not result in improvements that increase the value of X's property because X has merely restored its soil and groundwater to their approximate condition before they were contaminated by X's manufacturing operations.

No other aspect of section 263 requires capitalization of X's ongoing soil remediation or ongoing groundwater treatment expenditures. These expenditures do not prolong

the useful life of the land, nor do they adapt the land to a new or different use. Moreover, since the land is not subject to an allowance for depreciation, amortization, or depletion, the amounts expended to restore the land to its original condition are not subject to capitalization under section 263(a)(2). Accordingly, the expenses incurred by X for the soil remediation and ongoing groundwater treatment do not constitute capital expenditures under section 263.

The soil remediation and ongoing groundwater treatment expenditures incurred by X represent ordinary and necessary business expenses within the scope of section 162. They are appropriate and helpful in carrying on X's business and are commonly and frequently required in X's type of business. Therefore, the costs incurred by X to evaluate and remediate its soil and groundwater contamination (other than the costs of constructing the groundwater treatment facilities) constitute ordinary and necessary business expenses that are deductible under section 162.

#### *Notes*

1. *Environmental Remediation.* Does Revenue Ruling 94-38 stand for the proposition that environmental remediation expenditures always are deductible so long as they merely improve the safety of existing property? For example, asbestos removal from older buildings generally can be expensed under §162(a) even though the removal produces a long-term benefit to the building's owner. Revenue Ruling 94-38 seems to follow in the footsteps of *Midland Empire*.

It is possible, however, that Revenue Ruling 94-38 is consistent with the Supreme Court's opinion in *INDOPCO*. The Ruling involved three different expenditures: (1) removal of contaminated soil and groundwater; (2) construction of a monitoring facility; and (3) costs associated with operation of the monitoring facility. By contaminating the soil in the past rather than adopting procedures more environmentally sound, the taxpayer saved costs and thereby increased profits . . . *in the past*. If we try to match expenses with the income they generate, the cost of removing contaminated soil and groundwater should be allocated to past profits. Accordingly, immediate deduction of these remediation costs seems appropriate.

The cost of the monitoring facility will permit the taxpayer to continue operating in the future, and so its cost should be capitalized and recovered over the facility's useful life via depreciation. That was the conclusion reached in the Ruling. Finally, costs associated with operation of the monitoring facility incurred regularly and repeatedly yield only short-term benefits (because the costs have to be incurred repeatedly as the facility remains in



operation), and so these costs should be expenses. Again, that is the conclusion reached in the Ruling.

**Norwest Corp. v. Commissioner**

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**108 T.C. 265 (1997)**

JACOBS, *Judge*: . . . .

The issues for decisions are: 1 (1) Whether petitioner is entitled to deduct the costs of removing asbestos-containing materials from its Douglas Street bank building . . . .

**GENERAL FINDINGS**

One of petitioner's subsidiaries, Norwest Bank Nebraska, N.A. (Norwest Nebraska), owns a building at 1919 Douglas Street in Omaha, Nebraska (the Douglas Street building or building). The Douglas Street building is a three-story commercial office building that occupies half a square block and has a lower level parking garage. Norwest Nebraska constructed the building in 1969 at a \$ 4,883,232 cost. During all relevant periods, Norwest Nebraska used the Douglas Street building as an operations center as well as a branch for serving customers.

One of petitioner's subsidiaries, Norwest Bank Nebraska, N.A. (Norwest Nebraska), owns a building at 1919 Douglas Street in Omaha, Nebraska (the Douglas Street building or building). The Douglas Street building is a three-story commercial office building that occupies half a square block and has a lower level parking garage. Norwest Nebraska constructed the building in 1969 at a \$ 4,883,232 cost. During all relevant periods, Norwest Nebraska used the Douglas Street building as an operations center as well as a branch for serving customers.

In 1985 and 1986, Norwest Nebraska consolidated its "back room" operations at the Douglas Street building. Pursuant to that process, Norwest Nebraska undertook to determine the most efficient means for providing more space to accommodate the additional operations personnel within the building. The planning process indicated that the building needed a major remodeling. (The building had not been remodeled since its construction; Norwest Nebraska usually remodels its banks every 10 to 15 years.) Thus, by the end of 1986, petitioner and Norwest Nebraska had decided to completely remodel the Douglas Street building. In December 1986, both petitioner and Norwest Nebraska approved a preliminary budget of \$ 2,738,000 for carpet, furniture, and improvements.

The Douglas Street building was constructed with asbestos-containing materials as its main fire-retardant material. (The local fire code required that buildings contain fireproofing material.) Asbestos-containing materials were sprayed on all columns, steel I-beams, and decking between floors. The health dangers of asbestos were not widely known when the Douglas Street building was constructed in 1969, and

asbestos-containing materials were generally used in building construction in Omaha, Nebraska.

A commercial office building's ventilation system removes existing air from a room through a return air plenum as new air is introduced. The returned air is subsequently recycled through the building. The area between the decking and the suspended ceiling in the Douglas Street building functioned as the return air plenum. The top part of the return air plenum, the decking, was one of the components of the building where asbestos-containing materials had been sprayed during construction.

Over time, the decking, suspended ceiling tiles, and light fixtures throughout the building became contaminated. This contamination occurred because the asbestos-containing fireproofing had begun to delaminate, and pieces of this material reached the top of the suspended ceiling.

....

#### DISCUSSION

At issue is whether petitioner's costs of removing the asbestos-containing materials are currently deductible pursuant to section 162 or must be capitalized pursuant to section 263 or as part of a general plan of rehabilitation. . . .

The total cost of renovating the Douglas Street building was close to \$ 7 million, comprising nearly \$ 4,998,749 in remodeling costs and approximately \$ 1.9 million 6 in asbestos removal costs. Petitioner considered the cost of all demolition done by the asbestos removal contractors (including the cost of removing the asbestos tiles) as a removal cost for both book and tax purposes. Petitioner considered the cost of any demolition done by the general contractor or one of the subcontractors a remodeling cost for both book and tax purposes. . . .

At issue is whether petitioner's costs of removing the asbestos-containing materials are currently deductible pursuant to section 162 or must be capitalized pursuant to section 263 or as part of a general plan of rehabilitation. . . .

Section 263 requires taxpayers to capitalize costs incurred for permanent improvements, betterments, or restorations to property. In general, these costs include expenditures that add to the value or substantially prolong the life of the property or adapt such property to a new or different use. In contrast, section 162 permits taxpayers to currently deduct the costs of ordinary and necessary expenses (including incidental repairs) that neither materially add to the value of property nor appreciably prolong its life but keep the property in an ordinarily efficient operating condition. See sec. 1.162-4, Income Tax Regs. . . .

In *Illinois Merchants Trust Co. v. Commissioner*, 4 B.T.A. 103, 106 (1926), which involved the cost of shoring up a wall and repairing a foundation needed to prevent a building from collapsing, the Board of Tax Appeals drew the following distinctions:

To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. \* \* \* Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings. \* \*

....

Expenses incurred as part of a plan of rehabilitation or improvement must be capitalized even though the same expenses if incurred separately would be deductible as ordinary and necessary. Unanticipated expenses that would be deductible as business expenses if incurred in isolation must be capitalized when incurred pursuant to a plan of rehabilitation. Whether a plan of capital improvement exists is a factual question "based upon a realistic appraisal of all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done".

An asset need not be completely out of service or in total disrepair for the general plan of rehabilitation doctrine to apply. For example, in *Bank of Houston v. Commissioner*, T.C. Memo. 1960-110, the taxpayer's 50-year-old building was in "a general state of disrepair" but still serviceable for the purposes used (before, during, and after the work) and was in good structural condition. The taxpayer hired a contractor to perform the renovation (which included nonstructural repairs to flooring, electrical wiring, plaster, window frames, patched brick, and paint, as well as plumbing repairs, demolition, and cleanup). Temporary barriers and closures were erected during work in progress. The Court recognized that each phase of the remodeling project, removed in time and context, might be considered a repair item, but stated that "The Code, however, does not envision the fragmentation of an overall project for deduction or capitalization purposes." The Court held that the expenditures were not made for incidental repairs but were part of an overall plan of rehabilitation, restoration, and improvement of the building.

Petitioner contends that the costs of removing the asbestos-containing materials are deductible as ordinary and necessary business expenses because: (1) The asbestos removal constitutes "repairs" within the meaning of section 1.162-4, Income Tax Regs.; (2) the asbestos removal did not increase the value of the Douglas Street

building when compared to its value before it was known to contain a hazardous substance--a hazard was essentially removed and the building's value was restored to the value existing prior to the discovery of the concealed hazard; (3) although performed concurrently, the asbestos removal and remodeling were not part of a general plan of rehabilitation because they were separate and distinct projects, conceived of independently, undertaken for different purposes, and performed by separate contractors; and (4) using the principles of section 213 (which allows individuals to deduct certain personal medical expenses that are capital in nature) and section 1.162-10, Income Tax Regs. (which allows a trade or business to deduct medical expenses paid to employees on account of sickness), the cost of removing a health hazard is deductible under section 162.

Respondent, on the other hand, contends that the costs of removing the asbestos-containing materials must be capitalized because: (1) The removal was neither incidental nor a repair; (2) petitioner made permanent improvements that increased the value of the property by removing a major building component and replacing it with a new and safer component, thereby improving the original condition of the building; (3) petitioner permanently eliminated the asbestos hazard that was present when it built the building, creating safer and more efficient operating conditions and reducing the risk of future asbestos-related damage claims and potentially higher insurance premiums; (4) the asbestos removal and the remodeling were part of a single project to rehabilitate and improve the building; (5) the purpose of the expenditure was not to keep the property in ordinarily efficient operating condition, but to effect a general restoration of the property as part of the remodeling; and (6) section 213 and section 1.162-10, Income Tax Regs., are not analogous to the present case. . . .

We believe that petitioner decided to remove the asbestos-containing materials from the Douglas Street building beginning in 1987 primarily because their removal was essential before the remodeling work could begin. The extent of the asbestos-containing materials in the building or the concentration of airborne asbestos fibers was not discovered until after petitioner decided to remodel the building and a budget for the remodeling had been approved. Because petitioner's extensive remodeling work would, of necessity, disturb the asbestos fireproofing, petitioner had no practical alternative but to remove the fireproofing. Performing the asbestos removal in connection with the remodeling was more cost effective than performing the same work as two separate projects at different times. (Had petitioner remodeled without removing the asbestos first, the remodeling would have been damaged by subsequent asbestos removal, thereby creating additional costs to petitioner.) We believe that petitioner's separation of the removal and remodeling work is artificial and does not properly reflect the record before us.

The parties have stipulated that the asbestos removal did not increase the useful life of the Douglas Street building. We recognize (as did petitioner) that removal of the

asbestos did increase the value of the building compared to its value when it was known to contain a hazard. However, we do not find, as respondent advocates, that the expenditures for asbestos removal materially increased the value of the building so as to require them to be capitalized. We find, however, that had there been no remodeling, the asbestos would have remained in place and would not have been removed until a later date. In other words, but for the remodeling, the asbestos removal would not have occurred.

The asbestos removal and remodeling were part of one intertwined project, entailing a full-blown general plan of rehabilitation, linked by logistical and economic concerns. "A remodeling project, taken as a whole, is but the result of various steps and stages." *Bank of Houston v. Commissioner*, T.C. Memo. 1960-110. In fact, removal of the asbestos fireproofing in the Douglas Street building was "part of the preparations for the remodeling project." See *id.* Before remodeling could begin, nearly every ceiling light fixture in the building was ripped down and crews removed all the asbestos-containing materials that had been sprayed on the columns, I-beams, and decking between floors, as well as the floor tiles in the customer lobbies. Only then could the remodeling contractor perform its work. As described above, the entire project required close coordination of the asbestos removal and remodeling work.

Clearly, the purpose of removing the asbestos-containing materials was first and foremost to effectuate the remodeling and renovation of the building. Secondly, petitioner intended to eliminate health risks posed by the presence of asbestos and to minimize the potential liability for damages arising from injuries to employees and customers.

In sum, based on our analysis of all the facts and circumstances, we hold that the costs of removing the asbestos-containing materials must be capitalized because they were part of a general plan of rehabilitation and renovation that improved the Douglas Street building.

....

#### *Notes*

1. *The Norwest Corp. Doctrine*. The court agreed with the taxpayer that the cost of asbestos removal, standing alone, would qualify as a deduction under §162, a conclusion that can only be explained as an example of the now generally accepted rule that remediation costs are both ordinary and necessary. Putting that questionable rule aside, does it make sense that a deductible cost becomes capitalizable when included in some larger project? Isn't almost every large project a collection of smaller ones?

## 2. Rent or Purchase

### Estate of Starr v. Commissioner

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274 F.2d 294 (1959)

CHAMBERS, J.:

Yesterday's equities in personal property seem to have become today's leases. This has been generated not a little by the circumstance that one who leases as a lessee usually has less trouble with the federal tax collector. At least taxpayers think so.

But the lease still can go too far and get one into tax trouble. While according to state law the instrument will probably be taken (with the consequent legal incidents) by the name the parties give it, the Internal Revenue Service is not always bound and can often recast it according to what the service may consider the practical realities.<sup>33</sup> . . . The principal case concerns a fire sprinkler system installed at the taxpayer's plant at Monrovia, California, where Delano T. Starr, now deceased, did business as the Gross Manufacturing Company. The 'lessor' was 'Automatic' Sprinklers of the Pacific, Inc., a California corporation. The instrument entitled 'Lease Form of Contract' (hereafter 'contract') is just about perfectly couched in terms of a lease for five years with annual rentals of \$ 1,240. But it is the last paragraph thereof, providing for nominal rental for five years, that has caused the trouble. It reads as follows:

'28. At the termination of the period of this lease, if Lessee has faithfully performed all of the terms and conditions required of it under this lease, it shall have the privilege of renewing this lease for an additional period of five years at a rental of \$32.00 per year. If Lessee does not elect to renew this lease, then the Lessor is hereby granted the period of six months in which to remove the system from the premises of the Lessee.'

Obviously, one renewal for a period of five years is provided at \$32.00 per year, if Starr so desired. Note, though, that the paragraph is silent as to status of the system beginning with the eleventh year. Likewise the whole contract is similarly silent.

The tax court sustained the commissioner of internal revenue, holding that the five payments of \$1,240, or the total of \$6,200, were capital expenditures and not pure deductible rental. Depreciation of \$269.60 was allowed for each year. Generally, we agree.

Taxpayers took the deduction as a rental expense under trade or business pursuant to . . . Section [162].

The law in this field for this circuit is established in *Oesterreich v. Commissioner*, *supra*, and *Robinson v. Elliot*, 9 Cir., 262 F.2d 383. There we held that for tax purposes

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<sup>33</sup> Thus it shifts rental payments of a business (fully deductible) to a capital purchase for the business. If the nature of the property is wasting, then depreciation may be taken, but usually not all in one year.

form can be disregarded for substance and, where the foreordained practical effect of the rent is to produce title eventually, the rental agreement can be treated as a sale.

In this, Starr's case, we do have the troublesome circumstance that the contract does not by its terms ever pass title to the system to the 'lessee.' Most sprinkler systems have to be tailor-made for a specific piece of property and, if removal is required, the salvageable value is negligible. Also, it stretches credulity to believe that the 'lessor' ever intended to or would 'come after' the system. And the 'lessee' would be an exceedingly careless businessman who would enter into such contract with the practical possibility that the 'lessor' would reclaim the installation. He could have believed only that he was getting the system for the rental money. And we think the Commissioner was entitled to take into consideration the practical effect rather than the legal, especially when there was a record that on other such installations the 'lessor', after the term of the lease was over, had not reclaimed from those who had met their agreed payments. It is obvious that the nominal rental payments after five years of \$32.00 per year were just a service charge for inspection.

....

In *Wilshire Holding Corporation v. Commissioner*, 9 Cir., 262 F.2d 51, we referred the case back to the Tax Court to consider interest as a deductible item for the lessee. We think it is clearly called for here. [T]he normal selling price of the system was \$4,960 while the total rental payments for five years were \$6,200. The difference could be regarded as interest for the five years on an amortized basis. . . .

We do not criticize the Commissioner. It is his duty to collect the revenue and it is a tough one. If he resolves all questions in favor of the taxpayers, we soon would have little revenue. However, we do suggest that after he has made allowance for depreciation, which he concedes, and an allowance for interest, the attack on many of the 'leases' may not be worthwhile in terms of revenue.

Decision reversed for proceedings consistent herewith.

#### *Questions*

Q-22. The issue in the case was whether the transaction should be treated as an installment purchase of the sprinkler system or as a rental of the system. The parties agreed on the underlying facts and how both purchases and rentals are treated for tax purposes. So why was there a dispute? Who won the dispute? Why?

Q-23. What is the meaning of the court's final substantive paragraph?

Q-24. If we treat the transaction as an installment purchase and there was total interest paid of \$1,240 over 5 years, why is the first year's interest component greater than one-fifth of \$1,240. Can you describe how the interest in the first year should be computed?

### 3. Depreciation, Amortization, Expensing and Bonus Depreciation

#### a. Theory

Why should the cost of some assets be depreciable? Recall the definition of income under a Haig-Simons income tax: income equals consumption plus the change (positive or negative) in net worth. To fully implement this definition, all assets would have to be valued at the conclusion of each year. Such a scheme has never been employed: instead, we have the realization doctrine. Under the realization doctrine, changes in market appreciation and loss generally are ignored until disposition.

Some assets are “wasting” in the sense that, even if relative prices do not change, the value of the asset will decrease. Assuming the realization doctrine applies only to market value changes, a wasting asset should generate a deduction for the asset’s owner in an amount equal to the anticipated decline in value (not its actual market value decline, if any) resulting from the passage of time. This deduction will, over the useful life of the asset, generate deductions aggregating the taxpayer’s adjusted basis in the asset less any scrap value as of the end of its useful life. This is the justification for the depreciation deduction. Note that it implies that the realization doctrine protects market value changes from immediate recognition but has no application to inevitable changes in value (that is, changes in value that will occur even if relative prices in the economy do not change).

Why do assets waste in this sense? The current fair market value of an investment asset should equal the discounted value of the income stream it will produce. As the asset generates income, its ability to generate additional income in the future often will decline. A comparison of the present value of the income stream it will generate as of the beginning of the year as compared with the present value of the income stream it will generate as of the end of the year should equal the waste in the asset; that is, that difference should equal the appropriate depreciation deduction.

Consider an asset that will generate \$100 in each of the next 4 years and then will be worthless. Using a discount rate of 10% per year, the asset’s current value equals exactly \$316.98. The following chart presents the present value of the income stream when the asset is purchased and for the following four years.

Depreciation Chart 1

Year	Income	PV <sub>0</sub>	PV <sub>1</sub>	PV <sub>2</sub>	PV <sub>3</sub>	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

Based on this chart, the depreciation deduction for year 1 should be \$316.96 - \$248.68, or \$68.30 as shown in the final column. It is something of a coincidence in this chart that the depreciation deduction each year equals the reverse of the present value of the income stream as of the date of purchase. The example of constant rate income



production is sufficiently well known that the depreciation schedule resulting from that assumption is called “sinking fund” depreciation.

The following chart sets forth the relevant present values for a different four-year income producing asset. In this case, the asset will produce \$110.87 after one year, \$103.25 after two years, \$95.08 after three years, and \$87.18 after four years. The depreciation schedule that follows from the income production schedule, assuming a 10% annual discount rate, is set forth in the final column.

Depreciation Chart 2

Year	Income	PV <sub>0</sub>	PV <sub>1</sub>	PV <sub>2</sub>	PV <sub>3</sub>	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	<u>59.42</u>	<u>65.50</u>	<u>72.05</u>	<u>79.25</u>	<u>79.25</u>
		316.98	237.74	158.49	79.25	316.98

What are the assumptions underlying these charts? (1) We know the income production schedule of the asset with certainty, including both the amount of income the asset will generate and the exact timing when that income will be generated; (2) We know the discount rate with certainty; and (3) the asset has no scrap value once it stops producing income.

*Question*

Q-25. Some assets such as unimproved land (i.e., dirt) and common stock do not waste and so are not depreciable. Why don't these assets waste?

*b. Practice*

*i. Introduction*

The variables relevant to the depreciation deduction include (1) the period over which the depreciation will be claimed, (2) the rate at which the depreciation will be claimed, (3) how much allowance will be made for salvage value, and (4) the day when the depreciation should start. Historically, all but the second item were treated as questions of fact that could be litigated by taxpayers. So, for example, taxpayers would argue that some piece of equipment was valuable in the taxpayer's particular business for a relatively short period even if it had some residual use for other taxpayers. If this argument is accepted, then the period over which the depreciation would be claimed was shortened (good for the taxpayer) although the salvage value presumably would be increased (bad for the taxpayer). Note that the total depreciation that could be claimed always equaled cost (or other basis) less salvage value.

If depreciation is claimed at a fixed rate (say, one-fifth of basis for five consecutive year), we say that *straight-line depreciation* is being claimed. Any faster rate of depreciation (that is, more depreciation in the early years and less in the later years) is called

*accelerated depreciation*. Depreciation of intangible assets has always been limited to straight-line depreciation, also called *amortization* or *ratable* recovery.

ii. Prior Law: Depreciation Under §167

Section 167(a) provides a deduction for “a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)” for property used in a trade or business or other profit-seeking activity. Historically, what few additional rules existed also found in §167, but the operating rules have now been moved to §168 and, for most intangibles, to §197. Note, though, that which assets are covered by the rules in §168 remain defined in §167 and so are limited to property used in profit-seeking activity.

In 1971, the IRS established the Asset Depreciation Range (ADR) system of depreciation in which the useful lives of depreciable assets were estimated and used to generate an upper and lower bound for the period over which depreciation might be claimed. The purpose of this system was to eliminate some of the litigation that had plagued the historical system in which all aspects of depreciation (other than rate) were treated as facts that could be litigated. In addition, the statutory recovery period was set 20% below what the government thought was the best measure of an asset’s useful life, a tax giveaway lacking justification.

iii. ACRS Under Old §168

In 1981, Congress created the Accelerated Cost Recovery System (ACRS), sorting depreciable assets into limited categories and providing a uniform depreciable life for all assets falling within a particular class. These depreciable lives specified in ACRS were based on the old ADR system though deliberately shortened. See §168(e)(1). For example, assets having an ADR class life of at least 10 years but less than 16 years were classified as 7-year property. (And recall that the ADR class lives were deliberately shortened by 20% from the government’s best estimate of actual useful life.) Other aspects of ACRS were that salvage value was conclusively assumed to equal \$0, §168(b)(4), rate of depreciation was defined by reference to the underlying asset category, §168(b), and property was treated as placed in service using arbitrary dates dependent on asset type, §168(d).

iv. MACRS Under §168

The ACRS system was quickly modified, largely by lengthening the depreciable lives of real estate assets (it had been 15 years for all real estate assets) and eliminating a tax credit (called the Investment Tax Credit, or ITC) that allowed an immediate income tax credit of 10% of the cost of depreciable personal property. Current law as reflected in §168 is called MACRS depreciation (the Modified Accelerated Cost Recovery System).

(A) Recovery Periods in §168(e)

Now called “recovery period” rather than “useful life” to emphasize that depreciation schedules no longer are tied to the period over which an asset will be productive in the hands of a particular taxpayer, all depreciable assets are divided into 10 classes, see

168(e)(1), (2), (4) and (5). Recall that only assets subject to wear and tear qualify for any depreciation deduction. In particular, unimproved real estate (i.e., dirt) is not a depreciable asset.

#### (B) Recovery Rates

The cost of depreciable real-estate and similar property is recovered using straight-line cost recovery. §168(b)(3). Short-lived assets are recovered using the 200% declining balance method. This method generates in the first year exactly double the depreciation deduction that straight-line depreciation would generate.<sup>34</sup> The cost of longer-lived assets (other than those assets having the longest useful lives) are recovered using the 150% declining balance method, a method that generates exactly 150% of straight-line depreciation in the first year.

#### (C) First-Year Conventions

In general, most depreciable property is treated as placed in service (thereby starting depreciation) in the middle of the taxpayer's taxable year, called the mid-year convention. §§168(d)(1), 168(d)(e)(A). Accordingly, the amount of depreciation that can be claimed in that first taxable year is exactly one-half of what you would otherwise expect. For example, if property having a recovery life of 10 years is placed in service in 2019 and is recovered using the 150% declining balance method, then the owner would be entitled to claim 7.5% of the taxpayer's basis as a depreciation deduction in the year in which the property is placed in service (straight-line would equal 10%, 150% declining balance would increase that amount in the first year to 15%, and the mid-year convention then cuts that in half, to 7.5%).

Property subject to the mid-year convention is subject to an anti-abuse rule. If too much of such property is placed in service toward the end of the taxable year, it may seem as if the taxpayer is trying to manipulate the mid-year convention for her tax advantage. Congress has provided that if a taxpayer places in service in the last quarter of the year more than 40% (by basis) of the property placed in service during the entire year (excluding real estate), then all property that otherwise would be subject to the mid-year convention is instead subject to the mid-quarter convention. §168(d)(3).

#### *Problem*

P-9. Suppose a taxpayer places \$110,000 of property in service at the start of the year and another \$100,000 at the end of the year. This will trigger the anti-backloading anti-abuse rule of §168(d)(3). Does that section operate as an anti-abuse rule on these facts?

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Real estate assets are subject to the mid-month convention, §§168(d)(2), 168(d)(4)(B). So, for example, any depreciable real estate asset placed in service anytime in January would generate 11.5 twelfths of the depreciation otherwise allowed in the first year while

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<sup>34</sup> The declining balance methods are described in Reg. §1.167(b)-2.

any depreciable real estate asset placed in service in December would generate one-half of one-twelfth of the usual first year depreciation.

Because all depreciable property is subject to some first-year convention, the cost of all depreciable property will be recovered over one more year than its classification otherwise would suggest. For example, property classified as 7-year property under §168(e) has a recovery period of 7 years under §168(c) but, because of the mid-year convention, such property will generate a depreciation deduction across eight taxable years with the deduction in the eighth year equal to one-half of the depreciation otherwise generated in the seventh year. For both the 200% and 150% declining balance recovery methods, the amount of depreciation allowable each year declines after the second year (recall that the depreciation deduction in the first taxable year is only half of what would be expected because of the mid-year convention), eventually leveling off. For example, 7-year property costing \$100,000 and recovered using the 200% declining balance method subject to the mid-year convention would generate the following depreciation deductions (numbers rounded): \$14,290, \$24,490, \$17,490, \$12,490, \$8,930, \$8,930, \$8,930, \$4,460.<sup>35</sup>

(D) Salvage Value

Salvage value is set equal to zero, §168(b)(4), so that the depreciation deductions will equal the taxpayer's full basis in the depreciable property.

c. *Depreciation Recapture Under §§1245 and 1250*

A taxpayer's adjusted basis in depreciable property declines each year by the depreciation deduction. If the taxpayer claims a depreciation deduction equal to what the statute allows, then the basis reduction equals that amount. But sometimes taxpayers will claim more or less than the amount properly allowable. In fact, some taxpayers may claim no depreciation deduction at all even though they are entitled to such a deduction, attempting to save their depreciation until a more favorable time. But depreciation deductions cannot be saved in this way: section 1016(a)(2) requires a taxpayer to reduce adjusted basis by the amount of depreciation claimed by the taxpayer *but in no event less than the amount allowable under the statute*. Thus, even if a depreciation deduction is not claimed, the amount that should have been claimed reduces the taxpayer's adjusted basis in the depreciable property. Conversely, if a taxpayer claims a depreciation deduction greater than that allowed by statute and the deduction is not challenged by the government, the taxpayer must reduce adjusted basis of the depreciable property by the amount claimed by the taxpayer.

If depreciated property is transferred, special rules apply to calculate gain recognized on the transfer. For all depreciated property other than real property, transfer of the property triggers §1245. For depreciated real estate, §1250 applies. These two provisions are important for two reasons: (1) they can trigger recognition of gain even when a

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<sup>35</sup> You will not be expected to compute a declining balance depreciation schedule beyond the first year.

nonrecognition provision would apply; and (2) they can convert capital gain (and gain described in §1231) into ordinary income. We will consider only the first of these reasons now and the second in the chapter on capital gains and losses.

Many Code provisions include language such as “except as otherwise provided,” but §1245(a)(1) reads differently: “Except as otherwise provided *in this section*” (emphasis added). In case this language is not sufficiently clear in its statement that §1245 overrules all other Code provisions, §1245(d) makes the priority of §1245 unambiguous.

The property covered by §1245 is defined in §1245(a)(3). With some minor exceptions, that property is personal property (i.e., not real estate) that qualifies under §167 for depreciation. Without getting into the details of “recomputed basis,” §1245(a)(1) generally provides that so much of the taxpayers gain on the transfer of §1245 property as does not exceed depreciation claimed in the past is treated as recognized gain “notwithstanding any other provision of this subtitle.”

By its express language, §1245 overrules all the nonrecognition provisions in the Code. However, it has its own exceptions to immediate recognition in §1245(b). The various rules in §1245(b) largely incorporate the same nonrecognition rules found in other Code provisions. However, not every nonrecognition rule found in the Code is duplicated in §1245(b) so that whenever §1245 property is transferred and less than all the gain is immediately recognized, §1245 must be examined to ensure full or partial nonrecognition is provided by §1245(b).

Section 1250 applies to depreciable real property, §1250(c), and, like §1245, fully preempts all other parts of the code. §§1250(a) (initial language), 1250(h). It also includes its own exceptions to immediate recognition. §1250(d). However, because its operation is more complex than §1245, further examination of §1250 will be deferred until the chapter on capital gains and losses.

#### *d. Expensing and Bonus Depreciation*

Section 179 allows taxpayers to immediately expense the cost of some property otherwise depreciable over multiple years. Property that qualifies for this favorable treatment must be depreciable tangible property or certain computer software which either is also §1245 property or is certain qualified real property. §§179(d)(1), 179(e). Further, for such property to qualify under §179, it must have been acquired by purchase which generally excludes tax-free contributions to corporations and to partnerships as well as tax-free distributions from corporations and partnerships. See §179(d)(2). The dollar amount of such purchased property that qualifies for §179 treatment in any one year is limited to \$1,000,000. §179(b)(1). Note that the dollar limitation can be applied to a single asset costing more than \$1,000,000 or to multiple assets. Any excess cost above the dollar limit will then be recovered using the usual depreciation rules.

The dollar limitation is itself limited for taxpayers who place in service during the taxable year more than \$2,500,000 of §179 property. For such taxpayers, the \$1,000,000 limit is reduced on a dollar-for-dollar basis by the cost of the taxpayer’s property placed in service

in the taxable year in excess of \$2,500,000. So, for example, if a taxpayer places \$2,600,000 of §179 property in service, only \$900,000 of that cost can be expensed under §197. If a taxpayer places \$3,500,000 or more of §179 property in service during the taxable year, the benefit of §179 is lost entirely for that year.

Currently, §179 should be irrelevant because the benefit it provides has been fully captured by the bonus depreciation rules of §168(k). For qualifying depreciable property placed in service through the end of 2022, fully 100% of the cost of such property can be expensed rather than depreciated over time. §§168(k)(1), 168(k)(6)(A).<sup>36</sup> Unfortunately, the definition of property that qualifies for bonus depreciation under §168(k) is surprisingly complex.

First, such property includes depreciable property having a recovery period of 20 years or less. §168(k)(2)(A)(i)(I). It also includes a variety of other assets including certain computer software, certain film and television production assets, §168(k)(2)(A)(i)(II), as well as certain transportation property and aircraft, §168(k)(2)(B).

Second, the asset must meet an acquisition test described in §168(k)(2)(E). While the property can be new or used, it cannot have been used previously by the taxpayer. §168(k)(2)(E)(ii)(I). Note that this is a “use” test rather than an “ownership” test so that, for example, a taxpayer who leases with an option to buy should be disqualified from treating the property as §168(k) property if the option to buy is exercised. Note also that certain self-constructed property can qualify for bonus depreciation. §168(k)(2)(E)(i).

Finally, the property must not have been acquired from a related party, where related is defined in §179(d)(2)(A)-(B), nor can the property be acquired in a substituted basis transaction or through the estate of a decedent, §179(d)(2)(C). §168(k)(2)(E)(ii)(II).

Recall that allowing a taxpayer to expense (that is, immediately deduct in full) the cost of an asset is equivalent (under certain assumptions) to exempting the return from the asset from taxation. As a result, the effect of bonus depreciation on the return on newly purchased equipment and machinery should be to reduce its effective tax rate close to zero. Since most equipment and machinery is purchased by corporations, this means much corporate profit effectively will be tax-exempt. While the recent reduction of the corporate tax rate from 35% to 21% generated significant publicity, the effect of §168(k) on effective corporate tax rates may be even greater although its effect will certainly vary across industries.

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<sup>36</sup> Note that the percentage of an asset’s cost that qualifies for bonus depreciation under §168(k) is reduced starting in 2022. §168(k)(6)(A)-(B).

*Question*

Q-26. Would you favor a set of business tax rates that varied by industry? What consequences likely will flow from such a set of tax rates in the short run? In the long run?

*e. Goodwill and Other Intangibles*

**Houston Chronicle Publishing Co. v. United States**

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**481 F.2d 1240 (5th Cir. 1973)**

GOLDBERG, CIRCUIT JUDGE:

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The Internal Revenue Code's general section allowing taxpayers to depreciate certain property seems, at least at first blush, to be the essence of simplicity:

"There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)-

(1) of property used in the trade or business, or

(2) of property held for the production of income."

26 U.S.C. § 167(a). These deceptively uncomplicated words have, however, led to a floodtide of litigated cases, many of which have involved "intangible property" such as the lists here in dispute. No single rule for the tax treatment of intangible property emerges from those cases and no black-letter statement of the applicable law is available to guide our decision. Instead, each case seems to revolve on the precise nuances of its facts, and we must thus begin our analysis with an in-depth look at the facts before us.

Prior to 1964, taxpayer was in competition with a second afternoon newspaper, The Houston Press, which was published by the Houston Press Company [hereinafter The Press]. In late 1963 or early 1964, taxpayer resumed previously discontinued negotiations with The Press, aimed at acquiring the assets of The Houston Press. The negotiations were successful, and on March 20, 1964, taxpayer entered into a contract with The Press under which taxpayer acquired the land, improvements, fixtures, inventory, equipment, library, and subscription lists owned by The Press. In addition to these assets, taxpayer received a noncompetition agreement from The Press and E. W. Scripps Company restricting the latter from engaging in the publication of any weekly, daily, or Sunday newspaper in the Houston area for a period of ten years. Taxpayer paid The Press a total consideration of \$4,500,000, none of which was allocated among the various items prior to the time of sale.

Under the purchase agreement, taxpayer was entitled to receive all subscription lists of The Houston Press, and it eventually did receive the lists. The Press had distributed its newspapers by means of district managers. Each manager supervised a specific area and was responsible for distributing newspapers to the paperboys and street vending boxes in his area. The district managers were employees of The Press and

maintained the lists of subscribers to The Houston Press within their respective areas. The Press maintained a list of the aggregate number of subscribers, but only the district managers maintained lists showing the names and addresses of the subscribers.

Sometime after the sale, taxpayer engaged the services of the firm of Marshall & Stevens, Inc., Valuation Engineers, to evaluate the various assets acquired from The Press. The Houston Press had a circulation of approximately 89,000, and the valuation engineers estimated that about 40% of these would become subscribers to The Houston Chronicle. The anticipated number of new subscribers, approximately 35,600, was multiplied by the average cost of obtaining a new subscriber, \$2.00, to arrive at a total value of the subscription lists of \$71,200. That figure is not in dispute.

On the date that the purchase arrangement was announced to the public, March 20, 1964 (which was also the last day The Houston Press was published), taxpayer's president directed his staff to attempt to obtain employment contracts from the district managers previously employed by The Press. In compliance with this directive, taxpayer's city manager went to the offices of The Press on March 20, 1964. Through his efforts, at least 24 of the 28 to 30 district managers of The Press signed contracts to become independent contractors with taxpayer. In essence, then, taxpayer ultimately acquired virtually all of the distribution structure that The Press had utilized.

Taxpayer had agreed to complete all subscriptions to The Houston Press, and in addition, taxpayer furnished former subscribers to The Houston Press with one month's free delivery of The Houston Chronicle in order to acquaint them with that newspaper. As a result of these various efforts, approximately 36,000 Press subscribers ultimately began subscribing to The Houston Chronicle.

Because taxpayer had no intention of continuing publication of The Houston Press, it did not consider the subscription lists to be self-regenerating assets and considered them valuable only to the extent they furnished names and addresses of prospective subscribers to The Houston Chronicle. Concluding that the expected useful life of the lists was five years, taxpayer claimed as an amortization deduction for the taxable years here in question, 1964 and 1965, one-fifth of the assigned value per year.

In connection with an audit of taxpayer's income tax returns, the Commissioner disallowed the amortization expense deductions claimed for the subscription lists. Taxpayer paid the resulting deficiencies and filed claims for a refund, which were ultimately unsuccessful. Taxpayer thereafter filed the instant suit for a refund.

Taxpayer's position is that it may claim an amortization deduction under Sec. 167(a) of the Internal Revenue Code of 1954 for the subscription lists, an intangible capital asset, if the asset has (1) a limited useful life that is (2) of ascertainable duration. The government admits that those two qualities generally do allow an intangible capital asset to qualify for such a deduction but insists that subscription lists must be treated as being akin to the "goodwill" of a business, which is non-amortizable as a matter of law. The court below agreed with taxpayer and heard evidence on the question of whether these lists had ascertainable limited lives.



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The government does not contend that these newspaper subscription lists are non-amortizable because they are intangible capital assets. Indeed, it could not, for we have previously said:

"Under the present law, a reasonable amortization deduction is allowed for the exhaustion, wear and tear of property used in the taxpayer's business, or of property held for the production of income, I.R.C. Sec. 167(a) (1954). The property, to be depreciable, must be an inherently wasting asset, but this allowance is not limited to tangible assets."

Griswold v. Commissioner, 5 Cir. 1968, 400 F.2d 427, 433. Also, the Treasury Regulations specifically provide for amortization or depreciation of intangible capital assets:

"If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. . . ."

Treas. Reg. Sec. 1.167(a)-3. On the other hand, not every intangible capital asset is depreciable:

"Thus the statute does not include all property. There are even some kinds of property used in business on which depreciation is not allowable because none is sustained, and other property on which it is not allowable because any exhaustion which may occur is not susceptible of accurate measurement. Accordingly, in order to establish the right to depreciation, it is necessary to show that the property, whether tangible or intangible, will become exhausted within a definite period, which is known as its useful life, and which can be ascertained from specific terms, such as a contract, or can be determined from available facts."

Pohlen v. Commissioner, 5 Cir. 1948, 165 F.2d 258, 259.

Taxpayer admits that it bears all burdens in regard to establishing its right to claim a Sec. 167(a) deduction. See Bennett v. Commissioner, 8 Cir. 1944, 139 F.2d 961; Pohlen v. Commissioner, supra. This being so, taxpayers frequently are prevented from taking Sec. 167(a) deductions because they are unable to prove affirmatively that the particular asset involved satisfies all of the prerequisites for amortizability. Many of the reported cases turn on this factual question and thus stand not so much for the

proposition that the type of asset is never amortizable as they do for the conclusion that the very asset involved failed to qualify for one or more particular reasons.

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The most frequently reported case--those involving denials of Sec. 167(a) amortization deductions for intangible capital assets where the taxpayer failed to carry his burden of convincing the trier of fact that the asset has a limited useful life of ascertainable duration--are similarly distinguishable. In denying a Sec. 167(a) deduction in *Griswold v. Commissioner*, supra, for example, we emphasized that taxpayers had "offered no evidence to accurately establish the duration of the assets." 400 F.2d at 434. Similarly, in a case involving "insurance renewals," we denied amortization deductions where taxpayers had "adduced no controverting evidence of a limited useful life" of the asset. *Salome v. United States*, 5 Cir. 1968, 395 F.2d 990.

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Some intangible capital assets are, of course, non-amortizable as a matter of law, with the most frequently litigated example being the "goodwill" of an ongoing business. Treasury Regulation Sec. 1.167(a)-3 specifically provides, "No deduction for depreciation is allowable with respect to goodwill," and the cases are consistent in applying that regulation strictly. E. g., *Winn-Dixie Montgomery, Inc. v. United States*, 5 Cir. 1971, 444 F.2d 677; *United States v. Cornish*, 9 Cir. 1965, 348 F.2d 175; *Dodge Brothers, Inc. v. United States*, 4 Cir. 1941, 118 F.2d 95. Indeed, this proposition is so well settled that the only question litigated in recent years regarding this area of the law is whether a particular asset is "goodwill."

[T]he precise issue is often whether or not the asset involved is either ordinary goodwill or so much like goodwill that the reasons for denying amortization deductions for goodwill are fully applicable. Foremost among those reasons is the conclusive presumption that goodwill is a non-depreciating capital asset. See, e. g., *Id.*; *Golden State Towel & Linen Service, Ltd. v. United States*, 1967, 373 F.2d 938, 179 Ct. Cl. 300. Viewed in a business context, the economic value of a taxpayer's continuing goodwill within his field of operations is seen as an ongoing asset that fluctuates but does not necessarily diminish.<sup>37</sup> The crucial question becomes one of asking whether the intangible capital asset involved necessarily possesses similar characteristics.

... As a refinement of its argument that lists such as those before us are to be treated as goodwill for tax purposes, the government argues that the so-called "mass asset" or "indivisible asset" rule requires that amortization be denied.

The "mass asset" rule has been applied where arguably distinct assets are "inextricably" linked to goodwill, see *Golden State Towel & Linen Service, Ltd. v. United States*, supra, and where the seemingly separate assets possess the same qualities as goodwill, possessing no determinable useful life and having self-

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<sup>37</sup> [Note that this statement asserts that the cost of goodwill is nonamortizable because its useful life is not finite and ascertainable. Assuming this was an accurate statement of the law then in effect, there was no special rule for goodwill but rather it was subject to the same rule as other intangibles. – ed.]

regenerating capability, see *Winn-Dixie Montgomery, Inc. v. United States*, supra. The government here invokes that "rule" to insist that the instant taxpayer cannot amortize the cost of obtaining these lists. We cannot agree, and we do not read the "mass asset" cases as controlling this case.

. . . . Without compiling the myriad cases that discuss the "mass asset" rule, we are satisfied that the rule does not establish a per se rule of non-amortizability in every case involving both goodwill and other intangible assets. In the light of Sec. 167(a) of the Code and Regulation Sec. 1.167(a)-3, we are convinced that the "mass asset" rule does not prevent taking an amortization deduction if the taxpayer properly carries his dual burden of proving that the intangible asset involved (1) has an ascertainable value separate and distinct from goodwill, and (2) has a limited useful life, the duration of which can be ascertained with reasonable accuracy.

. . . .

Finding that the instant lists met the requirements of Sec. 167(a) of the Code and the Regulations promulgated thereunder, we explicitly hold that which we left unsaid in *Blaine v. United States*, 5 Cir. 1971, 441 F.2d 917--newspaper subscription lists such as those before us are intangible capital assets that may be depreciated for tax purposes if taxpayer sustains his burden of proving that the lists (1) have an ascertainable value separate and distinct from goodwill, and (2) have a limited useful life, the duration of which can be ascertained with reasonable accuracy. Cf. *Commissioner v. Killian*, 5 Cir. 1963, 314 F.2d 852. Therefore, as we did in *Blaine*, we must now turn to a consideration of whether the instant findings supporting amortizability, i.e., the jury's verdict, can withstand appellate review.

. . . .

#### *Note*

1. As recognized in *Houston Chronicle Publishing Co.*, the cost of a wasting asset could be recovered over time under the old rules in §167 only if it had a finite and determinable useful life. Intangible assets in particular often were problematic because their useful life often was not easily provable. Of course, the useful lives of some intangible assets such as patents, copyrights, and covenants not to compete with fixed durations were easy enough to measure, but other intangibles such as goodwill, customer-based intangibles (such as lists of potential customers and their buying habits), and supplier-based intangibles (such as expectation of discounts and availability of supplies) were much more difficult.

Section 168 eliminated litigation over the useful life of tangible property, replacing a fact-based inquiry with a few largely arbitrary categories. Ultimately, Congress determine that the cost of most business intangibles should be amortized, enacting the arbitrary period of 15 years for all qualifying intangibles. §197(a). Note that, as under prior law, basis recovery under §197 is limited to straight-line (i.e., ratable) amortization.

Almost all intangibles fall into the definition of a "Section 197 Intangible" in §197(d), with exceptions to that broad definition found in §197(e). Note in particular that some

intangibles are treated as Section 197 Intangibles only if acquired in connection with the acquisition of a trade or business. §197(e)(4). Note also that transaction costs incurred in connection with a *tax-free* corporate reorganization are excluded, §197(e)(7), leaving the outcome in *INDOPCO* unchanged.

Of those intangibles classified as “Section 197 Intangibles,” most are classified as “Amortizable Section 197 Intangibles.” §197(c). Excluded from this definition are intangibles acquired prior to the enactment of §197 as well as intangibles not held in connection with profit-seeking activity. §197(c)(1). Also excluded are self-created intangibles other than (1) licenses and similar governmental authorizations, (2) covenants not to compete, and (3) franchises, trademarks, and trade names. §§197(c)(2), 197(d)(1)(C)-(E).

Section 197 continues a limited version of the “mass asset” rule described in *Houston Chronicle Publishing Co.* If multiple Amortizable Section 197 Intangibles are acquired in a single transaction (or in a series of related transactions), then a disposition of some of those intangibles cannot generate a loss but instead the adjusted basis of the disposed intangibles is added to the adjusted basis of the retained intangibles. §197(f)(1).

Application of §197(a) is not limited to intangibles that were nonamortizable prior to enactment of §197. For example, many patents, copyrights, limited-term licenses as well as most covenants not to compete are covered by §197(a). As a result, the cost of such assets must be recovered ratably over 15 years from the date of acquisition even if the useful life of the asset is determinable and shorter than 15 years. For example, the cost of a covenant not to compete is recovered over 15 years even if the covenant lasts only 3 years. Similarly, the cost of a patent captured by §197(a) is recovered over 15 years even if the patent had only a few years remaining when acquired by the taxpayer. This counter-intuitive result is made clear in §197(b) which provides that “no depreciation or amortization deduction shall be allowed with respect to any amortizable 197 intangible” other than that provided by §197(a).

Note that §197(b) does not preclude amortization outside of §197(a) with respect to intangibles that are not “Amortizable Section 197 Intangibles.” For example, §197 does not preempt the usual rules of taxation for the cost of a patent not acquired in connection with the acquisition of a trade or business. See §197(e)(4)(C). But what are those rules?

Section 197 authorizes a deduction for wear and tear, and its applicability is not limited to tangible property. In fact, §197 used to have a specific reference to intangibles, providing that the cost of an intangible could be recovered only using straight-line (i.e., ratable) recovery. Presumably for intangibles falling outside the reach of §197(a), the old rules of §167 continue to apply including the rate at which the cost can be recovered as well as the requirements that the asset have a finite and determinable useful life. While the language limiting recovery of the cost of an intangible to straight-line amortization was removed from §167 as part of the Revenue Reconciliation Act of 1990 as “deadwood,” the legislative history to that Act provides that no substantive change was intended to have been made.

#### 4. Start-Up Costs

Costs incurred in connection with a trade or business but prior to the start of the trade or business have presented significant problems for the tax system. For example, consider the salary paid to an apartment leasing agent prior to completion of the apartment building. It is hard to classify the salary as current (that is, "ordinary") given that there is no income producing activity when the salary is paid. However, it is hard to define the proper period over which this cost should be recovered. Indeed, under the traditional rules in §167, because the appropriate useful life of a pre-opening expenditure could not be determined, the expenditure could neither be expensed nor recovered over time, a very harsh result.

As it did in in the definition of recovery periods in §168 as well as in the 15-year recovery period for amortizable intangibles in §197, Congress simply adopted an arbitrary period over which pre-opening expenses can be recovered. Under §195, such pre-opening expenditures (called "start-up expenditures") can be recovered over 180 months starting with the month in which the business begins. §195(b)(1)(B). In fact, a limited portion of the expenditure can be expenses when incurred, but in no event more than \$5,000.<sup>38</sup> §195(b)(1)(A).

Start-up expenditures within the meaning of §195 include amounts paid for investigating the creation or acquisition of a trade or business or spent creating a trade or business and which would be deductible if the trade or business were in operation. §195(c)(1). Note that §162(a) expressly is limited to ordinary and necessary expenditures incurred during the taxable year *carrying on* a trade or business. This "carrying on" language supports the interpretation of §162(a) that it does not cover expenditures made *in anticipation of* carrying on a trade or business.

#### 5. Education

##### **Carroll v. Commissioner**

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**418 F.2d 91 (7th Cir. 1969)**

CASTLE, CHIEF JUDGE.

. . . James A. Carroll (hereinafter referred to as the petitioner) was employed by the Chicago Police Department as a detective during the year in question. In his 1964 federal income tax return, he listed as a deduction \$720.80 which represented his cost of enrollment in DePaul University. The course of study entered into by plaintiff was stated by him to be in preparation for entrance to law school and consisted of a major in Philosophy. The six courses in which plaintiff was enrolled included two English, two Philosophy, one History and one Political Science course.<sup>4</sup> Petitioner justified the deduction under §162(a) . . . as an expense "relative to improving job skills to maintain [his] position as a detective."

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<sup>38</sup> If the expenditures captured by §195 exceed \$50,000, the amount that can be expensed is reduced dollar for dollar by the excess over \$50,000. §195(b)(1)(A). Accordingly, if the amount of the start-up expenditures equals or exceeds \$55,000, no expensing is permitted.

During 1964, the Police Department had in effect General Order No. 63-24, which encouraged policemen to attend colleges and universities by arranging their schedules of duties so as to not conflict with class schedules. Petitioner availed himself of the benefits of this order when he enrolled in DePaul University.

....

[Reg. §1.162-5] abolished the primary purpose test and established a more objective standard for determining whether the cost of education may be deducted as a business expense. Thus, petitioner in the instant case must justify his deduction under §1.162-5(a) (1), as maintaining or improving skills required by him in his employment.<sup>5</sup> However, even if his education maintains or improves his job skills, its cost will be disallowed under §1.162-5(b) (2) and (3) if the education is necessary "in order to meet the minimum educational requirements for qualification in his employment," (§1.162-5(b) (2)), or if the education "will lead to qualifying him in a new trade or business." (§1.162-5(b) (3)).

The latter clause is particularly applicable to the instant case since, as previously discussed, the Tax Court found that petitioner's primary purpose in enrolling in college was to qualify for law school. While the Commissioner concedes that a general college education "hold[s] out the potential for improved performance as a policeman," he argues that petitioner has failed to demonstrate a sufficient relationship between such an education and the particular job skills required by a policeman. Thus, although a college education improves the job skills of all who avail themselves of it, this relationship is insufficient to remove the expense of such education from the realm of personal expenses which are disallowed under §262. Many expenses, such as the cost of commuting,<sup>6</sup> clothing,<sup>7</sup> and a babysitter for a working mother,<sup>8</sup> are related and even necessary to an individual's occupation or employment, but may not be deducted under §162(a) since they are essentially personal expenditures. We are of the opinion that plaintiff's educational expenditure is even more personal and less related to his job skills than the expenditures enumerated above.

Of course, not all college courses may be so classified as non-deductible. Thus, the cost of a course in Industrial Psychology was properly deducted from the income of an Industrial Psychologist, although it led to an advanced degree and the potential of new job opportunities. Similarly, a housing administrator was allowed to deduct the cost of courses in housing administration, and a professional harpist was allowed to deduct the cost of music lessons. The difference between those cases and the instant case is that petitioner's courses were general and basically unrelated to his duties as a policeman. As the Commissioner notes in his brief, a currently employed taxpayer such as petitioner might be allowed to deduct the cost of college courses which directly relate to the duties of his employment.<sup>9</sup> If such courses were taken along with other, more general courses, their cost, or that part of the tuition representing their cost, would be deductible under §162(a). In the instant case, however, petitioner does not claim that any particular course in which he was enrolled in 1964 bears any greater relationship to his job skills than the others.

Therefore, while tax incentives might be employed as an effective tool to encourage such valuable public servants as policemen, as well as others, to acquire a college education so as to improve their general competence, we feel that such a decision should be made by the Congress rather than the courts. To allow as a deduction the cost of a general college education would surely go beyond the original intention of Congress in its enactment of the Internal Revenue Code of 1954. Accordingly, we affirm the judgment of the Tax Court.

Affirmed.

### *Notes*

1. *The Current Regulations.* Reg. §1.162-5 provides a series of objective tests applicable to the costs associated with education. First, the education must either (a) maintain or improve skills used by the taxpayer in the taxpayer's current trade or business, or (b) meet express requirements imposed on the taxpayer for continuing in the taxpayer's current trade or business. Even if either of those two conditions is satisfied, the cost of the education will not be deductible if the education meets the minimum educational requirements for the taxpayer's current trade or business. So, for example, suppose T has a temporary apprentice certificate to cut hair and works as a barber. To qualify for a permanent license, T must take an additional 100 hours of schooling. Under Reg. §1.162-5, the cost of this additional schooling is not deductible.

The cost of education again will not be deductible if it qualifies the taxpayer for a new trade or business. While the line demarcating one trade or business from another often is not clear, the regulations provide some examples. See Reg. §1.162-5(b)(3) (e.g., classroom teacher to principal is not a change of trade or business). Any profession that requires a state license to practice is treated as a distinct trade or business. Note that no part of a program of study is deductible if the program as a whole will lead to qualification for a new trade or business.

2. *Theory.* How should the cost of education be treated by the tax system? Consider the kind of deduction that is overwhelmingly incurred for a profit-seeking purpose. This would include, for example, the cost of law school as well as continuing education by lawyers, the cost of medical school and continuing education by doctors, and the cost of business school. In each of these examples, the financial benefit generated by the education will last many years and so the cost should be capitalized rather than expensed. Thus, the rules in Reg. §1.162-5 that allow some educational expenses to be expensed seem wrong.

Should the cost of professional education be amortized? Under traditional rules, no: the useful life of education cannot be proved with reasonable certainty. Reg. §1.162-5(b)(1) provides that educational expenditures not allowed under the current regulations are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures." While professional education does not seem to have any significant personal component, it surely is composed entirely of capital expenditures. Of course, the same reasoning applies to continuing education, but this regulation allows a deduction for that even though it should not.

But §162 is not about amortization. Recall that §262 provides that personal expenses cannot be deducted (and by reason of §167, also cannot be depreciated). Reg. §1.262-1(b)(9) lists as an example of personal expenditures education that is not allowed as a deduction under Reg. §1.162-5. Do you really think the government could successfully argue that the cost of law school or medical school cannot be depreciated *because it is personal rather than profit-seeking*? Of course, there remains the problem that such education produces a long-term benefit that cannot easily be measured.

#### Questions

Q-27. Suppose a lawyer spends a year at NYU getting an LLM in taxation. Is the cost of that education deductible under Reg. §1.162-5? What additional facts do you need to know?

Q-28. Should the cost of an MBA be deductible? What additional facts do you need to know?

#### **Duecaster v. Commissioner**

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##### **T.C. Memo 1990-518**

TANNENWALD, JUDGE.

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Prior to enrolling in law school in 1980, petitioner was a high school teacher. Petitioner enrolled in law school specifically for the purpose of starting a new trade, the practice of law. Petitioner commenced the practice of law in September 1982 and has continuously been practicing law since that time.

For the taxable years 1985, 1986, and 1987, asserting eligibility under section 195 as start-up expenses, petitioner amortized his law school expenses, incurred during the period April 10, 1980, through September 16, 1982, in the amounts of \$ 2,904, \$ 2,904, and \$ 2,178, respectively.

Petitioner contends that he has satisfied the requirements of section 195, namely: (1) the expenditures were incurred in connection with creating, or investigating the creation of, a trade or business and (2) the expenditures would have been allowable as a deduction for the taxable year in which they were paid if they had been paid in connection with the operation of an existing trade or business in the same field as that which petitioner subsequently entered, namely the practice of law. Respondent does not dispute petitioner's contention that he has satisfied the first requirement. Respondent's position is that petitioner has not satisfied the second requirement because the expenditures were for the purpose of acquiring the usual law degree which is a condition for admission to the bar and because such expenditures are not covered by section 195 since they could not, under any circumstances, constitute allowable deductions.

The starting point of our analysis is *Sharon v. Commissioner*, 66 T.C. 515 (1976), affd. per curiam 591 F.2d 1273 (9th Cir. 1979). That case involved in part the right of the taxpayer to amortize his expenditures for his education and admission to the bar in



order to practice law first in New York and later in California. In denying the taxpayer the right to amortize the New York expenditures, which included costs of obtaining a law degree and a bar review course, this Court stated:

There is no merit in the petitioner's claim to an amortization deduction for the cost of his education and related expenses in qualifying himself for the legal profession. His college and law school expenses provided him with a general education which will be beneficial to him in a wide variety of ways. See *James A. Carroll*, 51 T.C. 213, 216 (1968). The costs and responsibility for obtaining such education are personal.

Section 1.262-1(b)(9) of the Income Tax Regulations provides that expenditures for education are deductible only if they qualify under section 162 and section 1.162-5 of the regulations. In the words of section 1.162-5(b), all costs of "minimum educational requirements for qualification in \* \* \* employment" are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures." There is no "rational" or workable basis for any allocation of this inseparable aggregate between the nondeductible personal component and a deductible component of the total expense. *Fausner v. Commissioner*, 413 U.S. 838, 839 (1973).

Such expenses are not made any less personal or any more separable from the aggregate by attempting to capitalize them for amortization purposes. Since the inseparable aggregate includes personal expenditures, the preeminence of section 262 over section 167 precludes any amortization deduction. The same reasoning applies to the costs of review courses and related expenses taken to qualify for the practice of a profession.

In *Sharon*, we further held that the taxpayer was not entitled to amortize the expenditure for a bar review course taken in the process of preparing for the California bar examination, even though the expenditure had been incurred after the taxpayer was licensed to practice law in New York. In this connection, we stated:

Nor may the petitioner treat the payment for the California bar review course as a part of the costs of acquiring his license to practice in California. Educational expenses which are incurred to meet the minimum educational requirements for qualification in a taxpayer's trade or business or which qualify him for a new trade or business are "personal expenditures or constitute an inseparable aggregate of personal and capital expenditures." Sec. 1.162-5(b), Income Tax Regs. We find that the bar review course helped to qualify the petitioner for a new trade or business so that its costs are personal expenses. [66 T.C. at 528.]

The question before us is to what extent, if any, did the enactment of section 195 change the foregoing principles. Under section 195(c)(1)(B), in order for an expenditure to qualify, it must be one that would have been allowable as a deduction if the taxpayer had been engaged in that trade or business when it was paid or incurred. The legislative history confirms the thrust of this language in stating:

Startup expenditures eligible for amortization do not include any amount with respect to which a deduction would not be allowable to an existing trade or business for the taxable year in which the expenditure was paid or incurred. \* \* \* [S. Rept. 96-1036, at 12 (1980).]

Nothing in the statute or the legislative history suggests that section 195 was intended to create a deduction, by way of amortization, in respect of an item which would not, in any event, have been deductible under prior law. In this context, the role of section 195 is comparable to that of section 212 (formerly section 23(a)(2) of the Internal Revenue Code of 1939). It has long been established that the latter section creates no deduction for an expenditure that would not have been deductible under section 162, if the taxpayer had been engaged in a trade or business, e.g. *United States v. Gilmore*, 372 U.S. 39, 46 (1963).

Petitioner argues that, under section 195(c)(1)(B): (1) we are required to assume that he was a practicing attorney at the time he incurred the expenditures; (2) such expenditures cannot be considered as meeting the minimum education requirements for an attorney or as qualifying him in a new trade or business because he was already an attorney; and (3) therefore the expenditures could only have been to maintain or improve his skills and to expand his practice. Petitioner's syllogism proves too much. He would have us perform a double conversion, first by converting him into a lawyer before he was admitted to the bar and then by converting a nondeductible personal expenditure into a business expense deduction. This we are not prepared to do.

Leaving aside the fact that we would have difficulty assuming that petitioner was practicing law without a license, we are satisfied that the statutory language in question at most requires that we assume only that petitioner was engaged in a trade or business involving some law-related activity. It does not follow from such assumption that the expenditures should not continue to be viewed as personal expenditures for education and therefore not deductible under section 262. See sec. 1.262-1(b)(9), Income Tax Regs.

....

We hold that respondent's disallowance of the amortization deductions under section 195 in respect of petitioner's expenditures for his legal education should be sustained.

#### *Note*

1. *The Cost of Professional Education and §195.* Surely Judge Tannenwald is correct that nothing in §195 turns a personal expenditure into a profit-seeking expenditure. But that is exactly what Reg. §1.162-5 does. Recall that if a taxpayer is already in a trade or business, the cost of education that maintains or improves the taxpayer's skills used in that trade or business are treated as business expenses deductible under §162. Yet the same education expenses, incurred in connection with a trade or business not yet started, are treated as personal. Without apparent justification, this regulation treats an

expenditure as business or personal based not on the taxpayer's intention but rather on the timing of the cost.

Section 195 defines a start-up expenditure as a cost that would be deductible if incurred after a trade or business started but which was incurred in investigating or creating the trade or business. Consider the cost of law school. The cost of legal education incurred by a practicing lawyer is deductible under Reg. §1.162-5. Accordingly, the same expense incurred prior to becoming a practicing lawyer should be captured by §195 and so amortized over 15 years, starting when the taxpayer begins practicing law. Note that this result not only tracks the statute but also produces a theoretically sound outcome because the income-producing capability of the expenditure will last for many years. Is it plausible to treat the cost of a legal education as "personal" in the sense that the cost was not incurred in the pursuit of income?

## **F. Answers to Questions**

### **Q-1. Duberstein provides the definition of a “gift.” Why do we care?**

Under §102, gifts (and inheritances) are not includible in the income of the recipient.

### **Q-2. What is the definition of a “gift” for purposes of §102?**

It is a transfer that proceeds from a “detached and disinterested” generosity of the transferor. Note that the Court explicitly concludes that a corporation can make a “gift” within the meaning of §102. How does one determine the intention of a corporation? How does one even define the intention of a business entity?

### **Q-3. When a patron leaves a tip for a retail worker, can the worker exclude the tip under §102? What if the patron leaves money with a note that says the following? “Thank you for providing good service to me. In appreciation of your efforts, I chose to make this tax-free gift to you.” What if the note reads: “While the service today wasn’t the best, I think you’re really cute”?**

The Court holds that a statement of intention made by the transferor is not determinative. A tip left for good service has been held to constitute income in many cases and there are none to the contrary. As to the second question, I do not know of any authority speaking to this fact pattern, but I would hold that the tip is a “gift.”

### **Q-4. Can an employer make a gift to an employee? See §102(c)(1). What if the employee is the employer’s child? Note that §102(c)(1) requires an employer/employee relationship and so does not apply to payments to independent contractors.**

While §102(c)(1) does not provide an exception for transfers to close family members, I know of no authority that has applied §102(c)(1) in that context, and I would be surprised if a transfer from a parent to a child outside of the business context would be income simply because the child also works for the parent.

### **Q-5. Should gifts be includible in the income of the donor? Should they be deductible by the donor? Should a gift be an event of realization for the donor?**

This is discussed in the text.

### **Q-6. Why did the court not require an equitable apportionment between the interest sold and the interest retained? Are you persuaded by the court’s argument?**

The court accepted the taxpayer’s argument that equitably apportionment of the taxpayer’s cost basis could not be done with an acceptable level of certainty. Note that the consequence of the decision is to defer any gain or loss on the sale at issue until the remainder of the property is sold. Courts often make very difficult valuation determinations, but in most contexts that decision cannot be deferred by the court. In this case, it can.

### **Q-7. If Inaja Land Co. subsequently sells the land for \$35,000, will it recognize a gain or a loss? Of how much?**

Since the taxpayer's adjusted basis in the entire property was \$61,000 and the court allowed it to treat \$50,000<sup>39</sup> as a return of capital (that is, as a return of a portion of its adjusted basis), its adjusted basis must decline from \$61,000 to \$11,000. Accordingly, if the rest of the property is sold for \$35,000, there must be a gain of \$24,000.

**Q-8. How would the outcome in this case have been different if Los Angeles had paid not \$50,000 but rather had paid \$80,000?**

Since the taxpayer's adjusted basis in the entire property was \$61,000, no more than that amount could be treated as a return of basis. As a result, there would have to be a gain of \$19,000.

**9. What does "Reviewed by the Court" at the end of the opinion mean? What does "acq. 1948-1 C.B. 2" in the case citation mean?**

The Tax Court consists of 19 active judges but decides cases in panels of 1. The judge to whom the case was assigned by the Chief Judge prepares an opinion including findings of fact and conclusions of law, and the Chief Judge then decides if the opinion will be released as a "Memorandum" opinion of the court (generally an opinion that applies settled law to specific facts; a Memorandum opinion is not officially published by the court but is published by several private publishers), a "Published" opinion of the Court (published in the official Tax Court reporter as well as by private publishers) or is designated as a "Reviewed" opinion. A Reviewed opinion is circulated to all the active judges on the Tax Court, and they vote on the proposed opinion. If a majority of the votes goes against the proposed opinion, the case will be reassigned by the Chief Judge to a new judge who then writes an opinion consistent with the majority vote. Note that because the Tax Court is a trial court, this procedure has the peculiarity of having the official opinion written by a judge who did not participate in the trial. For a fully stipulated case (quite common in the Tax Court), this presents no real difficulty, but for a case in which the facts are in dispute, this can be very awkward. The original judge often writes a dissent; dissents by other judges also are quite common whether the proposed opinion is accepted or rejected by the court.

If an opinion of the Tax Court holds against the government in whole or as to any particular issue, the IRS will decide whether it accepts the defeat and will follow the opinion in subsequent cases or rejects the defeat and will continue to litigate the issue. It publishes that decision in the weekly Internal Revenue Bulletin (the "IRB"). Every 26 weeks, the IRBs are combined ("cumulated") into a single bound volume. "acq. 1948-1 C.B. 2" means the government has acquiesced in the Tax Court's decision, and that acquiescence can be found at page 2 of the second volume of the 1948 Cumulative Bulletin. The IRS can years to decide if it acquiesces or nonacquiesces in a particular Tax Court case.

**10. Why did this case come out differently from *Inaja Land*? Note that *Inaja Land* cited *Raytheon* with approval.**

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<sup>39</sup> I am ignoring the \$1,055 of expenses incurred by the taxpayer.

In *Inaja Land*, the court concluded that it was unable to equitably apportion the taxpayer's adjusted basis between the portion of the property sold and the portion retained. As a result, it was able to defer a decision of gain or loss to a later date when the taxpayer disposed of the remainder of the property. It was thus able to avoid making the equitable apportionment determination both at the time of the decision and in the future. But in *Raytheon*, the court concluded that all of the taxpayer's adjusted basis in its goodwill could be used against the \$350,000 proceeds, so the *Raytheon* case was not about equitably apportioning the taxpayer's basis in its goodwill. Rather, it was about determining the taxpayer's adjusted basis in its goodwill, and that determination could not be deferred by the court because there would never be another occasion to revisit the issue, directly or indirectly.

**11. Suppose an investor purchases a rental home in an upper middle-class neighborhood. Shortly after the purchase, a grisly murder generating significant publicity takes place next door, substantially reducing the market value of the investor's rental unit. Can the investor claim a loss deduction as a result of the decline in market value of the home? What if the murder took place in the rental home itself?**

Almost certainly not. There has been no injury to the taxpayer's asset (the home). Rather, something happened in the world that diminished the value of the asset. That diminution, to the extent it remains, will be recognized by the tax system when the taxpayer disposes of the asset. See *Chamales v. Commissioner*, T.C.Memo 2000-33 (Feb. 3, 2000).

**12. Suppose a taxpayer suffers a loss from an asset that is covered by insurance, but the taxpayer declines to report the loss to her insurance company (perhaps out of fear that the policy will be cancelled). Can the taxpayer claim the loss as a deduction?**

Section 165(a) only applies to losses "not compensated for by insurance or otherwise," but this limitation should be irrelevant because the loss in question, though covered by insurance, was not compensated by insurance. Congress now provides in §165(h)(4)(E) that certain losses are allowable only if an applicable insurance claim is filed, but that provision applies only to losses described in §165(c)(3), a provision that largely has been eliminated for taxable years 2018 through 2025, §165(h)(5).

**13. Suppose an employee embezzles funds from his employer, is caught, and repays the embezzled funds. Does the employer have income from the repayment?**

If the employer claimed a deduction on a prior federal income tax return, then the repayment is taxable under the inclusionary aspect of the tax benefit rule (unless §111 applies to the recovery). If no prior deduction was claimed, then the recovery is excludable.

**14. Suppose a restaurant employee has her tip income stolen. Upon hearing of the theft, the owner of the restaurant gives the employee a \$200 bonus. Does the bonus constitute taxable income to the employee? (The employee cannot exclude the bonus under §102 as a gift because of §102(c).)**

The bonus should be includible because it is not a recovery of her prior tip income but rather is additional income from an unrelated source.

**15. How should the cost of weekly advertising by Best Buy be treated for tax purposes?**

Historically, advertising has been allowed as a current deduction by the IRS even if there is considerable long-term benefit to the advertising.

**16. How should an architect's fee be treated when paid for the design of a building that the taxpayer then constructs?**

It should be capitalized into the cost of the building. Reg. §1.263(a)-2(f)(ii)(J).

**17. How should a taxpayer treat commissions paid to brokers for buying and selling shares of publicly-traded stock?**

Commissions paid to acquire property are capitalized into the cost of the property, Reg. §1.263(a)-4(c)(1), while sales commissions reduce the amount realized on the sale, Reg. §1.263(a)-1(e)(1).

**18. A taxpayer purchases raw land for the purpose of constructing a skateboard park. In constructing the park, the underlying land is graded in such a way that water runs onto a neighboring parcel. That water invades a building on the neighboring parcel, and the owner threatens to sue. In response, the taxpayer pays to establish a drain around the skateboard park to keep the water from invading neighboring parcels. Is the cost of the drain immediately deductible under §162(a)?**

Most likely, the cost of the constructing the drain would be treated as an improvement to the taxpayer's land and so capitalized into the adjusted basis of the land. Is that the right analysis? *If* the only benefit to the taxpayer of the drain is to eliminate a possible lawsuit by the neighbor, then presumably the cost of constructing the drain should be treated the same as would settling the lawsuit. (See immediately below.) But because construction of the drain presumably adds value to the land beyond its value in preventing a lawsuit by the neighbor, the cost likely will have to be capitalized into the cost of the land.

**19. What if the drain were constructed by the taxpayer on the neighbor's property?**

For tax purposes, the taxpayer is not constructing a drain but rather settling a lawsuit. Should the cost of that settlement be immediately deductible? Presumably a victory by the neighbor would allow the neighbor to obtain an order requiring the taxpayer to regrade the parcel to limit the runoff. If the taxpayer then paid for the regrading, presumably that expenditure would be capitalized into the cost of the land. Thus, the cost of the settlement – that is, the cost of constructing the drain – should be capitalized and added to the basis of the land. If the neighbor could obtain nothing but damages, then presumably the cost of the settlement to the taxpayer (in whatever form paid) should be deductible.

**20. The capitalization rules apply to corporate and noncorporate taxpayers alike. How should the costs of corporate mergers and acquisitions be treated in the following circumstances? In each fact pattern, the acquiring corporation desires to merge with or otherwise acquire the target corporation, and the target corporation may desire the acquisition (a friendly acquisition) or be opposed to it (a hostile acquisition).**

- a. The acquiring corporation's legal, accounting, and related costs in a successful acquisition.**

These costs are treated as part of the amount paid by the acquiring corporation to acquire the target corporation. In a stock acquisition, they are treated as part of the price of the stock. In an asset acquisition, they are treated as part of the cost of the assets.

- b. The acquiring corporation's legal, accounting, and related costs in an unsuccessful acquisition.**

Because the attempted acquisition failed, the costs should be deductible.

- c. The target corporation's legal, accounting and related costs in a failed acquisition that was successfully resisted by the target corporation.**

Presumably the target corporation resisted the proposed acquisition because the combination was not in the best interest of the target corporation (and its shareholders). That being true, the benefit of resisting the acquisition should be long-term so that the costs should be capitalized by the target corporation, much as in *Indopco*.

- d. The target corporation's legal, accounting and related costs in an acquisition that was mutually desired but failed because of regulatory disapproval.**

As in variation (b) above, the expenses should be deductible because the business venture failed.

- e. The target corporation's legal, accounting, and related costs in an acquisition that the target fought but which nevertheless occurred over the target's objection?**

This is the most difficult fact pattern. If the expenditures by the target resulted in an increase in acquisition price, then presumably the costs should be capitalized as in a desired acquisition. But if there was no benefit to the target or to the target's shareholders from the expenditures, then at least in theory the costs produced no benefit and so should be deductible. Because determining the benefit, if any, to the target and its shareholders will be difficult to determine, likely these costs will have to be capitalized in all cases.

**21. Suppose a business purchases a one-year fire insurance policy in the middle of its taxable year (say, July for a corporation that uses the calendar year as its taxable year). How should the cost of the policy be treated, assuming it is a necessary expenditure. What if the policy lasts for two years rather than for only one?**



Conceptually, the cost of the policy should be divided between the two taxable years during which it will provide coverage. However, the Tax Court determined in the 1980s that as a matter of expediency that if an asset will be fully consumed in the year acquired or in the subsequent taxable year, the cost of the expenditure may be expensed. However, if the asset produces benefits into the second taxable year following the year of acquisition, the cost of the asset must be recovered over time rather than expensed.

**22. The issue in the case was whether the transaction should be treated as an installment purchase of the sprinkler system or as a rental of the system. The parties agreed on the underlying facts and how both purchases and rentals are treated for tax purposes. So why was there a dispute? Who won the dispute? Why?**

Congress has deliberately allowed taxpayers to claim depreciation faster than an asset actually declines in value (with “bonus” depreciation, discussed below, as the extreme case). Accordingly, taxpayers generally will obtain better tax treatment if a transaction is treated as an installment purchase rather than as a lease. However, when the payments are front-loaded, allowing expensing of the nominal rental payments is preferable to depreciation, and that is what happened in this case.

The government won (the transaction should be taxed as a purchase).

The trial court concluded that the nominal lessor would have no economic incentive to remove the sprinkler system once the nominal lease expired, and so the lessee would in effect have obtained title to the sprinkler system.

**23. What is the meaning of the court’s final substantive paragraph?**

The court recognized that each side erred in its technical analysis. The government failed to separate out the implicit interest from the acquisition price. Because interest is deductible as it accrues, and because interest is greater in the earlier years than in the later years, moving some of the taxpayer’s cost from acquisition to interest has the effect of accelerating the taxpayer’s deductions. On the other hand, the taxpayer failed in its technical analysis by treating the nominal rent as deductible when paid even though under well-established tax principles the term of the nominal lease should be at least 10 years. Because the nominal rent was paid over five years, that means the rent for the final five years is prepaid, and prepaid rent constitutes an asset that must be recovered over time as it accrues.

**24. If we treat the transaction as an installment purchase and there was total interest paid of \$1,240 over 5 years, why is the first year’s interest component greater than one-fifth of \$1,240. Can you describe how the interest in the first year should be computed?**

We generally assume that the implicit interest on an installment purchase accrues at a constant rate. Given the amount paid over time (5 times \$1,240, or \$6,200) as well as the purchase price if paid in full at once (\$4,960), any financial calculator can determine the implicit interest rate. On these number, the implicit interest rate is just under 8%. Using 8% as the rate, the interest paid at the end of the first year should be 8% of the amount

borrowed of \$4,960, or about \$397. Note that one-fifth of the total interest is \$248, a much smaller amount.

**25. Some assets such as unimproved land (i.e., dirt) and common stock do not waste and so are not depreciable. Why don't these assets waste?**

The ability of land to produce income (i.e., rent) does not decline over time because generating rent in one year does not diminish its ability to produce rent in subsequent years and the mere passage of time should not affect the income-producing capability of the land. Similarly, the ability of a share of common stock to generate income in one year (such as appreciation in value or declaration of a dividend) does not diminish its ability to generate income in a subsequent year.

**26. Would you favor a set of business tax rates that varied by industry? What consequences likely will flow from such a set of tax rates in the short run? In the long run?**

Presumably not: having different effective tax rates for different industries would cause capital to flow into the low-taxed industries and out of the heavily-taxed industries. A tax system is considered *economically efficient* if it does not affect the investment decisions of taxpayers. That is, one goal of a good tax system generally is that investment decisions (necessarily based on relative after-tax returns, because that is what investors end up with) mirror the decisions that would be made in the absence of the tax system (i.e., based on before-tax returns). When effective tax returns vary significantly across industries, it sometimes is said that the tax system "is picking winners and losers."

**27. Suppose a lawyer spends a year at NYU getting an LLM in taxation. Is the cost of that education deductible under Reg. §1.162-5? What additional facts do you need to know?**

If the taxpayer was already in the trade or business of practicing law, then the cost of the LLM should be deductible under Reg. §1.162-5. However, if the taxpayer gets the LLM degree immediately following law school and was not practicing law during the summer between law school and the start of the LLM program, then the cost of the LLM will not be deductible under §1.162-5 because the education does not maintain or improve the taxpayer's skills used in [her] current trade or business.

**28. Should the cost of an MBA be deductible? What additional facts do you need to know?**

First, we need to know whether the taxpayer is carrying on a trade or business and, if so, whether the education received in pursuit of an MBA maintains or improves skills used by the taxpayer in her current trade or business. Second, we must determine whether the MBA qualifies the taxpayer for a new trade or business. Note that a business degree can be obtained both as a first college degree or as an advanced (MBA) degree. Note that obtaining an MBA does not entitle the taxpayer to any new form of business license. While not free from doubt, I think that an MBA does not qualify a taxpayer for a new trade or business if the taxpayer is currently working in a trade or business that demands business skills.

## Answers to Chapter 2 Problems

**1. X owns Greenacre with adjusted basis of \$500,000 and fair market value of \$800,000. Y owns Purpleacre with adjusted basis of \$200,000 and fair market value of \$600,000. X exchanges Greenacre for Purpleacre plus cash of \$200,000. How much gain does X realize on the exchange? How much gain does X recognize on the exchange? What is X's basis in Purpleacre?**

X realizes a gain of \$300,000 (amount realized of \$800,000 less adjusted basis of \$500,000), §1001(a), recognizes a gain of \$200,000, §1031(b), and takes a basis in Purpleacre of \$500,000 ( $\$500,000 - \$200,000 + \$200,000 - 0$ ), §1031(d).

**2. Reconsider problem 2-1 but assume that X receives \$200,000 in diamonds rather than cash. How do your answers change?**

No change (and X takes a basis in the diamonds of \$200,000, §1031(d)).

Realized gain again is \$300,000 and recognized gain is again \$200,000. Basis in the property received (Purpleacre and diamonds) =  $\$500,000 - \$0 + \$200,000 - 0 = \$700,000$ . That amount is first allocated to the diamonds in an amount equal to fair market value of \$200,000, leaving \$500,000 of basis for Purpleacre.

**3. Reconsider the facts of problem 2-1. How much gain does Y realize on the exchange? How much gain does Y recognize? What is Y's basis in Greenacre?**

The transaction is bifurcated into a pure like-kind exchange (Purpleacre for three-quarters of Greenacre) plus a purchase (\$200,000 in cash for one-quarter of Greenacre). Accordingly, Y realizes a gain of \$400,000, §1001(a), Y recognizes no gain, §1031(b), and Y takes a basis in Greenacre of \$400,000 (half carried over from Purpleacre and half from the cash).

**4. Reconsider the facts of problem 2-2. What are the tax consequences to Y, assuming Y's adjusted basis in the diamonds is \$170,000? Assuming Y's adjusted basis in the diamonds is \$210,000?**

Another bifurcated transaction. If Y's adjusted basis in the diamonds is \$170,000, then Y recognizes a gain on the diamonds of \$30,000, §1001(a); if Y's adjusted basis in the diamonds is \$210,000, then Y recognizes a loss of \$10,000 on the diamonds, §1001(a). On the exchange of real estate, Y realizes a gain of \$400,000, none of which is recognized. Y's basis in Greenacre is carryover plus gain or loss recognized on the diamond exchange, so basis in Greenacre is \$400,000 ( $\$370,000 + \$30,000$  or  $\$410,000 - \$10,000$ ).

**5. How do your answers to the questions in problem P-1 change if X's adjusted basis in Greenacre is \$710,000 rather than \$500,000?**

X realizes a gain of \$90,000, §1001(a); X recognizes a gain of \$90,000, §1031(b); X's basis in Purpleacre equals \$600,000, §1031(d).

**6. P owns Redacre with adjusted basis of \$500,000, fair market value of \$800,000, and encumbered by a debt of \$150,000. Q owns Blueacre with adjusted basis of \$200,000**

and fair market value of \$600,000. P exchanges Redacre for Blueacre plus cash of \$50,000, and Q takes Redacre subject to the existing liability. How much gain does P realize? How much gain does P recognize? What is P's basis in Blueacre?

P realizes a gain of \$300,000, §1001(a); P recognizes a gain of \$200,000, §1031(b) (release of debt treated as cash received); P's basis in Blueacre is \$500,000, §1031(d). This is the same as problem 1 above.

**7. Father owns stock with an adjusted basis of \$1,000. Father makes a gift of this stock to Daughter when it is worth the value specified in the first column of the chart below. Daughter subsequently sells the stock for the amount specified in the second column below. Compute the gain or loss to Daughter for each of the six possibilities, ignoring the possible application of the Kiddie Tax.**

Fair Market Value At Gift	Sale Price	Gain (Loss)
1500	1500	500
1500	1200	200
1500	900	(100)
900	1500	500
900	800	(100)
900	950	No gain, no loss

**8. In year 1, T incurs a deduction of \$100,000 in a year in which the taxpayer's gross income equals only \$80,000. Assume the excess deduction of \$20,000 does not contribute to a net operating loss under §172. In year 2, T recover \$45,000 of the prior deduction. In year 3, T recover \$50,000 of the deduction. How much income does T report in years 2 and 3 under the tax benefit rule?**

T reports income of \$25,000 in year 2 and \$50,000 in year 3.

**9. Suppose a taxpayer places \$110,000 of property in service at the start of the year and another \$100,000 at the end of the year. This will trigger the anti-backloading anti-abuse rule of §168(d)(3). Does that section operate as an anti-abuse rule on these facts?**

If there we no mid-quarter convention, then all \$210,000 of depreciable property would be treated as placed in service in the middle of the year. Treating all of the depreciation as allowable in the first two taxable year, the first-year depreciation would be \$210,000 times 0.5 or \$105,000.

Using the mid-quarter convention, the first-year depreciation would be \$110,000 times 10.5/12 plus \$100,000 times 1.5/12, or \$96,250 plus \$12,500, or \$108,750. Thus, application of the "anti-abuse" mid-quarter convention in fact increases the taxpayer's initial depreciation.