Chapter 3: Income

A. Noncash Benefits

"Gross income" is defined in §61, a provision you should read now. The definition may seem circular because "gross income" is defined in terms of "all income from whatever source derived." However, "gross income" is a defined term in the Internal Revenue Code while income as used in §61 refers to the same term in the 16th Amendment to the Constitution. Thus, §61 provides that Congress has determined to tax everything that constitutionally can be taxed, except as otherwise provided.

Recall the Haig-Simons definition of income: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and the end of the period in question." Note that this definition treats all accessions to wealth as income without regard to source (i.e., wages vs. gain from the sale of property) and without regard to form (i.e., interest paid in cash vs. increase in the value of land held for investment). While the full extent of this definition has never been considered practical, it tells us how we should measure income if possible.

1. Indirect or Unearned Benefits

Old Colony Trust Company v. Commissioner

279 U.S. 716 (1929)

Mr. Chief Justice Taft delivered the opinion of the Court.

. . . .

William M. Wood was president of the American Woolen Company during the years 1918, 1919 and 1920. In 1918 he received as salary and commissions from the company $ 978,725, which he included in his federal income tax return for 1918. In 1919 he received as salary and commissions from the company $ 548,132.27, which he included in his return for 1919.

August 3, 1916, the American Woolen Company had adopted the following resolution, which was in effect in 1919 and 1920:

> "Voted: That this company pay any and all income taxes, State and Federal, that may hereafter become due and payable upon the salaries of all the officers of the company, including the president, William M. Wood; the comptroller, Parry C. Wiggin; the auditor, George R. Lawton; and the following members of the staff, to wit: Frank H. Carpenter, Edwin L. Heath, Samuel R. Haines, and William M. Lasbury, to the end that said persons and officers shall receive their salaries or other compensation in full without deduction on account of income

> taxes, State or Federal, which taxes are to be paid out of the treasury of this corporation."

This resolution was amended on March 25, 1918, as follows:

> "Voted: That, in referring to the vote passed by this board on August 3, 1916, in reference to income taxes, State and Federal, payable upon the salaries or compensation of the officers and certain employees of this company, the method of computing said taxes shall be as follows, viz:
>
> 'The difference between what the total amount of his tax would be, including his income from all sources, and the amount of his tax when computed upon his income excluding such compensation or salaries paid by this company.'"

Pursuant to these resolutions, the American Woolen Company paid to the collector of internal revenue Mr. Wood's federal income and surtaxes due to salary and commissions paid him by the company, as follows:

Taxes for 1918 paid in 1919	$ 681,169.88
Taxes for 1919 paid in 1920	351,179.27

The decision of the Board of Tax Appeals here sought to be reviewed was that the income taxes of $ 681,169.88 and $ 351,179.27 paid by the American Woolen Company for Mr. Wood were additional income to him for the years 1919 and 1920.

The question certified by the Circuit Court of Appeals for answer by this Court is:

"Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?"

. . . .

Third. Coming now to the merits of this case, we think the question presented is whether a taxpayer, having induced a third person to pay his income tax or having acquiesced in such payment as made in discharge of an obligation to him, may avoid the making of a return thereof and the payment of a corresponding tax. We think he may not do so. The payment of the tax by the employers was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor. The form of the payment is expressly declared to make no difference. Section 213, Revenue Act of 1918, c. 18, 40 Stat. 1065. It is therefore immaterial that the taxes were directly paid over to the Government. The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed. The certificate shows that the taxes were imposed upon the employee, that the taxes were actually paid by the employer and that the employee entered upon his duties in the years in question under the express agreement that his income taxes would be paid by his employer. This is evidenced by the terms of the resolution passed August 3, 1916, more than one year prior to the year in which the taxes were imposed. The taxes were paid upon a valuable consideration, namely, the services rendered by the employee and as part

of the compensation therefor. We think therefore that the payment constituted income to the employee.

. . . .

Nor can it be argued that the payment of the tax . . . was a gift. The payment for services, even though entirely voluntary, was nevertheless compensation within the statute. . . .

It is next argued against the payment of this tax that if these payments by the employer constitute income to the employee, the employer will be called upon to pay the tax imposed upon this additional income, and that the payment of the additional tax will create further income which will in turn be subject to tax, with the result that there would be a tax upon a tax. This it is urged is the result of the Government's theory, when carried to its logical conclusion, and results in an absurdity which Congress could not have contemplated.

In the first place, no attempt has been made by the Treasury to collect further taxes, upon the theory that the payment of the additional taxes creates further income, and the question of a tax upon a tax was not before the Circuit Court of Appeals and has not been certified to this Court. We can settle questions of that sort when an attempt to impose a tax upon a tax is undertaken, but not now. . . . It is not, therefore, necessary to answer the argument based upon an algebrac formula to reach the amount of taxes due. The question in this case is, "Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?" The answer must be "Yes."

Note

1. *The Timing of Taxation*. Note that taxes on salary paid to an employee in 1918 are not due until April 15, 1919. If, on April 15, 1919, additional income is generated by the employer paying the employee's taxes, that will be treated as compensation income in 1919, and so taxes on this additional income will be due April 15, 1920.

Questions

Q-1. The Supreme Court held for the government. Why? If the case had been decided in favor of the taxpayer, can you see how that holding could be exploited?

Q-2. Why do you think the taxpayer's employer amended its resolution on March 15, 1918?

Q-3. Should a taxpayer have income if she directs her employer to send a portion of her salary to a specific charity?

Q-4. Suppose an employer promises to donate $1,000 to a charity named by an employee, although the employee has no right to receive the $1,000 herself. Is this income to the employee? Suppose the employer gave $1,000 to the employee's child without asking the employee? Income? To whom?

Q-5. Suppose the actor who portrays Ronald McDonald is charged with assault against a minor child. The McDonalds Corporation hires an expensive lawyer to defend the actor because it fears a conviction will hurt its business reputation. The lawyer properly treats the actor (and not the McDonald's Corporation) as her client. Does the actor have income equal to the fee paid to the lawyer? Income of some other amount? Suppose the McDonald's Corporation also hires a PR firm to minimize the fallout from the lawsuit. Does the actor have income on account of the hiring of the PR firm?

Commissioner v. Glenshaw Glass

348 U.S. 426 (1955)

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. . . . The common question is whether money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income . . . [T]he Court of Appeals affirmed the Tax Court's separate rulings in favor of the taxpayers. . . .

. . . .

It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by [§61(a)]?

The sweeping scope of the controverted statute is readily apparent:

. . . .

This Court has frequently stated that [the] language was used by Congress to exert in this field "the full measure of its taxing power." Respondents contend that punitive damages, characterized as "windfalls" flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee's improvements on the rented property was taxed in Helvering v. Bruun, 309 U.S. 461. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of [§61(a)], "gains or profits and income derived from any source whatever." The importance of that phrase has been too frequently recognized since its first appearance in the Revenue Act of 1913 to say now that it adds nothing to the meaning of "gross income."

Nor can we accept respondent's contention that a narrower reading of [§61(a)] is required by the Court's characterization of income in Eisner v. Macomber, 252 U.S. 189, 207, as "the gain derived from capital, from labor, or from both combined." The Court was there endeavoring to determine whether the distribution of a corporate

stock dividend constituted a realized gain to the shareholder, or changed "only the form, not the essence," of his capital investment. *Id.*, at 210. It was held that the taxpayer had "received nothing out of the company's assets for his separate use and benefit." *Id.*, at 211. The distribution, therefore, was held not a taxable event. In that context - distinguishing gain from capital - the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions.

Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion. The mere fact that the payments were extracted from the wrongdoers as punishment for unlawful conduct cannot detract from their character as taxable income to the recipients. Respondents concede, as they must, that the recoveries are taxable to the extent that they compensate for damages actually incurred. It would be an anomaly that could not be justified in the absence of clear congressional intent to say that a recovery for actual damages is taxable but not the additional amount extracted as punishment for the same conduct which caused the injury. And we find no such evidence of intent to exempt these payments.

It is urged that re-enactment of [the prior version of section §61(a)] without change since the Board of Tax Appeals held punitive damages nontaxable in Highland Farms Corp., 42 B. T. A. 1314, indicates congressional satisfaction with that holding. Re-enactment - particularly without the slightest affirmative indication that Congress ever had the Highland Farms decision before it - is an unreliable indicium at best. Moreover, the Commissioner promptly published his nonacquiescence in this portion of the Highland Farms holding and has, before and since, consistently maintained the position that these receipts are taxable. It therefore cannot be said with certitude that Congress intended to carve an exception out of [61(a)'s] pervasive coverage. Nor does the 1954 Code's legislative history, with its reiteration of the proposition that statutory gross income is "all-inclusive," give support to respondent's position. The definition of gross income has been simplified, but no effect upon its present broad scope was intended. Certainly punitive damages cannot reasonably be classified as gifts, nor do they come under any other exemption provision in the Code. We would do violence to the plain meaning of the statute and restrict a clear legislative attempt to bring the taxing power to bear upon all receipts constitutionally taxable were we to say that the payments in question here are not gross income.

Reversed.

MR. JUSTICE DOUGLAS dissents.

MR. JUSTICE HARLAN took no part in the consideration or decision of this case.

Notes

1. *The Court's Holding*. The Court in *Glenshaw Glass* rejected language in prior cases that seemed to limit gross income to (a) income from property and (b) compensation for labor. Saying the taxpayers in *Glenshaw Glass* recognized income because the recoveries were "undeniable accessions to wealth, clearly realized, . . . over which the taxpayers have

complete dominion," the Court made clear that it was the accession to wealth and not the source of the accession that is important.

2. *Unexpected Income.* Following *Glenshaw Glass*, someone who claims abandoned or lost property should have income. Similarly, someone who finds unexpected cash in a piano bought at auction must recognize income. And people who participate in barter clubs, exchanging assets or services for other assets or services must recognize income, Rev. Rul. 80-52, 1980-1 C.B. 100.[1]

Haverly v. United States

513 F.2d 227 (7th Cir. 1975))

HASTINGS, CIRCUIT JUDGE.
This case presents for resolution a single question of law which is of first impression: whether the value of unsolicited sample textbooks sent by publishers to a principal of a public elementary school, which he subsequently donated to the school's library and for which he claimed a charitable deduction, constitutes gross income to the principal within the meaning of Section 61 of the Internal Revenue Code of 1954, 26 U.S.C. § 61.

. . . .

During the years 1967 and 1968 Charles N. Haverly was the principal of the Alice L. Barnard Elementary School in Chicago, Illinois. In each of these years publishers sent to the taxpayer unsolicited sample copies of textbooks which had a total fair market value at the time of receipt of $400. The samples were given to taxpayer for his personal retention or for whatever disposition he wished to make. The samples were provided, in the hope of receiving favorable consideration, to give taxpayer an opportunity to examine the books and determine whether they were suitable for the instructional unit for which he was responsible. The publishers did not intend that the books serve as compensation.

In 1968 taxpayer donated the books to the Alice L. Barnard Elementary School Library. The parties agreed that the donation entitled the taxpayer to a charitable deduction under 26 U.S.C. § 170, in the amount of $400, the value of the books at the time of the contribution.

The parties further stipulated that the textbooks received from the publishers did not constitute gifts within the meaning of 26 U.S.C. § 102 since their transfer to the taxpayer did not proceed from a detached and disinterested generosity nor out of affection, respect, admiration, charity or like impulses.

Taxpayer's report of his 1968 income did not include the value of the textbooks received, but it did include a charitable deduction for the value of the books donated

[1] With an administrative exception for neighborhood babysitting trades and similar "informal exchanges on a noncommercial basis." Rev. Rul. 79-24, 1970-1 C.B. 60.

to the school library. The Internal Revenue Service assessed a deficiency against the taxpayer representing income taxes on the value of the textbooks received. Taxpayer paid the amount of the deficiency, filed a claim for refund and subsequently instituted this action to recover that amount.

The amount of income, if any, and the time of its receipt are not issues here since the parties stipulated that if the contested issue of law was decided in the taxpayer's favor, his taxable income for 1968 as determined by the Internal Revenue Service would be reduced by $400.00.

. . . .

The Supreme Court has frequently reiterated that it was the intention of Congress "to use the full measure of its taxing power" and "to tax all gains except those specifically exempted." James v. United States, 366 U.S. 213, 218-219 (1961). The Supreme Court has also held that the language of Section 61(a) encompasses all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." Id. at 219, 81 S.Ct. at 1055; Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955).

There are no reported cases which have applied these definitions of income to the question of the receipt of unsolicited samples. The parties have cited to the court a number of cases applying income definitions to other fact situations. We have considered these cases, but we find them of no particular assistance in resolving the question before us. In view of the comprehensive conception of income embodied in the statutory language and the Supreme Court's interpretation of that language, we conclude that when the intent to exercise complete dominion over unsolicited samples is demonstrated by donating those samples to a charitable institution and taking a tax deduction therefor, the value of the samples received constitutes gross income.

The receipt of textbooks is unquestionably an "accession to wealth." Taxpayer recognized the value of the books when he donated them and took a $400 deduction therefor. Possession of the books increased the taxpayer's wealth. Taxpayer's receipt and possession of the books indicate that the income was "clearly realized." Taxpayer admitted that the books were given to him for his personal retention or whatever disposition he saw fit to make of them. Although the receipt of unsolicited samples may sometimes raise the question of whether the taxpayer manifested an intent to accept the property or exercised "complete dominion" over it, there is no question that this element is satisfied by the unequivocal act of taking a charitable deduction for donation of the property.

The district court recognized that the act of claiming a charitable deduction does manifest an intent to accept the property as one's own. It nevertheless declined to label receipt of the property as income because it considered such an act indistinguishable from other acts unrelated to the tax laws which also evidence an intent to accept property as one's own, such as a school principal donating his sample

texts to the library without claiming a deduction. We need not resolve the question of the tax consequences of this and other hypothetical cases discussed by the district court and suggested by the taxpayer. To decide the case before us we need only hold, as we do, that when a tax deduction is taken for the donation of unsolicited samples the value of the samples received must be included in the taxpayer's gross income . . . .

In light of the foregoing, the judgment appealed from is reversed and the case is remanded to the district court with directions to enter judgment for the United States.

Note

1. *The timing issue*. The[2] taxpayer in *Haverly* received unsolicited books in 1967 and 1968 and transferred the books to charitable organizations in 1968. The court held that the taxpayer had income equal to the value of the books in 1968. Why in that year? If the taxpayer had read and enjoyed the books but never transferred them to a charity, would the taxpayer have income in any year? In what year?

2. Imputed Income

Suppose a taxpayer owns a rental house and uses the rental income to rent a similar house nearby. It is clear that the taxpayer (a) must treat the rent received as taxable income, §61(a)(5), (b) can treat the rental house as investment property as to which ordinary and necessary expenses can be claimed, §212(1)-(2), and as to which depreciation under §168 is allowable, §167(a)(2). Rent paid by the taxpayer for use of the taxpayer's personal residence is nondeductible because it is a personal (consumption) expense. §262.

How does the analysis change if the taxpayer elects to live in the house she owns (assume it is comparable to the house the taxpayer used to rent). If taxation should turn on the amount of a taxpayer's wealth and not on the form or source of that wealth, should the analysis change?

Commissioner v. Minzer

279 F.2d 338 (5th 1960)

JONES, CIRCUIT JUDGE.

. . . .

In 1954 the taxpayer was an insurance agent or broker. During that year he procured or kept in force policies of insurance upon his life. As a representative of the insurance companies which had issued the policies he became entitled to commissions on the policies to the same extent as though the insurance had been on the life of someone

[2] As discussed later in the course, the 2017 Tax Act eliminated deductions under §212 in a provision that sunsets in 2022. Until 2023, the ordinary and necessary expenses incurred in connection with investment activity (as opposed to activities constituting a trade or business) are nondeductible.

else. He received the commissions, or the benefit of them, upon these policies on his own life either by remitting the premiums, less commissions, to the companies, or by remitting the premiums in their entirety and receiving back from the companies their checks to him for the amounts of the commissions. The taxpayer did not include these commissions as taxable income in his return for 1954. . . .

. . . .

The contract between one of the insurance companies, Western States Life Insurance Company, is designated as an agency contract and the taxpayer is therein referred to as "the agent." The contract with the other company, Occidental Life Insurance Company, is called a brokerage agreement. In both contracts the taxpayer was authorized to solicit and submit applications for life insurance and in each contract the percentage of premiums which the taxpayer should receive as commissions was specified. The relationships created by the contracts were substantially the same. It does not seem to us that the tax incidence is dependent upon the tag with which the parties label the connection between them. The agent or broker, or by whatever name he be called, is to receive or retain a percentage of the premiums on policies procured by him, called commissions, as compensation for his service to the company in obtaining the particular business for it. The service rendered to the company, for which it was required to compensate him, was no different in kind or degree where the taxpayer submitted his own application than where he submitted the application of another. In each situation there was the same obligation of the company, the obligation to pay a commission for the production of business measured by a percentage of the premiums. In each situation the result was the same to the taxpayer. The taxpayer obtained insurance which the companies were prohibited by law from selling to him at any discount. 14 Vernon's Tex.Civ.Stat. Insurance Code, Art. 21.21. It cannot be said that the insurance had a value less than the amount of the premiums. It must then be said that a benefit inured to the taxpayer to the extent of his commissions. The benefit is neither diminished nor eliminated by referring, as does the Tax Court, to the word "commission" as a verbal trap. The commissions were, we conclude, compensation for services and as such were income within the meaning of § 61(a) (1).

. . . .

The Commissioner's position is sustained by precedent as well as upon principle and by administrative ruling. A case such as that before us has recently been decided by the Third Circuit with the result that commissions on insurance paid with respect to policies of the agent were held to be income taxable to him. Ostheimer v. United States, 3 Cir., 1959, 264 F.2d 789. We are in accord with that court's conclusions that the agent did not receive a bargain purchase and that the commissions were neither discounts nor rebates.

It is argued that the doctrine urged by the Commissioner represents an unprecedented extension of the concept of income as is found in Eisner v. Macomber, 252 U.S. 189. There taxable income was characterized as "the gain derived from capital, from labor, or from both combined." We cannot see that our decision in

any way expands the Eisner v. Macomber principle. On the contrary we think our determination is within it. But if the Eisner v. Macomber statement is regarded as a deterrent to the decision we have reached, we are taken from under its interdict by a later case from the Supreme Court where it is said that the phrase in Eisner v. Macomber "was not meant to provide a touchstone to all future gross income questions". Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426. See Commissioner of Internal Revenue v. LeBue, 351 U.S. 243..

It follows that the decision of the Tax Court must be and it is hereby

Reversed.

Question

Q-6. Suppose cases of soda sell at your local grocery store for $5.00 each or three for $12.00. If you purchase three cases for your family's eventual consumption, do you have income of $3.00? Suppose you pay for the purchase with a credit card that offers a 3% rebate on grocery store purchases. When you receive the rebate of $0.36, do you have income?

3. Fringe Benefits

The phrase "fringe benefit" can be used in two ways. First, it can mean any form of compensation for services paid other than in cash. In this sense, getting the use of a company car is a "fringe benefit." Second, "fringe benefit" can mean non-cash compensation that is excluded from gross income. We will look at three provisions that offer fringe benefits in this narrower sense: sections 119, 132, and 125.

a. Meals and Lodging: Section 119

Read §119. Is there a justification for excluding the value of meals and housing under any circumstances? Compare two taxpayers who otherwise are in similar positions. The first works and gets paid while the second does the same work, gets the same pay, and also gets free food and/or lodging. Which would you rather be? If they are not similarly situated, why are they taxed the same?

Silba v. Commissioner

611 F.2d 1260 426 (9th Cir. 1980)

CURTIS, DISTRICT JUDGE:

We have before us two appeals from decisions of the tax court upon nearly identical fact situations, the difference between them being of no relevance on this appeal. A single opinion therefore seems appropriate for the disposition of both.

These appeals involve an attempt by the taxpayers to deduct from their respective incomes their share of expenses of a mandatory organized mess at the firehouse where they were stationed. The tax court decided in favor of the taxpayers and the Commissioner has appealed.

The relevant facts are largely undisputed.

FACTS

During the relevant period the taxpayers were employed as firemen by the Los Angeles Fire Department and were assigned to Fire Station No. 89 in North Hollywood, California. They normally worked 24-hour shifts and were not permitted to leave the fire station on personal business while on duty.

In the late 1950's a desegregation plan was implemented by the Fire Department. Previously segregated posts were consolidated in order to eliminate segregation within a post. The Board of Fire Commissioners adopted rules requiring all firemen at each fire station to participate in a nonexclusionary organized mess at the station house, unless officially excused. The only recognized grounds for nonparticipation was a physical ailment verified by the city's own examining physician.

The Fire Department provided kitchen facilities, but the firemen themselves generally organized the activities themselves: they provided dishes and pots, purchased and prepared the food, assessed members for the cost of the meals and collected the assessments. Meal expenses averaged about $3.00 per man for each 24-hour shift which the taxpayers were required to pay even though they were at times away from the station on fire department business during the mess period.

In 1973, the appellant Sibla deducted his total payments for the year. The appellant Cooper deducted the amounts he had paid into the organized mess expense in the years 1972 and 1973. Both appellants claim the deduction as an ordinary and necessary business expense under section 162(a) of the Internal Revenue Code of 1954. In both cases the Commissioner disallowed the deduction as a non-deductible personal expense. The Commissioner was overruled, but by a divided court. The majority consisting of seven judges allowed the deduction under section 162(a). A concurring opinion written by Judge Simpson, although allowing the deduction, chose to do so under the provisions of section 119 and would have disallowed it under section 162(a). The concurring opinion was signed by five other judges, two judges dissented.

ISSUE ON APPEAL

The issue on appeal therefore is "whether the tax court erred in holding that taxpayer's share of the expenses of the organized mess at the firehouse was deductible under section 162(a) or section 119 of the Internal Revenue Code of 1954." We hold that such expenses are both deductible under section 162(a) and excludable under section 119.

BUSINESS EXPENSE DEDUCTION UNDER § 162

Section 162(a) provides a deduction for all the "ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business, . . ."

Section 262 of the Internal Revenue Code of 1954 provides: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

The Commissioner argues that an expense is "personal" rather than "business" if it is personal in character and could be incurred whether or not the taxpayer engaged in business activity. An expense for meals or groceries is generally considered a nondeductible personal expense. Here the taxpayer would have incurred a similar expense whether or not he ate at work. Consequently, the Commissioner contends the fact that the taxpayer incurred the expense while at work does not change the personal character of the expenditure.

In allowing the deduction, Judge Fay speaking for the majority observed initially that:

> "(M)any expenditures possess both personal and business attributes. In these situations placement of that often thin line which distinguishes a 'personal expense' from a 'business expense' depends primarily upon the facts and circumstances of each particular case. Cf. Robert J. Kowalski, 65 T.C. 44, 63 (1975) (Drennen, J., concurring and dissenting), Revd. 544 F.2d 686 (3d Cir. 1976). For example, Rev.Rul. 75-316, 1975-2 C.B. 54, provides in part as follows:
>
> 'The fact that a particular expense may under certain circumstances be a nondeductible personal expense does not preclude the deduction of such an expense as an ordinary and necessary business expense under other circumstances.' "

As the Tax Court has indicated, that which may be a personal expense under some circumstances can, when circumscribed by company regulations, directives, and conditions, lose its character as a personal expense and take on the color of a business expense. Recognizing the "unusual nature of petitioner's employment, the involuntary nature of the expense incurred, petitioner's limited ability to physically participate in the mess, and his employer's lack of intent to compensate or otherwise benefit petitioner for enacting the requirement, . . ." the court said, "upon consideration of the entire record, . . . we find that the amounts in issue constitute business expenses rather than personal expenses."

. . . .

Those judges who dissented from this view express the fear that, "If a deduction is allowed under section 162(a) for this personal expenditure, we may be launched down a slippery slope, and it may be difficult to find a rational basis for drawing a line in other cases involving personal expenditures." Although we recognize the court's concern, we do not consider the task so difficult as to justify abdicating what we believe is the court's duty to try to find the congressional intent in these complex statutes. The tax laws are shot through with instances in which courts are called upon to make delicate factual assessments and interpretive decisions in areas where rational distinctions are difficult to establish. And we think the task of doing so here is no greater than that often encountered by courts working in this field of the law.

. . . .

The concurring judges would allow such payment to be excluded from gross income under section 119. This section allows an employee to exclude the value of meals or lodging furnished him by his employer for the convenience of the employer. In summarizing the regulations section 1.119-1(a) (3), Income Tax Regulations, the court pointed out that employees are not taxable on amounts charged for meals if four conditions exist: (1) The meals are furnished by the employer, (2) there is a charge for the meals which must be paid irrespective of whether the employee chooses to eat the meals, and irrespective of how much he eats, (3) the meals are furnished for the convenience of the employer, and (4) the charge equals the value of the meals. From that the court reasons that while "(t)he employer did not purchase and supervise the preparation of the meals in this case and did not withhold the charge from the compensation paid the petitioner, . . . the employer furnished the facility for preparing the meals and required the employees to participate in the meals as a condition for their employment." The concurring court further pointed out:

> "There can be no question but that, if the meals were furnished in kind, they would qualify for the exclusion. During his tour of duty, the petitioner is not allowed to leave the fire station for personal purposes not allowed to leave to eat elsewhere; he must remain available at all times to respond to emergency calls. Such circumstances satisfy the requirements concerning meals furnished for the convenience of the employer. Sec. 1.119-1(a) (2) (ii) (a), Income Tax Regs."

The court concludes, "In substance, there is no difference between this situation and the typical situation in which the employer directs the preparation of the meals."

We agree, especially in the light of other similarities appearing in the record.

Admittedly, the record is sketchy, but it appears that meals are actually provided by the cook, in the sense that he selects the menus, supervises the purchase of the groceries, and cooks and serves the meals. The cook is appointed by the Fire Chief or the highest ranking officer at the station, presumably by some direction or authority from the employer. The money is collected by one "delegated by the chief." There is no evidence that the cook receives extra pay for his work, but it appears almost certain that he would be relieved of other duties in exchange for his culinary activities, from which it may well be argued that he is compensated by the employer. And the plan, whereby the meals are furnished, has been established by the management.

Relying upon these facts, a strong argument could have been made that the meals were in fact "furnished in kind" by the employer. The Tax Court found otherwise and we are of course bound by that ruling, nor are we critical of the tax court for so finding, for the evidence is ample to support it. We simply refer to these facts to show the faint line of difference between the two concepts. We think it too slender a reed upon which to hang tax liability.

The Commissioner places heavy reliance upon Commissioner v. Kowalski, 434 U.S. 77, 98 S. Ct. 315, 54 L. Ed. 2d 252 (1977), in which the Supreme Court held that "cash meal allowances" were not excludable under section [119]. In *Kowalski*, state police troopers employed by the state of New Jersey had included in their gross pay a cash meal allowance. Although the troopers were required to remain on call in their assigned patrol areas during their midshift break, they were not required to eat lunch at any particular location and, indeed, many ate at home. Nor were they required to spend the meal allowance on food. . . .The Supreme Court held that cash meal allowance payments were not excludable under section 119, since they are funds over which the taxpayer has complete dominion and they are not meals "furnished by the employer."

Kowalski is of course distinguishable upon the facts. The state troopers could eat any place they wanted, and they had complete dominion over their cash allowances and could spend it as they pleased. In the case before us the fire fighters were required to eat their meals on the employer's premises, and were required to pay for them whether they ate them or not.

The language in the *Kowalski* opinion however presents a more difficult problem. In interpreting section 119, the Court would allow deductions for meals "furnished by the employer in kind" but would disallow the deductions for "cash advances for food." It seems clear throughout the opinion and in the cases the Court discusses that the concept of "cash allowances" assumes an allowance over which the taxpayer has complete dominion. That is, he may eat as little or as much as he wants, or not at all if he wishes, and he may spend any unused portion any way he desires. We do not believe that the Court intended to rule that an allowance otherwise excludable should be denied excludability simply because it was paid in cash. We think the true holding of *Kowalski* can best be demonstrated by the following example. Let us assume that the taxpayers were given scrip for the purpose of paying for their meals. If the scrip were redeemable at any eating establishment in the vicinity or could be exchanged for cash at a bank or elsewhere, there is little doubt in the *Kowalski* factual setting but that the Court would have reached the same result. However, if the scrip were issued in the precise amount of the meal assessment; was redeemable only at the mess; and had to be surrendered whether the fireman ate or not, such an allowance in our view whether paid in scrip or cash would be deductible and we do not read *Kowalski* to the contrary.

In the light of all the circumstances in this case, the meals in question in a very real sense were "furnished in kind by the employer" upon the "business property" by means of a device conceived and established by the employer for its convenience. This being so, the taxpayers should be permitted to exclude from their gross income under the provisions of section 119 the value of these meals notwithstanding the fact that cash has been used as a simple method of implementing the plan.

We hold therefore that taxpayers may elect either to deduct the mess fees under section 162(a) or to exclude them from income under section 119.

We therefore affirm.

[KENNEDY, CIRCUIT JUDGE, dissented.]

Notes

1. *The* Kowalski d*ecision.* In *Kowalski*, state police troopers were given a cash allowance for meals and sought to exclude the allowance from gross income under §119. Putting aside some of the technical details (did they eat "on the business premises"?), the Court held that statutory exclusion is limited to the value of meals received in kind and not money used to pay for meals. How can *Silba* be distinguished?

2. *The* Silba d*ecision.* It is common for courts to distinguish between mere possession and ownership. For a taxpayer to own an asset (including cash), the taxpayer must have the customary benefits and burdens of ownership. The benefits include, among other things, discretion on how the asset will be deployed in the future. For example, if an employer advances funds to an employee to purchase assets needed in the business, the employee has no income but is a mere conduit for the transfer of funds from the employer to the seller of the assets.

In *Silba*, the taxpayer's right to receive cash reimbursement from his employer was conditioned on the taxpayer purchasing groceries; that is, the cash was a mere reimbursement of the grocery cost. As in the example above, Silba was a mere conduit for the transfer of funds from the employer to the grocery seller. To be sure, the order of purchase and funds transfer were reversed in *Silba*, but should that make a difference?

3. *The technical Issues.* Section 119 imposes a two-part test on exclusion of meals: they must be provided "for the convenience of the employer" and must be provided "on the business premises." For exclusion of employer-provided housing a third requirement is added: use of company housing must be required of the employee as a condition of employment.

The regulations tell us that meals or housing are furnished "for the convenience of the employer" if provided for a "substantial noncompensatory business reason." Such reasons include the inability of the employer to provide security for employees who eat off the business premises as well as a desire by the employer to keep the employee on the premises in case emergencies arise that require the employee's attention. Reg. §1.119-1(a)(2)(ii)(b)-(e).

"Business premises" means the "place of employment of the employee." Reg. §1.119-2(c). In particular, not every facility owned by the employer constitutes the "business premise" for particular employees. Is university housing provided to the university president located on the business premises? The answer surely is yes, and Congress ultimately codified that answer so long as adequate rent is paid. See §119(d). If adequate rent is paid, is there a need for an exclusion provision?

4. *Is valuation the Issue?* Section 119 largely is a codification of Benaglia v. Commissioner, 36 B.T.A. 838 (1937), acq. 1940-1 C.B. 1. In *Benaglia*, the taxpayer was the resident manager of two luxurious Hawaiian hotels. To ensure that the taxpayer was available to hotel guests around the clock, he received in addition to his salary free meals at the hotel restaurants and use of a hotel room (for himself and his wife) at no cost. The government sought to impose taxation equal to the retail value of the food eaten and the room used. The court held for the taxpayer.

The basis for the taxpayer's victory in *Benaglia* was the court's conclusion that "the petitioner's residence at the hotel was not by way of compensation for his services, not for his personal convenience, comfort or pleasure, but solely because he could not otherwise perform the services required of him." But Judge Arnold in dissent wrote: "Conceding that petitioner was required to live at the hotel and that his living there was solely for the convenience of his employer, it does not follow that he was not benefitted thereby to the extent of what such accommodations were reasonably worth to him." If Judge Arnold's observation is correct, how is the court supposed to determine what the accommodations were worth *to him*?

When a service provider such as Benaglia is paid in cash, there is no question as to the value of the taxpayer's compensation: a dollar is worth a dollar. But when the service provider is paid in kind, we lack a market transaction that gives us the subjective valuation that the service provider places on the compensation. Consider Benaglia: what if he had been diabetic so that eating in the hotel restaurant was a constant challenge? Or suppose because of a back injury he needed to sleep on a rigid surface and so slept on the floor? For hotel guests who can elect to go elsewhere, presumably the value of room and board at the hotel to them is at least equal to its cost. But for Benaglia who had no choice, we really have no way of determining its value *to him*? Should we ask him?

Regulations have long provided that if compensation is paid other than in cash, the amount of income equals the fair market value of the property or services received. Reg. §1.61-2(d)(1). In Benaglia's case, that would mean he would have had to include what hotel guests paid for the room and board he received. Is that the proper measure of his income if, say, the room and board had not been provided for the convenience of his employer? Suppose, for example, that as Benaglia and his employer had been negotiating his compensation package, the employer had offered to provide either room and board at the employer's cost or the same amount of cash. If Benaglia then accepted the room and board, do we know what it is worth to him? Do we know it is worth the full retail price?

b. Section 132

Section 132(a) excludes from a service provider's gross income a variety of fringe benefits, where the definition of those fringe benefits is provided in §132(b)-(m). Unlike §119, the exclusions provided by §132 are not conditional on the covered fringe benefit being provided "for the convenience of the employer. That is, §132 excludes fringe benefits that can be – and almost always are – provided as a form of compensation.

i. No Additional Cost Service

Let us start with the "no additional cost service" fringe benefit excluded by §132(a)(1) and defined in §132(b). Note that such a fringe benefit is excludible only when provided by an employer to an employee, although the term "employee" is broadened considerably in §132(h) to include certain former employees and certain members of an employee's family. This fringe benefit is further extended in §132(i). One important "no additional cost service" is free travel provided to airline employees. Once you have read §132(b), (h) and (i), answer the following questions:

Questions

Q-7. Can an airline employee exclude the value of a free first-class ticket on her employer's airline, assuming the ticket otherwise would have gone unsold?

Q-8. Can an airline employee exclude the value of a free ticket assuming a customer would have purchased the ticket if it had not been given to the employee?

Q-9. Can an airline employee exclude the value of a free stand-by ticket even if the government can show that if the ticket had not been given to the employee for free, the employee would have purchased it at retail?

Q-10. Can an employee of Delta airline exclude the value of a free stand-by ticket on United Airlines, assuming the two companies have agreed to offer stand-by tickets to their own employees and to the employees of the other airline?

Q-11. Can an employee of Virgin Galactic exclude the value of a free stand-by ticket on Virgin Air, assuming the two companies are affiliated corporations with common ownership?

Q-12. Can you think of a justification for the exclusion provided by §132(a)(1)? Is it all about valuation difficulties?

ii. Qualified Employee Discount

Now look at the exclusion in §132(a)(2) for a qualified employee discount as defined in §132(c). Under §132(c)(1)(A), the maximum excludible discount is based on the employer's gross profit percentage (as defined in §132(c)(1)(B)). For services, the maximum excludible amount is 20% of the sale price.

Questions

Q-13. Suppose an employer gives a discount to an employee in excess of the maximum allowable under §132(c) (such as a 25% discount when the maximum is 20%). Is the employee taxed on the total discount or only on the excess over the maximum excludible discount?

Q-14. Because a qualified employee discount can include a discounted price for services, there is a potential overlap between §§132(a)(1) and (a)(2). If an employer sells to an employee a no additional cost service to an employee for 50% of the retail price at which the service is sold to the general public, what are the tax consequences to the employee?

iii. Working Condition Fringe Benefit

Another important exclusion provided by §132 is a "working condition" fringe benefit in §132(a)(4) as defined in §132(d). If an employer provides something of value to an employee the cost of which would be deductible under §162 if paid for by the employee (or depreciable by the employee under §167), then the employee can exclude the value of the benefit (and necessarily loses the deduction under §162 or §167). This would cover, for example, use of an office chair, desk and computer provided by an employer to an

employee. We will see that there are significant limitations imposed on business deductions of employees, but these limitations play no role in the context of working condition fringe benefits because the test is not whether the cost would be deductible on the employee's return but only if the cost would be described in §162 or 167 if paid by the employee.

iv. De Minimis Fringe [Benefit]

A "de minimis" fringe benefit under §132(a)(4) is defined in §132(e) as "any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable." Note the special rule for employer-provided employee eating facilities so long as revenues of the facility generally cover its operating costs.

Question

Q-15. Consider whether the following can qualify as de minimis fringe benefits: (a) the cost of a taxi or Uber provided to associates at a law firm if they work past 10:00pm; (b) the cost of dinner provided to associates at a law firm if they work through dinner; (c) the cost of meals provided by a restaurant to its employees when they work through a meal, eaten immediately prior to the employee's shift or immediately afterward; or (4) free use of the Dean's parking space for one month to a law school's professor voted professor of the year by the student body, assuming the usual rental cost of the parking spot is $3600 per year.

v. Preemption

Read §132(*l*) closely. Note that it does not say that §132 is preempted if another Code provision covers a particular non-cash compensation. Rather, it says that §132 is preempted if a particular type of non-cash compensation is "of a type" covered by some other section. For example, an employee of a college or university (or a family member of such an employee) can exclude the value of a tuition reduction program under §117(d) provided the education is below the graduate level. Can this be extended to free graduate education under §132(a)(1) as a no additional cost fringe benefit? No.

c. Section 125: Cafeteria Plans

Employees like excludible fringe benefits but they don't like the lack of choice associated with them. Cafeteria Plans as described in §125 allow employees to pick and choose their fringe benefits. Employers are permitted to offer a menu of fringe benefits as described in §132 and similar provisions, see §125(f), and each employee can elect how much of the various benefits the employee desires to receive. In essence, the employer offers each employee a sum of money that can be spent among the fringe benefits the employer offers under the cafeteria plan. Note that if we think the principle justification for exclusion of fringe benefits is the problem of subjective valuation, that problem largely evaporates in the context of cafeteria plans.

4. Economic Effects

If one form of income is taxed less harshly than others, astute taxpayers will structure their affairs so as to maximize their receipt of such tax-preferred income. So, for example, if an employer can provide on-site parking as a tax-free benefit but cannot offer to subsidize bus passes without income recognition by the employee, we should expect to see more employee parking (and so more car transportation) and relatively less bus ridership.[3]

In addition to skewing behavior (including investment behavior), inconsistent taxation can create the problem of social *dead-weight loss*. For example, suppose an employer can provide medical coverage to the employer's workers. Suppose further than the monthly cost of the medical coverage is $1,000 per month, and assume that for some workers, the value of the coverage is only $850; that is, they would not purchase the coverage with their own funds if the cost exceeded $850. In the absence of an income tax, such a worker would prefer to receive $1,000 in cash to receiving the medical coverage. In the presence of an income tax, the worker's choice would be unchanged if both the cash compensation and the cost of the medical coverage were taxed equivalently. But if cash is taxable and but the medical coverage is not, then the worker will prefer the medical coverage to an additional cash compensation so long as the worker's marginal tax rate exceeds 15%. For example, if the worker's marginal tax rate equals 20%, the after-tax value of the taxable cash compensation is $800 per month while the after-tax value of the medical coverage is $850 per month. In either case, the employer spends $1,000 per month. In the case of the cash compensation, $800 in value goes to the worker and $200 goes to the government. In the cash of the medical coverage, the same $1,000 is spent, and while the worker gets $850 in value, the remaining value of $150 simply disappears. This loss of value is called a *dead-weight loss*.

B. Loans and Discharge of Indebtedness

Loan proceeds are not income to the borrower. Why? Assuming the loan must be repaid with fair interest, the immediate value of the loan proceeds should be offset by the present value of the future obligation to repay. Accordingly, loan proceeds (assuming fair interest must be paid on the borrowed funds) are not an accession to wealth.

Loan proceeds could be taxed on receipt and then principal payments deducted when made. With very limited exceptions, we have never adopted such a system. If, though, repayment is uncertain, immediate taxation might be a superior system of taxation.

[3] Section 132(f) defines a class of qualified transportation fringe benefits the value of which can be excluded by the employee. Qualification transportation fringe benefits include certain transit passes and bicycle commuting reimbursements, see §132(f)(1).

However, because virtually all loans are repaid, our income tax properly has ignored both borrowing and repayment transactions,

1. True Discharge

United States v. Kirby Lumber Co.

284 U.S. 1 (1931)

MR. JUSTICE HOLMES delivered the opinion of the court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year, it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. By the Revenue Act of (November 23) 1921, c. 136, § 213(a), gross income includes "gains or profits and income derived from any source whatever," and, by the Treasury Regulations authorized by § 1303, that have been in force through repeated reenactments,

> "If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year."

We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers v. Kerbaugh-Empire Co.,* 271 U. S. 170, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment, the marks had fallen in value, which, so far as it went, was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here, there was no shrinkage of assets, and the taxpayer made a clear gain. As a result of its dealings, it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.

Judgment reversed.

Commissioner v. Rail Joint Co.

61 F.2d 751 (2d Cir. 1932)

SWAN, CIRCUIT JUDGE.

In 1914 the taxpayer, a New York corporation, approved an appraisal of its assets which added $3,000,000 to its surplus account. It then declared a dividend payable in

bonds, and issued and distributed among its stockholders its own debenture bonds of a face value of $2,000,000. During the taxable years 1926 and 1927, some of these unmatured bonds were purchased by the corporation at less than their face value. The bonds so purchased were canceled, and the difference between the purchase price and the face value was credited to surplus. The question presented is whether the corporation realized a taxable gain in the amount of such difference in the years when the bonds were purchased and retired. The Board of Tax Appeals ruled that it did not. We are asked to reverse on the authority of United States v. Kirby Lumber Co., 284 U.S. 1, an opinion handed down subsequent to the Board's decision.

In the *Kirby* Case a corporation issued its bonds at par and later in the same year repurchased some of them at less than par. It was held that the sum thus saved was taxable income. The taxpayer's assets were increased by the cash received for the bonds, and, when the bonds were paid off for less than the sum received, it is clear that the taxpayer obtained a net gain in assets from the transaction. The cost of the money acquired by issuing the bond was decreased when the bond was retired at less than the issuing price. In other words, the consideration received for the obligation evidenced by the bond as well as the consideration paid to satisfy that obligation must be looked to in order to determine whether gain or loss is realized when the transaction is closed; i. e., when the bond is retired. This is recognized by the Regulations which the *Kirby* opinion held valid.

But that decision is not applicable to the facts of the case at bar. In paying dividends to shareholders, the corporation does not buy property from them. Here the respondent never received any increment to its assets, either at the time the bonds were delivered or at the time they were retired. They were issued against a surplus created by reappraising assets already owned; and no one suggests that in writing up the book value of property which had appreciated the corporation received anything. The bonds were merely a way of distributing a part of such surplus among shareholders. When certain of the bonds were retired at less than par, all that happened was that the corporation retained a part of the surplus it had expected to distribute, because it paid those shareholders whose bonds were redeemed at a discount, less than it had promised to pay them. Hence it is apparent that the corporation received no asset which it did not possess prior to the opening and closing of the bond transaction, and it is impossible to see wherein it has realized any taxable income. In such circumstances the *Kirby* Case cannot be regarded as controlling.

It is true that the purchase and retirement of the bonds in the two years in question resulted in decreasing the corporation's liabilities without a corresponding decrease in its assets, and the petitioner contends that the difference should be deemed income within the meaning of section 213 of the Revenue Act of 1926. But it is not universally true that by discharging a liability for less than its face the debtor necessarily receives a taxable gain. This may be demonstrated by a simple illustration: Suppose that a taxpayer validly contracts in 1930 to give $1,000 to a charity in 1931, and in the latter year compromises the obligation by paying $500 in full settlement. If the taxpayer returns his income on a cash basis, this transaction cannot possibly increase his income. The giving of the obligation certainly added nothing to income in 1930, and the payment of it in 1931 will appear only as a deduction of the sum actually paid in

that year to the use of a charitable corporation. If he were to report on an accrual basis and were allowed to deduct from gross income for 1930 the $1,000 liability incurred in that year, then it might be said that the settlement of the liability in 1931 for a less sum had released the difference to general uses of the taxpayer and the sum so released should appear as income then received in order that the returns for both years might truly reflect the effect of the whole transaction upon the net income. . . . But these authorities are inapplicable to the case at bar, for the dividend obligation evidenced by the bonds was not a liability deductible from gross income. Here neither the amount written up to surplus nor the bonds issued against it had ever been deducted from gross income for taxation purposes. Hence the entries in the surplus account are only bookkeeping entries, and do not reflect a realized taxable gain.

The order is affirmed.

Notes

1. *The* Kirby Lumber *transaction*. In *Kirby Lumber*, the corporate taxpayer issued bonds for $12,126,800 which is just a fancy way of saying that the taxpayer borrowed $12,126,800, and the bonds it issued were the pieces of paper representing the taxpayer's obligation to repay that borrowing along with whatever rate of interest was agreed upon between the taxpayer and its lender (or lenders). Corporate bonds usually can be bought and sold until the bonds are retired by the issuing corporation, and the price at which they trade can fluctuate over time.

Why does the price of a corporation's debt instrument fluctuate? The two principle reasons are (a) changes in market interest rates and (2) changes in the issuer's credit rating. Suppose bonds are issued paying 5% per year in interest at a time when that is the market rate of interest for the issuer. If market interest rates go down, the value of the corporate bonds will increase. For example, if market interest rates decline to 4%, a bond paying 5% will yield a greater return than newly-issued bonds paying 4%, and investors accordingly will be willing to pay a premium to obtain that greater annual return. To take an extreme example, if a bond pays 5% annually forever and interest rates drop to 4%, then the value of a $1,000 bond paying 5% will increase from $1,000 to $1,250 because $1,250 invested at 4% yields $50 per year in interest, and that is what the older bond pays. Of course, if market interest rates increase, the value of outstanding bonds will decline because investors will demand a discount to invest in below-market returns.

Even if market interest rates do not change, the appropriate interest rate for the particular bond issuer may change. The rate of interest that a borrower must pay should equal the risk-free rate of interest plus a risk-premium based on the possibility that the borrower will be unwilling or unable to pay some or all of the principle or interest due on the loan. A particular borrower's risk premium will fluctuate over time as the borrower's ability to repay the loan become more or less certain.

A good proxy for the risk-free rate of return is the interest rate on debt issued by the United States government because such debt is considered to be almost risk-free. It is worth mentioning that even government debt instruments generally pay a higher rate of interest if they will remain outstanding for a longer period of time: that is, the risk-free

rate of return increases with the investment horizon. This arises because many investors are risk-averse (that is, the premium they demand to invest in risky assets increases as the risk increases), and future predictions become less certain as the events upon which they are based become more uncertain.

2. *The* Kirby Lumber *rationale*. *Kirby Lumber* is another of Justice Holmes's foundational tax options, and its conclusion is clear: the taxpayer was able to purchase its outstanding debt instruments in the market for $137,521.30 less than it borrowed, and this difference is taxable income to the borrower, a result now codified in §61(a)(11). But the justification for this conclusion is less clear, and two alternate theories have developed, (a) the "freeing of assets theory and (b) the "now for then" theory.

Under the freeing of assets theory, the borrower has income as a result of acquiring its debt for less than the principle value of the debt obligation because the transactions frees some of its assets for general use. That is, if a debt of $1,000,000 is outstanding, the borrower must commit assets of $1,000,000 to repayment. But if that debt can be reacquired for, say, $850,000, then $150,000 of assets reserved for repayment are now free for other uses. Note, though, that borrowers rarely have assets "reserved" for repayment in any meaningful sense and, even if they do, this theory does not identify the accession to wealth that justifies taxation.

The "now for then" theory is used in the *Rail Joint Co*. case to permit the corporate taxpayer to avoid recognition of income when it repurchases its debt instruments in the market for less than principle value. In *Rail Joint Co.*, the bonds were not issued in exchange for loan proceeds but rather were distributed by the corporation to its shareholders as a dividend. That means that the issuer of the bonds received nothing in exchange when they were issued.

The court understood the *Kirby Lumber* case as standing for the proposition that loan proceeds are not income when received *because of the offsetting obligation to repay*. But when that offsetting obligation disappears (to some extent), the borrower is taxed now because of the loan proceeds received in the past. That is, had we known when the proceeds were received that they would not be fully repaid, we would have imposed taxation then on the excess of what was received over what would be repaid. Of course, we don't know that will be true until the borrower acquires its debt instrument in the market for less than the its principle value, and at that point we impose taxation on the excess amount received in the past: we treat the taxpayer as having income now because of the excess debt received proceeds back then.

Questions

Q-16. A doctor is sued for malpractice and a judgement for $1,000,000 is rendered against the doctor. The amount is never collected and the debt ultimately is discharged by reason of a statute of limitations. Does the doctor have income as a result of the discharge?

Q-17. A doctor is sued for malpractice and a judgement for $1,000,000 is rendered against him. The doctor appeals, and while the appeal is pending, the case is settled with a payment of $650,000. Does the doctor have income of $350,000?

Q-18. As part of a divorce, ex-wife is ordered to pay child support of $2,000 per month to ex-husband for a period of five years. The child support is never paid and the obligation ultimately is determined to be worthless. Does ex-wife have income? You can assume that child support payments are not deductible by the payor nor includible in income by the recipient.

Notes

1. *Section 108*. Debts often are cancelled when the borrower is insolvent or in bankruptcy. As a practical matter, it can be difficult to collect taxes from an insolvent taxpayer especially when – as in the case of *Kirby Lumber* income – the taxable event is not a receipt but a payment. Congress has provided a comprehensive statute dealing with income from the cancellation of indebtedness and its deferral (or exemption).

Section 108(a)(1) excludes from gross income any income from the cancellation of indebtedness if it occurs in a title 11 case (title 11 of the United States Code sets forth the federal rules of bankruptcy). Note that for this provision to apply, the taxpayer must be under the jurisdiction of the bankruptcy court at the time of the discharge. §108(d)(2).

To the extent a taxpayer excludes income from the cancellation of indebtedness by reason of §108(a)(1), the taxpayer loses favorable tax attributes. §108(b)(1). The effect of this loss of tax attributes is to increase the amount of taxable income the taxpayer will report in the future, thereby converting the exclusion of §108(a)(1) into a deferral provision. However, if the taxpayer lacks favorable tax attributes sufficient to fully pay for the exclusion in §108(a)(1), the exclusion still applies so that it can operate as an exemption provision as well as a deferral provision. The favorable tax attributes that can be lost are listed in §108(b)(2), and for taxpayers who have many of them, they generally are lost in the order listed, *id*. (initial flush language). While loss of adjusted basis is the fifth tax attribute lost, a taxpayer may elect to make it the first attribute lost.[4] Note that deductions are lost on a dollar-for-dollar basis with the exclusion while tax credits are lost on a one-for-three basis (based on a tacit assumption that the taxpayer is in the 33.3% tax bracket). §108(b)(3).

For taxpayers who are insolvent but not under the jurisdiction of a bankruptcy court, exclusion is still available but is limited. Section 108(a)(1)(B) provides the exclusion, but the exclusion is limited to the amount of the taxpayer's insolvency. §108(a)(2)(B). "Insolvency" is defined in §108(d)(3) to mean the excess of liabilities over the fair market value of assets. So, for example, if a taxpayer has assets worth $800,000 and liabilities of $1,000,000, and if the lender agrees to reduce the debt to $750,000 (giving the taxpayer $50,000 of breathing room), the taxpayer has $250,000 of income from the cancellation

[4] When adjusted basis is lost, the basis reduction is allocated among the taxpayer's assets under rules provided in §1017.

of indebtedness of which only $200,000 is excluded by §108(a)(1)(B). And to the extent of the excluded amount, the taxpayer must relinquish favorable tax attributes.

While §§108(a)(1)(A) and 108(a)(1)(B) exclude income based on the financial status of the taxpayer, §§108(1)(C) – 108(a)(1)(E) exclude income based on the use to which the loan proceeds were put. We will not cover §§108(a)(1)(C) – 108(a)(1)(E): their terms are idiosyncratic and the justification for their existence hard to find.

Section 108(e) provides operating rules for the application of §108. Look first at §108(e)(2). Why should the discharge of a deductible liability be excluded from the rule of *Kirby Lumber*? It is similar to the rule excluding working condition fringe benefits in §§132(a)(4) and 132(d): in theory, we would impute both the income (under *Kirby Lumber*) and then the deduction (under *Old Colony*), and because they would offset, there is no reason to impute either. To see this more clearly, suppose the taxpayer borrowed from a bank to repay the deductible liability and then was unable to repay the (nondeductible) loan from the bank: offsetting deduction and income.

Section 108(e)(5) provides a different exception to *Kirby Lumber*. Consider the following: you purchase a new television from Best Buy for $600, charging the cost on your Best Buy credit card. When you take it home and turn it on, you see a commercial from Walmart offering the same television for $500. You return to Best Buy and under its price match guarantee, your debt is reduced to $500. Should you have income because of the price reduction?

Questions

Q-19. In the Best Buy hypothetical above, what if you purchased the television on your VISA card and then Best Buy submitted a $100 refund to VISA?

Q-20. Suppose you hire a plumber to fix a leak, and you pay the plumber $500 for the work. But the leak continues, you complain to the plumber, and she reduces her fee to $100. Do you have $400 of income? Does §108(e)(5) apply? Could a court extend §108(e)(5) to services? Consider §108(e)(1).

2. Medium of Payment

Diedrich v. Commissioner

457 U.S. 191 (1982)

CHIEF JUSTICE BURGER delivered the opinion of the Court.

We granted certiorari to resolve a Circuit conflict as to whether a donor who makes a gift of property on condition that the donee pay the resulting gift tax receives taxable income to the extent that the gift tax paid by the donee exceeds the donor's adjusted basis in the property transferred. 454 U. S. 813 (1981). The United States Court of Appeals for the Eighth Circuit held that the donor realized income. 643 F. 2d 499 (1981). We affirm.

I

A

In 1972 petitioners Victor and Frances Diedrich made gifts of approximately 85,000 shares of stock to their three children, using both a direct transfer and a trust arrangement. The gifts were subject to a condition that the donees pay the resulting federal and state gift taxes. There is no dispute concerning the amount of the gift tax paid by the donees. The donors' basis in the transferred stock was [$51,000]; the gift tax paid in 1972 by the donees was [$60,000]. Petitioners did not include as income on their 1972 federal income tax returns any portion of the gift tax paid by the donees. After an audit the Commissioner of Internal Revenue determined that petitioners had realized income to the extent that the gift tax owed by petitioners but paid by the donees exceeded the donors' basis in the property. Accordingly, petitioners' taxable income for 1972 was increased by [$9,000]. . . .

II

A

Pursuant to its constitutional authority, Congress has defined "gross income" as income "from whatever source derived," including "[i]ncome from discharge of indebtedness." 26 U. S. C. § 61 (12). This Court has recognized that "income" may be realized by a variety of indirect means. In *Old Colony Trust Co.* v.*Commissioner,* 279 U. S. 716 (1929), the Court held that payment of an employee's income taxes by an employer constituted income to the employee. Speaking for the Court, Chief Justice Taft concluded that "[t]he payment of the tax by the employe[r] was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor." *Id.,* at 729. The Court made clear that the substance, not the form, of the agreed transaction controls. "The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Ibid.* The employee, in other words, was placed in a better position as a result of the employer's discharge of the employee's legal obligation to pay the income taxes; the employee thus received a gain subject to income tax.

The holding in *Old Colony* was reaffirmed in *Crane* v. *Commissioner,* 331 U. S. 1 (1947). In *Crane* the Court concluded that relief from the obligation of a nonrecourse mortgage in which the value of the property exceeded the value of the mortgage constituted income to the taxpayer. The taxpayer in *Crane* acquired depreciable property, an apartment building, subject to an unassumed mortgage. The taxpayer later sold the apartment building, which was still subject to the nonrecourse mortgage, for cash plus the buyer's assumption 196*196 of the mortgage. This Court held that the amount of the mortgage was properly included in the amount realized on the sale, noting that if the taxpayer transfers subject to the mortgage,

> "the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another." *Id.,* at 14.

Again, it was the "reality," not the form, of the transaction that governed. *Ibid.* The Court found it immaterial whether the seller received money prior to the sale in order to discharge the mortgage, or whether the seller merely transferred the property subject to the mortgage. In either case the taxpayer realized an economic benefit.

B

The principles of *Old Colony* and *Crane* control. A common method of structuring gift transactions is for the donor to make the gift subject to the condition that the donee pay the resulting gift tax, as was done in each of the cases now before us. When a gift is made, the gift tax liability falls on the donor under 26 U. S. C. § 2502(d). When a donor makes a gift to a donee, a "debt" to the United States for the amount of the gift tax is incurred by the donor. Those taxes are as much the legal obligation of the donor as the donor's income taxes; for these purposes they are the same kind of debt obligation as the income taxes of the employee in *Old Colony, supra.* Similarly, when a donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an immediate economic benefit by the donee's assumption of the donor's legal obligation to pay the gift tax.

An examination of the donor's intent does not change the character of this benefit. Although intent is relevant in determining whether a gift has been made, subjective intent has not characteristically been a factor in determining whether an individual has realized income. Even if intent were a factor, the donor's intent with respect to the condition shifting the gift tax obligation from the donor to the donee was plainly to relieve the donor of a debt owed to the United States; the choice was made because the donor would receive a benefit in relief from the obligation to pay the gift tax.

Finally, the benefit realized by the taxpayer is not diminished by the fact that the liability attaches during the course of a donative transfer. It cannot be doubted that the donors were aware that the gift tax obligation would arise immediately upon the transfer of the property; the economic benefit to the donors in the discharge of the gift tax liability is indistinguishable from the benefit arising from discharge of a preexisting obligation. Nor is there any doubt that had the donors sold a portion of the stock immediately before the gift transfer in order to raise funds to pay the expected gift tax, a taxable gain would have been realized. 26 U. S. C. § 1001. The fact that the gift tax obligation was discharged by way of a conditional gift rather than from funds derived from a pregift sale does not alter the underlying benefit to the donors.

C

Consistent with the economic reality, the Commissioner has treated these conditional gifts as a discharge of indebtedness through a part gift and part sale of the gift property transferred. The transfer is treated as if the donor sells the property to the donee for less than the fair market value. The "sale" price is the amount necessary to discharge the gift tax indebtedness; the balance of the value of the transferred property is treated as a gift. The gain thus derived by the donor is the amount of the gift tax liability less the donor's adjusted basis in the entire property. Accordingly,

income is realized to the extent that the gift tax exceeds the donor's adjusted basis in the property. This treatment is consistent with § 1001 of the Internal Revenue Code, which provides that the gain from the disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property.

III

We recognize that Congress has structured gift transactions to encourage transfer of property by limiting the tax consequences of a transfer. See, *e. g.,* 26 U. S. C. § 102 (gifts excluded from donee's gross income). Congress may obviously provide a similar exclusion for the conditional gift. Should Congress wish to encourage "net gifts," changes in the income tax consequences of such gifts lie within the legislative responsibility. Until such time, we are bound by Congress' mandate that gross income includes income "from whatever source derived." We therefore hold that a donor who makes a gift of property on condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor's adjusted basis in the property.

The judgment of the United States Court of Appeals for the Eighth Circuit is

Affirmed.

[JUSTICE REHNQUIST dissented].

Notes

1. *Inapplicability of* Kirby Lumber. The *Deidrich* case is *not* about income from cancellation of indebtedness: the creditor (the United States treasury) was paid in full. Whenever the creditor receives whatever value the debtor originally promised to pay, there has been no cancellation of indebtedness and so no *Kirby Lumber* income. In effect, the children paid the gift tax obligation owed by their parents. We know from *Old Colony* that if someone else pays a taxpayer's obligation, we treat the transaction as if the money were first transferred to the taxpayer and then the taxpayer paid her own debt. The relevant inquiry then becomes: why would the third-party transfer value to the taxpayer? It could be a gift, it could be compensation (say, from an employer to an employee), it could be a dividend (from a corporation to a shareholder), or some other reason. In *Deidrich*, it is clear that the children paid the gift tax liability of their parents in order to receive the much more valuable stock. That is, they transferred value on behalf of their parents as consideration for the shares that were transferred to them.

2. *The Taxpayer's Gain*. If the parents had been willing to transfer the shares to their children without asking for anything in return, we would call the transfer a "gift" and apply rules we already have learned. If they had transferred the shares to their children in exchange for the full value of the shares, we would call the transaction a "sale" and apply rules we already have learned. Here, though, the parents demanded value but deliberately accepted less than they knew the shares to be worth: such a transaction is called either a "part sale/part gift" or a "bargain sale." The Supreme Court held in *Deidrich* that the seller/donor in a part sale/ part gift transaction should be taxed under the usual

sale rules so that the value indirectly transferred to the parents – that is $60,000 -- should be treated as their "amount realized." Because their adjusted basis in the shares given up was only $51,000, the parents recognized a gain of $9,000.

3. *The Donee's Basis*. What basis should the children take in the shares? Their basis is the greater of cost ($60,000) and carryover ($51,000), or $60,000. Reg. §1.1015-4. Can you see why this rule makes sense? Consider the case where the gift tax liability imposed on the parents and paid by the children was less than the parents' adjusted basis in the shares (say, $45,000). Can you see why the loss realized on that bargain sale would not be recognized? Another way to describe the basis rule is that the children's equals carryover plus gain recognized by the parents.

4. *Section 1011(b)*. In *Diedrich*, the Supreme Court applied the rules applicable to sales to a part sale/part gift transaction. An alternative approach would be to bifurcate the transaction into two parts, one wholly gift and one wholly sale. Recall that the shares were worth $180,000 and the children paid $60,000, so that they paid exactly one-third of the cost of the shares. Using these numbers, we could treat the parties as if one-third ($60,000 / $180,000) of the shares were sold for fair market value and two-thirds ($120,000 / $180,000) were gifted from parents to their children. Bifurcating the parents' adjusted basis in the same proportion, one-third of $51,000 – that is, $17,000 – is their adjusted basis in the shares sold and two-thirds of $51,000 – that is, $34,000 – is their adjusted basis in the shares gifted.

On the sale portion of the transaction, the parents recognize a gain of $60,000 less $17,000, or $43,000, and the children take a cost basis of $60,000. On the gift portion of the transaction, the parents do not recognize gain or loss, the children have no income because of §102, and the children take a carryover basis in the gifted shares of $34,000. Putting the two pieces, the children's basis in all the shares combined equals $60,000 plus $34,000, or $94,000.

Is this a reasonable alternative approach to *Diedrich*? Under *Diedrich*, the parents recognize a gain of $9,000 and the children took a basis in the shares of $60,000. Under the alternative, the parents recognize a gain of $43,000 and the children take a basis in the shares of $94,000. Once again, the children's basis in the shares equals carryover plus gain recognized by the parents. *Diedrich* allows the parents to use all their share basis against the amount realized while the alternate approach only allows them to use a portion of their adjusted basis against the amount realized. As a result, more gain will be recognized by the parents with a dollar-for-dollar reduction in the gain recognized by the children when they eventually sell the shares.

This alternate approach is used when the transferee in a bargain sale is a charitable organization. §1011(b). Note that in such circumstances, whatever gain goes unrealized on the transfer will forever be exempted because charitable organizations are not (with certain limitations) subject to the income tax.

5. Other Medium of Payments Cases. In *Diedrich,* the creditor was paid in full and the consideration used (indirectly) by the parents was appreciated stock. Thus, the debt was fully paid by the parents but in a medium other than cash. Other medium of payment cases include: (1) an employee's debt to her employer is cancelled in exchange for additional services rendered (the employee has compensation income, not *Kirby Lumber* income); (2) a child's debt to a parent is forgiven out of detached and disinterested generosity (the child has no income because the value of a gift is excluded from income under §102); (3) a decedent provides in her will that a debt owed by a relative be forgiven (the relative has no income because the value of a devise is excluded from income by §102).

Problem

P-1. T borrows $10,000 from Lender. When the loan comes due (ignore interest on the loan), T is unable to pay but instead transfers a painting to Lender and the debt is discharged. Assume both T and Lender agree the painting is worth $6,000, and assume T's adjusted basis in the painting is $4,500. What are the tax consequences to T from the transfer and debt cancellation?

3. Below-Market Loans[5]

Suppose a corporation makes a below-market loan to an employee. To determine what tax consequences should follow from such a transaction, one technique is to recharacterize the unfamiliar transaction as two or more familiar transactions. Suppose, for example, that an employer loans $100,000 to an employee on an interest-free basis so that one year after the loan is extended, the employee is required to repay the principle without interest. Such a transaction is equivalent to a loan at market interest (say, 5% interest) coupled with a $5,000 bonus at the end of the year paid by the employer to the employee, with the bonus then immediately repaid as interest on the loan.

This recharacterization is consistent with the actual transaction because the bonus deemed *paid by* the employer offsets the deemed interest *received by* the employer. As a result, the principle of horizontal equity tells us that the actual transaction – the no-interest loan – should be taxed the same as the recharacterization.

How is the recharacterization taxed? The loan itself (that is, the lending transaction and repayment of principle) has no tax consequences. The bonus is includible income to the employee as compensation and deductible to the employer as an ordinary and necessary business expense. And the interest payment may be deductible to the employee[6] and is taxable income to the employer. Note that if the interest payment is deductible to the employee, all of the tax consequences net to zero for both the employer and the employee. But if we change the underlying facts slightly, the results can be very different.

[5] The analysis in this discussion is consistent with the statutory rules in §7872 although the details differ somewhat.
[6] See §163, a provision we will cover later in the course.

Problem

P-2. X makes a no-interest loan of $100,000 to Y when a market interest rate for the loan would be 5% per year. The loan is repayable in full in one year. What are the tax consequences to X and to Y if X is a corporation and Y is its controlling shareholder so that the transfer from X to Y is a dividend (dividends are not deductible by the corporation and are includible to the shareholder)? If X is the parent and Y is the child and the parent is transferring value to the child out of detached and disinterested generosity?

4. Transfer of Property Subject to Debt

In this Section, we will look at the tax consequences of purchasing property using debt as some or all of the purchase price. Such acquisition indebtedness can be either recourse to the borrower or nonrecourse. If the debt is recourse, the lender has the right to collect payment from the debtor using all of the debtor's assets to satisfy the obligation including assets acquired after the loan was made.[7] That is, the lender has the right to seek a personal judgement against the borrower if the loan is not paid according to its terms.

If a loan is nonrecourse, then the borrower pledges specific assets against the loan, and if the loan is not repaid as promised, the lender can have the pledged assets sold with the proceeds used to repay the loan (usually including unpaid interest as well as the costs of collection). But if sale of the pledged assets is insufficient to cover the outstanding balance of the debt, the lender has no right to go after the borrower or additional assets of the borrower. Thus, when a lender makes a loan on a nonrecourse basis, the lender must be willing to assume the risk that the pledged assets (called the "security" for the loan) will retain sufficient value to cover the debt.

A borrower often will provide security to a lender even when the loan is with recourse, but in this context the security plays a slightly different role. Because the debt is with recourse, the lender will have rights against all of the borrower's assets if the loan goes unpaid. The benefit of having a security interest in particular property when the loan is recourse is that the lender has priority against the security vis-à-vis other creditors of the borrower. That is, in the case of recourse borrowing, the pledging of property to secure repayment does not limit the lender's ability to collect the debt but rather gives the lender a preferred position with respect to the pledged assets in case the borrower is unable to pay multiple obligations.

The following case does not involve acquisition indebtedness but rather post-acquisition indebtedness; that is, borrowing against property after the property has been acquired. Such borrowing does not affect the taxpayer's adjusted basis in the security (if any). Of course, if the loan proceeds are invested in some new asset, the taxpayer will take a cost basis in the new asset.

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[7] Some assets may be protected even in the case of recourse borrowing under applicable federal or state laws. Such assets often include interests in qualified retirement plans and personal residences.

Woodsam Associates, Inc. v. Commissioner

198 F.2d. 357 (2d Cir. 1952)

CHASE, CIRCUIT JUDGE.

The petitioner paid its income and declared value excess profits taxes for 1943 as computed upon returns it filed which included as part of its gross income $146,058.10 as gain realized upon the mortgage foreclosure sale in that year of improved real estate which it owned and which was bid in by the mortgagee for a nominal sum. It filed a timely claim for refund on the ground that its adjusted basis for the property had been understated and its taxable gain, therefore, was less than that reported. The refund claim was denied and a deficiency in both its income taxes and declared value excess profits taxes was determined which was affirmed, without dissent, in a decision reviewed by the entire Tax Court. The decisive issue now presented is whether the basis for determining gain or loss upon the sale or other disposition of property is increased when, subsequent to the acquisition of the property, the owner receives a loan in an amount greater than his adjusted basis which is secured by a mortgage on the property upon which he is not personally liable. If so, it is agreed that part of the income taxes and all of the declared value excess profits taxes paid for 1943 should be refunded.

. . . .

On December 29, 1934, Samuel J. Wood and his wife organized the petitioner and each transferred to it certain property in return for one-half of its capital stock. One piece of property so transferred by Mrs. Wood was the above mentioned parcel of improved real estate consisting of land in the City of New York and a brick building thereon divided into units suitable for use, and used, in retail business. The property was subject to a $400,000 mortgage on which Mrs. Wood was not personally liable and on which the petitioner never became personally liable. Having, thus, acquired the property in a tax free exchange, I.R.C. [§351], the petitioner took the basis of Mrs. Wood for tax purposes. I.R.C. [§362(a)(1)]. Upon the final disposition of the property at the foreclosure sale there was still due upon the mortgage the principal amount of $381,000 and, as the petitioner concedes, the extent to which the amount of the mortgage exceeds its adjusted basis was income taxable to it even though it was not personally liable upon the mortgage.

. . . .

The contention of the petitioner may now be stated quite simply. It is that, when the borrowings of Mrs. Wood subsequent to her acquisition of the property became charges solely upon the property itself, the cash she received for the repayment of which she was not personally liable was a gain then taxable to her as income to the extent that the mortgage indebtedness exceeded her adjusted basis in the property. That being so, it is argued that her tax basis was, under familiar principles of tax law, increased by the amount of such taxable gain and that this stepped up basis carried over to the petitioner in the tax free exchange by which it acquired the property.

While this conclusion would be sound if the premise on which it is based were correct, we cannot accept the premise. It is that the petitioner's transferor made a taxable disposition of the property, within the meaning of I.R.C. [§1001(a)], when the second consolidated mortgage was executed, because she had, by then, dealt with it in such a way that she had received cash, in excess of her basis, which, at that time, she was freed from any personal obligation to repay. . . .Mrs. Wood merely augmented the existing mortgage indebtedness when she borrowed each time and, far from closing the venture, remained in a position to borrow more if and when circumstances permitted and she so desired. And so, she never "disposed" of the property to create a taxable event which [§1001(a)] makes a condition precedent to the taxation of gain. . . .Realization of gain was, therefore, postponed for taxation until there was a final disposition of the property at the time of the foreclosure sale. Therefore, Mrs. Wood's borrowings did not change the basis for the computation of gain or loss.

Affirmed.

Notes

1. *The* Woodsam Associates *Transaction*. When an asset is transferred to a corporation in a transaction described in §351, the transferor's adjusted basis carries over to the corporation.[8] The corporate taxpayer in *Woodsam Associates* sought a higher basis in contributed property by arguing that the borrowing transaction – a transaction that occurred prior to the transfer of the asset to the corporation – was a taxable event to the shareholder that increased the shareholder's basis in the asset, an increase that then benefitted the corporation because of the basis rule applicable to §351 transactions. Of course, a consequence of the corporation's argument is that the shareholder failed to report gain in the year the borrowing transaction took place, but because that was several years earlier, the statute of limitations protected the shareholder from audit. As a result, the IRS was in the peculiar position of arguing against treating a transaction as a taxable event. The government won the case, ensuring that similar borrowing transactions in the future would not be taxable. It was a victory the government ultimately regretted.

2. *The Taxpayer's Argument*. Suppose a taxpayer purchases a nondepreciable asset for $100,000. After the property appreciates to $500,000, the taxpayer borrows $350,000 against the property on a nonrecourse basis. Because the loan is nonrecourse, the borrower cannot be forced to repay the loan: the borrower can choose to walk away from the loan by allowing the lender to foreclose on the security. Thus, as a result of the loan proceeds the taxpayer has pocketed $350,000 on an investment of $100,000 *and the taxpayer has no legal obligation to repay the dollar amount of the loan*. The corporation in *Woodsam Associates* argued that when the shareholder borrowed on a nonrecourse basis an amount in excess of her adjusted basis in the security, she should be taxed on that excess because it was an accession to wealth that would not have to be repaid. Many tax shelters since *Woodsam Associates* have involved taxpayers borrowing on a nonrecourse basis in an amount in excess of the adjusted basis in the property.

[8] Section 358(a)(1). Sections 351 and 358 are not a part of this course.

Commissioner v. Tufts

461 U.S. 300 (1983)

JUSTICE BLACKMAN delivered the opinion of the Court.

Over 35 years ago, in *Crane v. Commissioner,* 331 U. S. 1 (1947), this Court ruled that a taxpayer, who sold property encumbered by a nonrecourse mortgage (the amount of the mortgage being less than the property's value), must include the unpaid balance of the mortgage in the computation of the amount the taxpayer realized on the sale. The case now before us presents the question whether the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the fair market value of the property sold.

I

On August 1, 1970, respondent Clark Pelt, a builder, and his wholly owned corporation, respondent Clark, Inc., formed a general partnership. The purpose of the partnership was to construct a 120-unit apartment complex in Duncanville, Tex., a Dallas suburb. Neither Pelt nor Clark, Inc., made any capital contribution to the partnership. Six days later, the partnership entered into a mortgage loan agreement with the Farm & Home Savings Association (F&H). Under the agreement, F&H was committed for a $1,851,500 loan for the complex. In return, the partnership executed a note and a deed of trust in favor of F&H. The partnership obtained the loan on a nonrecourse basis: neither the partnership nor its partners assumed any personal liability for repayment of the loan. Pelt later admitted four friends and relatives, respondents Tufts, Steger, Stephens, and Austin, as general partners. None of them contributed capital upon entering the partnership.

The construction of the complex was completed in August, 1971. During 1971, each partner made small capital contributions to the partnership; in 1972, however, only Pelt made a contribution. The total of the partners' capital contributions was $44,212. In each tax year, all partners claimed as income tax deductions their allocable shares of ordinary losses and depreciation. The deductions taken by the partners in 1971 and 1972 totaled $439,972. Due to these contributions and deductions, the partnership's adjusted basis in the property in August, 1972, was $1,455,740.

In 1971 and 1972, major employers in the Duncanville area laid off significant numbers of workers. As a result, the partnership's rental income was less than expected, and it was unable to make the payments due on the mortgage. Each partner, on August 28, 1972, sold his partnership interest to an unrelated third party, Fred Bayles. As consideration, Bayles agreed to reimburse each partner's sale expenses up to $250; he also assumed the nonrecourse mortgage.

On the date of transfer, the fair market value of the property did not exceed $1,400,000. Each partner reported the sale on his federal income tax return and indicated that a partnership loss of $55,740 had been sustained.[9] The Commissioner

[9] The loss was the difference between the adjusted basis, $1,455,740, and the fair market value of the property, $1,400,000. On their individual tax returns, the partners did not claim

of Internal Revenue, on audit, determined that the sale resulted in a partnership capital gain of approximately $400,000. His theory was that the partnership had realized the full amount of the nonrecourse obligation.[10]

. . . .

II

Section 752(d) of the Internal Revenue Code of 1954, 26 U.S.C. § 752(d), specifically provides that liabilities involved in the sale or exchange of a partnership interest are to "be treated in the same manner as liabilities in connection with the sale or exchange of property not associated with partnerships." Section 1001 governs the determination of gains and losses on the disposition of property. Under § 1001(a), the gain or loss from a sale or other disposition of property is defined as the difference between "the amount realized" on the disposition and the property's adjusted basis. Subsection (b) of § 1001 defines "amount realized":

> "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

At issue is the application of the latter provision to the disposition of property encumbered by a nonrecourse mortgage of an amount in excess of the property's fair market value.

A

In *Crane v. Commissioner, supra,* this Court took the first and controlling step toward the resolution of this issue. Beulah B. Crane was the sole beneficiary under the will of her deceased husband. At his death in January, 1932, he owned an apartment building that was then mortgaged for an amount which proved to be equal to its fair market value, as determined for federal estate tax purposes. The widow, of course, was not personally liable on the mortgage. She operated the building for nearly seven years, hoping to turn it into a profitable venture; during that period, she claimed income tax deductions for depreciation, property taxes, interest, and operating expenses, but did not make payments upon the mortgage principal. In computing her basis for the depreciation deductions, she included the full amount of the mortgage debt. In November, 1938, with her hopes unfulfilled and the mortgagee threatening foreclosure, Mrs. Crane sold the building. The purchaser took the property subject to

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deductions for their respective shares of this loss. In their petitions to the Tax Court, however, the partners did claim the loss.

[10] The Commissioner determined the partnership's gain on the sale by subtracting the adjusted basis, $1,455,740, from the liability assumed by Bayles, $1,851,500. Of the resulting figure, $395,760, the Commissioner treated $348,661 as capital gain, pursuant to § 741 of the Internal Revenue Code of 1954, 26 U.S.C. § 741, and $47,099 as ordinary gain under the recapture provisions of § 1250 of the Code. The application of § 1250 in determining the character of the gain is not at issue here.

the mortgage and paid Crane $3,000; of that amount, $500 went for the expenses of the sale.

Crane reported a gain of $2,500 on the transaction. She reasoned that her basis in the property was zero (despite her earlier depreciation deductions based on including the amount of the mortgage) and that the amount she realized from the sale was simply the cash she received. The Commissioner disputed this claim. He asserted that Crane's basis in the property, . . . was the property's fair market value at the time of her husband's death, adjusted for depreciation in the interim, and that the amount realized was the net cash received plus the amount of the outstanding mortgage assumed by the purchaser.

In upholding the Commissioner's interpretation of § 113 (a)(5) of the 1938 Act, the Court observed that to regard merely the taxpayer's equity in the property as her basis would lead to depreciation deductions less than the actual physical deterioration of the property, and would require the basis to be recomputed with each payment on the mortgage. The Court rejected Crane's claim that any loss due to depreciation belonged to the mortgagee. The effect of the Court's ruling was that the taxpayer's basis was the value of the property undiminished by the mortgage.

The Court next proceeded to determine the amount realized under § 111(b) of the 1938 Act, 52 Stat. 484 (the current version is § 1001(b) of the 1954 Code, 26 U.S.C. § 1001(b)). In order to avoid the "absurdity," of Crane's realizing only $2,500 on the sale of property worth over a quarter of a million dollars, the Court treated the amount realized as it had treated basis, that is, by including the outstanding value of the mortgage. To do otherwise would have permitted Crane to recognize a tax loss unconnected with any actual economic loss. The Court refused to construe one section of the Revenue Act so as "to frustrate the Act as a whole." *Ibid.*

Crane, however, insisted that the nonrecourse nature of the mortgage required different treatment. The Court, for two reasons, disagreed. First, excluding the nonrecourse debt from the amount realized would result in the same absurdity and frustration of the Code. Second, the Court concluded that Crane obtained an economic benefit from the purchaser's assumption of the mortgage identical to the benefit conferred by the cancellation of personal debt. Because the value of the property in that case exceeded the amount of the mortgage, it was in Crane's economic interest to treat the mortgage as a personal obligation; only by so doing could she realize upon sale the appreciation in her equity represented by the $2,500 boot. The purchaser's assumption of the liability thus resulted in a taxable economic benefit to her, just as if she had been given, in addition to the boot, a sum of cash sufficient to satisfy the mortgage.

In a footnote, pertinent to the present case, the Court observed:

> "Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or

> transferred it subject to the mortgage without receiving boot. That is not this case."

Id. at 331 U. S. 14, n. 37.

B

This case presents that unresolved issue. We are disinclined to overrule *Crane,* and we conclude that the same rule applies when the unpaid amount of the nonrecourse mortgage exceeds the value of the property transferred. *Crane* ultimately does not rest on its limited theory of economic benefit; instead, we read *Crane* to have approved the Commissioner's decision to treat a nonrecourse mortgage in this context as a true loan. This approval underlies *Crane's* holdings that the amount of the nonrecourse liability is to be included in calculating both the basis and the amount realized on disposition. That the amount of the loan exceeds the fair market value of the property thus becomes irrelevant.

When a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.

Another consequence to the taxpayer from this obligation occurs when the taxpayer applies the loan proceeds to the purchase price of property used to secure the loan. Because of the obligation to repay, the taxpayer is entitled to include the amount of the loan in computing his basis in the property; the loan, under § 1012, is part of the taxpayer's cost of the property. Although a different approach might have been taken with respect to a nonrecourse mortgage loan,[11] the Commissioner has chosen to

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[11] The Commissioner might have adopted the theory, implicit in Crane's contentions, that a nonrecourse mortgage is not true debt, but, instead, is a form of joint investment by the mortgagor and the mortgagee. On this approach, nonrecourse debt would be considered a contingent liability, under which the mortgagor's payments on the debt gradually increase his interest in the property while decreasing that of the mortgagee. Note, Federal Income Tax Treatment of Nonrecourse Debt, 82 Colum.L.Rev. 1498, 1514 (1982); Lurie, Mortgagor's Gain on Mortgaging Property for More than Cost Without Personal Liability, 6 Tax L.Rev. 319, 323 (1951); cf. Brief for Respondents 16 (nonrecourse debt resembles preferred stock). Because the taxpayer's investment in the property would not include the nonrecourse debt, the taxpayer would not be permitted to include that debt in basis. Note, 82 Colum.L.Rev. at 1515; cf. Gibson Products Co. v. United States, 637 F.2d 1041, 1047-1048 (CA5 1981) (contingent nature of obligation prevents inclusion in basis of oil and gas leases of nonrecourse debt secured by leases, drilling equipment, and percentage of future production).

We express no view as to whether such an approach would be consistent with the statutory structure and, if so, and Crane were not on the books, whether that approach would be preferred over Crane's analysis. We note only that the Crane Court's resolution of the basis issue presumed that, when property is purchased with proceeds from a nonrecourse mortgage, the purchaser becomes the sole owner of the property. 331 U.S. at 331 U. S. 6. Under the Crane approach, the mortgagee is entitled to no portion of the basis. Id. at 331 U. S. 10, n. 28. The nonrecourse mortgage is part of the mortgagor's investment in the property, and does not constitute a coinvestment by the mortgagee. But see Note, 82 Colum.L.Rev. at 1513

accord it the same treatment he gives to a recourse mortgage loan. The Court approved that choice in *Crane,* and the respondents do not challenge it here. The choice and its resultant benefits to the taxpayer are predicated on the assumption that the mortgage will be repaid in full.

When encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized. Because no difference between recourse and nonrecourse obligations is recognized in calculating basis, *Crane* teaches that the Commissioner may ignore the nonrecourse nature of the obligation in determining the amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the nonrecourse mortgage assumed by the purchaser. The rationale for this treatment is that the original inclusion of the amount of the mortgage in basis rested on the assumption that the mortgagor incurred an obligation to repay. Moreover, this treatment balances the fact that the mortgagor originally received the proceeds of the nonrecourse loan tax-free on the same assumption. Unless the outstanding amount of the mortgage is deemed to be realized, the mortgagor effectively will have received untaxed income at the time the loan was extended, and will have received an unwarranted increase in the basis of his property. The Commissioner's interpretation of § 1001(b) in this fashion cannot be said to be unreasonable.

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Respondents received a mortgage loan with the concomitant obligation to repay by the year 2012. The only difference between that mortgage and one on which the borrower is personally liable is that the mortgagee's remedy is limited to foreclosing on the securing property. This difference does not alter the nature of the obligation; its only effect is to shift from the borrower to the lender any potential loss caused by devaluation of the property. If the fair market value of the property falls below the amount of the outstanding obligation, the mortgagee's ability to protect its interests is impaired, for the mortgagor is free to abandon the property to the mortgagee and be relieved of his obligation.

This, however, does not erase the fact that the mortgagor received the loan proceeds tax-free, and included them in his basis on the understanding that he had an obligation to repay the full amount. When the obligation is canceled, the mortgagor is relieved of his responsibility to repay the sum he originally received, and thus realizes value to that extent within the meaning of § 1001(b). From the mortgagor's point of view, when his obligation is assumed by a third party who purchases the encumbered property, it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee on a nonrecourse basis, and then had used the cash to satisfy his obligation to the mortgagee.

(treating nonrecourse mortgage as coinvestment by mortgagee and critically concluding that Crane departed from traditional analysis that basis is taxpayer's investment in property).

Moreover, this approach avoids the absurdity the Court recognized in *Crane.* Because of the remedy accompanying the mortgage in the nonrecourse situation, the depreciation in the fair market value of the property is relevant economically only to the mortgagee, who, by lending on a nonrecourse basis, remains at risk. To permit the taxpayer to limit his realization to the fair market value of the property would be to recognize a tax loss for which he has suffered no corresponding economic loss. . . .

IV

When a taxpayer sells or disposes of property encumbered by a nonrecourse obligation, the Commissioner properly requires him to include among the assets realized the outstanding amount of the obligation. The fair market value of the property is irrelevant to this calculation. We find this interpretation to be consistent with *Crane v. Commissioner,* 331 U. S. 1 (1947), and to implement the statutory mandate in a reasonable manner.

The judgment of the Court of Appeals is therefore reversed.

It is so ordered.

JUSTICE O'CONNOR, concurring.

I concur in the opinion of the Court, accepting the view of the Commissioner. I do not, however, endorse the Commissioner's view. Indeed, were we writing on a slate clean except for the decision in *Crane v. Commissioner,* 331 U. S. 1 (1947), I would take quite a different approach -- that urged upon us by Professor Barnett as *amicus.*

Crane established that a taxpayer could treat property as entirely his own, in spite of the "coinvestment" provided by his mortgagee in the form of a nonrecourse loan. That is, the full basis of the property, with all its tax consequences, belongs to the mortgagor. That rule alone, though, does not in any way tie nonrecourse debt to the cost of property or to the proceeds upon disposition. I see no reason to treat the purchase, ownership, and eventual disposition of property differently because the taxpayer also takes out a mortgage, an independent transaction. In this case, the taxpayer purchased property, using nonrecourse financing, and sold it after it declined in value to a buyer who assumed the mortgage. There is no economic difference between the events in this case and a case in which the taxpayer buys property with cash; later obtains a nonrecourse loan by pledging the property as security; still later, using cash on hand, buys off the mortgage for the market value of the devalued property; and finally sells the property to a third party for its market value.

The logical way to treat both this case and the hypothesized case is to separate the two aspects of these events and to consider, first, the ownership and sale of the property, and, second, the arrangement and retirement of the loan. Under *Crane,* the fair market value of the property on the date of acquisition -- the purchase price -- represents the taxpayer's basis in the property, and the fair market value on the date of disposition represents the proceeds on sale. The benefit received by the taxpayer in return for the property is the cancellation of a mortgage that is worth no more than

the fair market value of the property, for that is all the mortgagee can expect to collect on the mortgage. His gain or loss on the disposition of the property equals the difference between the proceeds and the cost of acquisition. Thus, the taxation of the transaction in property reflects the economic fate of the property. If the property has declined in value, as was the case here, the taxpayer recognizes a loss on the disposition of the property. The new purchaser then takes as his basis the fair market value as of the date of the sale.

In the separate borrowing transaction, the taxpayer acquires cash from the mortgagee. He need not recognize income at that time, of course, because he also incurs an obligation to repay the money. Later, though, when he is able to satisfy the debt by surrendering property that is worth less than the face amount of the debt, we have a classic situation of cancellation of indebtedness, requiring the taxpayer to recognize income in the amount of the difference between the proceeds of the loan and the amount for which he is able to satisfy his creditor. 26 U.S.C. § 61(a)(12). The taxation of the financing transaction then reflects the economic fate of the loan.

The reason that separation of the two aspects of the events in this case is important is, of course, that the Code treats different sorts of income differently. A gain on the sale of the property may qualify for capital gains treatment, §§ 1202, 1221 (1976 ed. and Supp. V), while the cancellation of indebtedness is ordinary income, but income that the taxpayer may be able to defer. §§ 108, 1017 (1976 ed., Supp. V). Not only does Professor Barnett's theory permit us to accord appropriate treatment to each of the two types of income or loss present in these sorts of transactions, it also restores continuity to the system by making the taxpayer-seller's proceeds on the disposition of property equal to the purchaser's basis in the property. Further, and most important, it allows us to tax the events in this case in the same way that we tax the economically identical hypothesized transaction.

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Notes

1. *Recourse Acquisition Indebtedness and Basis*. When property is acquired by purchase, its basis is cost. §1012. But what does "cost" mean when there is acquisition indebtedness? For example, suppose a taxpayer purchases property for $1,000,000, paying $100,000 down and signing a recourse note for $900,000 (plus fair interest)? Is the taxpayer's "cost" the down payment of $100,000 or the full value of the property of $1,000,000. We treat the taxpayer's cost in this context as the full $1,000,000. Parker v. Delaney, 186 F.2d 455 (1st Cir. 1950).

2. *Nonrecourse Acquisition Indebtedness and Basis*. In Crane v. Commissioner, 331 U.S. 1 (1947), Ms. Crane inherited land and a building encumbered by a nonrecourse debt. The trial court found as a fact that the value of the property, ignoring the encumbrance, was $262,042.50. It also found as a fact that the amount of the nonrecourse debt on the day Ms. Crane inherited the property also was $262,042.50 (!). As a result, Ms. Crane had no equity in the property when she inherited it.

Mrs. Crane treated her basis in the property as $262,042.50. Recall that for property acquired through the estate of a decedent, basis is fair market value. By ignoring the encumbrance in computing her basis in the property, she was able to claim depreciation deductions on that portion of her basis properly allocable to the building. While *Crane* often is cited for the proposition that acquisition indebtedness contributes to basis, in fact that was not the issue litigated in the case: at issue in *Crane* was computation of gain when Ms. Crane ultimately disposed of the property.

Note that *Crane* involved inherited property while *Parker v. Delaney* involved purchased property. Because basis in the case of inherited property is fair market value while basis in the case of purchased property is cost – assumed to equal fair market value when the parties deal at arm's-length – they usually are treated as presenting the same basis question.

3. *Disposition of Property Secured by Recourse Debt*. Suppose a taxpayer owns property encumbered by a recourse debt of $350,000. Suppose further that the taxpayer transfers the property to a third party in exchange for a payment of $100,000. Assuming the taxpayer's adjusted basis in the property equals $220,000, what are the tax consequences to the taxpayer of the transfer? If a third party is willing to pay $100,000 for the property while it is encumbered by a debt of $350,000, the property must be worth at least $450,000 (because if the purchaser does not pay off the debt, the lender will foreclose on it). The taxpayer has sold the property for $450,000 just as surely as if that had been the purchase price and the taxpayer had used $350,000 of the purchase price to retire the debt. Thus, the taxpayer's amount realized should equal both the amount of cash received -- $100,000 – and the amount of the debt encumbering the property -- $350,000 – for a total of $450,000. Because the taxpayer's adjusted basis is $220,000, the taxpayer recognizes a gain of $230,000 on the transfer. In a variety of contexts, courts have held that the transfer of encumbered property should be treated as if the taxpayer received cash with which to satisfy the liability. E.g., United States v. Hendler, 303 U.S. 564 (1938).

The analysis is slightly different if the property is transferred back to the lender, whether in a foreclosure or otherwise. Suppose the taxpayer owns property encumbered by a recourse debt of $350,000, and assume it is foreclosed upon when the property is worth $275,000. This is a medium of payment case, and the taxpayer will be taxed as if the property were sold for its fair market value – that is, for $275,000 – in a taxable transaction. Accordingly, if the taxpayer's adjusted basis in the property equals $220,000, the taxpayer will recognize a gain of $55,000. If the lender retains the right to seek the remaining $75,000 from the taxpayer, there are no further tax consequences until that deficiency is resolved. But if the lender agrees to cancel the remaining debt as part of the foreclosure, the taxpayer will recognize $75,000 as income from the cancellation of indebtedness in addition to the gain.

4. *Disposition of Property Secured by Nonrecourse Debt*. Suppose a taxpayer owns property encumbered by a nonrecourse debt of $350,000. Suppose further that the taxpayer transfers the property to a third party in exchange for a payment of $100,000. Assuming the taxpayer's adjusted basis in the property equals $220,000, what are the tax consequences to the taxpayer of the transfer? We saw that when the debt was recourse, the amount of the outstanding debt is included in the taxpayer's amount realized. The

same analysis applies if the debt is nonrecourse, and at least when the property is worth more than the outstanding debt, the analysis is the same. Crane v. Commissioner, 331 U.S. 1 (1947). But what if the property is worth less than the outstanding debt?

For example, suppose the taxpayer owns property encumbered by a recourse debt of $350,000, and assume it is foreclosed upon when the property is worth $275,000. What is the taxpayer's amount realized on the transaction? This was the issue decided in *Tufts*, and the court held that the amount of the outstanding nonrecourse debt goes into amount realized whether the property is worth more than the debt or not. What was the Court's rationale in *Tufts*?

Assume the taxpayer purchased the property for $400,000, paying $50,000 down and signing an interest-only, nonrecourse note for $350,000. Over time, the taxpayer claims depreciation of $180,000, reducing the taxpayer's adjusted basis in the property to $220,000. And at this point, the lender forecloses on the property. Because the loan was nonrecourse, the lender has no right to seek a deficiency judgment against the taxpayer.

The taxpayer invested $50,000 in the property, and that investment is lost once the foreclosure occurs. The net effect of the transaction should be a loss of $50,000. But the taxpayer claimed depreciation of $180,000, which means that the foreclosure should trigger gain of $130,000 so that this gain, when netted against the depreciation, yields a loss of $50,000 consistent with the taxpayer's economic loss from the investment. If the taxpayer's adjusted basis equals $220,000, that means the taxpayer's amount realized must equal $350,000. And that is rule of *Tufts*.

Put another way, the holding in *Tufts* recognizes the taxpayer's basis was inflated by the amount of the debt on the theory that the debt would be paid. But if the debt is not fully paid when the property is transferred, we must either subtract the unpaid portion of the debt from the taxpayer's adjusted basis or, equivalently, increase amount realized by the same amount.

The concurrence in *Tufts* proposed that the transaction should be treated the same whether the encumbrance is recourse or not: that is, if the property has declined in value, then the taxpayer should treat amount realized as only the value of the property and the excess debt should be treated as income from the cancellation of indebtedness. To the extent the property is worth less than the outstanding encumbrance, that excess creates gain under *Tufts* and creates *Kirby Lumber* income under the concurrence. Note, though, because the loan is nonrecourse, when the property is transferred back to the lender in complete satisfaction of the debt, the lender is being paid everything the lender is entitled to receive under the loan agreement: that is, the lender is paid in full. As a result, it is hard to characterize any part of the transfer as resulting in income from the cancellation of indebtedness.

5. *Debt Reductions*. Suppose a taxpayer owns encumbered property and the property is worth less than the amount of the encumbrance. If the lender is willing to reduce the amount of the debt without foreclosing on the property, the taxpayer has income from the cancellation of indebtedness whether the debt is recourse or nonrecourse.

Summary of Dealings in Encumbered Property

Facts. T purchases property for $1,000,000, paying $100,000 in cash and signing a note for $900,000. While T holds the property, T claims $400,000 of depreciation and makes a principal payment of $150,000.

1. Case 1A: T transfers the property to Buyer in exchange for a cash payment of $350,000, and the loan is fully recourse to T. T's amount realized on the transfer equals $1,100,000, consisting of cash actually received of $350,000 plus the transfer of the $750,000 debt to Buyer (see *Old Colony* and *Hendler*). T's adjusted basis at the time of the transfer equals $600,000 (initial basis of $1,000,000 less depreciation of $400,000). As a result, T's gain on the transfer equals $1,100,000 less $600,000, or $500,000. This gain represents T's cash-flow economic gain of $100,000 (total cash invested of $250,000 as compared with cash received of $350,000) plus a pay-back of the depreciation claimed while T held the property (because the property in fact did not decline in value).

2. Case 1B: Same facts as case 1A except the note signed by T is nonrecourse. The outcome is the same although the authority for T's amount realized including the outstanding debt is *Tufts* rather than *Old Colony* and *Hendler*.

3. Case 2A: The holder of T's note forecloses on the property, paying T nothing, and the note was nonrecourse. T's amount realized equals $750,000 under *Tufts* while T's adjusted basis equals $600,000, so T recognizes a gain on the foreclosure of **$150,000**. T's economic loss equals $250,000 (down payment plus principal payment), but T deducted $400,000 while holding the property, so a dispositional gain of $150,000 causes T's net tax loss of $250,000 (depreciation deductions of $400,000 less dispositional gain of $150,000) to equal T's actual economic loss. Note that the value of the property at the time of the foreclosure plays no role in the calculation.

4. Case 2B: Same facts as case 2A except the note signed by T is fully recourse, the property is worth $680,000 when the foreclosure takes place, and the lender does not seek a deficiency judgment against T for sound business reasons. Because the lender had a right to be paid the full $750,000 remaining on the debt but instead received only collateral worth $680,000, **$70,000** of the debt was discharged and so T has $70,000 income from discharge of indebtedness (*Kirby Lumber* income), subject to possible exclusion under section 108. In addition, because T is credited with satisfying $680,000 of the debt with the property, T's amount realized on the foreclosure equals $680,000 while T's adjusted basis in the property equals $600,000, so there is a gain on the foreclosure (under section 1001(a)) of **$80,000**. Note that the total income realized by T on the disposition is the same in case 2A and in case 2B ($150,000; see the amounts in bold), with the difference being all gain in case 2A while there is a mix of gain and *Kirby Lumber* income in case 2B. The concurrence in *Tufts* argues that case 2A should be taxed the same as case 2B.

5. Case 2C: Same facts as case 2A except that the lender does not foreclose but instead agrees to write the loan down from the existing amount due of $750,000 to $680,000

(that being the value of the collateral). Sometime thereafter, the lender forecloses on the property in complete satisfaction of the (modified) loan. On the loan modification, T has *Kirby Lumber* income of $70,000. When the foreclosure occurs, T's amount realized equals $680,000 (under *Tufts*) and T's adjusted basis equals $600,000 (cost of $1,000,000 less depreciation of $400,000), for a gain under section 1001(a) of $80,000. Case 2A has in effect been turned into Case 2B.

Estate of Franklin v. Commissioner

544 F.2d. 1045 (9th Cir. 1976)

This case involves another effort on the part of the Commissioner to curb the use of real estate tax shelters. In this instance he seeks to disallow deductions for the taxpayers' distributive share of losses reported by a limited partnership with respect to its acquisition of a motel and related property. These "losses" have their origin in deductions for depreciation and interest claimed with respect to the motel and related property. These deductions were disallowed by the Commissioner on the ground either that the acquisition was a sham or that the entire acquisition transaction was in substance the purchase by the partnership of an option to acquire the motel and related property on January 15, 1979. The Tax Court held that the transaction constituted an option exercisable in 1979 and disallowed the taxpayers' deductions. Estate of Charles T. Franklin, 64 T.C. 752 (1975). We affirm this disallowance although our approach differs somewhat from that of the Tax Court.

The interest and depreciation deductions were taken by Twenty-Fourth Property Associates (hereinafter referred to as Associates), a California limited partnership of which Charles T. Franklin and seven other doctors were the limited partners. The deductions flowed from the purported "purchase" by Associates of the Thunderbird Inn, an Arizona motel, from Wayne L. Romney and Joan E. Romney (hereinafter referred to as the Romneys) on November 15, 1968.

Under a document entitled "Sales Agreement," the Romneys agreed to "sell" the Thunderbird Inn to Associates for $1,224,000. The property would be paid for over a period of ten years, with interest on any unpaid balance of seven and one-half percent per annum. "Prepaid interest" in the amount of $75,000 was payable immediately; monthly principal and interest installments of $9,045.36 would be paid for approximately the first ten years, with Associates required to make a balloon payment at the end of the ten years of the difference between the remaining purchase price, forecast as $975,000, and any mortgages then outstanding against the property.

The purchase obligation of Associates to the Romneys was nonrecourse; the Romneys' only remedy in the event of default would be forfeiture of the partnership's interest. The sales agreement was recorded in the local county. A warranty deed was placed in an escrow account, along with a quitclaim deed from Associates to the Romneys, both documents to be delivered either to Associates upon full payment of the purchase price, or to the Romneys upon default.

The sale was combined with a leaseback of the property by Associates to the Romneys; Associates therefore never took physical possession. The lease payments were designed to approximate closely the principal and interest payments with the consequence that with the exception of the $75,000 prepaid interest payment no cash

would cross between Associates and Romneys until the balloon payment. The lease was on a net basis; thus, the Romneys were responsible for all of the typical expenses of owning the motel property including all utility costs, taxes, assessments, rents, charges, and levies of "every name, nature and kind whatsoever." The Romneys also were to continue to be responsible for the first and second mortgages until the final purchase installment was made; the Romneys could, and indeed did, place additional mortgages on the property without the permission of Associates. Finally, the Romneys were allowed to propose new capital improvements which Associates would be required to either build themselves or allow the Romneys to construct with compensating modifications in rent or purchase price.

In holding that the transaction between Associates and the Romneys more nearly resembled an option than a sale, the Tax Court emphasized that Associates had the power at the end of ten years to walk away from the transaction and merely lose its $75,000 "prepaid interest payment." It also pointed out that a deed was never recorded and that the "benefits and burdens of ownership" appeared to remain with the Romneys. Thus, the sale was combined with a leaseback in which no cash would pass; the Romneys remained responsible under the mortgages, which they could increase; and the Romneys could make capital improvements. The Tax Court further justified its "option" characterization by reference to the nonrecourse nature of the purchase money debt and the nice balance between the rental and purchase money payments.

Our emphasis is different from that of the Tax Court. We believe the characteristics set out above can exist in a situation in which the sale imposes upon the purchaser a genuine indebtedness within the meaning of section 167(a), Internal Revenue Code of 1954, which will support both interest and depreciation deductions. They substantially so existed in Hudspeth v. Commissioner, 509 F.2d 1224 (9th Cir. 1975) in which parents entered into sale-leaseback transactions with their children. The children paid for the property by executing nonnegotiable notes and mortgages equal to the fair market value of the property; state law proscribed deficiency judgments in case of default, limiting the parents' remedy to foreclosure of the property. The children had no funds with which to make mortgage payments; instead, the payments were offset in part by the rental payments, with the difference met by gifts from the parents to their children. Despite these characteristics this court held that there was a bona fide indebtedness on which the children, to the extent of the rental payments, could base interest deductions. . . .

In none of these cases, however, did the taxpayer fail to demonstrate that the purchase price was at least approximately equivalent to the fair market value of the property. Just such a failure occurred here. The Tax Court explicitly found that on the basis of the facts before it the value of the property could not be estimated. 64 T.C. at 767-768. In our view this defect in the taxpayers' proof is fatal.

Reason supports our perception. An acquisition such as that of Associates if at a price approximately equal to the fair market value of the property under ordinary circumstances would rather quickly yield an equity in the property which the purchaser could not prudently abandon. This is the stuff of substance. It meshes with the form of the transaction and constitutes a sale.

No such meshing occurs when the purchase price exceeds a demonstrably reasonable estimate of the fair market value. Payments on the principal of the purchase price yield no equity so long as the unpaid balance of the purchase price exceeds the then existing fair market value. Under these circumstances the purchaser by abandoning the transaction can lose no more than a mere chance to acquire an equity in the future should the value of the acquired property increase. While this chance undoubtedly influenced the Tax Court's determination that the transaction before us constitutes an option, we need only point out that its existence fails to supply the substance necessary to justify treating the transaction as a sale ab initio. It is not necessary to the disposition of this case to decide the tax consequences of a transaction such as that before us if in a subsequent year the fair market value of the property increases to an extent that permits the purchaser to acquire an equity.

Authority also supports our perception. It is fundamental that "depreciation is not predicated upon ownership of property but rather upon an investment in property. Gladding Dry Goods Co., 2 BTA 336 (1925)." No such investment exists when payments of the purchase price in accordance with the design of the parties yield no equity to the purchaser. In the transaction before us and during the taxable years in question the purchase price payments by Associates have not been shown to constitute an investment in the property. Depreciation was properly disallowed. Only the Romneys had an investment in the property.

Authority also supports disallowance of the interest deductions. This is said even though it has long been recognized that the absence of personal liability for the purchase money debt secured by a mortgage on the acquired property does not deprive the debt of its character as a bona fide debt obligation able to support an interest deduction. However, this is no longer true when it appears that the debt has economic significance only if the property substantially appreciates in value prior to the date at which a very large portion of the purchase price is to be discharged. Under these circumstances the purchaser has not secured "the use or forbearance of money." Nor has the seller advanced money or forborne its use. Prior to the date at which the balloon payment on the purchase price is required, and assuming no substantial increase in the fair market value of the property, the absence of personal liability on the debt reduces the transaction in economic terms to a mere chance that a genuine debt obligation may arise. This is not enough to justify an interest deduction. To justify the deduction the debt must exist; potential existence will not do. For debt to exist, the purchaser, in the absence of personal liability, must confront a situation in which it is presently reasonable from an economic point of view for him to make a capital investment in the amount of the unpaid purchase price. Associates, during the taxable years in question, confronted no such situation.

Our focus on the relationship of the fair market value of the property to the unpaid purchase price should not be read as premised upon the belief that a sale is not a sale if the purchaser pays too much. Bad bargains from the buyer's point of view as well as sensible bargains from buyer's, but exceptionally good from the seller's point of view do not thereby cease to be sales. We intend our holding and explanation thereof to be understood as limited to transactions substantially similar to that now before us.

AFFIRMED.

Notes

1. *Acquisition Indebtedness and Basis.* Acquisition indebtedness, even nonrecourse indebtedness, is included in basis on the theory that the indebtedness ultimately will be paid. But if the nonrecourse debt significantly exceeds the value of the property, there is no economic reason why the borrower will repay it because it will be cheaper to walk away from the property than to make a principle payment that will not generate equity. This is what happened in *Franklin*, and the court held that when the nonrecourse indebtedness significantly exceeds the value of the security, it does not make sense to include the debt in basis because the debt is unlikely to be repaid. Of course, if principle payments in fact are made, they should increase the owner's adjusted basis in the property. Further, if the debt is not included in the owner's adjusted basis, then it should not be included in amount realized upon disposition of the property.[12]

2. *The Son-of-Tufts Problem*. X purchases property for $1,000,000, paying $200,000 in cash and signing a nonrecourse note for $800,000. Sometime later when the property has declined in value to $700,000, X transfers the property to Y for a payment of $1,000. What is Y's basis in the property?

Why has Y purchased the property from X? Y's out of pocket investment is very small, suggesting that Y sees some possibility of making a profit on the venture if something good happens. It is possible that the value of the property will increase significantly before the first principle payment comes due. If so, Y may have sufficient equity in the property to justify making principle payments; if not, Y will allow the lender to foreclose, and all Y will have lost will be the initial $1,000. In addition, Y might think the lender will be willing to renegotiate the loan, and if the loan is written down enough, Y again might have some equity in the property.

The usual rule is that debt goes into basis, and if that rule applies, Y's basis equals $801,000. However, because the debt significantly exceeds the value of the property, the rule of *Estate of Franklin* would limit Y's basis to $1,000. Which rule should apply? If the *Estate of Franklin* rule should apply only in abusive cases, then it should not apply on these facts because when the loan was made, it was not abusive. But if the *Estate of Franklin* rule should apply whenever a liability is unlikely to be paid, then it should apply. Which is it, or is there another alternative? See the next case.

Pleasant Summit Land Corp. v. Commissioner

863 F.2d. 263 (3d Cir. 1989)

GREENBERG, CIRCUIT JUDGE.

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George Prussin is an investor in a limited partnership, Pleasant & Summit Associates (PSA), which indirectly purchased Summit House from PSLC. The Prussins challenge

[12] Congress ultimately adopted a different response to the problem of excess nonrecourse debt in §465, the at-risk limitation.

the Tax Court's conclusions that: (1) nonrecourse financing of the Summit House purchase exceeded its fair market value; (2) the nonrecourse financing would not support depreciation and interest deductions which they claimed by reason of George Prussin's limited partnership interest in PSA; and (3) these deductions would be disallowed in full rather than only to the extent that they were the product of financing in excess of the fair market value of Summit House. . . .

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On May 3, 1978, in an arm's length transaction, PSLC entered into an agreement to purchase the Summit House, a property on Summit Street, West Orange, New Jersey, containing two apartment buildings and a small separate resident manager's apartment for $4,200,000. The purchase was closed on or about June 1, 1978 and the consideration was paid by $250,000 in cash, by delivery of a $1,350,000 note secured by a purchase money mortgage, and by PSLC taking title subject to a previously existing $2,600,000 nonrecourse mortgage.

Contemporaneously with the purchase, PSLC created a wholly owned subsidiary, Mount Orange Realty Corp. (MORC), to which it then sold the Summit House buildings while retaining the land beneath them. The sale price to MORC was $5,200,000, consisting of $500,000 in cash which MORC borrowed or owed and a $4,700,000 nonrecourse mortgage which wrapped around and was subject to the prior two mortgages. The note which this mortgage secured permitted accumulation of interest and principal through December 31, 1988, except that annual interest payments were required up to the available cash flow. This conveyance of the property placed the depreciable buildings in one entity while leaving the nondepreciable land in another.

PSLC then sold its MORC stock to the newly created PSA, which was organized to acquire the Summit House, for $2,559,200, paid in the form of a nonrecourse note secured by the MORC shares, for which a mortgage of Summit House to PSLC was immediately substituted. This note had provisions for accumulation of interest and principal through December 31, 1988, similar to those in the $4,700,000 note. PSA then dissolved MORC, took direct ownership of the Summit House buildings and took over MORC's obligations including the $500,000 due on the purchase of the Summit House and the $4,700,000 nonrecourse wraparound mortgage. Thus, the cost to PSA for acquisition of Summit House was the $2,559,200 indebtedness for the purchase of the MORC shares, assumption of MORC's $500,000 obligation, and assumption of MORC's $4,700,000 nonrecourse wraparound mortgage for a total of $7,759,200. The record, however, does not clearly establish that PSA paid the $500,000. Of course, this assumption of obligations did not transform the nonrecourse debts to recourse obligations. The consequence of these transactions was to leave PSA with large debts with interest charges and a substantial depreciable asset, a situation setting up the possibility for it to claim large tax deductions. Additionally, PSLC leased the land under the buildings to PSA for $10,000 a year under an agreement allowing rent to be accumulated and deferred at a fixed rate of interest. This provision caused PSA to generate additional tax deductions for the interest which accrued on the unpaid rent.

PSA sold thirty limited partnership units to a group of investors including George Prussin for a total of $1,980,000 paid with down payments and subsequent installments. The offering memorandum to the investors indicated that the $500,000 due on the sale from PSLC would be paid from the investors' down payments, leading the Commissioner in his brief to indicate that it appears that MORC's $500,000

obligation for its down payment was satisfied from the investors' funds. Inexplicably, the agreement for sale of the MORC shares between PSLC and PSA included a warranty by PSLC that MORC had no liabilities. Some months after PSA acquired Summit House, a new nonrecourse mortgage was substituted for the prior $2,600,000 mortgage but this did not enhance PSA's risk in the transaction. Most of the foregoing transactions were nearly contemporaneous and thus they formed part of one large structured undertaking.

PSA reported losses on its income tax returns for 1978 and 1979, and later years, largely attributable to interest deductions and depreciation. These losses were passed through to the limited partners who used them to off-set income on their individual tax returns. On December 19, 1985 an unrelated third party purchased the Summit House land from PSLC and the buildings and lease from PSA for a total of $7,000,000.

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The Prussins reported a loss of $417,012 from George Prussin's distributive share of the 1978 losses of PSA on their joint federal income tax return for 1978, and a loss of $345,170 from George Prussin's distributive share of PSA's 1979 losses on their 1979 income tax return. On April 22, 1985, the Commissioner issued a deficiency notice to the Prussins entirely disallowing his share of the partnership losses on the ground that the Prussins had not established the amount and character of any of the partnership items on which their individual loss claims were based.

PSLC and the Prussins brought these actions challenging the Commissioner's deficiency notices. Prior to the consolidated trial, PSLC conceded all issues other than its status as a personal holding company. A trial then ensued before Judge Cohen of the United States Tax Court whose opinion is reported as Pleasant Summit Land Corporation v. Commissioner, T.C.M. (CCH) 1987-469 at 566-76 (Sept. 17, 1987) [hereinafter PSLC]. Judge Cohen held that PSLC qualified as a personal holding company subject to the personal holding company tax and, accordingly, she upheld the Commissioner's assessment of a $236,840 deficiency for PSLC's taxable year ending May 31, 1979. On this appeal PSLC challenges the Tax Court's finding that PSLC was a personal holding company, though it does not contend that, if it was a personal holding company, the assessment was erroneously calculated.

Judge Cohen determined that the Prussins had deficiencies for their taxable years ending December 31, 1978, and December 31, 1979, respectively, of $264,571.00 and $141,496, attributable to her sustaining the disallowance of deductions that PSA passed through to its limited partners including the Prussins. The disallowance of PSA's deductions was based on Judge Cohen's factual finding that the nonrecourse debt underlying its purchase of Summit House was greater than its fair market value, which did not exceed $4,200,000. The judge held that as a matter of law nonrecourse indebtedness in excess of fair market value would not support deductions for either depreciation or interest payments as there was no investment in the property and no genuine indebtedness for its purchase. She explained that no depreciable basis in Summit House had been established and consequently no portion of the nonrecourse indebtedness would support tax deductions. On appeal the Prussins challenge Judge Cohen's findings of fact, her application of legal standards, and the constitutionality of the legal standards applied.

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B. Whether PSA's Nonrecourse Indebtedness Exceeded the Fair Market Value of Summit House

If we assume, even though the record is unclear on this point, that PSA paid the $500,000 which MORC was to have paid to PSLC, PSA's purchase price for Summit House was $7,759,200, of which no more than $500,000 was paid other than by creation of nonrecourse indebtedness. Otherwise it was $7,259,200. It is this investment which must be compared to the fair market value of Summit House.

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Given her consideration of many different bases for finding fair market value and the Prussins' failure to present expert testimony on value, we conclude that Judge Cohen's findings as to the maximum fair market value were not clearly erroneous. Accordingly, we will not disturb her finding that the nonrecourse financing exceeded the fair market value of Summit House.

The Internal Revenue Code does not expressly provide in any section germane to this case for any adjustment of deductions when nonrecourse debt exceeds fair market value. Thus, it is necessary to analyze the overall statutory framework and legal precedents to understand the significance of the Tax Court's finding that PSA's nonrecourse debt exceeded the fair market value of Summit House.

The Internal Revenue Code allows a deduction for "a reasonable allowance for the exhaustion, wear and tear" of property used in the taxpayer's trade or business and of property held for the production of income. I.R.C. Sec. 167(a). This depreciation deduction is calculated using the adjusted basis of the property used to calculate gain under section 1011. See I.R.C. Sec. 167(g). The basis of the property for purposes of calculating gain under section 1011 is ultimately defined in section 1012. Section 1012 provides that generally the "basis of property shall be the cost of such property." The cost of property includes the amount of indebtedness incurred or assumed by the purchaser as part of the purchase transaction. See Crane v. Commissioner, 331 U.S. 1, 9-10 (1947). However, several courts of appeals have held that nonrecourse debt in excess of fair market value is not included in the cost of property for purposes of calculating the depreciation deduction. See, e.g., Odend'hal v. Commissioner, 748 F.2d 908, 912-14 (4th Cir. 1984); Estate of Franklin v. Commissioner, 544 F.2d 1045, 1049 (9th Cir. 1976).

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While we regard *Odend'hal* and *Estate of Franklin* as the appropriate precedents, we do not consider them as authority to eliminate all deductions for interest and depreciation. While we realize that a taxpayer holding property subject to a nonrecourse debt in excess of the market value of the property may have no incentive to pay off any portion of the debt, including the amount not exceeding the fair market value of the property, it is equally logical to recognize that the creditor holding the debt has no incentive to take back the property if the taxpayer offers to pay the debt up to the value of the property. For example, if a creditor held a nonrecourse debt for $1,500,000 on a property with a fair market value of $1,000,000, he would have a disincentive to foreclose if his defaulting debtor offered to settle the debt for not less than $1,000,000. Thus, it is appropriate to disregard only the portion of nonrecourse

debt in excess of the fair market value of the property when it was acquired for purposes of calculations of the depreciation and interest deductions and to regard the nonrecourse debt as genuine indebtedness to the extent it is not disregarded. Moreover, there is precedent for disallowing deductions based on nonrecourse debt only insofar as attributable to the excess of debt over the fair market value. See *Odend'hal*, 748 F.2d at 912-14.

Unquestionably, the record compels the conclusion that Summit House, though not exceeding $4,200,000 in fair market value, had a substantial value. Thus, under our analysis the Tax Court's determination that the deductions should be disallowed in full cannot be sustained. Accordingly, we will remand the case to the Tax Court for a determination of fair market value of Summit House at the time of PSA's acquisition.

We also conclude that the actual cash investment of PSA in the purchase of Summit House, if there was any, should be disregarded in the calculation of the fair market value as it obviously was at risk. While Judge Cohen inferred that the $500,000 was not paid by PSA, we are not satisfied that this was necessarily correct, particularly in view of the Commissioner's brief in which it is recited that it appears that the $500,000 was paid from the investor's funds. According to the Prussins, the absence of evidence establishing that the $500,000 was paid is attributable to the fact that there was no issue at trial raised regarding this point. On the remand it may be definitively ascertained whether the payment was made. The significance of the cash investment is that there is an economic reason to pay off a nonrecourse debt when there is some equity in the property, even though the total debt when added to the equity exceeds the value of the property, as the alternative to paying the debt is the loss of the equity. Thus, if there is a $500,000 equity in a property worth $4,000,000, the owner of the property should logically be willing to pay off up to $4,000,000 in nonrecourse debt to save the property because his loss in that case will not exceed $500,000 but his loss in giving up the property will be $500,000.

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Note

1. *The fair market value alternative.* The court in *Pleasant Summit Land Corp.* determined that the taxpayer’s basis should equal so much of the debt as did not exceed the value of the property. What is its justification for that conclusion? Often a lender will be willing to reduce the debt to the fair market value of the property because that is all the lender would recover after foreclosure. Further, reducing the debt to fair market value allows the lender to avoid the costs – often considerable costs – of foreclosure and resale.

Setting basis equal to fair market value of the property in the Son-of-*Tufts* fact pattern has an important administrative implication. If X transfers property to Y when it is encumbered by a nonrecourse loan approximately equal to the value of the property, trying to apply the rule of *Estate of Franklin* becomes difficult: if the property is worth a little more (so that it exceeds the debt), basis includes all the debt while if it is worth a little less (so that it is less than the debt), basis includes none of the debt. Fair market value usually is a range rather than a value, and this uncertainty in the value of the property could have dramatic tax consequences (called a “cliff effect”).

For example, if the debt is $800,000 and the value of the property is something between $810,000 and $775,000, it might be hard to know if Y's basis includes all of the debt or none of the debt. But using the rule articulated in *Pleasant Summit Land Corp,* Y's basis will be something between $800,000 and $775,000, a relatively small range unlikely to justify litigation.

5. Illegal Income and Expense

Suppose an employee embezzles funds from her employer. Should the employee be taxed on the embezzled proceeds? In Commissioner v. Wilcox, 327 U.S. 404 (1946), the Supreme Court held that the embezzler should not be taxed because an obligation to repay the employer was imposed by the criminal law. That is, the Court treated the embezzlement as a sort of undiscovered borrowing.

Wilcox was overruled in *James v. Commissioner*, 366 U.S. 213 (1961). As a result, it now is clear that the fruits of an illegal activity are as taxable as legal profits even if the taxpayer has an obligation to repay those fruits if caught. Of course, if repayment is made in a subsequent taxable year, the taxpayer should be entitled to a deduction equal to the prior inclusion.

In that rare case when an embezzler, swindler or thief is caught before the misappropriated funds have been spent, there will be two claims on the money, one by the victim and one by the US Treasury for taxes arising in the year of embezzlement. Which takes priority? In general, the government's claim will come before the victim's[13] so that even though the funds have been recovered, the victim will receive only a partial recovery. Congress should reverse the priorities in such circumstances.

Notes

1. *Expenses incurred in connection with illegal business activity*. In Commissioner v. Sullivan, 356 U.S. 27 (1958), the Supreme held that rent and similar business expenses incurred in connection with running an illegal bookmaking operation were deductible. The Court wrote that denying business deduction to illegal enterprises would "come close to making [that] type of business taxable on the basis of its gross, while all other business would be taxable on the basis of its net income. If that choice is to be made, Congress should do it." However, in Tank Truck Rentals v. Commissioner, 356 U.S. 30 (1958), the Court held that fines paid by a trucking company for violations of state maximum weight laws were nondeductible. In Commissioner v. Tellier, 383 U.S. 687 (1966), a stockbroker incurred legal expenses unsuccessfully defending himself against charges of violating federal securities laws while conducting his underwriting business. The lower court disallowed the deduction as against public policy, but the Supreme Court reversed, writing:

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[13] As a practical matter, the government almost always will be able to file a tax lien before the victim is able to file a judgment lien, giving the government priority in bankruptcy.

> Congress has authorized the imposition of severe punishment upon those found guilty of the serious criminal offenses with which the respondent was charged and of which he was convicted. But we can find no warrant for attaching to that punishment an additional financial burden that Congress has neither expressly nor implicitly directed. To deny a deduction for expenses incurred in the unsuccessful defense of a criminal prosecution would impose such a burden in a measure dependent not on the seriousness of the offense or the actual sentence imposed by the court, but on the cost of the defense and the defendant's particular tax bracket. We decline to distort the income tax laws to serve a purpose for which they were neither intended nor designed by Congress.

Congress eventually accepted the Supreme Court's invitation to legislate on the matter, and it largely codified the Supreme Court's results. In §162(f), deductions for fines and penalties are disallowed, thereby codifying *Tank Truck Rentals*. Similarly, illegal bribes and kickbacks cannot be deducted, §162(c), and any other illegal payment is not deductible if (a) the payment is illegal under federal or generally enforced state law and (b) violation of such state law can result in criminal sanction or loss of a license, §162(c)(2). Consistent with the *Sullivan* decision, the legislative history of §162(c) makes clear that no public policy limitation should limit business deductions under §162 beyond those enacted by Congress. The Tax Court has interpreted this legislative history narrowly, ruling that its public policy limitations continue to limit loss deductions under §165. E.g., Mazzei v. Commissioner, 61 T.C. 497 (1974).

On a somewhat related note, Congress has provided that no deduction is permitted for any payment made in connection with sexual harassment and sexual abuse claims (including attorney fees related to such claims) if (but only if) if the settlement or payment is subject to a nondisclosure agreement. §162(q).

2. *Expenses of persons dealing in substances illegal under Federal law*. Proving that it can be tough on crime, Congress has provided that expenses are nondeductible if incurred in carrying on the trade or business of trafficking in controlled substances as defined by federal law. §280E. Not that this rule of nondeduction does not apply to other illegal, profit-seeking activities such as kidnapping for ransom and murder for hire. And note also that it applies to the trade or business of the sale of marijuana (medical or recreational), even if legal under applicable state law business the sale or use of marijuana remains illegal under federal law.

C. Exempt Income and Expense

Section 103(a) excludes from gross income interest received on state and local bonds. Such bonds often are called "tax exempt" but that is a slight misnomer because if such bonds are sold at a gain or a loss, the gain or loss is recognized by the selling taxpayer. It is only the interest on such bonds that is exempt.

Exclusion of such interest was once defended as required by constitutional limitations on the power of the government to tax activities of the states, see McCulloch v. Maryland,

17 U.S. (4 Wheat.) 316 (1819) (the power to tax is the power to destroy). It is now seen as a decision by Congress to subsidize state borrowing costs, albeit in an indirect way.

1. Section 103 as a Leaky Subsidy

Suppose that the market interest for a *taxable* state bond is 10% per year, so that a $100 face value bond would pay $10 per year to the holder. If the federal government were to tax this interest, it would receive $4 from a taxpayer in the 40% bracket and $1.50 for a taxpayer in a 15% tax bracket. Thus, the revenue loss to the federal government with respect to this bond if the interest from the bond is exempt from federal income tax is $4 per year if the bond is held by a 40% bracket taxpayer and $1.50 if it is held by a 15% taxpayer.

If the state wishes to sell a tax-free $100 bond to a 40% taxpayer, what interest rate must it pay on the bond, assuming that taxable bonds pay 10% per year? Because the holder of the bond will refuse to accept a reduction in after-tax value, the tax-exempt bond will have to yield 6% ($6 per year). Thus, the $4 per year lost by the federal government is captured by the state government in the form of a reduction in its borrowing cost (i.e., the state will pay only $6 per year instead of $10 per year in interest).

By the same reasoning, the state must pay interest of 8.5% ($8.50 per year) to induce a taxpayer in the 15% tax bracket to buy the tax-exempt bond. Once again, the revenue lost by the federal government ($1.50) is captured by the state in the form of a reduced borrowing cost. But if the state sets the tax-exempt interest rate at 8.5% to attract low-bracket taxpayers, high-bracket taxpayers will reap a windfall. That is, a taxpayer in the 40% bracket will buy the bond, and the federal government will lose $4 per year of tax revenue. But the state's borrowing cost is reduced by only $1.50 per year. Where is the remaining $2.50 of lost revenue? The bond holder has $8.50 from the exempt bond, yet she would have only $6 (after-tax) from a taxable bond. Thus, the tax-exempt bond produces a $2.50 annual windfall to the 40% bracket taxpayer. The subsidy, in other words, leaks $2.50 of its $4.00.

2. Section 103 as an Indirect Subsidy

Section 103 is an example of an *indirect* subsidy; that is, the subsidy is not intended to benefit the taxpayer given the exclusion (or given the deduction). Indirect subsidies rarely work because it is hard to target the intended beneficiaries (in the case of §103, the intended beneficiaries are state and municipal governments). Direct subsidies also have problems. For example, suppose Congress makes college tuition deductible to help subsidize poor students. Who gets the benefit of the deduction? Very poor students get no benefit, because a deduction is worthless to a taxpayer who has no income to offset. The deduction is worth a little to a low-bracket student. But the deduction is worth a lot to a high-bracket (i.e., rich) student: recall that the after-tax value of a deduction is the dollar amount of the deduction times the taxpayer's marginal tax bracket. Because the after-tax value of deductions is worth more to the rich than to the poor, we say that subsidies provided as deductions or exemptions through the internal revenue code are upside-down. Can subsidies be implemented through the tax code without this upside-

down effect? Yes: see Y. Edrey & H. Abrams, *Equitable Implementation of Tax Expenditures*, 9 VA. TAX REVIEW 109 (1989).

3. Arbitrage and Private Activity Bonds

States (not subject to federal income taxes) eventually realized that they could use §103 to raise an indefinite amount of revenue by issuing tax-exempt bonds backed by federal bonds. The tax-exempt bonds could be sold at, say, 8.5%, and the proceeds from sale of these bonds would be used to purchase federal bonds paying 10%. Because the proceeds received by the state are immediately invested in federal bonds, issuing even an unlimited amount of such bonds has no impact on the state's credit rating. Thus, the state would pocket the spread (1.5%) without doing or risking anything. Such bonds are called arbitrage bonds. This transaction no longer works because arbitrage bonds issued by states and municipalities are not tax-exempt. §103(b)(2).

States and municipalities effectively sold their ability to issue tax-exempt bonds by issuing private activity mortgage subsidy bonds. These bonds would be issued by a state or municipality and the proceeds would then be loaned to a local company (such as K-Mart or GM) at the same below-market interest rate, thereby lowering the cost of borrowing to the private company. In return, the local company would promise to provide jobs, build roads and parks, and do other things desired by the state or local government. Now, private activity bonds generally are not tax-exempt, see §103(b)(1), so we no longer see them.

4. Expenses Related to Exempt Income

Interest on indebtedness used to purchase or carry tax-exempt securities is nondeductible. §265(a)(2). Why? The reason for having deductions in the first place is so that we do not measure (and tax) gross receipts; instead, we tax only profit. However, if we do not include the receipts from an activity in gross income but allow the costs of producing that income as deductions, the activity will produce a tax loss even though it in fact turned an economic profit. Indeed, the more general rule is expressed in §265(a)(1); the provision in §265(a)(2) is simply an application of that more general rule as applied to interest and tax-exempt securities.

D. Personal Injuries

In general, amounts received on account of injury are taxable under the general rule that all accessions to wealth are includible within "gross income" as that term is defined in §61. This includes recoveries for business as well as personal injury. Note that if the income is includible, then the costs associated with obtaining such a recovery (including legal fees) should be deductible (or treated as part of the taxpayer's adjusted basis). Further, if the recovery is for destruction of property, then the taxpayer should be entitled to a recovery of basis before income recognition.

Under §104(a)(2), gross income does not include recoveries (including both court-ordered amounts as well as settlements) received on account of personal physical injuries or physical sickness. (Note that punitive damages are not covered by this exclusion.) People

sell their potential well-being all the time (think of a professional athlete in a dangerous sport or a stunt actor), and such sales are taxable. A woman who had an extremely rare blood type regularly sold her blood, and she was taxed on the sales. Why should an involuntary sale of one's health be treated differently?

Is there an analogy to a like-kind exchange (under §1031) or an involuntary conversion (under §1033)? Note that while there is no ability to convert an injury back into an uninjured body part, there is an element of involuntariness to the exchange. Presumably Congress feels sympathy for the injured. But is an exclusion the right response? Should Congress instead tax injury recoveries and then establish a fund to compensate the injured. Note that §104(a)(2) offers no benefit to the person who is injured but cannot obtain a recovery yet offers a great benefit to someone who suffers the same injury and then obtains a large recovery. Does this make sense?

Section 104(a)(2) will exclude recoveries of lost wages if resulting from a personal physical injury and not separately identified in the judgment or settlement. Why? Note that such wages would have been taxed had there been no injury.

Suppose an injured plaintiff is awarded a series of payments over time. Such an award is called a “structured settlement.” Will §104(a)(2) cover the entire gross amount received, or will some amount of the deferred payments be recharacterized as interest and then be subject to tax? Note that if a plaintiff receives a lump sum recovery and then purchases an annuity, a portion of the annuity will be taxable under the rules applicable to all purchased annuities so that only the taxpayer’s cost can be recovered free of tax.[14] Should the result be different simply because the defendant purchases the annuity? It *is* different (whether it should be different is much less clear). Note that in many circumstances the defendant will obtain an immediate deduction for the cost of the annuity and (because of the special rules applicable to the taxation of insurance companies) the company that makes the annuity payments will not be taxed on the interest earned on the defendant's payment. Thus, in essence the interest earned over the life of the annuity goes untaxed. We call the interest earned on the defendant's payment the "inside build-up" on the recovery amount.

E. Life Insurance

Section 101(a) excludes amounts received under a life insurance contract paid to the beneficiary by reason of death of the insured. Does this make any sense? (Note that on average life insurance benefits paid by an insurance company will approximately equal premiums received.) Since premiums generally are not deductible and benefits are not taxable, perhaps this makes sense (though it seems to reflect a subsidy from those who die late to those who die early). But why is neither the insured nor the beneficiary taxed on the inside build-up? That is the one great leakage in the system, with single-premium policies being the most obvious abuse. Note also that if the premiums were in fact deductible (perhaps as a business expense if paid by a corporation on the life of a key executive), then there would be a significant erosion of the tax base. Finally, note the

[14] Section 71.

extension in §101(g) to sales of policy benefits by terminally ill and chronically ill persons, so called “viatical settlements.”

Answers to Chapter 3 Problems

1. **T borrows $10,000 from Lender. When the loan comes due (ignore interest on the loan), T is unable to pay but instead transfers a painting to Lender and the debt is discharged. Assume both T and Lender agree the painting is worth $6,000, and assume T's adjusted basis in the painting is $4,500. What are the tax consequences to T from the transfer and debt cancellation?**

T has a taxable gain of $1,500 (amount realized of $6,000 less adjusted basis of $4,500) and income from the cancellation of indebtedness of $4,000. Note that if you change the fair market value of the property (say, from $6,000 to $5,000 or $7,500), the total amount of income remains at $5,500 but the mix between gain and *Kirby Lumber* income changes.

2. **X makes a no-interest loan of $100,000 to Y when a market interest rate for the loan would be 5% per year. The loan is repayable in full in one year. What are the tax consequences to X and to Y if X is a corporation and Y is its controlling shareholder so that the transfer from X to Y is a dividend (dividends are not deductible by the corporation and are includible to the shareholder)? If X is the parent and Y is the child and the parent is transferring value to the child out of detached and disinterested generosity?**

If the lender (X) is a corporation and the borrower (Y) is a shareholder of that corporation, then the foregone interest should be treated as a taxable dividend to Y and as a nondeductible dividend to X. As a result, X should have income from the transaction of $5,000 and Y should have income of $5,000 and, possibly, an interest paid deduction in the same amount. See §163.

If the lender is a parent and the borrower is the parent's child, then the foregone interest should be treated as a gift to Y and as interest income to the parent.