MAY 26, 2009
Taxes, Happiness, and Heliocentrism
by David Cay Johnston

David Cay Johnston is a former tax reporter for The New York Times. He is also the author of two books about taxes: Free Lunch and Perfectly Legal.

* * * * *

The most heavily taxed people in the world say that they are the most satisfied with their lives; the less heavily taxed, not quite so much.

The latest findings on who is happiest come from the Organization for Economic Cooperation and Development, which gathered data from 2006 on 11 measures of life satisfaction. The OECD also measures national tax burdens.

The Danes report by far the most satisfaction with their lives, followed by the Finns, Dutch, Norwegians, and Swiss. The 10 happiest countries are filled out by New Zealand, Australia, Canada, Belgium, and Sweden.

And the United States, which imposes lower tax burdens than any of these 10 countries? The United States ranked 11th, just behind the much more heavily taxed Sweden.

This is not to suggest that paying more taxes equates to happiness. That's absurd. Some countries with higher tax burdens than those of the United States ranked lower in satisfaction, so the relationship between taxes and happiness is more subtle.

Still, these happiness rankings should provoke questions about the relationship between taxes and happiness, or at least its pursuit.

### Happiness and Tax Burdens

<table>
<thead>
<tr>
<th>Country</th>
<th>Taxes as Share of GDPa</th>
<th>Satisfaction Rank 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Denmark</td>
<td>49.0</td>
<td>1</td>
</tr>
<tr>
<td>Finland</td>
<td>43.5</td>
<td>2</td>
</tr>
<tr>
<td>Netherlands</td>
<td>39.5</td>
<td>3</td>
</tr>
<tr>
<td>Norway</td>
<td>43.6</td>
<td>4</td>
</tr>
<tr>
<td>Switzerland</td>
<td>30.1</td>
<td>5</td>
</tr>
<tr>
<td>New Zealand</td>
<td>36.5</td>
<td>6</td>
</tr>
<tr>
<td>Australia</td>
<td>30.9</td>
<td>7</td>
</tr>
<tr>
<td>Canada</td>
<td>33.4</td>
<td>8</td>
</tr>
<tr>
<td>Belgium</td>
<td>44.8</td>
<td>9</td>
</tr>
<tr>
<td>Sweden</td>
<td>50.1</td>
<td>10</td>
</tr>
<tr>
<td>United States</td>
<td>28.2</td>
<td>11</td>
</tr>
</tbody>
</table>

**FOOTNOTE TO TABLE**

*a Latest data, either 2006 or 2007. Source: OECD.*
For those who cling to the dogma that the pursuit of happiness is based on tax cuts, these rankings pose a fundamental challenge. How can higher tax burdens be associated with greater life satisfaction? Higher taxes are supposed to equate with misery, not joy. So how can people who bear a tax burden more than 80 percent greater than that of Americans possibly be happier?

To those who hold that tax cuts are always a good thing, these are questions to be dismissed out of hand. This secular article of faith was on full display earlier this month after President Obama put forth his proposal to start tightening offshore corporate tax loopholes and to crack down on individual tax cheats who hide money in the Cayman Islands and other havens.

The leading defenders of the tax cutting faith appeared at every point on the dial. Generally they are renowned for their witty predictability rather than their knowledge of tax, government finance, or even contentment. Their general approach was to divert attention away from the president's focus on integrity, transparency, and enforcement. Speaking of tax truths as if they came with a capital T, they proclaimed it self-evident that, while necessary, taxes are bad and more taxes are awful.

It does seem that lower taxes are good for us, that each of us would be better off if we could just pay less and keep more of what we make. That lower taxes mean more prosperity seems as obvious as the sun rising in the east and rolling across the sky each day.

But what seems obvious is not always so, especially when facts get in the way of dogma. Imagine human progress if Aristarchus of Samos had won the day nearly 24 centuries ago when he figured out that the earth revolved around the sun, instead of being dismissed as a blasphemer for disputing that earth was the center of the universe.

When Galileo, with his telescope, observed what Aristarchus (and Copernicus) had figured out and wrote his "Dialogue Concerning the Two Chief World Systems," he was at risk of waterboarding, or worse, by the Inquisition. Empirical evidence that challenges dogma must be dismissed. (See http://www.law.umkc.edu/faculty/projects/FTrials/galileo/dialogue.html.)

And yet Galileo's myth-breaking insights were themselves deeply flawed. The father of modern empirical research taught heliocentrism, although we know today that the sun is no more the center of the universe than the earth. Yet without the imperfect insights of Galileo (and those before him), where would we be today?

And so it goes with taxes and the tax cutting dogma in the face of empirical evidence. Flawed as it may be, there is mounting evidence that tax cuts are not pure good, raising issues that will retard human progress unless they are thoroughly examined with an eye toward reason, not faith, in financing civilization.
So to go back to the data on happiness, tax burdens, and the questions they provoke: Can higher taxes be associated with greater contentment despite conservative dogma? Can tax cuts cause misery? And could it be that regressive taxes may be a good thing, however much that challenges liberal dogma?

Another question worthy of examination is the role of taxes in mitigating risk. Economic development depends on understanding and minimizing risk. Failure to appreciate the nature of risk can have catastrophic consequences, as the whole world should understand from the meltdown of the financial system because of the mismeasure of risks.

In the 10 countries where people say they are happier than Americans, taxes are used to mitigate risks that are subject to little and sometimes no individual control.

Lose your job in America through no fault of your own, and what happens? You pay lower to no taxes, but you also see your income slashed, with more than a third of the jobless receiving no unemployment benefits, and some getting as little as five bucks a week. When the same thing happens in the 10 happier countries, the jobless benefits run as high as 90 percent of the income that was earned, often combined with training for a new job.

Get cancer, or hit by a stray bus or bullet, and in America you face ruin. If you are among the one in six Americans without health insurance, you may not get anything but emergency healthcare, arguably a kind of civil death sentence in the name of low taxes. Even if you have healthcare benefits and are not out ill or injured so long that you lose them, the benefits are unlikely to cover all of your costs, and so bankruptcy becomes a significant risk. In the 10 happier countries, your healthcare is not a function of employment or wealth or status, and chronic illnesses and injuries are treated as a social cost, a risk spread among everyone through taxes.

Grow old in America, and you will get meager benefits after paying about an eighth of your wages for Social Security, reducing your capacity to save in a 401(k) if you are lucky enough to have one or an IRA if you are not. Grow old in the 10 happier countries, and you will get larger benefits and without the need to save much.
Using taxes to mitigate risk and invest in young minds means less individual wealth, but it also means more time for family and leisure. The Swedes, for example, are more than three times more likely to own a boat than Americans.

Earth does not sit motionless midway between heaven and hell, with the sun and the stars revolving around it. These are ideas that we accept today but that just 377 years ago were enough to put you at risk of the iron maiden and resulted in lifetime house arrest for Galileo because he loved facts, even imperfect facts, more than dogma.

Tax cuts are not necessarily a good, however much the Washington establishments and its patrons wish it were so. It is high time we seriously examined the facts, especially inconvenient facts like the greater happiness reported by millions of people who pay more in taxes than Americans do.
Updated Budget Projections: 2016 to 2026

Summary
As it typically does after the President’s budget is released, the Congressional Budget Office has updated the 10-year baseline budget projections it published early in the year. CBO now estimates that if no further legislation is enacted this year that affects the federal budget, the total federal deficit for fiscal year 2016 will be $534 billion, about $100 billion greater than the shortfall posted in fiscal year 2015 (see Table 1). If current laws generally remained unchanged, the deficit would increase (in dollar terms) in nearly every year over the next decade and, CBO projects, by 2026 it would be considerably larger as a share of the nation’s output (gross domestic product, or GDP) than its average over the past 50 years (see Figure 1). Debt held by the public also would rise significantly from its already high level, reaching 86 percent of GDP by 2026.

Growing Deficits Are Projected to Drive Up Debt
This year is likely to be the first since 2009 in which the federal deficit will increase as a share of the nation’s output—from 2.5 percent of GDP in 2015 to 2.9 percent in 2016, by CBO’s estimate. That growth in the deficit will result in part from a shift in the timing of some federal payments from the beginning of fiscal year 2017 to the end of 2016 because October 1, 2016—the first day of fiscal year 2017—falls on a weekend. Without that shift of an estimated $41 billion in payments, the deficit projected for 2016 would be $493 billion, or 2.7 percent of GDP.

In CBO’s baseline, deficits rise because growth in revenues over the next 10 years is outpaced by increases in spending—particularly for Social Security, Medicare, and interest payments on the federal debt. The deficit remains at roughly 2.8 percent of GDP through 2018 but climbs to 4.9 percent of GDP by 2026. The cumulative deficit projected for the 2017–2026 period is $9.3 trillion.

One important effect of such deficits would be a burgeoning amount of debt held by the public. In 10 years, debt held by the public would equal 86 percent of GDP—more than twice its average over the past five decades. Debt that high—and heading higher—would have significant negative budgetary and economic consequences (see Figure 2 on page 4):

- Once interest rates returned to more typical, higher levels, federal spending on interest payments would increase substantially.
- Because federal borrowing reduces national saving over time, the nation’s capital stock ultimately would be smaller, and productivity and total wages would be lower, than would be the case with lower debt.
- Lawmakers would have less flexibility to use tax and spending policies to respond to unexpected challenges.
- The probability of a fiscal crisis in the United States would increase. Specifically, the risk would rise of investors’ becoming unwilling to finance government borrowing unless they were compensated with significantly higher interest rates. If that occurred, interest rates on federal debt would rise suddenly and sharply relative to rates of return on other assets.

Beyond the 10-year period, if current laws remained in place, the pressures that contributed to rising deficits during the baseline period would build, and the consequences would be even more severe. Under those circumstances, debt held by the public three decades from now would constitute 155 percent of GDP, a far larger percentage than any recorded in the nation’s history.2

Changes Since January Are Relatively Small
CBO currently projects a deficit for 2016 that is $10 billion (or 2 percent) lower than the amount it projected in January—estimated outlays have been reduced by

---
2. Ibid., Table 1-6, www.cbo.gov/publication/51129.
### Table 1.

#### CBO’s Baseline Budget Projections

<table>
<thead>
<tr>
<th>Actual, 2015-2026</th>
<th>Total 2017-2026</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>In Billions of Dollars</td>
</tr>
<tr>
<td>Revenues</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>1.065 1.099 1.140 1.180 1.223 1.266 1.316 1.365 1.419 1.473 1.532 1.592 6.126 13.508</td>
</tr>
<tr>
<td>Corporate income taxes</td>
<td>344 329 357 366 372 400 395 401 407 417 429 444 4.890 3.988</td>
</tr>
<tr>
<td>Other</td>
<td>300 309 267 264 263 267 278 289 301 313 328 342 1.339 2.912</td>
</tr>
<tr>
<td>Total</td>
<td>3,250 3,364 3,508 3,645 3,772 3,931 4,082 4,247 4,423 4,615 4,825 5,042 18.937 42.089</td>
</tr>
<tr>
<td>Off-budget¹</td>
<td>770 794 826 858 887 918 950 985 1,021 1,059 1,098 1,138 4.439 9.739</td>
</tr>
</tbody>
</table>

| Outlays           |                  |                    |
| Net interest      | 223 253 306 355 437 501 557 613 673 728 782 839 2.167 5.801 |
| Total             | 3,688 3,897 4,058 4,194 4,482 4,729 4,972 5,290 5,504 5,709 5,901 6,104 18.434 51.373 |
| Off-budget¹       | 743 774 815 864 923 987 1,056 1,130 1,208 1,289 1,377 1,471 4.646 11.122 |

| Deficit (−) or Surplus |                  |                    |
| On-budget           | −438 −534 −550 −549 −710 −798 −890 −1,043 −1,080 −1,094 −1,226 −1,343 −3,497 −9.283 |
| Off-budget¹         | 27 21 11 −7 −36 −69 −106 −146 −187 −231 −280 −333 −207 −1.384 |

| Debt Held by the Public |                  |                    |
| 13,117 13,951 14,572 15,177 15,934 16,771 17,692 18,766 19,880 21,012 22,280 23,672 | n.a. n.a. |

#### Memorandum:

- As a Percentage of Gross Domestic Product
- Revenues
  - Payroll taxes: 6.0, 5.9, 5.9, 5.9, 5.8, 5.8, 5.8, 5.8, 5.8, 5.8, 5.8, 5.8, 5.9, 5.8
  - Corporate income taxes: 1.9, 1.8, 1.8, 1.8, 1.8, 1.7, 1.7, 1.6, 1.6, 1.8, 1.7
  - Other: 1.7, 1.7, 1.4, 1.3, 1.3, 1.2, 1.2, 1.2, 1.2, 1.2, 1.3, 1.3
- Total: 18.2, 18.2, 18.2, 18.1, 18.0, 18.1, 18.1, 18.1, 18.1, 18.2, 18.2, 18.1, 18.1
  - On-budget: 13.9, 13.9, 13.9, 13.9, 13.9, 13.9, 13.9, 13.9, 14.0, 14.1, 13.9, 13.9
  - Off-budget¹: 4.3, 4.3, 4.3, 4.3, 4.2, 4.2, 4.2, 4.2, 4.1, 4.1, 4.2, 4.2

- Outlays
  - Discretionary: 6.6, 6.5, 6.2, 6.0, 5.8, 5.8, 5.6, 5.6, 5.4, 5.3, 5.3, 5.2, 5.9, 5.6
  - Net interest: 1.3, 1.4, 1.6, 1.8, 2.1, 2.3, 2.5, 2.6, 2.7, 2.9, 3.0, 2.1, 2.5
- Total: 20.7, 21.1, 21.0, 20.8, 21.4, 21.8, 22.0, 22.5, 22.5, 22.4, 22.8, 23.1, 21.4, 22.1
  - On-budget: 16.5, 16.9, 16.8, 16.5, 17.0, 17.2, 17.3, 17.7, 17.3, 17.6, 17.8, 17.0, 17.3
  - Off-budget¹: 4.2, 4.2, 4.2, 4.3, 4.4, 4.5, 4.7, 4.8, 4.9, 5.1, 5.2, 5.3, 4.4, 4.8

| Deficit (−) or Surplus |                  |                    |
| On-budget           | −2.5 −2.9 −2.8 −2.7 −3.4 −3.7 −3.9 −4.4 −4.4 −4.3 −4.6 −4.9 −3.3 −4.0 |
| Off-budget¹         | 0.2 0.1 0.1 * −0.2 −0.3 −0.5 −0.6 −0.8 −0.9 −1.1 −1.2 −0.2 −0.6 |

| Debt Held by the Public |                  |                    |
| 73.6 74.5 75.5 75.4 76.2 77.2 78.3 79.8 81.2 82.4 83.9 85.6 | n.a. n.a. |

Source: Congressional Budget Office.

n.a. = not applicable; * = between -0.05 percent and zero.

a. The revenues and outlays of the Social Security trust funds and the net cash flow of the Postal Service are classified as off-budget.
$22 billion and revenues by $12 billion. The cumulative 10-year deficit projection has dropped by $95 billion (or 1 percent), mostly as the result of a $79 billion increase in projected revenues.

Those changes stem largely from the agency’s full incorporation of the economic forecast it published in the January 2016 volume, *The Budget and Economic Outlook: 2016 to 2026*. (Last-minute changes to that forecast to reflect major legislation enacted in December and economic developments through the end of that month could not be incorporated into the January budget projections published in that volume.) Those economic revisions involved changes in corporate profits relative to GDP, among other factors, and they reduced the cumulative projected deficit for the 2017–2026 period by $168 billion. Other, technical, updates partially offset the revisions resulting from changes in the economic forecast. Legislation enacted since January has had a negligible effect on CBO’s projections of revenues and outlays.

### Deficits and Debt

In CBO’s baseline, deficits rise because spending is projected to increase faster than revenues: Overall, revenues rise by an average of about 4 percent a year—but outlay growth averages 5 percent a year. As a result, budget deficits generally climb throughout the projection period, rising from slightly less than 3 percent of GDP from 2016 through 2018 to close to 5 percent in 2026.

Such deficits would boost federal debt held by the public, which consists mostly of the securities that the Treasury issues to raise cash to fund federal activities and pay off the government’s maturing liabilities. The net amount that the Treasury borrows by selling those securities (the amounts that are sold minus the amounts that have matured) is influenced primarily by the annual budget deficit.³

---

3. The Treasury also borrows to finance student loans and other credit programs. In the baseline, that additional borrowing, often referred to as other means of financing, is projected to average $44 billion per year during the 2017–2026 period.
Consequently, under current law, debt held by the public would increase significantly in upcoming years. CBO’s baseline, after accounting for all of the government’s borrowing needs, shows debt held by the public rising from $13.1 trillion at the end of 2015 to $23.7 trillion at the end of 2026 (see Table 2). Relative to the size of the economy, that debt stays close to 75 percent of GDP through 2018 but then increases sharply, reaching 86 percent of GDP by the end of the projection period. That amount of debt, relative to the size of the economy, would be the largest since 1947 and more than twice the 50-year average of 39 percent. By historical standards, debt that high would have significant negative consequences for the budget and the economy.

**Revenues**

In CBO’s baseline projections, total revenues relative to the size of the economy fluctuate in a narrow band, ranging from 18.0 percent to 18.2 percent of GDP from 2016 through 2026. At that level, revenues would be above the 50-year average of 17.4 percent of GDP (see Figure 3). Over the past half-century, revenues as a share of GDP have been as high as 20.0 percent in 2000 and as low as 14.6 percent in 2009 and 2010.

CBO projects that federal revenues in 2016 will total about $3.4 trillion, $114 billion (or 3.5 percent) more than the 2015 amount. That percentage increase is about the same as the increase in nominal GDP that CBO expects; hence, revenues as a share of GDP in 2016 remain unchanged from last year’s 18.2 percent (see Table 3 on page 7). Receipts of individual income taxes are expected to edge up by 0.1 percentage point of GDP, but corporate income tax revenues are projected to decline by a similar amount relative to GDP. The increase in individual income tax receipts occurs mainly because people’s taxable income is expected to rise faster than inflation, thereby pushing more of it into higher tax brackets (which are indexed only to inflation). Such “real bracket creep” generally occurs in years when the economy expands. The small downward shift in corporate income tax receipts relative to GDP stems largely from recently enacted legislation that extended certain tax-reducing provisions retroactively to 2015 and prospectively to 2016 (and in some cases to later years).

After 2016, revenues are projected to decline slightly, to 18.0 percent of GDP by 2019, and then to rise to 18.2 percent of GDP near the end of the projection period. The relative stability exhibited over the 2017–2026 period mainly reflects increases, relative to GDP, in individual income tax receipts, offset by corresponding declines in revenues from four other sources:

- Individual income tax receipts are projected to increase relative to GDP each year—rising by 0.8 percentage points between 2016 and 2026—mainly because of real bracket creep, an increase in the share of wages and salaries earned by higher-income taxpayers, and rising distributions from tax-deferred retirement accounts.
Table 2.

Federal Debt Projected in CBO’s Baseline

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt Held by the Public at</td>
<td>12,780</td>
<td>13,117</td>
<td>13,951</td>
<td>14,572</td>
<td>15,177</td>
<td>15,934</td>
<td>16,771</td>
<td>17,692</td>
<td>18,766</td>
<td>19,880</td>
<td>21,012</td>
<td>22,280</td>
</tr>
<tr>
<td>the Beginning of the Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in Debt Held by the</td>
<td>-438</td>
<td>534</td>
<td>550</td>
<td>549</td>
<td>710</td>
<td>798</td>
<td>890</td>
<td>1,043</td>
<td>1,080</td>
<td>1,094</td>
<td>1,226</td>
<td>1,343</td>
</tr>
<tr>
<td>Public Deficit</td>
<td>-102</td>
<td>300</td>
<td>71</td>
<td>57</td>
<td>46</td>
<td>39</td>
<td>31</td>
<td>31</td>
<td>34</td>
<td>38</td>
<td>43</td>
<td>49</td>
</tr>
<tr>
<td>Total</td>
<td>337</td>
<td>834</td>
<td>621</td>
<td>606</td>
<td>757</td>
<td>837</td>
<td>921</td>
<td>1,073</td>
<td>1,114</td>
<td>1,132</td>
<td>1,269</td>
<td>1,392</td>
</tr>
<tr>
<td>Debt Held by the Public at</td>
<td>13,117</td>
<td>13,951</td>
<td>14,572</td>
<td>15,177</td>
<td>15,934</td>
<td>16,771</td>
<td>17,692</td>
<td>18,766</td>
<td>19,880</td>
<td>21,012</td>
<td>22,280</td>
<td>23,672</td>
</tr>
<tr>
<td>the End of the Year</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt Held by the Public at</td>
<td>73.6</td>
<td>75.4</td>
<td>75.5</td>
<td>75.4</td>
<td>76.2</td>
<td>77.2</td>
<td>78.3</td>
<td>79.8</td>
<td>81.2</td>
<td>82.4</td>
<td>83.9</td>
<td>85.6</td>
</tr>
<tr>
<td>the End of the Year (As a</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>percentage of GDP)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Memorandum:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt Held by the Public</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minus Financial Assets a</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>In billions of dollars</td>
<td>11,755</td>
<td>12,491</td>
<td>13,021</td>
<td>13,549</td>
<td>14,237</td>
<td>15,012</td>
<td>15,897</td>
<td>16,897</td>
<td>17,951</td>
<td>19,020</td>
<td>20,219</td>
<td>21,536</td>
</tr>
<tr>
<td>As a percentage of GDP</td>
<td>66</td>
<td>68</td>
<td>67</td>
<td>67</td>
<td>68</td>
<td>69</td>
<td>70</td>
<td>72</td>
<td>73</td>
<td>75</td>
<td>76</td>
<td>78</td>
</tr>
<tr>
<td>Gross Federal Debt b</td>
<td>18,120</td>
<td>19,279</td>
<td>20,021</td>
<td>20,771</td>
<td>21,613</td>
<td>22,492</td>
<td>23,427</td>
<td>24,497</td>
<td>25,593</td>
<td>26,690</td>
<td>27,858</td>
<td>29,118</td>
</tr>
<tr>
<td>Debt Subject to Limit c</td>
<td>18,113</td>
<td>19,272</td>
<td>20,013</td>
<td>20,763</td>
<td>21,605</td>
<td>22,484</td>
<td>23,419</td>
<td>24,488</td>
<td>25,584</td>
<td>26,680</td>
<td>27,848</td>
<td>29,107</td>
</tr>
<tr>
<td>Average Interest Rate on</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt Held by the Public</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Percent) d</td>
<td>1.7</td>
<td>1.8</td>
<td>2.1</td>
<td>2.4</td>
<td>2.7</td>
<td>3.0</td>
<td>3.1</td>
<td>3.3</td>
<td>3.4</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office.

GDP = gross domestic product.

a. Federal debt held by the public minus the value of outstanding student loans and other credit transactions, cash balances, and other financial instruments.

b. Federal debt held by the public plus Treasury securities held by federal trust funds and other government accounts.

c. The amount of federal debt that is subject to the overall limit set in law. “Debt Subject to Limit” differs from gross federal debt in that most debt issued by agencies other than the Treasury and the Federal Financing Bank is excluded from the debt limit. That limit was most recently set at $18.4 trillion but has been suspended through March 15, 2017. On March 16, 2017, the debt limit will be raised to its previous level plus the amount of federal borrowing that occurred while the limit was suspended.

d. The average interest rate is calculated as net interest divided by debt held by the public at the end of the year.

- Remittances by the Federal Reserve System to the Treasury are projected to decline by 0.4 percentage points of GDP, reaching more typical amounts relative to the size of the economy. Those remittances have been substantial since 2010 because of the changing size and composition of the central bank’s portfolio. A further boost in such remittances occurred in December 2015 as a consequence of new legislation requiring the Federal Reserve to immediately remit most of its capital surplus account to the Treasury.

- Corporate income tax receipts are projected to decline relative to GDP by 0.2 percentage points largely because of an expected drop in domestic economic profits relative to the size of the economy—the result of rising costs of labor and higher interest payments on businesses’ debt, among other factors.

- Payroll tax receipts are also projected to decline by 0.2 percentage points relative to GDP over the next decade, primarily because of the expected continued increase in the share of wages earned by higher-income taxpayers. Although that increase boosts income tax receipts in the projections, it also causes a greater portion of wages in the economy to be above the maximum that is subject to Social Security payroll taxes. The resulting reduction in payroll taxes is projected to offset about three-fifths of the increase in individual income tax receipts that is expected to occur for the same reason.
Outlays
Under current law, CBO projects, total federal outlays would average about 22 percent of GDP over the coming decade—more than their average of 20.2 percent over the past 50 years—rising from 21.1 percent of GDP ($3.9 trillion) in 2016 to 23.1 percent of GDP ($6.4 trillion) in 2026 (see Figure 3). Over that period, net interest costs are projected to rise by 1.7 percentage points of GDP, and mandatory spending is projected to rise by 1.6 percentage points; in contrast, discretionary spending is projected to decline by 1.3 percentage points of GDP.

Mandatory Spending. Mandatory, or direct, spending includes outlays for some federal benefit programs and for certain other payments to people, businesses, nonprofit institutions, and state and local governments. Such outlays are generally governed by statutory criteria and are not normally constrained by the annual appropriation process. The Deficit Control Act requires CBO to construct baseline projections for most mandatory spending under the assumption that current laws continue unchanged. In CBO’s baseline, mandatory spending (net of offsetting receipts, which are recorded as reductions in outlays) increases from $2.4 trillion in 2016 to $4.1 trillion in 2026, an average annual growth rate of 5.3 percent. As a percentage of GDP, mandatory spending stays at about 13 percent through 2018 but then rises over time to reach 14.9 percent of GDP in 2026. Over the past 50 years, net mandatory spending has averaged 9.4 percent of GDP.

In CBO’s baseline projections, that assumption accounts for about $1 trillion in outlays between 2017 and 2026, about half of which is related to the Supplemental Nutrition Assistance Program. For a complete list of those mandatory programs, see Congressional Budget Office, The Budget and Economic Outlook: 2016 to 2026 (January 2016), Table 3-3, www.cbo.gov/publication/51129.

4. In keeping with rules established by the Deficit Control Act, CBO’s baseline projections incorporate the assumption that certain mandatory programs whose authorization expires within the current projection period will continue. In CBO’s projections, that assumption accounts for about $1 trillion in outlays between 2017 and 2026, about half of which is related to the Supplemental Nutrition Assistance Program. For a complete list of those mandatory programs, see Congressional Budget Office, The Budget and Economic Outlook: 2016 to 2026 (January 2016), Table 3-3, www.cbo.gov/publication/51129.

5. In CBO’s baseline, mandatory outlays decline as a percentage of GDP from 2016 through 2018, and then again from 2022 through 2024, largely because of shifts in the timing of certain payments. Because October 1 falls on a weekend in 2016, 2017, 2022, and 2023, certain federal payments due on that day will instead be made at the end of September and thus will be shifted into the previous fiscal year. Without those timing shifts, mandatory outlays in CBO’s baseline would rise, as percentage of GDP, in each year of the baseline period.
### Table 3.

**Key Projections in CBO’s Baseline**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenues</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual income taxes</td>
<td>8.8</td>
<td>9.0</td>
<td>9.2</td>
<td>9.5</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>5.9</td>
<td>5.9</td>
<td>5.8</td>
<td>5.8</td>
</tr>
<tr>
<td>Corporate income taxes</td>
<td>1.8</td>
<td>1.8</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Other</td>
<td>1.7</td>
<td>1.4</td>
<td>1.3</td>
<td>1.2</td>
</tr>
<tr>
<td><strong>Total Revenues</strong></td>
<td>18.2</td>
<td>18.2</td>
<td>18.1</td>
<td>18.1</td>
</tr>
<tr>
<td><strong>Outlays</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mandatory</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>4.9</td>
<td>4.9</td>
<td>5.2</td>
<td>5.7</td>
</tr>
<tr>
<td>Major health care programs&lt;sup&gt;a&lt;/sup&gt;</td>
<td>5.5</td>
<td>5.5</td>
<td>5.7</td>
<td>6.3</td>
</tr>
<tr>
<td>Other</td>
<td>2.8</td>
<td>2.8</td>
<td>2.7</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>Subtotal</strong></td>
<td>13.2</td>
<td>13.2</td>
<td>13.6</td>
<td>14.5</td>
</tr>
<tr>
<td>Discretionary</td>
<td>6.5</td>
<td>6.2</td>
<td>5.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Net interest</td>
<td>1.4</td>
<td>1.6</td>
<td>2.2</td>
<td>2.8</td>
</tr>
<tr>
<td><strong>Total Outlays</strong></td>
<td>21.1</td>
<td>21.0</td>
<td>21.5</td>
<td>22.7</td>
</tr>
<tr>
<td><strong>Deficit</strong></td>
<td>-2.9</td>
<td>-2.8</td>
<td>-3.5</td>
<td>-4.5</td>
</tr>
<tr>
<td><strong>Debt Held by the Public at the End of the Period</strong></td>
<td>75.4</td>
<td>75.5</td>
<td>78.3</td>
<td>85.6</td>
</tr>
</tbody>
</table>

**Memorandum:**

| Social Security                      |      |      |                                   |                                   |
| Revenues<sup>b</sup>                | 4.5  | 4.5  | 4.4                               | 4.4                               |
| Outlays<sup>c</sup>                 | 4.9  | 4.9  | 5.2                               | 5.7                               |
| Contribution to the Federal Deficit<sup>d</sup> | -0.4 | -0.4 | -0.7                              | -1.3                              |

| Medicare                            |      |      |                                   |                                   |
| Revenues<sup>b</sup>                | 1.5  | 1.5  | 1.5                               | 1.5                               |
| Outlays<sup>c</sup>                 | 3.8  | 3.7  | 3.8                               | 4.4                               |
| Offsetting receipts                 | -0.6 | -0.6 | -0.6                              | -0.7                              |
| Contribution to the Federal Deficit<sup>d</sup> | -1.7 | -1.6 | -1.7                              | -2.1                              |

Source: Congressional Budget Office.

This table satisfies a requirement specified in section 3111 of S. Con. Res. 11, the Concurrent Resolution on the Budget for Fiscal Year 2016.

a. Consists of spending for Medicare (net of premiums and other offsetting receipts), Medicaid, and the Children’s Health Insurance Program as well as spending to subsidize health insurance purchased by individuals and small employers.

b. Includes payroll taxes other than those paid by the federal government (which are intragovernmental transactions). Also includes income taxes paid on Social Security benefits, which are credited to the trust funds.

c. Does not include outlays related to administration of the program, which are discretionary. Outlays do not include intragovernmental offsetting receipts stemming from payroll taxes credited on behalf of federal employees to the Social Security and Medicare trust funds.

d. The net increase in the deficit shown in this table differs from the changes in the trust fund balances for the associated programs. It does not include intragovernmental transactions, interest earned on balances, or outlays related to administration of the programs.

The bulk of mandatory spending is for Social Security and the federal government’s major health care programs. Outlays for the major health care programs consist of spending for Medicare (net of premiums and other offsetting receipts), Medicaid, and the Children’s Health Insurance Program as well as spending to subsidize health insurance. Those outlays also include spending for the risk adjustment and reinsurance programs established by
Figure 4. Spending and Revenues Projected in CBO’s Baseline, Compared With Actual Values in 1966 and 1991

<table>
<thead>
<tr>
<th>Percentage of Gross Domestic Product</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Mandatory Spending</strong></td>
</tr>
<tr>
<td>Social Security</td>
</tr>
<tr>
<td>1966</td>
</tr>
<tr>
<td>1991</td>
</tr>
<tr>
<td>2016</td>
</tr>
<tr>
<td>2026</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office.

<table>
<thead>
<tr>
<th>Total Outlays</th>
<th>Total Revenues</th>
<th>Deficit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1966</td>
<td>17.2</td>
<td>16.7</td>
</tr>
<tr>
<td>1991</td>
<td>21.7</td>
<td>17.3</td>
</tr>
<tr>
<td>2016</td>
<td>21.1</td>
<td>18.2</td>
</tr>
<tr>
<td>2026</td>
<td>23.1</td>
<td>18.2</td>
</tr>
</tbody>
</table>

the Affordable Care Act (ACA) that are used to stabilize premiums for health insurance purchased by individuals and small employers.\(^6\)

In CBO’s projections, outlays for those components of mandatory spending increase from 10.5 percent of GDP in 2016 to 12.4 percent in 2026 (see Figure 4). By 2026, such outlays total $3.4 trillion, accounting for more than half of the $6.4 trillion in federal spending in that year (see Table 4). With such growth, those programs would account for about 60 percent of the total increase in outlays over the coming decade. The projected rise in spending results largely from rapid growth (averaging about 6 percent per year) in outlays for Social Security and Medicare, which is primarily attributable to the aging of the population and rising health care spending per beneficiary: By 2026, in CBO’s baseline, Social Security and net Medicare outlays reach 5.9 percent and 3.9 percent of GDP, respectively, compared with 4.9 percent and 3.2 percent in 2016. Spending for other major health care programs rises less over the same period: Federal outlays for Medicaid grow from 2.0 percent of GDP in 2016 to 2.3 percent in 2026, and spending on subsidies for health insurance purchased through the marketplaces (along with spending to stabilize premiums) increases from 0.3 percent of GDP in 2016 to 0.4 percent in 2026.\(^7\)

After Social Security and the major health care programs, the next-largest component of mandatory outlays consists of spending designed to provide income security—including outlays for certain refundable tax credits, the Supplemental Nutrition Assistance Program, Supplemental Security Income, and unemployment compensation. Such spending will amount to $307 billion in 2016, or 1.7 percent of GDP, by CBO’s estimate. Together, that

---

6. As referred to in this report, the ACA comprises the Patient Protection and Affordable Care Act (PL. 111-148); the health care provisions of the Health Care and Education Reconciliation Act of 2010 (PL. 111-152); and the effects of subsequent judicial decisions, statutory changes, and administrative actions. That legislation established the risk adjustment and reinsurance programs to reduce the likelihood that particular health insurers would bear especially high costs for having a disproportionate share of less healthy enrollees.

7. The subsidies for health insurance premiums are structured as refundable tax credits. Following the standard budgetary treatment for such credits, the portions that exceed taxpayers’ income tax liabilities are classified as outlays in baseline projections and the portions that reduce tax payments are classified as reductions in revenues. All subsidies for out-of-pocket spending are classified as outlays. Subsidies provided through the Basic Health Program are also included here and are classified as outlays.
spending is projected to grow by an average of 2 percent per year, which is slower than GDP is projected to grow. As a result, by 2026 those outlays are projected to shrink to 1.4 percent of GDP.

In CBO’s baseline, all other mandatory spending, net of offsetting receipts, remains steady at 1.2 percent of GDP, on average, from 2016 through 2026.

**Discretionary Spending.** Funding for most discretionary programs is provided by means of budget authority specified in annual appropriation acts. Each year, the Congress appropriates funding for defense, law enforcement, transportation, national parks, disaster relief, and foreign aid, for example. Depending on the activity or program, federal spending that arises from that budget authority can occur quickly (to pay salaries, for example) or slowly (to pay for long-term research and development projects). In any year, some discretionary outlays come from new budget authority and some come from past appropriations.

CBO’s baseline incorporates the caps specified in the Budget Control Act (as later amended) for defense and nondefense discretionary budget authority, and it accounts for additional reductions over the 2018–2021 period that are required under the law’s automatic enforcement procedures. Those caps remain at about the 2016 level in both 2017 and 2018 and then rise by about 2½ percent per year from 2019 through 2021. For years after 2021, appropriations for programs that are constrained by the caps are assumed to grow with inflation from the amounts projected for 2021. Appropriations for programs that are not constrained—overseas contingency operations (certain overseas military and diplomatic operations, such as those in Afghanistan), emergency requirements, and disaster relief and certain program integrity initiatives (up to certain limits)—are assumed to grow with inflation from the amounts provided in 2016.8

Discretionary outlays in 2016 are projected to be $28 billion above last year’s amount (see Table 5 on page 12). That increase results largely from the Bipartisan Budget Act of 2015 (P.L. 114-74), which raised the statutory limits on discretionary funding by $50 billion for 2016 (and by $30 billion for 2017), and from the resulting appropriations for 2016, which were equal to those limits.9 According to CBO’s estimates, discretionary outlays for national defense will increase in 2016 for the first time since 2011, edging up by 0.7 percent; nondefense discretionary outlays will climb by 4.1 percent.

Discretionary outlays (adjusted for shifts in the timing of certain payments) are projected to increase by 1.1 percent in 2017, remain roughly unchanged in 2018, and then grow at an average rate of 2.1 percent from 2018 through 2026. Both defense and nondefense discretionary spending follow that general pattern; defense outlays would grow slightly faster than nondefense outlays.

The growth rate of total discretionary spending is less than half of the rate projected for the growth of nominal GDP. As a result, discretionary outlays would drop from 6.5 percent of GDP in 2016 to 5.2 percent in 2026—a smaller ratio than in any year since 1962 (the first year for which comparable data are available).

**Net Interest.** CBO projects sharply rising interest payments over the projection period for two main reasons. The first is an anticipated increase in interest rates as the economy improves. CBO expects the average interest rate on 3-month Treasury bills to rise from 0.5 percent in 2016 to 3.2 percent a decade later, and it expects the average rate on 10-year Treasury notes to increase from 2.6 percent to 4.1 percent over the same period.

The second reason involves the sharp projected increase in debt held by the public, which rises by about 70 percent from 2016 to 2026 in CBO’s baseline. All told, rising interest rates and federal debt are projected to more than triple the government’s net interest costs in nominal terms—from $253 billion in 2016 to $839 billion in 2026. As a percentage of GDP, those costs more than double, from 1.4 percent to 3.0 percent, over the 10-year projection period.

**Alternative Assumptions About Fiscal Policy**

Fiscal policies that differed from those that CBO assumes in its baseline projections could lead to budget outcomes that are considerably different from those in the baseline.

---

8. The program integrity initiatives that are not constrained by the caps are aimed at reducing improper benefit payments in at least one of the following programs: Disability Insurance, Supplemental Security Income, Medicare, Medicaid, and the Children’s Health Insurance Program. For more information on the discretionary caps, see Congressional Budget Office, *Final Sequestration Report for Fiscal Year 2016* (December 2015), www.cbo.gov/publication/51038.

9. That act raised the limits for defense and nondefense funding by $25 billion each for 2016 and by $15 billion each for 2017 relative to what they would have been after automatic spending reductions.
For example, if lawmakers decided to extend tax provisions that are scheduled to expire over the next decade—such as the provision that allows businesses with large amounts of investment to immediately deduct, through 2019, a portion of the cost of new investments in equipment—without making offsetting changes in other tax policies, revenues would be lower than those in the baseline. In the other direction, policymakers could set discretionary funding at amounts lower than those projected in the baseline, thereby reducing outlays relative to the baseline.10

10. For the budgetary effects of some alternative tax and spending policies, see the supplemental material that accompanies this report on CBO’s website (www.cbo.gov/publication/51384).

Table 4.
Mandatory Outlays Projected in CBO’s Baseline

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Social Security</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Old-Age and Survivors Insurance</td>
<td>738</td>
<td>767</td>
<td>801</td>
<td>852</td>
<td>910</td>
<td>972</td>
<td>1,035</td>
<td>1,102</td>
<td>1,172</td>
<td>1,246</td>
<td>1,324</td>
<td>1,405</td>
</tr>
<tr>
<td>Disability Insurance</td>
<td>144</td>
<td>144</td>
<td>146</td>
<td>151</td>
<td>157</td>
<td>163</td>
<td>171</td>
<td>179</td>
<td>188</td>
<td>197</td>
<td>205</td>
<td>215</td>
</tr>
<tr>
<td>Subtotal</td>
<td>882</td>
<td>911</td>
<td>947</td>
<td>1,003</td>
<td>1,067</td>
<td>1,135</td>
<td>1,206</td>
<td>1,282</td>
<td>1,360</td>
<td>1,442</td>
<td>1,529</td>
<td>1,620</td>
</tr>
<tr>
<td>Major Health Care Programs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medicare</td>
<td>634</td>
<td>695</td>
<td>709</td>
<td>717</td>
<td>791</td>
<td>849</td>
<td>911</td>
<td>1,018</td>
<td>1,052</td>
<td>1,078</td>
<td>1,197</td>
<td>1,292</td>
</tr>
<tr>
<td>Medicaid</td>
<td>350</td>
<td>371</td>
<td>393</td>
<td>415</td>
<td>437</td>
<td>459</td>
<td>484</td>
<td>509</td>
<td>536</td>
<td>564</td>
<td>593</td>
<td>624</td>
</tr>
<tr>
<td>Health insurance subsidies and related spending</td>
<td>38</td>
<td>49</td>
<td>59</td>
<td>69</td>
<td>76</td>
<td>81</td>
<td>86</td>
<td>89</td>
<td>93</td>
<td>97</td>
<td>100</td>
<td>103</td>
</tr>
<tr>
<td>Children’s Health Insurance Program</td>
<td>9</td>
<td>13</td>
<td>13</td>
<td>12</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Subtotal</td>
<td>1,031</td>
<td>1,128</td>
<td>1,173</td>
<td>1,212</td>
<td>1,311</td>
<td>1,396</td>
<td>1,486</td>
<td>1,622</td>
<td>1,686</td>
<td>1,744</td>
<td>1,896</td>
<td>2,024</td>
</tr>
<tr>
<td>Income Security</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Earned income, child, and other tax credits</td>
<td>85</td>
<td>87</td>
<td>89</td>
<td>89</td>
<td>91</td>
<td>91</td>
<td>93</td>
<td>95</td>
<td>97</td>
<td>99</td>
<td>101</td>
<td>103</td>
</tr>
<tr>
<td>Supplemental Nutrition Assistance Program</td>
<td>76</td>
<td>75</td>
<td>73</td>
<td>73</td>
<td>72</td>
<td>72</td>
<td>71</td>
<td>71</td>
<td>71</td>
<td>72</td>
<td>72</td>
<td>74</td>
</tr>
<tr>
<td>Supplemental Security Income</td>
<td>55</td>
<td>59</td>
<td>56</td>
<td>53</td>
<td>59</td>
<td>61</td>
<td>63</td>
<td>69</td>
<td>66</td>
<td>63</td>
<td>71</td>
<td>73</td>
</tr>
<tr>
<td>Unemployment compensation</td>
<td>32</td>
<td>32</td>
<td>31</td>
<td>34</td>
<td>38</td>
<td>43</td>
<td>45</td>
<td>47</td>
<td>49</td>
<td>52</td>
<td>54</td>
<td>56</td>
</tr>
<tr>
<td>Family support and foster care</td>
<td>31</td>
<td>31</td>
<td>32</td>
<td>32</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>34</td>
<td>34</td>
<td>34</td>
<td>35</td>
<td>35</td>
</tr>
<tr>
<td>Child nutrition</td>
<td>22</td>
<td>23</td>
<td>24</td>
<td>25</td>
<td>26</td>
<td>27</td>
<td>28</td>
<td>29</td>
<td>30</td>
<td>31</td>
<td>31</td>
<td>34</td>
</tr>
<tr>
<td>Subtotal</td>
<td>300</td>
<td>307</td>
<td>304</td>
<td>305</td>
<td>318</td>
<td>326</td>
<td>333</td>
<td>345</td>
<td>348</td>
<td>351</td>
<td>366</td>
<td>375</td>
</tr>
<tr>
<td>Federal Civilian and Military Retirement</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civilian</td>
<td>97</td>
<td>98</td>
<td>100</td>
<td>103</td>
<td>107</td>
<td>110</td>
<td>114</td>
<td>118</td>
<td>122</td>
<td>126</td>
<td>130</td>
<td>134</td>
</tr>
<tr>
<td>Military</td>
<td>57</td>
<td>62</td>
<td>58</td>
<td>55</td>
<td>61</td>
<td>63</td>
<td>65</td>
<td>71</td>
<td>68</td>
<td>65</td>
<td>72</td>
<td>74</td>
</tr>
<tr>
<td>Other</td>
<td>7</td>
<td>5</td>
<td>6</td>
<td>5</td>
<td>5</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
<td>5</td>
<td>11</td>
</tr>
<tr>
<td>Subtotal</td>
<td>161</td>
<td>165</td>
<td>164</td>
<td>164</td>
<td>173</td>
<td>179</td>
<td>185</td>
<td>196</td>
<td>197</td>
<td>199</td>
<td>206</td>
<td>219</td>
</tr>
<tr>
<td>Veterans’ Programs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Income security</td>
<td>76</td>
<td>89</td>
<td>87</td>
<td>84</td>
<td>95</td>
<td>99</td>
<td>102</td>
<td>115</td>
<td>110</td>
<td>104</td>
<td>117</td>
<td>121</td>
</tr>
<tr>
<td>Other</td>
<td>16</td>
<td>21</td>
<td>21</td>
<td>17</td>
<td>17</td>
<td>18</td>
<td>18</td>
<td>20</td>
<td>21</td>
<td>21</td>
<td>23</td>
<td>24</td>
</tr>
<tr>
<td>Subtotal</td>
<td>92</td>
<td>110</td>
<td>108</td>
<td>102</td>
<td>112</td>
<td>116</td>
<td>121</td>
<td>135</td>
<td>130</td>
<td>125</td>
<td>141</td>
<td>146</td>
</tr>
<tr>
<td>Other Programs</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>13</td>
<td>15</td>
<td>19</td>
<td>19</td>
<td>16</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Deposit Insurance</td>
<td>-13</td>
<td>-10</td>
<td>-11</td>
<td>-13</td>
<td>-10</td>
<td>-11</td>
<td>-12</td>
<td>-13</td>
<td>-14</td>
<td>-14</td>
<td>-15</td>
<td>-57</td>
</tr>
<tr>
<td>MERHCF</td>
<td>10</td>
<td>10</td>
<td>11</td>
<td>11</td>
<td>12</td>
<td>13</td>
<td>13</td>
<td>13</td>
<td>14</td>
<td>14</td>
<td>15</td>
<td>16</td>
</tr>
<tr>
<td>Fannie Mae and Freddie Mac</td>
<td>0</td>
<td>0</td>
<td>3</td>
<td>2</td>
<td>1</td>
<td>1</td>
<td>*</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Higher education</td>
<td>22</td>
<td>3</td>
<td>-2</td>
<td>2</td>
<td>3</td>
<td>3</td>
<td>4</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>9</td>
<td>24</td>
</tr>
<tr>
<td>Other</td>
<td>56</td>
<td>49</td>
<td>73</td>
<td>72</td>
<td>74</td>
<td>72</td>
<td>69</td>
<td>67</td>
<td>66</td>
<td>65</td>
<td>65</td>
<td>68</td>
</tr>
<tr>
<td>Subtotal</td>
<td>88</td>
<td>67</td>
<td>91</td>
<td>91</td>
<td>94</td>
<td>92</td>
<td>90</td>
<td>87</td>
<td>86</td>
<td>85</td>
<td>89</td>
<td>459</td>
</tr>
</tbody>
</table>
Table 4. Mandatory Outlays Projected in CBO’s Baseline

<table>
<thead>
<tr>
<th>Source: Congressional Budget Office.</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Table 4. Mandatory Outlays Projected in CBO’s Baseline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bills of Dollars</td>
</tr>
<tr>
<td>Actual, 2015 - 2017</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Offseting Receipts</td>
</tr>
<tr>
<td>Medicare1</td>
</tr>
<tr>
<td>Federal share of federal employees' retirement</td>
</tr>
<tr>
<td>Social Security</td>
</tr>
<tr>
<td>Military retirement</td>
</tr>
<tr>
<td>Civil service retirement and other</td>
</tr>
<tr>
<td>Subtotal</td>
</tr>
<tr>
<td>Fannie Mae and Freddie Mac</td>
</tr>
<tr>
<td>Receipts related to natural resources</td>
</tr>
<tr>
<td>MERHCF</td>
</tr>
<tr>
<td>Other</td>
</tr>
<tr>
<td>Subtotal</td>
</tr>
<tr>
<td>Total Mandatory Outlays</td>
</tr>
<tr>
<td>2,297</td>
</tr>
<tr>
<td>Memorandum: Mandatory Spending Excluding the Effects of Offsetting Receipts</td>
</tr>
<tr>
<td>Spending for Medicare Net of Offsetting Receipts</td>
</tr>
<tr>
<td>Spending for Major Health Care Programs</td>
</tr>
<tr>
<td>Net of Offsetting Receipts1</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Source: Congressional Budget Office.</th>
</tr>
</thead>
</table>

Data for benefit programs in this table generally exclude administrative costs, which are discretionary.

MERHCF = Department of Defense Medicare-Eligible Retiree Health Care Fund (including TRICARE for Life); " = between zero and $500 million.

a. Gross spending, excluding the effects of Medicare premiums and other offsetting receipts. (Net Medicare spending is included in the memorandum section of the table.)

b. Spending to subsidize health insurance purchased in the marketplaces established by the Affordable Care Act and provided through the Basic Health Program and spending to stabilize premiums for health insurance purchased by individuals and small employers.

c. Includes outlays for the American Opportunity Tax Credit and other credits.

d. Includes the Temporary Assistance for Needy Families program, the Child Support Enforcement program, the Child Care Entitlement program, and other programs that benefit children.

e. Includes benefits for Civil Service, Foreign Service, Coast Guard, and smaller retirement programs as well as annuitants’ health care benefits.

f. Includes veterans’ compensation, pensions, and life insurance programs.

g. Primarily education subsidies; the costs of veterans’ health care are classified as discretionary spending and thus are not shown in this table.

h. The cash payments from Fannie Mae and Freddie Mac to the Treasury are recorded as offsetting receipts in 2015 and 2016. Beginning in 2017, CBO’s estimates reflect the net lifetime costs—that is, the subsidy costs adjusted for market risk—of the mortgage guarantees that those entities will issue and of the loans that they will hold. CBO counts those costs as federal outlays in the year of issuance.

i. Includes premium payments, recoveries of overpayments made to providers, and amounts paid by states from savings on Medicaid’s prescription drug costs.

j. Consists of spending for Medicare (net of premiums and other offsetting receipts), Medicaid, and the Children’s Health Insurance Program as well as spending to subsidize health insurance and to stabilize premiums for health insurance purchased by individuals and small employers.
Table 5.
Discretionary Spending Projected in CBO's Baseline

Billions of Dollars

<table>
<thead>
<tr>
<th>Source: Congressional Budget Office.</th>
</tr>
</thead>
</table>

CBO’s baseline projections incorporate the assumption that the caps on discretionary budget authority and the automatic enforcement procedures specified in the Budget Control Act of 2011 (as amended) remain in effect through 2021.

Nondefense discretionary outlays are usually higher than budget authority because of spending from the Highway Trust Fund and the Airport and Airway Trust Fund that is subject to obligation limitations set in appropriation acts. The budget authority for such programs is provided in authorizing legislation and is not considered discretionary.

n.a. = not applicable.

a. The amount of budget authority for 2015 and 2016 does not match the sum of the spending caps plus adjustments to the caps mostly because changes to mandatory programs included in the appropriation acts for those years were credited against the caps. In CBO’s baseline, those changes (which reduced mandatory budget authority) appear in their normal mandatory accounts.

b. Funding for overseas contingency operations, emergencies, disaster relief, and certain program integrity initiatives (which identify and reduce overpayments in some benefit programs) is generally not constrained by the statutory caps established by the Budget Control Act.

Changes in CBO’s Baseline Projections Since January 2016

The deficit that CBO now estimates for 2016, in the absence of further changes to tax and spending laws, is $10 billion (or 2 percent) less than the $544 billion projected in January (see Table 6). That decrease stems largely from technical adjustments (revisions made for reasons other than an updated economic forecast or the enactment of new laws) to estimates of mandatory spending.

CBO’s new baseline projections for the 2017–2026 period show a cumulative deficit that is $95 billion (or 1 percent) smaller than the $9.4 trillion deficit that the agency projected in January. The full incorporation of the economic forecast that CBO completed at the end of December contributed the largest changes to the baseline—reducing projected deficits by $168 billion between 2017 and 2026—largely because of an upward revision to...
### Table 6.

Changes Since January 2016 in CBO’s Baseline Projections of the Deficit

<table>
<thead>
<tr>
<th>Billions of Dollars</th>
<th>Total</th>
<th>2017-</th>
<th>2017-</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Legislative Changes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Increase or Decrease in the Deficit From Legislative Changes</td>
<td>*</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td><strong>Economic Changes</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual income taxes</td>
<td>2</td>
<td>-1</td>
<td></td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>-1</td>
<td>-1</td>
<td></td>
</tr>
<tr>
<td>Corporate income taxes</td>
<td>*</td>
<td>5</td>
<td>-1</td>
</tr>
<tr>
<td>Other</td>
<td>-2</td>
<td>-2</td>
<td>-1</td>
</tr>
<tr>
<td>All Changes in Revenues</td>
<td>1</td>
<td>8</td>
<td>17</td>
</tr>
<tr>
<td>Changes in Outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mandatory outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Social Security</td>
<td>0</td>
<td>-1</td>
<td>-2</td>
</tr>
<tr>
<td>Other</td>
<td>1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Subtotal, mandatory</td>
<td>1</td>
<td>-2</td>
<td>-3</td>
</tr>
<tr>
<td>Net interest outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt service</td>
<td>*</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>Effect of rates and inflation</td>
<td>-1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Subtotal, net interest</td>
<td>-1</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>All Changes in Outlays</td>
<td>*</td>
<td>-2</td>
<td>-3</td>
</tr>
<tr>
<td><strong>Decrease in the Deficit From Economic Changes</strong></td>
<td>1</td>
<td>10</td>
<td>20</td>
</tr>
<tr>
<td>Changes in Revenues</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual income taxes</td>
<td>2</td>
<td>*</td>
<td>*</td>
</tr>
<tr>
<td>Payroll taxes</td>
<td>-1</td>
<td>-2</td>
<td>-2</td>
</tr>
<tr>
<td>Corporate income taxes</td>
<td>2</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Other</td>
<td>-16</td>
<td>-11</td>
<td>-6</td>
</tr>
<tr>
<td>All Changes in Revenues</td>
<td>-12</td>
<td>-11</td>
<td>-5</td>
</tr>
<tr>
<td>Changes in Outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mandatory outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Health insurance subsidies and related spending</td>
<td>-7</td>
<td>-14</td>
<td>-11</td>
</tr>
<tr>
<td>Social Security</td>
<td>1</td>
<td>2</td>
<td>3</td>
</tr>
<tr>
<td>Medicaid</td>
<td>-10</td>
<td>-8</td>
<td>-5</td>
</tr>
<tr>
<td>Student loans</td>
<td>10</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Other</td>
<td>-13</td>
<td>10</td>
<td>7</td>
</tr>
<tr>
<td>Subtotal, mandatory</td>
<td>-18</td>
<td>-10</td>
<td>-6</td>
</tr>
<tr>
<td>Discretionary outlays</td>
<td>-2</td>
<td>*</td>
<td>1</td>
</tr>
<tr>
<td>Net interest outlays</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt service</td>
<td>*</td>
<td>-1</td>
<td>-1</td>
</tr>
<tr>
<td>Other</td>
<td>-2</td>
<td>-3</td>
<td>-4</td>
</tr>
<tr>
<td>Subtotal, net interest</td>
<td>-2</td>
<td>-3</td>
<td>-5</td>
</tr>
<tr>
<td>All Changes in Outlays</td>
<td>-22</td>
<td>-13</td>
<td>-9</td>
</tr>
<tr>
<td><strong>Increase (−) or Decrease in the Deficit From Technical Changes</strong></td>
<td>9</td>
<td>2</td>
<td>4</td>
</tr>
<tr>
<td><strong>Memorandum:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Changes in Revenues</td>
<td>-12</td>
<td>-3</td>
<td>12</td>
</tr>
<tr>
<td>Changes in Outlays</td>
<td>-22</td>
<td>-15</td>
<td>-12</td>
</tr>
</tbody>
</table>

Source: Congressional Budget Office.

* = between -$500 million and $500 million.
CBO’s projections of corporate and individual income taxes. Those changes were partially offset by technical updates that increased projected deficits by $73 billion over the same period. Legislation enacted since January has had a negligible effect on CBO’s projections.

**Economic Changes**

The portion of the change in CBO’s current projections of revenues and outlays that is attributable to economic factors reflects modifications to CBO’s forecast that were made too late in the process to be incorporated into the budget projections released in January 2016. In most years, the agency’s economic forecast is completed in early December and underlies the 10-year budget projections it publishes in the next two baseline updates, typically in January and March of each year. However, new legislation that was enacted in mid-December 2015 (after CBO had completed its initial economic forecast) affected certain aspects of the economic outlook. The economic forecast was updated both as a consequence of the new laws and as a result of economic developments through the end of the year, and the agency presented its updated outlook in the January 2016 report; CBO has not revised its forecast since then.

Although the budget projections in that report accounted for the direct budgetary effects of legislation enacted through the end of December 2015, they were based on the economic forecast that CBO had completed in early December. The budget projections in this volume, however, incorporate the forecast that the agency completed at the end of December and published in January. That change lowered CBO’s projection of the cumulative deficit by $168 billion (or 1.8 percent) for the 2017–2026 period, largely the result of its projection of higher revenues for the period.

**Revenues.** Incorporating the final economic forecast from January led CBO to increase its revenue projections by $134 billion for the 2017–2026 period. That rise is nearly evenly split between receipts from corporate and individual income taxes—both are higher in the current baseline than they were in January’s report. Much of that change reflects an anticipation of higher business profits than CBO had forecast in early December.

The increase in CBO’s projections for profits stemmed from, among other factors, lower interest payments by businesses. Those lower interest payments in part reflect lower borrowing needs that resulted from the business tax reductions enacted in the Consolidated Appropriations Act, 2016 (P.L. 114-113). Such lower borrowing costs flow through to higher taxable income and income tax payments of corporations and individuals.

**Outlays.** Economic updates to CBO’s projections of outlays had almost no effect on the current year’s baseline projections, but they led to a $33 billion reduction in spending estimates for the 2017–2026 period. That 10-year change stems mostly from lower projected spending for Social Security, partially offset by the effects on net interest.

**Social Security.** CBO now projects that Social Security beneficiaries will receive a cost-of-living adjustment (COLA) of 0.7 percent in January 2017, an increase that is 0.2 percentage points less than the estimated COLA used in the January baseline. In addition, the COLAs projected for 2021 and 2022 are 0.1 percentage point lower than previously incorporated. When combined with other, smaller changes that slightly reduce CBO’s estimate of initial benefit amounts for new retirees, the baseline projections of Social Security spending over the 2017–2026 period have declined by a total of $32 billion (or 0.3 percent).

**Net Interest.** CBO now anticipates interest rates on most securities that are slightly higher (by an average of less than 0.1 percentage point) than it forecast in December. Those revisions led CBO to increase—by $37 billion—its baseline projection for net interest spending over the 2017–2026 period. CBO also reduced its projection of borrowing for the same period because of economic updates in other areas of the baseline (mostly related to the increase in projected revenues and lower estimates of spending for Social Security), thereby reducing projected net interest by $29 billion. Overall, CBO raised its projections of net interest payments by $8 billion for the 2017–2026 period.

**Technical Changes**

Technical changes to budget projections led CBO to decrease its estimate of the 2016 deficit by $9 billion, the net result of lower projected outlays partially offset by lower projected revenues. In the other direction, technical changes increased CBO’s projection of the deficit for 2017.
through 2026 by $73 billion because of a combination of lower revenues and higher outlays.

Revenues. Since the January report was released, certain technical factors have led CBO to reduce its revenue projections by $12 billion for 2016 and by $55 billion for the 2017–2026 period. Most significantly, CBO has lowered its projections of revenues from the risk adjustment program implemented under the ACA to stabilize health insurance premiums. That change amounted to a total of $67 billion for the 2017–2026 period. The risk adjustment program transfers funds from health insurance plans that attract a relatively small proportion of high-risk enrollees (people with serious chronic conditions, for example) to plans that attract a relatively large proportion of such people in both the nongroup and small-group insurance markets. The new projections for the risk adjustment program did not affect CBO’s estimates of deficits because the lower revenue projections were matched by lower outlay projections for that program (those outlay projections are discussed below).

Outlays. Technical updates to CBO’s baseline projections of outlays resulted in a $22 billion drop in estimated spending for 2016 but an $18 billion increase for the 2017–2026 period. Adjustments to spending for student loan programs and Medicaid were responsible for the largest changes to current-year estimates. Higher projected costs for Social Security and net interest, partially offset by lower projected spending for other mandatory programs, drove the increase in CBO’s projections of outlays for the 10-year period.

Health Insurance Subsidies and Related Spending. CBO and the staff of the Joint Committee on Taxation (JCT) reduced their projection of outlays associated with tax credits for health insurance premiums and cost-sharing subsidies. That amount dropped by a total of $5 billion over the 2017–2026 period as a result of a lower projection for subsidized enrollment through the marketplaces, particularly over the next two years.\footnote{See Congressional Budget Office, Federal Subsidies for Health Insurance Coverage for People Under Age 65: 2016 to 2026 (March 2016), www.cbo.gov/publication/51385.}

Social Security. CBO has increased its projections of outlays for Social Security for the 2017–2026 period by $42 billion (or 0.3 percent). Almost all of that increase is in Old-Age and Survivors Insurance, primarily reflecting new data from the Social Security Administration showing that beneficiaries in 2015 were, on average, slightly older than CBO had projected. Because the older population is projected to grow a bit faster than the younger, CBO increased its projection of growth in the number of beneficiaries, particularly among older groups.

Medicaid. Since January, CBO has lowered its estimate of Medicaid spending by $10 billion for 2016 and by $40 billion (or 0.8 percent) for the 2017–2026 period. The amount for 2026 was reduced by $18 billion to correct a database error in the January baseline. Without that correction, CBO would have reduced its projection of spending for the 2017–2026 period by $22 billion (or 0.4 percent); the bulk of the decrease in outlays occurs between 2017 and 2019. The decreases are attributable to lower-than-anticipated spending during the first four months of the current fiscal year.

Student Loans. CBO increased its estimate of 2016 outlays for student loans by $10 billion, largely because the Department of Education is recording an upward revision to the subsidy costs of loans made in prior years. In addition, several technical updates led CBO to project an $18 billion (or 25 percent) net increase in outlays for student loans for the 2017–2026 period. Those updates, reflecting recent data, include an increase in the projected volume of income-based repayment plans, a reduction in the projected use of repayment plans that offer extended repayment terms, and an increase in estimates of the cost of administering the loan programs.
**Discretionary Spending.** CBO’s current projections of total discretionary outlays are similar to its previous projections because the caps on discretionary funding and other provisions of the Budget Control Act have not changed since the January baseline projections. As a result, projections of such outlays are just $5 billion higher for the 2017–2026 period than those in the previous baseline.

**Net Interest.** As a result of technical updates, CBO’s estimate of net interest outlays has increased by $33 billion (or 0.6 percent) for the 2017–2026 period, mainly attributable to new information about the mix of securities the Treasury plans to issue to finance future deficits. Specifically, the Treasury announced that for the foreseeable future it would issue more short-term bills relative to longer-term notes and bonds. That decrease in the average maturity of Treasury debt will lower projected interest payments for the next few years but raise total payments over the 10-year period because more debt will mature—and therefore require reissuance—later in the decade when interest rates are expected to be higher. In addition to those changes, CBO is now projecting smaller receipts from the financing accounts associated with the government’s credit programs than it estimated in January—mostly because of a reduction in the projected volume of federal student loans. Together, those changes increase projected outlays for net interest over the 2017–2026 period by $39 billion. In the opposite direction, CBO calculates that lower debt-service costs related to technical changes in other areas of the budget will subtract $6 billion from net interest outlays over the same period.
### Figure 1.
**Shares of Before-Tax Income and Federal Taxes, by Before-Tax Income Group, 2011**

<table>
<thead>
<tr>
<th>Percent</th>
<th>Lowest Quintile</th>
<th>Second Quintile</th>
<th>Middle Quintile</th>
<th>Fourth Quintile</th>
<th>81st to 99th Percentiles</th>
<th>Top 1 Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before-Tax Income</td>
<td>5.3</td>
<td>9.6</td>
<td>14.1</td>
<td>20.4</td>
<td>37.3</td>
<td>14.6</td>
</tr>
<tr>
<td>Federal Taxes</td>
<td>0.6</td>
<td>3.8</td>
<td>8.9</td>
<td>17.6</td>
<td>44.7</td>
<td>24.0</td>
</tr>
</tbody>
</table>

**Source:** Congressional Budget Office.

Notes: Before-tax income is market income plus government transfers. Market income consists of labor income, business income, capital gains (profits realized from the sale of assets), capital income excluding capital gains, income received in retirement for past services, and other sources of income. Government transfers are cash payments and in-kind benefits from social insurance and other government assistance programs. Those transfers include payments and benefits from federal, state, and local governments.

Federal taxes include individual income taxes, payroll taxes, corporate income taxes, and excise taxes.

Income groups are created by ranking households by before-tax income, adjusted for household size. Quintiles (fifths) contain equal numbers of people; percentiles (hundredths) contain equal numbers of people as well.

For more detailed definitions of income, see the appendix.
How Were Income and Federal Taxes Distributed in 2011?

Before-tax income was unevenly distributed across households in 2011. Average before-tax income among households in the lowest one-fifth (or quintile) of the distribution of before-tax income was approximately $25,000 in 2011, CBO estimates (see Table 1). Among households in the middle income quintile, average before-tax income was about $66,000. Relative to those two income groups, households in the highest income quintile had average before-tax income that was much higher—approximately $246,000.

Overall, federal taxes are progressive, meaning that average tax rates generally rise as income increases. Households in the lowest income quintile paid about $500 in federal taxes in 2011, on average, which amounted to an average federal tax rate of about 2 percent, CBO estimates. Households in the middle quintile paid about $7,000 in federal taxes, and households in the highest quintile paid about $58,000 in federal taxes, which results in average federal tax rates of approximately 11 percent and 23 percent, respectively.

As a result of the progressive federal tax structure, households in the highest quintile of before-tax income paid a greater share of federal taxes in 2011 than they received in before-tax income, while households in each of the other quintiles paid a smaller share of federal taxes than they received in before-tax income (see Figure 1). Households in the highest income quintile received a little more than half of total before-tax income and paid more than two-thirds of all federal taxes in 2011. In contrast, households in the lowest income quintile received approximately 5 percent of total before-tax income in 2011 and paid less than 1 percent of all federal taxes, CBO estimates.

The progressive federal tax structure also results in a distribution of after-tax income that is slightly more even than that of before-tax income. Households in the lowest income quintile received approximately 6 percent of after-tax income in 2011, compared with 5 percent of before-tax income, and households in the highest income quintile received about 48 percent of after-tax income, compared with 52 percent of before-tax income, CBO estimates.

Table 1.

| Average Household Income, Transfers, and Taxes, by Before-Tax Income Group, 2011 |
|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|---------------------------------|
|                                 | Lowest Quintile | Second Quintile | Middle Quintile | Fourth Quintile | Highest Quintile |
| Market Income                   | 15,500          | 29,600           | 49,800           | 83,300           | 234,700           |
| Government Transfers            | 9,100           | 15,700           | 16,500           | 14,100           | 11,000            |
| Before-Tax Income               | 24,600          | 45,300           | 66,400           | 97,500           | 245,700           |
| Federal Taxes                   | 500             | 3,200            | 7,400            | 14,800           | 57,500            |
| After-Tax Income                | 24,100          | 42,100           | 59,000           | 82,600           | 188,200           |

Source: Congressional Budget Office.
FIRST STEPS ON TIME VALUE

Dollars that are invested will give a return over time. It follows then that a dollar received early is worth more than a dollar received later. The earlier dollar will grow to be worth more than a dollar.

It follows also that dollars received at different times do not have the same real meaning (even if there were no inflation). They are like apples and oranges. Dollars received or paid at different times can not be compared or netted as if they were the same. One must first “translate” the earlier dollar into what it would be worth later, that is, take account of how much the earlier dollar would grow. Alternatively, one must first translate the later dollar into its equivalent at the earlier time. Conventionally dollars received or payable at different times are translated into either a “terminal value” or a “present value” before they are compared. Financial analysis does not, however, set a necessary time for comparing costs and benefits, but only insists on translation to a single time. Dollars received earlier than the point of comparison must be translated forward by taking into account the compound growth that is available; dollars received later than the point of comparison must be translated back by “discounting.”

Translating forward: Compound growth. Growth is measured by the yardstick of compound returns because, for instance, investment returns received at the end of the year (or whatever the compounding period) are themselves an amount, which can be invested and would grow. There is a return earned on the return previously earned. For example, if we assume an initial investment of $100 in a municipal bond mutual fund paying tax-exempt interest at 10% per year, an initial investment of $100 will be worth $110 at the end of a year. For the second year the interest will be 10% of $110 or $11 and the total fund will grow to be worth $121. For the third year the interest will be 10% of $121 or $111 and the total fund will grow to be worth $133.

The example can be generalized. The algebraic expression describing compound growth over period “n” of amount invested “P” (for principal) is

\[ P(1+d)^n, \]

where investment of P will yield return rate “d”. The expression is just a reflection of the fact that returns will themselves to earn money. Where a principal amount invested of “P” generates an after-tax return at rate “d,” then “dP” would be earned by the end of the year and the investment would be worth P+Pd or P(1+d) at the end of the year. The second year’s return would be computed on P(1+d), as if P(1+d) were a new investment or as if the return earned in the first year were withdrawn and then reinvested with the original P. Hence, the second year’s return would be d[P(1+d)]. At the end of the second year, the total investment would be the sum of P(1+d) (its value at the end of the first year) plus the new interest of dP(1+d). The total of P(1+d) + d(P(1+d)) is the equivalent to P(1+d)(1+d) or simply P(1+d)^2. Similarly at the end of the third year the investment would be worth P(1+d)^2 + dP(1+d)^2 or simply P(1+d)^3. After a number of years “n”, the investment would be worth P(1+d)^n.

Simple interest is mathematically simpler, but it is now considered “funny” interest. For simple interest you just multiply the principal P times the rate d, times the number of years n or Pdn. For instance at 10% simple, $100 will grow to $150 in 5 years. Simple interest is funny because it does not allow the earned interest to earn anything. Hence the principal is given first class ownership in that it earns a return, but the interest is given second class status in that it does not. If you can withdraw the interest, simple interest could be converted to compound growth simply by withdrawing the interest and putting it elsewhere.
Over short times, the difference between simple and compound growth is not all that dramatic and in the days before calculators the mathematics of exponents were formidable. In the long term the difference between simple and compound interest can be very dramatic. Over 25 years, $100 will grow to $350 with 10% simple interest ($250 of the $350 will be interest). With compound interest, $100 will grow to $100(1+10\%)^{25}$ or $1,083$, over three times as large. Two-thirds of the value comes from interest on the interest. With high returns (and calculators), simple interest that is neither withdrawable nor earning a return is considered to be a quite restricted kind of ownership, a funny concept, that must be measured by what the “real” or compound growth would be.

Translating back: “Discounting.” “Discounting” or present value calculations are just the inverse of compound growth calculations. The present value of an amount $A$ is the amount that will grow to equal $A$ at given compound growth rates. The present value answers the questions, “How much must I put into an account yielding a known rate, if I need to have $A$ by the end of $n$ periods?” and “What is future amount $A$ like in terms of having money in the bank now?” If, for instance, I need $133 in 3 years and get 10% tax exempt in my best investment, I can calculate that I must put $100 aside now: $100 will grow to equal $133 by the end of three years. So $133 in three years is like $100 now.

In general the present value of future amount $A$ is

\[
\frac{A}{(1+d)^n} \quad \text{since} \quad \frac{A}{(1+d)^n} \quad \text{will grow to equal} \quad \frac{A}{(1+d)^n} \quad \text{*(1+d)^n} \\
\text{or simply}\quad A \quad \text{in n years at return rate “d” compounded.}
\]

When “discounting” or computing a present value, the return rate is often called a “discount rate,” but the discount rate is still just another way of looking at the availability of compound growth or interest.
PROBLEM A: Net Present Value.

A. An investor is given the choice of three investments. Investment A requires a $100 investment now; it will give $20 back at the end of two years and $110 back at the end of 5 years. Investment B requires a $100 investment now and will give $40 back at the end of the first, second and third years. Investment C requires an investment of $30 now and will give $55 back in a year, $20 back at the end of the next two years and then will require another $70 payment at the end of four years. To summarize, the cash flows from the investment are as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>Investment A</th>
<th>Investment B</th>
<th>Investment C</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>($100)</td>
<td>($100)</td>
<td>($30)</td>
</tr>
<tr>
<td>1</td>
<td></td>
<td>$40</td>
<td>$55</td>
</tr>
<tr>
<td>2</td>
<td>$20</td>
<td>$40</td>
<td>$20</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>$40</td>
<td>$20</td>
</tr>
<tr>
<td>4</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
<td>($70)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>$110</td>
<td></td>
</tr>
</tbody>
</table>

1. Subtract cash invested from cash pulled out of each investment, i.e., what is the total accounting profit? What is the rank order of the investments?

2. Assume the investor's best alternative return is 5% after-tax. What is the net present value of each of the investments? What is the rank order?

3. Assume the investor's best alternative return is 10% after-tax. What is the net present value of each of the investments? What is the rank order?

Why did the rank order change?

PROBLEM B: Future Value.

This problem demonstrates the difference between an immediate deduction of cost versus recovery of cost at the time that an asset is disposed of. Assume that your client has the option to invest in only one of two investments. Investment A requires the investor to invest $1,000 in land that can be sold at the end of 5 years for $1,800. The only tax required is at the time that the land is sold. Investment B allows your client to invest $1,000 in a research project. The project allows an immediate tax deduction in year 1 for the investment. At the end of 5 years, you will be able to sell your interest in the project for $1,610. Assume that the after-tax return is 10% for your investment of the tax savings. Assume that the tax rate on Investment A and Investment B is 35%. It appears that Investment A is a better investment because it provides a higher after-tax return, but Investment B provides more after-tax cash to your client. How much more?

Investment A: Since you cannot deduct the investment, the gain on investment in year 5 is a simple calculation of taking $1,800 less the investment of $1,000 and deriving the $800 profit in year 5. Your client pays 35% on this profit of $800 (or $280) leaving her with $1,520 after-tax.

Investment B is slightly more nuanced.

Step One: The tax deduction gives a tax benefit in year one of $350 of savings. ($1,000 deduction x 35% tax rate). What is the future value in 5 years of taking the $350 tax savings and investing it for 5 years with an after-tax return of 10%?

Step Two: Because the investment was immediately expensed, there is no remaining tax basis in the investment. So, the entire $1,610 is taxable without basis offset in year 5 for a tax cost of $563.5.

Step Three: $1,610 + FV of Savings in Step One –$563.5 (i.e., the Tax Cost in Step Two) = ______[solve]

Thus, Investment B is made better because of the tax rules even though the market gives Investment A $290 more pre-tax profits. The difference is all related to timing of the deduction.
REV. RUL. 79-24, 1979-1 C.B. 60

FACTS

**Situation 1.** In return for personal legal services performed by a lawyer for a housepainter, the housepainter painted the lawyer’s personal residence. Both the lawyer and the housepainter are members of a barter club, an organization that annually furnishes its members a directory of members and the services they provide. All the members of the club are professional or trades persons. Members contact other members directly and negotiate the value of the services to be performed.

**Situation 2.** An individual who owned an apartment building received a work of art created by a professional artist in return for the rent-free use of an apartment for six months by the artist.

LAW

The applicable sections of the Internal Revenue Code of 1954 and the Income Tax Regulations thereunder are 61(a) and 1.61-2, relating to compensation for services.

Section 1.61-2(d)(1) of the regulations provides that if services are paid for other than in money, the fair market value of the property or services taken in payment must be included in income. If the services were rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary.

HOLDINGS

**Situation 1.** The fair market value of the services received by the lawyer and the housepainter are includible in their gross incomes under section 61 of the Code.

**Situation 2.** The fair market value of the work of art and the six months fair rental value of the apartment are includible in the gross incomes of the apartment-owner and the artist under section 61 of the Code.
Contested Historic Homers: What Are The Tax Consequences?

We have previously reported on the uncertain tax consequences that arise in connection with fans who catch historic home run balls, such as the widely publicized homers hit by Mark McGwire and Sammy Sosa during the 1998 season. See Shop Talk, "McGwire's 62nd Home Run: IRS Bobbles the Ball," 89 JTAX 253 (October 1998). Income and gift tax consequences may arise, depending on what the fan who catches the baseball does with it (e.g., returns it to the batter, donates it to charity, gives it to the Baseball Hall of Fame in Cooperstown, or keeps it). See Shop Talk, "More on Historic Homers: Is There 'Zero Basis' for Avoiding Taxable Income?,” 89 JTAX 318 (November 1998).

As one might imagine, the tax law is not well developed in connection with the treatment of catching or finding immensely valuable sports memorabilia. In a widely publicized press release from then-IRS Commissioner Charles Rossotti (IR-98-56, 9/8/98), issued just hours before Mark McGwire's historic 62nd homer, the Commissioner acknowledged that the ball-catcher "would not have taxable income" if the ball were immediately returned "based on an analogy to principles of tax law that apply when someone immediately declines a prize or returns unsolicited merchandise" (emphasis added). The release further stated that there likewise would be no gift tax in these circumstances.

Little authority deals with the tax consequences of catching what is immediately an immensely valuable sports collectible. "Finding" the ball at one's feet (by no means a "clean" catch) is functionally similar to finding treasure, which has long been taxable under Section 61. See, e.g., Cesarini, 26 AFTR 2d 70-5107, 428 F2d 812, 70-2 USTC ¶9509 Cesarini. The "treasure" is taxable not when later converted into cash but rather as soon as the property is in the finder's "undisputed possession" (see Reg. 1.61-14(a)).

What are the tax consequences if the prize ball's possession is in fact bitterly disputed? The issue arose with respect to Sosa's 62nd home run in 1998, hit at Chicago's Wrigley Field, which initially resulted in a wild scramble with a violent mob, a police complaint, civil litigation, and a promise to return the ball to Sosa. ((The ball ultimately made it to the Hall of Fame, and currently is part of the Hall's "Baseball as America" traveling exhibition.) Sosa's 62nd home run ball, literally knocked out of the park, landed on Waveland Avenue. Gary "Moe" Mullins, a 47-year-old delivery driver who allegedly has been shagging baseballs outside Wrigley Field most of his life, claimed he had possession of the ball but it was then pried away from him (in an ensuing pile-up of fans) by one Brendon Cunningham, a suburban Chicago mortgage broker. Mullins filed a lawsuit against Cunningham to regain ownership, but due to mounting legal fees and a judge's requirement that he post a $50,000 bond, Mullins gave up and voluntarily dismissed his lawsuit. (See Brown, "Fan Drops Suit Over Sosa Home Run Ball," Chicago Sun-Times, 9/26/98, Metro section, page 9.)

In our November 1998 Shop Talk column, we concluded that the hapless Mullins should not be taxed on receipt of the ball, since his ownership was at best momentary and contested, and at worst nonexistent. In light of the reported facts he had neither dominion and control nor the benefits of ownership (although he apparently suffered the burdens of ownership, being physically assaulted in the war on Waveland, in the ensuing pile-up).

A similar situation involving Barry Bonds's record-setting 73rd home run ball hit on 10/7/01 was recently the result of a court decision involving two fans who claimed ownership after a brawl in the stands. According to reports, TV news video showed that Alex Popov had the ball in his glove for at least 0.6 seconds before he was mobbed by a crowd. One Patrick Hayashi ended up with the ball, and both Hayashi and Popov claimed ownership. In October 2001 Popov obtained a temporary restraining order, forbidding Hayashi from transferring or concealing the ball and ordering the ball placed in a safe deposit box requiring a minimum of two keys with the keys held by counsel for both parties, pending completion of the trial ( Popov v. Hayashi, WL 31833731 Popov v. Hayashi, ). Popov's complaint for injunctive relief, conversion, battery, assault, punitive damages, and constructive trust can be found online at
www.findlaw.com. The matter was litigated (Hayashi estimated his legal bills alone exceeded $100,000), and in court both sides agreed the videotape showed the ball in Popov's glove, but the parties couldn't agree on what defines "possession"—Popov's split-second catch or Hayashi's final grab. (See Stewart, "A Split-Decision on Bonds' Baseball," Chicago Sun-Times, 12/19/02, page 3.)

The court ruled that Popov had been "set upon by a gang of bandits, who dislodged the ball from his grasp," but made it clear that Hayashi had done nothing wrong and was not part of that gang. The court was assisted by four distinguished law professors who participated in a forum to discuss the legal definition of "possession" of the baseball (held during an official session of the court). After obtaining the lawyers' respective definitions of "possession," the court reportedly described a "gray area" between securely catching the ball and never touching it, and ruled that "the ball must be sold and the proceeds divided equally between the parties." This arose from the court's conclusion that the legal claims were of equal quality, and the parties were equally entitled to the ball, hence the concept of "equitable division." (King Solomon comes to baseball—perhaps only in California!)

The decision raises anew the question of tax consequences. If the ownership of the ball became taxable on the issuance of the court's decision, both litigants arguably recognized taxable income in 2002. Although the "treasure"—Bonds's baseball—was never literally reduced to the "undisputed possession" of either party by the court's ruling (see Reg. 1.61-14(a)), the Solomonic decision effectively is that each of the parties owns the sales proceeds from half of the baseball, as a matter of legal right.

If either (or both) of the litigants appeals the court's ruling, the matter will not be disposed of until 2003 (at the earliest). This arguably should postpone taxability of the event. Moreover, given the parties' right to appeal the ruling (which right would expire in early 2003), query whether such right effectively postpones taxation until this year when the court's determination becomes final, even if neither one appeals.

Several other issues which we raised in our prior Shop Talk columns also may be applicable here. And the Popov-Hayashi litigation brings to mind further questions:

- Are the legal fees and costs incurred by both litigants deductible, presumably under Section 212 (rather than Section 162)?
- Are they instead capitalized, and ultimately offset against the sales proceeds received by Popov and Hayashi, when the ball is ultimately sold? (Compare Prop. Reg. 1.263(a)-4; see Hardesty, "The New Proposed Regulations Under Section 263 on Capitalization of Intangibles," 98 JTAX 86 (February 2003).)
- If the receipt of the ball and the court's ruling are not a taxable event, do Popov and Hayashi retain a zero basis in the ball until the sale occurs?
- Could the ball qualify for capital gains treatment? If so, is it to Popov and Hayashi's advantage to have the sale occur at least 12 months and one day from the time they are deemed to become the respective owners of the ball (or the proceeds thereof)?
- When does their holding period start: on 10/7/01 (the date of Bonds's epic homer), the date of the court's initial opinion (12/18/02), the date the court's order becomes final and non-appealable, or some other date?

Conversely, if Popov and Hayashi must include the ball's value in taxable income before it is ultimately sold (and the value then determined by an arm's-length sale price), what value should they use during the interim for income tax reporting purposes? Last fall, experts in sports memorabilia sales reportedly said the ball could easily fetch more than $1 million at auction. See "Trial Begins Over Barry Bonds' 73rd Home Run Ball," 10/15/02 (AP/Internet). Indeed, a footnote in the court's opinion states that "it has been suggested that the ball might sell for something in excess of $1,000,000." There may be a substantial difference between the FMV of the ball at the time it was caught (or the time of the court's decision) and the ultimate auction price. See Shop Talk, "More on Historic Homers: Do Auction Prices
Control?,” 90 JTAX 189 (March 1999). Should the subsequent sales price be applied in hindsight? Arguably not. (Valuation should be determined "without regard to subsequent illuminating events." See Diehl, 460 F Supp 1282, 76-2 USTC ¶9757 Diehl, aff’d per cur. 43 AFTR 2d 79-495, 586 F2d 1080, 79-1 USTC ¶9146.) We are sure that Messrs. Popov and Hayashi and their tax representatives are having a ball analyzing the alternatives!

Of course, sale of the ball requires the two sides to cooperate to find an auction house and then negotiate fees with the auction house, which could take more time and money, or else they could sell it on e-Bay. Experts already are raising doubts as to the value, in light of the court debacle. See Bean, "Who Wants to Buy a Baseball," Court TV, 1/14/03, at www.courttv.com. The court's December 18th decision imposed a December 30 deadline for an agreement as to how to implement the decision. The deadline came and went; the only thing Popov and Hayashi could agree on was to postpone the court order because they couldn't agree on how to sell the ball. See the Associated Press story, "Still No Resolution in Case of Bonds Ball," Chicago Sun-Times, 1/2/03, page 81.

Does the postponement into 2003 of the agreement on sales methodology affect the timing of income recognition? Will one of the parties appeal the California decision in any event? (No appeal was known to have been filed when this column was written.) Like Barry Bonds, we're having a "blast" with his 73rd homer, too!
Welcome to the NFL Concussion Settlement Program Website

A Settlement of a class action lawsuit was reached with the NFL and NFL Properties and retired NFL players, their representatives and family members. The retired NFL players sued, accusing the NFL of not warning players and hiding the damages of brain injury. On April 22, 2015, the United States District Court for the Eastern District of Pennsylvania entered a Final Order and Judgment approving this Settlement. The Settlement does not become effective unless no appeals are filed from that Final Order and Judgment within 30 days from that date, or if any appeals are timely filed, after those appeals are resolved in favor of the Settlement. You may check this website at any time for updates on the status of the Final Approval.

Class Members may sign up to receive future information by clicking “Sign Up for Future Information” below and providing your contact information or by calling 1-855-887-3485. There is no further action that a Class Member needs to take at this time to present a claim in the settlement. No claims for benefits can be submitted now and none have been submitted. No awards have been issued. If you are contacted by any person who is not a known and trusted source and who asserts that awards have been issued or who seeks information from you relating to a possible claim, you should not be influenced by the statements and should safeguard your personal information.

Retired players, legal representatives of incapacitated or deceased players, and families of deceased players may be eligible to receive benefits from this Settlement. A Class Member who opted out of the Settlement will not receive benefits.

The proposed settlement provides for three benefits:

1. Baseline medical exams for retired NFL players;
2. Monetary awards for diagnoses of ALS (Lou Gehrig’s disease), Alzheimer’s Disease, Parkinson’s Disease, Dementia and certain cases of chronic traumatic encephalopathy or CTE (a neuropathological finding) diagnosed after death; and
3. Education programs and initiatives related to football safety.

All valid claims for injury will be paid in full for 65 years.

Retired players, their legal representatives and family members do not have to prove that the players’ injuries were caused by playing NFL football to get money from the Settlement.

You will be able to register for benefits after the Settlement becomes effective, that is if no appeals are filed from that Final Order and Judgment, or if any appeals are timely filed, after those appeals are resolved in favor of the Settlement. If you would like information in the future when the registration period opens, click “Sign Up for Future Information” below and provide your contact information.

See https://www.nflconcussionsettlement.com
INAJA LAND COMPANY v. COMMISSIONER
9 T.C. 727 (1947)

[In 1928, the taxpayer paid $61,000 for 1,236 acres of land in Mono County, California. The land was used primarily as a private fishing club. In 1934, the City of Los Angeles constructed a tunnel near by and began to divert “foreign waters” into the Owens River upstream from the taxpayers property. These foreign waters contaminated the taxpayer’s property, caused flooding and erosion, and substantially impaired the taxpayer’s ability to use the property as a fishing lodge. In 1939, after the taxpayer had threatened legal action, the City of Los Angeles paid $50,000 to “release and forever discharge the city from liability for diversion of foreign waters onto the taxpayer’s property. The taxpayer incurred $1,055 of legal fees associated with this matter.]

LEECH, Judge

The question presented is whether the net amount of $48,945 received by petitioner in the taxable year 1939 under a certain indenture constitutes taxable income under section 22(a), or is chargeable to capital account. The respondent contends: (a) That the $50,000, less $1,055 expenses incurred, which petitioner received from the city of Los Angeles under the indenture of August 11, 1939, represented compensation for loss of present and future income and consideration for release of many meritorious causes of action against the city, constituting ordinary income; and, (b) since petitioner has failed to allocate such sum between taxable and nontaxable income, it has not sustained its burden of showing error. Petitioner maintains that the language of the indenture and the circumstances leading up to its execution demonstrate that the consideration was paid for the easement granted to the city of Los Angeles and the consequent damage to its property rights; that the loss of past or future profits was not considered or involved; that the character of the easement rendered it impracticable to attempt to apportion a basis to the property affected; and, since the sum received is less than the basis of the entire property, taxation should be postponed until the final disposition of the property. . . .

It is settled that since profits from business are taxable, a sum received in settlement of litigation based upon a loss of profits is likewise taxable; but where the settlement represents damages for lost capital rather than for lost profits the money received is a return of capital and not taxable. The difficulty is in determining whether the recovery is for lost profits or for lost capital. The test is as stated by this Court in Farmers’ & Merchants’ Bank v. Commissioner, supra, and approved in Swastika Oil & Gas Company v. Commissioner, supra, namely, ‘The fund involved must be considered in the light of the claim from which it was realized and which is reflected in the petition filed.’

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

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

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

Reviewed by the Court.

Decision will be entered for the petitioner.
HILLSBORO NATIONAL BANK v. COMMISSIONER and
UNITED STATES V. BLISS DIARY
460 U.S. 370

I

[Illinois imposed a property tax on shares held in incorporated banks. Hillsboro National Bank paid this tax on behalf of its shareholders, taking the deduction for taxes permitted by §164(e). The state refunded some of these payments directly to shareholders after the Supreme Court upheld a state constitutional amendment prohibiting ad valorem taxation of personal property owned by individuals. The IRS sought to include the repayment in Hillsboro's income.

Bliss Dairy deducted under §162 the full cost of cattle feed purchased for use in its operations. Bliss adopted a plan of liquidation in the next taxable year and distributed a substantial amount of remaining feed to its shareholders in a nontaxable transaction. The IRS asserted that Bliss Diary should have taken into income the value of the feed distributed to its shareholders.]

II

The Government in each case relies solely on the tax benefit rule -- a judicially developed principle1 that allays some of the inflexibilities of the annual accounting system. An annual accounting system is a practical necessity if the federal income tax is to produce revenue ascertainable and payable at regular intervals. Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365 (1931). Nevertheless, strict adherence to an annual accounting system would create transactional inequities. Often an apparently completed transaction will reopen unexpectedly in a subsequent tax year, rendering the initial reporting improper. For instance, if a taxpayer held a note that became apparently uncollectible early in the taxable year, but the debtor made an unexpected financial recovery before the close of the year and paid the debt, the transaction would have no tax consequences for the taxpayer, for the repayment of the principal would be recovery of capital. If, however, the debtor's financial recovery and the resulting repayment took place after the close of the taxable year, the taxpayer would have a deduction for the apparently bad debt in the first year under §166(a) of the Code.

Without the tax benefit rule, the repayment in the second year, representing a return of capital, would not be taxable. The second transaction, then, although economically identical to the first, could, because of the differences in accounting, yield drastically different tax consequences. The Government, by allowing a deduction that it could not have known to be improper at the time, would be foreclosed from recouping any of the tax saved because of the improper deduction.2 Recognizing and seeking avoid the possible distortions of income,3 the courts have long required the

2 When the event proving the deduction improper occurs after the close of the taxable year, even if the statute of limitations has not run, the Commissioner's proper remedy is to invoke the tax benefit rule and require inclusion in the later year rather than to reopen the earlier year.

3 As the rule developed, a number of theories supported taxation in the later year. One explained that the taxpayer who had taken the deduction "consented" to "return" it if events proved him not entitled to it, while another explained that the deduction offset income in the earlier year, which became "latent" income that might be recaptured. Still a third view maintained that the later recognition of income was a balancing entry. All these views reflected that the initial accounting for the item must be corrected to present a true picture of income. While annual accounting precludes reopening the earlier year, it does not prevent a less precise correction -- far superior to none -- in the current year, analogous to the practice of financial accountants. This

1 Although the rule originated in the courts, it has the implicit approval of Congress, which enacted 26 U. S. C. §111 limitation on the rule.
taxpayer to recognize the repayment in the second year as income. 4

The taxpayers and the Government in these cases propose different formulations of the tax benefit rule. The taxpayers contend that the rule requires the inclusion of amounts recovered in later years, and they do not view the events in these cases as "recoveries." The Government, on the other hand, urges that the tax benefit rule requires the inclusion of amounts previously deducted if later events are inconsistent with the deductions; it insists that no "recovery" is necessary to the application of the rule. Further, it asserts that the events in these cases are inconsistent with the deductions taken by the taxpayers. We are not in complete agreement with either view.

An examination of the purpose and accepted applications of the tax benefit rule reveals that a "recovery" will not always be necessary to invoke the tax benefit rule. The purpose of the rule is not simply to tax "recoveries." On the contrary, it is to * * * achieve rough transactional parity in tax, and to protect the Government and the taxpayer from the adverse effects of reporting a transaction

on the basis of assumptions that an event in a subsequent year proves to have been erroneous. Such an event, unforeseen at the time of an earlier deduction, may in many cases require the application of the tax benefit rule. We do not, however, agree that this consequence invariably follows. Not every unforeseen event will require the taxpayer to report income in the amount of his earlier deduction. On the contrary, the tax benefit rule will "cancel out" an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based. That is, if that event had occurred within the same taxable year, it would have foreclosed the deduction. In some cases, a subsequent recovery by the taxpayer will be the only event that would be fundamentally inconsistent with the provision granting the deduction. In such a case, only actual recovery by the taxpayer would justify application of the tax benefit rule. For example, if a calendar-year taxpayer made a rental payment on December 15 for a 30-day lease deductible in the current year under §162(a)(3) * * * the tax benefit rule would not require the recognition of income if the leased premises were destroyed by fire on January 10. The resulting inability of the taxpayer to occupy the building would be an event not fundamentally inconsistent with his prior deduction as an ordinary and necessary business expense under §162(a). The loss is attributable to the business and therefore is consistent with the deduction of the rental payment as an ordinary and necessary business expense. On the other hand, had the premises not burned and, in January, the taxpayer decided to use them to house his family rather than to continue the operation of his business, he would have converted the leasehold to personal use. This would be an event fundamentally inconsistent with the business use on which the deduction was based. In the case of the fire, only if the lessor -- by virtue of some provision in the lease -- had refunded the rental payment would the taxpayer be required under the tax benefit rule to recognize income on the subsequent destruction of the building. In other words, the subsequent recovery of the previously deducted rental payment would be the only event inconsistent with the provision allowing the

---

4 Even this rule did not create complete transactional equivalence. In the second version of the transaction discussed in the text, the taxpayer might have realized no benefit from the deduction, if, for instance, he had no taxable income for that year. Application of the tax benefit rule as originally developed would require the taxpayer to recognize income on the repayment, so that the net result of the collection of the principal amount of the debt would be recognition of income. Similarly, the tax rates might change between the two years, so that a deduction and an inclusion, though equal in amount, would not produce exactly offsetting tax consequences. Congress enacted §111 to deal with part of this problem. Although a change in the rates may still lead to differences in taxes due, see Alice Phelan Sullivan Corp. v. United States, 180 Ct. Cl. 659, 381 F.2d 399 (1967), §111 provides that the taxpayer can exclude from income the amount that did not give rise to some tax benefit. See Dobson v. Commissioner, 320 U.S. 489, 505-506 (1943). This exclusionary rule and the inclusionary rule described in the text are generally known together as the tax benefit rule. It is the inclusionary aspect of the rule with which we are currently concerned.
deduction. It therefore is evident that the tax benefit rule must be applied on a case-by-case basis. A court must consider the facts and circumstances of each case in the light of the purpose and function of the provisions granting the deductions.

When the later event takes place in the context of a nonrecognition provision of the Code, there will be an inherent tension between the tax benefit rule and the nonrecognition provision. * * * We cannot resolve that tension with a blanket rule that the tax benefit rule will always prevail. Instead, we must focus on the particular provisions of the Code at issue in any case.

In the cases currently before us, then, we must undertake an examination of the particular provisions of the Code that govern these transactions to determine whether the deductions taken by the taxpayers were actually inconsistent with later events and whether specific nonrecognition provisions prevail over the principle of the tax benefit rule.

III

In Hillsboro, the key provision is §164(e). That section grants the corporation a deduction for taxes imposed on its shareholders but paid by the corporation. It also denies the shareholders any deduction for the tax. In this case, the Commissioner has argued that the refund of the taxes by the State to the shareholders is the equivalent of the payment of a dividend from Hillsboro to its shareholders. If Hillsboro does not recognize income in the amount of the earlier deduction, it will have deducted a dividend. Since the general structure of the corporate tax provisions does not permit deduction of dividends, the Commissioner concludes that the payment to the shareholders must be inconsistent with the original deduction and therefore requires the inclusion of the amount of the taxes as income under the tax benefit rule.

In evaluating this argument, it is instructive to consider what the tax consequences of the payment of a shareholder tax by the corporation would be without §164(e) and compare them to the consequences under §164(e). Without §164(e), the corporation would not be entitled to a deduction, for the tax is not imposed on it. If the corporation has earnings and profits, the shareholder would have to recognize income in the amount of the taxes, because a payment by a corporation for the benefit of its shareholders is a constructive dividend. The shareholder, however, would be entitled to a deduction since the constructive dividend is used to satisfy his tax liability. See §164(a)(2). Thus, for the shareholder, the transaction would be a wash: he would recognize the amount of the tax as income, but he would have an offsetting deduction for the tax. For the corporation, there would be no tax consequences, for the payment of a dividend gives rise to neither income nor a deduction. Section 311(a).

Under §164(e), the economics of the transaction of course remain unchanged: the corporation is still satisfying a liability of the shareholder and is therefore paying a constructive dividend. The tax consequences are, however, significantly different, at least for the corporation. The transaction is still a wash for the shareholder; although §164(e) denies him the deduction to which he would otherwise be entitled, he need not recognize income on the constructive dividend, Treas. Reg. §1.164-7, 26 CFR §1.164-7 (1982). But the corporation is entitled to a deduction that would not otherwise be available. In other words, the only effect of §164(e) is to permit the corporation to deduct a dividend. Thus, we cannot agree with the Commissioner that, simply because the events here give rise to a deductible dividend, they cannot be consistent with the deduction. In at least some circumstances, a deductible dividend is within the contemplation of the Code. The question we must answer is whether §164(e) permits a deductible dividend in these circumstances -- when the money, though initially paid into the state treasury, ultimately reaches the shareholder -- or whether the deductible dividend is available, as the Commissioner urges, only when the money remains in the state treasury, as properly assessed and collected tax revenue.

Rephrased, our question now is whether
Congress, in granting this special favor to corporations that paid dividends by satisfying the liability of their shareholders, was concerned with the reason the money was paid out by the corporation or with the use to which it was ultimately put. Since §164(e) represents a break with the usual rules governing corporate distributions, the structure of the Code does not provide any guidance on the reach of the provision. This Court has described the provision as "prompted by the plight of various banking corporations which paid and voluntarily absorbed the burden of certain local taxes imposed upon their shareholders, but were not permitted to deduct those payments from gross income." The section, in substantially similar form, has been part of the Code since the Revenue Act of 1921. * * * The only discussion of the provision appears to be that between Dr. T. S. Adams and Senator Smoot at the Senate hearings. Dr. Adams' statement explains why the States imposed the property tax on the shareholders and collected it from the banks, but it does not cast much light on the reason for the deduction. Hearings on H. R. 8245 before the Committee on Finance, 67th Cong., 1st Sess., 250-251 (1921) (statement of Dr. T. S. Adams, tax advisor, Treasury Department). Senator Smoot's response, however, is more revealing:

"I have been a director in a bank . . . for over 20 years. They have paid that tax ever since I have owned a share of stock in the bank. . . . I know nothing about it. I do not take 1 cent of credit for deductions, and the banks are entitled to it. They pay it out." Id., at 251 (emphasis added).

The payment by the corporations of a liability that Congress knew was not a tax imposed on them gave rise to the entitlement to a deduction; Congress was unconcerned that the corporations took a deduction for amounts that did not satisfy their tax liability. It apparently perceived the shareholders and the corporations as independent of one another, each "[knowing] nothing about" the payments by the other. In those circumstances, it is difficult to conclude that Congress intended that the corporation have no deduction if the State turned the tax revenues over to these independent parties. We conclude that the purpose of §164(e) was to provide relief for corporations making these payments, and the focus of Congress was on the act of payment rather than on the ultimate use of the funds by the State. As long as the payment itself was not negated by a refund to the corporation, the change in character of the funds in the hands of the State does not require the corporation to recognize income, and we reverse the judgment below.

IV

The problem in Bliss more complicated. Bliss took a deduction under §162(a), so we must begin by examining that provision. Section 162(a) permits a deduction for the "ordinary and necessary expenses" of carrying on a trade or business. The deduction is predicated on the consumption of the asset in the trade or business. See Treas. Reg. §1.162-3, 26 CFR §1.162-3 (1982) ("Taxpayers . . . should include in expenses the charges for materials and supplies only in the amount that they are actually consumed and used in operation in the taxable year . . .") (emphasis added). If the taxpayer later sells the asset rather than consuming it in furtherance of his trade or business, it is quite clear that he would lose his deduction, for the basis of the asset would be zero, so he would recognize the full amount of the proceeds on sale as gain. See §1001(a), (c). In general, if the taxpayer converts the expensed asset to some other, nonbusiness use, that action is inconsistent with his earlier deduction, and the tax benefit rule would require inclusion in income of the amount of the unwarranted deduction. That nonbusiness use is inconsistent with a deduction for an ordinary and necessary business expense is clear from an examination of the Code. While §162(a) permits a deduction for ordinary and necessary business expenses, §262 explicitly denies a deduction for personal expenses. * * * Thus, if a corporation turns expensed assets to the analog of personal consumption, as Bliss did here -- distribution to shareholders -- it would seem that it should take into income the amount of the earlier deduction.

That conclusion, however, does not resolve this case, for the distribution by Bliss to its
shareholders is governed by a provision of the Code that specifically shields the taxpayer from recognition of gain -- §336. [Note to students: the "gain shielding" aspect of §336 referenced in the opinion was removed by the Tax Reform Act of 1986] We must therefore proceed to inquire whether this is the sort of gain that goes unrecognized under §336. Our examination of the background of §336 and its place within the framework of tax law convinces us that it does not prevent the application of the tax benefit rule.

[The Court's discussion of §336 is omitted]

Thus, the legislative history of §336, the application of other general rules of tax law, and the construction of the identical language in §337 all indicate that §336 does not permit a liquidating corporation to avoid the tax benefit rule. Consequently, we reverse the judgment of the Court of Appeals and hold that, on liquidation, Bliss must include in income the amount of the unwarranted deduction.

V

Bliss paid the assessment on an increase of $60,000 in its taxable income. In the District Court, the parties stipulated that the value of the grain was $56,565, but the record does not show what the original cost of the grain was or what portion of it remained at the time of liquidation. The proper increase in taxable income is the portion of the cost of the grain attributable to the amount on hand at the time of liquidation. In Bliss, then, we remand for a determination of that amount. In Hillsboro, the taxpayer sought a redetermination in the Tax Court rather than paying the tax, so no further proceedings are necessary, and the judgment of the Court of Appeals is reversed. It is so ordered.

[The dissenting opinions of Justice Brennan in Hillsboro National Bank and the opinion of Justice Stevens joined by Justice Marshall, concurring in Hillsboro National Bank and dissenting in Bliss Dairy have been omitted.]

Justice Blackmun, dissenting in both cases, would have required the corporations in both cases to have amended their tax returns and remove the deductions for the year in which the deductions were claimed. An excerpt from his dissent follows:

I have no difficulty in favoring some kind of "tax benefit" adjustment in favor of the Government for each of these situations. An adjustment should be made, for in each case the beneficial deduction turned out to be improper and undeserved because its factual premise proved to be incorrect. Each taxpayer thus was not entitled to the claimed deduction, or a portion of it, and this nonentitlement should be reflected among its tax obligations.

This takes me, however, to the difficulty I encounter with * * * the unraveling or rectification of the situation. The Commissioner and the United States in these respective cases insist that the Bank and the Dairy should be regarded as receiving income in the very next tax year when the factual premise for the prior year's deduction proved to be incorrect. I could understand that position, if, in the interim, the bar of a statute of limitations had become effective or if there were some other valid reason why the preceding year's return could not be corrected and additional tax collected. But it seems to me that the better resolution of these two particular cases and others like them -- and a resolution that should produce little complaint from the taxpayer -- is to make the necessary adjustment, whenever it can be made, in the tax year for which the deduction was originally claimed. This makes the correction where the correction is due and it makes the amount of net income for each year a true amount and one that accords with the facts, not [*426] one that is structured, imprecise, and fictional. This normally would be accomplished either by the taxpayer's filing an amended return for the earlier year, with payment of the resulting additional tax, or by the Commissioner's assertion of a deficiency followed by collection. This
actually is the kind of thing that is done all the time, for when a taxpayer's return is audited and a deficiency is asserted due to an overstated deduction, the process equates with the filing of an amended return. **

This, in my view, is the way these two particular tax controversies should be resolved. I see no need for anything more complex in their resolution than what I have outlined. Of course, if a statute of limitations problem existed, or if the facts in some other way prevented reparation to the Government, the cases and their resolution might well be different.

I realize that my position is simplistic, but I doubt if the judge-made tax benefit rule really was intended, at its origin, to be regarded as applicable in simple situations of the kind presented in these successive-tax-year cases. So often a judge-made rule, understandably conceived, ultimately is used to carry us further than it should.

I would vacate the judgment in each of these cases and remand each case for further proceedings consistent with this analysis.
ALICE PHELAN SULLIVAN CORPORATION v. UNITED STATES
381 F.2d 399 (Ct. Cl. 1967)

COLLINS, Judge.

Plaintiff, a California corporation, brings this action to recover an alleged overpayment in its 1957 income tax. During that year, there was returned to taxpayer two parcels of realty, each of which it had previously donated and claimed as a charitable contribution deduction. The first donation had been made in 1939; the second, in 1940. Under the then applicable corporate tax rates, the deductions claimed ($4,243.49 for 1939 and $4,463.44 for 1940) yielded plaintiff an aggregate tax benefit of $1,877.49FN1

FN1. The tax rate in 1939 was 18 percent; in 1940, 24 percent.

Each conveyance had been made subject to the condition that the property be used either for a religious or for an educational purpose. In 1957, the donee decided not to use the gifts; they were therefore reconveyed to plaintiff. Upon audit of taxpayer's income tax return, it was found that the recovered property was not reflected in its 1957 gross income. The Commissioner of Internal Revenue disagreed with plaintiff's characterization of the recovery as a nontaxable return of capital. He viewed the transaction as giving rise to 'income'-at least where that term is confined to its traditional sense of 'gain derived from capital, from labor, or from both combined.' Eisner v. Macomber, 252 U.S. 189, 207, 40 S.Ct. 189, 64 L.Ed. 521 (1920). Yet the principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. ** The only limitation upon that principle is the so-called 'tax-benefit rule.' This rule permits exclusion of the recovered item from income so long as its initial use as a deduction did not provide a tax saving. ** But where full tax use of a deduction was made and a tax saving thereby obtained, then the extent of saving is considered immaterial. The recovery is viewed as income to the full extent of the deduction previously allowed.FN2

FN2. The rationale which supports the principle, as well as its limitation, is that the property, having once served to offset taxable income (i.e., as a tax deduction) should be treated, upon its recoupment, as the recovery of that which had been previously deducted.**

Formerly the exclusive province of judge-made law, the tax-benefit concept now finds expression both in statute and administrative regulations. Section 111 of the Internal Revenue Code of 1954 accords tax-benefit treatment to the recovery of bad debts, prior taxes, and delinquency amounts. Treasury regulations have 'broadened' the rule of

analysis with the objective of a fresh review of what should be the controlling tax principles]

The foregoing considerations express sufficient reason to relinquish our deference to precedent in order to examine anew the issue which this case presents.

A transaction which returns to a taxpayer his own property cannot be considered as giving rise to 'income'-at least where that term is confined to its traditional sense of 'gain derived from capital, from labor, or from both combined.' Eisner v. Macomber, 252 U.S. 189, 207, 40 S.Ct. 189, 64 L.Ed. 521 (1920). Yet the principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery. ** The only limitation upon that principle is the so-called 'tax-benefit rule.' This rule permits exclusion of the recovered item from income so long as its initial use as a deduction did not provide a tax saving. ** But where full tax use of a deduction was made and a tax saving thereby obtained, then the extent of saving is considered immaterial. The recovery is viewed as income to the full extent of the deduction previously allowed.FN2

FN2. The rationale which supports the principle, as well as its limitation, is that the property, having once served to offset taxable income (i.e., as a tax deduction) should be treated, upon its recoupment, as the recovery of that which had been previously deducted.**

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

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

Set in historical perspective, it is clear that the cited regulation may not be regarded as an unauthorized extension of the otherwise limited congressional approval given to the tax-benefit concept. While the statute (i.e., section 111) addresses itself only to bad debts, prior taxes, and delinquency amounts, it was, as noted in Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248 (1943), designed not to limit the application of the judicially designed tax-benefit rule, but rather to insure against its demise. ‘A specific statutory exception was necessary in bad debt cases only because the courts reversed the Tax Court and established as matter of law a ‘theoretically proper’ rule which distorted the taxpayer's income (i.e., taxation of a recovery though no benefit may have been obtained through its earlier deduction).’ 320 U.S. at 506, 64 S.Ct. at 249.

The Dobson decision insured the continued validity of the tax-benefit concept, and the regulation-being but the embodiment of that principle-is clearly adequate to embrace a recovered charitable contribution. But the regulation does not specify which tax rate is to be applied to the recouped deduction, and this consideration brings us to the matter here in issue.

Ever since Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383 (1931), the concept of accounting for items of income and expense on an annual basis has been accepted as the basic principle upon which our tax laws are structured. ‘It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation.’ 282 U.S. at 365, 51 S.Ct. at 152. To insure the vitality of the single-year concept, it is essential not only that annual income be ascertained without reference to losses experienced in an earlier accounting period, but also that income be taxed without reference to earlier tax rates.

*** Since taxpayer in this case did obtain full tax benefit from its earlier deductions, those deductions were properly classified as income upon recoupment and must be taxed as such. This can mean nothing less than the application of that tax rate which is in effect during the year in which the recovered item is recognized as a factor of income. We therefore sustain the Government's position and grant its motion for summary judgment.
Oprah Winfrey To Shoulder Audiences' Taxes For Australian Trip

September 17, 2010 8:31 a.m. EST

Anne Lu - AHN Entertainment Contributor

Los Angeles, CA, United States (AHN) - When Oprah Winfrey said her audience will get an all-expenses paid trip to Australia, they will get an all-expenses paid trip to Australia. The media mogul's very lucky audience won't be shelling out a single cent, including tax and passport fees, for their trip Down Under.

According to Larry Edema from Michigan, one of the 300 audiences set to fly with Oprah and pilot John Travolta later this year, Oprah hired a certified public accountant to address the tax issue after the show's taping. He told TMZ that the CPA informed that that all taxes associated with the trip would be truly 100 percent free, and all expenses will be "handled by the Oprah show."

That includes all sightseeing costs and travel-related expenses, including passport costs for those who can't afford them.

But the 100 percent free tag doesn't include the government of New South Wales in Australia, which was handed a $2.7 million expense for Oprah and the gang's visit.

Oprah famously gave away brand new cars to all of her audience members in 2004, but it was laden with controversy after it was learned that the tax associated with the generous gift, around $7,000 each, would not be covered by the show.

Read more: http://www.allheadlinenews.com/articles/7019931927#ixzz0zvua0dbq
ACCOUNTING FOR DEFERRED-PAYMENT PROPERTY SALES

A sale of property (not subject to inventory accounting) involving future payments of principal cash from the buyer to the seller is variously called an “installment sale,” a “deferred-payment sale,” or a “seller-financed sale.” This type of transaction involves only two parties, possibly because a bank is unwilling to lend cash to the buyer (for example, because the purchased property, the security, is nonliquid or would require extensive management if taken over by the bank). In a two-party, deferred-payment sale, it can be assumed that the buyer’s obligation is secured by the property.

Various issues that arise in this type of transaction have already been discussed, namely, the buyer’s basis (under the so-called Crane doctrine), the tax treatment of the seller who repossesses the property if the buyer defaults, and the tax results (possibly involving § 108(e)(5)) if the loan principal is reduced. Additionally, a bad debt deduction could be available if the buyer’s obligation becomes worthless (unless § 1038 applies by reason of a repossession).

What hasn’t been discussed so far is the tax treatment of the seller by reason of the sale itself. As will be explained below, the sale is accounted for under one of: (a) §1001, (b) the §453 installment method (where available), or (c) the open-transaction method (where available). The open-transaction method is available only for contingent-payment sales, and that method will be discussed last.

1. Gains and Losses under § 1001

Suppose that cash-method Sinead sells unimproved investment real estate (adjusted basis $30K and unencumbered by any mortgage) to Basil in Year 1 for $100K. Basil is to make a cash down payment (at the time of closing in Year 1) of $20K and promises to pay four annual installments of $20K each, starting on the first anniversary of the closing, plus market-rate interest. Assume there are no transaction costs. The property’s title and possession are to pass to Basil at the closing. Basil’s deferred-payment interest-bearing obligation of $80K may or may not be evidenced by a note, but in all probability the note or other promise will be secured by a mortgage running to Sinead. Assume that the discounted PV of Basil’s obligation$^{49}$ is $78K, and its FMV is $75K.$^{50}$ Basil’s basis is the full $100K, starting at the closing, under the rule commonly referred to as the Crane doctrine.

---

$^{49}$ The PV of the obligation as a whole is the sum of the present values of all future principal and interest payments.

$^{50}$ The FMV is likely to be lower than the discounted PV due to credit and security risks, transaction costs involved in enforcing an obligation, and the inability to convert the security to cash (nonliquidity).
Interest is a separate income/expense item, meaning that interest it is not included in Basil’s basis, nor is it included in Sinead’s § 1001 “amount realized” on the sale. Interest is compensation to Sinead for Basil’s use of the money, not part of the payment for the property itself.

Section 1001(b) states that the “amount realized” equals the “sum of any money received plus the fair market value of the property (other than money) received.” Applying this language to Sinead’s situation appears to be straightforward, because Basil’s deferred-payment obligation is “property” (a right to future money), rather than itself being money. Although the amount realized “from” the sale could have been construed to include future money, the text of § 1001(b) refers to money and property received (from the sale), not money “to be received,” “money receivable,” or any other expression looking to the future receipt of cash. Thus, § 1001 has long been understood as requiring that the realized gain or loss be computed in the year of sale, with no deferral of gain or loss on account of the right to receive future cash. By treating the right to future cash as “property” under § 1001, then it follows that Sinead would have, in the year of sale, gain realized of $65K, obtained by subtracting her basis of $30K from her amount realized of $95K ($20K cash plus $75K FMV of the property received). Additionally, Sinead would have further collection gain as the result of receiving $80K principal cash in satisfaction of her deferred-payment obligation, which has a basis of $75K (under §1012, i.e., the amount included in amount realized on account of receipt of the obligation). The interest is additional gross income to Sinead, and lies outside of §1001.

However, as with credit sales of inventory or services, referring to the FMV of a deferred-payment obligation is awkward, because the valuation of such an obligation (especially if given by a non-repeat player in a casual sale) can be difficult. Perhaps here resort can be had to the seller’s tax accounting method, in which case an accrual-method taxpayer would treat the deferred-payment obligation as having a value equal to the face (principal) amount of the obligation. As to cash-method taxpayers, however, avoiding valuation would appear not to be an option. In Warren Jones Co. v. Comm’r, 524 F.2d 788 (9th Cir. 1975), the cash-method taxpayer argued that the FMV of a deferred-payment contract was not includible at all in the amount realized from the sale in question on the ground that it was not the equivalent of cash under the Cowden rule, and the Tax Court agreed. But, after reviewing the legislative history of § 1001, the Ninth Circuit reversed, and held that the amount realized by a cash-method taxpayer always includes the FMV of a deferred-payment obligation, regardless of the cash-equivalency doctrine as filtered through the Cowden rule. This decision had the effect of requiring valuation of the deferred-payment obligation in all cases involving a cash-method seller.

In 1996, the Treasury issued Reg. § 1.1001-1(g), which effectively abolishes reliance on either the seller’s accounting method or the FMV of the obligation. This regulation is difficult to comprehend.

---

51 Where the consideration consists wholly or mostly of “property,” the transaction is really an “exchange” rather than a sale. Nevertheless, transactions of the type discussed here (where the “property” is the buyer’s own promise or note) are called (deferred-payment) “sales.”

52 There is an exception in the rare case where the obligation is a publicly traded instrument (such as a corporate bond). See Reg. § 1.1001-1(g)(1), referring to Reg. § 1273-2(b) which refers to publicly traded debt issued for property. Reg. § 1.1001-1(g)(3) states that the rules of Reg. § 1.1001-1(g) supersede those of Temp. Reg. § 15A.453-1(d)(2)(ii), issued in 1981, subsequent to Warren Jones. Subparagraph (ii) of that superseded temporary
because it is littered with cross-references to unfamiliar provisions. Basically, the regulation treats the amount realized attributable to the debt instrument as being equal to its stated principal (i.e., face) amount. However, if the interest is at a below-market rate of interest, then the amount realized attributable to the debt instrument is determined under § 1274 (discussed below, but usually the discounted PV of the obligation, i.e., the sum of the present values of all principal and interest payments under the contract, and if § 1274 does not apply, the value of the instrument is its discounted PV as determined under § 483.

Thus, if the 4% interest rate charged by Sinead in the example set forth above is not below market, Sinead has gain in the year of sale equal to $70K [($20K cash + $80K stated principal) − $30K adjusted basis], and no subsequent collection gain (because the $80K basis in the obligation under § 1012 will be fully offset against the $80K of principal payments). The tax results are the same whether Sinead uses the cash method or the accrual method. (Another account of Reg. § 1.1001-1(g) is found in Chapter 27.B.1.) This method of computing gain or loss on a deferred-payment sale entirely in the year of sale is referred to as the “closed-transaction method.”

2. The Installment Method

The installment method, located in § 453, was enacted to provide relief from having to recognize all or most of the gain in the year of sale under § 1001(b). The installment method, spelled out in § 453(c), operates by prorating the gain “to” the payments of principal cash as and when received, in proportion to such payments. Thus, in the Sinead-Basil example, Sinead would have $14K of (capital) gain in each of Years 1 through 5 inclusive (since 70% of each $20K payment received represents gain) and no collection gain or loss.

a. Scope of Installment Method

It is helpful to start with a broad overview of the reach of § 453. An “installment sale” is defined as any disposition of property where at least one (cash) payment is to be received after the close of the taxable year in which the disposition occurs. See § 453(b)(1).

Section 453(a) only applies where the deferred-payment sale produces gain, not where it produces loss. Losses on sales are computed under the § 1001 closed-transaction method.

regulation states that the value of the deferred payment obligation (to a cash-method seller) shall be its FMV, but then states that such FMV shall not be less than the FMV of the property sold less other consideration received on the sale (such as the down payment). If the stated selling price is accepted as the FMV of the property, then the FMV of the note will usually turn out to be its stated principal amount. In the Sinead example, if the property sold is accepted as being worth $100K, then the FMV of the note under the superseded temporary regulation is $80K ($100K property FMV less $20K cash down payment), resulting in gain of $70 K ($20K cash + $80K obligation FMV − $30K basis). The principal difference between the approach of Reg. § 1.1001-1(g)(1) and the approach of the superseded temporary regulation is that it is now not necessary (in the first instance) to determine the FMV of the property sold (or the FMV of the deferred-payment obligation, unless the latter is publicly traded).
The installment method is not available for: (1) sales of inventory, (2) certain dealer dispositions,\(^53\) (3) most gain from depreciable personal property,\(^54\) (4) most sales to related parties, (5) sales of personal property under revolving credit plans, (6) sales of stock or securities (and certain other property) traded on an established market, and (7) sales where the debt obligation received is readily tradable or payable on demand. See § 453(b)(2), (f)(4), (g), (l), and (j). These exceptions are mostly based on the ready marketability of the property being sold and/or the obligations obtained, and in some cases on the lack of any compelling nontax reason for structuring the sale as an installment sale.

Once transactions that fall within the exceptions are eliminated, it turns out that the great bulk of transactions that are eligible for the installment method are “casual” (nondealer) gain sales of real property, especially unimproved land, farms, and ranches (for which a bank might be unwilling to lend money). Installment sales may also occur with respect to closely held businesses (and interests therein), but installment sales appear to be uncommon for art works and collectibles (where cash is obtainable through auction).

If a sale is eligible for the installment method, the seller can elect to use the installment method or elect to report the gain according to the § 1001 closed-transaction method. The election is made simply by how the taxpayer reports the gain on the tax return.\(^55\)

**b. Installment Method Mechanics**

Examine § 453(c). Under the installment method, eligible sale gain is recognized according to application of the following formula to the facts of each year that a payment (other than interest) is made:

\[
\text{Gross Profit} \times \text{Current Payments (other than interest)} = \text{Included Installment Gain}
\]

The relevant terms are defined in Temp. Reg. § 15A.453-1(b). “Gross Profit” is the Selling Price less basis. “Selling Price” means the gross selling price (other than interest), *at its face amount* (not PV or FMV), unreduced by mortgages and encumbrances. Commissions and other selling expenses augment (i.e., are added to) basis (rather than being subtracted from Selling Price). Really, Gross Profit is going

---

\(^53\) See § 453(l) for the definition of a “dealer disposition.” In general, the term “dealer” is tax jargon for a taxpayer who sells, in the ordinary course of its business, property described in § 1221(a)(1) (inventory, etc.), which are not “capital assets.”

\(^54\) Technically, gain equal to depreciation recapture under § 1245 (mentioned briefly in Chapter 2) cannot be reported under the installment method. See § 453(i). However, in the overwhelming majority of cases involving the sale of depreciable personal property, the entire gain will be § 1245 gain. See also § 453(g) (generally disallowing the installment method for the sale of any depreciable property, real or personal, to a controlled entity).

\(^55\) Under the statute, the installment method has priority and the taxpayer has to “elect out” of the installment method in order to use the closed-transaction method. See § 453(a) and (d). However, in practice, the election is made by how the gain is reported on the return. Form 6252 is used for installment-method reporting.
to be the same as § 1001 gain in virtually all cases.\(^{56}\)

Contract Price means “Selling Price,”\(^{57}\) supra, \textit{reduced by} mortgages assumed by (or taken subject to by) the buyer, \textit{except that} the excess (if any) of mortgages over augmented basis is \textit{not} subtracted. Stated differently, Contract Price is Selling Price reduced by so much of the mortgage balance as does \textit{not} exceed augmented basis.

“Payments” means \textit{cash payments received in the current year}. \textit{Interest is excluded}. The down payment (if any) is a Payment, as are any cash “principal” amounts received. “Payments” also includes certain highly liquid obligations of the borrower, namely, those that are payable on demand or (if the buyer is a corporation or government) that are publicly traded. See § 453(f)(3), (4), and (5). Payments are not reduced by commissions and other transaction costs (since they are accounted for in the augmented basis). As with Contract Price, debt (mortgage) relief (in the year of sale) is not a Payment except for any excess of debt relief over augmented basis. \textit{The Payments amount is the only item in the formula that can vary from year to year.}

The formula would apply to Sinead’s aggregate Payments (including the down payment) received from Basil during the year (for any year in which any Payment, including the down payment, is received), as follows:

$$\frac{\$70K}{\$100K} \times \$20K = \$14K \text{ gain (included each year)}$$

The remaining $6K of each payment would constitute a tax-free recovery of Sinead’s basis in the sold property, and the aggregate tax-free basis recovery over 5 years would equal her $30K basis ($5 \times 6K$).

If the payment schedule were not uniform, the amount of Sinead’s includible gain (and basis recovery) would vary from year to year because the Payments amount would vary from year to year (with the other numbers remaining constant).

To demonstrate the effect of mortgages, assume the same facts as before in the Sinead/Basil transaction (basis of $30K and selling price of $100K), except that the property is subject to a $50K mortgage, and the seller-paid transaction costs are $6K. Hence, the Gross Profit is now $64K. Again Basil pays $20K down, but he takes subject to the mortgage, and therefore he owes Sinead only $30K more, which he agrees to pay in full in Year 5. This time, the numbers plug into the formula as follows for Year 1:

$$\frac{\$64K}{\$64K} \times \$34K = \$34K \text{ Year 1 Gain}$$

\(^{56}\) An exception would lie for the rare gain in excess of § 1245 recapture gain on the sale of depreciable personal property. Section 1001 gain might be keyed to PV (rather than face amount) in the case of obligations that bear a below-market interest rate but which are not subject to §§ 483 and 1274, discussed in the text later in this chapter, which can operate to reduce the § 1001 gain and Gross Profit (§ 453 gain) to an equal extent.

\(^{57}\) However, Contract Price and Payments are not reduced by any § 1245 (or § 1250) depreciation recapture.
The Contract Price is $100K reduced by the portion of the $50K not in excess of (i.e., up to) the augmented basis of $36K. That is, $100K less $36K equals $64K. Payments in Year 1 are the sum of the cash ($20K) and the excess of the mortgage over the augmented basis ($14K, i.e., $50K - $36K). These add up to $34K.

In Year 5, the formula looks like this:

\[
\frac{64K}{64K} \times 30K = 30K \text{ Year 5 Gain}
\]

Total gain is $64K ($34K in Year 1 plus $30K in Year 5).

The installment method does not affect the character of the seller’s gain, which is determined at the time of sale. Thus, if the asset sold is a capital asset held for more than one year, the gain reported under the installment method will be long-term capital gain, regardless of whether that gain is reported in the year of sale or in the later years when the various installment payments are received. You will note that there is no “collection” gain or loss when the installment method is used.

c. Section 453A

Section 453 installment reporting creates a deferral opportunity relative to the closed transaction method of § 1001. Section 453 can be viewed either as a rule of deferral of realization or as a rule of deferral of tax on a realization that occurred entirely at the time of sale. Under an ability-to-pay concept of income, one can say that deferred realization is appropriate for situations in which nonliquid property is “exchanged” for a nonliquid installment obligation (secured by a mortgage on the sold property).\(^{58}\) (Whether § 453 adequately identifies “deserving” transactions is, of course, a pertinent question.) In contrast, an adherent of the Simons income concept would hold that the seller acquires wealth with an ascertainable FMV (or PV) in the year of sale, and that the realized gain should be fully taxed then. It follows that § 453 should be reconceptualized as a tax-deferral mechanism, and that interest should be charged on such tax deferral.

Being somewhat ambivalent on this issue, Congress enacted § 453A, which is really two separate provisions rolled into one. First, Congress fine-tuned the concept of a nonliquid installment obligation by providing that any borrowing by the property seller in which the deferred-payment obligation is pledged as security is treated as an accelerated payment on the obligation. See § 453A(d). This rule comes into play only where the sales price exceeds $150K, and the property is not farm property or personal-use property (such as a residence). Thus, if Basil’s deferred-payment obligation was $1M, and Sinead pledged this obligation as collateral to borrow $1M from a bank in Year 2, Sinead would be

\(^{58}\) Installment obligations on rural property (nonliquid collateral) are heavily discounted (in FMV terms) below PV.
treated as receiving a $1 million Year 2 Payment.

Second, § 453A treats certain installment sales as “tax deferral” scenarios. If the aggregate face amount of § 453A obligations obtained in the year (and outstanding at the end of that year) exceeds $5M, the seller must pay interest to the government on the deferred tax attributable to such excess aggregate face amount. See § 453A(b)(2) and (c).

d. Disguised Interest

Installment sales are “seller-financed” sales. The seller wears two hats: seller of property and lender of money with which the buyer purchases the property. Like all debt obligations, installment obligations usually bear interest. Interest on the installment obligations does not enter into the § 453 formula (nor the computation of gain or loss under the § 1001 closed-transaction method) and is accounted for separately, according to the taxpayer’s normal accounting method. The interest is includible by the seller, and is deductible by the buyer (if the requirements of § 163 are satisfied).

It did not require a great deal of sophistication to realize that installment sales can readily be structured to convert ordinary (interest) income into preferentially-taxed capital gain by the simple expedient of increasing the stated sales price (and capital gain) and reducing (or eliminating) the stated interest component of installment obligations by a corresponding amount, leaving the total value of the consideration unchanged. The buyer, it is true, might (if sophisticated) object to reducing or eliminating the stated interest (if the interest is deductible), but on the other hand the interest might not be deductible, and the buyer might benefit from a higher stated principal that may be depreciated or expensed. The buyer might even be able to negotiate some price reduction in return for the tax favor conferred on the seller.

To appreciate these points, suppose Sally sells Blackacre, which has a basis of $80K and a FMV of $100K, to Barry for a balloon payment due at the end of 3 years. Assuming that market-rate interest is 8%, the balloon payment would be $126K (with a little rounding off), consisting of $100K of principal and $26K of compound interest. Suppose, however, that the sale terms are changed to require Barry to pay $126K of “principal,” and no “interest,” in a lump sum at the end of 3 years. If the $126K were accepted by the tax law as the purchase price for Blackacre, Sally will have converted $26K of ordinary interest income into an increased amount realized (and capital gain), and Barry will have a $126K basis in Blackacre. In addition, the transaction may qualify for § 453 installment reporting, in which case Sally’s $46K of capital gain would be deferred to Year 3.

Congress has responded by enacting §§ 483 and 1274, both of which recalculate the “real principal” as being the present value (PV) of the buyer’s obligation (the sum of the present values of all principal and interest payments under the contract), computed in essentially the same manner as if § 7872 applied. In other words, the calculation uses the “applicable federal rate” (AFR), which is published periodically by the IRS, as the discount rate, and the discounting is done on a semi-annual basis. See §§ 483(a), 1274(b)(1) and (2). In the Sally/Barry example, the stated principal amount of Barry’s obligation is $126K, but the operation of these provisions would, if the AFR were 8%, yield a present value of $100K. An alternative measure of the real principal, to be used in potentially abusive situations (such as
where the debt obligation is nonrecourse), is the FMV of the property sold ($100K in this case), reduced by other consideration (none in this case). See § 1274(b)(3); Regs. §§ 1.483-2(a)(ii), 1.1274-2(b)(3), -5. (This back-up resort to the FMV of the property sold is the only way in which FMV can enter into the computation of gain or loss on a property sale, but note that the reference is to the FMV of the sold property, not the FMV of the deferred-payment obligation.)

So, if the real principal is $100K, then the (capital) gain, whether figured under § 453 or § 1001, is $20K, and the remaining $26K is really interest. In the § 453 formula, the Gross Profit would be reduced to $20K, the Contract Price would be reduced to $100K (as would the Year 3 “Payment”), yielding a Year 3 capital gain of $20K.

Sections 483 and 1274 differ with respect to how the imputed interest of $26K in the aggregate is to be accounted for. If § 1274 controls, the taxpayers (even those using the cash method) are required to take account of the imputed interest as earned, i.e., as it accrues. The method of calculation is explained in Chapter 27.B.1, but, briefly, interest compounding at 8% annually would be $8K for the first 12 months, $8,640 for the next 12 months, and $9,360 for the third 12 months, adding up to $26K. In contrast, § 483 requires that the imputed interest be taken into account according to the taxpayer’s normal accounting method. For cash-method sellers and buyers, this means deferral of the entire interest until received (or paid).

Sections 483 and 1274 potentially apply in any case where the AFR is greater (or lesser) than the stated interest rate. (There is a maximum AFR in certain cases, however.) Section 1274 takes priority over § 483, but § 1274 does not apply to sales of: (1) principal residences, (2) farms for less than $1M, (3) other property where total payments are $250K or less, and (4) sales of patents on a contingent-payment (royalty) basis. See § 1274(c)(3). In addition, cash-method sellers (who aren’t dealers) can elect out of § 1274 under § 1274A(c) if the principal amount does not exceed $2M. (This election binds the borrower/purchaser as well.) Sales (in excess of $3K) that fall within these exceptions (other than exception (4)) or the § 1274A(c) “election out” are subject to § 483.

**e. Disposition of Installment Obligations**

If, subsequent to an installment sale, the seller disposes of the installment obligation, gain or loss is realized (and recognized) under § 453B in an amount equal to the difference between the seller’s basis in the obligation and (1) the amount realized (in case of a sale or exchange of the obligation) or (2) the FMV of the obligation (in the case of any other kind of disposition). The “basis” of an installment obligation is its (remaining unsatisfied) face amount less the amount of gain that has not yet been recognized. (Conceptually, the basis in the obligation is the taxpayer’s basis in the sold property reduced

---

59 The discount rate for purposes of both §§ 483 and 1274 is not to exceed 9% in the case of sales of (most kinds of) property where the stated principal amount does not exceed $2.8M. See § 1274A(a) and (b). For purposes of § 483, the discount rate interest is not to exceed 6% on certain sales of land for $500K or less between related parties. See § 483(e). These ceilings on discount rates have the effect of increasing the present value of the buyer’s obligation (in relation to the real present value) during periods when the AFR is high (as it was when § 1274 was enacted).
by the basis therein that has already been recovered under § 453 by reason of having received prior Payments.\textsuperscript{60}

For example, suppose Serge sells Blackacre, with a basis of $60K, to Brenda for $100K, consisting of a $20K down payment in Year 1 and a promise to make a balloon payment of $80K in Year 5, plus market-rate interest. The total gain is $40K, of which 20\% ($8K) is recognized in Year 1 under § 453. In Year 4, Serge sells the $80K obligation to Dolly for $79K. Serge’s basis in the obligation is $48K ($80K face amount reduced by the $32K of as-yet-to-be recognized gain). As indicated above, the $48K figure can also be obtained by starting with Serge’s Blackacre basis of $60K and subtracting the $12K basis of Blackacre already “used up” under § 453 against the Year-1 down payment of $20K to produce the Year 1 gain of $8K. The Year-4 gain is $31K ($79K sales price less $48K basis).\textsuperscript{61} This gain has the same character as that of the underlying sale.

If the obligation, on account of not being paid, is disposed of (satisfied) in a transaction involving the repossession of personal property that had previously been sold to the obligor, the installment obligation is treated as being exchanged for the repossessed collateral at the latter’s then FMV. The taxpayer in these cases is usually a merchant or finance company, in which case the original credit sale of the personal property would not have been reportable under §453. (Recall that repossessions of real property are governed by § 1038, discussed in Chapter 22.A.6.)

If the obligation is cancelled or becomes unenforceable, the nonsale disposition rule applies, but the FMV is presumably zero, and the disposition is not treated as a sale or exchange. There, the seller would have a loss that is ordinary in character. If the obligor and obligee are related parties in this situation, however, the amount realized is deemed to be not less than the face amount of the obligation. In neither case can the transferor claim a bad debt deduction.

These rules assure that installment gain is accelerated to the seller on any disposition of the installment obligation. However, if an installment obligation is disposed of by reason of an individual’s death, § 453B does not apply, and the decedent’s successor essentially stands in the decedent’s shoes (that is, takes the decedent’s basis in the obligation).\textsuperscript{62}

Finally, § 453(e) requires an acceleration of installment gain in certain cases in which the installment sale was to a related party, and the related-party buyer disposes of the property within 2 years of the installment sale.

3. Open-Transaction Method for Contingent Payment Sales

Both § 453 and § 1001 presuppose that the selling price (or amount realized) can be ascertained at the

\textsuperscript{60} The basis of deferred-payment obligations was touched upon in connection with repossessions of sold property, discussed in Chapter 22.A.6.
\textsuperscript{61} The figure of $31K represents the deferred § 453 gain ($32K) less the $1K reduction in sales price of the obligation relative to its face amount.
\textsuperscript{62} See §§ 453B(c), 691(a)(4), 1014(c); Reg. § 1.691(a)-5(a). The successor does not obtain a § 1014 basis.
time of sale. Thus, neither the installment method nor the §1001 closed-transaction method can function if the future payments are contingent on speculative events.

Most contingent payment rights in commerce are referred to as “royalty” rights. A royalty is a stream of payments made by a transferee of a property right to the transferor that is contingent on (1) the transferee’s production from the transferred property (such as a mineral interest) or (2) the transferee’s sales receipts (either gross or net) derived from use of the property (as in the case of a transferee’s use of a patent right, copyright, or trade name to produce and sell products). The payments are structured to be contingent because neither party, at the time the arrangement is entered into, knows the true value of the underlying property, and, therefore, a price cannot be fixed. A royalty arrangement is a way in which the transferor and transferee “share” in the uncertain future success or failure of the property (but without entering into a “partnership” or “joint venture”). Royalty arrangements are common in the natural resources, high-tech, franchising, and entertainment industries.

If the transferor retains residual ownership of the property and the transferee only has the right to use the property, royalties are in the nature of contingent rent, and are treated for tax purposes as if they were rent. (Such a transaction, where it involves intangible property, is commonly referred to as a “license.”) If, however, all substantial rights in the property are transferred to the transferee, then the disposition is a sale (or possibly an exchange), and the royalty right is the consideration. Where some, or all, of the consideration for the purchase of property will be paid pursuant to a royalty arrangement, the transaction is a “contingent-payment sale.” The distinction between a license (or lease) and a sale is an important tax issue that is taken up in Chapters 28.C.3 (intangibles) and 29.A.2.c (mineral interests). Here it is assumed that the transaction is indeed a sale, and the issue on the table is: “How are contingent-payment sales taxed?”

The answer, in brief, is the “open-transaction method.” This method originated in the 1931 case of *Burnet v. Logan*, 283 U.S. 404, where the cash-method taxpayer in 1916 sold stock in a company for $137,500 cash plus a right to 60 cents per ton of ore obtained by the buyer from a mine to which the company had a long-term mineral lease. The government argued that the closed-transaction method should be applied and that the present value of the future payment right was $121,383, based on tonnage estimated to be mined over a projected 45-year period. The total cash received by the taxpayer from 1916 through 1920 was less than taxpayer’s basis in the stock that was sold, and the taxpayer reported no income or gain for those years. Under the open-transaction approach advocated by the taxpayer, she would have been entitled to exclude the payments from income until she had recovered an amount equal to her stock basis. All receipts above that amount would be included as capital gain from the 1916 sale of her stock. The Supreme Court agreed with the taxpayer, stating:

As annual payments on account of extracted ore come in, they can be readily apportioned first as return of capital and later as profit. The liability for income tax ultimately can be fairly determined without resort to mere estimates, assumptions, and speculation. When the profit, if any, is actually realized, the taxpayer will be required to respond. The consideration for the sale was the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty. The promise . . . had no ascertainable fair market value. The transaction was not a closed one. Respondent might never recoup her capital investment from payments only conditionally promised. She
properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture.

A contingent-payment sale fits the definition of “installment sale” in § 453(b)(1) because at least one payment will occur in a future year. However, since the Selling Price and Contract Price cannot be determined in such a case, the normal § 453 formula stated in § 453(c) cannot be used. Instead, the following alternative § 453 approaches are prescribed by Temp. Reg. § 15A.453-1(c). First, if the contingent-payment sale provides for a maximum possible selling price, the maximum price is treated as the “Selling Price” under the conventional installment-method formula, and the formula is then applied. If there is no maximum selling price but there is a maximum period over which payments are to be received, each year’s receipts (treated as “amount realized” for the year) are offset by a portion of the basis prorated evenly over the maximum period. If (as is likely) there is neither a maximum selling price nor a maximum payment period, the basis of the property sold is prorated equally over a 15-year period against the amount realized in each year.

The seller in a contingent-payment sale situation can elect to forego the methods described in the preceding paragraph and instead use the open-transaction method approved by the Logan case. In order to use the open-transaction method, both the buyer’s payment obligation and the value of the sold property must not be readily ascertainable. See Temp. Reg. § 15A.453-1(d)(2)(iii). In the usual contingent-payment sale, this test is readily satisfied. Despite protestations in the regulations about use of the open-transaction method being “rare and extraordinary,” that would hardly appear to be the case given the prominence of the industries where transactions of this type are common.

It would be unusual for a contingent-payment sale to provide for interest, because interest usually presupposes an ascertainable “principal,” and a stated principal is inherently lacking where the sale price is uncertain. Sections 483 and 1274 except certain contingent-payment sales of patents from their interest-imputation rules. Otherwise, interest is imputed in a contingent-payment sale on a retroactive basis. Thus, if the AFR for the time of sale in Year 1 was 5%, and the contingent payment received in Year 5 turns out to be $100K, the discounted present value (as of Year 1) would be about $78K (treated as the principal payment), and the remaining $22K would be deemed to be “interest,” includible by the recipient and deductible by the payee (if a deduction is allowed under § 163) in Year 5.

Another problem with contingent-payment sales is the buyer’s basis. With no stated or ascertainable “real” principal, the so-called Crane basis rule cannot be applied as of the year of sale. And with no ascertainable basis (and perhaps no ascertainable useful life), how would depreciation (if any) be

---

63 The transaction must be a “sale” and not an “exchange” (e.g., a patent right for shares of stock in the buyer).
64 Temp. Reg. §15A.453-1(d)(2)(iii) provides: “The fair market value of a contingent payment obligation may be ascertained from, and in no event shall be considered to be less than, the fair market value of the property sold (less the amount of any other consideration received in the sale).” This statement follows the holding of U.S. v. Davis, 370 U.S. 65 (1962), where the consideration received by a husband in exchange for his securities (the value of the wife’s support rights surrendered) was highly speculative and presumed by the Court to be equal to the securities given in exchanged. This approach is referred to as the barter-equation method of valuation.
65 See Reg. § 1.1275-4(c)(4)(i), (ii).
These problems are finessed by allowing the buyer to deduct the full amount of each payment.\textsuperscript{66} This method can be viewed as the equivalent of capitalizing the payment and deeming the depreciation (and interest) for the year to be exactly equal to such payment.

4. Deferred Sales Pursuant to Put and Call Options

Whereas a deferred-payment sale involves the receipt of consideration after a sale has occurred, the purchase of an option to buy or sell property in the future involves the payment of cash in advance of, but in connection with, a possible future property sale. An option to buy is known as a “call option” and an option to sell is a “put option.” A call or put option may lapse without being exercised. The tax issue here is the relation, if any, that the option transaction bears to the later property transaction.

To illustrate the “call option” scenario, suppose Gordon for several years has owned unimproved land (Blackacre), purchased for $10K and having a current FMV of $30K. Jane, an investor, is not interested in an immediate purchase of Blackacre, but she believes that it might appreciate. Accordingly, Jane in Year 1 offers Gordon a nonrefundable $1K payment (premium) for the right (option) to purchase the property from Gordon before the end of Year 5 for $35K (the “option price”). Gordon doubts that Blackacre’s value will rise above the option price ($35K) before the end of Year 5, and so he accepts Jane’s offer, seeing it as an opportunity to pick up a quick $1K while retaining the property. Gordon is called the “writer” or “grantor” of the option (or the “optionor”), and Jane is called the “grantee” (or “optionee”).

This transaction is not an “installment sale” (potentially eligible for § 453), because an installment sale involves one or more payments received after the year of sale. Instead, the issue posed by a call option is whether the call option premium is separate ordinary income (with no basis offset) to Gordon because Gordon has not yet disposed of the property (or any aspect thereof) or whether the option transaction should be held open for possible integration with the future sale.

In Rev. Rul. 58-234, 1958-1 C.B. 279, the IRS has adopted the open-transaction approach, stating in part (and in a somewhat conclusory manner):

An optionor, by the mere granting of an option, may not have parted with any physical or tangible assets; but, just as the optionee thereby acquires a right to buy certain property at a fixed price on or before a specified future date, so does the optionor become obligated to deliver, such property at that price, if the option is exercised. Since the optionor assumes such obligation, which may be burdensome and is continuing until the option is terminated, there is no closed transaction nor ascertainable income or gain realized by an optionor upon mere receipt of a premium for granting such an option. It is manifest . . . that there is no Federal income tax incidence on account of either the receipt or the payment of such option premiums, unless and until the options have been terminated, by failure to exercise, or [by exercise], with resultant gain or loss.

\textsuperscript{66} See Newton Insert Co. v. Comm’r, 61 T.C. 570 (1974), aff’d, 545 F.2d 1259 (9th Cir. 1976) (government concession).
Applying the ruling to the Gordon/Jane hypothetical, if the sale does not take place and the option lapses after 5 years, the option premium would be ordinary income to the property owner (Gordon) only at the time the option lapses. If the option is exercised, the option premium is treated as additional amount realized to Gordon, increasing his capital gain. On Jane’s side, the option premium is a capital expenditure. If the option lapses, she would have a loss deduction in Year 5, assuming that the transaction was entered into for profit (as is the case here). If the option is exercised, the option premium would be added to Jane’s basis in Blackacre.

The Gordon/Jane hypothetical can also be used to illustrate the “put option” scenario. Gordon wants to continue holding Blackacre because he believes that its value will continue to increase, but just in case the value actually falls, he wants to “lock in” his unrealized gain of $20K. Accordingly, Gordon offers Jane a nonrefundable $1K payment for Jane’s commitment to buy Blackacre from Gordon at any time Gordon chooses to “put” the property to Jane, up to the end of Year 5, at the $30K option price. Jane, thinking that the property’s value will not fall below $30K, accepts Gordon’s offer.

The same tax-treatment design options exist here as for call options, and again Rev. Rul. 58-234 treats the put option transaction as being an open transaction. Accordingly, if the value of Blackacre falls and the option is exercised, the $1K constitutes a reduction in Jane’s basis in Blackacre (sort of like a price rebate received in advance of a purchase) and a reduction in Gordon’s amount realized on the sale of Blackacre. If the option lapses in Year 5, Jane has ordinary income of $1K in Year 5 and Gordon has a deductible loss of $1K in Year 5.

The “character” of any loss attributable to the lapse of an option is governed by § 1234(a)(1) and (2), which would operate in most cases to produce a capital loss. (If the underlying property is stock, securities, and commodities, § 1234(b)(1) treats any deferred income resulting from the lapse of an option as a short-term capital gain.

NOTES

1. (a) The deferral of the seller’s gain under § 453 can combine with the Crane basis rule on the buyer’s side to create a tax arbitrage possibility in cases where the buyer’s basis can be written off at a faster rate than the seller’s inclusion. There is no across-the-board tax rule or principle to deal with timing mismatch situations, because generally the tax treatment of one party to a transaction does not dictate that of another party.

(b) There are ad hoc rules in the Code that deal with some situations of this type. For example, §§ 83(h) and 404(a)(5) delay an employer’s deduction for certain compensation to the year of the employee’s includibility. Another provision of this type is § 267(a)(2), which provides that any expense deduction by an accrual-method taxpayer to a cash-method related-party payee is to be deferred until the year of payee inclusion. Section 1239 deals with a “character mismatch” arbitrage opportunity by converting capital (or § 1231) gain into ordinary gain when a sale of depreciable property is made to (or by) a controlled entity, but not in other related-party situations.

2. The transaction in Burnet v. Logan today looks more like an “exchange” than a “sale,” because the
seller received a right to royalties based on the production of a mine. If the transaction had been treated as an exchange, it might well have been a tax-common-law nontaxable exchange (because both properties involved were not susceptible to reasonable valuation), but the royalties would have been ordinary income from mining subject to depletion.

3. The open-transaction rule for put and call options is illogical as to the person receiving payment. Normally, a payment for a person’s doing something (or not doing something) is compensation for services. Compensation is included when received, not as it is earned never time. In no sense is the option payment a loan or an addition to (or subtraction from) the sales price.
REV. RUL. 90-16, 1990-1 C.B. 12

ISSUE

A taxpayer transfers to a creditor a residential subdivision that has a fair market value in excess of the taxpayer’s basis in satisfaction of a debt for which the taxpayer was personally liable. Is the transfer a sale or disposition resulting in the realization and recognition of gain by the taxpayer under section 1001(c) and 61(a)(3) of the Internal Revenue Code?

FACTS

X was the owner and developer of a residential subdivision. To finance the development of the subdivision, X obtained a loan from an unrelated bank. X was unconditionally liable for repayment of the debt. The debt was secured by a mortgage on the subdivision.

X became insolvent (within the meaning of section 108(d)(3) of the Code) and defaulted on the debt. X negotiated an agreement with the bank whereby the subdivision was transferred to the bank and the bank released X from all liability for the amounts due on the debt. When the subdivision was transferred pursuant to the agreement, its fair market value was 10,000x dollars, X’s adjusted basis in the subdivision was 8,000x dollars, and the amount due on the debt was 12,000x dollars, which did not represent any accrued but unpaid interest. After the transaction X was still insolvent.

LAW AND ANALYSIS

Sections 61(a)(3) and 61(a)(12) of the Code provide that, except as otherwise provided, gross income means all income from whatever source derived, including (but not limited to) gains from dealings in property and income from discharge of indebtedness.

Section 108(a)(1)(B) of the Code provides that gross income does not include any amount that would otherwise be includible in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent. Section 108(a)(3) provides that, in the case of a discharge to which section 108(a)(1)(B) applies, the amount excluded under section 108(a)(1)(B) shall not exceed the amount by which the taxpayer is insolvent (as defined in section 108(d)(3)).

Section 1.61-6(a) of the Income Tax Regulations provides that the specific rules for computing the amount of gain or loss from dealings in property under section 61(a)(3) are contained in section 1001 and the regulations thereunder.

Section 1001(a) of the Code provides that gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain.

Section 1001(b) of the Code provides that 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.
Section 1001(c) of the Code provides that, except as otherwise provided in subtitle A, the entire amount of the gain or loss, determined under section 1001, on the sale or exchange of property shall be recognized.

Section 1.1001-2(a)(1) of the regulations provides that, except as provided in section 1.1001-2(a)(2) and (3), the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition. Section 1.1001-2(a)(2) provides that the amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). Example (8) under section 1.1001-2(c) illustrates these rules as follows:

Example (8). In 1980, F transfers to a creditor an asset with a fair market value of $6,000 and the creditor discharges $7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value ($6,000). In addition, F has income from the discharge of indebtedness of $1,500 ($7,500 -- $6,000).

In the present situation, X transferred the subdivision to the bank in satisfaction of the 12,000x dollar debt. To the extent of the fair market value of the property transferred to the creditor, the transfer of the subdivision is treated as a sale or disposition upon which gain is recognized under section 1001(c) of the Code. To the extent the fair market value of the subdivision, 10,000x dollars, exceeds its adjusted basis, 8,000x dollars, X realizes and recognizes gain on the transfer. X thus recognizes 2,000x dollars of gain.

To the extent the amount of debt, 12,000x dollars, exceeds the fair market value of the subdivision, 10,000x dollars, X realizes income from the discharge of indebtedness. However, under section 108(a)(1)(B) of the Code, the full amount of X’s discharge of indebtedness income is excluded from gross income because that amount does not exceed the amount by which X was insolvent.

If the subdivision had been transferred to the bank as a result of a foreclosure proceeding in which the outstanding balance of the debt was discharged (rather than having been transferred pursuant to the settlement agreement), the result would be the same. A mortgage foreclosure, like a voluntary sale, is a ‘disposition’ within the scope of the gain or loss provisions of section 1001 of the Code. See Helvering v. Hammel, 311 U.S. 504 (1941), 1941-1 C.B. 375; Electro- Chemical Engraving Co. v. Commissioner, 311 U.S. 513 (1941), 1941-1 C.B. 380; and Danenberg v. Commissioner, 73 T.C. 370 (1979), acq., 1980-2 C.B. 1.

**HOLDING**

The transfer of the subdivision by X to the bank in satisfaction of a debt on which X was personally liable is a sale or disposition upon which gain is realized and recognized by X under sections 1001(c) and 61(a)(3) of the Code to the extent the fair market value of the subdivision transferred exceeds X’s adjusted basis. Subject to the application of section 108 of the Code, to the extent the amount of debt exceeds the fair market value of the subdivision, X would also realize income from the discharge of indebtedness.
BLACKMAN v. COMMISSIONER
88 T.C. 677 (1987)

[Taxpayer set fire to his wife’s clothes, and that fire spread to and destroyed his residence. The taxpayer deducted the amount of the loss as a casualty loss within the meaning of sec. 165(c)(3), I.R.C. 1954.]

SIMPSON, JUDGE:

At the time of the filing of the petition in this case, the petitioner, Biltmore Blackman, resided in Billerica, Massachusetts. He and his wife filed their joint Federal income tax return for 1980 on April 28, 1981, with the Internal Revenue Service Center, Atlanta, Georgia.

The petitioner’s employer transferred him from Baltimore, Maryland, to South Carolina. The petitioner relocated his wife and children to South Carolina. Mrs. Blackman was dissatisfied with South Carolina and returned, with the couple’s five children, to Baltimore. During the 1980 Labor Day weekend, the petitioner returned to Baltimore, hoping to persuade his wife to give South Carolina another chance. When he arrived at his Baltimore home, he discovered that another man was living there with his wife. The neighbors told the petitioner that such man had been there on other occasions when the petitioner had been out of town on business.

On September 1, 1980, the petitioner returned to his former home to speak to his wife. However, Mrs. Blackman was having a party; her guests refused to leave despite the petitioner’s request that they do so. He returned to the house several times, repeating his request, and emphasizing it by breaking windows. Mrs. Blackman’s guests did not leave the house until about 3:00 a.m., September 2, 1980.

Later, on September 2, 1980, the petitioner again went to his former home. He wanted to ask his wife whether she wanted a divorce. They quarreled, and Mrs. Blackman left the house. After she left, the petitioner gathered some of Mrs. Blackman’s clothes, put them on the stove, and set them on fire. The petitioner claims that he then ‘took pots of water to dowse the fire, put the fire totally out * * *’ and left the house. The fire spread, and the fire department was called. When the firefighters arrived, they found some of the clothing still on the stove. The house and its contents were destroyed.

The petitioner was arrested later that day and charged with one count of Setting Fire while Perpetrating a Crime, a violation of Md. Ann. Code art. 27, sec. 11 (1982 Repl. Vol.), and one count of Destruction of Property (Malicious Mischief), a violation of Md. Ann. Code art. 27, sec. 111 (1982 Repl. Vol.). The arson charge was based on the allegation that the petitioner ‘had set fire to and burned * * * [the house] while perpetrating the crime of Destruction of Property’ and the malicious destruction charge was based on the allegation that he ‘did willfully and maliciously destroy, injure, deface and molest clothing, the property of’ Mrs. Blackman. The petitioner pleaded not guilty to both charges. On November 5, 1980, by order of the District Court of Baltimore County, the arson charge was placed on the ‘stet’ docket. The petitioner was ordered to serve 24 months unsupervised probation without verdict on the malicious destruction charge.

The petitioner filed a claim for the fire damage with his insurer, State Farm Fire and Casualty Company of Baltimore, Maryland. The company refused to honor the claim due to the cause of the fire.

OPINION

The primary issue for our decision is whether the petitioner is allowed to deduct the loss resulting from the fire started by him. Section 165(a) allows a deduction for ‘any loss sustained during the taxable year and not compensated for by insurance or
otherwise. Section 165(c)(3) provides, in pertinent part, that in the case of an individual, the deduction allowed in subsection (a) is to be limited to ‘losses of property not connected with a trade or business, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.’ The Commissioner concedes that the petitioner sustained a loss through fire. However, the Commissioner argues that the petitioner intentionally set the fire which destroyed his home in violation of Maryland’s public policy, that allowing the deduction would frustrate that public policy, and that, therefore, under the doctrine of Commissioner v. Heininger, 320 U.S. 467 (1943), and subsequent cases, the petitioner is not entitled to a deduction for the damage caused by his fire.

Courts have traditionally disallowed business expense and casualty loss deductions under section 162 or 165 where national or State public policies would be frustrated by the consequences of allowing the deduction. Commissioner v. Heininger, supra. ‘[T]he test of non-deductibility always is the severity and immediacy of the frustration resulting from allowance of the deduction.’ Tank Truck Rentals v. Commissioner, 356 U.S. 30, 35 (1958). ‘From the cases, it is clear that the question of illegality to frustrate public policy is, in the last analysis, ONE OF DEGREE, TO BE DETERMINED FROM THE PECULIAR FACTS OF EACH CASE.’ Fuller v. Commissioner, 213 F.2d 102, 106 (10th Cir. 1954), affd. 20 T.C. 308 (1953); emphasis supplied. In examining the facts of each case, courts have examined both the taxpayer’s conduct and the policy his conduct is said to frustrate. See, e.g., Commissioner v. Heininger, supra; Tank Truck Rentals v. Commissioner, supra; Holt v.


* * * * The taxpayer was alleged to have violated State usury statutes, but he was not arrested, nor were any charges filed against him. We upheld the disallowance of the loss deduction on the grounds that the taxpayer’s business practices violated the policy expressed by the State lending and usury laws. 30 B.T.A. at 1105-1107. Similarly, in Davis v. Commissioner, 17 T.C. 549 (1951), the taxpayer was accused, by the SEC, of a violation of section 16(b) of the Securities Exchange Act of 1934. The SEC ordered the taxpayer to pay a corporation, to which the taxpayer was general counsel, the profits taxpayer had received from sales of the corporation’s stock. The taxpayer was not formally charged with any crime. We upheld the Commissioner’s disallowance of a deduction of the payment as a loss on the ground that allowing the deduction would frustrate the public policy expressed in section 16(b). 17 T.C. at 556.

Moreover, it is well settled that the negligence of the taxpayer is not a bar to the allowance of the casualty loss deduction. Anderson v. Commissioner, 81 F.2d 457, 460 (10th Cir. 1936); Shearer v. Anderson, 16 F.2d 995, 997 (2d Cir. 1927). On the other hand, gross negligence on the part of the taxpayer will bar a casualty loss deduction. Heyn v. Commissioner, 46 T.C. 302, 308 (1966). ‘Needless to say, the taxpayer may not knowingly or willfully sit back and allow himself to be damaged in his property or willfully damage the property himself.’ White v. Commissioner, 48 T.C. 430, 435 (1967).

In our judgment, the petitioner’s conduct was grossly negligent, or worse. He admitted that he started the fire. He claims that he attempted to extinguish it by putting water on it. Yet, the firemen found clothing still on the stove, and there is no evidence to corroborate the petitioner’s claim that he attempted to douse the flame. The fact is that the fire spread to the entire house, and we have only vague and not very persuasive evidence concerning the petitioner’s attempt to extinguish the fire. Once a person starts a fire, he has an obligation to make extraordinary efforts to be sure that the fire is safely extinguished, and this petitioner has failed to demonstrate that he made such extraordinary efforts. The house fire was a foreseeable consequence of the setting of the clothes [on] fire, and a consequence made more likely if the petitioner failed to take adequate precautions to prevent it. We hold that the petitioner’s conduct was grossly negligent and that his grossly negligent conduct bars him from
deducting the loss claimed by him under section 165(a) and (c)(3).

In addition, allowing the petitioner a deduction would severely and immediately frustrate the articulated public policy of Maryland against arson and burning. Maryland’s policy is clearly expressed. Article 27, section 11, of the Maryland Annotated Code (1982 Repl. Vol.), makes it a felony to burn a residence while perpetrating a crime. The petitioner admits that he set fire to his wife’s clothes, and he has not denied that the residence burned as a result of the fire started by him. The petitioner was charged with violating that section, but that charge was placed on the ‘stet’ docket. As we understand Maryland practice, such action merely postponed any action on the charge. See Maryland Rule 4-248(a); Fuller v. State, 64 Md. App. 339, 495 A.2d 366 (1985); State v. Weaver, 52 Md. App. 728, 451 A.2d 1259 (1982). However, the mere fact that the petitioner was never brought to trial for burning the house does not foreclose a finding by this Court that the petitioner acted in violation of that policy. See Richey v. Commissioner, supra; Mazzei v. Commissioner, supra; Wagner v. Commissioner, supra; Davis v. Commissioner, supra. We are mindful, also, that Maryland has an articulated public policy against domestic violence. We refuse to encourage couples to settle their disputes with fire. We hold that allowing a loss deduction, in this factual setting, would severely and immediately frustrate the articulated public policies of Maryland against arson and burning, and against domestic violence.
SCOTT, JUDGE:

Due to a severe allergy, petitioner’s doctor instructed him not to mow his lawn. Petitioner in 1982 paid a total of $178 to have his lawn mowed and claimed a medical expense deduction in that amount for lawn care.

**OPINION**

Petitioner contends that since his doctor had advised him not to mow his lawn, he is entitled to a deduction for amounts he paid someone else to do his lawn mowing. Respondent contends the amounts paid by petitioner for lawn mowing are nondeductible personal expenses under section 262 rather than section 213 medical expenses. * * * *

In this case, petitioner, bearing the burden of proof under Rule 142(a) must establish that the apparently personal expense of lawn care is a medical expense. Petitioner has cited no authority to support his position either in general or with respect to lawn care expenses specifically. Petitioner testified that due to a severe allergy his doctor had directed him not to perform lawn care activities but there was no showing why other family members could not undertake these activities or whether petitioner would have paid others to mow his lawn even absent his doctor’s direction not to do so himself.

Doctor recommended activities have been held in a number of cases not to constitute deductible medical expenses where the expenses did not fall within the parameters of ‘medical care.’ For example in Altman v. Commissioner, 53 T.C. 487 (1969), this Court held that the expense of playing golf was not a deductible medical expense even though this activity was recommended by the taxpayer’s doctor as treatment for his emphysema and provided therapeutic benefits. On this record we conclude that petitioner has not carried his burden of proof with respect to the deduction of lawn care costs as a medical expense and is thus not entitled to include the $178 expended for lawn care in his medical expense deductions.

Decision will be entered for the respondent.
OTTAWA SILICA v. UNITED STATES
699 F.2d 1124 (Fed. Cir. 1983)

Before DAVIS, NICHOLS and NIES, Circuit Judges.

Ottawa was engaged in the mining, processing and marketing of industrial sand known as silica. Beginning in 1956, Ottawa acquired coast ranch properties in Oceanside, California. Oceanside, experienced rapid growth. By 1960’s it became apparent that a new high school would be needed to accommodate the ever increasing high school population of Oceanside. The Oceanside-Carlsbad Union High School District asked Ottawa whether it would be interested in donating approximately 50 acres of its land for a school site. Ottawa donated a 49.37-acre site for the high school and another almost 20 acres of right-of-way for two access roads to the school. Ottawa claimed a charitable deduction of $319,523 for the value of the 49 acres transferred by the school district.

On its 1971 federal tax return, the Ottawa redetermined the fair market value of the high school site on the basis of a subsequent sale of an adjacent parcel to some land developers. Plaintiff claimed that the value of the land at the time of the initial sale had been actually $415,223 and therefore increased its carryover by $95,700. The Internal Revenue Service disallowed the deduction on the ground that it was not a charitable contribution within the meaning of 26 U.S.C. § 170 (1976).

The case law dealing with this aspect of a §170 deduction makes clear that a contribution made to a charity is not made for exclusively public purposes if the donor receives, or anticipates receiving a substantial benefit in return. In Singer, this court considered whether discount sales of sewing machines to schools and other charities entitled Singer to a charitable deduction. The court found that Singer, which at the time of the sales was in the business of selling sewing machines, had made the discount sales to the schools for the predominant purpose of encouraging the students to use and, in the future, to purchase its sewing machines, thereby increasing Singer’s future sales. This purpose colored the discount sales, making them business transactions rather than charitable contributions. Accordingly, the court disallowed the deduction for the sales to the schools. The court allowed deductions for the discount sales made to other charities, however, because Singer had no expectation of increasing its sales by making the contributions and benefited only incidentally from them.

The Singer court noted that the receipt of benefits by the donor need not always preclude a charitable contribution. The court stated its reasoning as follows, at 106, 449 F.2d 413:

[I]f the benefits received, or expected to be received, [by the donor] are substantial, and meaning by that, benefits greater than those that inure to the general public from transfers for charitable purposes (which benefits are merely incidental to the transfer), then in such case we feel that the transferor has received, or expects to receive, a quid pro quo sufficient to remove the transfer from the realm of deductibility under section 170.

Singer Co. v. United States, 196 Ct.Cl. at 106, 449 F.2d 423. The parties to the present case disagree as to the meaning of the above quotation. The plain language clearly indicates that a “substantial benefit” received in return for a contribution constitutes a quid pro quo, which precludes a deduction. The court defined a substantial benefit as one that is
“greater than those that inure to the general public from transfers for charitable purposes.” Id. at 106, 449 F.2d at 423. Those benefits that inure to the general public from charitable contributions are incidental to the contribution, and the donor, as a member of the general public, may receive them. It is only when the donor receives or expects to receive additional substantial benefits that courts are likely to conclude that a quid pro quo for the transfer exists and that the donor is therefore not entitled to a charitable deduction. * * * *

Plaintiff argues that it received no benefits, except incidental ones as defined by Singer, in return for its contribution of the site, and it is therefore entitled to a § 170 deduction for the transfer of its land to the school district. After having considered the testimony and the evidence adduced at trial, I conclude that the benefits to be derived by plaintiff from the transfer were substantial enough to provide plaintiff with a quid pro quo for the transfer and thus effectively destroyed the charitable nature of the transfer.

To begin, although plaintiff is correct in arguing that it was not the moving party in this conveyance, and that the school district sought plaintiff out for a donation of a high school site, that alone fails to justify a § 170 deduction. The record clearly establishes that following the passage of a bonding referendum, which authorized the building of a new high school by the city of Oceanside in 1968, as many as nine sites had been evaluated. Because of the eastward growth of the city, Mr. LaFleur, the superintendent of the OCUHSD, felt that the ideal location for the new high school would be near El Camino Real. Following careful consideration, the city and school district decided that the best location for a high school would be on plaintiff’s land. Thus, during the summer of 1968, John Steiger, the vice-mayor of Oceanside, and Mr. LaFleur approached Mr. Thomas Jones to see if plaintiff would consider making a site on the Freeman Ranch available for the new high school.

On September 20, 1968, Mr. LaFleur wrote to plaintiff’s president, Mr. Thornton, to ask if plaintiff would be willing to donate 50 acres of its land for a school site. The record also establishes, however, that plaintiff was more than willing to oblige Mr. LaFleur on the basis of its own self-interest. Indeed, the evidence shows that on that same September 20, Mr. Jones also wrote to Mr. Thornton to advise him of the discussions he had participated in regarding a high school site. In his letter Mr. Jones stated that he had met with John Steiger and Larry Bagley, Oceanside’s planning director, and had learned that the school district’s first choice for a high school site was on land owned by plaintiff. In a most revealing statement, Mr. Jones went on to say:

I was pessimistic when talking to John and Larry, but this actually could trigger and hasten the development of the whole eastern end of [the] Freeman and Jones [ranches] at no cost to us. The increase in these property values should be substantial if this should go through. In any event, nothing more is to be done on this until the school board writes to you and asks to open negotiations. On the other hand, I recommend that OR & DC actively pursue this, since a high school in this location would probably trigger the early development of El Camino Real from the May Co. to Mission Road.

The exact meaning of Mr. Jones’ statement will be better understood following a full development of the prevailing circumstances at the time of the transfer. It should be recalled that plaintiff had amassed some 2,300 acres in eastern Oceanside, but only 481 acres had silica reserves. . . . . While a portion of the western boundary of the Freeman Ranch ran along El Camino Real, its northernmost boundary was about a mile from all of the major roads. The unavailability of major roads to service the northernmost reaches of the Cubbison and Freeman Ranches. * * * * The only thing frustrating the implementation of the plan was the inaccessibility of the Jones Ranch from Mission Boulevard. The following statement from the Pereira report shows that plaintiff was aware that the inaccessibility of the Jones Ranch to Mission Boulevard. * * * *
The construction of a high school on the Freeman Ranch, however, alleviated this problem for plaintiff. State and local officials required that the high school be serviced by two separate access roads. After some discussions, the school district and plaintiff agreed on the general direction of Mesa Drive which would provide the school with access to El Camino Real, and the surrounding topography dictated that the second road run north to Mission Boulevard through the Jones Ranch and parcels of property owned by Mr. Ivey and the Mission of San Luis Rey. This road, Rancho Del Oro Drive, provided plaintiff with access to the Jones Ranch directly from Mission Boulevard. Plaintiff could not have obtained such access to Mission Boulevard on its own unless both Mr. Ivey and the fathers at the mission had agreed to convey part of their land or easements to plaintiff. There is no evidence suggesting that either party was interested in doing so. Mr. Ivey, in fact, had resisted plaintiff’s overtures about selling or developing his land. * * * * * 

It is thus quite apparent that plaintiff conveyed the land to the school district fully expecting that as a consequence of the construction of public access roads through its property it would receive substantial benefits in return. In fact, this is precisely what happened. Plaintiff obtained direct access to the Jones Ranch via Rancho Del Oro Drive and ultimately sold the ranch to a developer. Plaintiff also sold two parcels of the Freeman Ranch, lying north of Mesa Drive, to other developers. * * * * It is my opinion that the plaintiff knew that the construction of a school and the attendant roads on its property would substantially benefit the surrounding land, that it made the conveyance expecting its remaining property to increase in value, and that the expected receipt of these benefits at least partially prompted plaintiff to make the conveyance. Under Singer, this is more than adequate reason to deny plaintiff a charitable contribution for its conveyance.

CONCLUSION
It is concluded that plaintiff is not entitled to a charitable contribution pursuant to 26 U.S.C. § 170 (1976) for its conveyance of a school site to the Oceanside-Carlsbad Union High School District.
[Taxpayer pleaded guilty to a state-law charge of felonious sale of marijuana. The police seized fourteen tons of marijuana, $148,000 of cash, and land where he was operating. Under a plea bargain agreement, the taxpayer was placed on probation but was required under the plea bargain agreement to pay $145,000 to the country school fund.]

The only matter before us for decision is the deductibility of the charitable ‘contributions’ made by petitioner in fulfillment of an obligation under the Probation Judgment which specifically required ‘compliance with the conditions of (petitioner’s) plea bargain agreement.’ * * * * [W]e think it clear that the . . . dominant objective of petitioner in accepting the plea bargain agreement was to avoid being sent to prison. His ‘contributions’ pursuant to the plea bargain agreement, as incorporated by the sentencing judge in the Probation Judgment, were nothing more than part of the consideration given by him to escape incarceration. We so find as a fact.

In the circumstances, petitioners’ ‘contributions’ made under the compulsion of the plea bargains agreement, as incorporated in the Probation Judgment, could hardly qualify for deduction as ‘charitable contributions’ within section 170(c)(1), I.R.C. 1954. It has been firmly settled that ‘(i)f a payment proceeds primarily from the incentive of anticipated benefit to the payor beyond the satisfaction which flows from the performance of a generous act, it is not a ‘gift’ that may be classified as a charitable contribution. * * * * It would strain our credulity to the breaking point to conclude that petitioner’s contributions proceeded even remotely from a charitable impulse. What we have here is a clear case of a ‘gift’ for a quid pro quo. In short, petitioner was faced with the unhappy choice: prison or ‘gift’. He chose the latter. His ‘gift’ was merely a transfer in exchange for an expectation of freedom from prison. We need not belabor the point further. Petitioner made no charitable contribution that qualifies for deduction.3

The facts of this case suggest an intriguing question as to whether the trial court in the criminal case went beyond its powers in adopting a requirement in the plea bargain agreement that petitioner make a ‘charitable’ contribution of $145,000. It would appear that under North Carolina law, as alleged in the petition, the maximum fine that the court could impose was $5,000, see N.C. Gen. Stat. sec. 90-95(b)(2) (1981), and that there might therefore be some question (one that we have not explored) whether it could in effect exact further payment of $145,000 to an instrumentality or subdivision of the state. However, regardless of whether the trial court exceeded its power in this connection under North Carolina law, the blunt fact is that it did embody such an order in its Probation Judgment, and petitioners’ compliance therewith certainly did not constitute a deductible charitable contribution within the meaning of section 170, I.R.C. 1954.

Decision will be entered for the respondent.
Sam Gilliam, Jr. (hereinafter sometimes referred to as ‘Gilliam’) . . . received a master of arts degree in painting from the University of Louisville. Gilliam is, and was at all material periods, a noted artist. His works have been exhibited in numerous art galleries throughout the United States and Europe, including the Corcoran Gallery of Art, Washington, D.C.; the Philadelphia Museum of Art, Philadelphia, Pennsylvania; the Karl Solway Gallery, Cincinnati, Ohio; the Phoenix Gallery, San Francisco, California; and the University of California, Irvine, California. His works have also been exhibited and sold at the Fendrick Gallery, Washington, D.C. In addition, Gilliam is, and was at all material periods, a teacher of art. On occasion, Gilliam lectured and taught art at various institutions.

Gilliam accepted an invitation to lecture and teach for a week at the Memphis Academy of Arts in Memphis, Tennessee. On Sunday, February 23, 1975, he flew to Memphis to fulfill this business obligation.

Gilliam had a history of hospitalizations for mental and emotional disturbances and continued to be under psychiatric care until the time of his trip to Memphis. In December 1963, Gilliam was hospitalized in Louisville; Gilliam had anxieties about his work as an artist. For periods of time in both 1965 and 1966, Gilliam suffered from depression and was unable to work. In 1970, Gilliam was again hospitalized. In 1973, while Gilliam was a visiting artist at a number of university campuses in California, he found it necessary to consult an airport physician; however, when he returned to Washington, D.C., Gilliam did not require hospitalization.

Before his Memphis trip, Gilliam created a 225-foot painting for the Thirty-fourth Biennial Exhibition of American Painting at the Corcoran Gallery of Art (hereinafter sometimes referred to as ‘the Exhibition’). The Exhibition opened on Friday evening, February 21, 1975. In addition, Gilliam was in the process of preparing a giant mural for an outside wall of the Philadelphia Museum of Art for the 1975 Spring Festival in Philadelphia. The budget plans for this mural were due on Monday, February 24, 1975.

On the night before his Memphis trip, Gilliam felt anxious and unable to rest. On Sunday morning, Gilliam contacted Ranville Clark (hereinafter sometimes referred to as ‘Clark’), a doctor Gilliam had been consulting intermittently over the years, and asked Clark to prescribe some medication to relieve his anxiety. Clark arranged for Gilliam to pick up a prescription of the drug Dalmane on the way to the airport. Gilliam had taken medication frequently during the preceding 10 years. Clark had never before prescribed Dalmane for Gilliam.


About one and one-half hours after the airplane departed Washington National Airport, Gilliam began to act in an irrational manner. He talked of bizarre events and had difficulty in speaking. According to some witnesses, he appeared to be airsick and held his head. Gilliam began to feel trapped, anxious, disoriented, and very agitated. Gilliam said that the plane was going to crash and that he wanted a life raft. Gilliam entered the aisle and, while going from one end of the airplane to the other, he tried to exit from three different doors. Then Gilliam struck Seiji Nakamura (hereinafter sometimes referred to as ‘Nakamura’), another passenger, several times with a telephone receiver. Nakamura was seated toward the rear of the airplane, near one of the exits. Gilliam also threatened the navigator and a stewardess, called for help, and cried. As a result of the attack, Nakamura
sustained a one-inch laceration above his left eyebrow which required four sutures. Nakamura also suffered ecchymosis of the left arm and pains in his left wrist. Nakamura was treated for these injuries at Methodist Hospital in Memphis.

On arriving in Memphis, Gilliam was arrested by Federal officials. On March 10, 1975, Gilliam was indicted. He was brought to trial in the United States District Court for the Western District of Tennessee, Western Division, on one count of violation of 49 U.S.C. section 1472(k) (relating to certain crimes aboard an aircraft in flight) and two counts of violation 49 U.S.C. section 1472(j) (relating to interference with flight crew members or flight attendants). Gilliam entered plea of not guilty to the criminal charges. The trial began on September 8, 1975, and ended on September 10, 1975. After Gilliam presented all of his evidence, the district court granted Gilliam’s motion for a judgment of acquittal by reason of temporary insanity.

Petitioners paid $8,250 and $8,600 for legal fees in 1975 and 1976, respectively, in connection with both the criminal trial and Nakamura’s civil claim. In 1975, petitioners also paid $3,800 to Nakamura in settlement of the civil claim. Petitioners claimed deductions for the amounts paid in 1975 and 1976 on the appropriate individual income tax returns. Respondent disallowed the amounts claimed in both years attributable to the incident on the airplane. Gilliam’s trip to Memphis was a trip in furtherance of his trades or businesses.

Petitioners contend that they are entitled to deduct the amounts paid in defense of the criminal prosecution and in settlement of the related civil claim under section 162. Petitioners maintain that the instant case is directly controlled by our decision in Dancer v. Commissioner, 73 T.C. 1103 (1980). According to petitioners, ‘(t)he clear holding of Dancer is * * * that expenses for litigation arising out of an accident which occurs during a business trip are deductible as ordinary and necessary business expenses.’ Petitioners also contend that Clark v. Commissioner, 30 T.C. 1330 (1958), is to the same effect as Dancer. Respondent maintains that Dancer and Clark are distinguishable. Respondent contends that the legal fees paid are not deductible under either section 162 or section 212 because the criminal charges against Gilliam were neither directly connected with nor proximately resulted from his trade or business and the legal fees were not paid for the production of income. Respondent maintains that ‘the criminal charges which arose as a result of * * * (the incident on the airplane), could hardly be deemed ‘ordinary,’ given the nature of (Gilliam’s) profession.’ Respondent contends ‘that the provisions of section 262 control this situation.’ As to the settlement of the related civil claim, respondent asserts that since Gilliam committed an intentional tort, the settlement of the civil claim constitutes a nondeductible personal expense.

We agree with respondent that the expenses are not ordinary expenses of Gilliam’s trade or business. Section 162(a) allows a deduction for all the ordinary and necessary expenses of carrying on a trade or business. In order for the expense to be deductible by a taxpayer, it must be an ordinary expense, it must be a necessary expense, and it must be an expense of carrying on the taxpayer’s trade or business. If any one of these requirements is not met, the expense is not deductible under section 162(a). Deputy v. du Pont, 308 U.S. 488 (1940); Welch v. Helvering, 290 U.S. 111 (1933); Kornhauser v. United States, 276 U.S. 145 (1928). In Deputy v. du Pont, the Supreme Court set forth a guide for application of the statutory requirement that the expense be ‘ordinary’, as follows (308 U.S. at 494-497):

In the second place, these payments were not ‘ordinary’ ones for the conduct of the kind of business in which, we assume arguendo, respondent was engaged. The District Court held that they were ‘beyond the norm of general and accepted business practice’ and were in fact ‘so extraordinary as to occur in the lives of ordinary business men not at all’ and in the life of the respondent ‘but once.’ 8 Certainly there are no norms of conduct to which we
have been referred or of which we are cognizant which would bring these payments within the meaning of ordinary expenses for conserving and enhancing an estate. We do not doubt the correctness of the District Court’s finding that respondent embarked on this program to the end that his beneficial stock ownership in the du Pont Company might be conserved and enhanced. But that does not make the cost to him an ‘ordinary’ expense within the meaning of the Act. Ordinary has the connotation of normal, usual, or customary. To be sure, an expense may be ordinary though it happen but once in the taxpayer’s lifetime. Cf. Kornhauser v. United States, supra. Yet the transaction which gives rise to it must be of common or frequent occurrence in the type of business involved. Welch v. Helvering, supra, 114. Hence, the fact that a particular expense would be an ordinary or common one in the course of one business and so deductible under section 23(a) does not necessarily make it such in connection with another business. * * * As stated in Welch v. Helvering, supra, pp. 113-114: ‘. . . What is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance.’

One of the extremely relevant circumstances is the nature and scope of the particular business out of which the expense in question accrued. The fact that an obligation to pay has arisen is not sufficient. It is the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling.

Review of the many decided cases is of little aid since each turns on its special facts. But the principle is clear. And on application of that principle to these facts, it seems evident that the payments in question cannot be placed in the category of those items of expense which a conservator of an estate, a custodian of a portfolio, a supervisor of a group of investments, a manager of wide financial and business interests, or a substantial stockholder in a corporation engaged in conserving and enhancing his estate would ordinarily incur. We cannot assume that they are embraced within the normal overhead or operating costs of such activities. There is no evidence that stockholders or investors, in furtherance of enhancing and conserving their estates, ordinarily or frequently lend such assistance to employee stock purchase plans of their corporations. And in absence of such evidence there is no basis for an assumption, in experience or common knowledge, that these payments are to be placed in the same category as typically ordinary expenses of such activities, e.g., rental of safe deposit boxes, cost of investment counsel or of investment services, salaries of secretaries and the like. Rather these payments seem to us to represent most extraordinary expenses for that type of activity. Therefore, the claim for deduction falls, as did the claim of an officer of a corporation who paid its debts to strengthen his own standing and credit. Welch v. Helvering, supra. And the fact that the payments might have been necessary in the sense that consummation of the transaction with the Delaware Company was beneficial to respondent’s estate is of no aid. For Congress has not decreed that all necessary expenses may be deducted. Though plainly necessary they cannot be allowed unless they are also ordinary. Welch v. Helvering, supra.

Petitioners bear the burden of proving entitlement to a deduction under section 162. Welch v. Helvering, 290 U.S. at 115; Rule 142(a), Tax Court Rules of Practice & Procedure. Gilliam is a noted artist and teacher of art. It undoubtedly is ordinary for people in Gilliam’s trades or businesses to travel (and to travel by air) in the course of such trades or businesses; however, we do not believe it is ordinary for people in such trades or businesses to be involved in altercations of the sort here involved in the course of any such travel. The travel was not itself the conduct of Gilliam’s trades or businesses. Also, the expenses here involved are not strictly a cost of Gilliam’s transportation. Finally, it is obvious that neither the altercation nor the expenses were undertaken to further Gilliam’s trades or businesses. We conclude that Gilliam’s expenses are not ordinary expenses of his trades or businesses.

It is instructive to compare the instant case with Dancer v. Commissioner, supra, upon which
petitioners rely. In both cases, the taxpayer was travelling on business. In both cases, the expenses in dispute were not the cost of the travelling, but rather were the cost of an untoward incident that occurred in the course of the trip. In both cases, the incident did not facilitate the trip or otherwise assist the taxpayer’s trade or business. In both cases, the taxpayer was responsible for the incident; in neither case was the taxpayer willful. In Dancer, the taxpayer was driving an automobile; he caused an accident which resulted in injuries to a child. The relevant expenses were the taxpayer’s payments to settle the civil claims arising from the accident. 73 T.C. at 1105. In the instant case, Gilliam was a passenger in an airplane; he apparently committed acts which would have been criminal but for his temporary insanity, and he injured a fellow passenger. Gilliam’s expenses were the costs of his successful legal defense, and his payments to settle Nakamura’s civil claim.

In Dancer, we stated as follows (73 T.C. at 1108-1109):
It is true that the expenditure in the instant case did not further petitioner’s business in any economic sense; nor is it, we hope, the type of expenditure that many businesses are called upon to pay. Nevertheless, neither factor lessens the direct relationship between the expenditure and the business. Automobile travel by petitioner was an integral part of this business. As rising insurance rates suggest, the cost of fuel and routine servicing are not the only costs one can expect in operating a car. As unfortunate as it may be, lapses by drivers seem to be an inseparable incident of driving a car. Anderson v. Commissioner (81 F.2d 457 (CA10 1936)). Costs incurred as a result of such an incident are just as much a part of overall business expenses as the cost of fuel. (Emphasis supplied.). Dancer is distinguishable.

In Clark, supra, also relied on by petitioners, the expenses consisted of payments of (a) legal fees in defense of a criminal prosecution and (b) amounts to settle a related civil claim. In this regard, the instant case is similar to Clark. In Clark, however, the taxpayer’s activities that gave rise to the prosecution and civil claim were activities directly in the conduct of Clark’s trade or business. In the instant case, Gilliam’s activities were not directly in the conduct of his trades or businesses. Rather, the activities merely occurred in the course of transportation connected with Gilliam’s trades or businesses. And, as we noted in Dancer, ‘in cases like this, where the cost is an adjunct of and not a direct cost of transporting an individual, we have not felt obliged to routinely allow the expenditure as a transportation cost deduction.’

Petitioners also rely on Commissioner v. Tellier, 383 U.S. 687 (1966), in which the taxpayer was allowed to deduct the cost of an unsuccessful criminal defense to securities fraud charges. The activities that gave rise to the criminal prosecution in Tellier were activities directly in the conduct of Tellier’s trade or business. Our analysis of the effect of Clark v. Commissioner, applies equally to the effect of Commissioner v. Tellier.

In sum, Gilliam’s expenses were of a kind similar to those of the taxpayers in Tellier and Clark; however the activities giving rise to Gilliam’s expenses were not activities directly in the conduct of his trades or businesses, while Tellier’s and Clark’s activities were directly in the conduct of their respective trades or businesses. Gilliam’s expenses were related to his trades or businesses in a manner similar to those of the taxpayer in Dancer; however Gilliam’s actions giving rise to the expenses were not shown to be ordinary, while Dancer’s were shown to be ordinary. Tellier, Clark, and Dancer all have similarities to the instant case; however, Tellier, Clark, and Dancer are distinguishable in important respects. The expenses are not deductible under section 162(a). We hold for respondent.
Rev. Rul. 99-7, 1999-1 C.B. 361

Issue: Under what circumstances are daily transportation expenses incurred by a taxpayer in going between the taxpayer's residence and a work location deductible under section 162(a) of the Internal Revenue Code?

Holding: In general, daily transportation expenses incurred in going between a taxpayer's residence and a work location are nondeductible commuting expenses. However, such expenses are deductible under the circumstances described in paragraph (1), (2), or (3) below.

(1) A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location OUTSIDE the metropolitan area where the taxpayer lives and normally works. However, unless paragraph (2) or (3) below applies, daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location WITHIN that metropolitan area are nondeductible commuting expenses.

(2) If a taxpayer has one or more regular work locations away from the taxpayer's residence, the taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a TEMPORARY work location in the same trade or business, regardless of the distance. * * * *

(3) If a taxpayer's residence is the taxpayer's principal place of business within the meaning of section 280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the other work location is REGULAR or TEMPORARY and regardless of the distance.

For purposes of paragraphs (1), (2), and (3), the following rules apply in determining whether a work location is temporary. If employment at a work location is realistically expected to last (and does in fact last) for 1 year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than 1 year or there is no realistic expectation that the employment will last for 1 year or less, the employment is not temporary, regardless of whether it actually exceeds 1 year. If employment at a work location initially is realistically expected to last for 1 year or less, but at some later date the employment is realistically expected to exceed 1 year, that employment will be treated as temporary (in the absence of facts and circumstances indicating otherwise) until the date that the taxpayer's realistic expectation changes, and will be treated as not temporary after that date.

The determination that a taxpayer's residence is the taxpayer's principal place of business within the meaning of section 280A(c)(1)(A) is not necessarily determinative of whether the residence is the taxpayer's tax home for other purposes, including the travel-away-from-home deduction under section 162(a)(2).
PELL, Circuit Judge.

Petitioners appeal the judgment of the United States Tax Court finding that profit was not their primary goal in owning a dairy farm. Based on this finding the tax court disallowed deductions for losses incurred in renovating the farm. The sole issue presented for our review is whether the tax court’s finding regarding petitioners’ motivation was clearly erroneous.

I. Facts
Melvin Nickerson (hereinafter referred to as petitioner) was born in 1932 in a farming community in Florida. He worked evenings and weekends on his father’s farm until he was 17. Petitioner entered the field of advertising after attending college and serving in the United States Army. During the years relevant to this case he was self-employed in Chicago, serving industrial and agricultural clients. His wife, Naomi W. Nickerson, was a full-time employee of the Chicago Board of Education. While petitioners were not wealthy, they did earn a comfortable living.

At the age of forty, petitioner decided that his career in the “youth oriented” field of advertising would not last much longer, and he began to look for an alternative source of income for the future. Petitioners decided that dairy farming was the most desirable means of generating income and examined a number of farms in Michigan and Wisconsin. After several years of searching, petitioners bought an 80-acre farm in Door County, Wisconsin for $40,000. One year later they purchased an additional 40 acres adjoining the farm for $10,000.

The farm, which had not been run as a dairy for eight years, was in a run-down condition. What little equipment was left was either in need of repair or obsolete. The tillable land, about 60 acres, was planted with alfalfa, which was at the end of its productive cycle. In an effort to improve this state of affairs petitioners leased the land to a tenant-farmer for $20 an acre and an agreement that the farmer would convert an additional ten acres a year to the cultivation of a more profitable crop. At the time of trial approximately 80 acres were tillable. The rent received from the farmer was the only income derived from the farm.

Petitioner visited the farm on most weekends during the growing season and twice a month the rest of the year. Mrs. Nickerson and the children visited less frequently. The trip to the farm requires five hours of driving from petitioners’ home in Chicago. During these visits petitioner and his family either worked on their land or assisted neighboring farmers. When working on his own farm petitioner concentrated his efforts on renovating an abandoned orchard and remodeling the farm house. In addition to learning about farming through this experience petitioner read a number of trade journals and spoke with the area agricultural extension agent.

Petitioners did not expect to make a profit from the farm for approximately 10 years. True to their expectations, petitioners lost $8,668 in 1976 and $9,872.95 in 1977. Although they did not keep formal books of account petitioners did retain receipts and cancelled checks relating to farm expenditures. At the time of trial, petitioners had not yet acquired any livestock or farm machinery. The farm was similarly devoid of recreational equipment and had never been used to entertain guests.

The tax court decided that these facts did not support petitioners’ claim that the primary goal in operating the farm was to make a profit. We will examine the tax court’s reasoning in more detail after setting out the relevant legal considerations.

II. The Statutory Scheme
Section 162(a) of the Internal Revenue Code of 1954 allows deduction of “all the ordinary and necessary expenses paid or incurred during the taxable year in
Supplement Page #75

carrying *404 on any trade or business.” Section 183, however, limits the availability of these deductions if the activity “is not engaged in for profit” to deductions that are allowed regardless of the existence of a profit motive and deductions for ordinary and necessary expenses “only to the extent that the gross income derived from such activity for the taxable year exceeds [otherwise allowable deductions].” I.R.C. § 183(b)(2). The deductions claimed by petitioners are only allowable if their motivation in investing in the farm was to make a profit.

Petitioners bear the burden of proving that their primary purpose in renovating the farm was to make a profit. In meeting this burden, however, “it is sufficient if the taxpayer has a bona fide expectation of realizing a profit, regardless of the reasonableness of such expectation.” Although petitioners need only prove their sincerity rather than their realism the factors considered in judging their motivation are primarily objective. In addition to the taxpayer’s statements of intent, which are given little weight for obvious reasons, the tax court must consider “all facts and circumstances with respect to the activity,” including the following:

(1) Manner in which the taxpayer carries on the activity. The fact that the taxpayer carries on the activity in a businesslike manner and maintains complete and accurate books and records may indicate that the activity is engaged in for profit....

(2) The expertise of the taxpayer or his advisors. Preparation for the activity by extensive study of its accepted business, economic, and scientific practices, or consultation with those who are expert therein, may indicate that the taxpayer has a profit motive where the taxpayer carries on the activity in accordance with such practices....

(3) The time and effort expended by the taxpayer in carrying on the activity. The fact that the taxpayer devotes much of his personal time and effort to carrying on the activity, particularly if the activity does not have substantial personal or recreational aspects, may indicate an intention to derive a profit.... The fact that the taxpayer devotes a limited amount of time to an activity does not necessarily indicate a lack of profit motive where the taxpayer employs competent and qualified persons to carry on such activity.

(4) Expectation that assets used in activity may appreciate in value....

(5) The success of the taxpayer in carrying on other similar or dissimilar activities....

(6) The taxpayer’s history of income or losses with respect to the activity....

(7) The amount of occasional profits, if any, which are earned....

(8) The financial status of the taxpayer....

(9) Elements of personal pleasure or recreation. The presence of personal motives in carrying on of an activity may indicate that the activity is not engaged in for profit, especially where there are recreational or personal elements involved. On the other hand, a profit motivation may be indicated where an activity lacks any appeal other than profit. It is not, however, necessary that an activity be engaged in with the exclusive intention of deriving a profit or with the intention of maximizing profits.... Treas.Reg. § 1.183–2(b)(1)–(9). None of these factors is determinative, nor is the decision to be made by comparing the number of factors that weigh in the taxpayer’s favor with the number that support the Commissioner. Id. There is no set formula for divining a taxpayer’s true motive, rather “[o]ne struggles in vain for any verbal formula that will supply a ready touchstone. The standard set by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle.” Welch v. Helvering, 290 U.S. 111, 115, 54 S.Ct. 8, 9, 78 L.Ed. 212 (1933). Nonetheless, we are given some guidance by the enumerated factors and by the Congressional purpose in enacting §183.
The legislative history surrounding section 183 indicates that one of the prime motivating factors behind its passage was Congress’ desire to create an objective standard to determine whether a taxpayer was carrying on a business for the purpose of realizing a profit or was instead merely attempting to create and utilize losses to offset other income. Jasionowski v. Commissioner, 66 T.C. 312, 321 (1976).

Congressional concern stemmed from a recognition that “[w]ealthy individuals have invested in certain aspects of farm operations solely to obtain ‘tax losses”—largely bookkeeping losses—for use to reduce their tax on other income.... One of the remarkable aspects of the problem is pointed up by the fact that persons with large nonfarm income have a remarkable propensity to lose money in the farm business.” S.Rep. No. 91–552, 91st Cong., 1st Sess., reprinted in 1969 U.S.Code Cong. & Ad.News 2027, 2376. With this concern in mind we will now examine the decision of the tax court.

III. Decision of the Tax Court

The tax court analyzed the relevant factors and determined that making a profit was not petitioners’ primary goal in engaging in farming. The court based its decision on a number of factors that weighed against petitioners. The court found that they did not operate the farm in a businesslike manner and did not appear to have a concrete plan for improving the profitability of the farm. The court believed that these difficulties were attributable to petitioners’ lack of experience, but did not discuss the steps actually taken by Melvin Nickerson to gain experience in farming.

The court found it difficult to believe that petitioners actually believed that the limited amount of time they were spending at the farm would produce a profit given the dilapidated condition of the farm. Furthermore, the court found that petitioners’ emphasis on making the farm house habitable rather than on acquiring or repairing farm equipment was inconsistent with a profit motive. These factors, combined with the consistent history of losses borne by petitioners, convinced the court that “petitioner at best entertains the hope that when he retires from the advertising business and can devote his complete attention to the farming operation, he may at that time expect to produce a profit.” The court did not think that this hope rose to the level of a bona fide expectation of profit.

IV. Review of the Tax Court’s Findings

Whether petitioners intended to run the dairy farm for a profit is a question of fact, and as such our review is limited to a determination of whether the tax court was “clearly erroneous” in determining that petitioners lacked the requisite profit motive. * * * * This standard of review applies although the only dispute is over the proper interpretation of uncontested facts. * * * * This is one of those rare cases in which we are convinced that a mistake has been made.

Our basic disagreement with the tax court stems from our belief that the court improperly evaluated petitioners’ actions from the perspective of whether they sincerely believed that they could make a profit from their current level of activity at the farm. On the contrary, petitioners need only prove that their current actions were motivated by the expectation that they would later reap a profit, in this case when they finished renovating the farm and began full-time operations. It is well established that a taxpayer need not expect an immediate profit; the existence of “start up” losses does not preclude a bona fide profit motive.* * * * We see no basis for distinguishing petitioners’ actions from a situation in which one absorbs larger losses over a shorter period of time by beginning full-time operations immediately. In either situation the taxpayer stands an equal chance of recouping start-up losses. In fact, it seems to us a reasonable decision by petitioners to prepare the farm before becoming dependent upon it for
sustenance. Keeping in mind that petitioners were not seeking to supplement their existing incomes with their current work on the farm, but rather were laying the groundwork for a contemplated career switch, we will examine the factors relied upon by the tax court.

The tax court found that the amount of time petitioners devoted to the farm was inadequate. In reaching this conclusion the court ignored petitioners’ agreement with the tenant-farmer under which he would convert 10 acres a year to profitable crops in exchange for the right to farm the land. In this situation the limited amount of time spent by petitioners, who were fully employed in Chicago, is not inconsistent with an expectation of profit. * * * *

The court also rested its decision on the lack of a concrete plan to put the farm in operable condition. Once again, this ignores petitioners’ agreement with the tenant-farmer concerning reclamation of the land. Under this agreement the majority of the land would be tillable by the time petitioners were prepared to begin full-time farming. The tax court also believed that petitioners’ decision to renovate the farm house and orchard prior to obtaining farm equipment evidenced a lack of profit motive. As petitioners planned to live on the farm when they switched careers refurbishing the house would seem to be a necessary first step. The court also failed to consider the uncontradicted testimony regarding repairs made to the hay barn and equipment shed, which supported petitioners’ contention that they were interested in operating a farm rather than just living on the land. Additionally, we fail to understand how renovating the orchard, a potential source of food and income, is inconsistent with an expectation of profit. * * * *

The tax court took into account the history of losses in considering petitioners’ intentions. While a history of losses is relevant, in this case little weight should be accorded this factor. Petitioners did not expect to make a profit for a number of years, and it was clear from the condition of the farm that a financial investment would be required before the farm could be profitable. * * * *

The court believed that most of petitioners’ problems were attributable to their lack of expertise. While lack of expertise is relevant, efforts at gaining experience and a willingness to follow expert advice should also be considered. Treas.Reg. 1.183–2(b)(2). The court here failed to consider the uncontradicted evidence that Melvin Nickerson read trade journals and Government-sponsored agricultural newsletters, sought advice from a state horticultural agent regarding renovation of the orchard and gained experience by working on neighboring farms. In addition, petitioners’ agreement with the tenant-farmer was entered into on the advice of the area agricultural extension agent. To weigh petitioners’ lack of expertise against them without giving consideration to these efforts effectively precludes a bona fide attempt to change careers. We are unwilling to restrict petitioners in this manner and believe that a proper interpretation of these facts supports petitioners’ claims.

The tax court recognized that the farm was not used for entertainment and lacked any recreational facilities, and that petitioners’ efforts at the farm were “prodigious,” but felt that this was of little importance. While the Commissioner need not prove that petitioners were motivated by goals other than making a profit, we think that more weight should be given to the absence of any alternative explanation for petitioners’ actions. As we previously noted the standard set out by the statute is to be applied with the insight gained from a lifetime of experience as well as an understanding of the statutory scheme. Common sense indicates to us that rational people do not perform hard manual labor for no reason, and if the possibility that petitioners performed these labors for pleasure is eliminated the only remaining motivation is profit. * * * *

If this were a case in which wealthy taxpayers were seeking to obtain tax benefits through the creation of paper losses we would hesitate to reverse. Before us today, however, is a family of modest means attempting to prepare for a stable financial future. The amount of time and hard work invested by petitioners belies any claim that allowing these
deductions would thwart Congress’s primary purpose, that of excluding “hobby” losses from permissible deductions. Accordingly, we hold that the tax court’s finding was clearly erroneous and reversed.
GOFFE, Judge:

Petitioner H. Connely Plunkett is an architectural engineer and a partner of an architectural firm located in Jackson, Mississippi. He also is in the business of building homes. Extensive income generated by these businesses partially paid for petitioner's mud-racing and truck-pulling activities.

Mud racing is a relatively new entrant to the American sporting scene. It generally involves speed competition amongst four-wheel drive vehicles on a circular track which has been intentionally transformed into a mudhole. A mud-racing track is usually constructed as follows: a round asphalt speedway with a pond in its center is selected; a dirt track is constructed within the inner perimeter of the asphalt speedway; earthen berms are built along the inner and outer edges of the dirt track; and finally, large amounts of water are drained from the pond and pumped onto the dirt track in order to create water depths between one and three feet depending upon the location within the newly formed mudhole. Apparently, deeper water creates more exciting starts while smaller amounts of water produce a thicker and more viscous mud, which in turn, provides for slow-motion finishes.

Mud-racing drivers compete in four different classes: (1) vehicles with six-cylinder engines; (2) “V-8 stock,” i.e., eight-cylinder vehicles whose engines and remaining components are substantially unchanged from the factory; (3) “street-modified,” i.e., eight-cylinder vehicles whose engines are modified for racing but the remainder is substantially unchanged; and (4) “super-modified” which encompasses generally unrestricted multi-cylinder vehicles.

Truck pulling is an entirely different sporting event. Although it also includes similar classes of four-wheel drive vehicles which have been modified for pulling, the participants compete by attempting to tow a large weighted sled along a straight dirt runway. The sled normally contains 3,500 pounds of weights. At the beginning of each pulling attempt, the weights are positioned in the rear of the sled. As a competitor pulls the sled forward, the weights are mechanically shifted towards the front of the sled which increases the total pulling resistance. At some point, the resistance usually exceeds the vehicle's pulling power; hence, the sled does not advance any further. A competitor's success is determined by measuring the distance that the sled has been pulled: the further, the better.

As in mud racing, each truck-pulling participant competes in as many different classes as he has qualifying vehicles. Unlike mud racing, however, participation in a truck-pulling contest is by invitation only and there usually is no registration fee. Most truck-pulling events involve several days of competition. Cash awards are distributed to the winners and other high finishers at the end of each day of competition. Depending upon the size of the total purse, a truck-pulling competitor can win up to $1,000 per day in the “super-modified” class and possibly even $2,000 over a weekend.

Petitioner began to mud race in 1975 without ever having been a spectator at such an event. Petitioner competed in only one mud race during the 1975 season yet won $100 on his debut. During the 1976, 1977 and 1978 mud-racing seasons, petitioner entered 10, 20 and 26 races, respectively. Petitioner generally competed in the “super-modified” class while mud racing.

During 1977, petitioner became increasingly interested in truck pulling. He eventually converted a truck which had been substantially destroyed during a mud race into a
truck-pulling vehicle and began to compete in this sport. * * * Petitioner's interest in mud racing waned as his truck-pulling activities increased. This was largely the result of his realization that he had an increased likelihood of winning more money in truck pulling. Truck-pulling contests generally have larger purses and this sport is increasing in popularity. Many truck pulls draw over 15,000 paying spectators.

Petitioner drove all of the vehicles he entered in mud races and truck pulls. He never had any formal training for these activities; he acquired expertise through participation. Petitioner did not employ any crew or experienced personnel to assist him in either competition format. Petitioner performed most of the maintenance work on his vehicles although he did employ a machinist to assist him in preparing and repairing various engine components. His 11-year-old son occasionally assisted him. Petitioner devoted approximately 500 hours per year to his mud-racing and truck-pulling activities during the years in issue.

Petitioner enjoyed mud racing and truck pulling. When petitioner began to mud race, he anticipated that it would take him three years to recover his initial outlays. * * *

Section 183(a) provides that, except as otherwise permitted in that section, individual taxpayers will not be allowed deductions which are attributable to activities that are “not engaged in for profit.” Section 183(b)(1) provides that deductions which would be allowable without regard to whether such activity is engaged in for profit shall be allowed. Section 183(b)(2) further provides that deductions which would be allowable only if such activity is engaged in for profit shall be allowed “but only to the extent that the gross income derived from such activity for the taxable year exceeds the deductions allowable by reason of paragraph (1).”

The standard * * * is: did the individual engage in the activity “with the actual and honest objective of making a profit”? Although a taxpayer's expectation of profit need not be reasonable, the facts and circumstances must indicate that the taxpayer had the requisite profit objective. * * *

The question of whether petitioner's mud-racing and truck-pulling activities fall within the purview of section 183(a) is one of fact which must be resolved on the basis of all of the facts and circumstances and not just one factor.

Section 1.183–2(b), Income Tax Regs., lists some of the relevant factors, derived principally from caselaw, which “should normally be taken into account” in determining whether an activity is engaged in for profit. Benz v. Commissioner, supra at 383. The factors include: (1) the manner in which the taxpayer carries on the activity; (2) the expertise of the taxpayer or his advisors; (3) the time and effort expended by the taxpayer in carrying on the activity; (4) the expectation that the assets used in the activity may appreciate in value; (5) the success of the taxpayer in carrying on other similar or dissimilar activities; (6) the taxpayer's history of income or loss with respect to the activity; (7) the amount of occasional profits, if any, which are earned; (8) the financial status of the taxpayer; and (9) whether elements of personal pleasure or recreation are involved.

Upon examination of petitioner's mud-racing activities in light of the nine objective criteria set forth in the regulations, we hold that such endeavors constitute an activity “not engaged in for profit” within the scope of section 183(a). Although petitioner was experienced in mechanics and racing and had been “playing with automobiles” since he was 12, he had no prior experience in four-wheel drive vehicle competition prior to the start of his mud-racing activities. The racing of four-wheel drive vehicles through specially built mudholes also involves a great deal of recreational characteristics. Further, the profit potential from mud racing is generally low. Each participant must successfully complete numerous heats to even be eligible for the cash awards, thus significantly increasing the likelihood of elimination or damage to the mud racer. Finally, even assuming petitioner had won every mud race he entered (which is totally unsupported by petitioner's actual track record),
his total winnings would have been significantly less than his attendant expenses; therefore, petitioner did not have an actual and honest during the years in issue. Accordingly, all of petitioner's mud-racing expenses during the years in issue shall be governed by the provisions of section 183.

Upon review of petitioner's truck-pulling activities, however, we hold that such endeavors were engaged in for profit during petitioner's taxable year 1978. FN4 Petitioner carried on his truck-pulling activities in a workmanlike fashion, guided by the additional racing experience he gained during his mud-racing competition. Through his diligence and devotion of large amounts of time and effort, petitioner was ultimately ranked 35th in the nation by Truck-O-Rama, a national truck-pulling promoter.

Petitioner also converted some of his mud-racing vehicles into truck-pulling devices, thus limiting his recreational use of such vehicles in future mud races, with no assurance that he would even be able to compete since participation in truck pulls is by invitation only. Finally, petitioner expanded into this new activity only after realizing that it had a greater profit potential than mud racing. Truck pulling differs from mud racing in several significant respects concerning its profitability potential. Truck-pulling contests generally have larger total purses and class prizes and this passtime is increasing in popularity. The truck-pulling circuit is also national in scope while mud racing is generally confined to the southeastern portions of the country. A truck-pulling participant's chances of elimination or damage to his vehicle is also significantly less than a mud racer's because a truck-pulling competitor's finish and eligibility for cash awards is determined by a single pulling attempt while mud racing involves numerous elimination heats.

While some of the objective criteria listed in the regulations weigh against the petitioner, we do not consider them significant enough to offset the criteria which weigh in his favor. Although petitioner did not maintain a formal set of records concerning his truck-pulling endeavors, he generally conducted this activity in a fashion similar to his construction business which was also engaged in for profit. ** Further, the fact that petitioner's truck-pulling activities were not immediately profitable does not alter our opinion that petitioner had a bona fide objective of making a profit when he began to compete in truck-pulling contests. The regulations specifically acknowledge that losses can be incurred during the formative years of profit-oriented activities. * * * Finally, the fact that truck-pulling competition and the related preparatory activities involve some elements of recreation and pleasure for petitioner, who liked to work on cars, is not determinative.
MIDLAND EMPIRE PACKING COMPANY v. COMMISSIONER
14 T.C. 635 (1950)

ARUNDELL, Judge:

The issue in this case is whether an expenditure for a concrete lining in petitioner’s basement to oilproof it against an oil nuisance created by a neighboring refinery is deductible as an ordinary and necessary expense under section 23(a) of the Internal Revenue Code, on the theory it was an expenditure for a repair, or, in the alternative, whether the expenditure may be treated as the measure of the loss sustained during the taxable year and not compensated for by insurance or otherwise within the meaning of section 23(f) of the Internal Revenue Code.

The respondent has contended, in part, that the expenditure is for a capital improvement and should be recovered through depreciation charges and is, therefore, not deductible as an ordinary and necessary business expense or as a loss. . . . [Reg. §1.162-4] is helpful in distinguishing between an expenditure to be classed as a repair and one to be treated as a capital outlay. In Illinois Merchants Trust Co., Executor, 4 B.T.A. 103, at page 106, we discussed this subject in some detail and in our opinion said:

It will be noted that the first sentence of the article (now Regulations 111, sec. 29.23(a)-4) relates to repairs, while the second sentence deals in effect with replacements. In determining whether an expenditure is a capital one or is chargeable against operating income, it is necessary to bear in mind that purpose for which the expenditure was made. To repair is to restore to a sound state or to mend, while a replacement connotes a substitution. A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements, or additions which prolong the life of the property, increase its value, or make it adaptable to a different use. The one is a maintenance charge, while the others are additions to capital investment which should not be applied against current earnings.

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

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

While it is conceded on brief that the expenditure was ‘necessary,’ respondent contends that the encroachment of the oil nuisance on petitioner’s property was not an ‘ordinary’ expense in petitioner’s particular business. But the fact that petitioner had not theretofore been called upon to make a similar expenditure to prevent damage and disaster to its property does not remove that expense from the classification of ‘ordinary’ for, as stated in Welch v. Helvering, 290 U.S. 111, ‘ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. * * * the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted *642 means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. * Steps to protect a business building from the seepage of oil from a nearby refinery, which had been erected long subsequent to the time petitioner started to operate its plant, would seem to us to be a normal thing to do, and in certain sections of the country it must be a common experience to protect one’s property from the seepage of oil. Expenditures to accomplish this result are likewise normal.

In American Bemberg Corporation, 10 T.C. 361, we allowed as deductions, on the ground that they were ordinary and necessary expenses, extensive expenditures made to prevent disaster, although the repairs were of a type which had never been needed before and were unlikely to recur. In that case the taxpayer, to stop cave-ins of soil which were threatening destruction of its manufacturing plant, hired an engineering firm which drilled to the bedrock and injected grout to fill the cavities were practicable, and made incidental replacements and repairs, including tightening of the fluid carriers. * * * We found that the cost (other than replacement) of this [drilling and grout] program did not make good the depreciation previously allowed, and stated in our opinion:

[The] program was intended to avert a plant-wide disaster and avoid forced abandonment of the plant. The purpose was not to improve, better, extend, or increase the original plant, nor to prolong its original useful life. Its continued operation was endangered; the purpose of the expenditures was to enable petitioner to continue the plant in operation not on any new or better scale, but on the same scale and, so far as possible, as efficiently as it had operated before.

The petitioner here made the repairs in question in order that it might continue to operate its plant. Not only was there danger of fire from the oil and fumes, but the presence of the oil led the Federal meat inspectors to declare the basement an unsuitable place for the purpose for which it had been used for a quarter of a century. After the expenditures were made, the plant did not operate on a changed or larger scale, nor was it thereafter suitable for new or additional uses. The expenditure served only to permit petitioner to continue the use of the plant, and particularly the basement for its normal operations. In our opinion, the expenditure of $4,868.81 for lining the basement walls and floor was essentially a repair and, as such, it is deductible as an ordinary and necessary business expense. This holding makes unnecessary a consideration of petitioner’s alternative contention that the expenditure is deductible as a business loss. * * *
ISSUE
Are costs incurred by a taxpayer to perform work on its aircraft airframe, including the costs of a “heavy maintenance visit,” deductible as ordinary and necessary business expenses under § 162 of the Internal Revenue Code, or must they be capitalized under §§ 263 and 263A?

FACTS
X is a commercial airline engaged in the business of transporting passengers and freight throughout the United States and abroad. To conduct its business, X owns or leases various types of aircraft. As a condition of maintaining its operating license and airworthiness certification for these aircraft, X is required by the Federal Aviation Administration “FAA” to establish and adhere to a continuous maintenance program for each aircraft within its fleet. * * * The maintenance manuals require a variety of periodic maintenance visits at various intervals during the operating lives of each aircraft. The most extensive of these for X is termed a “heavy maintenance visit” * * * which is required to be performed by X approximately every eight years of aircraft operation. The purpose of a heavy maintenance visit, according to X's maintenance manual, is to prevent deterioration of the inherent safety and reliability levels of the aircraft equipment and, if such deterioration occurs, to restore the equipment to their inherent levels.

In each of the following three situations, X reasonably anticipated at the time the aircraft was placed in service that the aircraft would be useful in its trade or business for up to 25 years, taking into account the repairs and maintenance necessary to keep the aircraft in an ordinarily efficient operating condition.***

Situation 1
In 2000, X incurred $2 million for the labor and materials necessary to perform a heavy maintenance visit on the airframe of Aircraft 1, which X acquired in 1984 for $15 million (excluding the cost of engines). To perform the heavy maintenance visit, X extensively disassembled the airframe, removing items such as its engines, landing gear, cabin and passenger compartment seats, side and ceiling panels, baggage stowage bins, galleys, lavatories, floor boards, cargo loading systems, and flight control surfaces. * * * X also performed additional work as part of the heavy maintenance visit for Aircraft 1. This work included applying corrosion prevention and control compounds; stripping and repainting the aircraft exterior; and cleaning, repairing, and painting airframe interior items such as seats, carpets, baggage stowage bins, ceiling and sidewall panels, lavatories, galleys, and passenger service units. * * *

None of the work performed by X as part of the heavy maintenance visit * * * for Aircraft 1 resulted in a material upgrade or addition to its airframe or involved the replacement of any (or a significant portion of any) major component or substantial structural part of the airframe. This work maintained the relative value of the aircraft. The value of the aircraft declines as it ages even if the heavy maintenance work is performed.

After 45 days, the heavy maintenance visit was completed, and Aircraft 1 was reassembled, tested, and returned to X's fleet. X then continued to use Aircraft 1 for the same purposes and in the same manner that it did prior to the performance of the heavy maintenance visit. The performance of the heavy maintenance visit did not extend the useful life of the airframe beyond the 25-year useful life that X anticipated when it acquired the airframe.

Situation 2
Also in 2000, X incurred costs to perform work in conjunction with a heavy maintenance visit on the airframe of Aircraft 2. The heavy maintenance visit on Aircraft 2 involved all of the same work described in Situation 1. In addition, X found significant wear and corrosion of fuselage skins of Aircraft 2 that necessitated more extensive work than was performed on Aircraft 1. Namely, X decided to remove all of the skin panels on the belly of Aircraft 2's fuselage and replace them
with new skin panels. The replaced skin panels represented a significant portion of all of the skin panels of Aircraft 2, and the work performed materially added to the value of the airframe.

Because Aircraft 2 was already out of service and its airframe disassembled for the heavy maintenance visit, X also performed certain modifications to the airframe. These modifications involved installing a cabin smoke and fire detection and suppression system, a ground proximity warning system, and an air phone system to enable passengers to send and receive voice calls, faxes, and other electronic data while in flight.

**Situation 3**

Also in 2000, X decided to make substantial improvements to Aircraft 3, which was 22 years old and nearing the end of its anticipated useful life, for the purpose of increasing its reliability and extending its useful life. X's improvement of Aircraft 3 involved many modifications to the structure, exterior, and interior of the airframe. The modifications included removing all the belly skin panels on the aircraft's fuselage and replacing them with new skin panels; replacing the metal supports under the lavatories and galleys; removing the wiring in the leading edges of both wings and replacing it with new wiring; removing the fuel tank bladders, harnesses, wiring systems, and connectors and replacing them with new components; opening every lap joint on the airframe and replacing the epoxy and rivets used to seal the lap joints with a non-corrosive sealant and larger rivets; reconfiguring and upgrading the avionics and the equipment in the cockpit; replacing all the seats, overhead bins, sidewall panels, partitions, carpeting, windows, galleys, lavatories, and ceiling panels with new items; installing a cabin smoke and fire detection system, and a ground proximity warning system; and painting the exterior of the aircraft.

In order to upgrade the airframe to the desired level, X performed much of the same work that would be performed during a heavy maintenance visit (as described in Situation 1). The result of the work performed on Aircraft 3 was to materially increase the value of the airframe and substantially prolong its useful life.

**LAW**

Section 162 and § 1.162-1(a) of the Income Tax Regulations allow a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including “incidental repairs.”

Section 1.162-4 allows a deduction for the cost of incidental repairs that neither materially add to the value of the property nor appreciably prolong its useful life, but keep it in an ordinarily efficient operating condition. However, § 1.162-4 also provides that the cost of repairs in the nature of replacements that arrest deterioration and appreciably prolong the life of the property must be capitalized and depreciated in accordance with § 167.

Section 263(a) provides that no deduction is allowed for (1) any amount paid out for new buildings or permanent improvements or betterments made to increase the value of any property or estate or (2) any amount expended in restoring property or in making good the exhaustion thereof for which an allowance has been made. See also § 1.263(a)-1(a).

Section 1.263(a)-1(b) provides that capital expenditures include amounts paid or incurred to (1) add to the value, or substantially prolong the useful life, of property owned by the taxpayer, or (2) adapt property to a new or different use. However, that regulation also provides that amounts paid or incurred for incidental repairs and maintenance of property within the meaning of § 162 and § 1.162-4 are not capital expenditures under § 1.263(a)-1.

Section 263A provides that the direct and indirect costs properly allocable to real or tangible personal property produced by the taxpayer must be capitalized. Section 263A(g)(1) provides that, for purposes of § 263A, the term “produce” includes construct, build, install, manufacture, develop, or improve.
The United States Supreme Court has specifically recognized that the “decisive distinctions between capital and ordinary expenditures] are those of degree and not of kind,” and a careful examination of the particular facts of each case is required. Deputy v. du Pont, 308 U.S. 488, 496 (1940), quoting Welch v. Helvering, 290 U.S. 111, 114 (1933). To determine whether certain costs should be classified as capital expenditures or as repair and maintenance expenses, “it is appropriate to consider the purpose, the physical nature, and the effect of the work for which the expenditures were made.” American Bemberg Corp. v. Commissioner, 10 T.C. 361, 376 (1948), aff’d, 177 F.2d 200 (6th Cir. 1949).

Any properly performed repair, no matter how routine, could be considered to prolong the useful life and increase the value of the property if it is compared with the situation existing immediately prior to that repair. Consequently, courts have articulated a number of ways to distinguish between deductible repairs and non-deductible capital improvements. For example, in Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103, 106 (1926), acq., V-2 C.B. 2, the court explained that repair and maintenance expenses are incurred for the purpose of keeping the property in an ordinarily efficient operating condition over its probable useful life for the uses for which the property was acquired. Capital expenditures, in contrast, are for replacements, alterations, improvements, or additions that appreciably prolong the life of the property, materially increase its value, or make it adaptable to a different use. In Estate of Walling v. Commissioner, 373 F.2d 190, 192-193 (3rd Cir. 1966), the court explained that the relevant distinction between capital improvements and repairs is whether the expenditures were made to “put” or “keep” property in ordinary efficient operating condition. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333, 338 (1962), nonacq. on other grounds, 1964-2 C.B. 8., the court stated that if the expenditure merely restores the property to the state it was in before the situation prompting the expenditure arose and does not make the property more valuable, more useful, or longer-lived, then such an expenditure is usually considered a deductible repair. In contrast, a capital expenditure is generally considered to be a more permanent increment in the longevity, utility, or worth of the property. The Supreme Court's decision in INDOPCO Inc. v. Commissioner, 503 U.S. 79 (1992) does not affect these general principles. See Rev. Rul. 94-12, 1994-1 C.B. 36; Ingram Industries, Inc. v. Commissioner, T.C.M. 2000-323.

Even if the expenditures include the replacement of numerous parts of an asset, if the replacements are a relatively minor portion of the physical structure of the asset, or of any of its major parts, such that the asset as whole has not gained materially in value or useful life, then the costs incurred may be deducted as incidental repairs or maintenance expenses. * * *

If, however, a major component or a substantial structural part of the asset is replaced and, as a result, the asset as a whole has increased in value, life expectancy, or use then the costs of the replacement must be capitalized. * * *

In addition, although the high cost of the work performed may be considered in determining whether an expenditure is capital in nature, cost alone is not dispositive. * * *

Similarly, the fact that a taxpayer is required by a regulatory authority to make certain repairs or to perform certain maintenance on an asset in order to continue operating the asset in its business does not mean that the work performed materially increases the value of such asset, substantially prolongs its useful life, or adapts it to a new use. * * *

The characterization of any cost as a deductible repair or capital improvement depends on the context in which the cost is incurred. Specifically, where an expenditure is made as part of a general plan of rehabilitation, modernization, and improvement of the property, the expenditure must be capitalized, even though, standing alone, the item may be classified as one of repair or maintenance. United States v. Wehrli, 400 F.2d 686, 689 (10th Cir. 1968). Whether a general plan of rehabilitation exists, and whether a particular repair or maintenance item is part of it, are
questions of fact to be determined based upon all the surrounding facts and circumstances, including, but not limited to, the purpose, nature, extent, and value of the work done. Id. at 690. The existence of a written plan, by itself, is not sufficient to trigger the plan of rehabilitation doctrine. See Moss v. Commissioner, 831 F.2d 833, 842 (9th Cir. 1987); * * *

In general, the courts have applied the plan of rehabilitation doctrine to require a taxpayer to capitalize otherwise deductible repair and maintenance costs where the taxpayer has a plan to make substantial capital improvements to property and the repairs are incidental to that plan. * * *

On the other hand, the courts and the Service have not applied the plan of rehabilitation doctrine to situations where the plan did not include substantial capital improvements and repairs to the same asset, the plan primarily involved repair and maintenance items, or the work was performed merely to keep the property in an ordinarily efficient operating condition. * * *

ANALYSIS

In Situation 1, the heavy maintenance visit on Aircraft 1 primarily involved inspecting, testing, servicing, repairing, reconditioning, cleaning, stripping, and repainting numerous airframe parts and components. The heavy maintenance visit did not involve replacements, alterations, improvements, or additions to the airframe that appreciably prolonged its useful life, materially increased its value, or adapted it to a new or different use. Rather, the heavy maintenance visit merely kept the airframe in an ordinarily efficient operating condition over its anticipated useful life for the uses for which the property was acquired. * * * The fact that the taxpayer was required to perform the heavy maintenance visit to maintain its airworthiness certificate does not affect this determination. * * *

Although the heavy maintenance visit did involve the replacement of numerous airframe parts with new parts, none of these replacements required the substitution of any (or a significant portion of any) major components or substantial structural parts of the airframe so that the airframe as a whole increased in value, life expectancy, or use. * * *

Thus, the costs of the heavy maintenance visit constitute expenses for incidental repairs and maintenance under §1.162-4.

Finally, the costs of the heavy maintenance visit are not required to be capitalized under §§ 263 or 263A as part of a plan of rehabilitation, modernization, or improvement to the airframe. Because the heavy maintenance visit involved only repairs for the purpose of keeping the airframe in an ordinarily efficient operating condition, it did not include the type of substantial capital improvements necessary to trigger the plan of rehabilitation doctrine. * * * Accordingly, the costs incurred by X for the heavy maintenance visit in Situation 1 may be deducted as ordinary and necessary business expenses under §162.

In Situation 2, in addition to performing all of the work described in Situation 1 on Aircraft 2, X replaced all of the skin panels on the belly of the fuselage and installed a cabin smoke and fire detection and suppression system, a ground proximity warning system and an air phone system. Because the replacement of the skin panels involved replacing a significant portion of the airframe's skin panels (which in the aggregate represented a substantial structural part of the airframe) thereby materially adding to the value of and improving the airframe, the cost of replacing the skin panels must be capitalized. * * * In addition, the additions and upgrades to Aircraft 2 in the form of the fire protection, air phone, and ground proximity warning systems must be capitalized because they materially improved the airframe. * * * Accordingly, the costs incurred by X for the heavy maintenance visit in Situation 1 may be deducted as ordinary and necessary business expenses under §162.

Further, the mere fact that these capital improvements were made at the same time that the work described in Situation 1 was performed on Aircraft 2 does not require capitalization of the cost of the heavy maintenance visit under the plan of rehabilitation doctrine. Whether a general plan of rehabilitation exists is a question of fact to be determined based on all the facts and
X's plan in Situation 2 was not to rehabilitate Aircraft 2, but merely to perform discrete capital improvements to the airframe. * * * Accordingly, the costs of the work described in Situation 1 are not part of a general plan of rehabilitation, modernization, or improvement to the airframe. The costs incurred by X for the work performed on Aircraft 2 must be allocated between capital improvements, which must be capitalized under §§ 263 and 263A, and repairs and maintenance, which may be deducted under § 162.

In Situation 3, X is required to capitalize under § 263 the costs of all the work performed on Aircraft 3. The work in Situation 3 involved replacements of major components and significant portions of substantial structural parts that materially increased the value and substantially prolonged the useful life of the airframe. * * * In addition, the value of Aircraft 3 was materially increased as a result of material additions, alterations and upgrades that enabled X to operate Aircraft 3 in an improved way. * * * In contrast to Situation 1, the extensiveness of the work performed on Aircraft 3 constitutes a restoration within the meaning of §263(a)(2). * * *

X performed much of the same work on Aircraft 3 that would be performed during a heavy maintenance visit (as described in Situation 1) (“Situation 1-type work”). Although these costs, standing alone, generally are deductible expenses under § 162, in this context, they are incurred as part of a general plan of rehabilitation, modernization, and improvement to the airframe of Aircraft 3 and X is required to capitalize under §§ 263 and 263A the costs of that work. * * * In this situation, X planned to perform substantial capital improvements to upgrade the airframe of Aircraft 3 for the purpose of increasing its reliability and extending its useful life. * * * The Situation 1-type work was incidental to X's plan to upgrade Aircraft 3. * * * The effect of all the work performed on Aircraft 3, including the inspection, repair, and maintenance items, is to materially increase the value of the airframe and substantially prolong its useful life. Thus, all the work performed by X on Aircraft 3 is part of a general plan of rehabilitation, modernization, and improvement to the airframe and the costs associated with this work must be capitalized under § 263. * * *

The conclusions in this ruling would be the same whether X transported only freight or only passengers.
Pittsburgh’s Persian Princess; Princess Farid-es-Sultaneh
By Janet Kettering  Originally published in The Homewood, newsletter of The Homewood Cemetery Historical Fund.

At first glance, her life seemed to be what dreams are made of: luxurious residences in Paris and New York, a priceless collection of jewels, world-wide travel to exotic ports of call, great wealth, and a handsome prince. But her Cinderella-like life did not, like the fairy tale, end happily ever after.
Doris Mercer, the daughter of a Pittsburgh police captain, was born circa 1889. As a child, she acquired a love of music at the knee of her pianist mother who often accompanied her as she sang. She grew into a talented, beautiful young woman. Not content with life in Pittsburgh, Doris ran away from home at the age of eighteen to seek fame and fortune on the operatic stage. Her father later found her in New York City performing a minor role on Broadway in the musical The Earl and the Girl. In hope of redirecting her life, he placed her in a church school, but she again escaped and returned to New York City. Eventually she met and married an older man, publisher Percival Harden. The marriage ended in divorce in 1919.

In 1924 she married again, becoming the second wife of Sebastian S. Kresge, a multimillionaire chain store founder more than twenty years her senior. Mr. Kresge, a merchandising genius, was known for his penchant for hard work, his opposition to the use of alcohol, tobacco and card playing, and his eccentric passion for frugality. Although his personal fortune was estimated at two hundred million, he reportedly lined his worn shoes with paper and wore inexpensive suits until they were threadbare. In spite of his personal parsimony, Mr. Kresge was a dedicated philanthropist, believing that men of wealth were obligated to return to society the money they had amassed. He attempted to please his young wife by professing an interest in her love of opera and her Fifth Avenue lifestyle, but the “old school gentleman” and the high-spirited Doris were a mismatch. Their brief and stormy marriage failed. His pinch-penny attitudes and her refusal to bear children were among the bitterly fought issues of their highly publicized divorce in 1928. Mrs. Kresge reportedly received a three million dollar settlement.

The wealthy divorcee set sail for Europe and settled in an aristocratic residential section of Paris overlooking the Seine. She again pursued her vocal career and enjoyed attending the opera and receptions with a close circle of friends. The beautiful American woman of means attracted the eye of Prince Farid Khan Sadri-Kajar, a relative of Persian royalty who lived in a nearby villa. A friendship and romance developed. In letters to her family in Pittsburgh, Doris described her suitor as closely resembling the film star Ramon Navarro. Although flattered by his attention, she was reluctant to consider marriage again, but the Prince was persistent and she eventually agreed to become his wife. The Prince’s family sent its blessings and gave betrothal gifts consisting of a necklace, bracelet, ring, and pin of exquisite emeralds and pearls.

In 1933, Doris Kresge became a Persian Princess in a Moslem mosque in Paris. After an extended honeymoon in Egypt, India and the Far East, the newlyweds returned to Paris where
their luxurious lifestyle and long-standing friendship seems to ensure a happy life. But within two years, the prince and Princess were divorced. It was rumored that the handsome Prince was in reality a “playboy Prince” who was more interested in his wife’s money than her beauty and charm.

In 1940, Princess Farid-es-Sultaneh (a title she retained, against the Prince’s wishes, until her death) returned to America and purchased Glen Alpin, a sixteen-acre private estate near Morristown, New Jersey, with an impressive history dating back to a land grant from King George in 1758. The estate’s handsome sixteen-room stone mansion, (built circa 1840) cited today as one of the finest Gothic Revival buildings in New Jersey, is still locally referred to as “the Princess mansion.” Among its amenities were nine baths, a guest cottage, a six-car garage, eight fireplaces, hand painted murals, a library, a music room, and a glass conservatory. The graves of the original pre-Revolutionary war owners of the estate lie in a grove of trees in the sprawling front yard.

The Princess never remarried, and her reclusive life at the mansion became increasingly precarious as she weathered a decade of court battles. She was robbed of nearly one hundred thousands dollars of jewels, swindled by a master con man, and sued for bad debts. In 1949, the Princess ordered an exhibition and public sale of her valuable furnishings at Glen Alpin in an attempt to recoup her financial losses. According to one newspaper account, “the Princess sat almost unobserved...while [the] auctioneer...pacingly chanted off the merchandise from the Alpine’s [sic] palatial front stoop.” Among the items sold for a fraction of their value was a half-room-wide Steinway concert piano inlaid with gold leaf. Reputedly, an exact duplicate was owned by Barbara Hutton and another was in the White House.

In 1959, the Princess, nearly broke and virtually alone, was diagnosed with chronic lymphatic leukemia. During her final years, she sought solace in religion and the Bible. In 1960, she sold a portion of land across the street from her mansion to the Seventh Day Adventists. A church was erected on the site, and she joined the congregation where she charmed the parishioners with her operatic renditions of church hymns. She died in Morristown, New Jersey, on August 12, 1963, at the age of seventy-four. Princess Farid-es-Sultaneh was brought home and buried beside her mother, Jennie S. Mercer in the shade of a sycamore tree in The Homewood Cemetery in Section 9.3, Lot 187. Sadly, the woman who lived such an extraordinary life lies in an unmarked grave. Her obituary stated that “As death came, a romantic title and a lonely mansion...were all that remained of her fairy-tale life.” As much of her intriguing life has been lost to history, perhaps she should be remembered by her own words: “I have no regrets. My life has been exciting, and I wouldn’t have wanted it any other way.”
PECK, Circuit Judge.

* * * On March 11, 1964, the decedent, Frank D. Stranahan, entered into a closing agreement with the Commissioner of Internal Revenue Service (IRS) under which it was agreed that decedent owed the IRS $754,815.72 for interest due to deficiencies in federal income, estate and gift taxes regarding several trusts created in 1932. Decedent, a cash-basis taxpayer, paid the amount during his 1964 tax year. Because his personal income for the 1964 tax year would not normally have been high enough to fully absorb the large interest deduction, decedent accelerated his future income to avoid losing the tax benefit of the interest deduction. To accelerate the income, decedent executed an agreement dated December 22, 1964, under which he assigned to his son, Duane Stranahan, $122,820 in anticipated stock dividends from decedent's Champion Spark Plug Company common stock (12,500 shares). At the time both decedent and his son were employees and shareholders of Champion. As consideration for this assignment of future stock dividends, decedent's son paid the decedent $115,000 by check dated December 22, 1964. The decedent thereafter directed the transfer agent for Champion to issue all future dividend checks to his son, Duane, until the aggregate amount of $122,820 had been paid to him. Decedent reported this $115,000 payment as ordinary income for the 1964 tax year and thus was able to deduct the full interest payment from the sum of this payment and his other income. During decedent's taxable year in question, dividends in the total amount of $40,050 were paid to and received by decedent's son. No part of the $40,050 was reported as income in the return filed by decedent's estate for this period. Decedent's son reported this dividend income on his own return as ordinary income subject to the offset of his basis of $115,000, resulting in a net amount of $7,282 of taxable income.

Subsequently, the Commissioner sent appellant (decedent's estate) a notice of deficiency claiming that the $40,050 received by the decedent's son was actually income attributable to the decedent. After making an adjustment which is not relevant here, the Tax Court upheld the deficiency in the amount of $50,916.78. The Tax Court concluded that decedent's assignment of future dividends in exchange for the present discounted cash value of those dividends “though conducted in the form of an assignment of a property right, was in reality a loan to [decedent] masquerading as a sale and so disguised lacked any business purpose; and, therefore, decedent realized taxable income in the year 1965 when the dividend was declared paid.”

As pointed out by the Tax Court, several long-standing principles must be recognized. First, under Section 451(a), a cash basis taxpayer ordinarily realizes income in the year of receipt rather than the year when earned. Second, a taxpayer who assigns future income for consideration in a bona fide commercial transaction will ordinarily realize ordinary income in the year of receipt. Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958); Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941). Third, a taxpayer is free to arrange his financial affairs to minimize his tax liability; thus, the presence of tax avoidance motives will not nullify an otherwise bona fide transaction. We also note there are no claims that the transaction was a sham, the purchase price was inadequate or that decedent did not actually receive the full payment of $115,000 in tax year 1964. And it is
agreed decedent had the right to enter into a binding contract to sell his right to future dividends.

The Commissioner's view regards the transaction as merely a temporary shift of funds, with an appropriate interest factor, within the family unit. He argues that no change in the beneficial ownership of the stock was effected and no real risks of ownership were assumed by the son. Therefore, the Commissioner concludes, taxable income was realized not on the formal assignment but rather on the actual payment of the dividends.

It is conceded by taxpayer that the sole aim of the assignment was the acceleration of income so as to fully utilize the interest deduction. Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935), established the landmark principle that the substance of a transaction, and not the form, determines the taxable consequences of that transaction. In the present transaction, however, it appears that both the form and the substance of the agreement assigned the right to receive future income. What was received by the decedent was the present value of that income the son could expect in the future. On the basis of the stock's past performance, the future income could have been (and was) estimated with reasonable accuracy. Essentially, decedent's son paid consideration to receive future income. Of course, the fact of a family transaction does not vitiate the transaction but merely subjects it to special scrutiny.

We recognize the oft-stated principle that a taxpayer cannot escape taxation by legally assigning or giving away a portion of the income derived from income producing property retained by the taxpayer. Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731 (1930); Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 (1940); Commissioner v. P. G. Lake, Inc., supra. Here, however, the acceleration of income was not designed to avoid or escape recognition of the dividends but rather to reduce taxation by fully utilizing a substantial interest deduction which was available. FN6 As stated previously, tax avoidance motives alone will not serve to obviate the tax benefits of a transaction. Further, the fact that this was a transaction for good and sufficient consideration, and not merely gratuitous, distinguishes the instant case from the line of authority beginning with Helvering v. Horst, supra. * * *

FN6. By accelerating income into the year 1964, when it would be offset by the interest deduction, decedent could reduce his potential tax liability for the future years in which the dividends would be paid.

The Commissioner also argues that the possibility of not receiving the dividends was remote, and that since this was particularly known to the parties as shareholders and employees of the corporation, no risks inured to the son. The Commissioner attempts to bolster this argument by pointing out that consideration was computed merely as a discount based on a prevailing interest rate and that the dividends were in fact paid at a rate faster than anticipated. However, it seems clear that risks, however remote, did in fact exist. The fact that the risks did not materialize is irrelevant. Assessment of the risks is a matter of negotiation between the parties and is usually reflected in the terms of the agreement. Since we are not in a position to evaluate those terms, and since we are not aware of any terms which dilute the son's dependence on the dividends alone to return his investment, we cannot say he does not bear the risks of ownership.

Accordingly, we conclude the transaction to be economically realistic, with substance, and therefore should be recognized for tax purposes even though the consequences may be unfavorable to the Commissioner. The facts establish decedent did in fact receive payment.
Decedent deposited his son's check for $115,000 to his personal account on December 23, 1964, the day after the agreement was signed. The agreement is unquestionably a complete and valid assignment to decedent's son of all dividends up to $122,820. The son acquired an independent right against the corporation since the latter was notified of the private agreement.  

Decedent completely divested himself of any interest in the dividends and vested the interest on the day of execution of the agreement with his son. * * *

The judgment is reversed and the cause remanded for further proceedings consistent with this opinion.
Supplement Page #94

HEIM v. FITZPATRICK
266 F.2d 887 (1959)

SWAN, Circuit Judge.

This litigation involves income taxes of Lewis R. Heim, for the years 1943 through 1946. On audit of the taxpayer’s returns, the Commissioner of Internal Revenue determined that his taxable income in each of said years should be increased by adding thereto patent royalty payments received by his wife, his son and his daughter. * * * *

Plaintiff was the inventor of a new type of rod end and spherical bearing. In September 1942 he applied for a patent thereon. On November 5, 1942 he applied for a further patent on improvements of his original invention. Thereafter on November 17, 1942 he executed a formal written assignment of his invention and of the patents which might be issued for it and for improvements thereof to The Heim Company.2 This was duly recorded in the Patent Office and in January 1945 and May 1946 plaintiff’s patent applications were acted on favorably and patents thereon were issued to the Company. The assignment to the Company was made pursuant to an oral agreement, subsequently reduced to a writing dated July 29, 1943, by which it was agreed (1) that the Company need pay no royalties on bearings manufactured by it prior to July 1, 1943; (2) that after that date the Company would pay specified royalties on 12 types of bearings; (3) that on new types of bearings it would pay royalties to be agreed upon prior to their manufacture; (4) that if the royalties for any two consecutive months or for any one year should fall below stated amounts, plaintiff at his option might cancel the agreement and thereupon all rights granted by him under the agreement and under any and all assigned patents should revert to him, his heirs and assigns; and (5) that this agreement is not transferable by the Company.

In August 1943 plaintiff assigned to his wife ‘an undivided interest of 25 per cent in said agreement with The Heim Company dated July 29, 1943, and in all his inventions and patent rights, past and future, referred to therein and in all rights and benefits of the First Party (plaintiff) thereunder * * *.’ As similar assignment was given to his son and another to his daughter. Plaintiff paid gift taxes on the assignments. The Company was notified of them and thereafter it made all royalty payments accordingly. As additional types of bearings were put into production from time to time the royalties on them were fixed by agreement between the Company and the plaintiff and his three assignees. * * * *

The appellant contends that the assignments to his wife and children transferred to them income-producing property and consequently the royalty payments were taxable to his donees, as held in Blair v. Commissioner of Internal Revenue, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465. Judge Anderson, however, was of opinion that (151 F.Supp. 576):

‘The income-producing property, i.e. the patents, had been assigned by the taxpayer to the corporation. What he had left was a right to a portion of the income which the patents produced. He had the power to dispose of and divert the stream of this income as he saw fit.’ Consequently he ruled that the principles applied by the Supreme Court in Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75 and Helvering v. Eubank, 311 U.S. 122, 61 S.Ct. 149, 85 L.Ed. 81 required all the royalty payments to be treated as income of plaintiff. * * * *

In the present case more than a bare right to receive future royalties was assigned by plaintiff to his donees. Under the terms of his contract with The Heim Company he retained the power to bargain for the fixing of royalties on new types of bearings, i.e. bearings other than the 12 products on which royalties were specified. This power was assigned and the assignees exercised it as to new products. Plaintiff also retained a reversionary interest in his invention and patents by reason of his option to cancel the agreement if certain conditions were not fulfilled. This interest was also assigned. The fact that the option was not exercised in 1945, when it could have been, is irrelevant so far as concerns the existence of the reversionary interest. We think that
the rights retained by plaintiff and assigned to his wife and children were sufficiently substantial to justify the view that they were given income-producing property.

In addition to Judge Anderson’s ground of decision appellee advances a further argument (page 19 of his brief) in support of the judgment, namely, that the plaintiff retained sufficient control over the invention and the royalties to make it reasonable to treat him as owner of that income for tax purposes. Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 68 S.Ct. 715, 92 L.Ed. 898 is relied upon. There a patent was licensed under a royalty contract with a corporation in which the taxpayer-inventor held 89% of the stock. An assignment of the royalty contract to the taxpayer’s wife was held ineffective to shift the tax, since the taxpayer retained control over the royalty payments to his wife by virtue of his control of the corporation, which could cancel the contract at any time. The argument is that, although plaintiff himself owned only 1% of The Heim Company stock, his wife and daughter together owned 68% and it is reasonable to infer from depositions introduced by the Commissioner that they would follow the plaintiff’s advice. Judge Anderson did not find it necessary to pass on this contention. But we are satisfied that the record would not support a finding that plaintiff controlled the corporation whose active heads were the son and son-in-law. No inference can reasonably be drawn that the daughter would be likely to follow her father’s advice rather than her husband’s or brother’s with respect to action by the corporation. * * * *

For the foregoing reasons we hold that the judgment should be reversed and the cause remanded with directions to grant plaintiff’s motion for summary judgment.

2 The stock of The Heim Company was owned as follows: plaintiff 1%, his wife 41%, his son and daughter 27% each, and his daughter-in-law and son-in-law 2% each.
Assignment of Income & Business Conducted Through Business Entities

The interplay of the assignment of income doctrine and the opportunity to assign business opportunities to business entities to earn that income has represented basic tension in the progressive income tax system.

A. Partnership Entities Earning Income for their Partners

In Commissioner v. Culbertson, 337 U.S. 733 (1949), the Supreme Court attempted to resolve the problematic use of family partnerships to shift income by issuing a set of criteria with which to determine whether a partnership “is real within the meaning of the federal revenue laws.” In response to that decision and the confusion the interplay of the assignment of income doctrine and the partnership tax provisions of subchapter K, Congress in 1951 adopted § 704(e). Under §704(e), a partner in a family partnership that receives her interest by gift is respected as a partner in the family partnership as long as capital is a material income-producing factor of the partnership. In this situation, the donee partner will be taxed on the income attributable to the donee partner’s share of partnership income. Thus, a parent who owns a cattle ranch may give a partnership interest to his or her child and the child will be taxed on his or her partnership income from that cattle ranch as long as capital is a material factor in the production of the partnership income. If the partnership is a service partnership where capital is not an income producing factor, then the donee partner’s status as a partner will not be respected. Moreover, even when capital is a material income-producing factor, the amount of income shifted is limited by the requirement that the donor receive reasonable compensation for her services rendered to the partnership.

When Section 704(e) does not apply and the partners are both contributing significant services to the partnership, the courts generally are deferential in respecting the manner in which the partnership allocates the partnership income as long as that allocation has substantial economic effect. The below case grapples with this issue and is instructive.

SCHNEER v. COMMISSIONER
97 T.C. 643 (1991)

Opinion Gerber, Judge:

We consider here basic principles of income taxation. There is agreement that the amounts paid to petitioner by his former employer- law firm are income in the year of receipt. The question is whether petitioner (individually) or the partners of petitioner’s partnerships (including petitioner) should report the income in their respective shares.

The parties have couched the issue in terms of the anticipatory assignment-of-income principles. See Lucas v. Earl, 281 U.S. 111 (1930). Equally important to this case, however, is the viability of the principle that partners may pool their earnings and report partnership income in amounts different from their contribution to the pool. See sec. 704(a) and (b). The parties’ arguments bring into focus potential conflict between these two principles and compel us to address both.

First, we examine the parties’ arguments with respect to the assignment-of-income doctrine. Respondent argues that *647 petitioner earned
the income in question before leaving BSI, despite the fact that petitioner did not receive that income until he was a partner in B&K and, later, SSG&M. According to respondent, by entering into partnership agreements requiring payment of all legal fees to his new partnerships, petitioner anticipatorily assigned to those partnerships the income earned but not yet received from BSI. * * *

The principle of assignment of income, in the context of Federal taxation, first arose in Lucas v. Earl, supra, where the Supreme Court, interpreting the Revenue Act of 1918, held that income from a husband-taxpayer’s legal practice was taxable to him, even though he and his wife had entered into a valid contract under State law to split all income earned by each of them. In so holding, Justice Holmes, speaking for the Court, stated:

There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. [281 U.S. at 114-115.] * * *

Respondent contends that Helvering v. Eubank, supra, is controlling in this case because petitioner had already earned the income in question at the time he entered into the partnership agreements. In that case, the taxpayer was an insurance agent who switched jobs and then assigned the future renewal commissions from policies already written. The taxpayer had written the policies and completed all work on them before leaving that job. The renewals and commissions were realized by the taxpayer solely due to the initiative and action of policyholders. “At the time of assignment there was nothing contingent in the * * * [taxpayer’s] right”’ to collect the money. See Helvering v. Eubank, supra at 126 (McReynolds, J., dissenting and quoting the lower court at 110 F.2d 737, 738 (2d Cir. 1940)).

In this case, petitioner was not entitled to the referral fees unless the work for the referred clients had been successfully completed. On the other hand, petitioner would be entitled to the fees if the work was completed or if at the time of the assignment there was nothing contingent in petitioner’s right to collect his percentage of the fees. Additionally, the majority of the services had not been performed prior to petitioner’s leaving BSI. In this regard services had been performed with respect to $1,250 prior to 1984. With respect to $3,325 of the $21,329 of fees received in 1984, petitioner did not consult and was not required to do anything subsequent to leaving BSI to be entitled to those fees. With respect to the remainder of the $21,329 for 1984 and all of the 1985 fees, petitioner was called upon to and did consult while he was a partner of B&K or SSG&M. * * *

The record in this case reflects that, with the exception of $1,250 of services performed in prior years, the billings and payments in question were performed and collected subsequent to the time of assignment of the income. The requirement that petitioner may have been called upon to consult is part of the contingency relating to the performance of the work prior to liability being established or fixed. The absence of consulting by petitioner is not decisive in the setting of this case. Additionally, as a corollary to the income principles, under section 461(h) a taxpayer is not entitled to a deduction under the accrual method unless there has been economic performance, i.e., the services have been performed or the property delivered.

With these principles as our guide, we hold that petitioner had not earned the fees in question prior to leaving BSI, with the exception of the $1,250 received for services performed in an earlier year. More specifically, we hold that petitioner earned the income in question while a partner of a partnership to which he had agreed to pay such income. With respect to
substantially all of the fees in issue, BSI records reflect that clients were billed and payment received during the years in issue. Moreover, if petitioner had refused a request for his consultation, it was, at very least, questionable whether he would have received his share of the fee if the work had been successfully completed without him. Petitioner was requested to and did provide further services with regard to clients from which about 90 percent of the fees were generated. We note that BSI did not request consultation with respect to $3,325 remitted during 1984. However, that amount was not earned as of the time of the assignment because the work had not yet been performed for the BSI clients (irrespective of whether or not *652 petitioner would be called upon to consult). Accordingly, with the exception of $1,250 for petitioner’s 1984 taxable year, we hold that petitioner had not earned the income in question prior to leaving BSI and did not make an anticipatory assignment of income which had been earned.

Two additional related questions remain for our consideration. First, respondent argues that irrespective of when petitioner earned the income from BSI, “there was no relationship * * [between] the past activity of introducing a client to * * [BSI], and the petitioner’s work as a partner with * * * [B&K or SSG&M].” Accordingly, with the exception of $1,250 for petitioner’s 1984 taxable year, we hold that petitioner had not earned the income in question prior to leaving BSI and did not make an anticipatory assignment of income which had been earned.

These final two questions bring into focus the true nature of the potential conflict in this case -- between respondent’s revenue ruling and the assignment-of-income doctrine. Both questions, in their own way, ask whether any partnership agreement -- under which partners agree in advance to turn over to the partnership all income from their individual efforts -- can survive scrutiny under the assignment-of-income principles.

Rev. Rul. 64-90, 1964-1 (Part 1) C.B. at 226-227, in pertinent part, contains the following: Federal income tax treatment of compensation received by a partner and paid over to a partnership where the partner, who uses the cash receipts and disbursements method of accounting, files his returns on a *653 calendar year basis and the partnership, which also uses the cash method, files its returns on a fiscal year basis.


Advice has been requested regarding the Federal income tax consequences of a change in the terms of a partnership agreement to provide that all compensation received by the partners will be paid over to the partnership immediately upon receipt.

In the instant case, several individuals formed a partnership for the purpose of engaging in the general practice of law. Aside from the partnership business, each of the partners has performed services from time to time in his individual capacity and not as a partner. The several partners have always regarded the fees received for such services as compensation to the recipient as an individual.

The partnership which was formed in 1954 and uses the cash receipts and disbursements method of accounting files its Federal income tax returns
for fiscal years ending January 31, and the partners file their individual returns on the cash method for calendar years. Each partner reports his distributive share of the partnership income, gain, loss, deduction or credit for the partnership fiscal year ending within the calendar year for which his individual return is filed. All compensation received by each partner for services performed in his individual capacity is reported in that partner’s return for the calendar year when received.

It is proposed to amend the partnership agreement as of the beginning of the partnership’s next fiscal year to provide that all compensation received by the partners be paid over to the partnership immediately upon receipt.

The question in the instant case is whether compensation remitted to the partnership pursuant to this provision will constitute partnership income.

Similar inquiries were previously considered by the Internal Revenue Service. * * * In both instances, it was pointed out that a partnership could not exist for the purpose of performing the services for which the compensation and allowances were received, and, thus, the recipient partner would be required to report the taxable portion of the compensation and allowances in his individual return, even though these items were pooled with partnership earnings. * * *

A key requirement of this ruling is that the services for which fees are received by individual partners must be SIMILAR to those normally performed by the partnership. See *654 also Rev. Rul. 80-338, 1980-2 C.B. 30 (enforcing same requirement); Rev. Rul. 54-223, 1954-1 C.B. 174 (same). Cases dealing with similar partnership agreement situations have also enforced this requirement. See Hamm v. Commissioner, 683 F.2d 1303 (10th Cir. 1982), affg. T.C. Memo. 1980-154; Brandschain v. Commissioner, supra; Philbin v. Commissioner, 26 T.C. 1159, 1167 (1956); Bufalino v. Commissioner, supra. Respondent now attempts to add to this requirement by arguing that the income here in question was earned through activity, which was admittedly legal work, but was not sufficiently related to the work of petitioner’s new partnerships. In other words, respondent argues that the income here was earned in BSI’s business activity and not B&K’s or SSG&M’s business activity.

* * * [The court proceeds to analyze and distinction a line of cases and then proceeds as follows:]

Thus, we arrive at the final question in this case. We have already held that petitioner had not yet earned the majority of the income in question when he joined his new partnerships. Additionally, petitioner’s fee income from his BSI clients qualifies, under the case law and respondent’s rulings, as income generated by services sufficiently related to the business conducted by petitioner’s new partnerships. If
we decide that petitioner’s partnerships should report the income in question, petitioner would be taxable only to the extent of his respective partnership share. This would allow petitioner, through his partnership agreements with B&K and SSG&M, to assign income not yet earned from BSI. Thus, the case law and respondent’s rulings permit (without explanation), in a partnership setting, the type of assignment addressed by Lucas v. Earl, 281 U.S. 111 (1930). We must reconcile the principle behind Rev. Rul. 64–90, 1964–1 C.B. (Part 1) 226, with Lucas v. Earl, supra. The question is whether income not yet earned and anticipatorily assigned under certain partnership agreements are without the reach of the assignment-of-income principle.

The Internal Revenue Code of 1954 provided the first comprehensive statutory scheme for the tax treatment of partners and partnerships. No section of the 1954 Code, successive amendments or acts, nor the legislative history specifically addresses the treatment of income earned by partners in their individual capacity but which is pooled with other partnership income. It is implicit in subchapter K, however, that the pooling of income and losses of partners was intended by Congress. This question is more easily answered where the partnership contracts with the client for services which are then performed by the partner. The question becomes more complex where the partner contracts and performs the services when he is a partner.

Moreover, no opinion contains a satisfactory rationale as to why partnership pooling agreements do not come within the holding of Lucas v. Earl, supra. Even in Mayes and Hamm (where the attempted pooling of income was treated as a prohibited assignment of income) it is suggested that in the appropriate circumstances, a partnership agreement *658 that effectuates anticipatory assignments of income should be respected for tax purposes. Indeed, other opinions contain similar holdings. See Brandschain v. Commissioner, supra at 752; Abbott v. Commissioner, 30 B.T.A. 227 (1934); Hillman v. Commissioner, 2 B.T.A. 1265 (1925); Bufalino v. Commissioner, supra.

The fundamental theme penned by Justice Holmes provides that the individual who earns income is liable for the tax.8 It is obvious that the partnership, as an abstract entity, does not provide the physical and mental activity that facilitates the process of “earning” income. Only a partner can do so. The income earned is turned over to the partnership due solely to a contractual agreement, i.e., an assignment, in advance, of income.

The pooling of income is essential to the meaningful existence of subchapter K. If partners were not able to share profits in an amount disproportionate to the ratio in which they earned the underlying income, the partnership provisions of the Code would, to some extent, be rendered unnecessary. See S. Rept. 1622, 83d Cong., 2d Sess., 89 (1954) (Finance Committee listing “flexibility” among partners as one of prime objectives of 1954 subchapter K reforms). See also United States v. Basye, 410 U.S. 441, 448–449 (1973), where the Supreme Court acknowledges partnerships as “independently recognizable [entities] apart from the aggregate of its partners” and that a partnership can, as an entity, earn income.

The provisions of subchapter K tacitly imply that the pooling of income is permissible. Said implication may provide sufficient reason to conclude that a partnership should be treated as an entity for the purpose of pooling the income of its partners. Under an entity approach, the income would be considered that of the partnership rather than the partner, even though the partner’s individual efforts may have earned the income. If the partnership is treated as an entity earning the income, then assignment-of-income concepts would not come into play.

In this regard, an analysis of personal service corporations (PSC’s) may provide, by way of
analogy, some assistance in reconciling the principles inherent in Rev. Rul. 64-90, 1964-1 C.B. (Part 1) at 226, with those underlying Lucas v. Earl, supra. Keeping in mind Justice Holmes’ desire to tax the “earner” of the income, we consider the assignment-of-income doctrine in the context of personal service corporation cases. In partnerships and personal service corporations an individual performs the services that earn income. In both, a separate entity -- the partnership or personal service corporation -- is cast as the “earner” for tax purposes. That characterization in both situations is, in essence, an assignment of income.9 If, in either situation, the transfer to the entity is of income earned before an agreement to turn it over is entered into, the assignment-of-income doctrine will serve to invalidate the transfer.10 In both the context of a PSC or partnership, transfers prior to the performance of a partner’s services may be subject to the partner’s or employee’s control -- in that either may refuse to perform.

In analyzing the status of personal service corporations, courts have relied upon the rationale that:

the realities of the business world present an overly simplistic application of the Lucas v. Earl rule whereby the true earner may be identified by merely pointing to the one actually turning the spade or dribbling the ball. Recognition must be given to corporations as taxable entities which, to a great extent, rely upon the personal services of their employees to produce corporate income. When a corporate employee performs labors which give rise to income, it solves little merely to identify the actual laborer. Thus, a tension has evolved between the basic tenets of Lucas v. Earl and recognition of the nature of the corporate business form. [Fn. ref. omitted.]

*660 *661 Johnson v. Commissioner, 78 T.C. 882, 890 (1982). Also see Foglesong v. Commissioner, 621 F.2d 865 (7th Cir. 1980), revg. a Memorandum Opinion of this Court; Keller v. Commissioner, 77 T.C. 1014, 1031 (1981), affd. 723 F.2d 58 (10th Cir. 1983); Moline Properties, Inc. v. Commissioner, 319 U.S. 436 (1943). Thus, an employee of a personal service corporation, or other corporate entity, is outside the holding of Lucas v. Earl, supra, to some degree because of the “entity concept.” The business entity is cast as the earner of the income, obviating the need to analyze whether there has been an assignment of income.

The same type of approach may be used with respect to partners of a partnership. In the same manner that a corporation is considered the earner of income gained through the labor of its employees, a partnership, with an appropriate partnership agreement, may be considered the earner of income.12 Income earned prior to such an agreement, of course, remains within the principles and holding of Lucas v. Earl, supra. The link between respondent’s Rev. Rul. 64-90, 1964-1 C.B. (Part 1) 226, and Lucas v. Earl, supra, must be the entity concept as it relates to partnerships.

The theory concerning partnerships as entities is not easily defined. It is well established that the partnership form is a hybrid -- part separate entity, part aggregate. See United States v. Basye, supra; see also 3 B. Bittker & L. Lokken, Federal Taxation of Income, Estates and Gifts, par. 85.1, at 85-2 to 85-5 (1981); 1 A. Willis, J. Pennell & P. Postlewaite, Partnership Taxation, secs. 4.01 through 4.06, at 4-1 to 4-8 (4th ed. 1989). The difficulty lies in deciding whether a particular set of circumstances relate to one end or the other of the partnership hybrid spectrum. The Supreme Court in Basye stated that “partnerships are entities for purposes of calculating and filing informational returns but * * * they are conduits through which the taxpaying obligation passes to the individual partners in accord with their distributive shares.”
410 U.S. at 448 n.8. This analysis provides some foundation for the idea that partners should report their distributive share, rather than the fruits of their personal labors. But it does not provide any guidance concerning the type of income or service that should be brought within the entity concept as it relates to partnerships.

The principle we must analyze in this case involves the role of the partnership with respect to the function of earning income. A general partnership is “an association of two or more persons to carry on as co-owners a business for profit.” Uniform Partnership Act sec. 6(1). Either a partnership or a corporation may enter into a contract with clients to perform services. In a partnership, however, either the entity or the individual may enter into contracts. The question we seek to answer is whether this distinction should be treated differently.

For purposes of an entity concept approach to partnerships, we must consider the type and source of income which should be included. Because we have already determined that the type of activity generating the income is relevant to an assignment-of-income analysis in the partnership setting, we focus our analysis of partnerships as entities on situations where the income is of a type normally earned by the partnership. Only in such situations has a partner acted as part of the partnership entity.

The entity concept as it relates to partnerships is based, in part, on the concept that a partner may further the business of the partnership by performing services in the name of the partnership or individually. The name and reputation of a professional partnership plays a role in the financial success of the partnership business. If the partners perform services in the name of the partnership or individually they are, nonetheless, associated with the partnership as a partner. This is the very essence of a professional service partnership, because each partner, although acting individually, is furthering the business of the partnership. See Burnet v. Leininger, 285 U.S. 136, 141 (1932), where partnership income was described as “produced * * * [by] the firm enterprise itself, that is, the capital of the firm and the labor and skill of its members employed in combination through the partnership relation in the conduct of the partnership business.” Also as stated in Ramos v. United States, 260 F. Supp. 479, 485 (N.D. Cal. 1966), revd. 393 F.2d 618 (9th Cir. 1968) (the circuit court held the ultimate factual finding to be “clearly erroneous”), a partnership is:

a group of persons having a common business interest, working together in their respective spheres toward the successful operation and conduct of that business interest. It does not connote the idea that each and every working partner must punch a clock at eight o’clock in the morning and work continuously through the day until five o’clock. * * *

The lack of structure inherent in the partnership form does not lend itself to easy resolution of the assignment-of-income question. A partnership’s characteristics do, however, militate in favor of treating a partner’s income from services performed in an individual capacity, which are contractually obligated to the partnership for allocation in accord with the pre-established distributive shares, in the same manner as income earned through partnership engagement.

Accordingly, in circumstances where individuals are not joining in a venture merely to avoid the effect of Lucas v. Earl, supra, it is appropriate to treat income earned by partners individually, as income earned by the partnership entity, i.e., partnership income, to be allocated to partners in their respective shares.14 To provide the essential continuity necessary for the use of an entity concept in the partnership setting, the income should be earned from an *663 activity which can reasonably be associated with the partnership’s business activity. In the setting of this case, with the exception of $1,250 in 1984, petitioner was a partner of B&K or SSG&M when the fees were earned. Additionally, about
90 percent of the fees were, in part, earned through petitioner’s efforts while he was a partner of B&K or SSG&M. In view of the foregoing, we hold that, with the exception of $1,250 for 1984, the fee income from BSI was correctly returned by the two partnerships in accord with the respective partnership agreements.

We find that petitioners are not liable for additions to tax under section 6653(a)(1) and (2) regarding the income received from BSI.

B. Business Income Earned Through Corporations.

The same tension has played out in the context of a corporation that is wholly controlled by the bread-winner for the business. When individual tax rates exceed corporate tax rates, individuals may want to incorporate their activities into a corporation in order to avail themselves of the lower corporate tax rate. What role does the assignment of income doctrine play in that context? The below case struggles with this central question.

FOGLESONG v. COMMISSIONER
621 F.2d 865 (7th Cir. 1980)

Opinion CUDAHY, Circuit Judge.

On August 30, 1966, taxpayer incorporated his business as Frederick H. Foglesong Company, Inc. The Corporation also issued preferred stock to the taxpayer’s four minor children (for which the total subscription price was $400). The four children received dividends totaling $32,000 over the period beginning September 1, 1966 and ending December 31, 1969.

At or about the time the Corporation was organized, the taxpayer notified Plymouth Tube and Pittsburgh Tube that the Corporation was being formed and asked that any commissions due under his agreements with them be paid to the Corporation. Both suppliers agreed to this request. As a result, certain commissions earned for services rendered before the date of incorporation were paid to the Corporation. In addition, the Corporation adopted a fiscal year ending August 31, and the taxpayer received no salary from the Corporation during the months of September through December 1966 although he continued to work as a salesman servicing Plymouth Tube and Pittsburgh Tube during that period.

On his personal income tax return for the calendar year 1966, taxpayer reported a net profit from his business as a sales representative in the amount of $86,665.88, all of which was derived from commissions paid to him personally during the months of January through August, 1966, by his principals. The Corporation made its first salary payment to taxpayer on January 9, 1967, and he received a regular monthly salary after that date during the years which are relevant here. Taxpayer’s salary income from the Corporation during calendar year 1967 was $56,500. In that year and in the succeeding relevant calendar years, he reported no personal income from any business as a sole proprietor. After the formation of the Corporation, all commissions from Plymouth Tube and Pittsburgh Tube were paid to the Corporation. But a written agreement with Pittsburgh Tube was not executed until May 19,

The Corporation paid taxpayer a regular salary as a salesman, paid all of taxpayer’s expenses incurred in connection with his sales activities, maintained a bank account, carried its own insurance coverage, maintained a company automobile and complied with all the formalities required of corporations in the state of New Jersey. The Corporation adopted bylaws, held an initial meeting of incorporators, at which the board of directors was elected, and conducted periodic board of directors’ and stockholders’ meetings as required by its bylaws. Taxpayer served as chairman of the board of directors as well as president and treasurer of the Corporation.

During the years in question here taxpayer did not enter into any written employment contracts with the Corporation nor did he enter into a covenant not to compete with the Corporation.

During these years taxpayer’s only gainful activity was as an employee of the Corporation. He had no legal rights under the representation contracts with Plymouth Tube and Pittsburgh Tube subsequent to the formation of the Corporation. Taxpayer testified that during the period at issue he did not engage in any business activity other than as an employee of the Corporation. ***

Personal service corporation tax cases reveal a tension between “the principle of a graduated income tax * * * and the policy of recognizing the corporation as a taxable entity distinct from its shareholders in all but extreme cases.” Rubin v. Commissioner, 429 F.2d 650, 652 (2d Cir. 1970). The impact of the graduated income tax is eroded when income is split artificially among several entities or over several tax years. The assignment of income doctrine under Section 61 of the Internal Revenue Code (as formulated in Lucas v. Earl ) seeks to recognize “economic reality” by cumulating income diffused among several recipients through “artificial” legal arrangements. The attribution of income to its “true earner” is simply a species of recognizing “substance” over “form.” See Rubin, supra, at 653.

But, if the issue is one of attributing the income of a corporation to its sole stockholder-employee who “really” earned it, we encounter the important policy of the law favoring recognition of the corporation as a legal person and economic actor. As Mr. Justice Holmes said in Klein v. Board of Supervisors, 282 U.S. 19, 24, 51 S.Ct. 15, 16, 75 L.Ed. 140 (1930):

But it leads nowhere to call a corporation a fiction. If it is a fiction it is a fiction created by law with intent that it should be acted on as if true. The corporation is a person and its ownership is a nonconductor that makes it impossible to attribute an interest in its property to its members.

In the instant case, the following circumstances, among others, are present: (1) the Corporation and not the taxpayer is the party to the contracts under which services are performed, (2) the Corporation is recognized to be a viable, taxable entity and not a mere sham, (3) non-tax business purposes are present even though tax avoidance is apparently a major concern, (4) the Corporation has not been formed for the purpose of taking advantage of losses incurred by a separate trade or business, (5) the corporate form (and the status of the Corporation as an actual operating enterprise) has been consistently honored by the taxpayer and other parties to the transactions giving rise to the income, (6) the taxpayer does not render services as an employee to any entity other than the Corporation, (7) the Corporation is not disqualified from performing the Services required of it by contract because the law requires these services to be performed by an individual, (8) the entities paying or providing the income are not controlled or dominated by the taxpayer, and (9) as will appear, other and
more appropriate legal bases exist for attacking apparent tax avoidance than broad-scale disregard of the corporate form through application of assignment of income theory. We note especially that the Tax Court did not find the Corporation to be a pure tax avoidance vehicle.

Under the circumstances of the instant case, we think it inappropriate to attempt to weigh “business purposes” against “tax avoidance motives” in a determination whether the assignment of income doctrine of Lucas v. Earl should apply, in effect, to substantially disregard the corporate form. Ostensibly this inquiry has been made in order to question the validity of a transaction purportedly entered into by a corporation, rather than the validity of the corporation itself. Cf. Rubin v. Commissioner, 51 T.C. 251, 266, n.19 (1968), rev’d and rem’d, 429 F.2d 650 (2d Cir. 1970), opinion on remand, 56 T.C. 1155 (1971), aff’d, 460 F.2d 1216 (2d Cir. 1972) (per curiam).11 But to apply Lucas v. Earl in this fashion under the circumstances present here is effectively (and more realistically) to nullify the determination that the Corporation is a viable taxable entity and not a sham. See Moline Properties v. Commissioner, 319 U.S. 436, 63 S.Ct. 436, 63 S.Ct. 1132, 87 L.Ed. 1348 (1943); National Carbide v. Commissioner, 336 U.S. 422, 69 S.Ct. 788, 791, 78 L.Ed. 1348 (1934).

In Moline Properties v. Commissioner, supra, the Supreme Court confronted the question whether the gain on sale of certain real estate held by a corporation as security was to be taxed to the corporation or to its sole shareholder. The Court perceived the problem as determining whether the corporate form might be disregarded for tax purposes as a sham or unreal. The Court said that the corporation was a viable taxable entity so long as the purpose of its creation is the equivalent of business activity or its creation is followed by the carrying on of business by the corporation. In Moline Properties, the question of purpose to evade or avoid income taxes (through the use of a corporation) was addressed as part of the theretofore live issue whether the corporation was a viable taxable entity or a sham. Although, as a practical matter the “viability” objection has apparently now fallen into general disuse, the Moline Properties analysis is still fundamental. National Carbide Corp. v. Commissioner, 336 U.S. 422, 429-30, 69 S.Ct. 726, 730, 93 L.Ed. 779 (1949). See also Siegel v. Commissioner, 45 T.C. 566 (1966); Bass v. Commissioner, 50 T.C. 595 (1968). We think it inappropriate, in light of Moline Properties and National Carbide, except on more extreme facts than appear here, to achieve, through recourse to the assignment of income doctrine, essentially the same result as would follow from treating the Corporation as a “sham” for tax purposes. See also New Colonial Ice Co. v. Helvering, 292 U.S. 435, 442, 54 S.Ct. 788, 791, 78 L.Ed. 1348 (1934).

The court analyzes and distinguishes several cases and then proceeds in its opinion with the following.]
realistic impact. Roubik, supra at 370.

We believe that, where the issue is application of the assignment of income doctrine to effectively set aside the corporation, under the particular circumstances of this case (which we have carefully delineated), an attempt to strike a balance between tax avoidance motives and “legitimate” business purposes is an unproductive and inappropriate exercise. Such an approach places too low a value on the policy of the law to recognize corporations as economic actors except in exceptional circumstances. This is true whether the analysis used to dismantle the corporation pursues the rubric of assignment of income or substance over form. Here there are other more precise devices for coping with the unacceptable tax avoidance which is unquestionably present in this case. But there is no need to crack walnuts with a sledgehammer. Cf. Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970).

In the instant case, Section 482 of the Internal Revenue Code appears available to allocate among controlled taxpayers “gross income, deductions, credits, or allowances” to prevent evasion of taxes or to clearly reflect the income of the controlled taxpayers.17 Other statutory provisions and “common law” doctrines, structured for more limited application, may also be available to remedy potential tax abuse. Thus, the dividends paid to taxpayer’s children, any undue accumulation of earnings by the Corporation, the assignment of commissions already earned before formation of the Corporation on September 1, 1966, and non-payment of taxpayer’s salary for the balance of 1966 after September 1 may each be subject to attack via one or a combination of the following routes: the assignment of income doctrine, the Code provisions governing the improper accumulation of surplus (I.R.C. ss 531-537) and the doctrine of constructive receipt. We think that the very aggressive tax avoidance measures which taxpayer employed here are vulnerable, but we express no opinion as to what statutory provisions or “common law” principles may properly address them.

We believe that, where all of the criteria set forth here are met, it is inappropriate to weigh “legitimate” business purposes against tax avoidance motivations in determining the application of the Lucas v. Earl assignment of income doctrine essentially to set aside a corporation for tax purposes. In the instant case, the Tax Court did not find that the Corporation was organized as a pure tax avoidance vehicle. Nor has the Tax Court perceived any flouting of the corporate form in the way business has been conducted. Pittsburgh Tube and Plymouth Tube entered into contracts requiring the Corporation to provide them services, for which they paid the Corporation. Taxpayer then worked exclusively for the Corporation in enabling it to carry out its responsibilities as a sales representative. The corporate tree seems sturdy enough to become fruit-bearing, subject, of course, to whatever pruning (radical or otherwise) by the tax collector appears appropriate.

We think that our approach in this case of recognizing some vitality in personal service corporations accords with congressional intent. “A history of legislation targeted at personal service corporations, the absence of any special exclusion of such corporations from corporate taxation and the personal holding company tax provisions indicate that to some extent Congress has sanctioned the incorporation of service businesses for tax purposes.” Battle, supra n.15 at 802.

We, therefore, remand to the Tax Court for consideration of the issues surrounding the Commissioner’s claim under Section 482 and other claims if available. For those purposes we do not disagree with the Tax Court’s basic findings of fact in this case. But we do not intimate any conclusive view on what specific results with respect to these claims should be. REVERSED AND REMANDED.
BRAMBLETT v. COMMISSIONER
960 F.2d 526 (5th Cir. 1992)

E. GRADY JOLLY, Circuit Judge:

On May 16, 1979, William Baker, Richard Bramblett, Robert Walker, and John Sexton formed the Mesquite East Joint Venture. Baker, Bramblett, Walker, and Sexton had respective 50%, 22%, 18%, and 10% interests in the joint venture. The stated purpose of the joint venture was to acquire vacant land for investment purposes. On June 4, 1979, the same four individuals formed Town East Development Company, a Texas corporation, for the purpose of developing and selling real estate in the Mesquite, Texas area. The shareholders' interests in Town East mirrored their interests in Mesquite East.

In late 1979 and early 1980, Mesquite East acquired 180.06 acres of land from Bramco, a corporation of which Bramblett was the sole shareholder. Also, in late 1979, Mesquite East acquired 84.5 acres of land from an unrelated third party, bringing its acquisitions to a total of 264.56 acres. Subsequent to its acquisition of the property and prior to the sale at issue here, Mesquite East made four separate sales of its acquired land. In three of the four instances, Mesquite East initially sold the property to Town East, which then developed it and sold it to third parties. In each of these instances, prior to the time Town East purchased the property from Mesquite East, it already had a binding sales agreement with the third party. In the fourth transaction, Mesquite East sold property directly to Langston/R & B Financial Joint Venture No. 1. Mesquite East's gross profit on these four transactions was $68,394.80 and it reported this amount as ordinary income on its 1981 partnership tax return.

Following these transactions, Town East still owned 121 acres. In 1982, Baker, acting as trustee, entered into five contingent contracts of sale for portions of this property. Mesquite East consulted its attorneys and accountants seeking advice on how to structure the transactions to avoid ordinary income tax on the sale. In December 1982, Mesquite East sold the property to Town East in exchange for two promissory notes totaling $9,830,000.00, the amount an appraiser determined to be the fair market value of the land. The notes provided for an interest rate of twelve percent per annum on the unpaid balance and an annual principle payment of $1.5 million. Town East proceeded to develop the property and sold most of it to unrelated third parties in eight different transactions. Town East made no payments on the notes until after the property had been sold to third parties. Town East paid the entire principal amount by the end of 1984, but it did not make the required interest payments.

Mesquite East characterized its profits from this sale as long-term capital gain on its 1983 and 1984 partnership tax returns. On audit, the Commissioner of Internal Revenue determined that the profits constituted ordinary income and asserted deficiencies in income tax attributable to the taxpayers' distributive share of the gain realized on the sale.

II

The Brambletts petitioned the tax court for a redetermination of the asserted deficiencies. The tax court upheld the deficiencies, finding that the sale of land was the business of Mesquite East, and that, therefore, the profits were ordinary income. * * * The Brambletts now appeal the decision of the tax court. * * *

IV
In order to qualify for favorable treatment as a long-term capital gain under Section 1202 of the Internal Revenue Code of 1954, the gain must arise from the sale or exchange of a “capital asset” held more than one year. 26 U.S.C. § 1222(3). “[P]roperty held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business” cannot be a capital asset. 26 U.S.C. § 1221(1). It is well settled that the definition of a capital asset is to be construed narrowly. Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 52, 76 S.Ct. 20, 24, 100 L.Ed. 29 (1955). The determination of whether Mesquite East was directly involved in the business of selling land is a factual determination, to be reversed only if clearly erroneous. Byram v. United States, 705 F.2d 1418, 1423-24 (5th Cir.1983). ***

V

Three principal questions must be considered:

(1) Was the taxpayer engaged in a trade or business, and if so, what business?
(2) Was the taxpayer holding the property primarily for sale in that business?
(3) Were the sales contemplated by the taxpayer “ordinary” in the course of that business? * * *

Seven factors which should be considered when answering these three questions are: (1) the nature and purpose of the acquisition of the property and the duration of the ownership; (2) the extent and nature of the taxpayer's efforts to sell the property; (3) the number, extent, continuity and substantiality of the sales; (4) the extent of subdividing, developing, and advertising to increase sales; (5) the use of a business office for the sale of the property; (6) the character and degree of supervision or control exercised by the taxpayer over any representative selling the property; and (7) the time and effort the taxpayer habitually devoted to the sales. Biedenharn, 526 F.2d at 415. The frequency and substantiality of sales is the most important factor. Suburban Realty, 615 F.2d at 178; Biedenharn, 526 F.2d at 416.

A review of these factors indicates that any finding by the tax court that Mesquite East was directly in the business of selling land is clearly erroneous. Mesquite East did not sell land frequently and the only substantial sale was the sale at issue. It conducted a total of five sales over a three-year period; two in 1979, one in 1980, one in 1981, and the one at issue in 1982. As a result of the first four transactions, Mesquite East made a profit of $68,394.80. On the sale at issue, Mesquite East made a profit of over seven million dollars. This record of frequency does not rise to the level necessary to reach the conclusion that the taxpayer held the property for sale rather than for investment. * * *

VI

It is not clear from the tax court's opinion whether the court found that Town East was the agent of Mesquite East, and that therefore, Mesquite East was in the business of selling land through Town East, or whether it attributed the
activities of Town East to Mesquite East based on a “substance over form” principle.

National Carbide and Bollinger set forth the standards for determining when a corporation is an agent of its shareholders. In National Carbide, the Court addressed whether three wholly owned subsidiaries of a corporation were agents of the parent corporation. The subsidiaries argued that since they were the agents of the parent, the income from their activities was really the parent's income. National Carbide, 336 U.S. at 424, 69 S.Ct. at 727. The Court held that the fact that the subsidiaries were completely owned and controlled by the parent was not enough to support the conclusion that they were the parent's agents. Id. 336 U.S. at 429, 69 S.Ct. at 730.

Whether the corporation operates in the name and for the account of the principal, binds the principal by its actions, transmits money received to the principal, and whether the receipt of income is attributable to the services of the employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. Its business purpose must be the carrying on of the normal duties of an agent. Id. 336 U.S. at 437, 69 S.Ct. at 734. * * * [NOTE TO STUDENTS: the court’s discussion of National Carbide factors omitted and this excerpt picks-up with the court’s analysis of those factors as applied to this case] An analysis of the National Carbide factors does not lead to the conclusion that Town East was the agent of Mesquite East. There is no evidence that Town East ever acted in the name of or for the account of Mesquite East. Town East did not have authority to bind Mesquite East. Town East did transfer money to Mesquite East, but it was the amount of the agreed upon fair market value of the property at the time of the sale. Town East realized a profit from its development that was much larger than a typical agency fee. The receipt of income by Town East was not attributable to the services of employees of Mesquite East or assets belonging to the joint venture. None of the first four factors support the conclusion that Town East was the agent of Mesquite East. Under the fifth factor, common ownership of both entities is not enough to prove an agency relationship. The sixth factor requires the business purpose of the agent to be the carrying on of normal agent duties. It is clear that Town East was not carrying on the normal duties of an agent; it was not selling or developing the property on behalf of Mesquite East because Town East retained all of the profit from development. Thus, under the standards set forth in National Carbide, Town East was not an agent of Mesquite East. Nor are there any other factors, such as those in Bollinger, that indicate that Town East was the agent of Mesquite East. Therefore, we cannot affirm the tax court's decision on the grounds that Town East was the agent of Mesquite East.

VII

The Commissioner argues that the tax court correctly attributed the activities of Town East to Mesquite East. He further argues that the well known principle of substance over form supports this attribution. The Supreme Court recently stated that in applying the principle of substance over form: the Court has looked to the objective economic realities of a transaction, rather than to the particular form the parties employed. The Court has never regarded “the simple expedient drawing up of papers,” as controlling for tax purposes when the objective economic realities are to the contrary. “In the field of taxation, administrators of the laws and the courts are concerned with substance and realities, and formal rigid documents are not rigidly binding.” Nor is the parties' desire to achieve a
particular tax result necessarily relevant.

Frank Lyon Co. v. United States, 435 U.S. 561, 573, 98 S.Ct. 1291, 1298, 55 L.Ed.2d 550 (1978) The Supreme Court further stated, however, that in cases where the form chosen by the taxpayer has a genuine economic substance, “is compelled or encouraged by business or regulatory realities, is imbued with tax-independent considerations, and is not shaped solely by tax-avoidance features,” Frank Lyon, 435 U.S. at 583-84, 98 S.Ct. at 1303-04, the government should honor the tax consequences effectuated by the taxpayer.

The Commissioner argues that when determining what the partnership's purpose was for holding the land, the tax court correctly looked to the economic substance of the transactions as a whole and attributed the activity of Town East to Mesquite East. We disagree. The business of a corporation is not ordinarily attributable to its shareholders. Neither the tax court nor the Commissioner argue that Town East is a sham corporation whose corporate shield can be pierced. Indeed, the tax court recognized and the Commissioner contends that both are separate taxable entities. Moreover, there was clearly at least one major independent business reason to form the corporation and have it develop the land and sell it -that reason being to insulate the partnership and the partners from unlimited liability from a multitude of sources. Furthermore, there is no substantial evidence that the transaction was not an arm's length transaction or that business and legal formalities were not observed. Finally, the partnership bought the real estate as an investment, hoping its value would appreciate.FN2 [emphasis added] The partnership, however, bore the risk that the land would not appreciate. Therefore, the tax court erred in finding that the activity of Town East can be attributed to Mesquite East and, consequently, that Mesquite East was in the business of selling land. Mesquite East held the land as an investment and is therefore entitled to capital gains treatment on the gain realized by the sale.

FN2. The main objective of the § 1221(1) exclusion is to distinguish between business and investment, and to disallow capital gains treatment on the everyday profits of the business and commercial world. A taxpayer who sells a parcel of undeveloped land bought as an investment is clearly entitled to capital gains treatment on the gain realized by the sale. * * *

VIII

Thus, we conclude. Any finding by the tax court that Mesquite East was directly in the business of selling land is clearly erroneous. Neither the frequency nor the substantiality of the sales made by Mesquite East supports the conclusion that Mesquite East was directly in the business of selling land. The tax court's opinion cannot be affirmed on the grounds that Town East was the agent of Mesquite East. An analysis of the National Carbide factors compels the conclusion that Town East was not acting as the agent of Mesquite East and there are no other factors, such as those in Bollinger, that support that conclusion. Finally, the activities of Town East may not be attributed to Mesquite East when determining whether Mesquite East was in the business of selling land. The corporation is not a sham; there was at least one major independent reason to form the corporation. Furthermore, the partners did invest in a capital asset in the sense that they bore the risk that the land would not appreciate. Therefore, the partnership held the land as a capital asset and is entitled to capital gains treatment. The decision of the tax court is

REVERSED.
MERCHANTS NATIONAL BANK v. COMMISSIONER

199 F.2d 657 (5th Cir. 1952)

STRUM, Circuit Judge.

On January 1, 1941, the petitioner held notes of Alabama Naval Stores Company, representing loans made by the bank to the Naval Stores Company, on which there was an unpaid balance of $49,025.00. In 1941 and 1943, at the direction of national bank examiners, the bank charged these notes off as worthless, thereafter holding them on a ‘zero’ basis. Deductions for the charge-offs, as ordinary losses, were allowed in full by the Commissioner on petitioner’s income tax returns in 1941 and 1943. In 1944, petitioner sold the notes to a third party for $18,460.58, which it reported on its return for 1944 as a long term capital gain and paid its tax on that basis. The Commissioner held this sum to be ordinary income, taxable at a higher rate than long term capital gains, and entered a deficiency assessment accordingly, in which he was sustained by the Tax Court. This is the basis of the 1944 controversy.

The rule is well settled, and this Court has held, that when a deduction for income tax purposes is taken and allowed for debts deemed worthless, recoveries on the debts in a later year constitute taxable income for that year to the extent that a tax benefit was received from the deduction taken in a prior year.

When these notes were charged off as a bad debt in the first instance, the bank deducted the amount thereof from its ordinary income, thus escaping taxation on that portion of its income in those years. The amount subsequently recovered on the notes restores pro tanto the amount originally deducted from ordinary income, and is accordingly taxable as ordinary income, not as a capital gain. When the notes were charged off, and the bank recouped itself for the capital loss by deducting the amount thereof from its current income, the notes were no longer capital assets for income tax purposes. To permit the bank to reduce its ordinary income by the amount of the loss in the first instance, thus gaining a maximum tax advantage on that basis, and then permit it to treat the amount later recovered on the notes as a capital gain, taxable on a much lower basis than ordinary income, would afford the bank a tax advantage on the transaction not contemplated by the income tax laws.

The fact that the bank sold these notes to a third party, instead of collecting the amount in question from the maker of the notes does not avoid the effect of the rule above stated. * * * *

As the recoveries in question were ordinary income, not capital gains, the 1944 deficiency was properly entered.

Affirmed.
Mr. Justice MARSHALL delivered the opinion of the Court.

During its tax year ending December 31, 1958, respondent refunded $505,536.54 to two of its customers for overcharges during the six preceding years. Respondent, an Oklahoma producer of natural gas, had set its prices during the earlier years in accordance with a minimum price order of the Oklahoma Corporation Commission. After that order was vacated as a result of a decision of this Court, respondent found it necessary to settle a number of claims filed by its customers; the repayments in question represent settlements of two of those claims. Since respondent had claimed an unrestricted right to its sales receipts during the years 1952 through 1957, it had included the $505,536.54 in its gross income in those years. The amount was also included in respondent's 'gross income from the property' as defined in §613 of the Internal Revenue Code of 1954, the section which allows taxpayers to deduct a fixed percentage of certain receipts to compensate for the depletion of natural resources from which they derive income. Allowable percentage depletion for receipts from oil and gas wells is fixed at 27 1/2% of the 'gross income from the property.' Since respondent claimed and the Commissioner allowed percentage depletion deductions during these years, 27 1/2% of the receipts in question was added to the depletion allowances to which respondent would otherwise have been entitled. Accordingly, the actual increase in respondent's taxable income attributable to the receipts in question was not $505,536.54, but only $366,513.99. Yet, when respondent made its refunds in 1958, it attempted to deduct the full $505,536.54. The Commissioner objected and assessed a deficiency. Respondent paid and, after its claim for a refund had been disallowed, began the present suit. The Government won in the District Court, but the Court of Appeals reversed, 392 F.2d 128 (1968). Upon petition by the Government, we granted certiorari, 393 U.S. 820, 89 S.Ct. 121, 21 L.Ed.2d 92 (1968), to consider whether the Court of Appeals decision had allowed respondent 'the practical equivalent of double deduction,' * * * in conflict with past decisions of this Court and sound principles of tax law. We reverse.

I.
The present problem is an outgrowth of the so-called 'claim-of-right' doctrine. Mr. Justice Brandeis, speaking for a unanimous Court in North American Oil Consolidated v. Burnet, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197 (1932), gave that doctrine its classic formulation. 'If a taxpayer receives earnings under a claim of right and without restriction as to its disposition, he has received income which he is required to return, even though it may still be claimed that he is not entitled to retain the money, and even though he may still be adjudged liable to restore its equivalent.' Should it later appear that the taxpayer was not entitled to keep the money, Mr. Justice Brandeis explained, he would be entitled to a deduction in the year of repayment; the taxes due for the year of receipt would *681 not be affected. This approach was dictated by Congress' adoption of an annual accounting system as an integral part of the tax code. See Burnet v. Sanford & Brooks Co., 282 U.S. 359, 365-366, 51 S.Ct. 150, 152, 75 L.Ed. 383 (1931). Of course, the tax benefit from the deduction in the year of repayment might differ from the increase in taxes attributable to the receipt; for example, tax rates might have changed, or the taxpayer might be in a different tax 'bracket.' See Healy v. Commissioner of Internal Revenue, 345 U.S. 278, 284-285, 73 S.Ct. 671, 675, 97 L.Ed. 1007 (1953). But as the doctrine was originally formulated, these discrepancies were accepted as an unavoidable consequence of the annual accounting system.

Section 1341 of the 1954 Code was enacted to alleviate some of the inequities which Congress felt existed in this area.FN1

FN1. * * * Section 1341(b)(2) contains an exclusion covering certain cases involving sales of
stock in trade or inventory. However, because of special treatment given refunds made by regulated public utilities, both parties agree that s 1341(b)(2) is inapplicable to this case and that, accordingly, s 1341(a) applies. As an alternative to the deduction in the year of repaymentFN2 which prior law allowed, s 1341(a)(5) permits certain taxpayers to recompute their taxes for the year of receipt. When ever s 1341(a)(5) applies, taxes for the current year are to be reduced by the amount taxes were increased in the year or years of receipt because the disputed items were included in gross income.

Nevertheless, it is clear that Congress did not intend to tamper with the underlying claim-of-right doctrine; it only provided an alternative for certain cases in which the new approach favored the taxpayer. When the new approach was not advantageous to the taxpayer, the old law was to apply under s 1341(a)(4).


In this case, the parties have stipulated that s 1341(a)(5) does not apply. Accordingly, as the courts below recognized, respondent's taxes must be computed under s 1341(a)(4) and thus, in effect, without regard to the special relief Congress provided through the enactment of s 1341. Nevertheless, respondent argues, and the Court of Appeals seems to have held, that the language used in s 1341 requires that respondent be allowed a deduction for the full amount of taxes he paid because of the inclusion of the item in income for a prior year. * * *

II.

Under the annual accounting system dictated by the Code, each year's tax must be definitively calculable at the end of the tax year. 'It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals.' Burnet v. Sanford & Brooks Co., supra, 282 U.S. at 365, 51 S.Ct. at 152. In cases arising under the claim-of-right doctrine, this emphasis on the annual accounting period normally requires that the tax consequences of a receipt should not determine the size of the deduction allowable in the year of repayment. There is no requirement that the deduction save the taxpayer the exact amount of taxes he paid because of the inclusion of the item in income for a prior year. * * *

Nevertheless, the annual accounting concept does not require us to close our eyes to what happened in prior years. For instance, it is well settled that the prior year may be examined to determine whether the repayment gives rise to a regular loss or a capital loss. Arrowsmith v. Commissioner of Internal Revenue, 344 U.S. 6, 73 S.Ct. 71, 97 L.Ed. 6 (1952). The rationale for the Arrowsmith rule is easy to see; if money was taxed at a special lower rate when received, the taxpayer would be accorded an unfair tax windfall if repayments were generally deductible from receipts taxable at the higher rate applicable to ordinary income. The Court in Arrowsmith was unwilling to infer that Congress intended such a result.

This case is really no different.FN4 In essence, oil and gas producers are taxed **1384 on only 72 1/2% of their ‘gross income from the property’ whenever they claim percentage depletion. The remainder of their oil and gas receipts is in reality tax exempt. We cannot believe that Congress
intended to give taxpayers a deduction for refunding money that was not taxed when received. * * * Accordingly, Arrowsmith teaches that the full amount of the repayment cannot, in the circumstances of this case, be allowed as a deduction.

FN4. The analogy would be even more striking if in Arrowsmith the individual taxpayers had not utilized the alternative tax for capital gains, as they were permitted to do by what is now s 1201 of the 1954 Code. Where the 25% alternative tax is not used, individual taxpayers are taxed at ordinary rates on 50% of their capital gains. See s 1202. In such a situation, the rule of the Arrowsmith case prevents taxpayers from deducting 100% of an item refunded when they were taxed on only 50% of it when it was received. Although Arrowsmith prevents this inequitable result by treating the repayment as a capital loss, rather than by disallowing 50% of the deduction, the policy behind the decision is applicable in this case. Here it would be inequitable to allow a 100% deduction when only 72 1/2% was taxed on receipt.

This result does no violence to the annual accounting system. Here, as in Arrowsmith, the earlier returns are not being reopened. And no attempt is being made to require the tax savings from the deduction to equal the tax consequences of the receipts in prior years. FN5 In addition, the approach here adopted will affect only a few cases. The percentage depletion allowance is quite unusual; unlike most other deductions provided by the Code, it allows a fixed portion of gross income to go untaxed. As a result, the depletion allowance increases in years when disputed amounts are received under claim of right; there is no corresponding decrease in the allowance because of later deductions for repayments. FN6 Therefore, if a deduction for 100% of the repayments were allowed, every time money is received and later repaid the taxpayer would make a profit equivalent to the taxes on 27 1/2% of the amount refunded. In other situations when the taxes on a receipt do not equal the tax benefits of a repayment, either the taxpayer or the Government may, depending on circumstances, be the beneficiary. Here, the taxpayer always wins and the Government always loses. We cannot believe that Congress would have intended such an inequitable result. * * *

FN5. Compare the analogous approach utilized under the ‘tax benefit’ rule. Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399, 180 Ct.Cl. 659 (1967); see Internal Revenue Code of 1954 s 111. In keeping with the analogy, the Commissioner has indicated that the Government will only seek to reduce the deduction in the year of repayment to the extent that the depletion allowance attributable to the receipt directly or indirectly reduced taxable income. Proposed Treas.Reg. s 1.613-2(c)(8), 33 Fed.Reg. 10702-10703 (1968).

FN6. The 10% standard deduction mentioned in Mr. Justice STEWART’S dissent, post, at 1389-1390, differs in that it allows as a deduction a percentage of adjusted gross income, rather than of gross income. See s 141; cf. ss 170, 213. As a result, repayments may in certain cases cause a decrease in the 10% standard deduction allowable in the year of repayment, assuming that the repayment is of the character to be deducted in calculating adjusted gross income. See s 62.

Reversed and remanded.

[The dissenting opinion of Justice Douglas and the dissenting Opinion of Justice STEWART’s in which Justice Harlan and Justice Douglas jointed are omitted]
Supplement Page #115

LATTERA v. COMMISSIONER
437 F.3d 39 (3rd Cir. 2006)

AMBRO, Circuit Judge,

Lottery winners, after receiving several annual installments of their lottery prize, sold for a lump sum the right to their remaining payments. They reported their sale proceeds as capital gains on their tax return, but the Internal Revenue Service (IRS) classified those proceeds as ordinary income. The substitute-for-ordinary-income doctrine holds that lump-sum consideration substituting for something that would otherwise be received at a future time as ordinary income should be taxed the same way. We agree with the Commissioner of the IRS that the lump-sum consideration paid for the right to lottery payments is ordinary income.

I. Factual Background and Procedural History

In June 1991 George and Angeline Lattera turned a one-dollar lottery ticket into $9,595,326 in the Pennsylvania Lottery. They did not then have the option to take the prize in a single lump-sum payment, so they were entitled to 26 annual installments of $369,051.

In September 1999 the Latteras sold their rights to the 17 remaining lottery payments to Singer Asset Finance Co., LLC for $3,372,342. ** On their joint tax return, the Latteras reported this sale as the sale of a capital asset held for more than one year. They reported a sale price of $3,372,342, a cost or other basis of zero, and a long-term capital gain of the full sale price. The Commissioner determined that this sale price was ordinary income. **

III. Discussion

The lottery payments the Latteras had a right to receive were gambling winnings, and the parties agree that the annual payments were ordinary income. But the Latteras argue that, when they sold the right to their remaining lottery payments, the sale gave rise to a long-term capital gain.

Whether the sale of a right to lottery payments by a lottery winner can be treated as a capital gain under the Internal Revenue Code is one of first impression in our Circuit. But it is not a new question. Both the Tax Court and the Ninth Circuit Court of Appeals have held that such sales deserve ordinary-income treatment. ** We propose a different approach. We begin with a discussion of basic concepts that underlie our reasoning.

A. Definition of a capital asset

A long-term capital gain (or loss) is created by the “sale or exchange of a capital asset held for more than 1 year.” I.R.C. § 1222(3). Section 1221 of the Internal Revenue Code defines a capital asset as “property held by the taxpayer (whether or not connected with his trade or business).” This provision excludes from the definition certain property categories, none of which is applicable here.

A 1960 Supreme Court decision suggested that this definition can be construed too broadly, stating that “it is evident that not
everything which can be called property in the
ordinary sense and which is outside the statutory
exclusions qualifies as a capital asset.” Comm'r v.
Gillette Motor Transp., Inc., 364 U.S. 130, 134,
80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960). The Court
noted that it had “long held that the term ‘capital
asset’ is to be construed narrowly in accordance
with the purpose of Congress to afford capital-
gains treatment only in situations typically
involving the realization of appreciation in value
accrued over a substantial period of time, and thus
to ameliorate the hardship of taxation of the entire
gain in one year.” Id. But the Supreme Court's
decision in Arkansas Best Corp. v. Commissioner,
485 U.S. 212, 108 S.Ct. 971, 99 L.Ed.2d 183
(1988), at least at first blush, seems to have
reversed that narrow reading. Arkansas Best
suggests instead that the capital-asset definition is
to be broadly construed. See id. at 218.

B. The substitute-for-ordinary-income doctrine

The problem with an overly broad
definition for capital assets is that it could *403
“encompass some things Congress did not intend
to be taxed as capital gains.” Maginnis, 356 F.3d
at 1181. An overly broad definition, linked with
favorable capital-gains tax treatment, would
encourage transactions designed to convert
ordinary income into capital gains. See id. at
1182. For example, a salary is taxed as ordinary
income, and the right to be paid for work is a
person's property. But it is hard to conceive that
Congress intends for taxpayers to get capital-gains
treatment if they were to sell their rights (i.e.,
"property held by the taxpayer") to their future
paychecks.

To get around this problem, courts have
created the substitute-for-ordinary-income
doctrine. This doctrine says, in effect, that “‘lump
sum consideration [that] seems essentially a
substitute for what would otherwise be received at
a future time as ordinary income’ may not be
taxed as a capital gain.” Maginnis, 356 F.3d at
1182 (quoting Comm'r v. P.G. Lake, Inc., 356
U.S. 260, 265, 78 S.Ct. 691, 2 L.Ed.2d 743
(1958)) (alteration in original).

The seminal substitute-for-ordinary-

income case is the 1941 Supreme Court decision
757, 85 L.Ed. 1168 (1941). * * * The Supreme
Court bolstered the doctrine in Lake. P.G. Lake,
Inc. * * *

The Latteras argue that the substitute-for-
ordinary-income doctrine, which takes “property
held by the taxpayer” outside the statutory capital-
asset definition, did not survive Arkansas Best.
But although Arkansas Best ostensibly cabined
the exceptions to the statutory definition, it made
clear that the Hort-Lake “line of cases, based on
the premise that § 1221 ‘property’ does not
include claims or rights to ordinary income, ha[d]
no application in the present context.” Arkansas
Best, 485 U.S. at 217 n. 5, 108 S.Ct. 971. The Tax
Court has several times confirmed that *404
Arkansas Best “in no way affected the viability of
the principle established in the [Hort-Lake ] line
of cases.” Davis, 119 T.C. at 6 (citing cases). And
the Ninth Circuit agrees. Maginnis, 356 F.3d at
1185. We follow suit, holding that the substitute-
for-ordinary-income doctrine remains viable in
the wake of Arkansas Best.

But there is a tension in the doctrine: in
theory, all capital assets are substitutes for
ordinary income. For example, a stock's value is
the present discounted value of the company's
future profits. See, e.g., Maginnis, 356 F.3d at
1182; cf. United States v. Dresser Indus., Inc., 324
F.2d 56, 59 (5th Cir.1963) (applying this concept
to the value of land). “[R]ead literally, the
[substitute-for-ordinary-income] doctrine would
completely swallow the concept of capital
losses.”). Also, an “overbroad ‘substitute for
ordinary income’ doctrine, besides being
analytically unsatisfactory, would create the
potential for the abuse of treating capital losses as
ordinary.” The doctrine must therefore be limited
so as not to err on either side.

C. The lottery cases

* * * In 2004 the Ninth Circuit decided
Maginnis, the first (and so far only) appellate
opinion to deal with this question. Maginnis won
$9 million in a lottery and, after receiving five of
his lottery payments, assigned all of his remaining
future lottery payments to a third party for a lump-sum payment of $3,950,000. Maginnis, 356 F.3d at 1180. The Ninth Circuit held that Maginnis's right to future lottery payments was not a capital asset and that the lump-sum payment was to be taxed as ordinary income. Id. at 1182.

The Court relied on the substitute-for-ordinary-income doctrine, but it was concerned about taking an “approach that could potentially convert all capital gains into ordinary income [or] one that could convert all ordinary income into capital gains.” Id. The Court opted instead for “case-by-case judgments as to whether the conversion of income rights into lump-sum payments reflects the sale of a capital asset that produces a capital gain, or whether it produces ordinary income.” Id. It set out two factors, which it characterized as “crucial to [its] conclusion,” but not “dispositive in all cases”: “Maginnis (1) did not make any underlying investment of capital in return for the receipt of his lottery right, and (2) the sale of his right did not reflect an accretion in value over cost to any underlying asset Maginnis held.”

The first factor-underlying investment of capital-would theoretically subject all inherited and gifted property (which involves no investment at all) to ordinary-income treatment. See Levine, supra, at 198. It also does not explain the result in Lake, where the company presumably made an investment in its working interest in oil and gas leases, yet the Supreme Court applied ordinary-income treatment. Id.

The second factor also presents analytical problems. Not all capital assets experience an accretion in value over cost. For example, cars typically depreciate, but they are often capital assets. See Sinclair, supra, at 421. Levine criticizes the second factor for “attempt[ing] to determine the character of a gain from its amount.” The Maginnis Court held that there was no accretion of value over cost in lottery winnings because there was no cost, as “Maginnis did not make any capital investment in exchange for his lottery right.” 356 F.3d at 1184. But if Maginnis's purchase of a lottery ticket had been a capital investment, would the second factor automatically have been satisfied? (That is, the “cost” in that scenario would have been $1, and the increase would have been $3,949,999.) Our first instinct is no. Moreover, the second factor does not seem to predict correctly the result in both Hort (where a building was inherited for no “cost”) and Lake (where the working interest in the oil lease presumably had a “cost”), in both of which the taxpayer got ordinary-income treatment.

Thus, while we agree with Maginnis's result, we do not simply adopt its reasoning. And it is both unsatisfying and unhelpful to future litigants to declare that we know this to be ordinary income when we see it. *** We therefore proceed to our case-by-case analysis, but in doing so we set out a method for analysis that guides our result. At the same time, however, we recognize that any rule we create could not account for every contemplated transactional variation.

D. Substitute-for-ordinary-income analysis

In our attempt to craft a rubric, we find helpful a Second Circuit securities case and a recent student comment. The Second Circuit dealt with a similarly “seamless spectrum” in 1976 when it needed to decide whether a note was a security for purposes of section 10(b) of the 1934 Securities and Exchange Act. See Exch. Nat'l Bank of Chi. v. Touche Ross & Co., 544 F.2d 1126, 1138 (2d Cir.1976). The Court created a “family resemblance” test. *** We adopt an analogous analysis. Several types of assets we know to be capital: stocks, bonds, options, and currency contracts, for example. See, e.g., Arkansas Best, 485 U.S. at 222-23, 108 S.Ct. 971 (holding-even though, as noted above, the value of a stock is really the present discounted value of the company's future profits-that “stock is most naturally viewed as a capital asset”). We could also include in this category physical assets like land and automobiles.

Similarly, there are several types of rights that we know to be ordinary income, e.g., rental income and interest income. In Gillette Motor, the Supreme Court held that ordinary-income treatment was indicated for the right to use
another’s property—rent, in other words. See 364 U.S. at 135, 80 S.Ct. 1497. Similarly, in Midland-Ross, the Supreme Court held that earned original issue discount should be taxed as ordinary income. See United States v. Midland-Ross Corp., 381 U.S. 54, 58, 85 S.Ct. 1308, 14 L.Ed.2d 214 (1965). There, the taxpayer purchased non-interest-bearing notes at a discount from the face amount and sold them for more than their issue price (but still less than the face amount). Id. at 55, 85 S.Ct. 1308. This gain was conceded to be equivalent to interest, and the Court held it taxable as ordinary income. Id. at 55-56, 58, 85 S.Ct. 1308. For the “family resemblance” test, we can set those two categories at the opposite poles of our analysis. For example, we presume that stock, and things that look and act like stock, will receive capital-gains treatment. For the in-between transactions that do not bear a family resemblance to the items in either category, like contracts and payment rights, we use two factors to assist in our analysis: (1) type of “carve-out” and (2) character of asset.

1. Type of carve-out

The notion of the carve-out, or partial sale, has significant explanatory power in the context of the Hort-Lake line of cases. There are two ways of carving out interests from property: horizontally and vertically. A horizontal carve-out is one in which “temporal divisions are made in a property interest in which the person owning the interest disposes of part of his interest but also retains a portion of it.” In lottery terms, this is what happened in Davis—the lottery winners sold some of their future lottery payment rights (e.g., their 2006 and 2007 payments) but retained the rights to payments further in the future (e.g., their 2008 and 2009 payments). This is also what happened in Hort and Lake; portions of the total interest (a term of years carved out from a fee simple and a three-year payment right from a working interest in a oil lease, respectively) were carved out from the whole.

A vertical carve-out is one in which “a complete disposition of a person’s interest in property” is made. In lottery terms, this is what happened in Watkins and Maginnis—the lottery winners sold the rights to all their remaining lottery payments. Horizontal carve-outs typically lead to ordinary-income treatment. See, e.g., Maginnis, 356 F.3d at 1185-86. This was also the result reached in Hort and Lake. Lake, 356 U.S. at 264, 78 S.Ct. 691; Hort, 313 U.S. at 32, 61 S.Ct. 757.

Vertical carve-outs are different. In Dresser Industries, for example, the Fifth Circuit distinguished Lake because the taxpayer in Dresser had “cut-off a ‘vertical slice’ of its rights, rather than carv[ed] out an interest from the totality of its rights.” But as the results in Maginnis and Watkins demonstrate, a vertical carve-out does not necessarily mean that the transaction receives capital-gains treatment. Because a vertical carve-out could signal either capital-gains or ordinary-income treatment, we must make another determination to conclude with certainty which treatment should apply. Therefore, when we see a vertical carve-out, we proceed to the second factor—character of the asset—to determine whether the sale proceeds should be taxed as ordinary income or capital gain.

2. Character of the asset

The Fifth Circuit in Dresser Industries noted that “[t]here is, in law and fact, a vast difference between the present sale of the future right to earn income and the present sale of the future right to earned income.” Dresser Indus., 324 F.2d at 59 (emphasis in original). The taxpayer in Dresser Industries had assigned its right to an exclusive patent license back to the patent holder in exchange for a share of the licensing fees from third-party licensees. Id. at 57. The Court used this “right to earn income”/“right to earned income” distinction to hold that capital gains treatment was applicable. It noted that the asset sold was not a “right to earned income, to be paid in the future,” but was “a property which would produce income.” Id. at 59. Further, it disregarded the ordinary nature of the income generated by the asset; because “all income-producing property” produces ordinary income, the sale of such property does not result in
ordinary-income treatment. Id. (This can be seen in the sale of bonds, which produce ordinary income, but the sale of which is treated as capital gain.)

Sinclair explains the distinction in this way: “Earned income conveys the concept that the income has already been earned and the holder of the right to this income only has to collect it. In other words, the owner of the right to earned income is entitled to the income merely by virtue of owning the property.” He gives as examples of this concept rental income, stock dividends, and rights to future lottery payments. Id. (Of course, in the wake of dividend tax reform, stock dividends are now taxed as capital gains. I.R.C. § 1(h)(11).) For the right to earn income, on the other hand, “the holder of such right must do something further to earn the income.... [because] mere ownership of the right to earn income does not entitle the owner to income.” * * * Assets that constitute a right to earn income merit capital-gains treatment, while those that are a right to earned income merit ordinary-income treatment.

Similarly, when an erstwhile employee is paid a termination fee for a personal-services contract, that employee still possesses the asset (the right to provide certain personal services) and the money (the termination fee) has already been “earned” and will simply be paid. The employee no longer has to perform any more services in exchange for the fee, so this is not like Dresser Industries’ s “right to earn income.” These termination fees are therefore rights to earned income and should be treated as ordinary income. See, e.g., Elliott v. United States, 431 F.2d 1149, 1154 (10th Cir.1970); Holt v. Comm'r, 303 F.2d 687, 690 (9th Cir.1962).

The factor also explains, for example, the Second Circuit's complex decision in Commissioner v. Ferrer, 304 F.2d 125 (2d Cir.1962). The actor José Ferrer had contracted for the rights to mount a stage production based on the novel Moulin Rouge. Id. at 126. In the contract, Ferrer obtained two rights relevant here: (1) the exclusive right to “produce and present” a stage production of the book and, if the play was produced, (2) a share in the proceeds from any motion-picture rights that stemmed from the book. Id. at 127. After a movie studio planned to make Moulin Rouge into a movie-and agreed that it would feature Ferrer-he sold these, along with other, rights. Id. at 128-29. Right (1) would have required Ferrer to have produced and presented the play to get income, so it was a right to earn income-thus, capital-gains treatment was indicated. Right (2), once it matured (i.e., once Ferrer had produced the play), would have continued to pay income simply by virtue of Ferrer's holding the right, so it would have become a right to earned income-thus, ordinary-income treatment was indicated. The Second Circuit held as such, dictating capital-gains treatment for right (1) and ordinary-income treatment for right (2). Id. at 131, 134.

E. Application of the “family resemblance” test

Applied to this case, the “family resemblance” test draws out as follows. First, we try to determine whether an asset is like either the “capital asset” category of assets (e.g., stocks, bonds, or land) or like the “income items” category (e.g., rental income or interest income). If the asset does not bear a family resemblance to items in either of those categories, we move to the following factors.

We look at the nature of the sale. If the sale or assignment constitutes a horizontal carve-out, then ordinary-income treatment presumably applies. If, on the other hand, it constitutes a vertical carve-out, then we look to the character-of-the-asset factor. There, if the sale is a lump-sum payment for a future right to earned income, we apply ordinary-income treatment, but if it is a lump-sum payment for a future right to earn income, we apply capital-gains treatment.

Turning back to the Latteras, the right to receive annual lottery payments does not bear a strong family resemblance to either the “capital assets” or the “income items” listed at the polar ends of the analytical spectrum. The Latteras sold their right to all their remaining lottery payments, so this is a vertical carve-out, which could indicate either capital-gains or ordinary-income treatment. But because a right to lottery payments
is a right to earned income (i.e., the payments will keep arriving due simply to ownership of the asset), the lump-sum payment received by the Latteras should receive ordinary-income treatment.

This result comports with Davis and Maginnis. It also ensures that the Latteras do not “receive a tax advantage as compared to those taxpayers who would simply choose originally to accept their lottery winning in the form of a lump sum payment,” something that was also important to the Maginnis Court. Maginnis, 356 F.3d at 1184.

IV. Conclusion

The lump-sum consideration paid to the Latteras in exchange for the right to their future lottery payments is ordinary income. We therefore affirm.