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Law Center
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Federal Income Taxation

Supplemental Reading Materials

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Taxes, Happiness, and Heliocentrism
by David Cay Johnston

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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.

<table>
<thead>
<tr>
<th>Country</th>
<th>Taxes as Share of GDP</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>
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<td>Norway</td>
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<td>4</td>
</tr>
<tr>
<td>Switzerland</td>
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<td>5</td>
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<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
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.

Have the good fortune to be born smart and the discipline to develop your brain in America, and you will face a new kind of tax on human capital, the rapidly rising costs of higher education, including tuition at so-called public institutions. In the 10 happier countries, college costs little out of pocket because it is seen as an investment that will be recouped through the taxes paid by a society made wealthier by nurturing its intellectual capital.

Have children in America and, if you are a woman, you get a few weeks of maternity pay. Have children in the 10 happier countries, and the government provides a range of benefits and, in Sweden and Norway, forces you to take time off work at nearly full pay so that your children are more likely to grow up emotionally secure, thus reducing the risk that they will become unproductive tax-eaters instead of taxpayers.

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.
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 and the total fund will be $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 worth 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

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

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>
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<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>$20</td>
<td>$40</td>
<td>$55</td>
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<td>$70</td>
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<td>5</td>
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</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.
The Commissioner determined a deficiency in the petitioners’ joint income tax for 1933 of $856.68, and for 1934 of $1,001.61, and they contest the inclusion in gross income each year of the alleged fair market value of rooms and meals furnished by the husband’s employer.

FINDINGS OF FACT.
The petitioners are husband and wife, residing in Honolulu, Hawaii, where they filed joint income tax returns for 1933 and 1934. The petitioner has, since 1926 and including the tax years in question, been employed as the manager in full charge of the several hotels in Honolulu owned and operated by Hawaiian hotels, Ltd., a corporation of Hawaii, consisting of the Royal Hawaiian, the Moana and bungalows, and the Waialae Golf Club. These are large resort hotels, operating on the American plan. Petitioner was constantly on duty, and, for the proper performance of his duties and entirely for the convenience of his employer, he and his wife occupied a suite of rooms in the Royal Hawaiian Hotel and received their meals at and from the hotel.

Petitioner’s salary has varied in different years, being in one year $25,000. In 1933 it was $9,625, and in 1934 it was $11,041.67. These amounts were fixed without reference to his meals and lodging, and neither petitioner nor his employer ever regarded the meals and lodging as part of his compensation or accounted for them.

STERNHAGEN
The Commissioner has added $7,845 each year to the petitioner’s gross income as ‘compensation received from Hawaiian Hotels, Ltd.’, holding that this is ‘the fair market value of rooms and meals furnished by the employer.’ In the deficiency notice he cites article 52 (53), Regulations 77, and holds inapplicable Jones v. United States, 60 Ct.Cls. 552; I.T. 2232; G.C.M. 14710; and G.C.M. 14836. The deficiency notice seems to hold that the rooms and meals were not in fact supplied ‘merely as a convenience to the hotels’ of the employer.

From the evidence, there remains no room for doubt that the petitioner’s residence at the hotel was not by way of compensation for his services, not for his personal convenience, comfort or pleasure, but solely because he could not otherwise perform the services required of him. The evidence of both the employer and employee shows in detail what petitioner’s duties were and why his residence in the hotel was necessary. His duty was continuous and required his presence at a moment’s call. He had a lifelong experience in hotel management and operation in the United States, Canada, and elsewhere, and testified that the functions of the manager could not have been performed by one living outside the hotel, especially a resort hotel such as this. The demands and requirements of guests are numerous, various, and unpredictable, and affect the meals, the rooms, the entertainment, and everything else about the hotel. The manager must be alert to all these things day and night. He would not consider undertaking the job and the owners of the hotel would not consider employing a manager unless he lived there. This was implicit throughout his employment, and when his compensation was changed from time to time no mention was ever made of it. Both took it for granted. The corporation’s books carried no accounting for the petitioner’s meals, rooms, or service.

Under such circumstances, the value of meals and lodging is not income to the employee, even though it may relieve him of an expense which he would otherwise bear. In Jones v. United
States, supra, the subject was fully considered in determining that neither the value of quarters nor the amount received as commutation of quarters by an Army officer in included within his taxable income. There is also a full discussion in the English case of Tennant v. Smith, H. L. (1892) App.Cas. 150, III British Tax Cases 158. 2 A bank employee was required to live in quarters located in the bank building, and it was held that the value of such lodging was not taxable income. The advantage to him was merely an incident of the performance of his duty, but its character for tax purposes was controlled by the dominant fact that the occupation of the premises was imposed upon him for the convenience of the employer. The Bureau of Internal Revenue has almost consistently applied the same doctrine in its published rulings.

The three cases cited by the respondent, Ralph Kitchen, 11 B.T.A. 855; Charles A. Frueauff, 30 B.T.A. 449; and Fontaine Fox, 30 B.T.A. 451, are distinguishable entirely upon the ground that what the taxpayer received was not shown to be primarily for the need or convenience of the employer. Of course, as in the Kitchen case, it can not be said as a categorical proposition of law that, where an employee is fed and lodged by his employer, no part of the value of such perquisite is income. If the Commissioner finds that it was received as compensation and holds it to be taxable income, the taxpayer contesting this before the Board must prove by evidence that it is not income. In the Kitchen case the Board held that the evidence did not establish that the food and lodging were given for the convenience of the employer. In the present case the evidence clearly establishes that fact, and it has been so found.

The determination of the Commissioner on the point in issue is reversed. MURDOCK concurs only in the result.

ARNOLD, dissenting:

I disagree with the conclusions of fact that the suite of rooms and meals furnished petitioner and his wife at the Royal Hawaiian Hotel were entirely for the convenience of the employer and that the cash salary was fixed without reference thereto and was never regarded as part of his compensation.

Petitioner was employed by a hotel corporation operating two resort hotels in Honolulu—the Royal Hawaiian, containing 357 guest bed rooms, and the Moana, containing 261 guest bed rooms, and the bungalows and cottages in connection with the Moana containing 127 guest bed rooms, and the Waialae Golf Club. His employment was as general manager of both hotels and the golf club.

His original employment was in 1925, and in accepting the employment he wrote a letter to the party representing the employer, with whom he conducted the negotiations for employment, under date of September 10, 1925, in which he says: “Confirming our meeting here today, it is understood that I will assume the position of general manager of both the Royal Waikiki Beach Hotel (now under construction) and the Moana Hotel in Honolulu, at a yearly salary of $10,000.00, payable monthly, together with living quarters, meals, etc., for myself and wife. In addition I am to receive $20.00 per day while traveling, this however, not to include any railroad or steamship fares, and I to submit vouchers monthly covering all such expenses.”

While the cash salary was adjusted from time to time by agreement of the parties, depending on the amount of business done, it appears that the question of living quarters, meals, etc., was not given further consideration and was not thereafter changed. Petitioner and his wife have always occupied living quarters in the
Royal Hawaiian Hotel and received their meals from the time he first accepted the employment down through the years before us. His wife performed no services for the hotel company.

This letter, in my opinion, constitutes the basic contract of employment and clearly shows that the living quarters, meals, etc., furnished petitioner and his wife were understood and intended to be compensation in addition to the cash salary paid him. Being compensation to petitioner in addition to the cash salary paid him, it follows that the reasonable value thereof to petitioner is taxable income.

Conceding that petitioner was required to live at the hotel and that his living there was solely for the convenience of the employer, it does not follow that he was not benefited thereby to the extent of what such accommodations were reasonably worth to him. His employment was a matter of private contract. He was careful to specify in his letter accepting the employment that he was to be furnished with living quarters, meals, etc., for himself and wife, together with the cash salary, as compensation for his employment. Living quarters and meals are necessities which he would otherwise have had to procure at his own expense. His contract of employment relieved him to that extent. He has been enriched to the extent of what they are reasonably worth.

The majority opinion is based on the finding that petitioner’s residence at the hotel was solely for the convenience of the employer and, therefore, not income. While it is no doubt convenient to have the manager reside in the hotel, I do not think the question here is one of convenience or of benefit to the employer. What the tax law is concerned with is whether or not petitioner was financially benefited by having living quarters furnished to himself and wife. He may have preferred to live elsewhere, but we are dealing with the financial aspect of petitioner’s relation to his employer, not his preference. He says it would cost him $3,600 per year to live elsewhere.

It would seem that if his occupancy of quarters at the Royal Hawaiian was necessary and solely for the benefit of the employer, occupancy of premises at the Moana would be just as essential so far as the management of the Moana was concerned. He did not have living quarters or meals for himself and wife at the Moana and he was general manager of both and both were in operation during the years before us. Furthermore, it appears that petitioner was absent from Honolulu from March 24 to June 8 and from August 19 to November 2 in 1933, and from April 8 to May 24 and from September 3 to November 1 in 1934—about 5 months in 1933 and 3 1/2 months in 1934. Whether he was away on official business or not we do not know. During his absence both hotels continued in operation. The $20 per day travel allowance in his letter of acceptance indicates his duties were not confined to managing the hotels in Honolulu, and the entire letter indicates he was to receive maintenance, whether in Honolulu or elsewhere, in addition to his cash salary.

At most the arrangement as to living quarters and meals was of mutual benefit, and to the extent it benefited petitioner it was compensation in addition to his cash salary, and taxable to him as income.

The Court of Claims in the case of Jones v. United States, relied on in the majority opinion, was dealing with a governmental organization regulated by military law where the compensation was fixed by law and not subject to private contract. The English case of Tennant v. Smith, involved the employment of a watchman or custodian for a bank whose presence at the bank was at all times a matter of necessity demanded by the employer as a condition of the employment. The facts in both these cases are so at variance with the facts in this case that they are not controlling in my opinion.
Rev. Rul. 2003-12
2003-1 C.B. 283

ISSUES
(1) Are grants individuals receive under a state’s program to pay or reimburse certain reasonable and necessary medical, temporary housing, or transportation expenses they incur as a result of a flood includible in gross income?
(2) Are grants individuals receive under a charitable organization’s program to pay or reimburse certain medical, temporary housing, or transportation expenses they incur as a result of a flood includible in gross income?
(3) Are grants employees receive under an employer’s program to pay or reimburse certain reasonable and necessary medical, temporary housing, or transportation expenses they incur as a result of a flood includible in gross income?

FACTS
Situation 1. An area within state ST was affected by a flood that was a Presidentially declared disaster as defined in § 1033(h)(3) of the Internal Revenue Code. ST enacted emergency legislation appropriating funds for grants to pay or reimburse medical, temporary housing, and transportation expenses individuals incur as a result of the flood that are not compensated for by insurance or otherwise. ST will not require individuals to provide proof of actual expenses to receive a grant payment. ST’s program, however, contains requirements (which are described in the program documents) to ensure that the grant amounts are reasonably expected to be commensurate with the amount of unreimbursed reasonable and necessary medical, temporary housing, and transportation expenses individuals incur as a result of the flood. The grants are not intended to indemnify all flood-related losses or to reimburse the cost of nonessential, luxury, or decorative items and services.

Situation 2. O, a charitable organization described in § 501(c)(3) that is exempt from tax under § 501(a), whose purpose is to provide assistance to individuals who are affected by disasters, also makes grants to distressed individuals affected by the flood described in Situation 1. The grants will pay or reimburse individuals for medical, temporary housing, and transportation expenses they incur as a result of the flood that are not compensated for by insurance or otherwise.

Situation 3. Employer R makes grants to its employees who are affected by the flood described in Situation 1. The grants will pay or reimburse employees for medical, temporary housing, and transportation expenses they incur as a result of the flood that are not compensated for by insurance or otherwise. R will not require individuals to provide proof of actual expenses to receive a grant payment. R’s program, however, contains requirements (which are described in the program documents) to ensure that the grant amounts are reasonably expected to be commensurate with the amount of unreimbursed reasonable and necessary medical, temporary housing, and transportation expenses R’s employees incur as a result of the flood. The grants are not intended to indemnify all flood-related losses or to reimburse the cost of nonessential, luxury, or decorative items and services. The grants are available to all employees regardless of length or type of service with R.

LAW AND ANALYSIS
Section 61(a) provides that, except as otherwise provided by law, gross income means all income from whatever source derived. Rev. Rul. 131, 1953-2 C.B. 112, concludes, in part, that certain payments by an employer to its employees for the purpose of helping the employees defray costs they incurred from personal injury and property loss resulting from a tornado do not come within the concept of gross income.
to the employees under the predecessor of § 61 because the payments are gratuitous, measured solely by need, not related to services rendered, and designed to place the employees in about the same economic position as they were before the tornado. In 1955, the Supreme Court of the United States held that Congress intended under § 61 to tax all gains or undeniable accessions to wealth, clearly realized, over which taxpayers have complete dominion. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), 1955-1 C.B. 207.

The Internal Revenue Service has concluded that payments made by governmental units under legislatively provided social benefit programs for the promotion of the general welfare (i.e., based on need) are not includible in the gross income of the recipients of the payments (“general welfare exclusion”). For example, Rev. Rul. 98-19, 1998-1 C.B. 840, concludes that a relocation payment, authorized by the Housing and Community Development Act of 1974 and funded under the 1997 Emergency Supplemental Appropriations Act for Recovery From Natural Disasters, made by a local jurisdiction to an individual moving from a flood-damaged residence to another residence, is not includible in the individual’s gross income. Likewise, Rev. Rul. 76-144, 1976-1 C.B. 17, concludes that grants received under the Disaster Relief Act of 1974 by individuals unable to meet necessary expenses or serious needs as a result of a disaster are in the interest of general welfare and are not includible in the recipients’ gross income.

Section 102(a) provides that the value of property acquired by gift is excluded from gross income. Under § 102(a) a gift “must proceed from a ‘detached and disinterested generosity,’ … ‘out of affection, respect, admiration, charity or like impulses.’” *Commissioner v. Duberstein*, 363 U.S. 278, 285 (1960), 1960-2 C.B. 428, 431. In general, a payment made by a charity to an individual that responds to the individual’s needs, and does not proceed from any moral or legal duty, is motivated by detached and disinterested generosity. Rev. Rul. 99-44, 1999-2 C.B. 549. Section 102(c) provides that § 102(a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee. Governmental grants in response to a disaster generally do not qualify as gifts because the government’s intent in making the payments proceeds from its duty to relieve the hardship caused by the disaster. *Kroon v. United States*, Civ. No. A-90-71 (D. Alaska 1974).

The Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (2001), added § 139 to the Code. Section 139(a) provides that gross income does not include any amount received by an individual as a qualified disaster relief payment.

Section 139(b) provides, in part, that the term “qualified disaster relief payment” means any amount paid to or for the benefit of an individual:

1. to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses incurred as a result of a qualified disaster (§ 139(b)(1));

2. to reimburse or pay reasonable and necessary expenses incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement, is attributable to a qualified disaster (§ 139(b)(2)); or

3. by a Federal, State, or local government, or agency or instrumentality thereof, in connection with a qualified disaster in order to promote the general welfare (§ 139(b)(4)).
Thus, § 139(b)(4) codifies (but does not supplant) the administrative general welfare exclusion with respect to certain disaster relief payments to individuals. Section 139(b) also provides that the exclusion from income applies only to the extent any expense compensated by such payment is not otherwise compensated for by insurance or otherwise.

Section 139(c) provides that the term “qualified disaster” means:

(1) a disaster that results from a terroristic or military action (as defined in § 692(c)(2));

(2) a Presidentially declared disaster as defined in § 1033(h)(3) (generally, a disaster in an area that has been subsequently determined by the President to warrant federal assistance under the Disaster Relief and Emergency Assistance Act);

(3) a disaster resulting from any event that the Secretary determines to be of a catastrophic nature; or

(4) with respect to amounts described in § 139(b)(4), a disaster that is determined by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance from the Federal, State, or local government or an agency or instrumentality thereof.

Because “of the extraordinary circumstances surrounding a qualified disaster, it is anticipated that individuals will not be required to account for actual expenses in order to qualify for the [§ 139] exclusion, provided that the amount of the payments can be reasonably expected to be commensurate with the expenses incurred.” Joint Committee on Taxation Staff, Technical Explanation of the “Victims of Terrorism Tax Relief Act of 2001,” as Passed by the House and Senate on December 20, 2001, 107th Cong., 1st Sess. 16 (2001). As under § 139, the Service will not require individuals to account for actual disaster-related expenses for governmental payments to qualify under the administrative general welfare exclusion if the amount of the payments is reasonably expected to be commensurate with the expenses incurred.

The grants that individuals receive from ST, O, and R, and the payments that the employees receive from their employer in Rev. Rul. 131, are accessions to wealth clearly realized over which the recipients have complete dominion, and therefore come within the concept of gross income under § 61 as described in Glenshaw Glass. Thus, these amounts are included in gross income unless specifically excluded by another provision of law. Accordingly, Rev. Rul. 131 is modified to the extent that it holds that the payments received by the employees from their employer do not come within the concept of gross income.

In Situation 1, the grants made by ST are reasonably expected to be commensurate with the unreimbursed reasonable and necessary medical, temporary housing, or transportation expenses individuals incur as a result of the flood. These expenses are personal, living, or family expenses within the meaning of § 139. Moreover, they are paid to compensate individuals for expenses that are not compensated for by insurance or otherwise. Thus, the grants are in the nature of general welfare and are, therefore, excluded from the recipients’ gross income under the general welfare exclusion. The payments also qualify for exclusion from gross income under § 139. Because ST’s intent in making the grants proceeds from its duty to relieve the hardship caused by the disaster, not from a detached and disinterested generosity, the grants made by
ST do not qualify for exclusion from income as gifts under § 102.

In Situation 2, the grants made by O are designed to help distressed individuals with unreimbursed medical, temporary housing, or transportation expenses they incur as a result of the flood. Under these facts, O’s grants are made out of detached and disinterested generosity rather than to fulfill any moral or legal duty. Thus, the grants are excluded from the gross income of the recipients as gifts under § 102. Because payments by non-governmental entities are not considered payments for the general welfare, the grants made by O are not excluded from the recipients’ gross income under the general welfare exclusion. Rev. Rul. 82-106, 1982-1 C.B. 16. It is not necessary to reach the question of whether § 139 applies to the grants.

In Situation 3, the grants made by R to its employees do not qualify as gifts under § 102. Also, because payments by non-governmental entities are not considered payments for the general welfare, the grants made by R are not excluded from the recipients’ gross income under the general welfare exclusion. The grants, however, are reasonably expected to be commensurate with the unreimbursed reasonable and necessary personal, living, or family expenses that R’s employees incur as a result of a flood that is a qualified disaster as defined in § 139(c). Moreover, they are paid to compensate individuals for expenses that are not compensated for by insurance or otherwise. Therefore, R’s grants are qualified disaster relief payments that are excluded from the gross income of R’s employees under § 139. Similar to the grants in Situation 3, the payments made by the employer described in Rev. Rul. 131 do not qualify as gifts under § 102 and are not excluded from the employees’ gross income under the general welfare exclusion. Whether the payments described in Rev. Rul. 131 are included in an employee’s gross income depends on whether the payments qualify for exclusion under § 139.

HOLDINGS

Under the facts of this ruling:

(1) Payments individuals receive under a state’s program to pay or reimburse unreimbursed reasonable and necessary medical, temporary housing, or transportation expenses they incur as a result of a flood are excluded from gross income under the general welfare exclusion. Such payments also qualify for exclusion under § 139.

(2) Payments that individuals receive under a charitable organization’s program to pay or reimburse unreimbursed medical, temporary housing, or transportation expenses they incur as a result of a flood are excluded from gross income under § 102.

(3) Payments that employees receive under an employer’s program to pay or reimburse unreimbursed reasonable and necessary medical, temporary housing, or transportation expenses they incur as a result of a flood are excluded from gross income under § 139.

Amounts that are excluded from gross income under this revenue ruling are not subject to information reporting under § 6041.
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#ixzz0zvuaOdbq](http://www.allheadlinenews.com/articles/7019931927#ixzz0zvuaOdbq)
FAIRFIELD PLAZA v. COMMISSIONER
39 T.C. 706(1963)

BRUCE, Judge: Respondent determined deficiencies in income taxes of the petitioner for the years 1957 and 1958 in the amounts of $413.74 and $17,669.70, respectively.

We are called upon to determine (1) the proper allocation of the basis of a single tract of real estate to two portions of that tract, one of which was sold in 1957, the other in 1958, and (2) whether any part of an amount of $50,000 placed in escrow for improvements to the retained center portion, or the $40,146.32 actually expended for such improvements, is allocable to the basis of the parcel sold in 1957 or to the basis of that parcel and the parcel sold in 1958.

In 1955 petitioner purchased a 10-acre tract of real estate, located between 16th and 17th Streets in Huntington, W. Va., with the intention of developing the property into a shopping center. After grading had been completed, negotiations were begun with Big Bear Stores Co. pursuant to which petitioner was to build and lease to Big Bear a store on approximately 30 percent of the property, which portion has frontage on 17th Street.

Petitioner had difficulty in obtaining financing for the building, and in 1957 sold this easterly portion of the tract to Big Bear for $100,000, $50,000 of which was placed in escrow pending petitioner’s completion of paving and lighting on the remainder of the tract.

In 1958 the western 30 percent of the tract, which has frontage on 16th Street, was sold to Paisley and associates for $150,000. The parties agree that the $50,000 placed in escrow in the Big Bear sale should be taken into income in 1958.

The purchase price to petitioner in 1955 of the whole tract, including the basic cost of the land, commissions, interest, taxes, and legal fees and insurance, was $110,941.12. In addition, petitioner spent a net of $29,584.64 for engineering, grading, and other miscellaneous items which are to be capitalized. The first issue involves the allocation of the above amounts in the computation of the bases of the two parcels sold to Big Bear and Paisley, respectively.

It is the position of respondent that the allocation must be made as of the 1955 purchase date and that since the petitioner then intended to use the land for a shopping center the only proper method of allocation is on the basis of square footage. Respondent reasons that reciprocal easements for access and the very nature of a shopping center support his assertion that no portion of the property has a value greater than that of any other.

We agree with respondent that the allocation of basis is to be made as of 1955. Wellesley A. Ayling, 32 T.C. 704. It is the proper method of allocation which remains in issue.

Section 1.61-6, Income Tax Regs., provides that ‘When a part of a larger property is sold, the cost or other basis of the entire property shall be equitably apportioned among the several parts.’ Such ‘equitable’ apportionment demands that relative values be reflected. Accordingly, if one parcel is of greater value than another, apportionment solely on the basis of square footage appears inappropriate. Biscayne Bay Islands Co., 23 B.T.A. 731; Cleveland-Sandusky Brewing Corp., 30 T.C. 539; and see 3-A Mertens, Law of Federal Income Taxation, sec. 21.12, p. 43. It is, of course, true that petitioner bears the burden of demonstrating the applicability of an allocation of basis other than that reflected in respondent’s determinations.

We are satisfied from the evidence presented that despite the fact the property was to be used as a
shopping center, thus having an integrated value, each lot or portion thereof reflecting upon each other portion, the land fronting on 16th Street, which was sold to the Paisley group, had a greater value than that reflected by a simple allocation of cost on the basis of square footage. Sixteenth Street is one of Huntington’s main thoroughfares. Any business fronting thereon is inevitably in the public eye. Two expert witnesses testified that the Paisley property had a value equal to the remainder of the tract. Despite petitioner’s intentions in 1955, we are satisfied that this property had a fair market value in excess of the approximately 30.9 percent of original cost assigned thereto by respondent. On the basis of all of the evidence, we have concluded that 40 percent of cost is allocable to the Paisley parcel. While we have not rested our conclusion thereon, it is significant that the sales price realized on the sale of the Big Bear parcel which fronts on the less-traveled 17th Street. Nothing in the evidence warrants a conclusion that the value of the 16th Street property increased so markedly from 1955 to 1958 that such a percentage difference is explained thereby. Yet, respondent valued the Big Bear and Paisley parcels almost equally.

The opinion of the experts did not differ greatly with respect to the relative value of the Big Bear parcel. Taking into account its frontage on 17th Street as well as its accessibility by reason of easements across the remainder of the tract, we have determined that the Big Bear parcel had a basis of 30 percent of the cost of the entire tract. Respondent has argued that since the witnesses called by petitioner did not specifically testify with respect to allocation as of 1955, their testimony should be wholly disregarded. Petitioner contends, however, that there was little or no change in the relative values of the parcels between 1955 and 1959. Such a posture of the facts is consistent with respondent’s own position, for his valuation as of 1955 reflects relative values which very closely parallel the relative values disclosed by the county assessor’s records as of 1959, upon which respondent places some emphasis. Thus, we are satisfied that the relative values of the properties remained fairly constant over the period in question and that the testimony of the expert witnesses called by petitioner is not to be disregarded.

What we have said thus far resolves the allocation issue only in connection with those costs incurred as part of the purchase price or clearly measurable thereby. Such costs total $110,941.12. There remains $29,584.64, consisting of grading and leveling expenses, engineering costs, and other related amounts incurred after purchase of the property. Petitioner has introduced no evidence to demonstrate that these costs may be apportioned or allocated to the Big Bear and Paisley tracts in any proportions other than those originally determined by respondent. Moreover, since these costs appear to have been incurred principally to fill and grade the excavation in the center parcel, allocation of some 41 percent thereof to that portion of the tract does not seem excessive. Accordingly, respondent’s determinations with respect to allocation of these costs, to wit, 27.567 percent to the Big Bear parcel and 30.942 percent to the Paisley parcel, are sustained.

The remaining question involves the $50,000 placed in escrow in 1957 upon sale of the Big Bear parcel. The parties now agree that the amount in question is $40,146.32, the actual cost to petitioner for paving and lighting the center tract. While it has been held that improvements made to specific parcels or contracted for with respect to specific parcels may be added to the basis thereof, Milton A. Mackay, 11 B.T.A. 569; Cambria Development Co., 34 B.T.A. 1155, and that costs of improvements to a subdivision as a whole may be allocated among the parcels thereof, Biscayne Bay Islands Co., supra, improvements to property retained by the
petitioner which may be sold at a later date may not be added to basis of another parcel in the tract. Colony, Inc., 27 T.C. 30, affd., 244 F.2d 75 (C.A. 6, 1957), reversed on other grounds 357 U.S. 28. Cf. Biscayne Bay Islands Co., supra. Cf. also Estate of M. A. Collins, 31 T.C. 238. Accordingly, since it is uncontested that the $40,146.32 was spent entirely on improvements placed on the center or retained parcel of the tract, no portion of that amount may be allocated to the basis of the Big Bear tract alone or to the Big Bear and Paisley parcels.

The matter of a net operating loss carryover from 1957 to 1958 depends upon the disposition of the above issues.

Decision will be entered under Rule 50.
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 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

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.
In 1972 petitioners Victor and Frances Diedrich made gifts of approximately 85,000 shares of stock to their three children, using both a direct transfer and a trust arrangement. The gifts were subject to a condition that the donees pay the resulting federal and state gift taxes. There is no dispute concerning the amount of the gift tax paid by the donees. The donors’ basis in the transferred stock was $51,073; the gift tax paid in 1972 by the donees was $62,992. Petitioners did not include as income on their 1972 federal income tax returns any portion of the gift tax paid by the donees. . . .

The Court of Appeals rejected the Tax Court’s conclusion that the taxpayers merely had made a “net gift” of the difference between the fair market value of the transferred property and the gift taxes paid by the donees. The court reasoned that a donor receives a benefit when a donee discharges a donor’s legal obligation to pay gift taxes. The Court of Appeals agreed with the Commissioner in rejecting the holding in Turner v. Commissioner, 49 T.C. 356 (1968), aff’d per curiam, 410 F.2d 752 (CA6 1969), and its progeny, and adopted the approach of Johnson v. Commissioner, 59 T.C. 791 (1973), aff’d, 495 F.2d 1079 (CA6), cert. denied, 419 U.S. 1040, 95 S.Ct. 527, 42 L.Ed.2d 317 (1974), and Estate of Levine v. Commissioner, 72 T.C. 780 (1979), aff’d, 634 F.2d 12 (CA2 1980). We granted certiorari to resolve this conflict, 454 U.S. 813, 102 S.Ct. 89, 70 L.Ed.2d 82 (1981), and we affirm. . . .

Pursuant to its constitutional authority, Congress has defined “gross income” as income “from whatever source derived,” including “[t]he income from discharge of indebtedness.” 26 U.S.C. § 61(12). This Court has recognized that “income” may be realized by a variety of indirect means. In Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918 (1929), the Court held that payment of an employee’s income taxes by an employer constituted income to the employee. Speaking for the Court, Chief Justice Taft concluded that “[t]he payment of the tax by the employer was in consideration of the services rendered by the employee and was a gain derived by the employee from his labor.” Id., at 729, 49 S.Ct. at 504. The Court made clear that the substance, not the form, of the agreed transaction controls. “The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed.” Ibid. The employee, in other words, was placed in a better position as a result of the employer’s discharge of the employee’s legal obligation to pay the income taxes; the employee thus received a gain subject to income tax.

The holding in Old Colony was reaffirmed in Crane v. Commissioner, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947). In Crane the Court concluded that relief from the obligation of a nonrecourse mortgage in which the value of the property exceeded the value of the mortgage constituted income to the taxpayer. The taxpayer in Crane acquired depreciable property, an apartment building, subject to an unassumed mortgage. The taxpayer later sold the apartment building, which was still subject to the nonrecourse mortgage, for cash plus the buyer’s assumption of the mortgage. This Court held that the amount of the mortgage was properly included in the amount realized on the sale, noting that if the taxpayer transfers subject to the mortgage, “the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been
assumed by another.” Id., at 14. Again, it was the “reality,” not the form, of the transaction that governed. Ibid. The Court found it immaterial whether the seller received money prior to the sale in order to discharge the mortgage, or whether the seller merely transferred the property subject to the mortgage. In either case the taxpayer realized an economic benefit.

The principles of Old Colony and Crane control.5 A common method of structuring gift transactions is for the donor to make the gift subject to the condition that the donee pay the resulting gift tax, as was done in each of the cases now before us. When a gift is made, the gift tax liability falls on the donor under 26 U.S.C. § 2502(d).6 When a donor makes a gift to a donee, a “debt” to the United States for the amount of the gift tax is incurred by the donor. Those taxes are as much the legal obligation of the donor as the donor’s income taxes; for these purposes they are the same kind of debt obligation as the income taxes of the employee in Old Colony, supra. Similarly, when a donee agrees to discharge an indebtedness in consideration of the gift, the person relieved of the tax liability realizes an economic benefit. In short, the donor realizes an immediate economic benefit by the donee’s assumption of the donor’s legal obligation to pay the gift tax.

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

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

We recognize that Congress has structured gift transactions to encourage transfer of property by limiting the tax consequences of a transfer. See, e.g., 26 U.S.C. § 102 (gifts excluded from donee’s gross income). Congress may obviously provide a similar exclusion for the conditional gift. Should Congress wish to encourage “net gifts,” changes in the income tax consequences of such gifts lie within the legislative responsibility. Until such time, we are bound by Congress’ mandate that gross income includes income “from whatever source derived.” We therefore hold that a donor who makes a gift of property on condition that the donee pay the resulting gift taxes realizes taxable income to the extent that the gift taxes paid by the donee exceed the donor’s adjusted basis in the property.10

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

Petitioners argue that even if this Court holds that a donor realizes income on a conditional gift to the extent that the gift tax exceeds the adjusted basis, that holding should be applied prospectively and should not apply to the taxpayers in this case. In this case, however, there was no dispositive Eighth Circuit holding prior to the decision on review. In addition, this Court frequently has applied decisions which have altered the tax law and applied the clarified law to the facts of the case before it.
Justice REHNQUIST, dissenting.

It is a well-settled principle today that a taxpayer realizes income when another person relieves the taxpayer of a legal obligation in connection with an otherwise taxable transaction. See *Crane v. Commissioner*, 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947) (sale of real property); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918 (1929) (employment compensation). In neither *Old Colony* nor *Crane* was there any question as to the existence of a taxable transaction; . . . .

Unlike *Old Colony* or *Crane*, the question in this case is not the amount of income the taxpayer has realized as a result of a concededly taxable transaction, but whether a taxable transaction has taken place at all. Only after one concludes that a partial sale occurs when the donee agrees to pay the gift tax do *Old Colony* and *Crane* become relevant in ascertaining the amount of income realized by the donor as a result of the transaction. Nowhere does the Court explain why a gift becomes a partial sale merely because the donor and donee structure the gift so that the gift tax imposed by Congress on the transaction is paid by the donee rather than the donor.

In my view, the resolution of this case turns upon congressional intent: whether Congress intended to characterize a gift as a partial sale whenever the donee agrees to pay the gift tax. Congress has determined that a gift should not be considered income to the donee. 26 U.S.C. § 102. Instead, gift transactions are to be subject to a tax system wholly separate and distinct from the income tax. See 26 U.S.C. § 2501 et seq. Both the donor and the donee may be held liable for the gift tax. §§ 2502(d), 6324(b). Although the primary liability for the gift tax is on the donor, the donee is liable to the extent of the value of the gift should the donor fail to pay the tax. I see no evidence in the tax statutes that Congress forbade the parties to agree among themselves as to who would pay the gift tax upon pain of such an agreement being considered a taxable event for the purposes of the income tax. Although Congress could certainly determine that the payment of the gift tax by the donee constitutes income to the donor, the relevant statutes do not affirmatively indicate that Congress has made such a determination.

I dissent.
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
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!
Helvering v. Bruun
309 U.S. 461

Mr. Justice ROBERTS delivered the opinion of the Court.

The controversy had its origin in the petitioner’s assertion that the respondent realized taxable gain from the forfeiture of a leasehold, the tenant having erected a new building upon the premises. The court below held that no income had been realized. Inconsistency of the decisions on the subject led us to grant certiorari.

The Board of Tax Appeals made no independent findings. The cause was submitted upon a stipulation of facts. From this it appears that on July 1, 1915, the respondent, as owner, leased a lot of land and the building thereon for a term of ninety-nine years.

The lease provided that the lessee might, at any time, upon giving bond to secure rentals accruing in the two ensuing years, remove or tear down any building on the land, provided that no building should be removed or torn down after the lease became forfeited, or during the last three and one-half years of the term. The lessee was to surrender the land, upon termination of the lease, with all buildings and improvements thereon.

In 1929 the tenant demolished and removed the existing building and constructed a new one which had a useful life of not more than fifty years. July 1, 1933, the lease was cancelled for default in payment of rent and taxes and the respondent regained possession of the land and building.

The parties stipulated ‘that as at said date, July 1, 1933, the building which had been erected upon said premises by the lessee had a fair market value of $64,245.68 and that the

unamortized cost of the old building, which was removed from the premises in 1929 to make way for the new building, was $12,811.43, thus leaving a net fair market value as at July 1, 1933, of $51,434.25, for the aforesaid new building erected upon the premises by the lessee.’

On the basis of these facts, the petitioner determined that in 1933 the respondent realized a net gain of $51,434.25. The Board overruled his determination and the Circuit Court of Appeals affirmed the Board’s decision.

The course of administrative practice and judicial decision in respect of the question presented has not been uniform. In 1917 the Treasury ruled that the adjusted value of improvements installed upon leased premises is income to the lessor upon the termination of the lease.\(^2\) The ruling was incorporated in two succeeding editions of the Treasury Regulations.\(^3\) In 1919 the Circuit Court of Appeals for the Ninth Circuit held in Miller v. Gearin, 258 F. 225, that the regulation was invalid as the gain, if taxable at all, must be taxed as of the year when the improvements were completed.

The regulations were accordingly amended to impose a tax upon the gain in the year of completion of the improvements, measured by their anticipated value at the termination of the lease and discounted for the duration of the lease. Subsequently the regulations permitted the lessor to spread the depreciated value of the improvements over the remaining life of the lease, reporting an aliquot part each year, with
provision that, upon premature termination, a tax should be imposed upon the excess of the then value of the improvements over the amount theretofore returned.

In 1935 the Circuit Court of Appeals for the Second Circuit decided in Hewitt Realty Co. v. Commissioner, 76 F.2d 880, 98 A.L.R. 1201, that a landlord received no taxable income in a year, during the term of the lease, in which his tenant erected a building on the leased land. The court, while recognizing that the lessor need not receive money to be taxable, based its decision that no taxable gain was realized in that case on the fact that the improvement was not portable or detachable from the land, and if removed would be worthless except as bricks, iron, and mortar. It said, 76 F.2d at page 884: ‘The question as we view it is whether the value received is embodied in something separately disposable, or whether it is so merged in the land as to become financially a part of it, something which, though it increases its value, has no value of its own when torn away.’

This decision invalidated the regulations then in force.

In 1938 this court decided M. E. Blatt Co. v. United States, 305 U.S. 267, 59 S.Ct. 186, 83 L.Ed. 167. There, in connection with the execution of a lease, landlord and tenant mutually agreed that each should make certain improvements to the demised premises and that those made by the tenant should become and remain the property of the landlord. The Commissioner valued the improvements as of the date they were made, allowed depreciation thereon to the termination of the leasehold, divided the depreciated value by the number of years the lease had to run, and found the landlord taxable for each year’s aliquot portion thereof. His action was sustained by the Court of Claims. The judgment was reversed on the ground that the added value could not be considered rental accruing over the period of the lease; that the facts found by the Court of Claims did not support the conclusion of the Commissioner as to the value to be attributed to the improvements after a use throughout the term of the lease; and that, in the circumstances disclosed, any enhancement in the value of the realty in the tax year was not income realized by the lessor within the Revenue Act.

The circumstances of the instant case differentiate it from the Blatt and Hewitt cases; but the petitioner’s contention that gain was realized when the respondent, through forfeiture of the lease, obtained untrammeled title, possession and control of the premises, with the added increment of value added by the new building, runs counter to the decision in the Miller case and to the reasoning in the Hewitt case.

The respondent insists that the realty, a capital asset at the date of the execution of the lease, remained such throughout the term and after its expiration; that improvements affixed to the soil became part of the realty indistinguishably blended in the capital asset; that such improvements cannot be separately valued or treated as received in exchange for the improvements which were on the land at the date of the execution of the lease; that they are, therefore, in the same category as improvements added by the respondent to his land, or accruals of value due to extraneous and adventitious circumstances. Such added value, it is argued, can be considered capital gain only upon the owner’s disposition of the asset. The position is that the economic gain consequent upon the enhanced value of the recaptured asset is not gain derived from capital or realized within the meaning of the Sixteenth Amendment and may not, therefore, be taxed without apportionment.

We hold that the petitioner was right in assessing the gain as realized in 1933.
We might rest our decision upon the narrow issue presented by the terms of the stipulation. It does not appear what kind of a building was erected by the tenant or whether the building was readily removable from the land. It is not stated whether the difference in the value between the building removed and that erected in its place accurately reflects an increase in the value of land and building considered as a single estate in land. On the facts stipulated, without more, we should not be warranted in holding that the presumption of the correctness of the Commissioner’s determination has been overborne.

The respondent insists, however, that the stipulation was intended to assert that the sum of $51,434.25 was the measure of the resulting enhancement in value of the real estate at the date of the cancellation of the lease. The petitioner seems not to contest this view. Even upon this assumption we think that gain in the amount named was realized by the respondent in the year of repossession.

The respondent can not successfully contend that the definition of gross income in Sec. 22(a) of the Revenue Act of 1932 is not broad enough to embrace the gain in question. That definition follows closely the Sixteenth Amendment. Essentially the respondent’s position is that the Amendment does not permit the taxation of such gain without apportionment amongst the states. He relies upon what was said in Hewitt Realty Co. v. Commissioner, supra, and upon expressions found in the decisions of this court dealing with the taxability of stock dividends to the effect that gain derived from capital must be something of exchangeable value proceeding from property, severed from the capital, however invested or employed, and received by the recipient for his separate use, benefit, and disposal. He emphasizes the necessity that the gain be separate from the capital and separately disposable. These expressions, however, were used to clarify the distinction between an ordinary dividend and a stock dividend. They were meant to show that in the case of a stock dividend, the stockholder’s interest in the corporate assets after receipt of the dividend was the same as and inseverable from that which he owned before the dividend was declared. We think they are not controlling here.

While it is true that economic gain is not always taxable as income, it is settled that the realization of gain need not be in cash derived from the sale of an asset. Gain may occur as a result of exchange of property, payment of the taxpayer’s indebtedness, relief from a liability, or other profit realized from the completion of a transaction. The fact that the gain is a portion of the value of property received by the taxpayer in the transaction does not negative its realization.

Here, as a result of a business transaction, the respondent received back his land with a new building on it, which added an ascertainable amount to its value. It is not necessary to recognition of taxable gain that he should be able to sever the improvement begetting the gain from his original capital. If that were necessary, no income could arise from the exchange of property; whereas such gain has always been recognized as realized taxable gain.

Judgment reversed.

The CHIEF JUSTICE concurs in the result in view of the terms of the stipulation of facts. Mr. Justice McREYNOLDS took no part in the decision of this case.

Crane v. Commissioner
331 U.S. 1 (1947)

Mr. Chief Justice VINSON delivered the opinion of the Court. The question here is how a taxpayer who acquires depreciable property subject to an unassumed mortgage, holds it for a period, and finally sells it still so encumbered, must compute her taxable gain.

Petitioner was the sole beneficiary and the executrix of the will of her husband, who died January 11, 1932. He then owned an apartment building and lot subject to a mortgage, which secured a principal debt of $255,000.00 and interest in default of $7,042.50. As of that date, the property was appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. Shortly after her husband’s death, petitioner entered into an agreement with the mortgagee whereby she was to continue to operate the property—collecting the rents, paying for necessary repairs, labor, and other operating expenses, and reserving $200.00 monthly for taxes—and was to remit the net rentals to the mortgagee. This plan was followed for nearly seven years, during which period petitioner reported the gross rentals as income, and claimed and was allowed deductions for taxes and operating expenses paid on the property, for interest paid on the mortgage, and for the physical exhaustion of the building. Meanwhile, the arrearage of interest increased to $15,857.71. On November 29, 1938, with the mortgagee threatening foreclosure, petitioner sold to a third party for $3,000.00 cash, subject to the mortgage, and paid $500.00 expenses of sale.

Petitioner reported a taxable gain of $1,250.00. Her theory was that the ‘property’ which she had acquired in 1932 and sold in 1938 was only the equity, or the excess in the value of the apartment building and lot over the amount of the mortgage. This equity was of zero value when she acquired it. No depreciation could be taken on a zero value. Neither she nor her vendee ever assumed the mortgage, so, when she sold the equity, the amount she realized on the sale was the net cash received, or $2,500.00. This sum less the zero basis constituted her gain, of which she reported half as taxable on the assumption that the entire property was a ‘capital asset’.

The Commissioner, however, determined that petitioner realized a net taxable gain of $23,767.03. His theory was that the ‘property’ acquired and sold was not the equity, as petitioner claimed, but rather the physical property itself, or the owner’s rights to possess, use, and dispose of it, undiminished by the mortgage. The original basis thereof was $262,042.50, its appraised value in 1932. Of this value $55,000.00 was allocable to land and $207,042.50 to building. During the period that petitioner held the property, there was an allowable depreciation of $28,045.10 on the building, so that the adjusted basis of the building at the time of sale was $178,997.40. The amount realized on the sale was said to include not only the $2,500.00 net cash receipts, but also the principal amount of the mortgage subject to which the property was sold, both totaling $257,500.00. The selling price was allocable in the proportion, $54,471.15 to the land and $203,028.85 to the building. The Commissioner agreed that the land was a ‘capital asset’, but thought that the building was not. Thus, he determined that petitioner sustained a capital loss of $528.85 on the land, of which 50% or $264.42 was taken into account, and an ordinary gain of $24,031.45 on the building, or a net taxable gain as indicated.

The Tax Court agreed with the Commissioner that the building was not a ‘capital asset.’ In all other respects it adopted petitioner’s contentions, and expunged the deficiency. Petitioner did not appeal from the part of the ruling adverse to her, and these questions are no longer at issue. On the Commissioner’s appeal, the Circuit Court of Appeals reversed, one judge dissenting. We granted certiorari because of the importance of the questions raised as to the proper construction of the gain and loss provisions of the Internal Revenue Code.

The 1938 Act, §111(a), defines the gain from ‘the sale or other disposition of property’ as ‘the excess of the amount realized therefrom over the adjusted basis provided in section 113(b) . . .’ It proceeds, §111(b), to define ‘the amount realized from the sale or other disposition of property’ as ‘the sum of any money received plus the fair market value of the property (other than money) received.’ Further, in §113(b), the ‘adjusted basis for determining the gain or loss from the sale or other disposition of property’ is declared to be the basis determined under subsection (a), adjusted . . . ((1)(B)) . . . for exhaustion, wear and tear, obsolescence, amortization . . . to the extent allowed (but not less than the amount allowable) * * *.’ The basis under subsection (a) ‘if the property was acquired by . . . devise. . . or by the decedent’s estate from the decedent’, §113(a)(5), is ‘the fair market value of such property at the time of such acquisition.’

Logically, the first step under this scheme is to determine the unadjusted basis of the property, under §111(a)(5), and the dispute in this case is as to the construction to be given the term ‘property’. If ‘property’, as used in that provision, means the same thing as ‘equity’, it would necessarily follow that the basis of petitioner’s property was zero, as she contends. If, on the contrary, it means the land and
building themselves, or the owner’s legal rights in them, undiminished by the mortgage, the basis was $262,042.50.

We think that the reasons for favoring one of the latter constructions are of overwhelming weight. In the first place, the words of statutes—including revenue acts—should be interpreted where possible in their ordinary, everyday senses. The only relevant definitions of ‘property’ to be found in the principal standard dictionaries are the two favored by the Commissioner, i.e., either that ‘property’ is the physical thing which is a subject of ownership, or that it is the aggregate of the owner’s rights to control and dispose of that thing. ‘Equity’ is not given as a synonym, nor do either of the foregoing definitions suggest that it could be correctly so used. Indeed, ‘equity’ is defined as ‘the value of a property . . . above the total of the liens. . . .’ The contradistinction could hardly be more pointed. Strong countervailing considerations would be required to support a contention that Congress, in using the word ‘property’, meant ‘equity’, or that we should impute to it the intent to convey that meaning.

In the second place, the Commission’s position has the approval of the administrative construction of §113(a)(5). With respect to the valuation of property under that section, Reg. 101, Art. 113(a)(5)—1, promulgated under the 1938 Act, provided that ‘the value of property as of the date of the death of the decedent as appraised for the purpose of the federal estate tax . . . shall be deemed to be its fair market value. . . .’ The land and building here involved were so appraised in 1932, and their appraised value—$262,042.50—was reported by petitioner as part of the gross estate. This was in accordance with the estate tax law and regulations, which had always required that the value of decedent’s property, undiminished by liens, be so appraised and returned, and that mortgages be separately deducted in computing the net estate. As the quoted provision of the Regulations has been in effect since 1918, and as the relevant statutory provision has been repeatedly reenacted since then in substantially the same form, the former may itself now be considered to have the force of law.

Moreover, in the many instances in other parts of the Act in which Congress has used the word ‘property’, or expressed the idea of ‘property’ or ‘equity’, we find no instances of a misuse of either word or of a confusion of the ideas. In some parts of the Act other than the gain and loss sections, we find ‘property’ where it is unmistakably used in its ordinary sense. On the other hand, where either Congress or the Treasury intended to convey the meaning of ‘equity,’ it did so by the use of appropriate language.

A further reason why the word ‘property’ in §113(a) should not be construed to mean ‘equity’ is the bearing such construction would have on the allowance of deductions for depreciation and on the collateral adjustments of basis.

Section 23(l) permits deduction from gross income of ‘a reasonable allowance for the exhaustion, wear and tear of property . . .’. Sections 23(n) and 114(a) declare that the ‘basis upon which depletion exhaustion, wear and tear . . . are to be allowed’ is the basis ‘provided in section 113(b) for the purpose of determining the gain upon the sale’ of the property, which is the §113(a) basis ‘adjusted . . . for exhaustion, wear and tear . . . to the extent allowed (but not less than the amount allowable) . . .’

Under these provisions, if the mortgagor’s equity were the §113(a) basis, it would also be the original basis from which depreciation allowances are deducted. If it is, and if the amount of the annual allowances were to be computed on that value, as would then seem to be required,26 they will represent only a fraction of the cost of the corresponding physical exhaustion, and any recoupment by the mortgagor of the remainder of that cost can be effected only by the reduction of his taxable gain in the year of sale. If, however, the amount of the annual allowances were to be computed on the value of the property, and then deducted from an equity basis, we would in some instances have to accept deductions from a minus basis or deny deductions altogether. The Commissioner also argues that taking the mortgagor’s equity as the §113(a) basis would require the basis to be changed with each payment on the mortgage, and that the attendant problem of repeatedly recomputing basis and annual allowances would be a tremendous accounting burden on both the Commissioner and the taxpayer. Moreover, the mortgagor would acquire control over the timing of his depreciation allowances.

Thus it appears that the applicable provisions of the Act expressly preclude an equity basis, and the use of it is contrary to certain implicit principles of income tax depreciation, and entails very great administrative difficulties.26 It may be added that the Treasury has never furnished a guide through the maze of problems that arise in connection with depreciating an equity basis, but, on the contrary, has consistently permitted the amount of depreciation allowances to be computed on the full value of the property, and subtracted from it as a basis. Surely, Congress’ long-continued acceptance of this situation gives it full legislative endorsement.

We conclude that the proper basis under §113(a)(5) is the value of the property, undiminished by mortgages thereon, and that the correct basis here was $262,042.50. The next step is to ascertain what adjustments are required under §113(b). As the depreciation rate was stipulated, the only question at this point is whether the Commissioner was warranted in making any depreciation adjustments whatsoever.
Section 113(b)(1)(B) provides that ‘proper adjustment in respect of the property shall in all cases be made . . . for exhaustion, wear and tear . . . to the extent allowed (but not less than the amount allowable . . . . ’ The Tax Court found on adequate evidence that the apartment house was property of a kind subject to physical exhaustion, that it was used in taxpayer’s trade or business, and consequently that the taxpayer would have been entitled to a depreciation allowance under § 23(l), except that, in the opinion of that Court, the basis of the property was zero, and it was thought that depreciation could not be taken on a zero basis. As we have just decided that the correct basis of the property was not zero, but $262,042.50, we avoid this difficulty, and conclude that an adjustment should be made as the Commissioner determined.

Petitioner urges to the contrary that she was not entitled to depreciation deductions, whatever the basis of the property, because the law allows them only to one who actually bears the capital loss, and here the loss was not hers but the mortgagee’s. We do not see, however, that she has established her factual premise. There was no finding of the Tax Court to that effect, nor to the effect that the value of the property was ever less than the amount of the lien. Nor was there evidence in the record, or any indication that petitioner could produce evidence, that this was so. The facts that the value of the property was only equal to the lien in 1932 and that during the next six and one-half years the physical condition of the building deteriorated and the amount of the lien increased, are entirely inconclusive, particularly in the light of the buyer’s willingness in 1938 to take subject to the increased lien and pay a substantial amount of cash to boot. Whatever may be the rule as to allowing depreciation to a mortgagor on property in his possession which is subject to an unassumed mortgage and clearly worth less than the lien, we are not faced with that problem and see no reason to decide it now.

At last we come to the problem of determining the ‘amount realized’ on the 1938 sale. Section 111(b), it will be recalled, defines the ‘amount realized’ from ‘the sale . . . of property’ as ‘the sum of any money received plus the fair market value of the property (other than money) received,’ and §111(a) defines the gain on ‘the sale . . . of property’ as the excess of the amount realized over the basis. Quite obviously, the word ‘property’, used here with reference to a sale, must mean ‘property’ in the same ordinary sense intended by the use of the word with reference to acquisition and depreciation in §113, both for certain of the reasons stated heretofore in discussing its meaning in §113, and also because the functional relation of the two sections requires that the word mean the same in one section that it does in the other. If the ‘property’ to be valued on the date of acquisition is the property free of liens, the ‘property’ to be priced on a subsequent sale must be the same thing.

Starting from this point, we could not accept petitioner’s contention that the $2,500.00 net cash was all she realized on the sale except on the absurdity that she sold a quarter-of-a-million dollar property for roughly one per cent of its value, and took a 99 per cent loss. Actually, petitioner does not urge this. She argues, conversely, that because only $2,500.00 was realized on the sale, the ‘property’ sold must have been the equity only, and that consequently we are forced to accept her contention as to the meaning of ‘property’ in §113. We adhere, however, to what we have already said on the meaning of ‘property’, and we find that the absurdity is avoided by our conclusion that the amount of the mortgage is properly included in the ‘amount realized’ on the sale.

Petitioner concedes that if she had been personally liable on the mortgage and the purchaser had either paid or assumed it, the amount so paid or assumed would be considered a part of the ‘amount realized’ within the meaning of §111(b). The cases so deciding have already repudiated the notion that there must be an actual receipt by the seller himself of ‘money’ or ‘other property’, in their narrowest senses. It was thought to be decisive that one section of the Act must be construed so as not to defeat the intention of another or to frustrate the Act as a whole,35 and that the taxpayer was the ‘beneficiary’ of the payment in ‘as real and substantial (a sense) as if the money had been paid it and then paid over by it to its creditors.’

Both these points apply to this case. The first has been mentioned already. As for the second, we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.37 If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.

Therefore we conclude that the Commissioner was right in determining that petitioner realized $257,500.00 on the
sale of this property.

The Tax Court’s contrary determinations, that ‘property’, as used in §113(a) and related sections, means ‘equity’, and that the amount of a mortgage subject to which property is sold is not the measure of a benefit realized, within the meaning of §111(b), announced rules of general applicability on clear-cut questions of law. The Circuit Court of Appeals therefore had jurisdiction to review them.

Petitioner contends that the result we have reached taxes her on what is not income within the meaning of the Sixteenth Amendment. If this is because only the direct receipt of cash is thought to be income in the constitutional sense, her contention is wholly without merit. If it is because the entire transaction is thought to have been ‘by all dictates of common-sense . . . a ruinous disaster’, as it was termed in her brief, we disagree with her premise. She was entitled to depreciation deductions for a period of nearly seven years, and she actually took them in almost the allowable amount. The crux of this case, really, is whether the law permits her to exclude allowable deductions from consideration in computing gain. We have already showed that, if it does, the taxpayer can enjoy a double deduction, in effect, on the same loss of assets. The Sixteenth Amendment does not require that result any more than does the Act itself.

Affirmed.

37 Obviously, if the value of the property is less than the amount of the mortgage, a mortgagor who is not personally liable cannot realize a benefit equal to the mortgage. Consequently, a different problem might be encountered where a mortgagor abandoned the property or transferred it subject to the mortgage without receiving boot. That is not this case.

Mr. Justice JACKSON, dissenting.

The Tax Court concluded that this taxpayer acquired only an equity worth nothing. The mortgage was in default, the mortgage debt was equal to the value of the property, and possession by the taxpayer was forfeited and terminable immediately by foreclosure, and perhaps by a receiver pendente lite. Arguments can be advanced to support the theory that the taxpayer received the whole property and thereupon came to owe the whole debt. Likewise it is argued that when she sold she transferred the entire value of the property and received release from the whole debt. But we think these arguments are not so conclusive that it was not within the province of the Tax Court to find that she received an equity which at that time had a zero value. Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248; Commissioner v. Scottish American Investment Co., Ltd., 323 U.S. 119, 65 S.Ct. 169, 89 L.Ed. 113. The taxpayer never became personally liable for the debt, and hence when she sold she was released from no debt. The mortgage debt was simply a subtraction from the value of what she did receive, and from what she sold. The subtraction left her nothing when she acquired it and a small margin when she sold it. She acquired a property right equivalent to an equity of redemption and sold the same thing. It was the ‘property’ bought and sold as the Tax Court considered it to be under the Revenue Laws. We are not required in this case to decide whether depreciation was properly taken, for there is no issue about it here.

We would reverse the Court of Appeals and sustain the decision of the Tax Court.

Mr. Justice FRANKFURTER and Mr. Justice DOUGLAS join in this opinion.
FACTS
In 1988, individual A borrowed $1,000,000 from C and signed a note payable to C for $1,000,000 that bore interest at a fixed market rate payable annually. A had no personal liability with respect to the note, which was secured by an office building valued at $1,000,000 that A acquired from B with the proceeds of the nonrecourse financing. In 1989, when the value of the office building was $800,000 and the outstanding principal on the note was $1,000,000, C agreed to modify the terms of the note by reducing the note’s principal amount to $800,000. The modified note bore adequate stated interest within the meaning of section 1274(c)(2).

The facts here do not involve the bankruptcy, insolvency, or qualified farm indebtedness of the taxpayer. Thus, the specific exclusions provided by section 108(a) do not apply.

LAW AND ANALYSIS
Section 61(a)(12) of the Code provides that gross income includes income from the discharge of indebtedness. Section 1.61-12(a) of the Income Tax Regulations provides that the discharge of indebtedness, in whole or in part, may result in the realization of income.

In Rev. Rul. 82-202, 1982-2 C.B. 35, a taxpayer prepaid the mortgage held by a third party lender on the taxpayer’s residence for less than the principal balance of the mortgage. At the time of the prepayment, the fair market value of the residence was greater than the principal balance of the mortgage. The revenue ruling holds that the taxpayer realizes discharge of indebtedness income under section 61(a)(12) of the Code, whether the mortgage is recourse or nonrecourse and whether it is partially or fully prepaid. Rev. Rul. 82-202 relies on United States v. Kirby Lumber Co., 284 U.S. 1 (1931), X-2 C.B. 356 (1931), in which the United States Supreme Court held that a taxpayer realized ordinary income upon the purchase of its own bonds in an arm’s length transaction at less than their face amount.

In Commissioner v. Tufts, 461 U.S. 300 (1983), 1983-1 C.B. 120, the Supreme Court held that when a taxpayer sold property encumbered by a nonrecourse obligation that exceeded the fair market value of the property sold, the amount realized included the amount of the obligation discharged. The Court reasoned that because a nonrecourse note is treated as a true debt upon inception (so that the loan proceeds are not taken into income at that time), a taxpayer is bound to treat the nonrecourse note as a true debt when the taxpayer is discharged from the liability upon disposition of the collateral, notwithstanding the lesser fair market value of the collateral. See section 1.1001-2(c), Example 7, of the Income Tax Regulations.

In Gershkowitz v. Commissioner, 88 T.C. 984 (1987), the Tax Court, in a reviewed opinion, concluded, in part, that the settlement of a nonrecourse debt of $250,000 for a $40,000 cash payment (rather than surrender of the $2,500 collateral) resulted in $210,000 of discharge of indebtedness income. The court, following the Tufts holding that income results when a taxpayer is discharged from liability for an undersecured nonrecourse obligation upon the disposition of the collateral, held that the discharge from a portion of the liability for an undersecured nonrecourse obligation through a cash settlement must also result in income.

The Service will follow the holding in Gershkowitz where a taxpayer is discharged from all or a portion of a nonrecourse liability when there is no disposition of the collateral. Thus, in the present case, A realizes $200,000 of discharge of indebtedness income in 1989 as a result of the modification of A’s note payable to C.

In an earlier Board of Tax Appeals decision, Fulton Gold Corp. v. Commissioner, 31 B.T.A. 519 (1934), a taxpayer purchased property without assuming an outstanding mortgage and subsequently satisfied the mortgage for less than its face amount. In a decision based on unclear facts, the Board of Tax Appeals, for purposes of determining the taxpayer’s gain or loss upon the sale of the property in a later year, held that the taxpayer’s basis in the property...
should have been reduced by the amount of the mortgage debt forgiven in the earlier year.

The Tufts and Gershkowitz decisions implicitly reject any interpretation of Fulton Gold that a reduction in the amount of a nonrecourse liability by the holder of the debt who was not the seller of the property securing the liability results in a reduction of the basis in that property, rather than discharge of indebtedness income for the year of the reduction. Fulton Gold, interpreted in this manner, is inconsistent with Tufts and Gershkowitz. Therefore, that interpretation is rejected and will not be followed.

HOLDING
The reduction of the principal amount of an under-secured nonrecourse debt by the holder of a debt who was not the seller of the property securing the debt results in the realization of discharge of indebtedness income under section 61(a)(12) of the Code.
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.
Estate of Levine v. Commissioner  
634 F.2d 12 (1980)

FRIENDLY, Circuit Judge:

The estate of Aaron Levine and his widow Anna appeal from a part of a decision of the Tax Court, 72 T.C. No. 68 (1979), which found a deficiency of $130,428.42 in Aaron Levine’s 1970 income tax. The deficiency resulted from a determination by the Commissioner that the taxpayer had realized gain upon his gift, on January 1, 1970, of income producing property consisting of land and a building at 20-24 Vesey Street in New York City (the property) to a previously created trust for the benefit of three grandchildren.

The property was originally purchased on November 1, 1944, by a corporation wholly owned by Levine. On August 22, 1957, the corporation, which was in the course of dissolution, made a liquidating distribution of the property to the taxpayer. Thereafter Levine obtained two non-recourse mortgages secured by the property. One of these, for $500,000, was obtained on March 17, 1966, from the Bowery Savings Bank and represented the consolidation of numerous earlier mortgages. The other, for $300,000, was obtained from the Commercial Trading Company on November 21, 1968; this was later amortized to $280,000.

Levine filed a gift tax return for 1970 reporting the transaction as follows:

20-24 Vesey Street, City, County and State of New York--

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Appraisal value</td>
<td>$925,000.00</td>
</tr>
<tr>
<td>Mortgages</td>
<td></td>
</tr>
<tr>
<td>Bowery Savings Bank</td>
<td>$500,000.00</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>2,291.67</td>
</tr>
<tr>
<td>Commercial Trading *</td>
<td>280,000.00</td>
</tr>
<tr>
<td>Interest accrued</td>
<td>3,616.67</td>
</tr>
<tr>
<td></td>
<td>$785,908.34</td>
</tr>
<tr>
<td>Expenses incurred by donor in 1969 and assumed and paid by donee:</td>
<td></td>
</tr>
<tr>
<td>Improvements</td>
<td>$117,716.53</td>
</tr>
<tr>
<td>Supplies</td>
<td>387.83</td>
</tr>
<tr>
<td>Repairs</td>
<td>1,253.93</td>
</tr>
<tr>
<td>Paint</td>
<td>63.60</td>
</tr>
<tr>
<td>Electricity</td>
<td>1,827.56</td>
</tr>
<tr>
<td>Steam</td>
<td>3,324.13</td>
</tr>
<tr>
<td>Total expenses</td>
<td>124,573.58</td>
</tr>
<tr>
<td>Total mortgages, interest and expenses</td>
<td>910,481.92</td>
</tr>
<tr>
<td>Equity</td>
<td>$ 14,518.08</td>
</tr>
</tbody>
</table>

* Between November 1968 and January 1970, $20,000 of the $300,000 principal was amortized.
and paid a gift tax on the equity of $14,518.08. The propriety of this was not challenged. However, the Commissioner assessed a deficiency in income tax on the ground that Levine had realized a gain in the amount of the excess of the total mortgages, interest and expenses aggregating $910,481.34, all of which were assumed by he donee, over Levine’s adjusted basis, which, as increased by stipulation between the parties, was $485,429.55. The result was an excess of $425,051.79 and, upon application of capital gains rates, a deficiency of $130,428.42 in income tax. The Tax Court upheld the Commissioner largely on the authority of Crane v. C.I.R., 331 U.S. 1, 67 S.Ct. 1047, 91 L.Ed. 1301 (1947), which had affirmed this court’s decision, 153 F.2d 504 (1945) (L. Hand, J.). This appeal followed.

At first blush the layman and even the lawyer or judge not conditioned by exposure to tax law would find it difficult to understand how a taxpayer can realize $425,051.79 in gain by giving away property in which he possessed an equity of $14,518.08. Doubtless Mrs. Crane experienced a similar difficulty when she was held to have realized $275,500 (for a net taxable gain of $23,031.45), after she netted a mere $2,500 on the sale of an apartment building that she had inherited subject to a $255,000 mortgage and $7,042.50 in overdue interest payments, and had sold, under threat of foreclosure, subject to the same mortgage principal and $15,857.71 in defaulted interest payments. However, as stated in the ironic dictum of a distinguished tax practitioner’s imaginary Supreme Court opinion,3 “(e)veryday meanings are only of secondary importance when construing the words of a tax statute and are very seldom given any weight when a more abstruse and technical meaning is available.”4 In any event, Crane binds us whatever the yearnings of our untutored intuitions may be. What is more, few scholars quarrel with the wisdom of its holding, as distinguished from some of its language including the famous note 37, 331 U.S. at 14, 67 S.Ct. at 1054, of which more hereafter.

Instead of addressing himself directly to the ultimately dispositive question, what did Mrs. Crane receive, Chief Justice Vinson stated in his Crane opinion, 331 U.S. at 6, 67 S.Ct. at 1051, that “Logically, the first step . . . is to determine the unadjusted basis of the property . . . .” This must have struck Mrs. Crane as peculiar since she had claimed what would normally be the most favorable stance for the Commissioner in the determination of gain, namely, that her basis was zero. The answer to the Chief Justice’s question lay in then s 113(a)(5), incorporated as modified in I.R.C. s 1014(a), which says that if property is acquired from a decedent the unadjusted basis is “the fair market value of such property at the time of such acquisition.” On Mr. Crane’s death the property had been appraised somewhat unscientifically one might guess as having exactly the value of the encumbrances, $262,042.50. If “property” as used in s 113(a) meant simply what the property was worth to Mrs. Crane, i. e., her “equity”, her basis was zero, as she contended. However, Crane accepted the Commissioner’s theory that since the term referred to “the land and buildings themselves, or the owner’s rights in them, undiminished by the mortgage, the basis was the appraised value of $262,042.50.”

The next step was to determine whether the unadjusted basis should be adjusted by deducting depreciation “to the extent allowed (but not less than the amount allowable)” as required by s 113(b)(1)(B), now incorporated as modified in I.R.C. s 1016(a)(2). Here again the parties took unconventional positions. Proceeding from her zero basis theory, Mrs. Crane maintained that no depreciation could be taken, although she had in fact taken
depreciation deductions totalling $25,500, 331 U.S. at 3 n.2, 67 S.Ct. at 1049. The Commissioner, true to his theory of basis, see ss 23(n) and 114(a) of the 1938 Act, now I.R.C. s 167(g), thought that depreciation deductions of $28,045.10 should have been taken, and the Court agreed.

“At last”, said the Chief Justice, 331 U.S. at 12, “we come to the problem of determining the ‘amount realized’ on the 1938 sale.” In fact the Court’s answers to the two earlier questions had predetermined the answer to the dispositive one. If non-recourse mortgages contribute to the basis of property, then they must be included in the amount realized on its sale. Any other course would render the concept of basis nonsensical by permitting sellers of mortgaged property to register large tax losses stemming from an inflated basis and a diminished realization of gain. It would also permit depreciation deductions in excess of a property holder’s real investment which could never subsequently be recaptured. Although the Court bolstered its holding by explicating the use of the word “property” in s 111(a) and (b) of the 1938 Act, now I.R.C. s 1001(a) and (b), and with certain other arguments, it was hardly necessary to go beyond the statement that “(i)fe the ‘property’ to be valued on the date of acquisition is the property free of liens, the ‘property’ to be priced on a subsequent sale must be the same thing.” (Footnote omitted.) 331 U.S. at 12.

Taxpayer argues that, be all this as it may, Crane is inapplicable because the transaction here was a gift and not a sale.

Apart from the general incongruity in finding that a gift yields a realized gain to the donor, petitioner argues that it is by no means clear how the Code’s gross income, realization and recognition provisions apply to a donor’s “gain” realized as incidental to a gift. Section 61(a)(3) defines gross income to include “(g)ains derived from dealings in property” a term seemingly broad enough to include gains from gifts. The same is true with respect to s 1001(a), which provides that “(t)he 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 . . . .” (Emphasis supplied). Apparent difficulty is encountered, however, when we come to the critical provision, s 1001(c), entitled “(r)ecognition of gain or loss”, which states that “(e)xcept as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.” (Emphasis supplied).

Taxpayer suggests that the change in language from “other disposition of property” in s 1001(a), which seems broad enough to encompass a gift, but see United States v. Davis, 370 U.S. 65, 68-69 & n. 5, 82 S.Ct. 1190, 1192, 8 L.Ed.2d 335 (1962), to “sale or exchange” in s 1001(c), which would appear not to be so, postpones recognition of any “gain” realized in the instant transaction. This, he argues, is appropriate because while a sale or exchange results in the transferee’s acquisition of a new basis, see s 1012, a gift ordinarily transfers the donor’s basis plus any gift tax paid to the donee, s 1015, and tax on any gain can thus fairly be postponed until the donee engages in a taxable disposition. However, this argument overlooks “(t)he general rule . . . that when property is sold or otherwise disposed of, any gain realized must also be recognized, absent an appropriate nonrecognition provision in the Internal Revenue Code. (Footnote omitted.) King Enterprises v. United States, 418 F.2d 511, 514 (Ct.Cl.1969). See 3 Mertens, Federal Income Taxation, s 20.13 at 50 n. 4 (1980). A comparison of the present s 1001(c) with its pre-1976 predecessors, which, of course, are here controlling, suggests that s 1001(c)
merely limits nonrecognition to certain transactions described in detail elsewhere in the Code and does not confer it on all dispositions other than sales or exchanges. However, we need not decide this question in view of our disposition of the case.

Levine relies also on the established principle that a gift of appreciated unmortgaged property does not give rise to a gain, even when deductions have been taken for business expenses which were necessary to the appreciation of the property. Campbell v. Prothro, 209 F.2d 331 (5 Cir. 1954). See also First National Industries, Inc. v. C.I.R., 404 F.2d 1182, 1183 (6 Cir. 1968), cert. denied, 394 U.S. 1014, 89 S.Ct. 1633, 23 L.Ed.2d 41 (1969); The Humacid Company v. C.I.R., 42 T.C. 894, 913 (1964). However, the transaction here in question was not a “pure” gift. The donee assumed not only the $785,908.34 in mortgages and accrued interest for which Levine was not personally liable but also the $124,573.58 of 1969 expenses, not constituting a lien, for which he was. If the donee had paid the latter sum directly to Levine, this case would clearly be governed by Crane since the donor would have received “boot”. However, the assumption of another’s legal obligation or debt is considered income under Old Colony Trust Co. v. C.I.R., 279 U.S. 716, 729, 49 S.Ct. 1633, 23 L.Ed. 918 (1929), and United States v. Hendler, supra, 303 U.S. at 566, 58 S.Ct. at 656. We can thus see no sound reason for reaching a result differing from that in Crane on the facts of this case. We need not decide what the result should be if Levine had merely donated the property subject to non-recourse mortgages without an explicit “sale” element in this case, the donee’s assumption of his 1969 personal liabilities.

We need not decide what the result should be if Levine had merely donated the property subject to non-recourse mortgages without an explicit “sale” element in this case, the donee’s assumption of his 1969 personal liabilities.

The calculation of Levine’s taxable gain, as found by the Tax Court, may be presented as follows:

(1) Amount realized
   (a) Expenses assumed by donee $124,573.00
   (b) Mortgages 780,000.00
   (c) Interest payments assumed by donee 5,908.34
   (d) Total $910,481.34

(2) Less: Adjusted basis
   (a) Unadjusted basis12 $385,485.02
   (b) Plus: Capital Improvements 334,452.00
   (c) Improvements paid for by done 117,716.53
   (d) Subtotal 837,743.55
   (e) Less: Depreciation 352,314.00
   (f) Adjusted basis $485,429.55

(3) Gain $425,051.79
The record does not indicate Levine’s unadjusted basis, but this can readily be calculated by subtracting capital improvements from, and adding depreciation deductions to, the stipulated adjusted basis of $485,429.55.

Of the total taxable gain of $425,051.79, the sum of $124,573.00 may be allocated directly to the 1969 expenses which Levine shifted to the donee trust. As was previously noted, these expenses are closely akin to the “boot” of $2,500 received by Mrs. Crane. In addition Levine’s mortgage schedule, supra note 2, indicates that of the $780,000 in mortgages on the Vesey Street property at the time of its transfer, at least $235,044.23 derived from an outstanding mortgage which Levine acquired with the property in 1957, while the remaining $544,955.77 represents the net non-recourse indebtedness incurred during the period of Levine’s ownership. As the table above indicates, $334,452 of the later amount was reinvested in capital improvements. Since the original mortgage of $235,044.23 must be assumed to have contributed toward Levine’s unadjusted basis in the property, and the subsequent capital improvements adjusted Levine’s basis upward by the extent of their value, $569,496.23 (or $235,044.23 + $334,452.00) in basis credit derives solely from the non-recourse mortgages. Yet, upon disposition of the property in 1970 Levine’s stipulated basis was merely $485,429.55. The shortfall between this and the aggregate contribution of the non-recourse mortgages, i.e., $84,066.68, can only be explained by depreciation deductions that Levine could not have taken but for the mortgages. Finally, there are two additional sources of “benefit” in this case with no analogue in Crane. One is the sum of $210,503.77 out of Levine’s net borrowings of $544,955.77, see discussion supra, which was apparently not reinvested in capital improvements on the property, and which the taxpayer may thus be considered to have “pocketed”. The second is the $5,908.34 in interest payments owed by the taxpayer but assumed by the donee.14

Together, these four varieties of “benefit” sum exactly to what was found to be the taxpayer’s total taxable income:

<table>
<thead>
<tr>
<th>Item</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Expenses assumed by donee</td>
<td>$124,573.00</td>
</tr>
<tr>
<td>(b) Depreciation resulting from non-recourse mortgages</td>
<td>84,066.68</td>
</tr>
<tr>
<td>(c) Pocketed mortgage funds</td>
<td>210,503.77</td>
</tr>
<tr>
<td>(d) Interest assumed by donee</td>
<td>5,908.34</td>
</tr>
<tr>
<td>TOTAL</td>
<td>$425,051.79</td>
</tr>
</tbody>
</table>

To tax these “benefits” upon a disposition, at capital gains rates and without interest, is scarcely harsh. Failure to do so would mean, so far as we can see, that the $210,503.77 which the taxpayer obtained for his personal use by non-recourse loans against the appreciation of the property would never be taxed either as ordinary income or as gain (although, unless paid off by the donee, it would diminish any realization on the property), and that the benefits obtained by the depreciation deductions would remain untaxed unless and
until the donee sold the property, when they would operate as a reduction of the donee’s adjusted basis which was passed on to the donee. In light of the seeming equity of the result reached, an otherwise similar case lacking the element of personal debt assumed by the donee might lead us to look with sympathy on the scant case law suggesting that the Crane principle may apply even to “pure” gifts, see Malone v. United States, 326 F.Supp. 106 (N.D.Miss.1971), aff’d, 455 F.2d 502 (5 Cir. 1972), even though a taxpayer could avoid application of Crane by withholding his beneficence until death. For reasons we have indicated, we simply do not find it necessary to decide that broader question on the facts here before us.

The judgment of the Tax Court is affirmed.
Clark v. Commissioner
40 B.T.A. 333 (1939)

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

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

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

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

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

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

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

8. Thereafter, tax counsel admitted that if he had not erred in computing the tax liability shown on the joint return filed by the petitioner, he would have advised petitioner to file separate returns for himself and his wife, and accordingly tax counsel tendered to petitioner the sum of $19,941.10, which was the difference between what petitioner and his wife would have paid on their 1932 returns if separate returns had been filed and the amount which petitioner was actually required to pay on the joint return as filed. Petitioner accepted the $19,941.10.

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

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

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

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

When the joint return was filed, petitioner became obligated to and did pay the taxes computed on that basis. John D. Biggers, 39 B.T.A. 480. In paying that obligation, he sustained a loss which was caused by the negligence of his tax counsel. The $19,941.10 was paid to petitioner, not qua taxes (cf. T. G. Nicholson, 38 B.T.A. 190), but as compensation to petitioner for his loss. The measure of that loss, and the compensation therefor, was the sum of money which petitioner became legally obligated to and did pay because of that negligence. The fact that such obligation was for taxes is of no moment here.

It has been held that payments in settlement of an action for breach of promise to marry are not income. Lyde McDonald, 9 B.T.A. 1340. Compromise payments in settlement of an action for damages against a bank on account of conduct impairing the taxpayer’s good will by injuring its reputation are also not taxable. Farmers & Merchants Bank of Catlettsburg, Ky. v. Commissioner, 59 Fed.(2d) 912. The same result follows in the case of payments in settlement for injuries caused by libel and slander. C. A. Hawkins, 6 B.T.A. 1023. Damages for personal injury are likewise not income. Theodate Pope Riddle, 27 B.T.A. 1339.

The theory of those cases is that recoupment on account of such losses is not income since it is not ‘derived from capital, from labor or from both combined.’ See Merchants Loan & Trust Co. v. Smietanka, 255 U.S. 509; United States v. Safety Car Heating & Lighting Co., 297 U.S. 88. And the fact that the payment of the compensation for such loss was voluntary, as here, does not change its exempt status. Rice, Barton & Fales Inc. v. Commissioner, 41 Fed.(2d) 339. It was, in fact, compensation for a loss which impaired petitioner’s capital.

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

Decision will be entered for the petitioner.
**Dobson v. Commissioner**

320 U.S. 489 (1943)

Mr. Justice JACKSON delivered the opinion of the Court. These four cases were consolidated in the Court of Appeals. The facts of one will define the issue present in all.

The taxpayer, Collins, in 1929 purchased 300 shares of stock of the National City Bank of New York which carried certain beneficial interests in stock of the National City Company. The latter company was the seller and the transaction occurred in Minnesota. In 1930 Collins sold 100 shares, sustaining a deductible loss of $41,600.80, which was claimed on his return for that year and allowed. In 1931 he sold another 100 shares, sustaining a deductible loss of $28,163.78, which was claimed in his return and allowed. The remaining 100 shares he retained. He regarded the purchases and sales as closed and completed transactions.

In 1936 Collins learned that the stock had not been registered in compliance with the Minnesota Blue Sky Laws and learned of facts indicating that he had been induced to purchase by fraudulent representations. He filed suit against the seller alleging fraud and failure to register. He asked rescission of the entire transaction and offered to return the proceeds of the stock, or an equivalent number of shares plus such interest and dividends as he had received. In 1939 the suit was settled, on a basis which gave him a net recovery of $45,150.63, of which $23,296.45 was allocable to the stock sold in 1930 and $6,454.18 allocable to that sold in 1931. In his return for 1939 he did not report as income any part of the recovery. Throughout that year adjustment of his 1930 and 1931 tax liability was barred by the statute of limitations.

The Commissioner adjusted Collins’ 1939 gross income by adding as ordinary gain the recovery attributable to the shares sold, but not that portion of it attributable to the shares unsold. The recovery upon the shares sold was not, however, sufficient to make good the taxpayer’s original investment in them. And if the amounts recovered had been added to the proceeds received in 1930 and 1931 they would not have altered Collins’ income tax liability for those years, for even if the entire deductions claimed on account of these losses had been disallowed, the returns would still have shown net losses.

Collins sought a redetermination by the Board of Tax Appeals, now the Tax Court. He contended that the recovery of 1939 was in the nature of a return of capital from which he realized no gain and no income either actually or constructively, and that he had received no tax benefit from the loss deductions. In the alternative he argued that if the recovery could be called income at all it was taxable as capital gain. The Commissioner insisted that the entire recovery was taxable as ordinary gain and that it was immaterial whether the taxpayer had obtained any tax benefits from the loss deduction reported in prior years. The Tax Court sustained the taxpayer’s contention that he had realized no taxable gain from the recovery.

The Court of Appeals (133 F.2d 732, 735) concluded that the ‘tax benefit theory’ applied by the Tax Court ‘seems to be an injunction into the law of an equitable principle, found neither in the statutes nor in the regulations.’ Because the Tax Court’s reasoning was not embodied in any statutory precept, the court held that the Tax Court was not authorized to resort to it in determining whether the recovery should be treated as income or return of capital. It held as matter of law that the recoveries were neither return of capital nor capital gain, but were ordinary income in the year received. Questions important to tax administration were involved, conflict was said to exist, and we granted certiorari.

It is contended that the applicable statutes and regulations properly interpreted forbid the
method of calculation followed by the Tax Court. If this were true, the Tax Court’s decision would not be ‘in accordance with law’ and the Court would be empowered to modify or reverse it. Whether it is true is a clear-cut question of law and is for decision by the courts.

The court below thought that the Tax Court’s decision ‘evaded or ignored’ the statute of limitation, the provision of the Regulations that ‘expenses, liabilities, or deficit of one year cannot be used to reduce the income of a subsequent year,’ and the principle that recognition of a capital loss presupposes some event of ‘realization’ which closes the transaction for good. We do not agree. The Tax Court has not attempted to revise liability for earlier years closed by the statute of limitation, nor used any expense, liability, or deficit of a prior year to reduce the income of a subsequent year. It went to prior years only to determine the nature of the recovery, whether return of capital or income. Nor has the Tax Court reopened any closed transaction; it was compelled to determine the very question whether such a recognition of loss had in fact taken place in the prior year as would necessitate calling the recovery in the taxable year income rather than return of capital.

* * * * The Government says that ‘the principal question in this case turns on the application of the settled principle that the single year is the unit of taxation.’ But the Tax Court was aware of this principle and in no way denied it. Whether an apparently integrated transaction shall be broken up into several separate steps and whether what apparently are several steps shall be synthesized into one whole transaction is frequently a necessary determination in deciding tax consequences.

Where no statute or regulation controls, the Tax Court’s selection of the course to follow is no more reviewable than any other question of fact. Of course we are not here considering the scope of review where constitutional questions are involved. The Tax Court analyzed the basis of the litigation which produced the recovery in this case and the obvious fact that ‘regarding the series of transactions as a whole, it is apparent that no gain was actually realized.’ It found that the taxpayer had realized no tax benefits from reporting the transaction in separate years. It said the question under these circumstances was whether the amount the taxpayer recovered in 1939 ‘constitutes taxable income, even though he realized no economic gain.’ It concluded that the item should be treated as a return of capital rather than as taxable income. There is no statute law to the contrary, and the administrative rulings in effect at the time tended to support the conclusion.

It is true that the Board in a well considered opinion reviewed a number of court holdings, but it did so for the purpose of showing that they did not fetter its freedom to reach the decision it thought sound. With this we agree.

Viewing the problem from a different aspect, the Government urges in this Court that although the recovery is capital return, it is taxable in its entirety because taxpayer’s basis for the property in question is zero. The argument relies upon s 113(b)(1)(A) of the Internal Revenue Code, 26 U.S.C.A. Int.Rev.Code, s 113(b)(1)(A), which provides for adjusting the basis of property for ‘expenditures, receipts, losses, or other items, properly chargeable to capital account.’ This provision, it is said, requires that the right to a deduction for a capital loss be treated as a return of capital. Consequently, by deducting in 1930 and 1931 the entire difference between the cost of his stock and the proceeds of the sales, taxpayer reduced his basis to zero. But the statute contains no such fixed rule as the Government would have us read into it. It does not specify the circumstances or manner in which adjustments of the basis are to be made, but merely provides that ‘Proper adjustment . . . shall in all cases be made’ for the items named if ‘properly chargeable to
capital account.’ What, in the circumstances of this case, was a proper adjustment of the basis was thus purely an accounting problem and therefore a question of fact for the Tax Court to determine. Evidently the Tax Court thought that the previous deductions were not altogether ‘properly chargeable to capital account’ and that to treat them as an entire recoupment of the value of taxpayer’s stock would not have been a ‘proper adjustment.’ We think there was substantial evidence to support such a conclusion.

The Government relies upon Burnet v. Sanford & Brooks Co., 282 U.S. 359, 51 S.Ct. 150, 75 L.Ed. 383, for the proposition that losses of one year may not offset receipts of another year. But the case suggested its own distinction: ‘While (the money received) equalled, and in a loose sense was a return of, expenditures made in performing the contract, still, as the Board of Tax Appeals found, the expenditures were made in defraying the expenses * * *. They were not capital investments, the cost of which, if converted, must first be restored from the proceeds before there is a capital gain taxable as income.’ 282 U.S. at pages 363, 364, 51 S.Ct. at page 151, 75 L.Ed. 383. It is also worth noting that the Court affirmed the Board’s decision, which had been upset by the circuit court of appeals, and answered, in part, the contention of the circuit court that certain regulations were applicable by saying, ‘. . . nor on this record do any facts appear tending to support the burden, resting on the taxpayer, of establishing that the Commissioner erred in failing to apply them.’ 282 U.S. at pages 366, 367, 51 S.Ct. at page 152, 75 L.Ed. 383.

It is argued on behalf of the Commissioner that the Court should overrule the Board by applying to this question rules of law laid down in decisions on the analogous problem raised by recovery of bad debts charged off without tax benefit in prior years. The court below accepted the argument. However, instead of affording a reason for overruling the Tax Court, the history of the bad debt recovery question illustrates the mischief of overruling the Tax Court in matters of tax accounting. Courts were persuaded to rule as matter of law that bad debt recoveries constitute taxable income, regardless of tax benefit from the charge-off. The Tax Court had first made a similar holding,32 but had come to hold to the contrary.33 Substitution of the courts’ rule for that of the Tax Court led to such hardships and inequities that the Treasury appealed to Congress to extend relief.34 It did so. The Government now argues that by extending legislative relief in bad debt cases Congress recognized that in the absence of specific exemption recoveries are taxable as income. We do not find that significance in the amendment. 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. Congress would hardly expect the courts to repeat the same error in another class of cases, as we would do were we to affirm in this case.36

36 The question of whether a recovery is properly accounted for as income in the year received or should be related to a previous reported deduction without tax benefit is one with a long history and much conflict. It arises not only in case of recoveries of previously charged off bad debts and recoveries of the type we have here. It is also present in case of refund of taxes or cancellation of expenses or interest previously reported as accrued, adjustments of depreciation and depletion or amortization, and other similar situations.

The Government also suggests that ‘If the tax benefit rule were judicially adopted the question would then arise of how it should be determined,’ and the difficulties of determining tax benefits, it says, create ‘an objection in itself to an attempt to adopt such a rule by judicial action.’ We are not adopting any rule of tax benefits. We only hold that no statute or regulation having the force of one and no principle of law compels the Tax
Court to find taxable income in a transaction where as matter of fact it found no economic gain and no use of the transaction to gain tax benefit. The error of the court below consisted of treating as a rule of law what we think is only a question of proper tax accounting.

There is some difference in the facts of these cases. In two of them the Tax Court sustained deficiencies because it found that the deductions in prior years had offset gross income for those years and therefore concluded that the recoveries must to that extent be treated as taxable gain. The taxpayers object that this conclusion disregards certain exemptions and credits which would have been available to offset the increased gross income in the prior years, so that the deductions resulted in no tax savings. In determining whether the recoveries were taxable gain, however, the Tax Court was free to decide for itself what significance it would attach to the previous reduction of taxable income as contrasted with reduction of tax. The statute gives no inkling as to the correctness or incorrectness of the Tax Court’s view, and we can find no compelling reason to substitute our judgment. In No. 47 the decision of the Tax Court was upheld by the court below, and in that case the judgment is affirmed. In Nos. 44, 45, and 46, the Court of Appeals reversed the Tax Court, and for the reasons stated its judgments in those cases are reversed.

Reversed.
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 $1,877.49.

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 taxable income and therefore adjusted plaintiff's income by adding to it $8,706.93—the total of the charitable contribution deductions previously claimed and allowed. This addition to income, taxed at the 1957 corporate tax rate of 52 percent, resulted in a deficiency assessment of $4,527.60. After payment of the deficiency, plaintiff filed a claim for the refund of $2,650.11, asserting this amount as overpayment on the theory that a correct assessment could demand no more than the return of the tax benefit originally enjoyed, i.e., $1,877.49. The claim was disallowed.

* * * [Professor's Note: The court reviews prior precedent and then proceeds with the following 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
140 (A)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.
North American Oil Consolidated v. Commissioner
286 U.S. 417 (1932)

Mr. Justice BRANDEIS delivered the opinion of the Court. The question for decision is whether the sum of $171,979.22, received by the North American Oil Consolidated in 1917, was taxable to it as income of that year.

The money was paid to the company under the following circumstances: Among many properties operated by it in 1916 was a section of oil land, the legal title to which stood in the name of the United States. Prior to that year, the government, claiming also the beneficial ownership, had instituted a suit to oust the company from possession; and on February 2, 1916, it secured the appointment of a receiver to operate the property, or supervise its operations, and to hold the net income thereof. The money paid to the company in 1917 represented the net profits which had been earned from that property in 1916 during the receivership. The money was paid to the receiver as earned. After entry by the District Court in 1917 of the final decree dismissing the bill, the money was paid, in that year, by the receiver to the company.

United States v. North American Oil Consolidated, 242 F. 723. The government took an appeal (without supersedeas) to the Circuit Court of Appeals. In 1920, that court affirmed the decree. 264 F. 336. In 1922, a further appeal to this Court was dismissed by stipulation. 258 U. S. 633, 42 S. Ct. 315, 66 L. Ed. -.

The income earned from the property in 1916 had been entered on the books of the company as its income. It had not been included in its original return of income for 1916; but it was included in an amended return for that year which was filed in 1918. Upon auditing the company’s income and profits tax returns for 1917, the Commissioner of Internal Revenue determined a deficiency based on other items. The company appealed to the Board of Tax Appeals. There, in 1927, the Commissioner prayed that the deficiency already claimed should be increased so as to include a tax on the amount paid by the receiver to the company in 1917. The Board held that the profits were taxable to the receiver as income of 1916; and hence made no finding whether the company’s accounts were kept on the cash receipts and disbursements basis or on the accrual basis. 12 B. T. A. 68. The Circuit Court of Appeals held that the profits were taxable to the company as income of 1917, regardless of whether the company’s returns were made on the cash or on the accrual basis. 50 F. (2d) 752. This Court granted a writ of certiorari. 284 U. S. 614, 52 S. Ct. 208, 76 L. Ed. -.

It is conceded that the net profits earned by the property during the receivership constituted income. The company contends that they should have been reported by the receiver for taxation in 1916; that, if not returnable by him, they should have been returned by the company for 1916, because they constitute income of the company accrued in that year; and that, if not taxable as income of the company for 1916, they were taxable to it as income for 1922, since the litigation was not finally terminated in its favor until 1922.

First. The income earned in 1916 and impounded by the receiver in that year was not taxable to him, because he was the receiver of only a part of the properties operated by the company. Under section 13(c) of the Revenue Act of 1916, receivers who ‘are operating the property or business of corporations’ were obliged to make returns ‘of net income as and for such corporations,’ and ‘any income tax due’ was to be ‘assessed and collected in the same manner as if assessed directly against the organizations of whose businesses or properties they have custody and control.’ The phraseology of this section was adopted without change in the Revenue Act of 1918, 40 Stat.
1057, 1081, c. 18, s 239. The regulations of the Treasury Department have consistently construed these statutes as applying only to receivers in charge of the entire property or business of a corporation; and in all other cases have required the corporations themselves to report their income. Treas. Regs. 33, arts. 26, 209; Treas. Regs. 45, arts. 424, 622. That construction is clearly correct. The language of the section contemplates a substitution of the receiver for the corporation; and there can be such substitution only when the receiver is in complete control of the properties and business of the corporation. Moreover, there is no provision for the consolidation of the return of a receiver of part of a corporation’s property or business with the return of the corporation itself. It may not be assumed that Congress intended to require the filing of two separate returns for the same year, each covering only a part of the corporate income without making provision for consolidation so that the tax could be based upon the income as a whole.

Second. The net profits were not taxable to the company as income of 1916. For the company was not required in 1916 to report as income an amount which it might never receive. See Burnet v. Logan, 283 U. S. 404, 413, 51 S. Ct. 550, 75 L. Ed. 1143. Compare Lucas v. American Code Co., 280 U. S. 445, 452, 50 S. Ct. 202, 74 L. Ed. 538; Burnet v. Sanford & Brooks Co., 282 U. S. 359, 363, 51 S. Ct. 150, 75 L. Ed. 383. There was no constructive receipt of the profits by the company in that year, because at no time during the year was there a right in the company to demand that the receiver pay over the money. Throughout 1916 it was uncertain who would be declared entitled to the profits. It was not until 1917, when the District Court entered a final decree vacating the receivership and dismissing the bill, that the company became entitled to receive the money. Nor is it material, for the purposes of this case, whether the company’s return was filed on the cash receipts and disbursements basis, or on the accrual basis. In neither event was it taxable in 1916 on account of income which it had not yet received and which it might never receive.

Third. The net profits earned by the property in 1916 were not income of the year 1922-the year in which the litigation with the government was finally terminated. They became income of the company in 1917, when it first became entitled to them and when it actually received them. 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. See Board v. Commissioner of Internal Revenue (C. C. A.) 51 F.(2d) 73, 75, 76. Compare United States v. S. S. White Dental Manufacturing Co., 274 U. S. 398, 403, 47 S. Ct. 598, 71 L. Ed. 1120. If in 1922 the government had prevailed, and the company had been obliged to refund the profits received in 1917, it would have been entitled to a deduction from the profits of 1922, not from those of any earlier year. Compare Lucas v. American Code Co., supra.

Affirmed.
United States v. Lewis  
340 U.S. 590 (1951)

Mr. Justice BLACK delivered the opinion of the Court. Respondent Lewis brought this action in the Court of Claims seeking a refund of an alleged overpayment of his 1944 income tax. The facts found by the Court of Claims are: In his 1944 income tax return, respondent reported about $22,000 which he had received that year as an employee’s bonus. As a result of subsequent litigation in a state court, however, it was decided that respondent’s bonus had been improperly computed; under compulsion of the state court’s judgment he returned approximately $11,000 to his employer. Until payment of the judgment in 1946, respondent had at all times claimed and used the full $22,000 unconditionally as his own, in the good faith though ‘mistaken’ belief that he was entitled to the whole bonus.

On the foregoing facts the Government’s position is that respondent’s 1944 tax should not be recomputed, but that respondent should have deducted the $11,000 as a loss in his 1946 tax return. See G.C.M. 16730, XV—1 Cum. Bull. 179 (1936). The Court of Claims, however, relying on its own case, Greenwald v. United States, 57 F.Sup. 569, 102 Ct.Cl. 272, held that the excess bonus received ‘under a mistake of fact’ was not income in 1944 and ordered a refund based on a recalculation of that year’s tax. 91 F.Sup. 1017, 1022, 117 Ct.Cl. 336. We granted certiorari, 340 U.S. 903, 71 S.Ct. 279, because this holding conflicted with many decisions of the courts of appeals, see, e.g., Haberkorn v. United States, 6 Cir., 173 F.2d 587, and with principles announced in North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197.

In the North American Oil case we said: ‘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.’ 286 U.S. at 424, 52 S.Ct. at page 615, 76 L.Ed. 1197. Nothing in this language permits an exception merely because a taxpayer is ‘mistaken’ as to the validity of his claim.

* * * Income taxes must be paid on income received (or accrued) during an annual accounting period. Cf. I.R.C. ss 41, 42, 26 U.S.C.A. ss 41, 42; and see Burnet v. Sanford & Brooks Co., 282 U.S. 359, 363, 51 S.Ct. 150, 151, 75 L.Ed. 383. The ‘claim of right’ interpretation of the tax laws has long been used to give finality to that period, and is now deeply rooted in the federal tax system. See cases collected in 2 Mertens, Law of Federal Income Taxation, s 12.103. We see no reason why the Court should depart from this well-settled interpretation merely because it results in an advantage or disadvantage to a taxpayer. Reversed.

Mr. Justice DOUGLAS (dissenting).

The question in this case is not whether the bonus had to be included in 1944 income for purposes of the tax. Plainly it should have been because the taxpayer claimed it as of right. Some years later, however, it was judicially determined that he had no claim to the bonus. The question is whether he may then get back the tax which he paid on the money.

Many inequities are inherent in the income tax. We multiply them needlessly by nice distinctions which have no place in the practical administration of the law. If the refund were allowed, the integrity of the taxable year would not be violated. The tax would be paid when due; but the government would not be permitted to maintain the unconscionable position that it can keep the tax after it is shown that payment was made on money which was not income to the taxpayer.
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
**Rev. Rul. 2012-25**  
2012-2 C.B.337

**ISSUE**

Whether an arrangement that recharacterizes taxable wages as nontaxable reimbursements or allowances satisfies the business connection requirement of the accountable plan rules under § 62(c) and the applicable regulations.

**Situation 1.**

Employer A, a company contracting with cable providers, employs technicians to install cable television systems at residential locations on behalf of different cable providers. Employee technicians are required to provide the tools and equipment necessary to complete the various installation jobs to which they are assigned.

Employer A compensates its employees on an hourly basis, which takes into account the fact that technicians are required to provide their own tools and equipment. Employer A decides to begin reimbursing its technicians for their tool and equipment expenses through a tool reimbursement arrangement (tool plan).

Under Employer A’s tool plan, a technician provides Employer A with an amount equivalent to the technician’s tool and equipment expenses incurred in connection with providing services to Employer A. Employer A takes the technician’s total expenses for the year and divides the total amount by the number of hours a technician is expected to work over the course of a year to arrive at an hourly tool rate. Once Employer A has determined the hourly tool rate amount for a technician, it pays the technician a reduced hourly compensation rate and an hourly tool rate. Employer A treats the reduced hourly compensation as taxable wages. Employer A treats the hourly tool rate as a nontaxable reimbursement. The hourly tool rate plus the reduced hourly compensation rate approximately equal the pre-tool plan compensation rate. The tool plan tracks the hourly tool rate up to the amount of substantiated tool and equipment expenses. Once a technician has received tool plan payments for the total amount of his or her tool and equipment expenses, Employer A ceases paying the technician an hourly tool rate but increases the technician’s hourly compensation to the pre-tool plan hourly compensation rate.

**Situation 2.**

Employer B, a staffing contractor, employs nurses and provides their services to hospitals throughout the country for short-term assignments. Employer B compensates all of the nurses on an hourly basis and the hourly compensation amount does not vary depending on whether the hospital is located away from the assigned nurse’s tax home.

When Employer B sends nurses on assignment to hospitals that require them to travel away from their tax home and incur deductible expenses in connection with Employer B’s business, Employer B treats a portion of the nurses’ hourly compensation as a nontaxable *per diem* allowance for lodging, meals,
and incidental expenses under Employer B’s *per diem* plan; Employer B treats the remaining portion of the nurses’ hourly compensation as taxable wages. When Employer B sends the nurses on assignment to hospitals within commuting distance of their tax home, Employer B treats all of the nurses’ compensation as taxable wages. In each case, the nurses receive the same total compensation per hour.

**Situation 3.**

Employer C, a construction firm, employs workers to build commercial buildings throughout a major metropolitan area. As part of their duties, some of Employer C’s workers are required to travel between construction sites or otherwise use their personal vehicles for business purposes. These workers incur deductible business expenses in operating their personal vehicles in connection with their employment with Employer C. Employer C compensates all of its workers for their services on an hourly basis, which Employer C treats as taxable wages. Employer C also pays all of its workers, including those who are not required to travel or otherwise use their personal vehicles for Employer C’s business, a flat amount per pay period that Employer C treats as a nontaxable mileage reimbursement.

**Situation 4.**

Employer D, a cleaning services company, employs cleaning professionals to perform house cleaning services for Employer D’s clients. Employee cleaning professionals are required to provide the cleaning products and equipment necessary to complete the cleaning service jobs to which they are assigned.

Employer D compensates its employees on an hourly basis, which takes into account that employees are required to provide their own cleaning products and equipment. Employer D decides to begin reimbursing its employees for their cleaning and equipment expenses through a reimbursement arrangement.

Employer D prospectively alters its compensation structure by reducing the hourly compensation paid to all employees. Under Employer D’s new reimbursement arrangement, employees can substantiate to Employer D the actual amount of deductible expenses incurred in purchasing their cleaning products and equipment in connection with performing services for Employer D. Employer D reimburses its employees for substantiated expenses incurred in performing services for Employer D. Any reimbursement paid under Employer D’s reimbursement arrangement is paid in addition to the hourly compensation paid for the employees’ services. Employees who do not incur expenses for cleaning products and equipment in connection with their jobs for Employer D, or who do not properly substantiate such expenses to Employer D, continue to receive the lower hourly compensation and do not receive any reimbursement and are not compensated in another way (for example, with a bonus) to substitute for the reduction in the hourly compensation. Employer D treats the hourly compensation as taxable wages. Employer D treats reimbursements for cleaning and equipment expenses as nontaxable reimbursements.
LAW AND ANALYSIS

Section 61 of the Internal Revenue Code (Code) defines gross income as all income from whatever source derived. Section 62(a) defines adjusted gross income as gross income minus certain deductions. Section 62(a)(2)(A) provides that, for purposes of determining adjusted gross income, an employee may deduct certain business expenses paid by the employee in connection with the performance of services as an employee of the employer under a reimbursement or other expense allowance arrangement. Section 62(c) provides that, for purposes of § 62(a)(2)(A), an arrangement will not be treated as a reimbursement or other expense allowance arrangement if (1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or (2) the arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under section 1.62-2(c) of the Income Tax Regulations, if a reimbursement or other expense allowance arrangement meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses, all amounts paid under the arrangement are treated as paid under an accountable plan. Amounts treated as paid under an accountable plan are excluded from an employee’s gross income, are exempt from withholding and payment of employment taxes, and are not reported as wages on the employee’s Form W-2. If the arrangement fails any one of these requirements, amounts paid under the arrangement are treated as paid under a nonaccountable plan, must be included in the employee’s gross income for the taxable year, are subject to withholding and payment of employment taxes, and must be reported as wages or other compensation on the employee’s Form W-2.

Section 1.62-2(d)(1) provides that an arrangement satisfies the business connection requirement if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions by part VI, subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee of the employer. Thus, not only must an employee actually pay or incur a deductible business expense, but the expense must arise in connection with the employment for that employer.

Section 1.62-2(d)(3)(i) provides that the business connection requirement will not be satisfied if a payor pays an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur deductible business expenses. Failure to meet this reimbursement requirement of business connection is referred to as wage recharacterization because the amount being paid is not an expense reimbursement but rather a substitute for an amount that would otherwise be paid as wages.

Section 1.62-2(j) Example 1 provides an illustration of a case in which the reimbursement requirement is not satisfied. In this example, Employer S pays its engineers $200 a day. On those days that an engineer travels away from home on business for Employer S, Employer S designates $50 of the $200 as paid to reimburse the engineer’s travel expenses. On all other days, the engineer receives the full $200 as taxable wages. Because Employer S would pay an engineer $200 a day regardless of whether the engineer was traveling away from home, the $50 Employer S redesignates as travel expense reimbursement on days the engineer is away from home on business is not a reimbursement and the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the $50 Employer S designated as a reimbursement is treated as paid under an accountable plan. Rather,
all payments under the arrangement are treated as paid under a nonaccountable plan. Employer S must report the entire $200 as wages or other compensation on the employees’ Forms W-2, and must withhold and pay employment taxes on the entire $200 when paid.

Section 1.62-2(j) Example 3 also illustrates a failure to satisfy the reimbursement requirement. In this example, Corporation R pays all its salespersons a salary. Corporation R also pays a travel allowance under an arrangement that otherwise meets the requirements of business connection, substantiation, and returning amounts in excess of substantiated expenses. The allowance is paid to all salespersons, including salespersons that Corporation R knows, or has reason to know, do not travel away from their offices on Corporation R business and would not be reasonably expected to incur travel expenses. Because the allowance is not paid only to those employees who incur (or are reasonably expected to incur) expenses of the type described in § 1.62-2(d)(1) or (d)(2), the arrangement does not satisfy the reimbursement requirement of § 1.62-2(d)(3)(i). Thus, no part of the allowance Corporation R designated as a reimbursement is treated as paid under an accountable plan. Rather, all payments under the arrangement are treated as paid under a nonaccountable plan. Corporation R must report all payments under the arrangement as wages or other compensation on the employees’ Forms W-2 and must withhold and pay employment taxes on the payments when paid.

In Rev. Rul. 2004-1, 2004-1 C.B. 325, drivers of a courier company were paid a mileage allowance for local transportation expenses. In situation 1 of the ruling, the employer paid the couriers a commission equal to X percent of the per package charge (based on location, time of day, type of service, mileage between pickup and delivery, and other factors), known as the tag rate, and a mileage allowance equal to Y percent of the tag rate. In situation 2, the employer paid the couriers a commission equal to Z percent of the tag rate reduced by a mileage allowance equal to the number of miles traveled multiplied by the standard mileage rate. The revenue ruling concludes that the reimbursement arrangement in situation 1, which pays a mileage allowance as a fixed percentage of the tag rate, meets the business connection requirement. In contrast, the revenue ruling concludes that the reimbursement arrangement in situation 2, which subtracts a mileage allowance (calculated at the standard business mileage rate) from the driver’s set commission rate and treats only the remaining commission as wages, fails the business connection requirement. The variable allocation between commission and mileage allowance in situation 2 ensures that each driver always receives the same gross amount regardless of the amount of deductible employee business expenses incurred by the courier by varying the amount treated as wages in light of the mileage allowance paid. Accordingly, the arrangement effectively recharacterizes amounts otherwise payable as a taxable commission as a non-taxable mileage allowance. The ruling provides that a bona fide reimbursement arrangement must preclude the recharacterization as a mileage allowance of amounts otherwise payable as commission. See Shotgun Delivery v. United States, 269 F.3d 969 (9th Cir. 2001) (holding that a plan guaranteeing that employee drivers always received 40% of the tag rate with a variable allocation between taxable wages and nontaxable mileage reimbursement was nonaccountable, and noting that “the evidence suggests that the plan’s primary purpose was to treat the least amount possible of the driver’s commission as taxable wages”).

The legislative history of § 62(c) indicates that a taxpayer should not be able to recharacterize an amount that would have been paid as wages as a nontaxable reimbursement in order to avoid the two-percent of adjusted gross income limitation (two-percent floor), enacted by the Tax Reform Act of 1986, for deducting most employee business expenses. Specifically, the Tax Reform Act of 1986
significantly changed rules for deduction of employee business expenses by converting most of these expenses into itemized deductions that an employee could only deduct if the aggregate of such expenses exceeded the two-percent floor. However, the 1986 Act left in place the ability of a taxpayer to deduct from gross income and without regard to the two-percent floor, pursuant to § 62(a)(2)(A), employee business expenses incurred by a taxpayer as part of a reimbursement or other expense allowance arrangement with his or her employer. After enactment of the 1986 Act, tax practitioners proposed that employers could use reimbursement and expense allowance arrangements to (1) eliminate the effect of the two-percent floor on deductible employee expenses, and (2) save both employer and employee employment taxes by restructuring their compensation packages to convert a portion of an employee’s compensation into a nontaxable reimbursement. This restructuring would permit employers to pay a lesser total amount while increasing employees’ after-tax compensation.

Congress responded by enacting § 62(c) in § 702 of the Family Support Act of 1988, 100 P.L. 485, 102 Stat. 2343(1988). In describing the conference agreement, the House-Senate Conference Committee Report on that Act states that “[i]f an above-the-line deduction is allowed for expenses incurred pursuant to a nonaccountable plan, the two-percent floor enacted in the [Tax Reform Act of 1986] could be circumvented solely by restructuring the form of the employee’s compensation so that the salary amount is decreased, but the employee receives an equivalent nonaccountable expense allowance.” H.R. Rep. No. 100-998, at 203, 100th Cong., 2nd Sess. (Sept. 28, 1988). Section 62(c) was enacted to prevent such restructuring of compensation arrangements and permit an above-the-line deduction only for expenses reimbursed under what legislative history referred to as an accountable plan.

Consistent with legislative history, the preamble to Treasury Decision 8324, 55 FR 51688, 1991-1 C.B. 20, 21 (1990), states:

Some practitioners have asked whether a portion of an employee’s salary may be recharacterized as being paid under a reimbursement arrangement. The final regulations clarify that if a payor arranges to pay an amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) deductible business expenses or other bona fide expenses related to the employer’s business that are not deductible, the arrangement does not meet the business connection requirement of § 1.62-2(d) of the regulations and all amounts paid under the arrangement are treated as paid under a nonaccountable plan.... Thus, no part of an employee’s salary may be recharacterized as being paid under a reimbursement arrangement or other expense allowance arrangement.

While an employer may establish or modify its compensation structure to include nontaxable reimbursement under an accountable plan, recharacterizing as nontaxable reimbursements amounts that would otherwise be paid as wages violates the business connection requirement of § 1.62-2(d), and more specifically the reimbursement requirement of § 1.62-2(d)(3)(i). This is true even if an employee actually incurs a deductible expense in connection with employment with the employer.

The presence of wage recharacterization is based on the totality of facts and circumstances. Generally, wage recharacterization is present when the employer structures compensation so that the employee receives the same or a substantially similar amount whether or not the employee has incurred
deductible business expenses related to the employer’s business. Wage recharacterization may occur in different situations. For example, an employer recharacterizes wages if it temporarily reduces taxable wages, substituting the reduction in wages with a payment that is treated as a nontaxable reimbursement and then, after total expenses have been reimbursed, increases taxable wages to the prior wage level. Similarly, an employer recharacterizes wages if it pays a higher amount as wages to an employee only when the employee does not receive an amount treated as nontaxable reimbursement and pays a lower amount as wages to an employee only when the employee also receives an amount treated as nontaxable reimbursement. An employer also recharacterizes wages if it routinely pays an amount treated as a nontaxable reimbursement to an employee who has not incurred bona fide business expenses.

**HOLDINGS**

**Situation 1.**

Employer A’s tool plan does not satisfy the business connection requirement of the accountable plan rules because the employer pays the same gross amount to a technician regardless of whether the technician incurs (or is reasonably expected to incur) expenses related to Employer A’s business. Specifically, Employer A’s tool plan ensures that a technician receives approximately the same gross hourly amount by substituting a portion of what was paid as taxable wages with a tool rate amount that is treated as nontaxable reimbursement, and then increasing the wages again once all tool expenses have been reimbursed. Accordingly, the purported tool reimbursements are merely a recharacterization of wages because approximately the same amount is paid in all circumstances. The fact that a technician actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer A’s tool plan is not an accountable plan under § 62(c) and the applicable regulations.

**Situation 2.**

Employer B’s per diem plan does not satisfy the business connection requirement of the accountable plan rules because Employer B pays the same gross amount to nurses regardless of whether the nurses incur (or are reasonably expected to incur) travel expenses related to Employer B’s business. Specifically, Employer B pays the same gross compensation to nurses, but a portion of the hourly compensation is treated as nontaxable per diem when a nurse is traveling away from his or her tax home on assignment. For nurses traveling away from their tax home on assignment, Employer B reduces the amount of the nurses’ compensation treated as taxable wages and treats an amount equal to the reduction in compensation as a nontaxable per diem. For nurses assigned to hospitals within commuting distance of their tax homes, Employer B treats all compensation as taxable wages. Accordingly, the purported per diem payments are merely recharacterized wages because nurses receive the same gross compensation per hour regardless of whether travel expenses are incurred (or are reasonably expected to be incurred). The fact that a nurse traveling away from his or her tax home actually incurs a deductible expense in connection with employment does not cure the incidence of wage recharacterization. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable
plan as set forth in § 1.62-2, Employer B’s per diem plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 3.

Employer C’s mileage reimbursement plan does not satisfy the business connection requirement of the accountable plan rules because it operates to routinely pay an amount as a mileage reimbursement to workers who have not incurred (and are not reasonably expected to incur) deductible business expenses in connection with Employer C’s business. The purported mileage reimbursement is merely recharacterized wages because all workers receive an amount as a mileage reimbursement regardless of whether they incur (or are reasonably expected to incur) mileage expenses. The arrangement fails to satisfy the business connection requirement of § 1.62-2(d). Therefore, without regard to whether it meets the other requirements of an accountable plan as set forth in § 1.62-2, Employer C’s mileage reimbursement plan is not an accountable plan under § 62(c) and the applicable regulations.

Situation 4.

Employer D’s reimbursement arrangement satisfies the business connection requirement of the accountable plan rules. Employer D’s plan only reimburses employees when a deductible business expense has been incurred in connection with performing services for Employer D and the reimbursement is not in lieu of wages that the employees would otherwise receive. Although Employer D has reduced the amount of compensation it pays all of its employees, the reduction in compensation is a substantive change in Employer D’s compensation structure. Under Employer D’s arrangement, reimbursement amounts are not guaranteed and employees who do not incur expenses in connection with Employer D’s business, or who do not properly substantiate such expenses, continue to receive the reduced hourly compensation amount. These employees do not receive any reimbursement and are not compensated in another way to make up for the reduction in the hourly compensation. Employer D’s reimbursement arrangement does not operate to pay the same or a substantially similar gross amount to an employee regardless of whether the employee incurs (or is reasonably expected to incur) expenses related to Employer D’s business. The reimbursement is paid in addition to the employees’ wages rather than as a substitute for wages that would otherwise be paid. Accordingly, Employer D’s reimbursement arrangement satisfies the business connection requirement of § 1.62-2(d). Therefore, as long as the substantiation and return of excess amounts requirements are also met, Employer D’s reimbursement arrangement is an accountable plan under § 62(c) and the applicable regulations.
Supplement Page #65

Commissioner v. Flowers
326 U.S. 465 (1945)

Mr. Justice MURPHY delivered the opinion of the Court.

This case presents a problem as to the meaning and application of the provision of §23(a)(1)(A) of the Internal Revenue Code allowing a deduction for income tax purposes of ‘traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business.’

The taxpayer, a lawyer, has resided with his family in Jackson, Mississippi, since 1903. There he has paid taxes, voted, schooled his children and established social and religious connections. He built a house in Jackson nearly thirty years ago and at all times has maintained it for himself and his family. He has been connected with several law firms in Jackson, one of which he formed and which has borne his name since 1922.

In 1906 the taxpayer began to represent the predecessor of the Gulf, Mobile & Ohio Railroad, his present employer. He acted as trial counsel for the railroad throughout Mississippi. From 1918 until 1927 he acted as special counsel for the railroad in Mississippi. He was elected general solicitor in 1927 and continued to be elected to that position each year until 1930, when he was elected general counsel. Thereafter he was annually elected general counsel until September, 1940, when the properties of the predecessor company and another railroad were merged and he was elected vice president and general counsel of the newly formed Gulf, Mobile & Ohio Railroad.

The main office of the Gulf, Mobile & Ohio Railroad is in Mobile, Alabama, as was also the main office of its predecessor. When offered the position of general solicitor in 1927, the taxpayer was unwilling to accept it if it required him to move from Jackson to Mobile. He had established himself in Jackson both professionally and personally and was not desirous of moving away. As a result, an arrangement was made between him and the railroad whereby he could accept the position and continue to reside in Jackson on condition that he pay his traveling expenses between Mobile and Jackson and pay his living expenses in both places. This arrangement permitted the taxpayer to determine for himself the amount of time he would spend in each of the two cities and was in effect during 1939 and 1940, the taxable years in question.

The railroad company provided an office for the taxpayer in Mobile but not in Jackson. When he worked in Jackson his law firm provided him with office space, although he no longer participated in the firm’s business or shared in its profits. He used his own office furniture and fixtures at this office. The railroad, however, furnished telephone service and a typewriter and desk for his secretary. It also paid the secretary’s expenses while in Jackson. Most of the legal business of the railroad was centered in or conducted from Jackson, but this business was handled by local counsel for the railroad. The taxpayer’s participation was advisory only and was no different from his participation in the railroad’s legal business in other areas.

The taxpayer’s principal post of business was at the main office in Mobile. However, during the taxable years of 1939 and 1940, he devoted nearly all of his time to matters relating to the merger of the railroads. Since it was left to him where he would do his work, he spent most of his time in Jackson during this period. In connection with the merger, one of the companies was involved in certain litigation in the federal court in Jackson and the taxpayer
participated in that litigation. During 1939 he spent 203 days in Jackson and 66 in Mobile, making 33 trips between the two cities. During 1940 he spent 168 days in Jackson and 102 in Mobile, making 40 trips between the two cities. The railroad paid all of his traveling expenses when he went on business trips to points other than Jackson or Mobile. But it paid none of his expenses in traveling between these two points or while he was at either of them.

The taxpayer deducted $900 in his 1939 income tax return and $1,620 in his 1940 return as traveling expenses incurred in making trips from Jackson to Mobile and as expenditures for meals and hotel accommodations while in Mobile. The Commissioner disallowed the deductions, which action was sustained by the Tax Court. But the Fifth Circuit Court of Appeals reversed the Tax Court’s judgment, 148 F.2d 163, and we granted certiorari because of a conflict between the decision below and that reached by the Fourth Circuit Court of Appeals in Barnhill v. Commissioner, 148 F.2d 913.

No claim for deduction was made by the taxpayer for the amounts spent in traveling from Mobile to Jackson. He also took trips during the taxable years to Washington, New York, New Orleans, Baton Rouge, Memphis and Jackson (Tenn.), which were apparently in the nature of business trips for which the taxpayer presumably was reimbursed by the railroad. No claim was made in regard to them.

Three conditions must thus be satisfied before a traveling expense deduction may be made under [§162(a)(2)]:

(1) The expense must be a reasonable and necessary traveling expense, as that term is generally understood. This includes such items as transportation fares and food and lodging expenses incurred while traveling.

(2) The expense must be incurred ‘while away from home.’

(3) The expense must be incurred in pursuit of business. This means that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer or of his employer. Moreover, such an expenditure must be necessary or appropriate to the development and pursuit of the business or trade.

Whether particular expenditures fulfill these three conditions so as to entitle a taxpayer to a deduction is purely a question of fact in most instances. And the Tax Court’s inferences and conclusions on such a factual matter, under established principles, should not be disturbed by an appellate court.

In this instance, the Tax Court without detailed elaboration concluded that ‘The situation presented in this proceeding is, in principle, no different from that in which a taxpayer’s place of employment is in one city and for reasons satisfactory to himself he resides in another.’ It accordingly disallowed the deductions on the ground that they represent living and personal expenses rather than traveling expenses incurred while away from home in the pursuit of business. The court below accepted the Tax Court’s findings of fact but reversed its judgment on the basis that it had improperly construed the word ‘home’ as used in the second condition precedent to a traveling expense deduction under [§162(a)(2)]. The Tax Court, it was said, erroneously construed the word to mean the post, station or place of business where the taxpayer was employed—in this instance, Mobile—and thus erred in concluding that the expenditures in issue were not incurred ‘while away from home.’ The Court below felt that the word was to be given no such ‘unusual’ or ‘extraordinary’ meaning in this statute, that it simply meant ‘that place where one in fact resides’ or ‘the principal place of abode of one who has the intention to live there permanently.’ 148 F.2d at page 164. Since the taxpayer here admittedly had his
home, as thus defined, in Jackson and since the expenses were incurred while he was away from Jackson, the deduction was permissible.

The meaning of the word ‘home’ in §162(a)(2) with reference to a taxpayer residing in one city and working in another has engendered much difficulty and litigation. The Tax Court and the administrative rulings have consistently defined it as the equivalent of the taxpayer’s place of business. On the other hand, the decision below and Wallace v. Commissioner, 9 Cir., 144 F.2d 407, have flatly rejected that view and have confined the term to the taxpayer’s actual residence.

We deem it unnecessary here to enter into or to decide this conflict. The Tax Court’s opinion, as we read it, was grounded neither solely nor primarily upon that agency’s conception of the word ‘home.’ Its discussion was directed mainly toward the relation of the expenditures to the railroad’s business, a relationship required by the third condition of the deduction. Thus even if the Tax Court’s definition of the word ‘home’ was implicit in its decision and even if that definition was erroneous, its judgment must be sustained here if it properly concluded that the necessary relationship between the expenditures and the railroad’s business was lacking. Failure to satisfy any one of the three conditions destroys the traveling expense deduction.

Turning our attention to the third condition, this case is disposed of quickly. There is no claim that the Tax Court misconstrued this condition or used improper standards in applying it. And it is readily apparent from the facts that its inferences were supported by evidence and that its conclusion that the expenditures in issue were non-deductible living and personal expenses was fully justified.

The facts demonstrate clearly that the expenses were not incurred in the pursuit of the business of the taxpayer’s employer, the railroad. Jackson was his regular home. Had his post of duty been in that city the cost of maintaining his home there and of commuting or driving to work concededly would be non-deductible living and personal expenses lacking the necessary direct relation to the prosecution of the business. The character of such expenses is unaltered by the circumstance that the taxpayer’s post of duty was in Mobile, thereby increasing the costs of transportation, food and lodging. Whether he maintained one abode or two, whether he traveled three blocks or three hundred miles to work, the nature of these expenditures remained the same.

The added costs in issue, moreover, were as unnecessary and inappropriate to the development of the railroad’s business as were his personal and living costs in Jackson. They were incurred solely as the result of the taxpayer’s desire to maintain a home in Jackson while working in Mobile, a factor irrelevant to the maintenance and prosecution of the railroad’s legal business. The railroad did not require him to travel on business from Jackson to Mobile or to maintain living quarters in both cities. Nor did it compel him, save in one instance, to perform tasks for it in Jackson. It simply asked him to be at his principal post in Mobile as business demanded and as his personal convenience was served, allowing him to divide his business time between Mobile and Jackson as he saw fit. Except for the federal court litigation, all of the taxpayer’s work in Jackson would normally have been performed in the headquarters at Mobile. The fact that he traveled frequently between the two cities and incurred extra living expenses in Mobile, while doing much of his work in Jackson, was occasioned solely by his personal propensities. The railroad gained nothing from this arrangement except the personal satisfaction of the taxpayer.

Travel expenses in pursuit of business within the meaning of § 23(a)(1)(A) could arise only when the railroad’s business forced the
taxpayer to travel and to live temporarily at some place other than Mobile, thereby advancing the interests of the railroad. Business trips are to be identified in relation to business demands and the traveler’s business headquarters. The exigencies of business rather than the personal conveniences and necessities of the traveler must be the motivating factors. Such was not the case here. It follows that the court below erred in reversing the judgment of the Tax Court. Reversed.

Mr. Justice RUTLEDGE, dissenting.

I think the judgment of the Court of Appeals should be affirmed. When Congress used the word ‘home’ in [§162(a)(2)] of the Code, I do not believe it meant ‘business headquarters.’ And in my opinion this case presents no other question.

. . . By construing ‘home’ as ‘business headquarters’; by reading ‘temporarily’ as ‘very temporarily’ into [§162]; by bringing down ‘ordinary and necessary’ from its first sentence into its second; 7 by finding ‘inequity’ where Congress has said none exists; by construing ‘commuter’ to cover long-distance, irregular travel; and by conjuring from the ‘statutory setting’ a meaning at odds with the plain wording of the clause, the Government makes over understandable ordinary English into highly technical tax jargon. There is enough of this in the tax laws inescapably, without adding more in the absence of either compulsion or authority. The arm of the tax gatherer reaches far. In my judgment it should not go the length of this case. Congress has revised s 23 once to overcome niggardly construction. It should not have to do so again.
Mr. Justice STEWART delivered the opinion of the Court.

The Commissioner of Internal Revenue has long maintained that a taxpayer traveling on business may deduct the cost of his meals only if his trip requires him to stop for sleep or rest. The question presented here is the validity of that rule.

The respondent in this case was a traveling salesman for a wholesale grocery company in Tennessee. He customarily left home early in the morning, ate breakfast and lunch on the road, and returned home in time for dinner. In his income tax returns for 1960 and 1961, he deducted the cost of his morning and noon meals as ‘traveling expenses’ incurred in the pursuit of his business ‘while away from home’ under §162(a)(2) of the Internal Revenue Code of 1954. Because the respondent’s daily trips required neither sleep nor rest, the Commissioner disallowed the deductions, ruling that the cost of the respondent’s meals was a ‘personal, living’ expense under §262 rather than a travel expense under §162(a)(2). The respondent paid the tax, sued for a refund in the District Court, and there received a favorable jury verdict. The Court of Appeals for the Sixth Circuit affirmed, holding that the Commissioner’s sleep or rest rule is not ‘a valid regulation under the present statute.’ 369 F.2d 87, 90. In order to resolve a conflict among the circuits on this recurring question of federal income tax administration, we granted certiorari.

Under §162(a)(2), taxpayers ‘traveling . . . away from home in the pursuit of a trade or business’ may deduct the total amount ‘expended for meals and lodging.’ As a result, even the taxpayer who incurs substantial hotel and restaurant expenses because of the special demands of business travel receives something of a windfall, for at least part of what he spends on meals represents a personal living expense that other taxpayers must bear without receiving any deduction at all. Not surprisingly, therefore, Congress did not extend the special benefits of §162(a)(2) to every conceivable situation involving business travel. It made the total cost of meals and lodging deductible only if incurred in the course of travel that takes the taxpayer ‘away from home.’ The problem before us involves the meaning of that limiting phrase.

Prior to the enactment in 1921 of what is now §162(a)(2), the Commissioner had promulgated a regulation allowing a deduction for the cost of meals and lodging away from home, but only to the extent that this cost exceeded ‘any expenditures ordinarily required for such purposes when at home.’ Treas.Reg. 45 (1920 ed.), Art. 292, 4 Cum.Bull. 209 (1921). Despite its logical appeal, the regulation proved so difficult to administer that the Treasury Department asked Congress to grant a deduction for the ‘entire amount’ of such meal and lodging expenditures. See Statement of Dr. T. S. Adams, Tax Adviser, Treasury Department, in Hearings on H.R. 8245 before the Senate Committee on Finance, 67th Cong., 1st Sess., at 50, 234—235 (1921). Accordingly, s 214(a)(1) of the Revenue Act of 1921, c. 136, 42 Stat. 239, for the first time included the language that later became §162(a)(2). See n. 2, supra. The section was amended in a respect not here relevant by the Revenue Act of 1962, s 4(b), 76 Stat. 976.

In resolving that problem, the Commissioner has avoided the wasteful litigation and continuing uncertainty that would inevitably accompany any purely case-by-case approach to the question of whether a particular taxpayer was ‘away from home’ on a particular day. Rather than requiring ‘every meal-purchasing taxpayer to take pot luck in the courts,’ the Commissioner has consistently construed travel ‘away from home’ to exclude all trips requiring neither sleep nor rest, regardless of how many cities a given trip may have touched, how many miles it may have covered, or how many hours it may have consumed. By
so interpreting the statutory phrase, the Commissioner has achieved not only ease and certainty of application but also substantial fairness, for the sleep or rest rule places all one-day travelers on a similar tax footing, rather than discriminating against intracity travelers and commuters, who of course cannot deduct the cost of the meals they eat on the road. See Commissioner Internal Revenue v. Flowers, 326 U.S. 465, 66 S.Ct. 250, 90 L.Ed. 203.

Any rule in this area must make some rather arbitrary distinctions, but at least the sleep or rest rule avoids the obvious inequity of permitting the New Yorker who makes a quick trip to Washington and back, missing neither his breakfast nor his dinner at home, to deduct the cost of his lunch merely because he covers more miles than the salesman who travels locally and must finance all his meals without the help of the Federal Treasury. And the Commissioner’s rule surely makes more sense than one which would allow the respondent in this case to deduct the cost of his breakfast and lunch simply because he spends a greater percentage of his time at the wheel than the commuter who eats breakfast on his way to work and lunch a block from his office.

The Court of Appeals nonetheless found in the ‘plain language of the statute’ an insuperable obstacle to the Commissioner’s construction. 369 F.2d 87, 89. We disagree. The language of the statute—‘meals and lodging . . . away from home’—is obviously not self-defining. And to the extent that the words chosen by Congress cut in either direction, they tend to support rather than defeat the Commissioner’s position, for the statute speaks of ‘meals and lodging’ as a unit, suggesting—at least arguably—that Congress contemplated a deduction for the cost of meals only where the travel in question involves lodging as well.

Ordinarily, at least, only the taxpayer who finds it necessary to stop for sleep or rest incurs significantly higher living expenses as a direct result of his business travel, and Congress might well have thought that only taxpayer in that category should be permitted to deduct their living expenses while on the road. In any event, Congress certainly recognized, when it promulgated \$162(a)(2), that the Commissioner had so understood its statutory predecessor. This case thus comes within the settled principle that ‘Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially reenacted statutes, are deemed to have received congressional approval and have the effect of law.’ Alternatives to the Commissioner’s sleep or rest rule are of course available. Improvements might be imagined. But we do not sit as a committee of revision to perfect the administration of the tax laws. Congress has delegated to the Commissioner, not to the courts, the task of prescribing ‘all needful rules and regulations for the enforcement’ of the Internal Revenue Code. 26 U.S.C. \$7805(a). In this area of limitless factual variations ‘it is the province of Congress and the Commissioner, not the courts, to make the appropriate adjustments.’ Commissioner v. Stidger, 386 U.S. 287, 296, 87 S.Ct. 1065, 1071, 18 L.Ed.2d 53. The rule of the judiciary in cases of this sort begins and ends with assuring that the Commissioner’s regulations fall within his authority to implement the congressional mandate in some reasonable manner. Because the rule challenged here has not been shown deficient on that score, the Court of Appeals should have sustained its validity. The judgment is therefore reversed.

Mr. Justice DOUGLAS, with whom Mr. Justice BLACK and Mr. Justice FORTAS, concur, dissenting.
The statutory words ‘while away from home,’ 26 U.S.C. §162(a)(2), may not in my view be shrunken to ‘overnight’ by administrative construction or regulations. ‘Overnight’ injects a time element in testing deductibility, while the statute speaks only in terms of geography. As stated by the Court of Appeals:

‘In an era of supersonic travel, the time factor

is hardly relevant to the question of whether or not travel and meal expenses are related to the taxpayer’s business and cannot be the basis of a valid regulation under the present statute.’

Correll v. United States, 369 F.2d 87, 89—90.

I would affirm the judgment below.
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).
Rev. Rul. 94-24, 1994-1 CB 87

ISSUE
How will the Internal Revenue Service apply the "relative importance" and "time" tests set forth in Commissioner v. Soliman, 113 S. Ct. 701 (1993), to determine whether an office in the taxpayer's home is the taxpayer's principal place of business for purposes of section 280A(c)(1)(A) of the Internal Revenue Code?

FACTS
In each of the following situations, the taxpayer uses the office in the home regularly and exclusively for the taxpayer's trade or business.

Situation 1. A is a self-employed plumber who installs and repairs plumbing in customers' homes and offices. A spends approximately 40 hours of A's work time per week at these customer locations, with approximately 10 hours of A's work time per week spent in an office in A's home talking with customers on the telephone, deciding what supplies to order, and reviewing the books of the business. A also employs E, a full-time unrelated employee, in that office to perform administrative services such as answering the telephone, scheduling A's appointments, ordering supplies, and keeping A's books.

Situation 2. B is employed as a teacher. B is required to teach and meet with students at the school, and to grade papers and tests. In addition to a small shared office at the school, B maintains a home office for use in class preparation and for grading papers and tests. B spends approximately 25 hours per week of B's work time at the school, with an additional 30 to 35 hours of B's work time per week spent in B's home office.

Situation 3. C is a self-employed author who uses a home office to write. C spends 30 to 35 hours of C's work time per week in the home office writing. C also spends another 10 to 15 hours of C's work time per week at other locations conducting research, meeting with C's publishers, and attending promotional events.

Situation 4. D is a self-employed retailer of costume jewelry. D orders the jewelry from wholesalers and sells it at craft shows, on consignment, and through mail orders. D spends approximately 25 hours of D's work time per week in D's home filling and shipping mail orders, ordering supplies, and keeping the books of D's business. D also spends approximately 15 hours of D's work time per week at craft shows and consignment sale locations. D generates a substantial amount of income from each type of sales activity.

LAW AND ANALYSIS
Section 162(a) provides a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Section 262 provides that no deduction is allowed for personal, living, or family expenses.

Section 280A(a) generally prohibits otherwise allowable deductions with respect to the use of a dwelling unit which is used by a taxpayer as a residence. This deduction prohibition does not apply to any deduction, such as interest or taxes, that is allowable without regard to its connection with the taxpayer's trade or business. Section 280A(b).

Under section 280A(c)(1), the section 280A deduction prohibition does not apply to the portion of a dwelling unit which is exclusively used on a regular basis -

(A) as the principal place of business for any trade or business of the taxpayer,

(B) as a place of business which is used by patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of the taxpayer's trade or business, or

(C) in the case of a separate structure which is not attached to the dwelling unit, in connection with the taxpayer's trade or business.
In the case of an employee, the preceding sentence applies only if the exclusive use is for the convenience of the employer.

In Commissioner v. Soliman, 113 S. Ct. 701 (1993), the Supreme Court identified two primary factors in determining whether a home office is the taxpayer's principal place of business for purposes of section 280A(c)(1)(A):  

1. the relative importance of the activities performed at each business location; and
2. the amount of time spent at each location.

A comparison of the relative importance of the activities performed at each business location depends on the characteristics of each business. If the nature of a trade or business requires a taxpayer to meet or confer with clients or patients or to deliver services or goods to customers, the place where that contact occurs must be given great weight in determining where the most important activities of the business are performed. If the nature of the business requires that its services are rendered or its goods are delivered at a facility with unique or special characteristics, this is a further and weighty consideration in determining where the most important activities of the business are undertaken.

In addition to comparing the relative importance of the activities performed at each business location, Soliman also directs that a comparison be made of the time spent on business at home with the time spent on business at other locations. This time test is particularly significant when a comparison of the relative importance of the activities performed at each business location yields no definitive answer to the principal place of business inquiry. This may happen when a taxpayer performs income-generating activities at both the office in the taxpayer's home and at some other location.

Consistent with the Supreme Court's analysis in Soliman, the Service will first apply the "relative importance" test, comparing the activities performed at each business location, to determine whether an office in the taxpayer's home is the taxpayer's principal place of business for purposes of section 280A(c)(1)(A). If the relative importance test yields no definitive answer to the principal place of business inquiry (which may occur, for example, if the taxpayer delivers services or goods to customers both at the office in the taxpayer's home and elsewhere), the Service will look to the "time" test. However, as the Supreme Court specifically noted in Soliman, in some cases the application of the relative importance and time tests may result in a determination that there is no principal place of business for purposes of section 280A(c)(1)(A).

Situation 1. The essence of A's trade or business as a plumber requires A to perform services and deliver goods at the homes or offices of A's customers. The telephone activities, supply ordering, and bookkeeping review that A performs at A's home office, although essential, are less important and take less time than A's service calls to customers. Therefore, A's office in the home is not A's principal place of business, and A cannot deduct expenses for the business use of the home. The fact that E, A's employee, performs administrative activities at A's home office does not alter this result.

Situation 2. The essence of B's trade or business as a teacher requires B to teach and meet with students at the school. The class preparation and grading of papers and tests that B performs at B's home office, although essential and more time consuming, are less important than B's activities at the school. Therefore, B's office in the home is not B's principal place of business, and B cannot deduct expenses for the business use of the home. The fact that E, B's employee, performs administrative activities at B's home office does not alter this result.

Situation 3. The essence of C's trade or business as an author is writing. C's research, meetings with publishers, and attendance at promotional events, although essential, are less important and take less time than C's writing. Therefore, C's office in the home is C's principal place of business, and C can deduct expenses for the business use of the home.

Situation 4. The essence of D's trade or business as a retailer of costume jewelry requires D to sell jewelry to customers. D does this at craft shows, at consignment shops, and through catalog orders filled from the office in
D's home. D generates substantial income from the sales made at each of these locations. Because the most important activities of D's business, sales to customers, are performed in more than one location, D's principal place of business cannot be determined definitively based on a comparison of the relative importance of the activities performed at D's home office and at D's other business locations. In this circumstance, the time spent on business activities at each business location assumes particular significance. D spends approximately 25 hours of D's work time per week in the home office filling and shipping mail orders, ordering supplies, and keeping the books of D's business. D also spends approximately 15 hours of D's work time per week at craft shows and consignment shops. Accordingly, D's office in the home is D's principal place of business, and D can deduct expenses for the business use of the home.

**HOLDING**

To determine whether an office in the taxpayer's home is the taxpayer's principal place of business for purposes of section 280A(c)(1)(A), the Service will first apply the "relative importance" test in Soliman to compare the activities performed at each business location. If the relative importance test yields no definitive answer to the principal place of business inquiry (which may occur, for example, if the taxpayer delivers services or goods to customers both at the office in the taxpayer's home and elsewhere), the Service will look to the "time" test. However, as the Supreme Court specifically noted in Soliman, in some cases application of the relative importance and time tests may result in a determination that there is no principal place of business for purposes of section 280A(c)(1)(A).
In 1947 petitioner purchased 13 acres of farm land located on the outskirts of Flint, Michigan, upon which it proceeded to construct a drive-in or outdoor theatre. Prior to its purchase by the petitioner the land on which the theatre was built was farm land and contained vegetation. The slope of the land was such that the natural drainage of water was from the southerly line to the northerly boundary of the property and thence onto the adjacent land, owned by David and Mary D. Nickola, which was used both for farming and as a trailer park. The petitioner’s land sloped sharply from south to north and also sloped from the east downward towards the west so that most of the drainage from the petitioner’s property was onto the southwest corner of the Nickolas’ land. The topography of the land purchased by petitioner was well known to petitioner at the time it was purchased and developed. The petitioner did not change the general slope of its land in constructing the drive-in theatre, but it removed the covering vegetation from the land, slightly increased the grade, and built aisles or ramps which were covered with gravel and were somewhat raised so that the passengers in the automobiles would be able to view the picture on the large outdoor screen.

As a result of petitioner’s construction on and use of this land rain water falling upon it drained with an increased flow into and upon the adjacent property of the Nickolas. This result should reasonably have been anticipated by petitioner at the time when the construction work was done.

The Nickolas complained to the petitioner at various times after petitioner began the construction of the theatre that the work resulted in an acceleration and concentration of the flow of water which drained from the petitioner’s property onto the Nickolas’ land causing damage to their crops and roadways. On or about October 11, 1948, the Nickolas filed a suit against the petitioner in the Circuit Court for the County of Genesee, State of Michigan, asking for an award for damages done to their property by the accelerated and concentrated drainage of the water and for a permanent injunction restraining the defendant from permitting such drainage to continue. Following the filing of an answer by the petitioner and of a reply thereto by the Nickolas, the suit was settled by an agreement dated June 27, 1950. This agreement provided for the construction by the petitioner of a drainage system to carry water from its northern boundary across the Nickolas’ property and thence to a public drain. The cost of maintaining the system was to be shared by the petitioner and the Nickolas, and the latter granted the petitioner and its successors an easement across their land for the purpose of constructing and maintaining the drainage system. The construction of the drain was completed in October 1950 under the supervision of engineers employed by the petitioner and the Nickolas at a cost to the petitioner of $8,224, which amount was paid by it in November 1950. The performance by the petitioner on its part of the agreement to construct the drainage system and to maintain the portion for which it was responsible constituted a full release of the Nickolas’ claims against it. The petitioner chose to settle the dispute by constructing the drainage system because it did not wish to risk the possibility that continued litigation might result in a permanent injunction against its use of the drive-in theatre and because it wished to eliminate the cause of the friction between it and the adjacent landowners, who were in a position to seriously interfere with the petitioner’s use of its property for outdoor theatre purposes. A settlement based on a monetary payment for past damages, the petitioner believed, would not
remove the threat of claims for future damages.

On its 1950 income and excess profits tax return the petitioner claimed a deduction of $822.40 for depreciation of the drainage system for the period July 1, 1950, to December 31, 1950. The Commissioner disallowed without itemization $5,514.60 of a total depreciation expense deduction of $19,326.41 claimed by the petitioner. In its petition the petitioner asserted that the entire amount spent to construct the drainage system was fully deductible in 1950 as an ordinary and necessary business expense incurred in the settlement of a lawsuit, or, in the alternative, as a loss, and claimed a refund of part of the $10,591.56 of income and excess profits tax paid by it for that year.

The drainage system was a permanent improvement to the petitioner’s property, and the cost thereof constituted a capital expenditure.

The stipulation of facts and exhibits annexed thereto are incorporated herein by this reference.

OPINION. KERN, Judge:

When petitioner purchased, in 1947, the land which it intended to use for a drive-in theatre, its president was thoroughly familiar with the topography of this land which was such that when the covering vegetation was removed and graveled ramps were constructed and used by its patrons, the flow of natural precipitation on the lands of abutting property owners would be materially accelerated. Some provision should have been made to solve this drainage problem in order to avoid annoyance and harassment to its neighbors. If petitioner had included in its original construction plans an expenditure for a proper drainage system no one could doubt that such an expenditure would have been capital in nature.

Within a year after petitioner had finished its inadequate construction of the drive-in theatre, the need of a proper drainage system was forcibly called to its attention by one of the neighboring property owners, and under the threat of a lawsuit filed approximately a year after the theatre was constructed, the drainage system was built by petitioner who now seeks to deduct its cost as an ordinary and necessary business expenses, or as a loss.

We agree with respondent that the cost to petitioner of acquiring and constructing a drainage system in connection with its drive-in theatre was a capital expenditure.

Here was no sudden catastrophic loss caused by a ‘physical fault’ undetected by the taxpayer in spite of due precautions taken by it at the time of its original construction work as in American Bemberg Corporation, 10 T.C. 361; no unforeseeable external factor as in Midland Empire Packing Co., 14 T.C. 635; and no change in the cultivation of farm property caused by improvements in technique and made many years after the property in question was put to productive use as in J. H. Collingwood, 20 T.C. 937. In the instant case it was obvious at the time when the drive-in theatre was constructed, that a drainage system would be required to properly dispose of the natural precipitation normally to be expected, and that until this was accomplished, petitioner’s capital investment was incomplete. In addition, it should be emphasized that here there was no mere restoration or rearrangement of the original capital asset, but there was the acquisition and construction of a capital asset which petitioner had not previously had, namely, a new drainage system.

That this drainage system was acquired and constructed and that payments therefor were made in compromise of a lawsuit is not determinative of whether such payments were ordinary and necessary business expenses or capital expenditures. ‘The decisive test is still the character of the transaction which gives rise to the payment.’ Hales-Mullalay v. Commissioner, 131 F.2d 509, 511, 512.

In our opinion the character of the transaction in the instant case indicates that the transaction was
a capital expenditure. Decision will be entered for the respondent.

RAUM, J. concurring: The expenditure herein was plainly capital in nature, and, as the majority opinion points out, if provision had been made in the original plans for the construction of a drainage system there could hardly be any question that its cost would have been treated as a capital outlay. The character of the expenditure is not changed merely because it is made at a subsequent time, and I think it wholly irrelevant whether the necessity for the drainage system could have been foreseen, or whether the payment therefor was made as a result of the pressure of a law suit. FISHER, J., agrees with this concurring opinion.

RICE, J. dissenting: It seems to me that J. H. Collingwood, 20 T.C. 937 (1953), Midland Empire Packing Co., 14 T.C. 635 (1950), American Bemberg Corporation, 10 T.C. 361 (1948), aff’d. 177 F.2d 200 (C.A. 1949), and Illinois Merchants Trust Co., Executor, 4 B.T.A. 103 (1926), are ample authority for the conclusion that the expenditure which petitioner made was an ordinary and necessary business expense, which did not improve, better, extend, increase, or prolong the useful life of its property. The expenditure did not cure the original geological defect of the natural drainage onto the Nickolas’ land, but only dealt with the intermediate consequence thereof. The majority opinion does not distinguish those cases adequately. And since those cases and the result reached herein do not seem to me to be able to ‘live together,’ I cannot agree with the majority that the expenditure here was capital in nature. OPPER, JOHNSON, BRUCE, and MULRONEY, JJ., agree with this dissent.

Mt. Morris Drive-In Theate Company v. Commissioner
238 F.2d 85 (6th Cir. 1956)

Before SIMONS, Chief Judge, and ALLEN and McALLISTER, Circuit Judges.

PER CURIAM. The above cause is affirmed for the reasons given in the memorandum opinion of the Tax Court. The drainage system there involved we think was a capital improvement. There is substantial evidence that it added to the value of the petitioner’s land for the use to which it had been put; that it is immaterial that that increase in value was not by evidence measured in dollars, and that the inferences of the Tax Court could be and were drawn from the physical configuration of the land and what it had been necessary to do to establish thereon the Drive-In Theatre which the petitioner erected thereon. The decision of the Tax Court is affirmed.

McALLISTER, Circuit Judge (dissenting).

It appears clear to me that the finding of the Tax Court that the drainage system in question was a permanent improvement to petitioner’s property was unsupported by the evidence. If it had not been for the action brought against petitioner by the Nickolas’ for damages to their property because of the alleged conduct of petitioner in increasing the drainage of rainfall upon their land, petitioner would never have thought of constructing a drain; and if it had paid $8,224 to the Nickolas’ in settlement of their suit or claims for past, present, and future damages resulting from such increased drainage of water, such payment could not be considered as an expenditure for a permanent improvement to increase the value of its property, or, as the Tax Court found, ‘a permanent improvement to petitioner’s property.’ There is no difference between the construction of the drain by petitioner and the payment to the Nickolas’ of the amount required for its construction. I therefore concur with the minority opinion of the Tax Court and accordingly am of the view that the decision should be reversed.
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 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, 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. . . .
AIRCRAFT MAINTENANCE COSTS

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 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

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. **

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 labor and materials allocable to these capital improvements must be treated as capital expenditures under § 263. * * *

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
circumstances. * * * 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.
Mr. Justice BLACKMUN delivered the opinion of the Court.

. . . . The taxpayer-respondent, Idaho Power Company, is a Maine corporation organized in 1915, with its principal place of business at Boise, Idaho. It is a public utility engaged in the production, transmission, distribution, and sale of electric energy. The taxpayer keeps its books and files its federal income tax returns on the calendar year accrual basis. The tax years at issue are 1962 and 1963.

For many years, the taxpayer has used its own equipment and employees in the construction of improvements and additions to its capital facilities. The major work has consisted of transmission lines, transmission switching stations, distribution lines, distribution stations, and connecting facilities.

During 1962 and 1963, the tax years in question, taxpayer owned and used in its business a wide variety of automotive transportation equipment, including passenger cars, trucks of all descriptions, power-operated equipment, and trailers. Radio communication devices were affixed to the equipment and were used in its daily operations. The transportation equipment was used in part for operation and maintenance and in part for the construction of capital facilities having a useful life of more than one year.

On its books, the taxpayer used various methods of charging costs incurred in connection with its transportation equipment either to current expense or to capital accounts. To the extent the equipment was used in construction, the taxpayer charged depreciation of the equipment, as well as all operating and maintenance costs (other than pension contributions and social security and motor vehicle taxes) to the capital assets so constructed. This was done either directly or through clearing accounts in accordance with procedures prescribed by the Federal Power Commission and adopted by the Idaho Public Utilities Commission.

For federal income tax purposes, however, the taxpayer treated the depreciation on transportation equipment differently. It claimed as a deduction from gross income all the year’s depreciation on such equipment, including that portion attributable to its use in constructing capital facilities. The depreciation was computed on a composite life of 10 years and under straight-line and declining-balance methods. The other operating and maintenance costs the taxpayer had charged on its books to capital were not claimed as current expenses and were not deducted. . . .

Upon audit, the Commissioner of Internal Revenue disallowed the deduction for the construction-related depreciation. He ruled that that depreciation was a nondeductible capital expenditure to which § 263(a)(1) had application. He added the amount of the depreciation so disallowed to the taxpayer’s adjusted basis in its capital facilities, and then allowed a deduction for an appropriate amount of depreciation on the addition, computed over the useful life (30 years or more) of the property constructed. A deduction for depreciation of the transportation equipment to the extent of its use in day-to-day operation and maintenance was also allowed. . . .

Our primary concern is with the necessity to treat construction-related depreciation in a manner that comports with accounting and taxation realities. Over a period of time a capital asset is consumed and, correspondingly
over that period, its theoretical value and utility are thereby reduced. Depreciation is an accounting device which recognizes that the physical consumption of a capital asset is a true cost, since the asset is being depleted. As the process of consumption continues, and depreciation is claimed and allowed, the asset’s adjusted income tax basis is reduced to reflect the distribution of its cost over the accounting periods affected. . . . When the asset is used to further the taxpayer’s day-to-day business operations, the periods of benefit usually correlate with the production of income. Thus, to the extent that equipment is used in such operations, a current depreciation deduction is an appropriate offset to gross income currently produced. It is clear, however, that different principles are implicated when the consumption of the asset takes place in the construction of other assets that, in the future, will produce income themselves. In this latter situation, the cost represented by depreciation does not correlate with production of current income. Rather, the cost, although certainly presently incurred, is related to the future and is appropriately allocated as part of the cost of acquiring an income-producing capital asset.

The Court of Appeals opined that the purpose of the depreciation allowance under the Code was to provide a means of cost recovery, Knoxville v. Knoxville Water Co., 212 U.S. 1, 13—14, 29 S.Ct. 148, 152, 53 L.Ed. 371 (1909), and that this Court’s decisions, e.g., Detroit Edison Co. v. Commissioner of Internal Revenue, 319 U.S. 98, 101, 63 S.Ct. 902, 903, 87 L.Ed.2d 1286 (1943), endorse a theory of replacement through ‘a fund to restore the property.’ 477 F.2d, at 691. Although tax-free replacement of a depreciating investment is one purpose of depreciation accounting, it alone does not require the result claimed by the taxpayer here. Only last Term, in United States v. Chicago, B. & Q.R. Co., 412 U.S. 401, 93 S.Ct. 2169, 37 L.Ed.2d 30 (1973), we rejected replacement as

the strict and sole purpose of depreciation:

‘Whatever may be the desirability of creating a depreciation reserve under these circumstances, as a matter of good business and accounting practice, the answer is . . . ‘(d)epreciation reflects the cost of an existing capital asset, not the cost of a potential replacement." Id., at 415, 93 S.Ct., at 2177.

Even were we to look to replacement, it is the replacement of the constructed facilities, not the equipment used to build them, with which we would be concerned. If the taxpayer now were to decide not to construct any more capital facilities with its own equipment and employees, it, in theory, would have no occasion to replace its equipment to the extent that it was consumed in prior construction. . . .

There can be little question that other construction-related expense items, such as tools, materials, and wages paid construction workers, are to be treated as part of the cost of acquisition of a capital asset. The taxpayer does not dispute this. Of course, reasonable wages paid in the carrying on of a trade or business qualify as a deduction from gross income. s 162(a)(1) of the 1954 Code, 26 U.S.C. s 162(a)(1). But when wages are paid in connection with the construction or acquisition of a capital asset, they must be capitalized and are then entitled to be amortized over the life of the capital asset so acquired.

Construction-related depreciation is not unlike expenditures for wages for construction workers. The significant fact is that the exhaustion of construction equipment does not represent the final disposition of the taxpayer’s investment in that equipment; rather, the investment in the equipment is assimilated into the cost of the capital asset constructed. Construction-related depreciation on the equipment is not an expense to the taxpayer of
its day-to-day business. It is, however, appropriately recognized as a part of the taxpayer’s cost or investment in the capital asset. The taxpayer’s own accounting procedure reflects this treatment, for on its books the construction-related depreciation was capitalized by a credit to the equipment account and a debit to the capital facility account. By the same token, this capitalization prevents the distortion of income that would otherwise occur if depreciation properly allocable to asset acquisition were deducted from gross income currently realized.

An additional pertinent factor is that capitalization of construction-related depreciation by the taxpayer who does its own construction work maintains tax parity with the taxpayer who has its construction work done by an independent contractor. The depreciation on the contractor’s equipment incurred during the performance of the job will be an element of cost charged by the contractor for his construction services, and the entire cost; of course, must be capitalized by the taxpayer having the construction work performed. The Court of Appeals’ holding would lead to disparate treatment among taxpayers because it would allow the firm with sufficient resources to construct its own facilities and to obtain a current deduction, whereas another firm without such resources would be required to capitalize its entire cost including depreciation charged to it by the contractor.

Some, although not controlling, weight must be given to the fact that the Federal Power Commission and the Idaho Public Utilities Commission required the taxpayer to use accounting procedures that capitalized construction-related depreciation. . . .

The presence of § 263(a)(1) in the Code is of significance. Its literal language denies a deduction for ‘(a)ny amount paid out’ for construction or permanent improvement of facilities. The taxpayer contends, and the Court of Appeals held, that depreciation of construction equipment represents merely a decrease in value and is not an amount ‘paid out,’ within the meaning of § 263(a)(1). We disagree.

. . . . There is no question that the cost of the transportation equipment was ‘paid out’ in the same manner as the cost of supplies, materials, and other equipment, and the wages of construction workers. The taxpayer does not question the capitalization of these other items as elements of the cost of acquiring a capital asset. We see no reason to treat construction-related depreciation differently. In acquiring the transportation equipment, taxpayer ‘paid out’ the equipment’s purchase price; depreciation is simply the means of allocating the payment over the various accounting periods affected. As the Tax Court stated in Brooks v. Commissioner, 50 T.C., at 935, ‘depreciation—inasmuch as it represents a using up of capital— is as much an ‘expenditure’ as the using up of labor or other items of direct cost.’

Finally, the priority-ordering directive of § 161—or, for that matter, § 261 of the Code, 26 U.S.C. s 261—requires that the capitalization provision of § 263(a) take precedence, on the facts here, over § 167(a). Section 161 provides that deductions specified in Part VI of Subchapter B of the Income Tax Subtitle of the Code are ‘subject to the exceptions provided in part IX.’ Part VI includes § 167 and Part IX includes s 263. The clear import of § 161 is that, with stated exceptions set forth either in § 263 itself or provided for elsewhere (as, for example, in s 404 relating to pension contributions), none of which is applicable here, an expenditure incurred in acquiring capital assets must be capitalized even when the expenditure otherwise might be deemed deductible under Part VI.

The Court of Appeals concluded, without reference to § 161, that § 263 did not apply to a deduction, such as that for depreciation of property used in a trade or business, allowed
78 (Id by the Code even though incurred in the construction of capital assets. We think that the court erred in espousing so absolute a rule, and it obviously overlooked the contrary direction.

Mr. Justice DOUGLAS, dissenting.

A company truck has, let us say, a life of 10 years. If it cost $10,000, one would expect that ‘a reasonable allowance for the exhaustion, wear and tear’ of the truck would be $1,000 a year within the meaning of §167(a). . . . Not so, says the Government. Since the truck was used to build a plant for the taxpayer and the plant has a useful life of 40 years, a lower rate of depreciation must be used—a rate that would spread out the life of the truck for 40 years even though it would not last more than 10. Section 167 provides for a depreciation deduction with respect to property ‘used in the (taxpayer’s) trade or business’ or ‘held for the production of income’ by the taxpayer. There is no intimation that §167(a) is not satisfied. The argument is rested upon §161 which allows the deductions specified in §167(a) ‘subject to the exceptions’ in §263(a). . . .

I agree with the Court of Appeals that depreciation claimed on a truck whose useful life is 10 years is not an amount ‘paid out’ within the meaning of §263(a)(1). If ‘payment’ in the setting of §263(a)(1). . . .

I suspect that if the life of the vehicle were 40 years and the life of the building were 10 years the Internal Revenue Service would be here arguing persuasively that depreciation of the vehicle should be taken over a 40-year period. That is not to impugn the integrity of the IRS. It is only an illustration of the capricious character of how law is construed to get from the taxpayer the greatest possible return that is permissible under the Code. . . .

If the test under §263(a)(1) were the cost of capital improvements, the result would be different. But, as noted, the test is ‘any amount paid out,’ which certainly does not describe depreciation deductions unless words are to acquire esoteric meanings merely to accommodate the IRS. Congress is the lawmaker; and taking the law from it, we should affirm the Court of Appeals.
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 carrying 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. 1 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 ground work 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 viscid 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. 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.
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. * * * This phenomenal population growth forced the city to expand geographically in the only direction it could, eastward, and generally towards plaintiff’s mining operations. * * * By the mid-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. It was plain that if the school were built that this would hasten development of access roads that would benefit Ottawa. 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, petitioner’s ‘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 petitioner’s 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.
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.
**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-a-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.”
ESTATE of Frank D. STRANAHAN v. COMMISSIONER
472 F.2d 867 (6th Cir. 1973)

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 this 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 notnullify 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. 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.
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. 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 * * *.’ A 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.
Mr. Justice Goldberg, Mr. Chief Justice Warren and Mr. Justice Black dissented.

Mr. Justice WHITE delivered the opinion of the Court.

... Clay Brown, members of his family and three other persons owned substantially all of the stock in Clay Brown & Company, with sawmills and lumber interests near Fortuna, California. Clay Brown, the president of the company and spokesman for the group, was approached by a representative of California Institute for Cancer Research in 1952, and after considerable negotiation the stockholders agreed to sell their stock to the Institute for $1,300,000, payable $5,000 down from the assets of the company and the balance within 10 years from the earnings of the company’s assets. It was provided that simultaneously with the transfer of the stock, the Institute would liquidate the company and lease its assets for five years to a new corporation, Fortuna Sawmills, Inc., formed and wholly owned by the attorneys for the sellers. Fortuna would pay to the Institute 80% of its operating profit without allowance for depreciation or taxes, and 90% of such payments would be paid over by the Institute to the selling stockholders to apply on the $1,300,000 note. This note was noninterest bearing, the Institute had no obligation to pay it except from the rental income and it was secured by mortgages and assignments of the assets transferred or leased to Fortuna. If the payments on the note failed to total $250,000 over any two consecutive years, the sellers could declare the entire balance of the note due and payable. The sellers were neither stockholders nor directors of Fortuna but it was provided that Clay Brown was to have a management contract with Fortuna at an annual salary and the right to name any successor manager if he himself resigned.

The transaction was closed on February 4, 1953. Fortuna immediately took over operations of the business under its lease, on the same premises and with practically the same personnel which had been employed by Clay Brown & Company. Effective October 31, 1954, Clay Brown resigned as general manager of Fortuna and waived his right to name his successor. In 1957, because of a rapidly declining lumber market, Fortuna suffered severe reverses and its operations were terminated. Respondent sellers did not repossess the properties under their mortgages but agreed they should be sold by the Institute with the latter retaining 10% of the proceeds. Accordingly, the property was sold by the Institute for $300,000. The payments on the note from rentals and from the sale of the properties totaled $936,131.85. Respondents returned the payments received from rentals as the gain from the sale of capital assets. The Commissioner, however, asserted the payments were taxable as ordinary income and were not capital gain within the meaning of I.R.C.1939, s 117(a)(4) and I.R.C.1954, s 1222(3). These sections provide that ‘(t)he term ‘long-term capital gain’ means gain from the sale or exchange of a capital asset held for more than 6 months ....’

In the Tax Court, the Commissioner asserted that the transaction was a sham and that in any event respondents retained such an economic interest in and control over the property sold that the transaction could not be treated as a sale resulting in a long-term capital gain. A divided Tax Court, 37 T.C. 461, found that there had been...
considerable good faith bargaining at arm’s length between the Brown family and the Institute, that the price agreed upon was within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of its assets, that the primary motivation for the Institute was the prospect of ending up with the assets of the business free and clear after the purchase price had been fully paid, which would then permit the Institute to convert the property and the money for use in cancer research, and that there had been a real change of economic benefit in the transaction. Its conclusion was that the transfer of respondents’ stock in Clay Brown & Company to the Institute was a bona fide sale arrived at in an arm’s-length transaction and that the amounts received by respondents were proceeds from the sale of stock and entitled to long-term capital gains treatment under the Internal Revenue Code. The Court of Appeals affirmed, 9 Cir., 325 F.2d 313, and we granted certiorari, 377 U.S. 962, 84 S.Ct. 1647, 12 L.Ed.2d 734.

Having abandoned in the Court of Appeals the argument that this transaction was a sham, the Commissioner now admits that there was real substance in what occurred between the Institute and the Brown family. The transaction was a sale under local law. The Institute acquired title to the stock of Clay Brown & Company and, by liquidation, to all of the assets of that company, in return for its promise to pay over money from the operating profits of the company. If the stipulated price was paid, the Brown family would forever lose all rights to the income and properties of the company. Prior to the transfer, these respondents had access to all of the income of the company; after the transfer, 28% of the income remained with Fortuna and the Institute. Respondents had no interest in the Institute nor were they stockholders or directors of the operating company. Any rights to control the management were limited to the management contract between Clay Brown and Fortuna, which was relinquished in 1954.

Whatever substance the transaction might have had, however, the Commissioner claims that it did not have the substance of a sale within the meaning of s 1222(3). His argument is that since the Institute invested nothing, assumed no independent liability for the purchase price and promised only to pay over a percentage of the earnings of the company, the entire risk of the transaction remained on the sellers. Apparently, to qualify as a sale, a transfer of property for money or the promise of money must be to a financially responsible buyer who undertakes to pay the purchase price other than from the earnings or the assets themselves or there must be a substantial down payment which shifts at least part of the risk to the buyer and furnishes some cushion against loss to the seller.

To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term ‘sale,’ is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it.

‘Capital gain’ and ‘capital asset’ are creatures of the tax law and the Court has been inclined to give these terms a narrow, rather than a broad, construction. Corn Products Co. v. Commissioner, 350 U.S. 46, 52, 76 S.Ct. 20, 24, 100 L.Ed. 29. A ‘sale,’ however, is a common event in the non-tax world; and since it is used in the Code without limiting definition and without legislative history indicating a contrary result, its common and ordinary meaning should at least be persuasive of its meaning as used in the Internal Revenue Code. ‘Generally speaking, the language in the Revenue Act, just as in any statute, is to be given its ordinary meaning, and the words ‘sale’ and ‘exchange’ are not to be read any differently.’ Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 249, 61 S.Ct.
A sale, in the ordinary sense of the word, is a transfer of property for a fixed price in money or its equivalent,' State of Iowa v. McFarland, 110 U.S. 471, 478, 4 S.Ct. 210, 214, 28 L.Ed. 198; it is a contract ‘to pass rights of property for money,—which the buyer pays or promises to pay to the seller . . .’ Williamson v. Berry, 8 How. 495, 544, 12 L.Ed. 1170. Compare the definition of ‘sale’ in s 1(2) of the Uniform Sales Act and in s 2—106(1) of the Uniform Commercial Code. The transaction which occurred in this case was obviously a transfer of property for a fixed price payable in money.

Unquestionably the courts, in interpreting a statute, have some ‘scope for adopting a restricted rather than a literal or usual meaning of its words where acceptance of that meaning would lead to absurd results . . . or would thwart the obvious purpose of the statute.’ Helvering v. Hammel, 311 U.S. 504, 510—511, 61 S.Ct. 368, 371, 85 L.Ed. 303; cf. Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134, 80 S.Ct. 1497, 1500, 4 L.Ed. 1617; and Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694, 2 L.Ed.2d 743. But it is otherwise ‘where no such consequences (would) follow and where * * * it appears to be consonant with the purposes of the Act . . . .’ Helvering v. Hammel, supra, 311 U.S. at 511, 61 S.Ct, at 371; Takao Ozawa v. United States, 260 U.S. 178, 194, 43 S.Ct. 65, 67, 67 L.Ed. 199. We find nothing in this case indicating that the Tax Court or the Court of Appeals construed the term ‘sale’ too broadly or in a manner contrary to the purpose or policy of capital gains provisions of the Code.

Congress intended 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.’ Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134, 80 S.Ct. 1497, 1500. It was to ‘relieve the taxpayer from . . . excessive tax burdens on gains resulting from a conversion of capital investments’ that capital gains were taxed differently by Congress. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199; Commissioner v. P. G. Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694, 2 L.Ed.2d 743.

As of January 31, 1953, the adjusted net worth of Clay Brown & Company as revealed by its books was $619,457.63. This figure included accumulated earnings of $448,471.63, paid in surplus, capital stock and notes payable to the Brown family. The appraised value as of that date, however, relied upon by the Institute and the sellers, was $1,064,877, without figuring interest on deferred balances. Under a deferred payment plan with a 6% interest figure, the sale value was placed at $1,301,989. The Tax Court found the sale price agreed upon was arrived at in an arm’s-length transaction, was the result of real negotiating and was ‘within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.’ 37 T.C. 461, 486.

Obviously, on these facts, there had been an appreciation in value accruing over a period of years, Commissioner v. Gillette Motor Transport, Inc., supra, and an ‘increase in the value of the income-producing property.’ Commissioner v. P. G. Lake, Inc., supra, at 266, 78 S.Ct. at 695. This increase taxpayers were entitled to realize at capital gains rates on a cash sale of their stock; and likewise if they sold on a deferred payment plan taking an instalment note and a mortgage as security. Further, if the down payment was less than 30% (the 1954 Code requires no down payment at all) and the transaction otherwise satisfied I.R.C.1939, s 44,
the gain itself could be reported on the installment basis.

In the actual transaction, the stock was transferred for a price payable on the installment basis but payable from the earnings of the company. Eventually $936,131.85 was realized by respondents. This transaction, we think, is a sale, and so treating it is wholly consistent with the purposes of the Code to allow capital gains treatment for realization upon the enhanced value of a capital asset.

The Commissioner, however, embellishes his risk-shifting argument. Purporting to probe the economic realities of the transaction, he reasons that if the seller continues to bear all the risk and the buyer none, the seller must be collecting a price for his risk-bearing in the form of an interest in future earnings over and above what would be a fair market value of the property. Since the seller bears the risk, the so-called purchase price must be excessive and must be simply a device to collect future earnings at capital gains rates.

We would hesitate to discount unduly the power of pure reason and the argument is not without force. But it does present difficulties. In the first place, it denies what the tax court expressly found—that the price paid was within reasonable limits based on the earnings and net worth of the company; and there is evidence in the record to support this finding. We do not have, therefore, a case where the price has been found excessive.

Secondly, if an excessive price is such an inevitable result of the lack of risk-shifting, it would seem that it would not be an impossible task for the Commissioner to demonstrate the fact. However, in this case he offered no evidence whatsoever to this effect; and in a good many other cases involving similar transactions, in some of which the reasonableness of the price paid by a charity was actually contested, the Tax Court has found the sale price to be within reasonable limits, as it did in this case.7

Thirdly, the Commissioner ignores as well the fact that if the rents payable by Fortuna were deductible by it and not taxable to the Institute, the Institute could pay off the purchase price at a considerably faster rate than the ordinary corporate buyer subject to income taxes, a matter of considerable importance to a seller who wants the balance of his purchase price paid as rapidly as he can get it. The fact is that by April 30, 1955, a little over two years after closing this transaction, $412,595.77 had been paid on the note and within another year the sellers had collected another $238,498.80, for a total of $651,094.57.

Furthermore, risk-shifting of the kind insisted on by the Commissioner has not heretofore been considered an essential ingredient of a sale for tax purposes. In LeTulle v. Scofield, 308 U.S. 415, 60 S.Ct. 313, 84 L.Ed. 355, one corporation transferred properties to another for cash and bonds secured by the properties transferred. The Court held that there was ‘a sale or exchange upon which gain or loss must be reckoned in accordance with the provisions of the revenue act dealing with the recognition of gain or loss upon a sale or exchange,’ id., at 421, 60 S.Ct. at 316, since the seller retained only a creditor’s interest rather than a proprietary one. ‘(T)hat the bonds were secured solely by the assets transferred and that upon default, the bonholder would retake only the property sold, (did not change) his status from that of a creditor to one having a proprietary stake.’ Ibid. Compare Marr v. United States, 268 U.S. 536, 45 S.Ct. 575, 69 L.Ed. 1079. To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than the earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale. The term ‘sale’ is used a great many times in the Internal Revenue Code and a wide variety of tax results hinge on the occurrence of a ‘sale.’ To accept the Commissioner’s definition of sale would have wide ramifications which we are not prepared to visit upon taxpayers, absent
congressional guidance in this direction.

The Commissioner relies heavily upon the cases involving a transfer of mineral interests, the transferor receiving a bonus and retaining a royalty or other interest in the mineral production. Burnet v. Harmel, 287 U.S. 103, 53 S.Ct. 74, 77 L.Ed. 199; Palmer v. Bender, 287 U.S. 551, 53 S.Ct. 225, 77 L.Ed. 489; Thomas v. Perkins, 301 U.S. 655, 57 S.Ct. 911, 81 L.Ed. 1324; Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 66 S.Ct. 409, 90 L.Ed. 343; Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 66 S.Ct. 861, 90 L.Ed. 1062; Commissioner v. Southwest Exploration Co., 350 U.S. 308, 76 S.Ct. 395, 100 L.Ed. 347. Thomas v. Perkins is deemed particularly pertinent. There a leasehold interest was transferred for a sum certain payable in oil as produced and it was held that the amounts paid to the transferor were not includable in the income of the transferee but were income of the transferor. We do not, however, deem either Thomas v. Perkins or the other cases controlling.

First, ‘Congress . . . has recognized the peculiar character of the business of extracting natural resources,’ Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25, 33, 66 S.Ct. 861, 866; see Stratton’s Independence Ltd. v. Howbert, 231 U.S. 399, 413—414, 34 S.Ct. 136, 138—139, 58 L.Ed. 285, which is viewed as an income-producing operation and not as a conversion of capital investment, Anderson v. Helvering, supra, at 407, 60 S.Ct. 952 at 953, 84 L.Ed. 1277, but one which has its own built-in method of allowing through depletion ‘a tax-free return of the capital consumed in the production of gross income through severance,’ Anderson v. Helvering, supra, at 408, 60 S.Ct. at 954, which is independent of cost and depends solely on production, Burton-Sutton, 328 U.S. at 34, 66 S.Ct. at 866. Percentage depletion allows an arbitrary deduction to compensate for exhaustion of the asset, regardless of cost incurred or any investment which the taxpayer may have made. The Commissioner, however, would assess to respondents as ordinary income the entire amount of all rental payments made by the Institute, regardless of the accumulated values in the corporation which the payments reflected and without regard for the present policy of the tax law to allow the taxpayer to realize on appreciated values at the capital gains rates.

Second, Thomas v. Perkins does not have unlimited sweep. The Court in Anderson v. Helvering, supra, pointed out that it was still possible for the owner of a working interest to divest himself finally and completely of his mineral interest by effecting a sale. In that case the owner of royalty interest, fee interest and deferred oil payments contracted to convey them for $160,000 payable $50,000 down and the balance from one-half the proceeds which might be derived from the oil and gas produced and from the sale of the fee title to any of the lands conveyed. The Court refused to extend Thomas v. Perkins beyond the oil payment transaction involved in that case. Since the transferor in Anderson had provided for payment of the purchase price from the sale of fee interest as well as from the production of oil and gas, ‘the reservation of this additional type of security for the deferred payments serve(d) to distinguish this case from Thomas v. Perkins. It is similar to the reservation in a lease of oil payment rights together with a personal guarantee by the lessee that such payments shall at all events equal the specified sum.’ Anderson v. Helvering, supra, at 412—413, 60 S.Ct. at 956. Hence, there was held to be an outright sale of the properties, all of the oil income therefrom being taxable to the transferee notwithstanding the fact of payment of part of it to the seller. The respondents in this case, of course, not only had rights against income, but if the income failed to amount to $250,000 in any two consecutive years, the entire amount could be declared due, which was secured by a lien on the real and personal properties of the company.

There is another reason for us not to disturb the ruling of the Tax Court and the Court of Appeals. In 1963, the Treasury Department, in the course
of hearings before the Congress, noted the availability of capital gains treatment on the sale of capital assets even though the seller retained an interest in the income produced by the assets. The Department proposed a change in the law which would have taxed as ordinary income the payments on the sale of a capital asset which were deferred over more than five years and were contingent on future income. Payments, though contingent on income, required to be made within five years would not have lost capital gains status nor would payments not contingent on income even though accompanied by payments which were. Hearings before the House Committee on Ways and Means, 88th Cong., 1st Sess., Feb. 6, 7, 8 and 18, 1963, Pt. I (rev.), on the President’s 1963 Tax Message, pp. 154—156.

Congress did not adopt the suggested change but it is significant for our purposes that the proposed amendment did not deny the fact or occurrence of a sale but would have taxed as ordinary income those income-contingent payments deferred for more than five years. If a purchaser could pay the purchase price out of earnings within five years the seller would have capital gain rather than ordinary income. The approach was consistent with allowing appreciated values to be treated as capital gain but with appropriate safeguards against reserving additional rights to future income. In comparison, the Commissioner’s position here is a clear case of ‘overkill’ if aimed at preventing the involvement of tax-exempt entities in the purchase and operation of business enterprises. There are more precise approaches to this problem as well as to the question of the possibly excessive price paid by the charity or foundation. And if the Commissioner’s approach is intended as a limitation upon the tax treatment of sales generally, it represents a considerable invasion of current capital gains policy, a matter which we think is the business of Congress, not ours.

The problems involved in the purchase of a going business by a tax-exempt organization have been considered and dealt with by the Congress. Likewise, it was given its attention to various kinds of transactions involving the payment of the agreed purchase price for property from the future earnings of the property itself. In both situations it has responded, if at all, with precise provisions of narrow application. We consequently deem it wise to ‘leave to the Congress the fashioning of a rule which, in any event, must have wide ramifications.’ American Automobile Ass’n v. United States, 367 U.S. 687, 697, 81 S.Ct. 1727, 1732, 6 L.Ed.2d 1109. Affirmed.

Mr. Justice HARLAN, concurring.

Were it not for the tax laws, the respondents’ transaction with the Institute would make no sense, except as one arising from a charitable impulse. However the tax laws exist as an economic reality in the businessman’s world, much like the existence of a competitor. Businessmen plan their affairs around both, and a tax dollar is just as real as one derived from any other source. The Code gives the Institute a tax exemption which makes it capable of taking a greater after-tax return from a business than could a non-tax-exempt individual or corporation. Respondents traded a residual interest in their business for a faster payout apparently made possible by the Institute’s exemption. The respondents gave something up; they received something substantially different in return. If words are to have meaning, there was a ‘sale or exchange.’

Obviously the Institute traded on its tax exemption. The Government would deny that there was an exchange, essentially on the theory that the Institute did not put anything at risk; since its exemption is unlimited, like the magic purse that always contains another penny, the
Institute gave up nothing by trading on it.

One may observe preliminarily that the Government’s remedy for the so-called ‘bootstrap’ sale—defining sale or exchange so as to require the shifting of some business risks—would accomplish little by way of closing off such sales in the future. It would be neither difficult nor burdensome for future users of the bootstrap technique to arrange for some shift of risks. If such sales are considered a serious abuse, ineffective judicial correctives will only postpone the day when Congress is moved to deal with the problem comprehensively. Furthermore, one may ask why, if the Government does not like the tax consequences of such sales, the proper course is not to attack the exemption rather than to deny the existence of a ‘real’ sale or exchange.

The force underlying the Government’s position is that the respondents did clearly retain some risk-bearing interest in the business. Instead of leaping from this premise to the conclusion that there was no sale or exchange, the Government might more profitably have broken the transaction into components and attempted to distinguish between the interest which respondents retained and the interest which they exchanged. The worth of a business depends upon its ability to produce income over time. What respondents gave up was not the entire business, but only their interest in the business’ ability to produce income in excess of that which was necessary to pay them off under the terms of the transaction. The value of such a residual interest is a function of the risk element of the business and the amount of income it is capable of producing per year, and will necessarily be substantially less than the value of the total business. Had the Government argued that it was that interest which respondents exchanged, and only to that extent should they have received capital gains treatment, we would perhaps have had a different case.

I mean neither to accept nor reject this approach, or any other which falls short of the all-or-nothing theory specifically argued by the petitioner, specifically opposed by the respondents, and accepted by the Court as the premise for its decision. On a highly complex issue with as wide ramifications as the one before us, it is vitally important to have had the illumination provided by briefing and argument directly on point before any particular path is irrevocably taken. Where the definition of ‘sale or exchange’ is concerned, the Court can afford to proceed slowly and by stages. The illumination which has been provided in the present case convinces me that the position taken by the Government is unsound and does not warrant reversal of the judgment below. Therefore I concur in the judgment to affirm.

Mr. Justice GOLDBERG, with whom THE CHIEF JUSTICE and Mr. Justice BLACK join, dissenting.

The essential facts of this case which are undisputed illuminate the basic nature of the transaction at issue. Respondents conveyed their stock in Clay Brown & Co., a corporation owned almost entirely by Clay Brown and the members of his immediate family, to the California Institute for Cancer Research, a tax-exempt foundation. The Institute liquidated the corporation and transferred its assets under a five-year lease to a new corporation, Fortuna, which was managed by respondent Clay Brown, and the shares of which were in the name of Clay Brown’s attorneys, who also served as Fortuna’s directors. The business thus continued under a new name with no essential change in control of its operations. Fortuna agreed to pay 80% of its pretax profits to the Institute as rent under the lease, and the Institute agreed to pay 90% of this amount to respondents in payment for their shares until the respondents received $1,300,000, at which time their interest would terminate and the Institute would own the complete beneficial interest as well as all legal interest in the
business. If remittances to respondents were less than $250,000 in any two consecutive years or any other provision in the agreements was violated, they could recover the property. The Institute had no personal liability. In essence respondents conveyed their interest in the business to the Institute in return for 72% of the profits of the business and the right to recover the business assets if payments fell behind schedule.

At first glance it might appear odd that the sellers would enter into this transaction, for prior to the sale they had a right to 100% of the corporation’s income, but after the sale they had a right to only 72% of that income and would lose the business after 10 years to boot. This transaction, however, afforded the sellers several advantages. The principal advantage sought by the sellers was capital gain, rather than ordinary income, treatment for that share of the business profits which they received. Further, because of the Tax Code’s charitable exemption and the lease arrangement with Fortuna,\(^2\) the Institute believed that neither it nor Fortuna would have to pay income tax on the earnings of the business. Thus the sellers would receive free of corporate taxation, and subject only to personal taxation at capital gains rates, 72% of the business earnings until they were paid $1,300,000. Without the sale they would receive only 48% of the business earnings, the rest going to the Government in corporate taxes, and this 48% would be subject to personal taxation at ordinary rates. In effect the Institute sold the respondents the use of its tax exemption, enabling the respondents to collect $1,300,000 from the business more quickly than they otherwise could and to pay taxes on this amount at capital gains rates. In return, the Institute received a nominal amount of the profits while the $1,300,000 was being paid, and it was to receive the whole business after this debt had been paid off. In any realistic sense the Government’s grant of a tax exemption was used by the Institute as part of an arrangement that allowed it to buy a business that in fact cost it nothing. I cannot believe that Congress intended such a result.

The Court today legitimates this bootstrap transaction and permits respondents the tax advantage which the parties sought. The fact that respondent Brown, as a result of the Court’s holding, escapes payment of about $60,000 in taxes may not seem intrinsically important—although every failure to pay the proper amount of taxes under a progressive income tax system impairs the integrity of that system. But this case in fact has very broad implications. We are told by the parties and by interested amici that this is a test case. The outcome of this case will determine whether this bootstrap scheme for the conversion of ordinary income into capital gain, which has already been employed on a number of occasions, will become even more widespread.\(^3\) It is quite clear that the Court’s decision approving this tax device will give additional momentum to its speedy proliferation. In my view Congress did not sanction the use of this scheme under the present revenue laws to obtain the tax advantages which the Court authorizes. Moreover, I believe that the Court’s holding not only deviates from the intent of Congress but also departs from this Court’s prior decisions.

The purpose of the capital gains provisions of the Internal Revenue Code of 1954, s 1201 et seq., is to prevent gains which accrue over a long period of time from being taxed in the year of their realization through a sale at high rates resulting from their inclusion in the higher tax brackets. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199. These provisions are not designed, however, to allow capital gains treatment for the recurrent receipt of commercial or business income. In light of these purposes this Court has held that a ‘sale’ for capital gains purposes is not produced by the mere transfer of legal title. Burnet v. Harmel, supra; Palmer v. Bender,
Rather, at the very least, there must be a meaningful economic transfer in addition to a change in legal title. See Corliss v. Bowers, 281 U.S. 376, 50 S.Ct. 336, 74 L.Ed. 916. Thus the question posed here is not whether this transaction constitutes a sale within the terms of the Uniform Commercial Code or the Uniform Sales Act—we may assume it does—but, rather, the question is whether, at the time legal title was transferred, there was also an economic transfer sufficient to convert ordinary income into capital gain by treating this transaction as a ‘sale’ within the terms of I.R.C. s 1222(3). . . .

To hold as the Court does that this transaction constitutes a ‘sale’ within the terms of I.R.C. s 1222(3), thereby giving rise to capital gain for the income received, legitimates considerable tax evasion. Even if the Court restricts its holding, allowing only those transactions to be s 1222(3) sales in which the price is not excessive, its decision allows considerable latitude for the unwarranted conversion of ordinary income into capital gain. Valuation of a closed corporation is notoriously difficult. The Tax Court in the present case did not determine that the price for which the corporation was sold represented its true value; it simply stated that the price ‘was the result of real negotiating’ and ‘within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.’ 37 T.C., at 486. The Tax Court, however, also said that ‘(i)t may be . . . that petitioner (Clay Brown) would have been unable to sell the stock at as favorable a price to anyone other than a tax-exempt organization.’ 37 T.C., at 485. Indeed, this latter supposition is highly likely, for the Institute was selling its tax exemption, and this is not the sort of asset which is limited in quantity. Though the Institute might have negotiated in order to receive beneficial ownership of the corporation as soon as possible, the Institute, at no cost to itself, could increase the price to produce an offer too attractive for the seller to decline. Thus it is natural to anticipate sales such as this taking place at prices on the upper boundary of what courts will hold to be a reasonable price—at prices which will often be considerably greater than what the owners of a closed corporation could have received in a sale to buyers who were not selling their tax exemptions. Unless Congress repairs the damage done by the Court’s holding, I should think that charities will soon own a considerable number of closed corporations, the owners of which will see no good reason to continue paying taxes at ordinary income rates. It should not be necessary, however, for Congress to address itself to this loophole, for I believe that under the present laws it is clear that Congress did not intend to accord capital gains treatment to the proceeds of the type of sale present here.

Although the Court implies that it will hold to be ‘sales’ only those transactions in which the price is reasonable, I do not believe that the logic of the Court’s opinion will justify so restricting its holding. If this transaction is a sale under the Internal Revenue Code, entitling its proceeds to capital gains treatment because it was arrived at after hard negotiating, title in a conveyancing sense passed, and the beneficial ownership was expected to pass at a later date, then the question recurs, which the Court does not answer, why a similar transaction would cease to be a sale if hard negotiating produced a purchase price much greater than actual value. The Court relies upon Kolkey v. Commissioner, 254 F.2d 51 (C.A.7th Cir.), as authority holding that a bootstrap transaction will be struck down where the price is excessive. In Kolkey, however, the price to be paid was so much greater than the worth of the corporation in terms of its anticipated income that it was highly unlikely that the price would in fact ever be paid; consequently it was improbable that the sellers’ interest in the business would ever be extinguished. Therefore, in Kolkey the
court, viewing the case as one involving ‘thin
capitalization,’ treated the notes held by the
sellers as equity in the new corporation and
payments on them as dividends. Those who
fashion ‘bootstrap’ purchases have become
considerably more sophisticated since Kolkey;
vastly excessive prices are unlikely to be found
and transactions are fashioned so that the ‘thin
capitalization’ argument is conceptually
inapplicable. Thus I do not see what rationale
the Court might use to strike down price
transactions which, though excessive, do not
reach Kolkey’s dimensions, when it upholds
the one here under consideration. Such
transactions would have the same degree of
risk-shifting, there would be no less a transfer
of ownership, and consideration supplied by
the buyer need be no less than here.

Further, a bootstrap tax avoidance scheme can
easily be structured under which the holder of
any income-earning asset ‘sells’ his asset to a
tax-exempt buyer for a promise to pay him the
income produced for a period of years. The
buyer in such a transaction would do nothing
whatssoever; the seller would be delighted to
lose his asset at the end of, say, 30 years in
return for capital gains treatment of all income
earned during that period. It is difficult to see,
on the Court’s rationale, why such a scheme is
not a sale. And, if I am wrong in my reading of
the Court’s opinion, and if the Court would
strike down such a scheme on the ground that
there is no economic shifting of risk or control,
it is difficult to see why the Court upholds the
sale presently before it in which control does
not change and any shifting of risk is nominal.

I believe that the Court’s overly conceptual
approach has led to a holding which will
produce serious erosion of our progressive
taxing system, resulting in greater tax burdens
upon all taxpayers. The tax avoidance routes
opened by the Court’s opinion will surely be
used to advantage by the owners of closed
Corporations and other income-producing
assets in order to evade ordinary income taxes
and pay at capital gains rates, with a resultant
large-scale ownership of private businesses by
tax-exempt organizations. While the Court
justifies its result in the name of conceptual
purity, it simultaneously violates longstanding congressional tax policies that capital
gains treatment is to be given to significant
economic transfers of investment-type assets
but not to ordinary commercial or business
income and that transactions are to be judged
on their entire substance rather than their naked
form. Though turning tax consequences on
form alone might produce greater certainty of
the tax results of any transaction, this stability
exacts as its price the certainty that tax evasion
will be produced. In Commissioner v. P.G.
Lake, Inc., 356 U.S. 260, 265, 78 S.Ct. 691, 694,
2 L.Ed.2d 743, this Court recognized that
the purpose of the capital gains provisions of
the Internal Revenue Code is “to relieve the
taxpayer from ... excessive tax burdens on
gains resulting from a conversion of capital
investments, and to remove the deterrent effect
of those burdens on such conversions.” ... And this
exception has always been narrowly construed
so as to protect the revenue against artful
devices.’ I would hold in keeping with this
purpose and in order to prevent serious erosion
of the ordinary income tax provisions of the
Code, that the bootstrap transaction revealed
by the facts here considered is not a ‘sale’
within the meaning of the capital gains
provisions of the Code, but that it obviously is
an ‘artful device,’ which this Court ought not
to legitimate. The Court justifies the untoward
result of this case as permitted tax avoidance; I
believe it to be a plain and simple case of
unwarranted tax evasion.
Mr. Justice HARLAN delivered the opinion of the Court.

The question in this case is whether a sum received by respondent from the United States as compensation for the temporary taking by the Government of its business facilities during World War II represented ordinary income or a capital gain. . . .

In 1944, respondent was a common carrier of commodities by motor vehicle. On August 4, 1944, respondent’s drivers struck, and it completely ceased to operate. Shortly thereafter, because of the need for respondent’s facilities in the transportation of war materiel, the President ordered the Director of the Office of Defense Transportation to ‘take possession and assume control of’ them. The Director assumed possession and control as of August 12, and appointed a Federal Manager, who ordered respondent to resume normal operations. The Federal Manager also announced his intention to leave title to the properties in respondent and to interfere as little as possible in the management of them. Subject to certain orders given by the Federal Manager from time to time, respondent resumed normal operations and continued so to function until the termination of all possession and control by the Government on June 16, 1945.

Pursuant to an Act of Congress creating a Motor Carrier Claims Commission, 62 Stat. 1222, 49 U.S.C.A. s 305 note, respondent presented its claim for just compensation. The Government contended that there had been no ‘taking’ of respondent’s property but only a regulation of it. The Commission, however, determined that by assuming actual possession and control or respondent’s facilities, the United States had deprived respondent of the valuable right to determine freely what use was to be made of them. In ascertaining the fair market value of that right, the Commission found that one use to which respondent’s facilities could have been put was to rent them out, and that therefore their rental value represented a fair measure of respondent’s pecuniary loss. The Commission noted that in other cases of temporary takings, it has typically been held that the market value of what is taken is the sum which would be arrived at by a willing lessor and a willing lessee. Accordingly, it awarded, and the respondent received in 1952, the sum of $122,926.21, representing the fair rental value of its facilities from August 12, 1944, until June 16, 1945, plus $34,917.78, representing interest on the former sum, or a total of $157,843.99.

The Commission of Internal Revenue asserted that the total compensation award represented ordinary income to respondent in 1952. Respondent contended that it constituted an amount received upon an ‘involuntary conversion’ of property used in its trade or business and was therefore taxable as long-term capital gain pursuant to s 117(j) of the Internal Revenue Code of 1939. . . .

Respondent stresses that the Motor Carrier Claims Commission, rejecting the Government’s contention that only a regulation, rather than a taking, of its facilities had occurred, found that respondent had been deprived of property, and awarded compensation therefor. That is indeed true. But the fact that something taken by the Government is property compensable under the Fifth Amendment does not answer the entirely different question whether that thing comes within the capital-gains provisions of the Internal Revenue Code. Rather, it is necessary to determine the precise nature of the
property taken. Here the Commission determined that what respondent had been deprived of, and what the Government was obligated to pay for, was the right to determine freely what use to make of its transportation facilities. The measure of compensation adopted reflected the nature of that property right. Given these facts, we turn to the statute.

Section 117(j), under which respondent claims, is an integral part of the statute’s comprehensive treatment of capital gains and losses. Long-established principles govern the application of the more favorable tax rates to long-term capital gains: (1) There must be first, a ‘capital asset,’ and second, a ‘sale or exchange’ of that asset (s 117(a)); (2) ‘capital asset’ is defined as ‘property held by the taxpayer,’ with certain exceptions not here relevant (s 117(a)(1)); and (3) for purposes of calculating gain, the cost or other basis of the property (s 113(b), 26 U.S.C.A. s 113(b)) must be subtracted from the amount realized on the sale or exchange (s 111(a), 26 U.S.C.A. s 111(a)).

Section 117(j), added by the Revenue Act of 1942, effects no change in the nature of a capital asset. It accomplishes only two main objectives. First, it extends capital-gains treatment to real and depreciable personal property used in the trade or business, the type of property involved in this case. Second, it accords such treatment to involuntary conversions of both capital assets, strictly defined, and property used in the trade or business. Since the net effect of the first change is merely to remove one of the exclusions made to the definition of capital assets in s 117(a)(1), it seems evident that ‘property used in the trade or business,’ to be eligible for capital-gains treatment, must satisfy the same general criteria as govern the definition of capital assets. The second change was apparently required by the fact that this Court had given a narrow construction to the term ‘sale or exchange.’ See Helvering v. William Flaccus Oak Leather Co., 313 U.S. 247, 61 S.Ct. 878, 85 L.Ed. 1310. But that change similarly had no effect on the basic notion of what constitutes a capital asset.

While a capital asset is defined in s 117(a)(1) as ‘property held by the taxpayer,’ 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. This Court has 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. Burnet v. Harmel, 287 U.S. 103, 106, 53 S.Ct. 74, 75, 77 L.Ed. 199. Thus the Court has held that an unexpired lease, Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168, corn futures, Corn Products Refining Co. v. Commissioner, 350 U.S. 46, 76 S.Ct. 20, 100 L.Ed. 29 and oil payment rights, Commissioner of Internal Revenue v. P. G. Lake, Inc., 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743, are not capital assets even though they are concededly ‘property’ interests in the ordinary sense. And see Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv.L.Rev. 985, 987—989 and Note 7.

In the present case, respondent’s right to use its transportation facilities was held to be a valuable property right compensable under the requirements of the Fifth Amendment. However, that right was not a capital asset within the meaning of ss 117(a)(1) and 117(j). To be sure, respondent’s facilities were themselves property embraceable as capital assets under s 117(j). Had the Government taken a fee in those facilities, or damaged them physically beyond the ordinary wear and tear incident to normal use, the resulting compensation would no doubt have been treated as gain from the involuntary conversion
of capital assets. See, e.g., Waggoner, 15 T.C. 496; Henshaw, 23 T.C. 176. But here the Government took only the right to determine the use to which those facilities were to be put.

That right is not something in which respondent had any investment, separate and apart from its investment in the physical assets themselves. Respondent suggests no method by which a cost basis could be assigned to the right; yet it is necessary, in determining the amount of gain realized for purposes of s 117, to deduct the basis of the property sold, exchanged, or involuntarily converted from the amount received. s 111(a). Further, the right is manifestly not of the type which gives rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions. See cases cited, 364 U.S. at page 134, 80 S.Ct. at page 1500. In short, the right to use is not a capital asset, but is simply an incident of the underlying physical property, the recompense for which is commonly regarded as rent. That is precisely the situation here, and the fact that the transaction was involuntary on respondent’s part does not change the nature of the case.

Respondent lays stress on the use of the terms ‘seizure’ and ‘requisition’ in s 117(j). More specifically, the section refers to the ‘involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets * * *.’ (Emphasis added.) It is contended that the Government’s action in the present case is perhaps the most typical example of a seizure or requisition, and that, therefore, Congress must have intended to treat it as a capital transaction. This argument, however, overlooks the fact that the seizure or requisition must be ‘of property used in the trade or business (or) capital assets.’ We have already shown that s 117(j) does not change the long-standing meaning of these terms and that the property taken by the Government in the present case does not come within them. The words ‘seizure’ and ‘requisition’ are not thereby deprived of effect, since they equally cover instances in which the Government takes a fee or damages or otherwise impairs the value of physical property.

We conclude that the amount paid to respondent as the fair rental value of its facilities from August 12, 1944, to June 16, 1945, represented ordinary income to it. A fortiori, the interest on that sum is ordinary income. Kieselbach v. Commissioner, 317 U.S. 399, 63 S.Ct. 303, 87 L.Ed. 358.

Reversed.

Mr. Justice DOUGLAS dissents.
This controversy concerns the tax status of certain payments received by Jose Ferrer with respect to the motion picture ‘Moulin Rouge’ portraying the career of Henri de Toulouse-Lautrec. The difficulties Mr. Ferrer must have had in fitting himself into the shape of the artist can hardly have been greater than ours in determining whether the transaction here at issue fits the rubric ‘gain from the sale or exchange of a capital asset held for more than 6 months,’ Internal Revenue Code of 1939, § 117(a)(1) and (4), 26 U.S.C.A. § 117(a)(1, 4), as the Tax Court held, 35 T.C. 617 (1967), or constitutes ordinary income, as the Commissioner contends. We have concluded that neither party is entirely right, that some aspects of the transaction fall on one side of the line and some on the other, and that the Tax Court must separate the two.

In 1950 Pierre LaMure published a novel, ‘Moulin Rouge,’ based on the life of Toulouse-Lautrec. He then wrote a play, ‘Monsieur Toulouse,’ based on the novel. On November 1, 1951, LaMure as ‘Author’ and Ferrer, a famous actor but not a professional producer, as ‘Manager’ entered into a contract, called a Dramatic Production Contract, for the stage production of the play by Ferrer.

The contract was largely on a printed form recommended by the Dramatists Guild of the Authors League of America, Inc. However great the business merits of the document, which are extolled in Burton, Business Practices in the Copyright Field, in C.C.H., 7 Copyright Problems Analyzed (1952) 87, 109, for a court, faced with the task of defining the nature of the rights created, it exemplifies what a contract ought not to be. Its first six pages include eleven articles, some introduced by explanatory material whose contractual status is, to say the least, uncertain. Here the last of these pages was preceded by three single-spaced typewritten pages of ‘Additional Clauses,’ one with a still further insert. Finally come 15 pages of closely printed ‘Supplemental Provisions,’ introduced by explanatory material of the sort noted. We shall thread our way through this maze as best we can.

By the contract the Author ‘leased’ to the Manager ‘the sole and exclusive right’ to produce and present ‘Monsieur Toulouse’ on the speaking stage in the United States and Canada, and gave certain rights for its production elsewhere. Production had to occur on or before June 1, 1952, unless the Manager paid an additional advance of $1500 not later than that date, in which event to deadline was extended to December 1, 1952. Five hundred dollars were paid as an initial advance against Author’s royalties; the Manager was required to make further advances of like amount on December 1, 1951, and January 1, 1952. Royalties were to be paid the Author on all box-office receipts, on a sliding scale percentage basis.

Article Seventh said that ‘In the event that under the terms hereof the Manager shall be entitled to share in the proceeds of the Motion Picture and Additional Rights hereafter referred to, it is agreed that the Manager shall receive’ 40% for the first ten years and diminishing percentages thereafter. Among the additional rights so described were ‘Radio and Television.’

For the beginning of an answer whether the
Manager would be so entitled, we turn to Article IV, § 2, of the Supplemental Provisions. This tells us that ‘In the event the Manager has produced and presented the play for the ‘Requisite Performances and Terms,’ the Negotiator shall pay the Manager’ the above percentages ‘of the proceeds, from the disposal of the motion picture rights.’ Article VI, § 3, contains a similar provision as to payment by the Author of the proceeds of the ‘additional rights’ including radio and television. The ‘Requisite Performances and Terms’ are defined in Article XIII, § 9(b); we shall say more about the ‘Negotiator’ hereafter.

Further provisions put flesh on these bones. Article IV, § 1(a), says that ‘The title’ to the motion picture rights ‘vests in the Author, as provided in Article VIII hereof.’ Article VIII says, even more broadly, ‘The Author shall retain for his sole benefit, complete title, both legal and equitable, in and to all rights whatsoever (including, but not by way of limitation, the Motion Picture Rights . . . Radio and Television Rights . . . ),’ other than the right to produce the play. The Motion Picture Negotiator, a person appointed by the Council of the Dramatists Guild, Article V, §§ 1 and 6, has power to dispose of the motion picture rights. However, he may not do this without the written consent of both Author and Manager ‘prior to the time the play has been playing for any of the respective periods of time referred to in Article XIII, Section 9(b) hereof,’ Article IV, § 1(b). This prohibition serves a double purpose—it protects the Manager from dilution of the value of the right to produce the play through too early exhibition of a picture, and it promotes realization of the enhancement in the value of the motion picture rights normally resulting from successful dramatic production. Doubtless for similar reasons, the Author could not, without the consent of the Manager, permit the release of radio and television rights until first-class production of the play had ceased. Article V, § 1(b), decrees that the Manager shall ‘have no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive the Manager’s share of the proceeds * * *’ Article V, § 1(c), lays down that if the Manager deems ‘himself aggrieved by any disposition of motion picture rights, he shall have no recourse, in law or in equity,’ against a purchaser, a lessee, or the Negotiator; ‘the Manager’s sole recourse * * * shall be against the Author and only by arbitration as provided hereunder.’ Article V, § 1(d), says it again: ‘No claim of the Manager, howsoever arising, shall constitute a cloud on the title to the motion picture rights; and a purchaser or lessee thereof shall have the right to deal freely and exclusively with the Author and Negotiator . . . ’

Having been somewhat upstaged by these provisions, the Manager then returns toward the center under other clauses. The Negotiator must confer with him, as well as with the Author, on every step in the disposition of the motion picture rights. ‘It is desirable that the price shall be mutually satisfactory to both Author and Manager,’ Article V, § 2(a). If the Manager does not like an offer the Negotiator is planning to accept, he has an opportunity to turn up a better one, ibid. All moneys received for the motion picture rights are to be deposited in a special account, Article V, § 3. An insert to one of the ‘Additional Clauses’ provides that if the Manager desires, the Author, not later than three weeks after the New York opening of the play, will ‘discuss a proposed deal for the Manager to acquire’ the motion picture rights. Finally, another ‘Additional Clause’ prescribes that ‘All dramatic, motion picture, radio and television rights in the novel MOULIN ROUGE shall merge in and with the play during the existence of this contract,’ and if the Manager produces and presents the play for a sufficient period, ‘throughout the copyright period of the play.’

Shortly after signature of the Dramatic Production Contract, John Huston called
Ferrer to ask whether he would be interested in playing Toulouse-Lautrec in a picture based upon ‘Moulin Rouge.’ On getting an affirmative indication, Huston said he would go ahead and acquire the motion picture rights. Ferrer replied, in somewhat of an exaggeration, ‘When you get ready to acquire them talk to me because I own them.’

Both Huston and Ferrer then had discussions with LaMure. Ferrer expressed a willingness ‘to abandon the theatrical production in favor of the film production, provided that, if the film production were successful, I would be recompensed for my abandoning the stage production.’ On the strength of this, LaMure signed a preliminary agreement with Huston’s corporation. In further negotiations, Huston’s attorney insisted on ‘either an annulment or conveyance’ of the Dramatic Production Contract. LaMure’s lawyer prepared a letter of agreement, dated February 7, 1952, whereby Ferrer would cancel and terminate the Contract. Ferrer signed the letter but instructed his attorney not to deliver it until the closing of a contract between himself and the company that was to produce the picture; the letter was not delivered until May 14, 1952.

Meanwhile, on May 7, 1952, Ferrer entered into a contract with Huston’s company, Moulin Productions, Inc. (‘Moulin’), hereafter the Motion Picture Contract. This was followed by an agreement and assignment dated May 12, 1952, whereby LaMure sold Huston all motion picture rights to his novel, including the right to exploit the picture by radio and television. Under this agreement LaMure was to receive a fixed sum of $25,000, plus 5% and 4% of the Western and Eastern Hemisphere motion picture profits, respectively, and 50% of the net profits from exploitation by live television.

The Motion Picture Contract said that Romulus Films Limited, of London, proposed to produce the picture ‘Moulin Rouge,’ that Moulin on behalf of Romulus was interested in engaging Ferrer’s service to play the role of Toulouse-Lautrec. Under clause 4(a), Ferrer was to receive $50,000 to cover 12 weeks of acting, payments to be made weekly as Ferrer rendered his services. Ferrer’s performance was to begin between June 1 and July 1, 1952. By clause 4(b), Ferrer was to receive $10,416.66 per week for each additional week, but this, together with an additional $50,000 of salary provided by clause 4(c), was ‘deferred and postponed’ and was payable only out of net receipts. Finally, clauses 4(d) and (e) provided ‘percentage compensation’ equal to stipulated percentages of the net profits from distribution of the picture in the Western and Eastern Hemispheres respectively- 17% of the Western Hemisphere net profits until Ferrer had received $25,000 and thereafter 12 3/4% (such payments to ‘be made out of sixty-five (65%) percent of the net profits,’ whatever that may mean), and 3 3/4% of the Eastern Hemisphere net profits. If Ferrer’s services were interrupted by disability or if production of the picture had to be suspended for causes beyond Moulin’s control, but the picture was thereafter completed and Ferrer’s ‘acts, poses and appearances therein’ were recognizable to the public, he was to receive a proportion of the compensation provided in clauses 4(c), (d) and (e) corresponding to the ratio of his period of acting to 12 weeks. The same was true if Ferrer failed to ‘conduct himself with due regard to public conventions and morals’ etc. and Moulin cancelled on that account. The absence of any similar provision with respect to termination for Ferrer’s wilful refusal or neglect to perform services indicates that all his rights, except that for compensation already due under clause 4(a), would be forfeited in that event. Over objections by the Commissioner, Ferrer offered testimony by Huston’s attorney, who was also president of Moulin, that in the negotiation ‘it was said that the ultimate percentage payment to be made to Ferrer would be his compensation for giving
up his interest in the dramatization guild,’ and a letter from the same attorney, dated March 3, 1953, confirming that in the negotiations with Ferrer’s attorney ‘for the sale of the dramatic rights held by you to the property entitled ‘MONSIEUR TOULOUSE’ and the novel ‘MOULIN ROUGE,’ is was understood that the consideration for such sale price was the payments due, or to become due, to you under Clause 4(d) and Clause 4(e),’ and also that LeMure ‘refused to sell the motion picture rights for the production of the motion picture known as ‘MOULIN ROUGE’ unless you sold the aforesaid dramatic rights.’ Ferrer’s agent testified, again over objection, that the largest salary Ferrer had previously received for a moving picture appearance was $75,000. Moulin’s books showed $109,027.74 as a salary payment to Ferrer in August, 1953, and $178,751.46 at various later dates in 1953 as the payment of ‘Participating Interests’ under clause 4(d). Ferrer’s 1953 return reported the former as ordinary income, and the latter, less expenses of $26,812.72, as a long-term capital gain. The Commissioner determined a deficiency on the basis that the difference, $151,938.74, constituted ordinary income; from the Tax Court’s annulment of that determination he has taken this appeal.

Section 117(a) of the 1939 Code, now § 1221 of the 1954 Code, 26 U.S.C.A. § 1221, tells us, not very illuminatingly, that ‘capital asset’ means property held by the taxpayer (whether or not connected with his trade or business), but does not include ‘four (now five) types of property therein defined. However, it has long been settled that a taxpayer does not bring himself within the capital gains provision merely by fulfilling the simple syllogism that a contract normally constitutes ‘property,’ that he held a contract, and that his contract does not fall within a specified exclusion, C.I.R. v. Gillette Motor Transport, Inc., 364 U.S. s30, 134-135, 80 S.Ct. 1497, 4 L.Ed.2d 1617 (1960); Surrey, Definitional Problems in Capital Gains Taxation, 69 Harv. L.Rev. 985, 988 (1956). This is easy enough; what is difficult, perhaps impossible, is to frame a positive definition of universal validity. Attempts to do this in terms of the degree of clothing adorning the contract cannot explain all the cases, however helpful they may be in deciding some, perhaps even this one; it would be hard to think of a contract more ‘naked’ than a debenture, yet no one doubts that is a ‘capital asset’ if held by an investor. Efforts to frame a universal negative, e.g., that a transaction can never qualify if the taxpayer has merely collapsed anticipation of future income, are equally fruitless; a lessor’s sale of his interest in a 999 year net lease and an investor’s sale of a perpetual bond sufficiently illustrate why, as does Ayrton Metal Co. v. C.I.R., 299 F.2d 741 (2 Cir. 1962).

Perhaps we can get more help from analyzing the fact situations in cases in adjacent areas, including those decided since Judge Smith’s careful review in C.I.R. v. Pittston Company, 252 F.2d 344 (2 Cir.), cert. denied, 357 U.S. 919, 78 S.Ct. 1360, 2 L.Ed.2d 1364 (1958), than from the language of the opinions. Putting aside Jones v. Corbyn, 186 F.2d 450 (10 Cir. 1950), which we have disapproved, C.I.R. v. Starr Bros., Inc., 204 F.2d 673, 674 (2 Cir. 1953) and whose status in its own circuit has now become rather doubtful, Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654, (10 Cir. 1962), a case to which we refer below, and C.I.R. v. Goff, 212 F.2d 875 (3 Cir.), cert. denied, 348 U.S. 829, 75 S.Ct. 52, 99 L.Ed. 654 (1954), which is only dubiously reconcilable with our Pittston decision, the principal relevant authorities on the two sides of the line in the Supreme Court and in the courts of appeals are as follows: There is no sale or exchange of a capital asset when a lessor receives payment for releasing a lessee from an obligation to pay future rent, Hort v. C.I.R., 313 U.S. 28, 61 S.Ct. 757, 85 L.Ed. 1168 (1941). The same was true of the cancellation of an exclusive distributorship,

One common characteristic of the group held to come within the capital gain provision is that the taxpayer had either what might be called an ‘estate’ in (Golonsky, McCue, Metropolitan), or an ‘encumbrance’ on (Ray), or an option to acquire an interest in (Dorman), property which, if itself held, would be a capital asset. In all these cases the taxpayer had something more than an opportunity, afforded by contract, to obtain periodic receipts of income, by dealing with another (Starr, Leh, General Artists, Pittston), or by rendering services (Holt), or by virtue of ownership of a larger ‘estate’ (Hort, P.G. Lake). We are painfully aware of the deficiencies of any such attempt to define the wavering line even in this limited area, but it is the best we can do. We add, with greater confidence, that more recent cases, such as McCue & Drummond, Ray, Metropolitan, and Dorman, have moved away from the distinction, relied upon to some extent in Starr Brothers and General Artists,\(^3\) between a sale to a third person that keeps the ‘estate’ or ‘encumbrance’ alive, and a release that results in its extinguishment.\(^4\) Indeed, although reasoning from another section of a statute so full of anomalies is rather treacherous business, we take § 1241 of the 1954 Code as indicating Congressional disenchantment with this formalistic distinction. In the instant case we can see no sensible business basis for drawing a line between a release of Ferrer’s rights to LaMure for a consideration paid by Moulin, and a sale of them, with LaMure’s consent, to Moulin or to a stranger who would then release them. Moulin’s attorney, as we have seen, did not care a fig whether there was ‘an annulment or conveyance’ of the Dramatic Production Contract. Tax law is concerned with the substance, here the voluntary passing of ‘property’ rights allegedly constituting ‘capital assets,’ not with whether they are passed to a stranger or to a person already having a larger ‘estate.’ So we turn to an analysis of what rights Ferrer conveyed.

Two issues can be eliminated before we do this. We need no longer concern ourselves, as
at one time we might have been obliged to do, over the alleged indivisibility of a copyright; the Commissioner is now satisfied that sales and exchanges of less than the whole copyright may result in capital gain, Rev.Rul. 60-226, 1960-1 Cum.Bull. 26. See also Gitlin & Woodward, Tax Aspects of Patents, Copyrights and Trademarks (1960 rev.) 18-19; Sargoy, Formalities and Ownership, 9 Bull.Cr.Soc. 20, 43 (1961); Surrey & Warren, Federal Income Taxation, Cases and Materials (1960) 753. Neither do we have in this case any issue of excludability under § 117(a)(1)(A), now § 1221(1); Ferrer was not in the ‘trade or business’ of acquiring either dramatic production rights or motion picture rights.

When Huston displayed an interest in the motion picture rights in November, 1951, Ferrer was possessed of a bundle of rights, three of which are relevant here. First was his ‘lease’ of the play. Second was his power, incident to that lease, to prevent any disposition of the motion picture rights until June 1, 1952, or, on making an additional $1500 advance, to December 1, 1952, and for a period thereafter if he produced the play, and to prevent disposition of the radio and television rights even longer. Third was his 40% share of the proceeds of the motion picture and other rights if he produced the play. All these, in our view, Ferrer ‘sold or exchanged,’ although the parties set no separate price upon them. To be sure, Moulin had no interest in producing the play. But Ferrer did, unless a satisfactory substitute was provided. Hence Moulin had to buy him out of that right, as well as to eliminate his power temporarily to prevent a sale of the motion picture, radio and television rights and to liquidate his option to obtain a share of their proceeds.

(1) Surrender of the ‘lease’ of the play sounds like the transactions held to qualify for capital gain treatment in Golonsky and McCue Bros. & Drummond, see § 1241 of the 1954 Code. Such cases as Wooster v. Crane & Co., 147 F. 515 (8 Cir. 1906), Underhill v. Schenck, 238 N.Y. 7, 143 N.E. 773, 333 A.L.R. 303 (1924), and Kirke La Shelle Co. v. Paul Armstrong Co., 263 N.Y. 79, 188 N.E. 163 (1933) are a fortiori authority that courts would have enjoined LaMure, or anyone else, from interfering with this, unless the Dramatic Production Contract dictated otherwise. None of its many negations covered this basic grant. Ferrer thus had an ‘equitable interest’ in the copyright of the play.

The Commissioner did not suggest in the Tax Court, and does not here, that this interest or, indeed, any with which we are concerned in this case, fell within § 117(a)(1)(A), now § 1221(1); Ferrer was not in the ‘trade or business’ of acquiring either dramatic production rights or motion picture rights.
other personnel, and the author, is not analogous to that of the writer or even the ‘creator’ of a radio program mentioned by the Committee. Moreover, the dramatic producer does not normally ‘sell’ the production to a single purchaser, as an author or radio program ‘creator’ usually does- he offers it directly to public custom.

We see no basis for holding that amounts paid Ferrer for surrender of his lease of the play are excluded from capital gain treatment because receipts from the play would have been ordinary income. The latter is equally true if a lessee of real property sells or surrenders a lease from which he is receiving business income or subrentals; yet Golonsky and McCue Bros. & Drummound held such to be the sale or exchange of a capital asset, as § 1241 now provides. Likewise we find nothing in the statute that forbids capital gain treatment because the payment to Ferrer might be spread over a number of years rather than coming in a lump sum; although prevention of the unfairness arising from applying ordinary income rates to a ‘bunching’ of income may be one of the motivations of the ‘capital gain’ provisions, the statute says nothing about this. Compare Burnet v. Logan, 283 U.S. 404, 51 S.Ct. 550, 75 L.Ed. 1143 (1931). Finally, with respect to the lease of the play, there was no such equivalence between amounts paid for its surrender and income that would have been realized by its retention as seems to lie at the basis of the Tenth Circuit’s recent refusal of capital gain treatment in Wiseman v. Halliburton Oil Well Cementing Co., 301 F.2d 654 (1962), a decision as to which we take no position.

(2) Ferrer’s negative power, as an incident to the lease, to prevent any disposition of the motion picture, radio and television rights until after production of the play, was also one which, under the cases previously cited, as well as Harper Bros. v. Klaw, 232 F. 609, 613 (S.D.N.Y.1916) and Manners v. Morosco, 252 U.S. 317, 40 S.Ct, 335, 64 L.Ed 590 (1920), would be protected in equity unless he had contracted to the contrary, and would thus constitute an ‘equitable interest’ in this portion of the copyright. Although we should not regard Articles IV, § 1(a) and VIII as outlawing equitable relief to protect the rights granted as to the play, a literal reading of Article V, § 1(c), quoted above, would negate Ferrer’s power to enjoin disposition of the motion picture rights prior to production of the play and would remit him to arbitration- a consequence serious from the standpoint of definition of a capital asset, especially in view of the emphasis we placed in Pittston, 252 F.2d at 348, on the unavailability of injunctive relief there. In the absence of authority, we should not read the clause so broadly; we would construe it as relating to disputes as to the manner of disposition of the rights after the Negotiator had become entitled to dispose of them, not as closing the door on the only effective method for protecting the Manager’s important interest against premature disposition. As a practical matter, this feature of the Dramatic Production Contract ‘clouded’ LaMure’s title, despite the Contract’s contrary assertion. Huston would not conclude with LaMure and LaMure would not conclude with Huston unless Ferrer released his rights; Huston’s attorney testified that a contract like Ferrer’s ‘imposes an encumbrance on the motion picture rights.’ Ferrer’s dissipation of the cloud arising from the negative covenant seems analogous to the tenant’s relinquishment of a right to prevent his landlord from leasing to another tenant in the same business, held to be the sale or exchange of a capital asset in Ray. What we have said in (1) with respect to possible grounds for disqualification as a capital asset is a fortiori applicable here.

(3) We take a different view with respect to the capital assets status of Ferrer’s right to receive 40% of the proceeds of the motion picture and other rights if he produced ‘Monsieur
Toulouse.’

We assume, without deciding, that there is no reason in principle why if the holder of a copyright grants an interest in the portion of a copyright relating to motion picture and other rights contingent on the production of a play, or, to put the matter in another way, gives the producer an option to acquire such an interest by producing the play, the option would not constitute a ‘capital asset’ unless the producer is disqualified by § 117(a)(1)(A), now § 1221(1). Although the copyright might not be such an asset in the owner’s hands because of that section or § 117(a)(1)(C)(i), now § 1221(3)(A), the latter disqualification would not apply to the producer for reasons already discussed, and the former would not unless the producer was a professional. However, it is equally possible for the copyright owner to reserve the entire ‘property’ both legal and equitable in himself and agree with the producer that a percentage of certain avails shall be paid as further income from the lease of the play—just as the lessor of real estate might agree to pay a lessee a percentage of what the lessor obtained from other tenants attracted to the building by the lessee’s operations. In both instances such payments would be ordinary income. If the parties choose to cast their transaction in the latter mold, the Commissioner may take them at their word.

Here the parties were at some pains to do exactly that. LaMure was to ‘retain for his sole benefit, complete title, both legal and equitable, in and to all rights whatsoever’ other than the right to produce the play. Ferrer was to ‘have no right, title or interest, legal or equitable, in the motion picture rights, other than the right to receive the Manager’s share of the proceeds’; even as to that, he was to have ‘no recourse, in law or in equity’ against a purchaser, a lessee, or the Negotiator, but only a right to arbitration against the Author. We cannot regard all this as mere formalism. The Contract is full of provisions designed to emphasize the Negotiator’s freedom to act—provisions apparently stemming from a fear that, without them, the value of the motion picture rights might disintegrate in controversy. McClintic v. Sheldon, 269 App.Div. 356, 55 N.Y.S.2d 879 (1st Dept. 1945), aff’d, 295 N.Y. 682, 65 N.E.2d 328 (1946), greatly relied upon by the taxpayer, does not show that, despite the contrary language of the Contract, Ferrer had, or ever would have, an affirmative equitable interest in the motion picture or other rights, as distinguished from his temporary negative ‘encumbrance’ on them. Although the Appellate Division’s opinion contains some remarks as to the equitable interest of a licensee in a copyright, these were not essential to the holding, namely, that ‘the clear language’ of the agreement entitled the producer to the moneys there in question. Moreover, examination of the papers on appeal shows that the contract between the producer and the author in that case was an earlier form not containing the extensive negation of equitable property interests present here. 6

It follows that if Ferrer had produced the play and LaMure had sold the motion picture, radio and television rights for a percentage of the profits, Ferrer’s 40% of that percentage would have been ordinary income and not the sale or exchange of a capital asset. The decisions in Hort and Holt point to what would seem the inevitable corollary that if, on the same facts, Ferrer had then sold his rights to a percentage of the profits for a lump sum, that, too, would have been ordinary income, see Herman Shumlin, 16 T.C. 407 (1951). The situation cannot be better from Ferrer’s standpoint because he had merely a contingent right to, or an option to obtain, the 40% interest; the case differs from Dorman v. United States, supra, in that there the option was to acquire what would admittedly have been a ‘capital asset.’

The situation is thus one in which two of the
rights that Ferrer sold or exchanged were ‘capital assets’ and one was not. Although it would be easy to say that the contingent contract right to a percentage of the avails of the motion picture, radio and television rights was dominant and all else incidental, that would be viewing the situation with the inestimable advantage of hindsight. In 1952 no one could tell whether the play might be a huge success and the picture a dismal failure, whether the exact opposite would be true, whether both would succeed or both would fail. We cannot simply dismiss out of hand the notion that a dramatic production, presenting an actor famous on the speaking stage and appealing to a sophisticated audience, might have had substantial profit possibilities, perhaps quite as good as a film with respect to a figure, not altogether attractive and not nearly so broadly known then as the success of the picture has made him now, which presumably would require wide public acceptance before returning production costs. At the very least, when Ferrer gave up his lease of the play, he was abandoning his bet on two horses in favor of a bet on only one.

In such instances, where part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded, Helvering v. Taylor, 293 U.S. 507, 55 S.Ct. 287, 79 L.Ed, 623 (1935); Ditmars v. C.I.R., 302 F.2d 481 (2 Cir. 1962). If it be said that to remand for this purpose is asking the Tax Court to separate the inseparable, we answer that no one expects scientific exactness; that however roughly hewn the decision may be, the result is certain to be fairer than either extreme; and that similar tasks must be performed by the Tax Court in other areas, see Webster Investors, Inc. v. C.I.R., 291 F.2d 192 (2 Cir. 1961); Meister v. C.I.R., 302 F.2d 54 (2 Cir. 1962) (determination of portion of purchase price attributable to good-will).

Still we have not reached the end of the road. The Commissioner contends that, apart from all else, no part of the payments here can qualify for capital gain treatment, since Ferrer could receive ‘percentage compensation’ only if he fulfilled his acting commitments, and all the payments were thus for personal services. Citing C.I.R. v. Dwight’s Estate, 205 F.2d 298, 301 (2 Cir.), cert. denied, 346 U.S. 871, 74 S.Ct. 121, 98 L.Ed. 380 (1958), the Commissioner says it was error for the Tax Court to rely on extrinsic evidence to vary the written contract.

Although the parties have taken opposing positions on the applicability of the ‘parol evidence rule’ to a dispute involving a stranger to the contract, a question discussed by Professor Corbin in his usual illuminating fashion in 3 Contracts (rev.ed. 1960) § 596, cf. 9 Wigmore, Evidence (3d ed. 1940) § 2446, at p. 150, and see, with respect to tax controversies, Stern v. C.I.R., 137 F.2d 43, 46 (2 Cir. 1943); Scofield v. Greer, 185 F.2d 551, 552 (5 Cir. 1950); Landa v. C.I.R., 92 U.S.App.D.C. 196, 206 F.2d 431, 432 (1953); Mustard v. United States, 155 F.Supp. 325, 332 (Ct.Cl.1957); Thorsness v. United States, 260 F.2d 341, 345 (7 Cir. 1958); Cooper Foundation v. O’Malley, 121 F.Supp. 438, 444 (D.Neb.1954), no such issue is here presented. No one argued the contract provided anything other than what was plainly said. Huston’s attorney did not assert that Ferrer would become entitled to the percentage compensation without fulfilling his acting commitment; what the attorney said in his testimony, as he had earlier in his letter, was that Ferrer was selling two things to Moulin—his services as an actor and his rights under the Dramatic Production Contract- and that the parties regarded the payments under clauses 4(a), (b) and (c) as the consideration for the former and those under clauses 4(d) and (e) as the consideration for the latter.

On the basis of this evidence the Tax Court found that the percentage compensation was not ‘to any extent the consequence of,’ or
consideration for, petitioner’s personal services.’ In one sense, this is hardly so. Under the Motion Picture Contract, Ferrer would receive no percentage compensation if he wrongfully refused to furnish acting services, and none or only a portion if, for reasons beyond his control, he furnished less than all. Since that must have been as plain to the Tax Court as to us, we read the finding to mean rather that Ferrer and Moulin adopted the percentage of profits formula embodied in clauses 4(d) and (e) as an equivalent and in lieu of a fixed sum payable in all events for the release of the Dramatic Production Contract. If they had first agreed on such a sum and had then substituted the arrangement here made, it would be hard to say that although payments under their initial arrangement would not be disqualified for capital gain treatment, payments under the substituted one would be. Ferrer was already bound to play the role of Toulouse-Lautrec, at a salary implicitly found to constitute fair compensation for his services; adoption of a formula whereby his receipt of percentage compensation for releasing his rights was made contingent on his fulfilling that undertaking does not mean that the percentage compensation could not be solely for his release of the Contract. The Tax Court was not bound to accept the testimony that this was the intent- it could lawfully have found that the percentage compensation was in part added salary for Ferrer’s acting services and in part payment for the release. However, it found the contrary, and we cannot say that in doing so it went beyond the bounds to which our review of its fact findings is confined, Internal Revenue Code of 1954, § 7482(a), 26 U.S.C.A. § 7482(a); F.R.Civ.Proc. 52(a). Since, on the taxpayer’s own evidence, the percentage compensation was for the totality of the release of his rights under the Dramatic Production Contract, allocation is required as between rights which did and rights which did not constitute a ‘capital asset.’

We therefore reverse and remand to the Tax Court to determine what portion of the percentage compensation under clauses 4(d) and (e) of the Motion Picture Contract constituted compensation for Ferrer’s surrendering his lease of the play and his incidental power to prevent disposition of the motion picture and other rights pending its production, as to which the determination of deficiency should be annulled, and what part for the surrender of his opportunity to receive 40% of the proceeds of the motion picture and other rights as to which it should be sustained. The expenses allowed as basis must likewise be allocated. Doubtless further evidence will have to be taken unless the parties can reach some practical adjustment.

It is so ordered.
Mr. Justice BLACK delivered the opinion of the Court.

In 1937 two taxpayers, petitioners here, decided to liquidate and divide the proceeds of a corporation in which they had equal stock ownership. Partial distributions made in 1937, 1938, and 1939 were followed by a final one in 1940. Petitioners reported the profits obtained from this transaction, classifying them as capital gains. They thereby paid less income tax than would have been required had the income been attributed to ordinary business transactions for profit. About the propriety of these 1937—1940 returns, there is no dispute. But in 1944 a judgment was rendered against the old corporation and against Frederick R. Bauer, individually. The two taxpayers were required to and did pay the judgment for the corporation, of whose assets they were transferees. . . . . Classifying the loss as an ordinary business one, each took a tax deduction for 100% of the amount paid. Treatment of the loss as a capital one would have allowed deduction of a much smaller amount. . . .

[Section 165(f)] treats losses from sales or exchanges of capital assets as ‘capital losses’ and requires that liquidation distributions be treated as exchanges. The losses here fall squarely within the definition of ‘capital losses’ contained in these sections. Taxpayers were required to pay the judgment because of liability imposed on them as transferees of liquidation distribution assets. And it is plain that their liability as transferees was not based on any ordinary business transaction of theirs apart from the liquidation proceedings. It is not even denied that had this judgment been paid after liquidation, but during the year 1940, the losses would have been properly treated as capital ones. For payment during 1940 would simply have reduced the amount of capital gains taxpayers received during that year. It is contended, however, that this payment which would have been a capital transaction in 1940 was transformed into an ordinary business transaction in 1944 because of the well-established principle that each taxable year is a separate unit for tax accounting purposes. United States v. Lewis, 340 U.S. 590, 71 S.Ct. 522, 95 L.Ed. 560; North American Oil Consolidated v. Burnet, 286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197. But this principle is not breached by considering all the 1937—1944 liquidation transaction events in order properly to classify the nature of the 1944 loss for tax purposes. Such an examination is not an attempt to reopen and readjust the 1937 to 1940 tax returns, an action that would be inconsistent with the annual tax accounting principle.

The petitioner Bauer’s executor presents an argument for reversal which applies to Bauer alone. He was liable not only by reason of being a transferee of the corporate assets. He was also held liable jointly with the original corporation, on findings that he had secretly profited because of a breach of his fiduciary relationship to the judgment creditor. . . . . The judgment was against both Bauer and the corporation. For this reason it is contended that the nature of Bauer’s tax deduction should be considered on the basis of his liability as an individual who sustained a loss in an ordinary business transaction for profit. We agree with the Court of Appeals that this contention should not be sustained. While there was a liability against him in both capacities, the individual judgment against him was for the whole amount. His payment of only half the judgment indicates that both he and the other transferee were paying in their capacities as such. We see no reason for giving Bauer a preferred tax position. Affirmed.
Mr. Justice DOUGLAS, dissenting.

I agree with Mr. Justice JACKSON that these losses should be treated as ordinary, not capital, losses. There were no capital transactions in the year in which the losses were suffered. Those transactions occurred and were accounted for in earlier years in accord with the established principle that each year is a separate unit for tax accounting purposes. See United States v. Lewis, 340 U.S. 590, 71 S.Ct. 522, 95 L.Ed. 560. I have not felt, as my dissent in the Lewis case indicates, that the law made that an inexorable principle. But if it is the law, we should require observance of it—not merely by taxpayers but by the government as well. We should force each year to stand on its own footing, whoever may gain or lose from it in a particular case. We impeach that principle when we treat this year’s losses as if they diminished last year’s gains.

Mr. Justice JACKSON, whom Mr. Justice FRANKFURTER joins, dissenting.

This problem arises only because the judgment was rendered in a taxable year subsequent to the liquidation.

Had the liability of the transferor-corporation been reduced to judgment during the taxable year in which liquidation occurred, or prior thereto, this problem, under the tax laws, would not arise. The amount of the judgment rendered against the corporation would have decreased the amount it had available for distribution which would have reduced the liquidating dividends proportionately and diminished the capital gains taxes assessed against the stockholders. Probably it would also have decreased the corporation’s own taxable income.

Congress might have allowed, under such circumstances, tax returns of the prior year to be reopened or readjusted so as to give the same tax results as would have obtained had the liability become known prior to liquidation. Such a solution is foreclosed to us and the alternatives left are to regard the judgment liability fastened by operation of law on the transferee as an ordinary loss for the year of adjudication or to regard it as a capital loss for such year.

This Court simplifies the choice to one of reading the English language, and declares that the losses here come ‘squarely within’ the definition of capital losses contained within two sections of the Internal Revenue Code. What seems so clear to this Court was not seen at all by the Tax Court, in this case or in earlier consideration of the same issue; nor was it grasped by the Court of Appeals for the Third Circuit. Commissioner of Internal Revenue v. Switlik, 1950, 184 F.2d 299.

I find little aid in the choice of alternatives from arguments based on equities. One enables the taxpayer to deduct the amount of the judgment against his ordinary income which might be taxed as high as 87%, while if the liability had been assessed against the corporation prior to liquidation it would have reduced his capital gain which was taxable at only 25% (now 26%). The consequence may readily be characterized as a windfall (regarding a windfall as anything that is left to a taxpayer after the collector has finished with him).

On the other hand, adoption of the contrary alternative may penalize the taxpayer because of two factors: (1) since capital losses are deductible only against capital gains, plus
$1,000, a taxpayer having no net capital gains in the ensuing five years would have no opportunity to deduct anything beyond $5,000; and (2) had the liability been discharged by the corporation, a portion of it would probably in effect have been paid by the Government, since the corporation could have taken it as a deduction, while here the total liability comes out of the pockets of the stockholders.

Solicitude for the revenues is a plausible but treacherous basis upon which to decide a particular tax case. A victory may have implications which in future cases will cost the Treasury more than a defeat. This might be such a case, for anything I know. Suppose that subsequent to liquidation it is found that a corporation has undisclosed claims instead of liabilities and that under applicable state law they may be prosecuted for the benefit of the stockholders. The logic of the Court’s decision here, if adhered to, would result in a lesser return to the Government than if the recoveries were considered ordinary income. Would it be so clear that this is a capital loss if the shoe were on the other foot?

Where the statute is so indecisive and the importance of a particular holding lies in its rational and harmonious relation to the general scheme of the tax law, I think great deference is due the twice-expressed judgment of the Tax Court. In spite of the gelding of Dobson v. Commissioner, 320 U.S. 489, 64 S.Ct. 239, 88 L.Ed. 248, by the recent revision of the Judicial Code, Act of June 25, 1948, s 36, 62 Stat. 991—992, 26 U.S.C.A. s 1141(a), I still think the Tax Court is a more competent and steady influence toward a systematic body of tax law than our sporadic omnipotence in a field beset with invisible boomerangs. I should reverse, in reliance upon the Tax Court’s judgment more, perhaps, than my own.
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.
The question presented is whether the transactions whereby taxpayers transferred one parcel of realty and acquired another constituted a sale, the gain from which is recognizable under [Section 1001(c)].

On May 21, 1957, following negotiations between petitioners and Alloy Die Casting Company, hereinafter referred to as Alloy, representatives of petitioners and Alloy executed escrow instructions to the Orange County Title Company, hereinafter referred to as Orange, constituting a purchase and sale agreement whereby petitioners agreed to sell their Buena Park property, consisting of 31.148 acres or agricultural property, to Alloy for $5,550.00 per acre, a total price of $172,871.40. Pursuant to the terms of said agreement, Alloy deposited $17,205.00 in the Orange escrow toward purchase of the Buena Park property.

Some time after the execution of the May 21st escrow petitioners located 115.32 acres of farming land in Monterey County, California, hereinafter referred to as the Salinas property, which they desired to obtain in exchange for their Buena Park property.

On August 19, 1957, petitioners and Alloy executed an amendment to their May 21, 1957, escrow providing that 'the Salinas property be acquired by Alloy and exchanged for the Buena Park property in lieu of the original contemplated cash transaction.' (R. 21). The amendment further provides that if the exchange was not effected by September 11, 1957, the original escrow re the purchase for cash would be carried out. On the same day (August 19th) petitioners’ daughter, Jean Marie Howard, acting for petitioners, executed escrow instructions to the Salinas Title Guarantee Company, hereinafter referred to as Salinas Title, in the form of ‘Buyer’s Instructions.’ The parties have agreed that the acts of petitioners’ daughter, Jean Marie Howard, with respect to the transactions here involved, are to be considered as acts of the petitioners, and any acts of said daughter are hereinafter referred to as acts of petitioners. The escrow instructions last mentioned provided for payment of $190,000.00 for the Salinas property, that title was to be taken in the name of Salinas Title, that $19,000.00 had been deposited with Orange and that the remaining $171,000.00 would also be deposited with Orange. The instructions also stated that Salinas Title was authorized to deed the Salinas property to Alloy, provided Salinas Title could ‘immediately record a deed from Alloy . . . to James Alderson and Clarissa E. Alderson, his wife, issuing final title evidence in the last mentioned grantees.’ (R. 21-22, R.Br. 5).

On August 20, 1957, petitioners authorized Orange to pay $19,000.00 into the Salinas escrow, which was done, and directed Orange to pay $171,000.00 into the Salinas escrow when these funds became available. (R. 22).

On August 22, 1957, Alloy, by letter to petitioners, summarized the agreements of the parties re the manner of accomplishing the transfer of the properties between them. (R.Br. 6). The letter further stated that Alloy’s representative would deposit $172,871.40 (the cash amount for the Buena Park property as per May 21st escrow) with Salinas Title on assurance that the agreements would be effected. The letter was countersigned by petitioners.

By deed dated August 20, 1957, title to the
Salinas property was transferred to Salinas Title. By deed dated August 21, 1957, Salinas Title conveyed the Salinas property to Alloy. By deed dated August 26, 1957, petitioners conveyed the Buena Park property to Alloy and deed dated August 29, 1957, conveyed the Salinas property from Alloy to petitioners. All four of these deeds were recorded September 4, 1957. (R.Br. 6).

On September 3, 1957, Alloy, acting through its attorney, Elliott H. Pentz, deposited $172,871.40, belonging to Alloy, into the Salinas escrow, on Alloy’s behalf, with instruction that said sum should be used to complete the purchase of the Salinas property. (R. 17, 24, 72-73). The said $172,871.40, plus the $19,000.00 previously deposited with Salinas Title by Orange, made up something more than the $190,000.00 purchase price for the Salinas property, and the excess was returned to the petitioners. Alloy’s original deposit of $17,205.00 in the Orange escrow was returned to it sometime after August 28, 1957. (R. 23).

The petitioners paid approximately $10,000.00 into the Orange escrow for real estate commissions and escrow charges and paid for documentary stamps on the transfer of the Buena Park property to Alloy, and $471.80 into the Salinas escrow for fees and escrow charges together with cost of documentary stamps on the transfer of the Salinas property from Salinas Title to Alloy.

Alloy paid $106.38 to Orange for escrow charges and paid nothing to Salinas Title for escrow charges or stamps.

The Commissioner determined that the transfer of the Buena Park property to Alloy constituted a sale upon which petitioners realized a long term capital gain (R. 9) and the Tax Court sustained the decision of the Commissioner (R. 27) holding ‘* * * that the transactions in which petitioners disposed of the Buena Park property and acquired the Salinas property did not constitute an exchange within the meaning of Section 1031(a).’

In considering the question involved, there are certain findings of the Tax Court which this court believes to be particularly pertinent. Said findings are as follows:

‘From the outset, petitioners desired to exchange their Buena Park property for other property of a like kind. They intended to sell the property for cash only if they were unable to locate a suitable piece of property to take in exchange.’ (R. 20) (Emphasis ours.)

‘The deposit by Alloy of $172,871.40 in the Salinas escrow was made by Elliott Pentz, an attorney, pursuant to the commitment of his client, Alloy. The funds were received from Alloy by Pentz; were the property of Alloy; and were deposited by him in Alloy’s behalf.

‘Alloy acquired title to the Salinas property solely to enable it to perform its agreement to exchange that property for the Buena Park property.’ (R. 24) (Emphasis ours.)

‘The Buena Park property and the Salinas property were of like kind.’ (R. 24)

By the findings of the Tax Court, supra, it was determined that there was from the outset no intention on the part of the petitioners to sell the Buena Park property for cash if it could be exchanged for other property of like kind. There is no question that the desired property of like kind was located (Salinas property) and that, as determined by the findings, petitioners had no intention other than to exchange the Buena Park property for the Salinas property. It also follows from the findings that petitioners had no intention to purchase the Salinas property and that title to the Salinas property was to come to the petitioners by
exchange thereof for the Buena Park property. The intention of the parties and what actually occurred re the obtaining of the Salinas property for the exchange is further established by the finding that the $172,871.40 deposited by Alloy’s attorney, Pentz, in the Salinas escrow was the ‘property of Alloy’ and deposited by Pentz ‘in Alloy’s behalf.’ Further, ‘Alloy acquired title to the Salinas property solely to enable it to perform its agreement to exchange the property for the Buena Park property.’

Respondent concedes that an exchange is not vitiated because cash is received in addition to property held for productive use or investment, but asserts that the $19,000.00 deposited by petitioners with Orange escrow was transmitted by Orange to Salinas escrow, whereas Alloy’s initial deposit of $17,205.00 into the Orange escrow was returned by Orange to Alloy, and that if petitioners were not the purchasers of the Salinas property that Orange would have returned the $19,000.00 to petitioners and deposited the $17,205.00 with Salinas escrow in payment of the difference between the value of the Buena Park property and the purchase price of the Salinas property.

It is the position of respondent that from the facts and circumstances outlined above it must be concluded the Buena Park property was sold by petitioners to Alloy and the Salinas property was purchased by petitioners. However, it does not appear from the terms of the amended Orange escrow (August 19, 1957) that there was ever any obligation on the part of Alloy to pay cash for the Buena Park property or for the petitioners to receive cash for said property as provided in the May 21, 1957, escrow, by reason of the fact that prior to September 11, 1957, Alloy did deposit with Orange a deed to the Salinas property conveying same to petitioners. Neither liability of Alloy to petitioners for payment of cash for the Buena Park property nor liability of petitioners to sell the said property to Alloy for money ever matured because under no conditions was there to be a sale of the Buena Park property for cash until September 11, 1957, and then only if the Salinas property was not acquired by Alloy and exchanged for the Buena Park Property as of that date (R. 21). Deed of Alloy to petitioners conveying the Salinas property and deed of petitioners to Alloy conveying the Buena Park property were exchanged and recorded September 4, 1957. Consequently, an agreement on the part of petitioners to sell to Alloy the Buena Park property for money did not come into being.

Petitioners, on finding the Salinas property, took steps to make it available to Alloy for the exchange by signing buyer’s instructions in the escrow of August 19, 1957, opened at Salinas Title, but the fact is, as found by the Tax Court, that petitioners at that time intended to accomplish an exchange of properties and that the Salinas property was ‘acquired by Alloy’ for the sole purpose of such exchange.

True, the intermediate acts of the parties could have hewn closer to and have more precisely depicted the ultimate desired result, but what actually occurred on September 3 or 4, 1957, was an exchange of deeds between petitioners and Alloy which effected an exchange of the Buena Park property for the Salinas property. It is also noted by the court that the buyer’s instructions in the Salinas escrow did not conform to the seller’s instructions although the transfer from the original owner of the Salinas property to Salinas Title was, as to the provision at variance, pursuant to the terms of the buyer’s instructions. If Alloy had signed the said ‘Buyer’s Instructions’ this litigation would have been avoided, but even in the circumstances here involved the court concludes that the intended exchange was accomplished.

Respondent argues the Tax Court found only that petitioners from the outset ‘desired’ to exchange their Buena Park property and not that from the outset they ‘intended’ to do so.
This would appear in the circumstances to be a distinction without a difference since it does not seem logical that one would intentionally take steps to accomplish a result not desired, and that, therefore, all acts of the petitioners may be considered as having been performed with the intent to accomplish their desired result, to wit, ‘exchange their Buena Park property for other property of a like kind.’

Referring again to the Salinas escrow and the instructions to Orange, it is to be noted that the terms of the buyer’s instructions in the Salinas escrow and the instructions to Orange were not carried out in important details not heretofore mentioned. Although the petitioners authorized Orange to pay $19,000.00 into the Salinas escrow and to pay $171,000.00, when available, into the Salinas escrow, and although the Salinas escrow provided for the depositing of $171,000.00 into the Orange escrow (R.Br. 5), this was not done. The $171,000.00 nor any part thereof was ever paid into the Orange escrow, but on the contrary $172,871.40, property of Alloy, was by its attorney, Pentz, deposited in the Salinas escrow in Alloy’s behalf.

The court concludes the holding of the Tax Court, ‘that in essence petitioners acquired the Salinas property in a separate transaction; that payment of the $172,871.40, made by Alloy, was a payment made for petitioners’ (R. 32), is not supported by the Tax Court’s Findings of Fact, Stipulation of Facts or by the evidence in the case when considered in all of its aspects.

The court further concludes that there was no sale by petitioners of the Buena Park property to Alloy, but that the pertinent transactions resulted in an exchange of the Buena Park property for property of like kind to be held either for productive use in trade or for investment, and that by reason thereof there was no gain or loss from said exchange which should be recognized for income tax purposes. For the reasons set forth above, the Decision of the Tax Court of the United States Entered herein May 8, 1962, ‘That there is a deficiency in the income tax for the taxable year 1957 in the amount of $39,530.58’ (R. 33), is reversed.
Jordan Marsh Company v. Commissioner
269 F.2d 453 (2d Cir. 1959)

Before HINCKS, LUMBARD and MOORE, Circuit Judges.

HINCKS, Circuit Judge.

The transactions giving rise to the dispute were conveyances by the petitioner in 1944 of the fee of two parcels of property in the city of Boston where the petitioner, then as now, operated a department store. In return for its conveyances the petitioner received $2,300,000 in cash which, concededly, represented the fair market value of the properties. The conveyances were unconditional, without provision of any option to repurchase. At the same time, the petitioner received back from the vendees leases of the same properties for terms of 30 years and 3 days, with options to renew for another 30 years if the petitioner-lessee should erect new buildings thereon. The vendees were in no way connected with the petitioner. The rentals to be paid under the leases concededly were full and normal rentals so that the leasehold interests which devolved upon the petitioner were of no capital value.

In its return for 1944, the petitioner, claiming the transaction was a sale . . . sought to deduct from income the difference between the adjusted basis of the property and the cash received. The Commissioner disallowed the deduction, taking the position that the transaction represented an exchange of property for other property of like kind. Under [§1031] such exchanges are not occasions for the recognition of gain or loss; and even the receipt of cash or other property in the exchange of the properties of like kind is not enough to permit the taxpayer to recognize loss.[§1031(c)] Thus the Commissioner viewed the transaction, in substance, as an exchange of a fee interest . . . .

The controversy centers around the purposes of Congress in enacting [§1031], dealing with non-taxable exchanges. The section represents an exception to the general rule . . . that upon the sale or exchange of property the entire amount of gain or loss is to be recognized by the taxpayer. . . . Congress was primarily concerned with the inequity, in the case of an exchange, of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort. If such gains were not to be recognized, however, upon the ground that they were theoretical, neither should equally theoretical losses. And as to both gains and losses the taxpayer should not have it within his power to avoid the operation of the section by stipulating for the addition of cash, or boot, to the property received in exchange. These considerations, rather than concern for the difficulty of the administrative task of making the valuations necessary to compute gains and losses, were at the root of the Congressional purpose in enacting [§1031]. . . . That such indeed was the legislative objective is supported by Portland Oil Co. v. Commissioner of Internal Revenue, 1 Cir., 109 F.2d 479. There Judge Magruder, in speaking of a cognate provision contained$ in 112(b), said at page 488:

‘It is the purpose of Section 112(b)(5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really ‘cashed in’ on the theoretical gain, or closed out a losing venture.’
In conformity with this reading of the statute, we think the petitioner here, by its unconditional conveyances to a stranger, had done more than make a change in the form of ownership: it was a change as to the quantum of ownership whereby, in the words just quoted, it had ‘closed out a losing venture.’ By the transaction its capital invested in the real estate involved had been completely liquidated for cash to an amount fully equal to the value of the fee. This, we hold, was a sale—not an exchange within the purview of [§1031].

The Tax Court apparently thought it of controlling importance that the transaction in question involved no change in the petitioner’s possession of the premises: it felt that the decision in Century Electric Co. v. Commissioner of Internal Rev., supra, controlled the situation here. We think, however, that that case was distinguishable on the facts. For notwithstanding the lengthy findings made with meticulous care by the Tax Court in that case, 15 T.C. 581, there was no finding that the cash received by the taxpayer was the full equivalent of the value of the fee which the taxpayer had conveyed to the vendee-lessee, and no finding that the lease back called for a rent which was fully equal to the rental value of the premises. Indeed, in its opinion the Court of Appeals pointed to evidence that the fee which the taxpayer had ‘exchanged’ may have had a value substantially in excess of the cash received. And in the Century Electric case, the findings showed, at page 585, that the taxpayer-lessee, unlike the taxpayer here, was not required to pay ‘general state, city and school taxes’ because its lessor was an educational institution which under its charter was exempt from such taxes. Thus the leasehold interest in Century Electric on this account may well have had a premium value. In the absence of findings as to the values of the properties allegedly ‘exchanged,’ necessarily there could be no finding of a loss. And without proof of a loss, of course, the taxpayer could not prevail.

Indeed, in the Tax Court six of the judges expressly based their concurrences on that limited ground. 15 T.C. 596.

In the Century Electric opinion it was said, 192 F.2d at page 159:

‘Subsections 112(b)(1) and 112(e) indicate the controlling policy and purpose of the section, that is, the nonrecognition of gain or loss in transactions where neither is readily measured in terms of money, where in theory the taxpayer may have realized gain or loss but where in fact his economic situation is the same after as it was before the transaction. See Fairfield S.S. Corp. v. Commissioner, 2 Cir., 157 F.2d 321, 323; Trenton Cotton Oil Co. v. Commissioner, 6 Cir., 147 F.2d 33, 36.’

But the Fairfield case referred to was one in which the only change in taxpayer’s ownership was through the interposition of a corporate title accomplished by transfer to a corporation wholly owned by the taxpayer. And in the Trenton Cotton Oil case, the court expressly relied on Portland Oil Co. v. Commissioner of Internal Revenue, supra, as stating correctly the purpose of§112(b), but stating only the first of the two requisites stated in Portland. As we have already observed, in that case Judge Magruder said that it was the purpose of§112(b) ‘to intermit the claim of a loss’ not only where the economic situation of the taxpayer is unchanged but also ‘where *** the taxpayer has not *** closed out a losing venture.’ Here plainly the petitioner by the transfer finally closed out a losing venture. And it cannot justly be said that the economic situation of the petitioner was unchanged by a transaction which substituted $2,300,000 in cash for its investment in real estate and left it under a liability to make annual payments of rent for upwards of thirty years. Many bona fide business purposes may be served by such a transaction. Cary, Corporate Financing

In ordinary usage, an ‘exchange’ means the giving of one piece of property in return for another - not, as the Commissioner urges here, the return of a lesser interest in a property received from another. It seems unlikely that Congress intended that an ‘exchange’ should have the strained meaning for which the Commissioner contends. For the legislative history states expressly an intent to correct the indefiniteness of prior versions of the Act by excepting from the general rule ‘specifically and in definite terms those cases of exchanges in which it is not desired to tax the gain or allow the loss.’

But even if under certain circumstances the return of a part of the property conveyed may constitute an exchange for purposes of §112, we think that in this case, in which cash was received for the full value of the property conveyed, the transaction must be classified as a sale. Standard Envelope Manufacturing Co. v. C.I.R., 15 T.C. 41; May Department Stores Co. v. C.I.R., 16 T.C. 547.

Reversed.
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-finance 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 is $78K, and its FMV is $75K. Basil’s basis is the full $100K, starting at the closing, under the rule commonly referred to as the Crane doctrine.

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.

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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).
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

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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 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
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.

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

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).

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).
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), (i), 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.\(^5\)

### 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:

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

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), \textit{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 to be the same as § 1001 gain in virtually all cases.\(^6\)

Contract Price means “Selling Price,”\(^5\) 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. 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

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\(^5\) 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.

\(^6\) 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.

\(^5\) However, Contract Price and Payments are not reduced by any § 1245 (or § 1250) depreciation recapture.
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. 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 x $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:

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

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 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

58 Installment obligations on rural property (nonliquid collateral) are heavily discounted (in FMV terms) below PV.
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 §

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
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 by the basis therein that has already been recovered under § 453 by reason of having received prior Payments.)

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). 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.

*buyer’s obligation (in relation to the real present value) during periods when the AFR is high (as it was when § 1274 was enacted).*

*60 The basis of deferred-payment obligations was touched upon in connection with repossessions of sold property, discussed in Chapter 22.A.6.*

*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.*
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). \(^{62}\)

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 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

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\(^{62}\) See §§ 453B(c), 691(a)(4), 1014(c); Reg. § 1.691(a)-5(a). The successor does not obtain a § 1014 basis.
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.63 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.64 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

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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.
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 5.65

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 calculated? These problems are finessed by allowing the buyer to deduct the full amount of each payment.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

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65 See Reg. § 1.1275-4(c)(4)(i), (ii).
66 See Newton Insert Co. v. Comm’r, 61 T.C. 570 (1974), aff’d, 545 F.2d 1259 (9th Cir. 1976) (government concession).
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.

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.
26 C.F.R. § 1.446–1(e), Treas. Reg. §1.446–1(e)

(e) Requirement respecting the adoption or change of accounting method. (1) A taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. See section 446(c) and paragraph (c) of this section for permissible methods. Moreover, a taxpayer may adopt any permissible method of accounting in connection with each separate and distinct trade or business, the income from which is reported for the first time. See section 446(d) and paragraph (d) of this section. See also section 446(a) and paragraph (a) of this section.

(2)(i) Except as otherwise expressly provided in chapter 1 of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. Consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations under sections 471 and 472), a change from the cash or accrual method to a long-term contract method, or vice versa (see §1.460–4), certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section), a change involving the adoption, use or discontinuance of any other specialized method of computing taxable income, such as the crop method, and a method where the Internal Revenue Code and regulations under the Internal Revenue Code specifically require that the consent of the Commissioner must be obtained before adopting such a change.

(b) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. For example, corrections of items that are deducted as interest or salary, but that are in fact payments of dividends, and of items that are deducted as business expenses, but that are in fact personal expenses, are not changes in method of accounting. In addition, a change in the method of accounting does not include an adjustment with respect to the addition to a reserve for bad debts. Although such adjustment may involve the question of the proper time for the taking of a deduction, such items are traditionally corrected by adjustment in the current and future years. For the treatment of the adjustment of the addition to a bad debt reserve (for example, for banks under section 585 of the Internal Revenue Code), see the regulations under section 166 of the Internal Revenue Code. A change in the method of accounting also does not include a change in treatment resulting from a change in underlying facts. For further guidance on changes involving depreciable or amortizable assets, see paragraph (e)(2)(ii)(d) of this section and §1.1016–3(h).

(c) A change in an overall plan or system of identifying or valuing items in inventory is a change in method of accounting. Also a change in the treatment of any material item used in the overall plan for identifying or valuing items in inventory is a change in method of accounting.

(d) Changes involving depreciable or amortizable assets—(1) Scope. This paragraph (e)(2)(ii)(d) applies to property subject to section 167, 168, 197, 1401L, 1400L(c), to section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121) (former section 168), or to an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)).
(2) Changes in depreciation or amortization that are a change in method of accounting. Except as provided in paragraph (e)(2)(ii)(d)(3) of this section, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable, or vice versa, is a change in method of accounting. Additionally, a correction to require depreciation or amortization in lieu of a deduction for the cost of depreciable or amortizable assets that had been consistently treated as an expense in the year of purchase, or vice versa, is a change in method of accounting. Further, except as provided in paragraph (e)(2)(ii)(d)(3) of this section, the following changes in computing depreciation or amortization are a change in method of accounting:

(i) A change in the depreciation or amortization method, period of recovery, or convention of a depreciable or amortizable asset.

(ii) A change from not claiming to claiming the additional first year depreciation deduction provided by, for example, section 168(k), 1400L(b), or 1400N(d), for, and the resulting change to the amount otherwise allowable as a depreciation deduction for the remaining adjusted depreciable basis (or similar basis) of, depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), provided the taxpayer did not make the election out of the additional first year depreciation deduction (or did not make a deemed election out of the additional first year depreciation deduction; for further guidance, for example, see Rev. Proc. 2002–33 (2002–1 C.B. 963), Rev. Proc. 2003–50 (2003–2 C.B. 119), Notice 2006–77 (2006–40 I.R.B. 590), and § 601.601(d)(2)(ii)(b) of this chapter) for the class of property in which the depreciable property that qualifies for the additional first year depreciation deduction (for example, qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property) is included.

(iii) A change from claiming the 30–percent additional first year depreciation deduction to claiming the 50–percent additional first year depreciation deduction for depreciable property that qualifies for the 50–percent additional first year depreciation deduction, provided the property is not included in any class of property for which the taxpayer elected the 30–percent, instead of the 50–percent, additional first year depreciation deduction (for example, 50–percent bonus depreciation property or qualified Gulf Opportunity Zone property), or a change from claiming the 50–percent additional first year depreciation deduction to claiming the 30–percent additional first year depreciation deduction for depreciable property that qualifies for the 30–percent additional first year depreciation deduction, including property that is included in a class of property for which the taxpayer elected the 30–percent, instead of the 50–percent, additional first year depreciation deduction (for example, qualified property or qualified New York Liberty Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property’s remaining adjusted depreciable basis (or similar basis). This paragraph (e)(2)(ii)(d)(2)(iii) does not apply if a taxpayer is making a late election or revoking a timely valid election under the applicable additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) (see paragraph (e)(2)(ii)(d)(3)(iii) of this section).

(iv) A change from claiming to not claiming the additional first year depreciation deduction for an asset that does not qualify for the additional first year depreciation deduction, including an asset that is included in a class of property for which the taxpayer elected not to claim any additional first year depreciation deduction (for example, an asset that is not qualified property, 50–percent bonus depreciation property, qualified New York Liberty Zone property, or qualified Gulf Opportunity Zone property), and the resulting change to the amount otherwise allowable as a depreciation deduction for the property’s depreciable basis.

(v) A change in salvage value to zero for a depreciable or amortizable asset for which the salvage value is expressly treated as zero by the Internal Revenue Code (for example, section 168(b)(4)), the regulations under the Internal Revenue Code (for example, § 1.197–2(f)(1)(ii)), or other guidance published in the Internal Revenue Bulletin.

(vi) A change in the accounting for depreciable or amortizable assets from a single asset account to a multiple asset account (pooling), or vice versa, or from one type of multiple asset account (pooling) to a different type of multiple asset account (pooling).
(vii) For depreciable or amortizable assets that are mass assets accounted for in multiple asset accounts or pools, a change in the method of identifying which assets have been disposed. For purposes of this paragraph (e)(2)(ii)(d)(2)(vii), the term mass assets means a mass or group of individual items of depreciable or amortizable assets that are not necessarily homogeneous, each of which is minor in value relative to the total value of the mass or group, numerous in quantity, usually accounted for only on a total dollar or quantity basis, with respect to which separate identification is impracticable, and placed in service in the same taxable year.

(viii) Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(3) Changes in depreciation or amortization that are not a change in method of accounting. Section 1.446–1(e)(2)(ii)(b) applies to determine whether a change in depreciation or amortization is not a change in method of accounting. Further, the following changes in depreciation or amortization are not a change in method of accounting:

(i) Useful life. An adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is not a change in method of accounting. This paragraph (e)(2)(ii)(d)(3)(i) does not apply if a taxpayer is changing to or from a useful life (or recovery period or amortization period) that is specifically assigned by the Internal Revenue Code (for example, section 167(f)(1), section 168(c), section 168(g)(2) or (3), section 197), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin and, therefore, such change is a change in method of accounting (unless paragraph (e)(2)(ii)(d)(3)(v) of this section applies). See paragraph (e)(2)(ii)(d)(5)(iv) of this section for determining the taxable year in which to correct an adjustment in useful life that is not a change in method of accounting.

(ii) Change in use. A change in computing depreciation or amortization allowances in the taxable year in which the use of an asset changes in the hands of the same taxpayer is not a change in method of accounting.

(iii) Elections. Generally, the making of a late depreciation or amortization election or the revocation of a timely valid depreciation or amortization election is not a change in method of accounting, except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin. This paragraph (e)(2)(ii)(d)(3)(iii) also applies to making a late election or revoking a timely valid election made under section 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (107 Stat. 312, 540) (relating to amortizable section 197 intangibles). A taxpayer may request consent to make a late election or revoke a timely valid election by submitting a request for a private letter ruling. For making or revoking an election under section 179 of the Internal Revenue Code, see section 179(c) and § 1.179–5.

(iv) Salvage value. Except as provided under paragraph (e)(2)(ii)(d)(2)(v) of this section, a change in salvage value of a depreciable or amortizable asset is not treated as a change in method of accounting.

(v) Placed-in-service date. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, any change in the placed-in-service date of a depreciable or amortizable asset is not treated as a change in method of accounting. For example, if a taxpayer changes the placed-in-service date of a depreciable or amortizable asset because the taxpayer incorrectly determined the date on which the asset was placed in service, such a change is a change in the placed-in-service date of the asset and, therefore, is not a change in method of accounting. However, if a taxpayer incorrectly determines that a depreciable or amortizable asset is nondepreciable property and later changes the treatment of the asset to depreciable property, such a change is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2) of this section. Further, a change in the convention of a depreciable or amortizable asset is not a change in the placed-in-service date of the asset and, therefore, is a change in method of accounting under paragraph (e)(2)(ii)(d)(2)(i) of this section. See paragraph (e)(2)(ii)(d)(5)(v) of this section for determining the taxable year in which to make a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting.
(vi) Any other change in depreciation or amortization as the Secretary may designate by publication in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter).

(4) Item being changed. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies, the item being changed generally is the depreciation treatment of each individual depreciable or amortizable asset. However, the item is the depreciation treatment of each vintage account with respect to a depreciable asset for which depreciation is determined under § 1.167(a)–11 (class life asset depreciation range (CLADR) property). Similarly, the item is the depreciation treatment of each general asset account with respect to a depreciable asset for which general asset account treatment has been elected under section 168(i)(4) or the item is the depreciation treatment of each mass asset account with respect to a depreciable asset for which mass asset account treatment has been elected under former section 168(d)(2)(A).

Further, a change in computing depreciation or amortization under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))) is permitted only with respect to all assets in a particular account (as defined in § 1.167(a)–7) or vintage account.

(5) Special rules. For purposes of a change in depreciation or amortization to which this paragraph (e)(2)(ii)(d) applies—

(i) Declining balance method to the straight line method for MACRS property. For tangible, depreciable property subject to section 168 (MACRS property) that is depreciated using the 200–percent or 150–percent declining balance method of depreciation under section 168(b)(1) or (2), a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method of depreciation in the first taxable year in which the use of the straight line method with respect to the adjusted depreciable basis of the MACRS property as of the beginning of that year will yield a depreciation allowance that is greater than the depreciation allowance yielded by the use of the declining balance method. When the change is made, the adjusted depreciable basis of the MACRS property as of the beginning of the taxable year is recovered through annual depreciation allowances over the remaining recovery period (for further guidance, see section 6.06 of Rev. Proc. 87–57 (1987–2 C.B. 687) and § 601.601(d)(2)(ii)(b) of this chapter).

(ii) Depreciation method changes for section 167 property. For a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d))), see § 1.167(e)–1(b), (c), and (d) for the changes in depreciation method that are permitted to be made without the consent of the Commissioner. For CLADR property, see § 1.167(a)–11(c)(1)(iii) for the changes in depreciation method for CLADR property that are permitted to be made without the consent of the Commissioner. Further, see § 1.167(a)–11(b)(4)(iii)(c) for how to correct an incorrect classification or characterization of CLADR property.

(iii) Section 481 adjustment. Except as otherwise expressly provided by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin, no section 481 adjustment is required or permitted for a change from one permissible method of computing depreciation or amortization to another permissible method of computing depreciation or amortization for an asset because this change is implemented by either a cut-off method (for further guidance, for example, see section 2.06 of Rev. Proc. 97–27 (1997–1 C.B. 680), section 2.06 of Rev. Proc. 2002–9 (2002–1 C.B. 327), and § 601.601(d)(2)(ii)(b) of this chapter) or a modified cut-off method (under which the adjusted depreciable basis of the asset as of the beginning of the year of change is recovered using the new permissible method of accounting), as appropriate. However, a change from an impermissible method of computing depreciation or amortization to a permissible method of computing depreciation or amortization for an asset results in a section 481 adjustment. Similarly, a change in the treatment of an asset from nondepreciable or nonamortizable to depreciable or amortizable (or vice versa) or a change in the treatment of an asset from expensing to depreciating (or vice versa) results in a section 481 adjustment.

(iv) Change in useful life. This paragraph (e)(2)(ii)(d)(5)(iv) applies to an adjustment in the useful life of a depreciable or amortizable asset for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), former section 168, or an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k), 1400L(b), or 1400N(d)) and
that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this adjustment in useful life, no section 481 adjustment is required or permitted. The adjustment in useful life, whether initiated by the Internal Revenue Service (IRS) or a taxpayer, is corrected by adjustments in the taxable year in which the conditions known to exist at the end of that taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)–1(b) (or if the period of limitation for assessment under section 6501(a) has expired for that taxable year, in the first succeeding taxable year open under the period of limitation for assessment), and in subsequent taxable years. In other situations (for example, the useful life is incorrectly determined in the placed-in-service year), the adjustment in the useful life, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the correction in useful life, in lieu of filing amended Federal tax returns (for example, because the conditions known to exist at the end of a prior taxable year changed thereby resulting in a redetermination of the useful life under § 1.167(a)–1(b)), the taxpayer may correct the adjustment in useful life by adjustments in the current and subsequent taxable years.

(v) Change in placed-in-service date. This paragraph (e)(2)(ii)(d)(5)(v) applies to a change in the placed-in-service date of a depreciable or amortizable asset that is not a change in method of accounting under paragraph (e)(2)(ii)(d) of this section. For this change in placed-in-service date, no section 481 adjustment is required or permitted. The change in placed-in-service date, whether initiated by the IRS or a taxpayer, may be corrected by adjustments in the earliest taxable year open under the period of limitation for assessment under section 6501(a) or the earliest taxable year under examination by the IRS but in no event earlier than the placed-in-service year of the asset, and in subsequent taxable years. However, if a taxpayer initiates the change in placed-in-service date, in lieu of filing amended Federal tax returns, the taxpayer may correct the placed-in-service date by adjustments in the current and subsequent taxable years.

(iii) Examples. The rules of this paragraph (e) are illustrated by the following examples:

Example 1. Although the sale of merchandise is an income producing factor, and therefore inventories are required, a taxpayer in the retail jewelry business reports his income on the cash receipts and disbursements method of accounting. A change from the cash receipts and disbursements method of accounting to the accrual method of accounting is a change in the overall plan of accounting and thus is a change in method of accounting.

Example 2. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis except for real estate taxes which have been reported on the cash receipts and disbursements method of accounting. A change in the treatment of real estate taxes from the cash receipts and disbursements method to the accrual method is a change in method of accounting because such change is a change in the treatment of a material item within his overall accounting practice.

Example 3. A taxpayer in the wholesale dry goods business computes its income and expenses on the accrual method of accounting and files its Federal income tax returns on such basis. Vacation pay has been deducted in the year in which paid because the taxpayer did not have a completely vested vacation pay plan, and, therefore, the liability for payment did not accrue until that year. Subsequently, the taxpayer adopts a completely vested vacation pay plan that changes its year for accruing the deduction from the year in which payment is made to the year in which the liability to make the payment now arises. The change for the year of deduction of the vacation pay plan is not a change in method of accounting but results, instead, because the underlying facts (that is, the type of vacation pay plan) have changed.

Example 4. From 1968 through 1970, a taxpayer has fairly allocated indirect overhead costs to the value of inventories on a fixed percentage of direct costs. If the ratio of indirect overhead costs to direct costs increases in 1971, a change in the underlying facts has occurred. Accordingly, an increase in the percentage in 1971 to fairly reflect the increase in the relative level of indirect overhead costs is not a change in method of accounting but is a change in treatment resulting from a change in the underlying facts.
Example 5. A taxpayer values inventories at cost. A change in the basis for valuation of inventories from cost to the lower of cost or market is a change in an overall practice of valuing items in inventory. The change, therefore, is a change in method of accounting for inventories.

Example 6. A taxpayer in the manufacturing business has for many taxable years valued its inventories at cost. However, cost has been improperly computed since no overhead costs have been included in valuing the inventories at cost. The failure to allocate an appropriate portion of overhead to the value of inventories is contrary to the requirement of the Internal Revenue Code and the regulations under the Internal Revenue Code. A change requiring appropriate allocation of overhead is a change in method of accounting because it involves a change in the treatment of a material item used in the overall practice of identifying or valuing items in inventory.

Example 7. A taxpayer has for many taxable years valued certain inventories by a method which provides for deducting 20 percent of the cost of the inventory items in determining the final inventory valuation. The 20 percent adjustment is taken as a “reserve for price changes.” Although this method is not a proper method of valuing inventories under the Internal Revenue Code or the regulations under the Internal Revenue Code, it involves the treatment of a material item used in the overall practice of valuing inventory. A change in such practice or procedure is a change of method of accounting for inventories.

Example 8. A taxpayer has always used a base stock system of accounting for inventories. Under this system a constant price is applied to an assumed constant normal quantity of goods in stock. The base stock system is an overall plan of accounting for inventories which is not recognized as a proper method of accounting for inventories under the regulations. A change in this practice is, nevertheless, a change of method of accounting for inventories.

Example 9. In 2003, A1, a calendar year taxpayer engaged in the trade or business of manufacturing knitted goods, purchased and placed in service a building and its components at a total cost of $10,000,000 for use in its manufacturing operations. A1 classified the $10,000,000 as nonresidential real property under section 168(e). A1 elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003, 2004, and 2005 Federal tax returns, A1 depreciated the $10,000,000 under the general depreciation system of section 168(a), using the straight line method of depreciation, a 39–year recovery period, and the mid-month convention. In 2006, A1 completes a cost segregation study on the building and its components and identifies items that cost a total of $1,500,000 as section 1245 property. As a result, the $1,500,000 should have been classified in 2003 as 5–year property under section 168(e) and depreciated on A1’s 2003, 2004, and 2005 Federal tax returns under the general depreciation system, using the 200–percent declining balance method of depreciation, a 5–year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, A1’s change to this depreciation method, recovery period, and convention is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 10. In 2003, B, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $1,000,000 for use in its plant located outside the United States. The equipment is 15–year property under section 168(e) with a class life of 20 years. The equipment is required to be depreciated under the alternative depreciation system of section 168(g). However, B incorrectly depreciated the equipment under the general depreciation system of section 168(a), using the 150–percent declining balance method, a 15–year recovery period, and the half-year convention. In 2010, the IRS examines B’s 2007 Federal income tax return and changes the depreciation of the equipment to the alternative depreciation system, using the straight line method of depreciation, a 20–year recovery period, and the half-year convention. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, this change in depreciation method and recovery period made by the IRS is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the assets are depreciated under section 168.

Example 11. In May 2003, C, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or
Example 12. Since 2003, D, a calendar year taxpayer, has used the distribution fee period method to amortize distributor commissions and, under that method, established pools to account for the distributor commissions (for further guidance, see Rev. Proc. 2000–38 (2000–2 C.B. 310) and § 601.601(d)(2)(ii)(b) of this chapter). A change in the accounting of distributor commissions under the distribution fee period method from pooling to single asset accounting is a change in method of accounting pursuant to paragraph (e)(2)(ii)(d)(2) of this section. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 13. Since 2003, E, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that are placed in service by E in the same taxable year. E is able to identify the cost basis of each asset in each pool. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). E identified any disposals of these mass assets by specific identification. Because of changes in E’s recordkeeping in 2006, it is impracticable for E to continue to identify disposed mass assets using specific identification. As a result, E wants to change to a first-in, first-out method under which the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year in existence as of the beginning of the taxable year of each disposition. Pursuant to paragraph (e)(2)(ii)(d)(2)(vii) of this section, this change is a change in method of accounting. This method change results in no section 481 adjustment because the change is from one permissible method to another permissible method.

Example 14. In August 2003, F, a calendar year taxpayer, purchased and placed in service a copier for use in its trade or business. F incorrectly classified the copier as 7–year property under section 168(e). F elected not to deduct the additional first year depreciation provided by section 168(k) on its 2003 Federal tax return. As a result, on its 2003 and 2004 Federal tax returns, F depreciated the copier under the general depreciation system of section 168(a), using the 200–percent declining balance method of depreciation, a 7–year recovery period, and the half-year convention. In 2005, F realizes that the copier is 5–year property and should have been depreciated on its 2003 and 2004 Federal tax returns under the general depreciation system using a 5–year recovery period rather than a 7–year recovery period. Pursuant to paragraph (e)(2)(ii)(d)(2)(i) of this section, F’s change in recovery period from 7 to 5 years is a change in method of accounting. This method change results in a section 481 adjustment. The useful life exception under paragraph (e)(2)(ii)(d)(3)(i) of this section does not apply because the copier is depreciated under section 168.

Example 15. In 2004, G, a calendar year taxpayer, purchased and placed in service an intangible asset that is not an amortizable section 197 intangible and that is not described in section 167(f). G amortized the cost of the intangible asset under section 167(a) using the straight line method of depreciation and a determinable useful life of 13 years. The safe harbor useful life of 15 or 25 years under § 1.167(a)–3(b) does not apply to the intangible asset. In 2008, because of changing conditions, G changes the remaining useful life of the intangible asset to 2 years. Pursuant to paragraph (e)(2)(ii)(d)(3)(i) of this section, G’s change in useful life is not a change in method of accounting because the intangible asset is depreciated under section 167 and G is not changing to or from a useful life that is specifically assigned by the Internal Revenue Code, the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin.

Example 16. In July 2003, H, a calendar year taxpayer, purchased and placed in service “off-the-shelf” computer software and a new computer. The cost of the new computer and computer software are separately stated. H incorrectly included the cost of this software as part of the cost of the computer, which is 5–year property under section 168(e). On its 2003 Federal tax return, H elected to depreciate its 5–year property placed in service in 2003 under the alternative depreciation system of section 168(g) and H elected not to deduct the additional first year depreciation provided by section 168(k). The class life for a computer is 5 years. As a result, because H included the cost of the computer software as part of the cost of the computer hardware, H depreciated the cost of the software under the alternative depreciation system, using the straight line method of depreciation, a 5–year recovery period, and the half-year convention. In 2005, H realizes that the cost of the software should have been amortized under section 167(f)(1), using the straight line method of depreciation, a 36–month useful life, and a monthly
convention. H’s change from 5–years to 36–months is a change in method of accounting because H is changing to a useful life that is specifically assigned by section 167(f)(1). The change in convention from the half-year to the monthly convention also is a change in method of accounting. Both changes result in a section 481 adjustment.

Example 17. On May 1, 2003, I2, a calendar year taxpayer, purchased and placed in service new equipment at a total cost of $500,000 for use in its business. The equipment is 5–year property under section 168(e) with a class life of 9 years and is qualified property under section 168(k)(2). I2 did not place in service any other depreciable property in 2003. Section 168(g)(1)(A) through (D) do not apply to the equipment. I2 intended to elect the alternative depreciation system under section 168(g) for 5–year property placed in service in 2003. However, I2 did not make the election. Instead, I2 deducted on its 2003 Federal tax return the 30–percent additional first year depreciation attributable to the equipment and, on its 2003 and 2004 Federal tax returns, depreciated the remaining adjusted depreciable basis of the equipment under the general depreciation system under 168(a), using the 200–percent declining balance method, a 5–year recovery period, and the half-year convention. In 2005, I2 realizes its failure to make the alternative depreciation system election in 2003 and files a Form 3115, “Application for Change in Accounting Method,” to change its method of depreciating the remaining adjusted depreciable basis of the 2003 equipment to the alternative depreciation system. Because this equipment is not required to be depreciated under the alternative depreciation system, I2 is attempting to make an election under section 168(g)(7). However, this election must be made in the taxable year in which the equipment is placed in service (2003) and, consequently, I2 is attempting to make a late election under section 168(g)(7). Accordingly, I2’s change to the alternative depreciation system is not a change in accounting method pursuant to paragraph (e)(2)(ii)(d)(3)(iii) of this section. Instead, I2 must submit a request for a private letter ruling under § 301.9100–3 of this chapter, requesting an extension of time to make the alternative depreciation system election on its 2003 Federal tax return.

Example 18. On December 1, 2003, J, a calendar year taxpayer, purchased and placed in service 20 previously-owned adding machines. For the 2004 taxable year, J incorrectly classified the adding machines as items in its “suspense” account for financial and tax accounting purposes. Assets in this suspense account are not depreciated until reclassified to a depreciable fixed asset account. In January 2006, J realizes that the cost of the adding machines is still in the suspense account and reclassifies such cost to the appropriate depreciable fixed asset account. As a result, on its 2004 and 2005 Federal tax returns, J did not depreciate the cost of the adding machines. Pursuant to paragraph (e)(2)(ii)(d)(2) of this section, J’s change in the treatment of the adding machines from nondepreciable assets to depreciable assets is a change in method of accounting. The placed-in-service date exception under paragraph (e)(2)(ii)(d)(3)(v) of this section does not apply because the adding machines were incorrectly classified in a nondepreciable suspense account. This method change results in a section 481 adjustment.

Example 19. In December 2003, K, a calendar year taxpayer, purchased and placed in service equipment for use in its trade or business. However, K did not receive the invoice for this equipment until January 2004. As a result, K classified the equipment on its fixed asset records as being placed in service in January 2004. On its 2004 and 2005 Federal tax returns, K depreciated the cost of the equipment. In 2006, K realizes that the equipment was actually placed in service during the 2003 taxable year and, therefore, depreciation should have begun in the 2003 taxable year instead of the 2004 taxable year. Pursuant to paragraph (e)(2)(ii)(d)(3)(v) of this section, K’s change in the placed-in-service date of the equipment is not a change in method of accounting.

(3)(i) Except as otherwise provided under the authority of paragraph (e)(3)(ii) of this section, to secure the Commissioner’s consent to a taxpayer’s change in method of accounting the taxpayer generally must file an application on Form 3115, “Application for Change in Accounting Method,” with the Commissioner during the taxable year in which the taxpayer desires to make the change in method of accounting. See §§ 1.381(c)(4)–1(d)(2) and 1.381(c)(5)–1(d)(2) for rules allowing additional time, in some circumstances, for the filing of an application on Form 3115 with respect to a transaction to which section 381(a) applies. To the extent applicable, the taxpayer must furnish all information requested on the Form 3115. This information includes all classes of items that will be treated differently under the new method of accounting, any amounts that will be duplicated or omitted as a result of the proposed change, and the taxpayer’s computation of any adjustments necessary to prevent such duplications or omissions. The Commissioner may require such other information as may be necessary to determine whether the proposed change will be permitted. Permission to change a taxpayer’s
method of accounting will not be granted unless the taxpayer agrees to the Commissioner’s prescribed terms and conditions for effecting the change, including the taxable year or years in which any adjustment necessary to prevent amounts from being duplicated or omitted is to be taken into account. See section 481 and the regulations thereunder, relating to certain adjustments resulting from accounting method changes, and section 472 and the regulations thereunder, relating to adjustments for changes to and from the last-in, first-out inventory method. For any Form 3115 filed on or after May 15, 1997, see § 1.446–1T(e)(3)(i)(B).

(ii) Notwithstanding the provisions of paragraph (e)(3)(i) of this section, the Commissioner may prescribe administrative procedures under which taxpayers will be permitted to change their method of accounting. The administrative procedures shall prescribe those terms and conditions necessary to obtain the Commissioner’s consent to effect the change and to prevent amounts from being duplicated or omitted. The terms and conditions that may be prescribed by the Commissioner may include terms and conditions that require the change in method of accounting to be effected on a cut-off basis or by an adjustment under section 481(a) to be taken into account in the taxable year or years prescribed by the Commissioner.

(iii) This paragraph (e)(3) applies to Forms 3115 filed on or after December 31, 1997. For other Forms 3115, see § 1.446–1(e)(3) in effect prior to December 31, 1997 (§ 1.446–1(e)(3) as contained in the 26 CFR part 1 edition revised as of April 1, 1997).

(4) Effective date—(i) In general. Except as provided in paragraphs (e)(3)(iii), (e)(4)(ii), and (e)(4)(iii) of this section, paragraph (e) of this section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see § 1.446–1(e) in effect prior to December 30, 2003 (§ 1.446–1(e) as contained in 26 CFR part 1 edition revised as of April 1, 2003).

(ii) Changes involving depreciable or amortizable assets. With respect to paragraph (e)(2)(ii)(d) of this section, paragraph (e)(2)(iii) Examples 9 through 19 of this section, and the language “certain changes in computing depreciation or amortization (see paragraph (e)(2)(ii)(d) of this section)” in the last sentence of paragraph (e)(2)(ii)(a) of this section—

(A) For any change in depreciation or amortization that is a change in method of accounting, this section applies to such a change in method of accounting made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003; and

(B) For any change in depreciation or amortization that is not a change in method of accounting, this section applies to such a change made by a taxpayer for a depreciable or amortizable asset placed in service by the taxpayer in a taxable year ending on or after December 30, 2003.

(iii) Effective/applicability date for paragraph (e)(3)(i). The rules of paragraph (e)(3)(i) of this section apply to corporate reorganizations and tax-free liquidations described in section 381(a) that occur on or after August 31, 2011.
ISSUE AND FACTS

The Internal Revenue Service has reconsidered the position set forth in Rev. Rul. 70-539, 1970-2 C.B. 70. In Rev. Rul. 70-539, a corporation organized in 1966 and engaged in developing real estate capitalized interest, taxes, and other carrying charges by including them in the tax basis of real estate sold. Rev. Rul. 70-539 holds that the corporation did not make a valid election under section 266 of the Internal Revenue Code because it failed to file a statement with its returns for 1966, 1967, and 1968 identifying the items it was capitalizing as required by section 1.266-1(c)(3) of the Income Tax Regulations. Because the corporation capitalized these items without making a valid election, Rev. Rul. 70-539 holds that the corporation may treat these items as current operating expenses on amended returns for 1966, 1967, and 1968. Rev. Rul. 75-56, 1975-1 C.B. 98, distinguishes Rev. Rul. 70-539 by holding that a taxpayer may not amend its returns to deduct erroneously capitalized expenses if the period for amending the first return reflecting the capitalized expenses has expired.

LAW AND ANALYSIS

Section 446(e) of the Code and section 1.446-1(e) of the regulations provide that a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes.

Section 1.446-1(e) of the regulations provides rules for determining what a method of accounting is, how an adoption of a method of accounting occurs, and how a change in method of accounting may be made.

Section 1.446-1(e)(2)(ii)(a) of the regulations provides:

A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment.

The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns represents consistent treatment of that item for purposes of section 1.446-1(e)(2)(i)(a) of the regulations. See Diebold, Inc. v. United States, 891 F.2d 1579 (Fed. Cir. 1989). In addition, section 1.446-1(e)(2)(i) indicates that the consistent, but erroneous, treatment of material items constitutes a method of accounting. See section 1.446-1(e)(2)(iii), Examples (6)-(8); see also Fruehauf Corp. v. Commissioner, 356 F.2d 975 (6th Cir.), cert. denied, 385 U.S. 822 (1966); Commissioner v. O. Liquidating Corp., 292 F.2d 225 (3rd Cir.), cert. denied, 368 U.S. 898 (1961); and Rev. Rul. 80-190, 1980-2 C.B. 161. Compare Rev. Rul. 72-491, 1972-2 C.B. 104, which holds that a taxpayer erroneously using an accelerated method of depreciation for "used" property may file an amended return using a proper method, provided the taxpayer has not filed the tax return for the succeeding tax year.

If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns before it has adopted a method of accounting. Section 1.446-1(e)(1) of the regulations provides, for example, that a taxpayer filing its first return may adopt any permissible method of accounting in computing taxable income for the tax year covered by such return. Similarly, the Supreme Court has held that once a permissible election as to a method of accounting for an item has been made on a return, it may not be changed after the time for filing the return has expired. See Pacific National Co. v. Welch, 304 U.S. 191 (1938), 1938-1 C.B. 274; see also Lord v. United States, 296 F.2d 333 (9th Cir. 1961); National Western Life Insurance Co. v. Commissioner, 54 T.C. 33 (1970); Rev. Rul. 74-154, 1974-1 C.B. 59.

Section 1.446-1(e)(3)(i) of the regulations provides that (except as otherwise provided by administrative procedures prescribed by the Commissioner) in order to secure the Commissioner’s consent to a change of a taxpayer’s method of accounting, the taxpayer must file an application on Form 3115, Application for Change in Accounting Method, within 180 days after the beginning of the tax year in which the taxpayer desires to make the change.

If a taxpayer’s treatment of an item is a method of accounting under these principles, section 446(e) of the Code and section 1.446-1(e)(3) of the regulations preclude a taxpayer from making a retroactive change in method of accounting by amending prior tax returns without the consent of the Commissioner. Section 446(e) authorizes the Commissioner to consent to a
retroactive change in method of accounting, whether the change is from a permissible method or an impermissible method. E.g., Barber v. Commissioner, 64 T.C. 314 (1975); Notice 89-15, 1989-1 C.B. 816; Notice 88-78, 1988-2 C.B. 394, modified by Notice 89-67, 1989-1 C.B. 723; Rev. Proc. 78-6, 1978-1 C.B. 558. Section 446(e) does not give the taxpayer a right to demand that a change in method be made retroactively, however. See Diebold, Inc., 891 F.2d at 1583. Except in certain limited circumstances, and as specifically provided by revenue procedure or other administrative pronouncement, a taxpayer that seeks to change its method of accounting in accordance with section 1.446-1(e) may only request to change the method of accounting prospectively. See section 1.446-1(e)(3)(i); section 4.04, Rev. Proc. 84-74, 1984-2 C.B. 736, 741.

Under section 1.446-1(e)(2)(i) of the regulations, consent to change any method of accounting used by a taxpayer is a matter within the discretion of the Commissioner. The Commissioner, however, may prescribe other administrative procedures, subject to such limitations, terms and conditions as are deemed necessary to obtain the Commissioner’s consent, to permit taxpayers to change their accounting method to a permissible method. See section 1.446-1(e)(3)(ii). Permission to change a taxpayer’s method of accounting will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. See section 1.446-1(e)(3)(i).

The corporation under consideration in Rev. Rul. 70-539 adopted a method of accounting when it filed the second consecutive tax return in which it erroneously capitalized charges for interest, taxes, and other carrying charges associated with real estate. In that ruling, the corporation, which was required to obtain the Commissioner’s consent to change the erroneous method, was permitted by the Service to change the method which capitalized charges to a method that treated the charges as current expenses by timely amending all prior returns reflecting the erroneous capitalization. However, upon reconsideration, the Service has determined that the special procedure under section 266 of the Code contained in Rev. Rul. 70-539 is not an appropriate departure from the general requirements of section 446(e) and the regulations. The Service has further determined that, in the circumstances described in Rev. Rul. 70-539, consent should be granted only for a prospective change of accounting method and only pursuant to an application for consent made under the generally applicable rules of section 1.446-1(e)(3)(i).

HOLDING

A taxpayer may not, without the Commissioner’s consent, retroactively change from an erroneous to a permissible method of accounting by filing amended returns, even if the period for amending the return for the first year in which the erroneous method was used has not expired. Thus, a taxpayer that, for two or more consecutive tax years, has capitalized interest and other carrying charges under section 266 of the Code without making a valid election as required by applicable regulations has nonetheless adopted a method of accounting with respect to the interest and carrying charges. The taxpayer may not change that method of accounting by filing amended returns for those prior tax years. Instead, the taxpayer may only change the method of accounting with the consent of the Commissioner pursuant to section 1.446-1(e) of the regulations.

Consistent with the above, the Service will not follow Gimbel Bros., Inc. v. United States, 535 F.2d 14 (Ct. Cl. 1976), in which the court permitted the taxpayer to file amended returns for prior open years to effect a change in method of accounting for a material item.
Judge: RADER, Judge

* * * * Plaintiff filed its original 1977 return on June 15, 1978, and paid the $3,545,343 reported due. As in 1976, the plaintiff treated replacement modules as inventory. The plaintiff claimed no depreciation for service modules in its original 1977 tax return.

In the wake of the retrofitting module settlement, Diebold began to list these replacement modules as depreciable assets in its 1980 return and in financial statements. On October 6, 1980, plaintiff filed amended returns for the years 1976, 1977, 1978, and 1979. In the amended returns, Diebold changed its tax accounting treatment of spare service modules from inventory to depreciable property eligible for the investment tax credit. Accordingly, Diebold claimed a refund for 1976 of $454,261 and for 1977 of $350,509. At the time it filed these amended returns, Diebold’s 1976 and 1977 returns were being audited by the IRS.

The Service on April 18, 1983 disallowed plaintiff’s 1976 and 1977 refund claims, maintaining that Diebold was not entitled to change unilaterally its method of accounting. After Diebold treated spare parts as inventory for several years, the Service asserted that Diebold was required to secure the consent of the Commissioner of Internal Revenue (Commissioner) prior to changing accounting methods. The plaintiff did not file Form 3115 (request for Commissioner’s consent to change accounting method) prior to attempting to amend its returns and apparently has not filed such form to date.

Each of the plaintiff’s amended returns (1976, 1977, 1978, and 1979) and refund claims was based upon a change in accounting method, effected in 1980 and beginning with the amended return for 1976. * * * *

Discussion * * *

I. Consent requirements

Defendant has moved for summary judgment asserting that plaintiff attempted to change its method of accounting for certain rotatable spare service parts without having properly requested or obtained the consent of the Commissioner. Def’s Brief filed March 17, 1987, at 1. The uncontroverted facts, construed to resolve doubts in favor of the plaintiff, indicate that Diebold changed from an inventory accounting method for spare service modules to a depreciation method without obtaining the required consent.

The Internal Revenue Code sets forth the consent requirement governing changes in accounting method:

Requirement Respecting Change of Accounting Method.—

Except as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting on the basis of which he regularly computes his income in keeping his books shall, before computing his taxable income under the new method, secure the consent of the Secretary.

26 U.S.C. §446(e).

Treasury Regulations further clarify the foregoing Code requirements:

(e) Requirement respecting the adoption or change of accounting method. (1) a taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the taxable year covered by such return. ...

(2)(i) Except as otherwise expressly provided in chapter I of the Code and the regulations thereunder, a taxpayer who changes the method of accounting employed in keeping his books shall, before computing his income upon such new method for purposes of taxation, secure the consent of the Commissioner. consent must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.

(ii)(a) A change in the method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. Although a method of accounting may exist under this definition without the necessity of a pattern of consistent treatment of an item, in most instances a method of accounting is not established for an item without such consistent treatment. A material item is any item which involves the proper time for the inclusion of the item in income or the taking of a deduction. Changes in method of accounting include a change from the cash receipts and disbursement method to an accrual method, or vice versa, a change involving the method or basis used in the valuation of inventories (see sections 471 and 472 and the regulations thereunder ....

(3)(i) Except as otherwise provided under the authority of subdivision (ii) of this subparagraph, in order to secure the Commissioner’s consent to a
change of taxpayer’s method of accounting, the taxpayer must file an application on form 3115 ....


Thus, to briefly restate the requirements of the statute as interpreted by the regulations, taxpayer intending to change any method of regularly computing income on any material item must first obtain the consent of the Secretary of Treasury. A material item, according to the regulations is any item involving the timing of computing income or deductions.

The Court of Claims applied this rule in a 1965 case where the taxpayer attempted to switch from a strict cash basis of accounting to a hybrid of accrual and cash basis accounting:
The possibility that taxpayers might wish to change their system of accounting from time to time was contemplated, and a procedure whereby such change might be effected was prescribed ....

... Therefore, if the plaintiff desired to change its treatment ... the plaintiff had the privilege of applying to the Commissioner of Internal Revenue for permission to make such a change ....

... The reason for the exercise of such discretionary power by the Commissioner was that a change in the method of reporting an important item of expense or of income would almost certainly result in some distortion of net income ... and it was incumbent upon the Commissioner to see that such distortion was not unduly detrimental to the revenue of the Government.


As a matter of uncontested fact, Diebold did consistently account, over a period of at least four years (tax years 1976-79), for its replacement modules as inventory. In 1980, the plaintiff sought by amended return to treat the modules instead as noninventory depreciable assets eligible for the investment tax credit. A ‘change,’ from inventory to depreciation treatment constituted a ‘change in the method of accounting’ within the meaning of the Code and the Treasury Regulations. This term, according to Treasury Regulations, is defined as ‘a change in the treatment of any material item.’ A ‘material item,’ in turn, is defined as ‘any item which involves the proper time for the ... taking of a deduction.’ 26 C.F.R. §1.446(e)(2)(ii)(a).

In this case, the plaintiff’s attempt to claim depreciation (over a five-year useful life) on rotatable spare parts involves the proper time for the taking of a deduction. Diebold initially treated its spare modules as inventory, a method that permits the cost of acquiring inventory to be deducted in a single year.2 Diebold’s amended returns, in contrast, seek to recover the cost of the spares ratably over their useful life. See 26 U.S.C. §167. By plaintiff’s own figures, the accounting treatment it proposes by amended return would generate $9,110,913 more in deductions (all at an earlier time) than would its original (inventory) treatment, for the period 1976-1982 alone.

According to applicable law, as well, the plaintiff’s amended return involves the proper time for the taking of a deduction. See e.g., Southern Pac. Transp. Co. v. Commissioner, 75 T.C. 497, 680-83 (1980), Supp. op. 82 T.C. 122 (1984) (change in depreciating certain assets affected time of deduction and was change of accounting method); Hooker Industries, Inc. v. Commissioner, T.C. Memo (PH) ¶82,357, at 1546-47 (1982) (change from deducting cost of inventory at time of use to deducting inventory at time of purchase was a material item). These cases establish that changes within inventory or depreciation techniques, let alone a change from inventory to depreciation, involve the timing of deductions.

Because shifting from inventory to depreciation clearly involves the proper time for the taking of a deduction—a point which the plaintiff virtually concedes, Pl. Findings at ¶¶30, 31, 40, 56—Diebold’s amended return changed accounting methods for a ‘material item.’ Therefore, the threshold requirements for the application of the consent rule have been satisfied. Witte v. Commissioner, 513 F.2d 391, 393 [ 36 AFTR2d 76-5095] (D.C. Cir. 1975).

Thus, §446(e) requires the Commissioner’s consent prior to such a change, and C.F.R. §1.446-1(e)(3)(ii) prescribes the method for securing that consent. The plaintiff admits that it did not file an application for consent on Form 3115 as the regulation requires. Declaration of Lyman Friedman, February 20, 1987, Def. Br. filed March 17, 1987, App. C, at A-165. (Bricken Declaration). The requirement of Form 3115 is also established by case law. See, e.g., Southern Pac. Transp., 75 T.C. at 682; Casey v. Commissioner, 38 T.C. 357, 385-86 (1962); Advertisers Exchange, Inc. v. Commissioner, 25 T.C. 1086, 1093 (1956), aff’d per curiam, 240 F.2d 958 [ 50 AFTR 1430] (2d Cir. 1957).

While not contesting these material facts, the plaintiff opposes the defendant’s summary judgment motion on three alternative grounds. First, Diebold argues that the Commissioner’s approval was not required. The plaintiff makes three alternative contentions in support of this argument: (1) Its conduct fits within an exception in
§446(e) because the plaintiff merely corrected an accounting error; (2) §446(e) does not govern because the plaintiff had not 'regularly' used its original accounting method; and (3) its amended returns do not interfere with the purposes underlying the consent rule of §446(e).

Second, Diebold argues that even if consent was required it was, directly or indirectly, granted. Third, Diebold takes the position that, if neither of the arguments above prevail, there are still substantial unresolved issues of material fact requiring full evidentiary hearings.

II. Not a correction, but a change

The plaintiff first contends that its amended return treatment of spare parts fits within an exception to the §446(e) regulation, which states that ‘[a] change in method of accounting does not include correction of mathematical or posting errors ....’ 26 C.F.R. §1.446-1(e)(2)(ii)(b). Diebold maintains that its amended return corrected an ‘erroneous application of the inventory method of accounting’ and consequently did not require consent. Pl. Br. filed May 29, 1987, at 26. This argument fails because the plaintiff changed methods of accounting, rather than simply correcting the ‘mathematics or posting’ of its original accounting system. In other words, the plaintiff would be allowed, without securing IRS approval, to correct mathematical or posting errors in the figures generated by its original inventory accounting method. Instead, the plaintiff changed from inventory accounting to depreciation accounting—a change which involved the timing of deductions. By definition, this change required consent.

The regulations also highlight the distinction between corrections and changes by clarifying that ‘a change in method of accounting does not include adjustment of any item of income or deduction which does not involve the proper time for ... the taking of a deduction.’ 26 C.F.R. 1.446-1(e)(2)(ii)(b). If, therefore, the plaintiff’s amended return merely corrected or adjusted items which did not involve deduction timing, consent would not be required. Diebold’s 1980 attempt to amend the 1976 and 1977 returns, however, drastically altered deduction timing.

Construing the facts favorably to the plaintiff, Diebold in 1980 proposed to change from an incorrect accounting method to a correct accounting method without obtaining consent. Correcting an error in the selection of accounting methods, however, is not exempted from the consent requirement. In the first place, the words of the Tax Code state clearly that ‘[e]xcept as otherwise expressly provided in this chapter, a taxpayer who changes the method of accounting ... shall ... secure the consent of the Secretary.’ 26 U.S.C. 446(e) (emphasis added). Thus, Congress provided that the only exceptions to the consent rule would be expressly stated in the Code. The effect of this statutory language, therefore, is to make any change in accounting method, except those specifically excluded by statute or regulation, comply with the prior consent rule.

Moreover, the language of the applicable regulation is unequivocal: ‘[c]onsent [to change methods] must be secured whether or not such method is proper or is permitted under the Internal Revenue Code or the regulations thereunder.’ 26 C.F.R. §1.446-1(e)(2)(i) (emphasis added). The examples given in the regulation further illustrate that consent is required even where the taxpayer changes from an incorrect method to a correct one. 26 C.F.R. §1.446-1(e)(2)(iii) examples 6-8.

Most federal courts faced with the question have enforced the consent rule without taking into consideration the correctness of the original method. * * * In the event of a change in accounting methods, the 1954 Code established a prior consent requirement. The correctness of the original return, which governed consideration of changes in accounting methods under the 1939 Code, became in 1954 an exception to §446. Under the 1954 Code, federal courts have consistently required accounting method changes to meet the prior consent requirement without regard to which method more accurately reflects the taxpayer’s income. See, e.g., Witte, 513 F.2d at 394; American Can, 317 F.2d at 606.

The legislative history accompanying enactment of §446(e) further confirms Congress’s intent to require the Commissioner’s consent for any changes regardless of which method correctly reflects the taxpayer’s income. Identical language in the House and Senate Reports accompanying the Internal Revenue Code of 1954 indicates that ‘[s]ubsection (e) codifies existing regulations. ‘ H.R. Rep. No. 1337, 83d Cong., 2d Sess. A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 300 (1954). Beacon, which ruled against requiring the Commissioner’s consent, construed the pre-1954 regulations to state that a taxpayer ‘cannot change its system of accounting without the consent of the Commissioner. Treasury Regulations 111, Sec. 29.41-2. ‘ Beacon, 218 F.2d at 701. Thus, the regulations rejected by Beacon and later codified by §446(e) required consent regardless of whether a taxpayer proposed changing to a method that more accurately reflected its income. In light of the changes enacted in the Internal Revenue Code of 1954, Beacon helps clarify that the Commissioner’s consent is required for all changes in accounting methods, including ‘corrections’ intended to more accurately reflect a taxpayer’s true income. In sum, the 1954 Act created a prior consent requirement for changes in accounting method, which has since been repeatedly upheld.

Other language in the House and Senate Reports accompanying the Internal Revenue Code of 1954 conveys...
the same meaning. Both reports state: ‘In computing taxable income, a taxpayer who changes his general method of accounting or who treats material items inconsistently must obtain the consent of the Secretary or his delegate unless an express provision of this chapter permits such a change at the election of the taxpayer without consent.’ H.R. Rep. No. 1337, 83d Cong., 2d Sess. at A158 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. at 300-01 (1954). Thus, the reports accompanying H.R. 8300 clarified that any change in ‘material items ... must obtain the consent of the Secretary.’ Id. The reports included in this class any ‘change in the method of depreciating any property.’ Id. (emphasis added).

Thus, the language of §446(e), the regulations clarifying §446(e), the case law interpreting §446(e) in six circuits, the statutory history of §446(e) and its predecessors in earlier versions of the Code, as well as the legislative history accompanying §446(e)’s enactment, separately and cumulatively establish that a taxpayer may not change from an incorrect to a correct accounting method without the Commissioner’s consent. Regardless of the correctness of the original or the proposed new method, the taxpayer may not, under the 1954 Code, make the change without the Commissioner’s consent.

In attempting to fit within the narrow correction exception for mathematical or technical errors within an original method of accounting, Diebold relies principally upon three cases—one a decision of this court’s predecessor. In Gimbel Brothers, Inc. v. United States, 210 Ct.Cl. 17, 535 F.2d 14 [ 37 AFTR2d 76-1414], later proceeding, 211 Ct.Cl. 383 (1976), the taxpayer elected under §44(a) of the 1939 Code (and §453(a) of the 1954 Code) to report income from its department store sales on the installment method. At the same time, Gimbel Brothers reported one subclass of these sales, revolving credit plan sales, under a different and erroneous accrual method.

Upon discovering the error, Gimbel Brothers maintained that its election of the installment method in 1952 covered all its installment sales income, including that from revolving credit plan sales. Because it had deviated from its elected method, Gimbel Brothers sought to correct the error in applying its elected method, not to change its election. In short, Gimbel Brothers misapplied its validly elected method with respect to revolving credit sales, and the Court of Claims required correction of the error.

In contrast, Diebold selected at the outset no accounting method other than inventory for service modules. Nor does the plaintiff seek to correct an error in applying the inventory accounting method. Instead, the plaintiff attempts to change from an inventory method to a depreciation method. Gimbel Brothers, therefore, is inapposite.

The second case, Thompson-King-Tate, Inc. v. United States, 296 F.2d 290 [ 8 AFTR2d 5920] (6th Cir. 1961), is inapposite for the same reason. In Thompson-King-Tate, the taxpayer erroneously applied its completed contract method of accounting by reporting income in its 1953 and 1954 returns that should have been properly reported in 1955. The Sixth Circuit held that plaintiff could correct the error in applying its properly adopted method without the Commissioner’s consent. Again, the plaintiff in Thompson-King-Tate did not vary from its original method of accounting.

Diebold also relies on Amling-De Vor Nurseries v. United States, 139 F.Supp. 303, 304 [ 49 AFTR 694] (N.D. Cal. 1956), in an effort to fit within the very narrow correction exception to the consent rule. Amling-De Vor, however, did not apply the consent requirement at all. Instead, the IRS opposed the plaintiff’s amended return on the ground that original returns were correct and required no correction. Like Beacon, Amling-De Vor concerned tax years prior to 1954 that were governed by §41 of the 1939 Code. Accordingly, the correctness of the original returns was appropriately the central focus of the case.8 Under current law and regulations, this distinction is no longer material to the outcome of this case. Section 446(e) now requires consent to change accounting methods regardless of whether the original method election was correct. 26 C.F.R. §1.446-1(e)(2)(i)(a). Because the correction doctrine under §41 of the 1939 Code is very different from the current correction exception under Treasury regulations, the Amling-De Vor decision does not support the plaintiff’s effort to fit within the narrow regulatory exception.

Finally, plaintiff in its supplementary brief, cites dictum from First National Bank of Gainesville v. Commissioner, 88 T.C. 1069 (1987), for the proposition that it was not required to file Form 3115 to request consent for ‘correction’ of its ‘error.’ Plaintiff’s reliance again is misplaced.

In Gainesville, the plaintiff bank was a transferee of Hall Paving, a mining business. In 1976, Hall began to include soil aggregate in inventory at an erroneously overvalued rate of $1 per ton. Although it validly changed in 1977 to the LIFO inventory method—which requires inventory to be valued at cost—the mining business nevertheless maintained the erroneous valuation for soil aggregate until 1978. In 1979, the business attempted to decrease the value assigned to the soil aggregate to $.10 per ton. Although this transaction appears to be the permissible correction of a valuation error under an unchanged accounting method9, the Tax Court held that the write-down constituted a change of accounting method without the Commissioner’s consent.
The court also suggested in passing, however, that Hall might have corrected the 1976 error, among other ways, by filing an amended return for 1976 and subsequent years. The court’s suggestion in dicta was presumably based on the perception that Hall had made an error in applying its existing inventory accounting method, that is, a permissible valuation error. In any event, the United States Tax Court was clearly aware that correction of an erroneous method of valuing inventory is a change of accounting method. See Primo Pants Co. v. Commissioner, 78 T.C. 705 (1982); Fruehauf Trailer Corp. v. Commissioner, 42 T.C. 83 (1964), aff’d 356 F.2d 975 [17 AFTR2d 560] (6th Cir.), cert. denied, 385 U.S. 822 (1966).

This is evident from the Tax Court’s holding in Gainesville: ‘Though the write-down of soil aggregate in 1979 may have constituted the correction of an error, it also constituted a change of accounting method pursuant to section 472(e). Where the correction of an error results in a change in accounting method, the requirements of section 446(e) are applicable.’ 88 T.C. at 557 (emphasis added).

Accordingly, Gainesville is properly cited for the proposition that the correction of an error that constitutes a change of accounting method requires the Commissioner’s consent. The taxpayer in Gainesville did not seek, as the plaintiff does, to have its product treated retroactively as noninventory depreciable assets. Gainesville and the other cases plaintiff cites hold that taxpayers may, without consent, correct mere errors in applying original accounting methods. In other words, a taxpayer may make, without obtaining consent, corrections that do not amount to changes of accounting method. Thus, these cases do not apply to the plaintiff’s proposed change which clearly affects deduction timing.

In sum, construing this correction argument to resolve all possible doubts in Diebold’s favor, the defendant is nevertheless entitled to judgment as a matter of law. Although only allegedly seeking to correct an error, the plaintiff must still obtain the Commissioner’s consent if correction of that error results in a change of accounting method. Because its amended return changed the timing of when the plaintiff would deduct the cost of the service modules, Diebold is correcting its error by changing accounting methods. Therefore, the plaintiff cannot make the correction without consent under §446(e).

III. ‘Regularly’ requirement

The Tax Code requires a taxpayer to secure the Commissioner’s consent to any change in accounting method ‘on the basis of which he regularly computes his income.’ 26 U.S.C. §446(e). Diebold’s second challenge to the defendant’s summary judgment motion is that it did not regularly employ inventory accounting treatment. The plaintiff instead contends that the first year (1976) in which it sought to depreciate its spare parts as capital assets is currently before the court.

Diebold relies primarily on Silver Queen Motel v. Commissioner, 55 T.C. 1101 (1971), for the proposition that a taxpayer may correct an accounting error in its first year without consent. Accordingly, the plaintiff asserts that correcting its choice of method for the first year the method was employed establishes that it had not regularly used the method in the intervening four years. To the contrary, undisputed facts indicate that Diebold’s 1980 amendments attempted to change an accounting method for spare parts which plaintiff had treated as inventory at least from 1976 through 1979—a period sufficient to constitute regular usage under §446(e).10

The plaintiff’s attempt to avoid its regular treatment of spare modules as inventory is unavailing. Silver Queen, contrary to the plaintiff’s contention, does not represent the proposition that a taxpayer may change its accounting method unilaterally as long as the proposed change reaches all the way back to the first year of the original method. In Silver Queen, the IRS disallowed the taxpayer’s use of an impermissible method of depreciation in the taxpayer’s first year of existence. Then the Service sought to impose straight-line depreciation on the taxpayer. The Tax Court agreed with the taxpayer that it should be allowed to change to the permissible 150% declining balance method without consent because the taxpayer was only in its first year and had not ‘regularly’ used the impermissible method (double declining balance).

Silver Queen is distinguishable from this case on several grounds. First, uncontested facts show that the plaintiff used inventory treatment regularly from at least 1976 until 1979. Unlike Diebold, the Silver Queen was in its first tax year and had not even filed a second tax return, let alone established a regular method of accounting. Second, unlike Silver Queen, the Service has not disallowed the plaintiff’s regular method. Instead, the plaintiff desires to change unilaterally its regularly established, and presumably acceptable, method of inventory accounting. The IRS ordered the Silver Queen to change methods and then attempted to deny consent to the Motel’s alternative method. Diebold, on the other hand, is not compelled to make a change and has not sought consent for its preferred alternative. Third, Diebold did not employ an alternative method of depreciation in its original returns, as did the Silver Queen Motel, but instead employed solely inventory treatment. Choosing between depreciation methods at the outset of a taxable venture is different from changing methods four years later.

Most significantly, Diebold, unlike the Silver Queen Motel, is not in its first year of existence. Whereas the Silver Queen Motel was able to change methods in its first

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year before establishing a regular accounting pattern. Diebold had a long established and regular pattern which it desired to change retroactively. The facts of Silver Queen are significantly different from the facts now before this court.11

The plaintiff also misplaces its reliance on Foley v. Commissioner, 56 T.C. 765 (1971). In Foley, the taxpayer purchased eighteen used vehicles in 1964. In its original return, Foley depreciated sixteen of the vehicles under the impermissible double-declining balance method (as in Silver Queen). Foley used straight-line depreciation for the other two. Later in the same year, Foley sought, in an amended 1964 return filed before its 1965 return, to depreciate all eighteen vehicles using the 150% declining balance method. As in Silver Queen, the Commissioner disallowed the changes for both the sixteen and the two vehicles. The IRS preferred to impose straight-line depreciation on all of the transactions. Accordingly, the IRS argued that the plaintiff could not change his permissible straight-line method of accounting for the two vehicles without securing consent. Although Foley had amended his return before filing a return for the next year, the Commissioner relied on the consent requirement.

The United States Tax Court invoked Silver Queen for the proposition that the plaintiff may change an impermissible accounting method—the scheme used for the sixteen vehicles—without the Commissioner’s consent.12 Because the taxpayer had elected a permissible method for the two vehicles, the court disallowed any change without the Commissioner’s consent. The consent rule was thus strictly enforced even though Foley had filed an amended return in the first year prior to any returns for future years.13

Foley is of no assistance, however, to the plaintiff in this instance. Foley involved an instance in which the amended return for the first year of the activity was filed before the filing of original returns for subsequent years. The plaintiff did not file its amended 1976 return until after it had filed initial returns for 1977, 1978, and 1979. In similar circumstances where the taxpayer has clearly adopted a regular method of accounting, the Tax Court, which is otherwise more lenient on the consent rule, requires the Commissioner’s permission for a change. Mitchell v. Commissioner, 42 T.C. 953, 967-68 (1964); Casey v. Commissioner, 38 T.C. 357, 385-86 (1962).

Under the terms of a Revenue Ruling and a General Counsel Memorandum (G.C.M.), the IRS has acquiesced in the Silver Queen and Foley results where facts crucial to those two decisions are present. Rev.Rul. 72-491, 1972-2 C.B. 104, G.C.M. 38,680 (Apr. 18, 1981). These exceptions to the consent requirement are operative only where the taxpayer uses an erroneous method (of ‘depreciation’ in the Ruling, of ‘accounting’ in the G.C.M.) in the first year of the applicable activity. In these limited cases, the taxpayer may, without seeking consent, change to a correct method of depreciation or accounting for the first year if either: (a) The IRS disallows the use of the erroneous method in that first year (as in Silver Queen), or (b) the taxpayer files an amended return, using a correct method, for the first year before filing his return for the following year (as in Foley).

The plaintiff does not meet either criterion. The Revenue Ruling allows a taxpayer, in certain specified circumstances, to correct ‘an erroneous method of depreciation’ without consent. The plaintiff, however, clearly seeks to ‘correct’ its treatment of items classified as inventory. Inventory treatment is not a method of depreciation; thus, Diebold had no method of depreciation to correct. Moreover, the plaintiff is not attempting to correct a method rejected by the IRS in the first year before filing a subsequent year’s return. The ruling does not apply to the plaintiff.

The G.C.M. applies to liquidations under §334(b)(2) where the taxpayer, ‘prior to filing its return for the following tax year,’ attempts by amended return to correct ‘the liquidated subsidiary’s impermissible method of accounting for items in its inventory.’ G.C.M. 38,680. In this case, however, the plaintiff filed returns for 1977, 1978, and 1979 before attempting to amend its 1976 return. Thus, the plaintiff does not meet the requirements of G.C.M. 38,680.

The plaintiff states that it initiated the 1980 amendment to the 1976 and 1977 returns to be consistent with positions taken by the revenue agent in charge of the audits for 1974 and 1975. By this argument, the plaintiff attempts to establish that the 1974 and 1975 audits implicitly disallowed the 1976 inventory method. The audit of the plaintiff’s 1974 and 1975 returns focused on conversion modules, not its 1976 treatment of spare service modules. By definition, the revenue agent’s comments regarding tax years 1974 and 1975 could not have constituted a disallowance of the plaintiff’s 1976 treatment of spare parts, especially if, as Diebold maintains, 1976 was the first year in which it held a pool of rotatable replacement modules.

The plaintiff’s argument that the Revenue Ruling is an improper limitation of Silver Queen and Foley, overlooks the express language of the Tax Code. The statute requires the Commissioner’s consent for any change of accounting method unless specifically excepted by the Tax Code. The Commissioner has essentially granted consent in advance in cases presenting the same circumstances as Silver Queen or Foley. This is not such a case.

Although Silver Queen and Foley are factually
distinguishable from this case, these decisions also represent a legal policy unique to the United States Tax Court. Unlike several circuit courts, the Tax Court has granted taxpayers leeway to correct impermissible or incorrect accounting methods without securing the Commissioner’s consent. This divergence of Tax Court policy was noted in Southern Pacific Transportation Co. v. Commissioner:

On the question of whether consent is necessary to change from a clearly incorrect accounting method, some Courts of Appeals have adopted a fairly strict approach. See, for example, Witte v. Commissioner. In each of the appellate decisions cited above, the Court of Appeals held that the consent of the Commissioner is necessary for a change even where the taxpayer’s old method is shown to be wrong. This Court has tended not to require consent in such situations.

75 T.C. 497, at 682 n.208 (citations omitted).

This unique Tax Court policy, however, is not consistent with the language and history of §446(e) that the language and history is accurately reflected by regulations which specifically require that consent to change an accounting method ‘must be secured whether or not such method is proper.’ 26 C.F.R. §1.446-1(e)-(2)(i). This clarification of the stated intent of Congress has, as noted earlier, been upheld by numerous appellate court decisions. See, e.g., Witte, 513 F.2d at 394; Poorbaugh, 423 F.2d at 163; Wright Contracting, 316 F.2d at 249.

Of singular importance, this unique policy of the United States Tax Court does not accurately reflect the law in this circuit. Hackensack Water, 352 F.2d at 807; Ed Smithback Plumbing, 209 Ct.Cl. at 743. According to the prevailing view, the statute and regulations require the Commissioner’s consent even when the change is from an improper method.

IV. Purpose of consent requirement

The plaintiff posits, as a third reason to avoid §446(e), that the underlying purposes of the consent requirement will be frustrated by prohibiting a change that does not require compensating adjustments. The plaintiff seeks again, in essence, to avoid the consent rule because changing from an incorrect to a correct method would accurately reflect its income and require no further adjustments. Although the court, for purposes of this motion, accepts plaintiff’s assertion that no adjustments would be necessary, the Internal Revenue Code simply does not condition the consent rule upon a finding that adjustments will be necessary. The Commissioner is charged with the responsibility of ascertaining what adjustments are required when a taxpayer applies for consent to switch methods. Unlike the 1939 Tax Code, however, the need for adjustments is not, under current law, the test for whether the taxpayer must request consent at all. Consent is required except ‘as otherwise provided’ in the statute or regulation. 26 U.S.C. §446(e).

The policy underlying the consent rule was articulated by the Supreme Court in Pacific National Co. v. Welch, 304 U.S. 191, 194 (20 AFTR 1248) (1938):

Change from one method to the other, as petitioner seeks, would require recomputation and readjustment of tax liability for subsequent years and impose burdensome uncertainties upon the administration of the revenue laws. It would operate to enlarge the statutory period for filing returns (§53(a)) to include the period allowed for recovering overpayments (§322(b)). There is nothing to suggest that Congress intended to permit a taxpayer, after expiration of the time within which return is to be made, to have his tax liability computed and settled according to the other method. 26 U.S.C. §112.

The Court of Claims employed similar reasoning in stating the reasons for §446(e): ‘The courts have enforced the Commissioner’s permission requirement to enable him to protect the fisc most effectively. Any change of accounting method will almost certainly distort net income in the year of change. ’ Wanamaker Philadelphia, Inc. v. United States, 175 Ct.Cl. 169, 175, 359 F.2d 437, 440 (17 AFTR2d 809) (1966).

Finally the United States Tax Court has identified several policies served by this section of the Internal Revenue Code: ‘(1) to protect against the loss of revenue; (2) to prevent administrative burdens and inconvenience in administering the tax law; and (3) to promote consistent accounting practice thereby securing uniformity in the collection of revenue.’ Barber v. Commissioner, 64 T.C. 314, 319-20 (1975) (citations omitted).

According to these decisions, a central policy underlying the consent requirement is that the Commissioner should have an opportunity to review consent requests in advance. With advance notice, the Commissioner has leverage to protect the fisc, to avoid burdensome administrative uncertainties, and to promote accounting uniformity. If taxpayers generally were permitted to change accounting methods unilaterally, the Commissioner would face the enormous administrative burden of detecting changes and
reviewing the propriety of each switch without ready leverage to protect the fisc or promote uniformity.

In the absence of the prior consent rule, a taxpayer could adopt a method of accounting and after several years unilaterally switch to an alternative method which hindsight suggests would have been more financially beneficial. Thus, the Commissioner’s ability to protect the fisc and prevent unnecessary variations in accounting procedures would be substantially reduced. In order to avoid missing taxable income, the IRS would be required to multiply its detection and examination efforts to prevent abuse of unconsented retroactive changes. The administrative advantages of advance notice are thus integrally linked to the purposes of protecting the fisc and promoting accounting uniformity.

The plaintiff retorts that its switch to a correct accounting procedure will not endanger the fisc or disrupt uniformity. The D.C. Circuit considered and rejected this argument: ‘The danger of distortion of income detrimental to governmental revenues exists regardless of whether the change in method is from one proper method to another or from an improper method to a proper one.’ Witte, 513 F.2d at 394.

Moreover, the plaintiff in this case desires to make precisely the kind of change that could undermine the purposes of the prior consent rule. The plaintiff seeks to apply a unilateral change retroactively to cover many past tax years. If taxpayers were permitted to select the accounting method which best reflects their income over the past four years, only those taxpayers gaining a financial advantage from switching methods would seek refunds. Thus, uniformity in accounting would become a function of financial advantage and the administrative difficulties of detecting unwarranted unilateral changes would be multiplied. Moreover, the potential impact on the fisc would be likely to vary unpredictably from year to year. In sum, the purposes and policies underlying the consent requirement are still served when a taxpayer presumes to change unilaterally from an incorrect to a correct procedure.

V. Was consent granted?

The plaintiff argues that even if the proposed change of accounting methods requires consent, the Commissioner has already granted consent. The plaintiff finds this implied consent in the Revenue Agent’s Report (RAR) issued after audit of the plaintiff’s 1974 and 1975 tax years, in the RAR for 1976 and 1977, and in the payment of a refund on 1979 taxes. For various reasons, none of these events constituted consent, express or implied, sufficient to satisfy §446(e).

A. 1974 and 1975 Audit The plaintiff claims to have already secured consent because the accounting change for spare service modules was initiated by the IRS’ examination of plaintiff’s ‘retrofitting’ or ATM conversions in years 1974 and 1975. In the 1974 and 1975 audits, the Service and the plaintiff negotiated an agreement under which Diebold would: (a) deduct one-half of the costs of converting ‘A’ and ‘B’ units into ‘C’ units in 1975 and one-half in 1976; and (b) treat R & D costs in developing the ‘C’ model as having created an amortizable intangible asset, as the Service proposed. The plaintiff contends that this action led its tax manager to believe that the Service had approved treatment of all replacement modules—both rotatable service modules and conversion modules—as noninventory capital assets. Thus, the plaintiff sought by amended returns for 1976 and 1977 to depreciate the service modules to comply with IRS guidance. The plaintiff states that its tax manager’s belief that this was the proper treatment was ‘reconfirmed’ by its receipt in February 1981 of a refund check for taxable year 1979. For this reason, ‘no Form 3115 was filed.’ Pl. Br. filed May 29, 1987, at 11. The solitary belief of the plaintiff’s tax manager is simply not supported by adequate corroborating evidence. Other than the coincidence that both the 1974-75 audit and the 1976 proposed change deal with ATM modules, these two events have very little in common. At issue in the 1974 and 1975 audits was treatment of the costs of converting ‘B’ models to ‘C’ models and R & D expenses. The settlement had nothing whatsoever to do with the plaintiff’s accounting treatment for spare service modules. The plaintiff does not present any facts that would give its tax manager a basis for believing the IRS had approved any treatment at all of service modules. Neither the Service’s partial allowance of Diebold’s 1975 deduction of conversion costs nor the IRS-imposed amortization of R & D expenses could logically have approved any change in spare service module treatment. Furthermore, the plaintiff maintains that it did not even engage in the activity of using rotatable service modules until 1976. If this is correct, the revenue agent could hardly have proposed to change, in 1974 and 1975, Diebold’s accounting treatment of a non-existent activity. The 1974 and 1975 audit changes, in sum, could not have imposed on plaintiff a method of depreciation for the service modules. The record shows that the audit changes allowed no 1976 depreciation at all.

B. The 1976 and 1977 Audit The plaintiff observes that the revenue agent for the 1976-77 audit agreed partially, in proposing audit changes, with its current position that spare modules are noninventory depreciable assets. The plaintiff argues essentially that the revenue agent’s position, as set forth in the 1976-77 RAR, constitutes consent to Diebold’s proposed 1980 change. The defendant answers that the Commissioner ultimately denied the plaintiff’s claims for 1976 and 1977 refunds. According to uncontroversial facts, the Commissioner obviously did not concur in the revenue
agent’s proposed treatment of Diebold’s service modules. In other words, the Commissioner did not ‘accept’ amended returns going back to the ‘first year’ in which plaintiff offered service contracts that included replacement parts at no additional charge. As a matter of law, a revenue agent’s initial position, taken prior to final action on a refund claim, does not bind the Commissioner. See Biever v. Commissioner, 341 F.2d 394, 396-97 [15 AFTR2d 398] (6th Cir. 1965); H. F. Campbell Co. v. Commissioner, 53 T.C. 439, 449-50 (1969), supplemented, 54 T.C. 1021 (1970), aff’d, 443 F.2d 965 [27 AFTR2d 71-1511] (6th Cir. 1971) (revenue agent’s recommendations to be viewed as tentative; it was Commissioner’s prerogative to reject them). Moreover, §446(e) requires the Commissioner’s final, as opposed to an agent’s preliminary, consent to a change of accounting method. The Commissioner’s 1976-77 audit denied consent to the proposed change of accounting method. Finally, the RAR for the plaintiff’s 1976 and 1977 taxable years is dated August 20, 1981. The plaintiff attempted to change accounting methods in amended returns dated October 6, 1980. The Tax Code requires a taxpayer to obtain the Commissioner’s consent prior to changing methods. A revenue agent’s remarks subsequent to the change does not constitute a prior approval by the Commissioner, as required by law.

C. The 1979 Refund In October 1980, plaintiff amended its 1976, 1977, 1978, and 1979 returns to claim depreciation on service modules. In late December 1980 and in February 1981, plaintiff received the refund claimed for 1979. The plaintiff argues that issuance of the refund constituted a prior approval by the Commissioner, as opposed to an agent’s preliminary, consent to a change of accounting method. The facts indicate that the 1979 refund was issued merely to correct an error. The 1979 refund was issued prior to examination of the plaintiff’s 1979 taxable year and two years before its 1976 and 1977 amended returns were processed. As a result, the agent who processed the 1979 claim was not likely to have known it was based on a change of accounting method. The plaintiff failed to put the agent, and certainly the Commissioner, on notice of the change of method. See, e.g., Fowler Bros. & Cox v. Commissioner, 138 F.2d 774, 775-76 [31 AFTR 830] (6th Cir. 1943) (45 (45 Commissioner may grant consent informally by accepting amended return that puts him on notice that taxpayer has changed its accounting method); Falk v. Commissioner, 37 T.C. 1078, 1085 (1962), aff’d, 332 F.2d 922 [13 AFTR2d 1641] (5th Cir. 1964). After citing Fowler Bros. and other implied consent cases, the Court of Claims suggested in Ed Smithback Plumbing, that ‘in those cases [where] the Commissioner was fully aware of the change in accounting methods … or played some part in initiating said change …,’ consent may be implied. 37 AFTR2d ¶76-366, at 496, adopted, 209 Ct.Cl. at 743. In contrast, the Commissioner clearly did not initiate the 1979 change and the plaintiff failed to disclose its unilateral accounting method change. The facts indicate that the Commissioner after audit of the 1976 and 1977 years, disallowed the change for 1976 and 1977 and currently proposes to do so for 1978 and 1979.16 In the absence of adequate notice of the change, the Commissioner cannot be deemed to have ‘accepted’ the amended returns or given consent to a change of method.

VI Distortion of income

The plaintiff seeks to avoid the consent requirement by arguing that retention of its original accounting treatment results in a distortion of its income for the years in question. To avoid ‘a mismatching of income and deductions,’ plaintiff argues, a change of accounting method for rotatable service modules should be permitted by this court.

For purposes of this motion, the court assumes that treating Diebold’s modules as inventory mismatches income and deductions, nonetheless this contention is not sufficient to deny the defendant judgment as a matter of law. Regardless of whether the plaintiff’s inventory accounting method distorted income, the plaintiff, by virtue of having used that method regularly in reporting income, at least from 1976 through 1979, was obligated to secure consent prior to making a method change. 26 C.F.R. §1.446-1(e)(2)(i). If the plaintiff had filed Form 3115 requesting a change in accounting methods, and the Commissioner had then
disallowed the change, the plaintiff’s distortion of income argument would appropriately raise the question of whether the Commissioner abused his discretion. See generally Clement v. United States, 217 Ct.Cl. 495, 580 F.2d 422 [ 42 AFTR2d 78-5434] (1978), cert. denied, 440 U.S. 907 (1979).

The Commissioner has broad discretion to permit or deny a requested change. The failure of the Commissioner to grant permission can successfully be challenged only by a showing that the Commissioner’s decision was arbitrary or an abuse of discretion. As stated in Southern Pacific, “[I]t is not sufficient for a taxpayer merely to show the correctness of the new method; that fact alone cannot justify a change without the 20

Until the plaintiff seeks consent, the Commissioner has exercised no discretion which this court can examine for abuse. The argument that the Commissioner’s failure to consent sanctions a distortion of income cannot relieve plaintiff of its statutory obligation to seek the required consent. Until the plaintiff gives the Commissioner an opportunity to consent in the manner provided by law and regulation, i.e., in response to filing of a Form 3115, the issue of whether its original accounting method distorts income is immaterial.

VII. Equal treatment

The plaintiff contends as well that the Commissioner’s position in this case puts it at a competitive disadvantage. The plaintiff states that the Commissioner has permitted other companies such as Memorex Corporation to treat their rotatable spares as depreciable assets. Consequently, the plaintiff argues that it is entitled to prevail in this case under principles of International Business Machines Corp. v. United States, 170 Ct.Cl. 357, 343 F.2d 914 [ 15 AFTR2d 1526] (1965), cert. denied, 382 U.S. 1028 (1966). * * * * IBM has been strictly limited to its particular circumstances. In a refund suit, plaintiff has the burden of proving its entitlement to the relief it seeks. The mere fact that another taxpayer has been treated differently from the plaintiff does not establish the plaintiff’s entitlement. On the facts, defendant is entitled, as a matter of law, to prevail because plaintiff, not having requested consent to change its accounting method, cannot establish that the Commissioner exercised any discretion to be reviewed by this court.

VIII Alleged disputes of material fact

Finally, plaintiff attempts to suggest that material fact disputes persist. However, the facts genuinely in dispute are not material to the disposition of a motion based ‘solely on plaintiff’s attempt to change its method of accounting for certain rotatable spare service parts without having properly requested or obtained the consent of the Commissioner.’ Def.’s Brief filed March 17, 1987, at 1.

The substantive legal question presented in this case is whether taxpayer is entitled by an amended return to change treatment of rotatable spare service parts from inventory to depreciable assets qualifying for an investment tax credit without first obtaining the consent of the Commissioner of Internal Revenue to a change in method of accounting as required by §446(e).

Because the substantive law of this case involves consent requirements for changes in accounting methods, facts concerning a taxpaying corporation’s original methods of accounting, its attempt (if any) to change that treatment, its efforts to procure consent for actual changes, and its eligibility for any exceptions to the consent rule are all material. Thus, several potential disputed issues of fact are not material. For instance, the plaintiff contends, and the IRS disputes, that the spare service modules may only be correctly classified as depreciable property. This dispute is immaterial because the substantive law requires consent regardless of the correctness of the initial accounting method. In addition, the facts establish that the IRS never disallowed the original inventory treatment, thus suggesting that the initial methodology was at least acceptable at the time that the plaintiff made its unilateral switch of methods.

The plaintiff also asserts the existence of a contested issue of material fact as to whether 1974 or 1976 was the first year of inventory treatment. This question, however, can be answered by resort to the plaintiff’s own Proposed Findings: ‘[A]t the introduction of the Tabs 500 to the market in 1974, for both financial reporting and tax purposes, plaintiff erroneously accounted for its spare service modules by treating them ... as a non-depreciable asset (inventory) without a determinable life, rather than to expense or depreciate the modules.’ Pl. Findings ¶30 (emphasis added).

While this court could find that plaintiff’s proposed finding amounts to a stipulation that Diebold began to treat spare modules as inventory as early as 1974, this question still does not create an issue of material fact. Even if this factual dispute is genuine, it is immaterial for purposes of the current motion. The defendant is entitled to prevail as a matter of law even if, as plaintiff contends, 1976 was the first year in which Diebold conducted the activity.

Because the plaintiff had regularly employed inventory accounting from 1976-1979,21 the Commissioner’s consent was required prior to any change in methods. * * *
Conclusion
In the absence of a genuine issue of material fact, defendant is entitled to judgment as a matter of law. Accordingly, the court grants defendant’s motion and directs the clerk to enter judgment for the United States and to dismiss the plaintiff’s complaint.
SECTION 7. TERMS AND CONDITIONS OF CHANGE

.01 In general. A change in method of accounting requested under this revenue procedure for which consent is granted must be implemented pursuant to both the terms and conditions provided in this revenue procedure and either the List of Automatic Changes (in the case of an automatic change) or the letter ruling for the change (in the case of a non-automatic change). Notwithstanding the terms and conditions in this revenue procedure, based on the unique facts of a particular case and in the interest of sound tax administration, the national office may prescribe in the letter ruling for a non-automatic change terms and conditions for the requested change in method of accounting that differ from and override those provided in this revenue procedure.

.02 Section 481(a) adjustment. Except as otherwise provided in this revenue procedure, the List of Automatic Changes (in the case of an automatic change), a letter ruling to the taxpayer (in the case of a non-automatic change), or other guidance published in the IRB, a taxpayer making a change in method of accounting under this revenue procedure must apply § 481(a) and take into account the § 481(a) adjustment in the manner provided in SECTION 7.03. See SECTION 2.06(1); but see SECTION 13.01(3).

.03 Section 481(a) adjustment period.

(1) In general. Except as otherwise provided [Editor note: exceptions deal with involuntary changes and other special situations] *, *, *, the § 481(a) adjustment period is one taxable year (year of change) for a negative § 481 (a) adjustment [Editor note: negative means reduction in taxable income] and four taxable years (year of change and next three taxable years) for a positive § 481(a) adjustment [Editor Note: positive means increase in taxable income].

SECTION 8. AUDIT PROTECTION FOR TAXABLE YEARS PRIOR TO YEAR OF CHANGE

.01 In general. Except as provided in SECTION 8.02 or under any other guidance published in the IRB, when a taxpayer timely files a Form 3115 under this revenue procedure, the IRS will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the requested year of change.

.02 Exceptions. SECTION 8.01 does not apply if any exception in SECTIONS 8.02(1) through 8.02(7) applies.

(1) No audit protection for taxpayers under examination. Except as provided in SECTIONS 8.02(1)(a) through (f), the IRS may require the taxpayer to change its method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the taxpayer is under examination as of the date the taxpayer files the Form 3115.

(a) Change filed in a three-month window.

(i) In general. Except as provided in SECTION 8.02(1 )(a)(iii), SECTION 8.02(1) (no audit protection for taxpayers under examination) does not apply to a request for a change in method of accounting for an item filed in a three-month window if (1) the taxpayer has been under examination for at least 12 consecutive months as of the first day of the three-month window, and (2) the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration as described in SECTION 3.08 as of the date the taxpayer files the Form 3115.

(ii) Three-month window. A “three-month window” is the period beginning on the fifteenth day of the seventh month of the taxpayer’s taxable year and ending on the fifteenth day of the tenth month of the taxpayer’s taxable year. However, if the taxable year is a short taxable year that ends before the fifteenth day of the tenth month after the short taxable year begins, the “three-month window” is the period beginning on the first day of the second month preceding the month in which the short taxable year ends and ending on the last day of the short taxable year.
(iv) Statement required. The Form 3115 must include a statement that the Form 3115 is filed under a three-month window in SECTION 8.02(1)(a) of Rev. Proc. 2015-13.

(b) Change filed in a 120-day window. (i) In general. Except as provided in SECTION 8.02(1)(b)(iii), SECTION 8.02(1)(b) (no audit protection for taxpayers under examination) does not apply to a request for a change in method of accounting for an item filed in a 120-day window if the method of accounting for the same item the taxpayer is requesting to change is not an issue under consideration as described in SECTION 3.08 as of the date the taxpayer files the Form 3115. However, the 120-day window ends on the date the IRS notifies the taxpayer that jurisdiction for the case has been transferred from Appeals to the examining agent(s) for reconsideration. See SECTION 3.18(1)(c).

(ii) “120-day window. A “120-day window” is the 120-day period following the date an examination of the taxpayer ends, regardless of whether a subsequent examination has commenced.

(e) Change resulting in a negative § 481(a) adjustment.

(i) In general. SECTION 8.02(1)(b) (no audit protection for taxpayers under examination) does not apply to a change in method of accounting for an item that:

(A) results in a negative § 481(a) adjustment for that item for the year of change; and

(B) would have resulted in a negative § 481(a) adjustment in each taxable year under examination if the change in method of accounting for that item had been made in the taxable year(s) under examination.

(2) Change lacking audit protection. The IRS may change a taxpayer’s method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the description of the change in the List of Automatic Changes, or other guidance published in the IRB, provides that the change is not subject to the audit protection provisions of SECTION 8.01.

(6) Criminal investigation. The IRS may change a taxpayer’s method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if there is any pending or future criminal investigation or proceeding concerning (i) directly or indirectly, any issue relating to the taxpayer’s federal tax liability for any taxable year prior to the year of change, or (ii) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change.

(7) Issue under consideration. The IRS may change a taxpayer’s method of accounting for the same item that is the subject of a Form 3115 filed under this revenue procedure for taxable years prior to the requested year of change if the taxpayer’s method of accounting for the same item is an issue under consideration pursuant to SECTION 3.08 as of the date the taxpayer filed the Form 3115. However, for a CFC or 10/50 corporation, the preceding sentence does not apply to an item to which SECTION 8.02(1)(b) (no audit protection for taxpayers under examination) ceases to apply pursuant to SECTION 8.02(1)(a)(iii) or that is the subject of a Form 3115 filed in a three-month window pursuant to SECTION 8.02(1)(a)(iii).

(8) Prior year IRS-initiated change. The IRS may make adjustments to the taxpayer’s returns for the same item for taxable years prior to the requested year of change to reflect a change in method of accounting imposed by the IRS for a prior taxable year pursuant to Rev. Proc. 2002 18 (or successor).
Rev. Proc. 2002-18, 2002-1 CB 678

5. Examination Discretion To Resolve Accounting Method Issues

.04. Terms and Conditions of Change.

(1) Year of change. An examining agent changing a taxpayer's method of accounting will make the change in a year under examination. Ordinarily, the change will be made in the earliest taxable year under examination, or, if later, the first taxable year the method is considered to be impermissible. However, in appropriate circumstances, an examining agent may defer the year of change to a later taxable year. For example, an examining agent may defer the year of change if the examining agent determines that:

(a) the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment for the taxable year in which the change would otherwise be imposed and the adjustment cannot be reasonably estimated;
(b) the taxpayer's existing method of accounting does not have a material effect for the taxable year in which the change would otherwise be imposed; or
(c) there are taxable years for which the statute of limitations has expired following the taxable year in which the change would otherwise be imposed. An examining agent will not defer the year of change in order to reflect the hazards of litigation. Moreover, an examining agent will not defer the year of change to later than the most recent year under examination on the date of the agreement finalizing the change.

(2) Section 481(a) adjustment. An examining agent changing a taxpayer's method of accounting ordinarily will impose a § 481(a) adjustment, subject to a computation of tax under § 481(b)(if applicable). However, an examining agent should use a cut-off method to make a change (other than a change within the LIFO inventory method as defined in section 3.09 of Revenue Procedure 97-27, 1997-1 C.B. 680, or a change in method of accounting for intercompany transactions, see § 1.1502-13) when a statute, regulation or administrative pronouncement of the Service effective for the year of change directs that the change be made using a cut-off method. See, e.g., § 174. In addition, an examining agent may use a cut-off method to make a change in appropriate circumstances. For example, the examining agent may use a cut-off method to make a change if the agent determines that the taxpayer's books and records do not contain sufficient information to compute a § 481(a) adjustment and the adjustment cannot be reasonably estimated. Finally, an examining agent will not make a change on a cut-off method in order to reflect the hazards of litigation.

(3) Spread of § 481(a) adjustment. The § 481(a) adjustment, whether positive or negative, will be taken into account entirely in the year of change.

6. Appeals And Counsel For The Government Discretion To Resolve Accounting Method Issues

.02. Types of Resolutions.

(1) In general. An appeals officer or counsel for the government may resolve an accounting method issue by using any of the means described in section 6 of this revenue procedure, or any other means deemed appropriate under the circumstances, to reflect the hazards of litigation. See sections 10.02 through 10.04 of this revenue procedure for examples of the application of section 6 of this revenue procedure.

(2) Accounting method changes

(a) Treating an accounting method issue as a method change. An appeals officer or counsel for the government resolving an accounting method issue may treat the issue as a change in method of accounting.

(b) Selection of new method of accounting. Except as provided in section 2.06 of this revenue procedure, an appeals officer or counsel for the government changing a taxpayer's method of accounting will select a new method of accounting by properly applying the law to the facts. The appeals officer or counsel for the government will not put the taxpayer on an improper method of accounting in order to reflect the hazards of litigation.

(c) Terms and conditions of change. An appeals officer or counsel for the government changing a taxpayer's method of accounting may agree to terms and conditions that differ from those ordinarily applicable to an Examination-imposed accounting method change, including the following (or any combination thereof):
(i) Year of change. An appeals officer or counsel for the government may compromise the year of change (for example, by agreeing to a later year of change). However, an appeals officer or counsel for the government changing a taxpayer's method of accounting ordinarily will not defer the year of change to later than the most recent taxable year under examination on the date of the agreement finalizing the change, and, in no event, will defer the year of change to later than the taxable year that includes the date of the agreement finalizing the change;

(ii) Section 481(a) adjustment. An appeals officer or counsel for the government may make the change using a § 481(a) adjustment or a cut-off method. If a § 481(a) adjustment is used, the appeals officer or counsel for the government may compromise the amount of the § 481(a) adjustment (for example, by agreeing to a reduced § 481(a) adjustment). If the appeals officer or counsel for the government agrees to compromise the amount of the § 481(a) adjustment, the agreement must be in writing; and

(iii) Spread of the § 481(a) adjustment. An appeals officer or counsel for the government may compromise the § 481(a) adjustment period (for example, by agreeing to a longer § 481(a) adjustment period).