CHAPTER 2 p.96
WHAT IS INCOME?

How is the concept of "income" defined?

Consider the Haig-Simons definition:

"Accession to wealth" consists of

1) Consumption (occurring during the measurement period), and

2) Increase (if any) of the value of property rights (during the measurement period).

Basic Code Structure & Tax Base Definition p.97

- Code §1 – the tax <u>imposing</u> provision (for individuals) & Code §11 (for corporations).
- §61 - statutory definition of "gross income"
  - §61(a)(1) compensation
  - §61(a)(2) business income
  - §61(a)(3) property gains
  - §61(a)(4) interest, etc.
- §63(a) – defining taxable income

Windfall Gains
Glenshaw Glass p.97

- Punitive portion of a treble damage antitrust recovery is includible as gross income under [now] Code §61.
- Income is to be determined based on "accession to wealth, clearly realized".
- No requirement of "source-based" taxation (cf., Eisner v. Macomber re stock dividends & a "derived from" concept).
- Can be recurring or non-recurring receipts.

CH 2-1 p.98
Compensation for Services

Compensation includes:

- Wages, salaries, commissions, professional fees, fringe benefits

Need not be an "employee"; cf., a partner or a sole proprietor receiving compensation.

Possible forms of payment:

- (1) Cash & (2) "in-kind," i.e., property (including stock, notes, tangible & intangible personal property, etc.); e.g., promissory note.

Old Colony Trust Co. p.98
Discharge of an Obligation

- Employer pays the employee's tax liability, i.e., employer pay employee "debt" to IRS.
- Held: Discharge of this debt of the employee was gross income to the employee.
- Really a three party transaction (also IRS)?
- Note: Does the corporate resolution (and the payment obligation) present a "pyramiding" problem? What is that?
- What is the "bracket stacking" problem?

Considering Winnings as Gross Income p.102

- Accession to wealth from prizes?
- TV shows (including Oprah's cars given to audience members?)
- Giveaways.
- Lottery winners, etc.
- Catching the record setting baseball?
- Cf., being in the right "gene pool."

Other Benefits sourced from an Employer p.103

Payment by employer of:

- employee debt (not for income tax), including as a “guarantor.”
- employee’s rent for employee’s personal residence
- employee’s expense for employee’s child (e.g., for school tuition)

What is the motivation for these payments?

Fringe Benefits §132 p.103

What are "fringe benefits"?

Are they "gross income", i.e., an accession to wealth?

Possible reasons for exclusion from GI (for federal income tax purposes):

- Statutory exemption (based on what tax policy rationale?)
- Deemed to be *de minimis* (i.e., for administrative convenience.

Health Insurance Benefits to Employees p.104

- §106 - exclusion for employer's <u>contribution</u> to health care <u>plan.</u>
- §105 – exclusion for <u>benefits paid</u> under employer's health plan for employees and family members. Sick pay is taxable.
- §104 – exclude compensation for injuries.
- See tax expenditure effect – p. 105 <u>(& Supp</u>.)
- See distributional effects of (1) exclusion and (2) medical expense deduction (at p. 107-8).

Retirement Income Plans p.109 "Lack of Symmetry"

- Employee gets benefit of income <u>exclusion</u> for
  - (1) <u>employer's</u> contribution to plan, and
  - (2) <u>employee's</u> contribution to plan
- Employer gets immediate <u>deduction</u> for contributions to the plan. A tax "whip-saw" effect (i.e., deduction but no inclusion in recipient's gross income)?
- <u>And, no gross income for the income build-up</u> during the accumulation/investment phase (when earnings are credited to the individual's retirement account).

Life Insurance p.109
Group Term Insurance

- Employer's payment of insurance premiums – gross income inclusion (unless <u>employer</u> is the beneficiary). Same as Old Colony?
- But, IRC §79 – <u>exclusion</u> from gross income for first $50,000 of group term insurance provided by employer.
- What is "<u>term</u> life" insurance?
- Is an employer tax deduction available?

Other Employer Provided Excluded Benefits p.110

1) Moving expenses - §132(a)(6); cf., §82.
2) Dependent care - §129 ($5,000 limit)
3) Educational benefits - §127 ($5,250 limit).
4) Adoption assistance - §137 ($10,000 limit).
   (subject to an income level phase-out)
5) Cafeteria plans - §125
   (but a deduction for the employer?)

Considering Fringe Benefit Taxation p.111

1) Horizontal equity concerns.
2) Efficiency
3) Complexity – valuation and administration issues

Consider the risks of a “barter economy” - subverting the income tax system by avoiding income inclusion.

Work-related Fringe Benefits p. 113

- Should consumption items provided by the employer be excluded from gross income when motivated by "the convenience of the *employer*", e.g., meals on site to keep the employee on location for the lunch period?
- Consider horizontal equity issues if employers furnish many "in-kind" benefits to (only) some employees.
- Are working conditions not consumption substitutes? Enable partial exclusion only?

Code §132(a) Fringe Benefits p.113

- No additional cost service. §132(b)
- Qualified employee discount. §132(c)
- Working condition fringe. §132(d)
- De minimis fringe. §132(e)
- Qualified transportation fringe. §132(f)
- Qualified moving expense fringe. §132(g)
- Qualified retirement planning services. §132(m)

Treatment of Frequent Flyer Miles p.118

- Inclusion in gross income (1) when received or (2) when used? What if a sale (or equivalent) of frequent flyer miles?
- What if miles attributable to business travel are not credited to the employer?
- Why is the IRS not acting administratively on this issue? Note IRS Announcement 2002-18, p.119, re no gross income, pending further study.

Interest Free Loan from Employer to Employee

- Code § 7872 re "Loans with below-market interest rates." Imputed income.
- Assume: Interest free loan from employer to employee. Treatment of value of the use of the money as compensation.
- Compensation deduction to the employer?
- Interest income to the employer?
- What timing issues?

Personal Activities <u>Incidental to</u> Business p.120

- <u>Gotcher</u> case: Expense paid recruiting trip for benefit of the <u>employer.</u>
- What was the dominant purpose for the trip?
  - personal benefit as a "side effect"?
- Was this trip an award for past services? No.
- Vacation trip for the "little wife"? Income (if any) to whom – husband/wife?
- Consider the relevance of Texas residence status and community property provisions.
- Cf., §274(m)(3) re spouse expenses.

Meals & Lodging p.125

- Benaglia case – p.125
  - hotel manager & “no cost” meals and lodging
- Requirements for Code §119 gross income exclusion eligibility:
- 1) For the convenience of the employer; <u>and</u>
- 2) On the business premises. What are the “business premises”?
- Employment attorney: How negotiate the manager’s employment contract (considering the importance of Code §119)?

Code §119 & the Kowalski Sup. Ct. case p.126

- Kowalski case - meal cash allowance - not furnished in kind and not fitting within the Code provision (& legislation).
  - Is, however, a "tax common law" exclusion available? No.
- What are the "business premises" for purposes of state troopers? Other taxpayers? See p.127.
- §119(b)(3) – re fixed charge exclusion.
- "Supper money" for law firm associates?

Other Excludible Benefits p. 129

- §107 - Exclusion of rental value of house for a "minister of the gospel."
- Violating "establishment of religion" clause?
  - Standing to sue? 2010 lawsuit – E.D. Cal. in *Freedom from Religion Fdn. v. Geithner*
- §134 – gross income exclusion for "qualified military benefits."

Section 83 p.129
Property for Services

- Person receives property for services – gross income inclusion (IRC §61).
- But, if property is subject to (1) substantial risk of forfeiture (e.g., employee earn-out), and (2) is not transferable, has anything been presently transferred to the employee? Therefore, no current income inclusion?
- But, §83(b) election – shifting from employee status to "investor status" when election is made. What adverse aspects of election?

CH 2-2 p.130 Exchanges

Exchange of services situations as possibly producing gross income:

-Lawyer & doctor exchange?

-Lawyer & house painter exchange?

Barter exchanges? Reporting to IRS is required for barter exchanges (IRC §6045(c)(1)(B)). Why?

Imputed Income p.130

1. Imputed Income from Self-Provided Services – imputed income from a self-created economic benefit?

2. Imputed Income from the Ownership of Consumer Assets – homes, vehicles & consumer durables? How value? Cost of consumer assets would not be deductible under a cash flow consumption tax.

3. General Psychic Benefits – the "happy life" as a gross income item. Value of leisure?

CH 2-3 p.133
Gifts & Bequests – Income?

- Duberstein case: Gift of a Cadillac from Berman to Duberstein for providing good business information to Duberstein.
- Also, the Stanton case – retiree receives cash.
- Gift exclusion treatment for income tax purposes requires "detached and disinterested generosity". Cf., Code §102.
- Measured by: (i) “maxims of experience”, and (ii) “the mainsprings of human conduct to the totality of the facts of each case”.

Business Gift Taxation Decision Options p.138

Choices for deciding these cases:

1) Factual analysis for each situation.
2) Rebuttable <u>presumption</u> that <u>not</u> gifts, but rather income derived in a business transaction exchange.
3) <u>Non-rebuttable</u> presumption that compensation received. Cf., §102(c).

Relevance of FRCP 52(a) in this context?

Note §274(b) concerning limit on the donor's deduction for §102(a) gift transfers.

Fees for Other Services? U.S. v. Harris p.139

- Tax evasion criminal convictions for two sisters receiving "gifts" from an older man.
- Gift tax returns by the donor, but only for small amounts. How prove criminal intent by the recipients when failure to report the receipts as income for FIT purposes?
- Court says should have been permitted to include the donor's letters in evidence.
- Law too uncertain to support a criminal conviction in this situation. Where is the dividing line for tax criminality?

Other Compensation v. Gift Scenarios p.139

- "Gifts" to former employees (or employees of one's child?) to buy secrecy? Or?
- Street beggars – accretion to wealth?
- Tips to food service providers –
  - note tip reporting requirements - §6053(c)
- "Gift" or compensation to live-in roommate? cf., Yang case, FIT supplement, p. 14
- Cf., federal gift tax applicability.

Olk v. United States p. 139 Tokes

- Trial Court held “tokes” were gifts to craps dealer.
- Did "tokes" constitute (1) taxable income or (2) “gifts” within Code §102(a)?
- Note the “findings of fact” (legal conclusion?).
- The receipt of tokes is <u>not</u> a result of “detached and disinterested generosity” but superstition?
- Held: includible in recipient’s gross income, similar to the required inclusion of a waiter’s tips in gross income.

Political Contributions p.140

- Contributions are not taxable to the political candidate. Cf., are they bribes?
- Inclusion if diverted for personal purposes.
- The intermediary fund for this purpose is the "Section 527 Organization."
- What purpose of this (tax-exempt) org.?
- Cf., contributions to the politician's charity?
- Contributions to a § 501(c)(4) organization, i.e., an advocacy organization? Gift tax?

Government Transfer Payments p.140

Welfare benefits <u>excluded</u> from GI. Why?

Disaster relief payments – exclusions (under IRC §139) for:

1) Personal and living expense
2) Repair of personal residence
3) General welfare payments

IR 2008-107, 9-18-2008, re tax filing relief & Hurricane Ike (but not noting IRC §139).

Rev. Rul. 2009-19 – re HAMP (USG program) & the "general welfare exemption"

Unemployment and Social Security p.141

- Code §85 - Unemployment compensation is <u>includible</u> in GI. Why? See 2009 change.
- Code §86 - Up to 85% of Social Security benefit is <u>includible</u> in GI. Why include in gross income when the taxpayer has a possible "tax basis" in prior social security contributions? In what amount?
- Is the Social Security tax <u>merely another tax</u> (rather than a "retirement account" held by each taxpayer/individual)?

Prizes p.142
Code Section 74

- GI inclusion required under Code §74.
- Possible exception (under limited circumstances) if the prize is assigned to charity by the prize winner. Code §74(b). Why provide this exception?
- Nobel prizes/ gold medals? Or, Olympic winner gold medals?
- Treatment of a Texas lottery winner? <u>When</u> (if deferred payments)?

Gifts, Bequests and Inheritances p.141 & 143

- Code §102(a) excludes gifts, bequests and inheritances from the gross income of the recipient; and, no deduction is available to the donor upon the gratuitous transfer to the donee. Gift as an after-tax transfer.
- Other tax options: (i) Income to the donee and a deduction to the donor, or (ii) income to the donee and no deduction to the donor.
- Who should be taxed? Either? Both?
- Should tax occur: (i) once (thereby assuring "symmetry" between taxpayers) or (ii) to both (assuring symmetry for tax system)?

Gross Income Inclusion of a "Bequest"

- Code §102 provides for exclusion from gross income of gifts and bequests.
- What is a "bequest"?
- What about a "will contest" settlement amount?
- Cf., Wolder case (p. 143) - attorney provided lifetime services in exchange for a promise to bequeath certain shares of stock.
  - Cf., Duberstein case.
  - Cf., contingent fee to an attorney.

Scholarships as Gross Income p. 144

Code §117 - GI exclusion for scholarships (i.e., tuition, fees & books). Why exclude?

Must be pursuing a degree plan.

No exclusion is available where services are to be provided to the scholarship provider.

Scholarships for room and board are gross income. Consider the income tax result to "student athletes"?

However, no “tracing” of cash is required.

CH 2-4 Capital Appreciation Tax Basis Recovery p.145

§61(a)(3) – gross income includes <u>gains</u> derived from dealing in property;

Reg. §1.61-3(a) (sales less cost of goods sold).

§1001- determining the amount of gain (the amount <u>realized</u> less tax "basis")

§1012 – identifying "cost basis" - <u>Should</u> a person be entitled to recover "investment" in a property without gross income inclusion?

Choices for recovery of investment/cost p.146

1) Immediate deduction of the entire cost.
   Note §179 re tangible property; & recurrent proposals for M&E deductions.
2) Partial recovery of the cost for each year of anticipated life – i.e., depreciation or amortization.
3) Cost is retained (without any tax benefit) until used to offset the proceeds received upon the final disposition of the asset (e.g., personal residence or land).

Cost Basis p.146
§1012 – Purchased Property

- Tax basis is "cost" – even if the purchase was a "good deal" or a "bad deal."
- This assumes not a "bargain purchase," i.e., a favorable price differential attributable to a relationship, e.g., employee or child.
- Tax basis determined in a taxable property swap: fmv of the property received.
- Basis when property received for services: fmv of the property at time of receipt.

Income Tax Basis for In-Kind Property <u>Gifts</u> p.148

- §1015 - tax basis <u>carryover</u> in the event of <u>gift</u> of <u>appreciated</u> property; cf., <u>depreciated</u> property - tax basis to donee is the property's FMV, not tax basis to the donor.
- The donor cannot transfer accrued <u>loss</u>.
- Example: Donor's basis was 100x; fmv at gift to donee was 90x. What if a later sale by donee at: (i) 105x; (ii) 85x; or, (iii) 95x?
- Cf., §1041– carryover basis; <u>not</u> loss limiting.

Tax Basis for Gratuitous Transfers at Death p.148

- Tax basis step-up as of death - §1014(a). (But 2010?)
- Risk of "lock-in effect" re property holdings?
- What happens to the accrued appreciation?
- Could be a step-down in income tax basis if the property is depreciated as of the time of death.
- Tax basis step-up at death is not applicable to IRD - "income in respect of a decedent". See §691.
- Relevance of estate tax alternative valuation date?
- What tax policy option: gain realization at death?
- What is cost of §1014(a) to the U.S. Treasury? See the Tax Expenditure list. A bonanza for the rich?

Possible Expiration of the Estate Tax - Tax Basis Effects

- The estate tax was repealed for (only) the year 2010). Election for no estate tax.
- Should §1014 be retained when this occurs?
- See §1022 re carryover basis, subject to upward basis adjustments of (i) $1.3 million (as indexed for inflation) and (ii) $3.0 million (indexed for inflation) for transfers to the surviving spouse. Possible net tax <u>increase</u> for the "<u>moderately</u> wealthy"? Dependent upon the capital gains tax rate?

Allocation of Tax Basis When Sale of a Part Occurs p.149

- How is tax basis to be allocated when only a portion of a property interest is sold?
- Example: Purchase of 100 shares for 100x; then sell 40 shares for 80x (shares doubled in value).
- Choices: (1) Gain of 40x (each share has 1x basis), or (2) 80x basis recovery and remaining 20x basis is remaining for the remaining 60 shares (having 120x value and then a 100x gain)?
- Reg. §1.61-6(a) requires pro-rata allocation of basis.

Division of the horizontal interests in real property

Consider the possible allocation of purchase price between these property components:

1) Land & shrubbery/landscaping
2) Building/improvements
3) Subsurface (e.g., mineral) rights
4) Air rights
5) Environmental rights
6) Easement/Other?

Inaja Land Co. p.150
Open Transaction Treatment?

Consideration received for an <u>easement</u> (fishing rights) in a river adjacent to owned land. The amount received was less than the total tax basis for the entire property. How allocate this tax basis to the amount received?

Exclude entire proceeds received and reduce tax basis by that amount received?

Note: Burnet v. Logan case (p.733) re basis recovery first before any gain recognition (re: "Open Transaction" treatment.

& see Reg. §1.1001-1(a).

Choices for Tax Basis Recovery p.150

1) Allocate basis between various components (based on relative FMVs)
2) Basis recovery only, until all the tax basis has been recovered, then all gain includible.
3) Treat all current recovery as gross income (e.g., in the property damages context), with the basis being unaffected.

Similar Assets Acquired at Different Times p.151

- What should be the ordering/allocation rule?
- Example: Purchase (1) 10 shares for 10x on date 1; (2) 10 shares for 15x on date 2; and (3) 10 shares for 20x on date 3.
  - Sell 10 shares for 25x on date 4.
- Which shares are those sold? 1ST, last? Average?
- Reg. § 1.1012-1(c) specifies FIFO rule.
- Option for "specific identification" is possible? Use this option in the example above, i.e., a "highest basis/lowest gain" rule?
- Cf., §1012(c) & (d) (2008) & 6045(g).

"Part-gift & part-sale" family transaction p.151

Gift transfer of stock: Basis is 10x; fmv is 30x.

Condition that the donee to pay the 15x gift tax.

Sale transaction? Gain of <u>5x</u>? Cf., *Old Colony*.

Is the donee's tax basis for the property 15x?

Reg. §1.1015-4 (higher-cost or donor's basis).

<u>Or</u>, is the sale made of 1/2 of the property?
  (15/30; basis of 5x) for 15x received and, therefore, gain of <u>10x</u> (15x less 5x), not 5?

Cf., "bargain sale to charity" rule. §1011(b).

Hort v. Commr. p.151
Lease Cancellation Amount

Cancellation of a lease and the lessor obtains consideration of $140,000 from the lessee to cancel the lease. Lessor claims a tax loss.

Holding: that the amount received for the cancellation of the lease must be entirely included in gross income (ordinary income).

This payment was merely a substitute for the rent which would have been received. *continued*

Hort v. Commr. continued

- What relevance here of any tax basis step-up as determined by the application of Code §1014?
- A separate tax basis for the premium lease? Basis to be recovered through amortization over the remaining life of the lease?
- See Code §167(c)(2) & Code §197(e)(5)(A)) precluding the allocation of any tax basis to a "premium lease."

CH 2-5 p.154
The Realization Requirement

Consider the following alternatives:

1) Purchase for 10 and sale for 100 cash.
2) Purchase for 10 and swap for non-like kind asset also worth 100.
3) Purchase for 10 and value appreciates to 100 (still holding the asset). "Mark to market" & current gain to be recognized?
4) Purchase for 10, value appreciates to 100 (still holding the asset) and borrow 50 cash with the asset as collateral.

Cesarini v. US p.156

- Cash found in the purchased piano.
- Included in gross income, since GI includes income "from whatever source derived."
- See Reg. §1.61-14(a) re required inclusion in GI of "treasure trove."
- What if discovered the painting purchased at the garage sale is by Rembrandt? Or, oil is discovered under the land purchased?
- What about catching a record setting home-run baseball, i.e., "baseball windfalls"? P. 158

Gross Income Inclusion? Haverly p.159

- Free textbook samples - Gross income? When the samples were received?
- Why treat as income samples received only <u>when</u> deduction is claimed for income tax?
- Necessity for "symmetry" in the tax system?
- Was the <u>correct</u> <u>*timing*</u> approach utilized here? Why not include item in gross income when the books were <u>received</u>? A valuation dilemma? Another argument, i.e., no "double-dipping?"

Eisner v. Macomber (5-4) p.161

- Issue: Power to tax & the 16th Amendment.
- Stock dividend was issued – what is a "stock dividend" – contrasted with a cash dividend made on stock? Cf., a "stock split."
- Income "derived from" capital? Cf., gain accruing to capital. Is appreciation not "income"? P. 164
- Brandeis dissent: similar to an alternative of (1) a cash distribution & (2) a stock purchase with the dividend amount received?
- Does Congress have the ***power to define income*** (if having the power to tax income)?

Sequels to Eisner vs. Macomber p.166

Is Eisner v. Macomber still "good law'?

Cf., Glenshaw Glass (p. 97) - punitive damages as includible in gross income.

Cf., various "mark-to-market" income inclusion rules. E.g., Code §475 (dealers).

Note: Code §305 (Subchapter C) excluding stock dividends from gross income inclusion; however, subject to §305(b) exceptions (e.g., a cash or stock option for dividend payment).

Cottage Savings Assn. - Loan Package Swap p.166

Facts: Financial institution exchanges one group of residential mortgage loans with another financial institution for another package of residential mortgage loans. A swap of "participation interests" occurs. Long-term low interest income mortgage obligations had declined in value because of the significant increase in market interest rates.

continued, next slide

Cottage Savings Association, continued

Seller did not want to record the losses on its "books" (i.e., reporting for regulatory and financial accounting purposes).

Issue: Does a tax disposition event occur only if properties are "materially different"?

Holding: This exchange *does* cause realized losses for federal income tax purposes.

Cf., inclusion of income based merely on appreciation, i.e., an accretion to wealth.

Debt Modifications - A "Disposition"? p.171

Is the modification of a debt a realization event?
  Reg. §1.1001-3(b) states a "significant modification" of a debt instrument is an "exchange."

Consider a change in (1) length of term,

(2) interest rate, (3) other element (e.g., priority)?

Exception from realization for a "unilateral option."

Receipt of Leasehold Improvements p.171

- Helvering v. Bruun, U.S. Sup. Ct.
- Landlord owns the tenant’s improvements to the property at expiration of the lease.
- Gross income? Timing: (1) when improvements made? (2) periodically as the lease runs? (3) at expiration of the lease? (4) at the subsequent time of property sale?
- If (4), what income tax impact in the interim?
- Note Code §§109 and 1019 (no GI inclusion and no tax basis adjustment).

CH 2-6 Annuities & Life Insurance p.171

What is an "annuity"? A payment for living – often paid periodically. How is an annuity purchased? Lump sum? Other? From whom?

What is "life insurance"? A payment for dying – ordinarily paid in a lump sum. If paid at death, why not call it "death insurance," rather than "life insurance"?

Annuities p.172
Level Payment Contract

Annuitant can have an annuity contract providing for the receipt of level payments for:

a) A specified term (e.g., ten years)

b) One life or several lives

c) One life plus a specified term.

An annuity recipient is in a similar position to the lender in a level payment mortgage loan.

Amounts of gross income are "realized" periodically when annuity payments are received.

Annuities - How Is an Annuity Contract Acquired?

An annuity contract can be acquired:

1) For a lump sum amount

2) For periodic contributions (including qualified plan contributions – then, a zero basis)

Types of annuity contract payouts:

1) Fixed payments (agreed sum at the beginning); What is a "deferred" annuity?

2) Variable payments – investment of contributed funds into stocks & the investment results will then dictate the payout amount.

3) Joint & survivorship annuity? Then (ordinarily) a longer payout period.

Annuity Income Taxation - Timing Options p.172

Tax policy choices for determining the timing for the inclusion of annuity income:

1) As the value accrues within the contract? Cf., amounts credited to a bank account or a mutual fund account or "original issue discount" (OID) concepts. Cf., tax shelter benefit with an annuity.

2) Only as amounts are paid out under the annuity contract either (i) before or (ii) after the annuity starting date.

Distributions made Before the Annuity Starting Date

1) Pre-starting date annuity contract withdrawals are sourced first from accumulated income. Code §72(e)(2)(B).

2) Loans are also treated as withdrawals (& sourced from income?). Code §72(e)(4)(A).

3) A penalty tax of 10 percent (of the distribution) is applicable for pre-age 59 1/2 distributions. Code §72(q).

Annuity Income Amount - Measurement Options

Choices for determining the GI includible amount:

1) **Recovery of the entire tax basis first.**

2) **A specified percentage of each payment is the includible interest income equivalent.**

3) **Current method – a proportionate amount of each payment, based on the anticipated return (the straight-line approach is beneficial).**

4) **Constant interest rate (but how deal with the life expectancy factor?)**

continued re: current method

Annuities - Current Inclusion Method - §72(b)

1) Determine the total income tax basis.

2) Determine the "expected return" - i.e., the payment amount <u>times</u> the anticipated number of payments (how determine amount?)

3) This ratio is applied to each payment when received. The formula is:

(i) total basis/expected payments <u>times</u>

(ii) each payment <u>equals</u>

(iii) the amount <u>excluded</u> from gross income.

continued

Annuities, cont.
Refund Feature Considered

- What is the impact of a "refund feature" on determining the annuitant's "investment in the [annuity] contract"?
- What is the purpose of a "refund feature"? Is this a life insurance equivalent?
- See Code §72(c)(2) - concerning the impact of the refund feature on (1) the "investment in the contract" and (2) the annuity income inclusion/exclusion fraction under §72(b).

Annuities, cont.
Impact of Death on Annuity

- What is the impact of death? See p. 174.
  - Termination of the annuity contract - if based on life expectancy (cf., term annuity). If tax basis is <u>not</u> recovered? Deduction on annuitant's last return for the unrecovered basis. §72(b)(3).
- If tax basis <u>is</u> recovered prior to death?
  - <u>All</u> subsequent proceeds are <u>includible</u> in gross income. Code §72(b)(2).
- What happens at death with a "<u>term</u>" annuity contract? Remainder interest to the successor.

Annuity Income Calculation for a Term Contract

Purchase for $100,000 of a single premium annuity. Assume anticipated 15 payments (based on life expectancy) of $12,000.

Code §72 exclusion computation:

100,000   (investment in the contract)

180,000   (12,000 per year times 15 years)

Equals: 55.55% x $12,000 payment = $6,667.

Equals: 6,667 to be excluded and 5,333 to be included in gross income (12,000 less 6,667). *continued*

Example cont. - <u>Life</u> Contract Anticipated 15 Year Life

- Assume death occurs before end of 15 year expected annuity period (e.g, after only nine payments).
- Total tax basis recovered was $60,003 – ($6,667 times the nine payments received). The unrecovered basis in the contract is $39,997 of the original $100,000 investment.
- Deducting this amount on the annuitant's final income tax return is permitted (if expiration of the contract occurs at death). §72(b)(3).

Life Insurance P.174
Defining Life Insurance

What is "life insurance"? Payment for dying!

Cf., a mutual fund investment.

If <u>not</u> treated as "life insurance," then taxed as if a "savings account":

i.e., inclusion in <u>current</u> gross income of:

(1) the increase in the cash surrender value of the account, and

(2) the value of current insurance coverage.

Life Insurance P.174
Life Insurance Types

Types of life insurance:

1) Term life: payment for insurance risk only;

(although small investment return during insurance period). No residual value after expiration of term (without death).

2) Whole life: often level payments i.e., early year payments exceed insurance risk, creating savings element, producing internal income, reducing insurance cost (not includible in gross income).

3) Other types: e.g., universal life

Life Insurance - Code §101 GI Exclusion p.174

Gross income exclusion (§101) is available when proceeds are paid at <u>death</u> for <u>both</u>:

(1) the pre-death interest buildup, and

(2) the mortality gain (i.e., the “windfall” because of an early death).

The “transfer for consideration” limitations may apply. §101(a)(2). Purpose of these limits?

The gross income exclusion is not applicable to any <u>post-death</u> interest accumulation.

continued

Life Insurance, cont.

- No income tax deduction is available for policy premiums paid. Code §264(a)(1).
- Policy <u>loans</u> are <u>not</u> treated as distributions. Code §72(e)(5)(A). Cf., annuity contract loan.
- Policy <u>settlement options after maturity</u> at death: deferred receipt produces taxable income; see Code §101(c) & (d) (re: annuity option).
- What if life insurance policy terminated prior to death? Gain (if any) on policy termination?
- What if a "viatical settlement"? Code §101(g).

CH 2-7 Transactions with Borrowed Funds p.179

No income is realized upon the receipt of loan proceeds. Why? No "accession to wealth"?

Remember the personal balance sheet:

Assets minus liabilities = net worth

When borrowing occurs what happens to:

(1) assets and (2) liabilities on one's personal balance sheet?

Is a tax deduction available when loan is repaid? No.

Debt Cancellation p. 180

- What income tax treatment occurs when a debt is cancelled/forgiven by the lender (rather than being repaid in full)?
- Does an accession to wealth then arise?
- See §61(a)(12) providing that cancellation of indebtedness income <u>is</u> included in GI.
- But, numerous exceptions to this GI inclusion exist: e.g., for gifts, compensation, and certain statutory exceptions.

Illegal Income p.180
Collins case - Racing Tickets

- Do proceeds from embezzlement constitute gross income?
- Note Kirby Lumber (p. 181) that purchase by issuer of its own corporate bonds for less than the original issue price constituted GI.
- But, does embezzlement mean an obligation (under state law) to repay the embezzled amount?
- James case (Sup. Ct.): unlawful gains are GI.
- Consider: gambling loss deduction (§165(d) limit) vs. theft income.

GI Inclusion of Illegal Income p. 185

- Sullivan case – p. 185 – inclusion in GI of individual's illegal (bootlegger) income.
- Tax return considerations: Constitutional prohibition against compulsory self-incrimination (i.e., 5th Amendment)?
- How solve the income reporting issue without self-incrimination of oneself? Use "creative" income tax return reporting of this income amount?

Discharge of Indebtedness p.187 §61(a)(12)

Kirby Lumber Co. - Corporation issues its own bonds; repurchase by Corp. of these bonds for less than offering price (assumed to be par value).

Held: the differential/gain is to be included in the gross income of the corporation.

An increase in corporation's net worth has resulted.

How can the issuer buy bonds at less than their par value (or their original issue price)?

Zarin case p.187
Gambling Debt Compromised

- Discharge of gambling indebtedness.
- Taxpayer delivered his personal checks for $3.435 million and the checks were invalid.
- State court collection action was filed.
- Settled this action for $500,000 and IRS then asserts $2.9 million COD income to the taxpayer.
- Not purchase money debt reduction
- Tax Court: Inclusion as debt cancellation income.
- Note:Tannenwald dissent – no genuine debt created.

Zarin case (appeal) p.194 Disputed Debt?

- 3rd Circuit reverses Tax Court and treats the cancelled debt as a disputed debt or a contested liability. Treated as if the initial loan were for the eventual settlement amount.
- Was this debt unenforceable? See state law.
- 3rd Circuit dissent (p.194): COD income and this was a bona fide debt situation. Assets of taxpayer were "freed from liability."

Code §108 p.195
Debtor Insolvency

- An exception from COD income treatment exists to the extent of a taxpayer's insolvency of it the discharge occurs in a Title 11 case. See Code §108(a)(1).
- Code § 108(d)(3) identifies "insolvency" as excess of liabilities over fair market value of assets.
- Tax attribution reduction is then required – Code §108(b). "Tax attributes" could include (1) net operating losses and (2) tax basis for property.

Code §108 p.196
Purchase Price Reduction

- An exception from COD income treatment exists for purchase money debt.
- Code §108(e)(5) – no COD income resulting from a purchase price reduction. What effect on the original tax basis of the acquired asset?
- Cf., a third party rebate and eligibility under §108(e)(5).

Third party satisfies debt of another person p.196

Is gross income realized if:

1) The employer pays an employee's income tax liability? Note: Old Colony Trust case

2) Shareholder causes his/her wholly owned corporation to pay the shareholder's debt owing to a third party? Dividend distribution?

3) Corporate debt to shareholder is cancelled – contribution to capital – Code § 108(e)(6).

4) Tort damages caused by the insured are paid by an insurer? Is insurance different?

Qualified Principal Residence Indebtedness p.197

- Home owner mortgage debt is cancelled (usually in part). What are "underwater mortgages"?
- Code §108(a)(1)(E) & (h) provide for exclusion of debt discharge from gross income; but, a tax basis reduction does occur.
- Limit on the exclusion is $2 million.
- Expires at end of 2012 (extended from 2009).
- How is COD income reported? IRS Form 1099-C.

Student Loan Forgiveness p.197

- §108(f) provides GI does <u>not</u> include forgiveness of <u>certain</u> student loans.
- Student loans as made by US or other government (or an intermediary) or a tax-exempt educational organization.
- Is a public interest job required?   See Rev. Rul. 2008-34, re law school loan forgiveness programs. And, not substitute compensation for services rendered for a charitable purpose.

CH 2-8 Effect of Debt on Basis and the Amount Realized

Identifying alternative types of debt arrangements:

1) Recourse – personal liability

2) Nonrecourse – debt is secured <u>only</u> by the pledged asset. Why?

Crane case – p.199 – recourse and nonrecourse debt is to be treated similarly for federal tax purposes. Here claimed debt (1) in the original tax basis (and tax depreciation eligibility), but (2) asserted as not an amount being "realized" upon the debt relief.

Debt and Property Purchases

- What is the effect of debt on the income tax basis of an acquired property?
- Acquisition debt is to be included in the buyer's tax basis for acquired property.
- This can include "seller financing" debt.
- Also, property can be acquired with debt attached, i.e., either (1) assumed debt, or (2) non-recourse debt, with property subject to debt (but no personal liability).
- Cf., post-acquisition debt (i.e., borrowing with existing property as collateral).

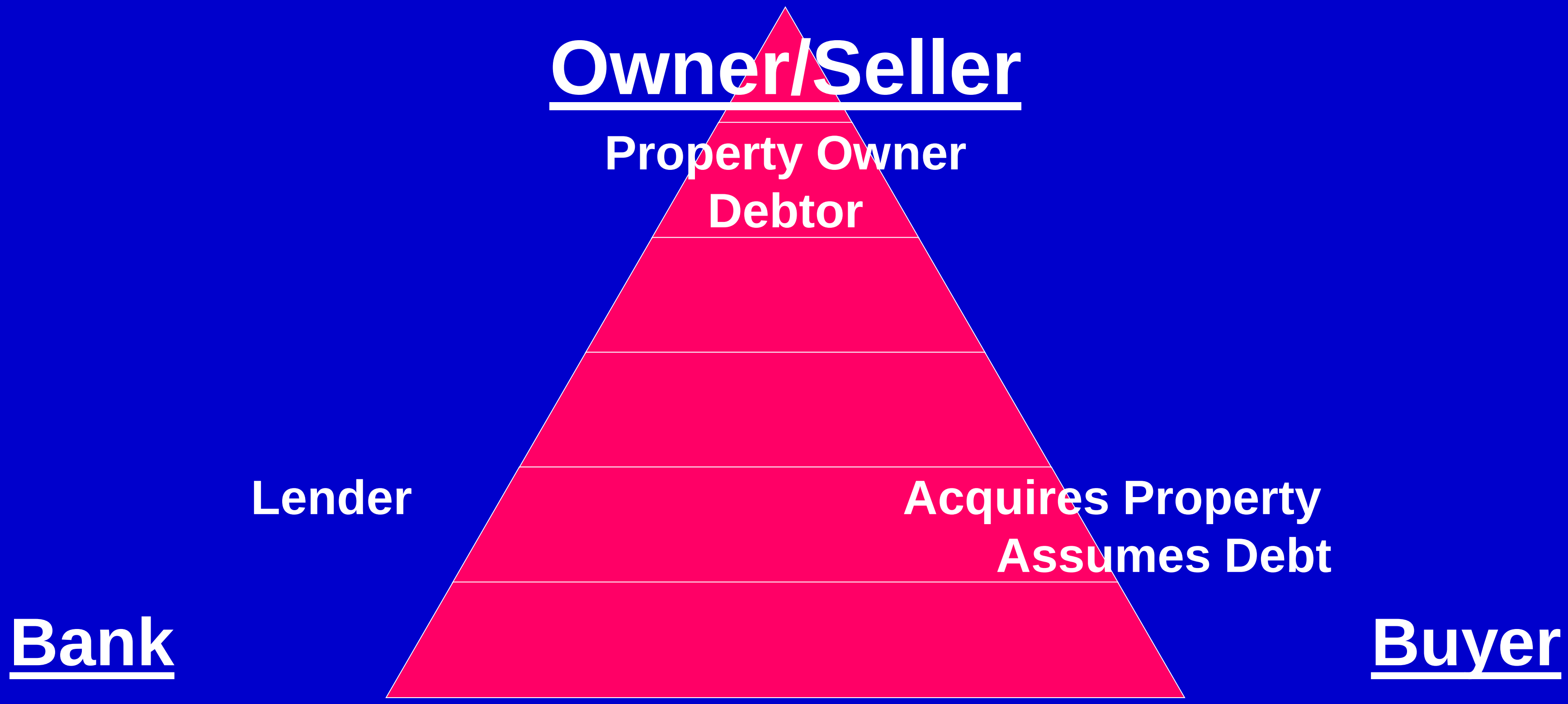
Computing Gain Upon Property <u>Disposition</u>

- Do the <u>proceeds</u> of <u>*sale*</u> also <u>include</u> <u>relief</u> from the <u>debt</u>, either (1) assumed by the purchaser, or (2) being nonrecourse debt which is attached to the property transferred to another?
- <u>Crane</u> case supports <u>inclusion</u> of the debt in the tax basis for the property owner.
- What would occur if no inclusion in tax basis was permitted: (1) upon asset purchase? (2) when the asset is sold?

Tufts case p.200
Debt Exceeds Property FMV

- Facts: Property purchase for $1.85 million <u>nonrecourse</u> debt & initial tax basis of $1.85 mil. $400,000 depreciation claimed.
- Tax basis is reduced to $1.45 million (§1016).
- Property FMV at disposition was $1.4 million - $1.850 debt exceeds (1) then tax basis <u>and</u> (2) the FMV of the property at disposition.
- Tax issues: Gain or other income? Loss? Tax character? How much? COD income & §108?

One or Two Transactions?



Tufts choices for decision
One or Two Transactions?

Integrated transaction

1.850 debt

Less 1.450 basis

Equals: 400 gain

(capital gain?)

Two transactions

1) 1.850 debt relief

Less: 1.400 value

= 450 COD income.

2) 1.450 basis

Less: 1.400 value

= 50 capital loss.

Treasury Regulations & Nonrecourse Debt

- Reg. §1.1001-2(a)(1) - the amount realized includes the amount of liabilities from which the transferor is "discharged."
- Reg. §1.1001-2(a)(4)(i) - the sale of property that secures a nonrecourse liability "discharges" the transferor from the (nonrecourse) liability.
- Reg. §1.1001-2(b) - the fair market value of the security is ***not* relevant** for determining the amount of liabilities being discharged.

Estate of Franklin p.209

- Is the purchase money debt includible in basis?
- Facts: Purchase of motel for only prepaid interest and a nonrecourse debt (with a balloon payment). Warranty deed is in escrow. Leaseback to sellers & the lease payment from sellers is equal to the P&I amount on debt.
- Value of property not shown, but presumably far less than the promissory note amount.
- Held: No real investment in the property and no depreciation & no interest expense deduction.
- Query: Was this really an option?

Pleasant Summit Land p.213

- Different approach than the Franklin case.
- Depreciation deduction was allowed – but, to the extent that the nonrecourse debt did not exceed the FMV of the property – that amount was effectively recognized as tax basis on the acquisition.
- Consider the tax basis to Bayse – the purchaser in the Tufts case. Is his tax basis limited as in (1) the Franklin case or (2) the Pleasant Summit case?

Revenue Ruling 90-16 Bifurcation p.214-5

Assume: Acquisition of property with ***recourse* liability**, i.e., personal liability of borrower.

Subsequently, property was transferred to the lender and the borrower was released from liability.

Debt balance 45x

Property FMV 30x (15x COD income?)

Basis 10x (20x property gain?)

Foreclosure proceeding: same tax result.

(Nonrecourse debt: 35x property gain).

Rev. Rul. 91-31 p.215
Debt Reduction - No Transfer

- Lender agreed to reduce the nonrecourse debt when the value of the building ($800,000) was less than the outstanding mortgage debt ($1 million). No insolvency situation existed.
- Reduction of the principal amount of the undersecured non-recourse debt was made by the holder of debt who was not the seller.
- This debt reduction constitutes realization of COD income (even in the non-recourse debt context) - since no disposition of the collateral has occurred. 200x COD income.
- Or, should a tax basis reduction result here?

Woodsam Associates p. 215

- Post-acquisition borrowing, using the appreciated property as collateral for a nonrecourse loan.
- Borrowing in excess of income tax basis.
- The borrowing is not an income realization event.
- Loan amount is not included in basis since the borrowing was a a post-acquisition event.
- Example: Basis 10x, FMV 100x & borrow 50x.
- Note: Later property sale for 100x – net proceeds received are 50x (after the debt payment), but 90x gross income is realized.

Diedrich case
Supreme Ct. case p.216

Gift transfer of property but required assumption by the donee of the liability for gift tax .

Part-gift & part sale transaction.

E.g., obligation of the buyer/donee to pay gift tax – in excess of tax basis for the property.

What is the gain amount? Gain to the extent the liability assumed exceeds the tax basis for the property transferred.

Example: FMV 100; gift tax 30x; basis 20x.

10x gain, or 24x, i.e., 30x less allocated 6x basis? (i.e., allocation based on 30% of 20x)

Damages p.216
Business Interest Damaged

- Tax classification issue: What are the damages a substitute for?
- Raytheon case (p. 217): damages in an antitrust action – ordinary income where the damages represent payment for a loss of profits.
- Damages as a return of capital where destruction of the business and goodwill occurred.
- Here: destruction of goodwill – but no tax basis proved; therefore, basis assumed to be zero (and all proceeds treated as income – cap gain?).

Damages for Personal Injury p.218 Attn: Tort Lawyers

- Code §104(a)(2) – exclusion for damages received for personal <u>physical</u> injuries.
- Exclusion available whether amount received as a lump sum payment or in periodic payments.
- Not including sex/race/age discrimination lawsuit proceeds. <u>Not</u> including payments for <u>emotional distress</u> (unless the distress is attributable to physical injury).
- Punitive damages <u>are</u> includible in GI.

Court Settlement Allocations

- Assume a tort action court petition/complaint specifies damages as (1) $1 million compensatory and (2) $9 million punitive.
- Parties then settle dispute for $2 million: how allocate this amount to the GI excluded and GI included amounts?
- Amend the petition prior to effective date of the settlement agreement? Why?

Amounts Received for Nonphysical Injuries p.220

- Do amounts received for nonphysical injuries (e.g., emotional distress, not physical injury) even constitute gross income?
- See Murphy case (DC Cir) discussion, p.220.
- Even constituting "income" within the meaning of the 16th Amendment?
- What about U.S. Const., Art. 1, §8, taxing power (if not a "direct tax," Art. 1, §9[4]).
- I.e., is the 16th Amendment even necessary?

Structured Settlements

- What is a “structured settlement”?
  - Example: 1x now or 3x paid over ten years.
- Code §104(a)(2) provides for exclusion whether amount received “as lump sums <u>or as periodic payments</u>” for amounts received for personal physical injuries.
- What about the “interest” income component inherent in the delayed payments?
- How assure that the agreed deferred payments will actually be made? I.e., a security of payment issue.

Tax Exempt Interest p. 224

- Code §103 – exclusion from gross income is available for interest income received from investment in state and local debt obligations.
- Economic effect: reduce the amount of interest cost payable by the state/local govt. obligor.
- Therefore, indirect “revenue sharing” with state and local governments?
- But, note the “leakage” for this gross income exclusion between (1) the benefit to local government and (2) the cost to U.S. Treasury.

U.S. Constitutional Authority to Tax Muni Bond Interest?

- Is income <u>taxation</u> of muni-bond interest by the U.S. Government <u>constitutional</u>?
- Consider the rights of states as being impaired if federal income taxation occurs.
- Cf., South Carolina v. Baker (p. 226) that muni-bond interest is to be included in GI if the bonds are not in "<u>registered</u>" form. Code §103(b)(3) & §149. What is "registered form" for a bond? What is the purpose for this inclusionary rule? Cf, "bearer" form of ownership.

Private Activity Bonds, etc. p.226 Code §§141-150

- Use of muni-bonds (1) for government functions and (2) to assist private industry (by the government acting as an intermediary).
- Note various exceptions to private activity bonds. Must be a "qualified bond." See., e.g., Code §§ 141(e) & 142 (exempt facility bonds). Cf., muni-bonds for an athletic stadium; other purposes?
- Code §148 re "arbitrage" bonds. What is an arbitrage bond? What is the benefit?