A. Judicial and Administrative Definitions of Income

Code: IRC §61(a).

Regs: Treas. Reg. §§1.61–2(d)(1); 1.61–14(a).

As explained in Chapter 2, the starting point for the determination of “taxable income” is the computation of “gross income.” Section 61(a) defines gross income as “all income from whatever source derived.” The Sixteenth Amendment to the United States Constitution (adopted in 1913) gives Congress the power “to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states and without regard to any census or enumeration” (emphasis added). Apparently, in defining gross income as “all income from whatever source derived,” Congress states its intention to exercise the full measure of the power granted to it by the Sixteenth Amendment. See *Glenshaw Glass, infra*.

We are still left, then, with the question of what is meant by “income.” Section 61(a) offers fifteen examples of items that are included in gross income, but the list is only representative and not exclusive. The Treasury Department has not offered any regulatory guidance on the general concept of income. Since the Code and the Treasury Regulations offer no help on this issue, we have to look elsewhere for help.
Economists have debated the meaning of “income” and have not reached consensus. The most common definition of income in economic theory is the Haig-Simons definition of income that states that income is the sum of a taxpayer's consumption plus his or her change in wealth for a particular period.  

\[ \text{Income} = \text{Consumption} + \text{Change in wealth} \]

Example: Taxpayer receives wages from employment totaling $50,000. The taxpayer spends $40,000 of the wages on personal living expenses (groceries, apparel, rent, gasoline, and the like) and invests the remaining $10,000 by purchasing stock in a publicly-traded corporation. What is the taxpayer's income under the Haig-Simons definition of income?

Answer: The taxpayer's income is $50,000. The $40,000 spent on personal expenses represents consumption and the remaining $10,000 represents an increase in the taxpayer's net worth.

\[ \text{Income} = \text{Consumption} ($40,000) + \text{Change in net worth} ($10,000) \]

The Haig–Simons definition is of greater utility in more complex cases.

Example: The same taxpayer in the prior example receives another $50,000 in wages in the following taxable year. The taxpayer spends all of these wages on personal expenses, making no additional investments. Yet the value of the corporate stock purchased in the prior year increases from $10,000 to $15,000. What is the taxpayer's income under the Haig–Simons definition of income?

Answer: The taxpayer's income is $55,000. The $50,000 on personal expenses represents consumption and the $5,000 represents an increase in the taxpayer's net worth.

\[ \text{Income} = \text{Consumption} ($50,000) + \text{Change in net worth} ($5,000) \]

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While consumption is fairly easy to measure, imagine the inherent complexities in administering a system where mere fluctuations in value were of significance! In the prior example, the taxpayer has $5,000 of income because the value of the taxpayer's stock increases during the year. If the income from the appreciation in value is subject to taxation, the taxpayer will have to use a portion of the taxpayer's wages to pay that tax. That result may be acceptable, but suppose the taxpayer did not have any wages for the year. The appreciation in the value of the stock would still be subject to tax, but the taxpayer would not have the cash to pay any tax on this increased wealth. Nonetheless, the Haig–Simons definition of income would require the appreciation to be included in gross income. If the Haig–Simons formula was followed, taxpayers would have to value their assets at the end of each year and measure gains and losses. Taxpayers would also have to sell assets to obtain the cash necessary to pay the resulting income tax.

But the fun would not stop there. Presumably, if the stock in the prior example was sold at the beginning of the next year for $15,000, there would be no additional tax on the sale since the $5,000 appreciation was already taken into account in the prior tax year. But what if the value declined in the next year and there was no sale? Would the taxpayer be entitled to a deduction in the amount of the decreased value (an unfortunate result that requires more appraisals)? Or would the taxpayer simply be out of luck (a result that would probably cause a revolt akin to the Boston Tea Party)? If a deduction was allowed, what should happen if the taxpayer has no other income to offset that loss? These additional issues could all be answered, of course, but the very complexities created by these additional issues have precluded the adoption of the Haig–Simons definition for all federal income tax purposes.

The Haig–Simons definition might be helpful from a theoretical perspective, but the practical limitations have forced the courts to find a more suitable definition of income. The United States Supreme Court first tackled the issue in *Eisner v. Macomber*, briefed below. The Court then modified its definition in *Glenshaw Glass*, which follows the *Macomber* brief. As you read these cases, consider the extent to which the definitions adopted by the Court are consistent with the Haig–Simons formula.

### (1.) Defining Gross Income

**Eisner v. Macomber**

*252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).*

**Facts:** The Standard Oil Company of California, a publicly traded corporation, declared a 50–percent stock dividend. Myrtle Macomber, the taxpayer in this case, owned 2,200 shares of Standard's stock. She received 1,100 additional shares
of stock pursuant to the distribution, bringing her total ownership to 3,300 shares. Because all Standard shareholders participated proportionately in the stock dividend distribution, the receipt of the additional shares did not affect her proportionate interest in Standard’s assets or profits.

**Issue:** Does the taxpayer have gross income from the receipt of 1,100 additional shares of Standard stock pursuant to the distribution?

**Holding:** No.

**Rationale:** Although the Income Tax Act of 1916 expressly included stock dividends as part of “net income” (the statutory predecessor of “gross income” set forth in §61(a) of the modern statute), Justice Pitney, writing for the majority (5–4), relied on other definitions of income from earlier decisions to conclude that a stock dividend was not within the meaning of “income” as used in the Sixteenth Amendment:

We find little to add to the succinct definition adopted in two cases arising under the Corporation Tax Act of 1909 (Stratton’s Independence v. Howbert, 231 U.S. 399, 415; Doyle v. Mitchell Bros. Co., 247 U.S. 179, 185—"Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the Doyle Case. * * *

* * *The Government, although basing its argument upon the definition as quoted, placed chief emphasis upon the word “gain,” which was extended to include a variety of meanings; while the significance of the next three words [“derived from capital”] was either overlooked or misconceived. * * * Here we have the essential matter: not a gain accruing to capital, not a growth or increment of value in the investment; but a gain, a profit, something of exchangeable value proceeding from the property, severed from the capital however invested or employed, and coming in, being “derived,” that is, received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal;—that is income derived from property. Nothing else answers the description.
The same fundamental conception is clearly set forth in the Sixteenth Amendment—“incomes from whatever source derived”—the essential thought being expressed with conciseness and lucidity entirely in harmony with the form and style of the Constitution.

Can a stock dividend, considering its essential character, be brought within the definition? * * * [It] does not alter the pre-existing proportionate interest of any stockholder or increase the intrinsic value of his holding or of the aggregate holdings of the other stockholders as they stood before. The new certificates simply increase the number of the shares, with consequent dilution of the value of each share.

* * *

Far from being a realization of profits of the stockholder, [a stock dividend] tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

The essential and controlling fact is that the stockholder has received nothing out of the company’s assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.

**Dissents:** Justice Holmes, joined by Justice Day, reasoned in a brief dissent that because the 1916 Act expressly identified stock dividends as income, and since most lay persons would consider such dividends as income, the statutory definition of income should be constitutional. Justice Brandeis, in a lengthy dissent joined by Justice Clarke, analyzed the issue as one of substance versus form. Justice Brandeis argued that the stock dividend was no different than a cash distribution followed by a purchase of additional shares in the corporation. A cash distribution would, of course, be a taxable event; thus, according to Justice Brandeis, the stock dividend should also be taxed.
Notes and Questions

1. The Realization Requirement. The majority distinguished accretion and appreciation on the one hand and income on the other. In order for a taxpayer to have income from property, says the majority, the taxpayer must receive some right or asset that is sufficiently distinct from the property. The Court called this a “realization” of the profits. Macomber seemingly makes realization a constitutional prerequisite to income, but in later decisions we will see the Court back down from this position.

Yet while realization may no longer be constitutionally required, the concept remains a helpful guidepost for determining the proper timing of taxation.

The Macomber case is like an impressionist painting: easy to comprehend from a distance, but increasingly unclear upon closer examination. Generally, the tax code does not provide for the taxation of the mere appreciation of an asset, but the question after Macomber is whether Congress could, if it chooses, tax unrealized appreciation under the Sixteenth Amendment? The Macomber Court answers this question in the negative, but the issue was not really before the Court. The Court could have concluded that “income,” for purposes of the Sixteenth Amendment, includes unrealized appreciation and still hold for the taxpayer; the Court could have ruled that a stock dividend simply does not represent “appreciation” in value. Macomber is therefore a troubling case because it pronounces a rule (that realization must occur) that is broader than warranted by the facts.

This is not to say that the Macomber Court reached the wrong result. Prior to the enactment of the Sixteenth Amendment, the Court had decided that mere appreciation in value was not income. It is widely accepted that the purpose of the Sixteenth Amendment was only to eliminate the requirement that a federal income tax, like any other direct tax imposed by Congress, be apportioned among the States according to population. The Sixteenth Amendment was not an attempt to supplant prior definitions of income. From the perspective of stare decisis, the holding in Macomber is correct.
2. *The Benefit of a Stock Dividend.* Part of the majority’s rationale is based on the assumption that a shareholder participating in a proportionate stock distribution receives nothing of benefit from the distribution. One could argue that a stock dividend does provide a shareholder with at least some benefit. With more shares, the shareholder is able to sell smaller portions of his or her original interest, and a smaller per share price may attract more buyers. Is that benefit sufficient to warrant the imposition of tax?

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**Self-Assessment Questions**

(Solutions to Self-Assessment Questions are set forth in Appendix 3.)

**SAQ 3–1.** Would the result in *Macomber* be different if, instead of additional Standard stock, the taxpayer and the other shareholders received:

(a) cash?

(b) other corporate assets?

(c) promissory notes from the corporation?

The Court clarified the definition of income in the following case:

**Commissioner v. Glenshaw Glass Company**

United States Supreme Court, 1955.


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

This litigation involves two cases with independent factual backgrounds yet presenting the identical issue. The two cases were consolidated for argument before the Court of Appeals for the Third Circuit and were heard en banc. The common question is wheth-
er money received as exemplary damages for fraud or as the punitive two-thirds portion of a treble-damage antitrust recovery must be reported by a taxpayer as gross income * * *.

The facts of the cases were largely stipulated and are not in dispute. So far as pertinent they are as follows:

Commissioner v. Glenshaw Glass Co. The Glenshaw Glass Company, a Pennsylvania corporation, manufactures glass bottles and containers. It was engaged in protracted litigation with the Hartford–Empire Company, which manufactures machinery of a character used by Glenshaw. Among the claims advanced by Glenshaw were demands for exemplary damages for fraud and treble damages for injury to its business by reason of Hartford’s violation of the federal antitrust laws. In December, 1947, the parties concluded a settlement of all pending litigation, by which Hartford paid Glenshaw approximately $800,000. Through a method of allocation which was approved by the Tax Court, and which is no longer in issue, it was ultimately determined that, of the total settlement, $324,529.94 represented payment of punitive damages for fraud and antitrust violations. Glenshaw did not report this portion of the settlement as income for the tax year involved. The Commissioner determined a deficiency claiming as taxable the entire sum less only deductible legal fees. * * *

Commissioner v. William Goldman Theatres, Inc. William Goldman Theatres, Inc., a Delaware corporation operating motion picture houses in Pennsylvania, sued Loew’s, Inc., alleging a violation of the federal antitrust laws and seeking treble damages. After a holding that a violation had occurred, the case was remanded to the trial court for a determination of damages. It was found that Goldman had suffered a loss of profits equal to $125,000 and was entitled to treble damages in the sum of $375,000. Goldman reported only $125,000 of the recovery as gross income and claimed that the $250,000 balance constituted punitive damages and as such was not taxable. The Tax Court agreed, and the Court of Appeals, hearing this with the Glenshaw case, affirmed.

It is conceded by the respondents that there is no constitutional barrier to the imposition of a tax on punitive damages. Our question is one of statutory construction: are these payments comprehended by §22(a) [the predecessor of §61(a)]?

The sweeping scope of the controverted statute is readily apparent:

“§22. Gross income

“(a) General definition. ‘Gross income’ includes gains, profits, and income derived from salaries, wages, or compensation for personal service
* * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * "

This Court has frequently stated that this language was used by Congress to exert in this field “the full measure of its taxing power.” Respondents contend that punitive damages, characterized as “windfalls” flowing from the culpable conduct of third parties, are not within the scope of the section. But Congress applied no limitations as to the source of taxable receipts, nor restrictive labels as to their nature. And the Court has given a liberal construction to this broad phraseology in recognition of the intention of Congress to tax all gains except those specifically exempted. Thus, the fortuitous gain accruing to a lessor by reason of the forfeiture of a lessee’s improvements on the rented property was taxed in Helvering v. Bruun, 309 U.S. 461, 60 S.Ct. 631, 84 L.Ed. 864. Such decisions demonstrate that we cannot but ascribe content to the catchall provision of §22(a), “gains or profits and income derived from any source whatever.” * * *

Nor can we accept respondents’ contention that a narrower reading of §22(a) is required by the Court’s characterization of income in Eisner v. Macomber, 252 U.S. 189, 207, 40 S.Ct. 189, 193, 64 L.Ed. 521, as “the gain derived from capital, from labor, or from both combined.” The Court was there endeavoring to determine whether the distribution of a corporate stock dividend constituted a realized gain to the shareholder, or changed “only the form, not the essence,” of his capital investment. It was held that the taxpayer had “received nothing out of the company’s assets for his separate use and benefit.” The distribution, therefore, was held not a taxable event. In that context—distinguishing gain from capital—the definition served a useful purpose. But it was not meant to provide a touchstone to all future gross income questions.

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

Reversed.

Mr. Justice Douglas dissents.

Mr. Justice Harlan took no part in the consideration or decision of this case.

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Note

The Glenshaw Glass Court revealed that the definition of income used by the majority in Eisner v. Macomber was not the exclusive test for income subject to tax under the Sixteenth Amendment. In its place, the Court indirectly offered a more comprehensive test for income, one broader than that employed by the Macomber Court. The Glenshaw Glass definition of income has survived for half a century—to this day it is the preferred test for identifying whether a taxpayer has income.

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(2.) Finds

Cesarini v. United States

United States District Court, Northern District of Ohio, 1969. 296 F.Supp. 3.

Young, District Judge.

This is an action by the plaintiffs as taxpayers for the recovery of income tax payments made in the calendar year 1964. Plaintiffs contend that the amount of $836.51 was erroneously overpaid by them in 1964, and that they are entitled to a refund in that amount, together with the statutory interest from October 13, 1965, the date which they made their claim upon the Internal Revenue Service for the refund.
In 1957, the plaintiffs purchased a used piano at an auction sale for approximately $15.00, and the piano was used by their daughter for piano lessons. In 1964, while cleaning the piano, plaintiffs discovered the sum of $4,467.00 in old currency, and since have retained the piano instead of discarding it as previously planned. Being unable to ascertain who put the money there, plaintiffs exchanged the old currency for new at a bank, and reported the sum of $4,467.00 on their 1964 joint income tax return as ordinary income from other sources. On October 18, 1965, plaintiffs filed an amended return with the District Director of Internal Revenue in Cleveland, Ohio, this second return eliminating the sum of $4,467.00 from the gross income computation, and requesting a refund in the amount of $836.51, the amount allegedly overpaid as a result of the former inclusion of $4,467.00 in the original return for the calendar year of 1964. On January 18, 1966, the Commissioner of Internal Revenue rejected taxpayers’ refund claim in its entirety, and plaintiffs filed the instant action in March of 1967.

Plaintiffs make three alternative contentions in support of their claim that the sum of $836.51 should be refunded to them. First, that the $4,467.00 found in the piano is not includable in gross income under Section 61 of the Internal Revenue Code. Secondly, even if the retention of the cash constitutes a realization of ordinary income under Section 61, it was due and owing in the year the piano was purchased, 1957, and by 1964, the statute of limitations provided by §6501 had elapsed. And thirdly, that if the treasure trove money is gross income for the year 1964, it was entitled to capital gains treatment under Section 1221.

The Government, by its answer and its trial brief, asserts that the amount found in the piano is includable in gross income under Section 61(a) of Title 26, U.S.C., that the money is taxable in the year it was actually found, 1964, and that the sum is properly taxable at ordinary income rates, not being entitled to capital gains treatment * * *.

After a consideration of the pertinent provisions of the Internal Revenue Code, Treasury Regulations, Revenue Rulings, and decisional law in the area, this Court has concluded that the taxpayers are not entitled to a refund of the amount requested, nor are they entitled to capital gains treatment on the income item at issue.

The starting point in determining whether an item is to be included in gross income is, of course, Section 61(a) of Title 26 U.S.C., and that section provides in part:
“Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items: * * * “

Subsections (1) through (15) of Section 61(a) then go on to list fifteen items specifically included in the computation of the taxpayer’s gross income, and Part II of Subchapter B of the 1954 Code (Sections 71 et seq.) deals with other items expressly included in gross income. While neither of these listings expressly includes the type of income which is at issue in the case at bar, Part III of Subchapter B (Sections 101 et seq.) deals with items specifically excluded from gross income, and found money is not listed in those sections either. This absence of express mention in any of the code sections necessitates a return to the “all income from whatever source” language of Section 61(a) of the code, and the express statement there that gross income is “not limited to” the following fifteen examples. Section 1.61–1(a) of the Treasury Regulations, the corresponding section to Section 61(a) in the 1954 Code, reiterates this board construction of gross income, providing in part:

“Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. * * * “

The decisions of the United States Supreme Court have frequently stated that this broad all-inclusive language was used by Congress to exert the full measure of its taxing power under the Sixteenth Amendment to the United States Constitution.

In addition, the Government in the instant case cites and relies upon an I.R.S. Revenue Ruling which is undeniably on point:

“The finder of treasure-trove is in receipt of taxable income, for Federal income tax purposes, to the extent of its value in United States Currency, for the taxable year in which it is reduced to undisputed possession.” Rev. Rul. 61, 1953–1, Cum. Bull. 17.

The plaintiffs argue that the above ruling does not control this case for two reasons. The first is that subsequent to the Ruling’s pronouncement in 1953, Congress enacted Sections 74 and 102 of the 1954 Code, §74 expressly including the
value of prizes and awards in gross income in most cases, and §102 specifically exempting the value of gifts received from gross income. From this, it is argued that Section 74 was added because prizes might otherwise be construed as non-taxable gifts, and since no such section was passed expressly taxing treasure-trove, it is therefore a gift which is non-taxable under Section 102. This line of reasoning overlooks the statutory scheme previously alluded to, whereby income from all sources is taxed unless the taxpayer can point to an express exemption. Not only have the taxpayers failed to list a specific exclusion in the instant case, but also the Government has pointed to express language covering the found money, even though it would not be required to do so under the broad language of Section 61(a) and the foregoing Supreme Court decisions interpreting it.

* * *

Although not cited by either party, and noticeably absent from the Government’s brief, the following Treasury Regulation appears in the 1964 Regulations, the year of the return in dispute:

“§1.61–14 Miscellaneous items of gross income.

“(a) In general. In addition to the items enumerated in section 61(a), there are many other kinds of gross income * * *. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.”

Identical language appears in the 1968 Treasury Regulations, and is found in all previous years back to 1958. This language is the same in all material respects as that found in Rev. Rul. 61, 53–1, Cum. Bull. 17, and is undoubtedly an attempt to codify that ruling into the Regulations which apply to the 1954 Code. This Court is of the opinion that Treas. Reg. §1.61–14(a) is dispositive of the major issue in this case if the $4,467.00 found in the piano was “reduced to undisputed
possession” in the year petitioners reported it, for this Regulation was applicable to returns filed in the calendar year of 1964.

[The Court then concluded that because Ohio law was silent, the common-law rule of England applied. Under English common law, “title belongs to the finder against all the world except the true owner.” The Court thus concluded that the plaintiffs did not have a right to the property until it was “reduced to undisputed possession in 1964.”]

[The court then concluded that since Ohio law was silent, the common-law rule of England applied. Under English Common Law “title belongs to the finder as against all the world expect the true owner.” The court held that the plaintiff did not have a right to the property until it was “reduced to undisputed possession” in 1969.]

Finally, plaintiffs’ contention that they are entitled to capital gains treatment upon the discovered money must be rejected. While the broad definition of “capital asset” in Section 1221 of Title 26 would on its face cover both the piano and the currency, Section 1222(3) defines long-term capital gains as those resulting from the “sale or exchange of a capital asset * * *.” Aside from the fact that the piano for which plaintiffs paid $15.00 and the $4,467.00 in currency found within it are economically dissimilar, neither the piano nor the currency have been sold or exchanged. The benefits of capital gains treatment in the taxing statutes are not allowed to flow to every gain growing out of a transaction concerning capital assets, but only to gains from the “sale or exchange” of capital assets, and the terms “sale” and “exchange” are to be given ordinary meaning in determining whether capital gains treatment is proper. It has been held that a “sale” in the ordinary sense of the word is a transfer of property for a fixed price in money or its equivalent. Applying the ordinary meaning of the words sale or exchange to the facts of this case, it is readily apparent that neither transaction has occurred, the plaintiffs not having sold or exchanged the piano or the money. They are therefore not entitled to capital gains treatment on the $4,467.00 found inside the piano, but instead incurred tax liability for the sum at ordinary income rates. Since it appears to the Court that the income tax on these taxpayers’ gross income for the calendar year of 1964 has been properly assessed and paid, this taxpayers’ suit for a refund in the amount of $836.51 must be dismissed, and judgment entered for the United States. An order will be entered accordingly.
Chapter 3  The Meaning of “Gross Income”

Ethical Issue

Getting Caught. Were the taxpayers foolish to have included the value of the currency in gross income on their 1964 federal income tax return? Suppose a client informs you of some cash found on the client’s property earlier this year, and the client wants to know whether the cash should be included in the client’s gross income. How would you advise the client? Would your advice change if you knew that only a little more than one percent of all federal income tax returns are subject to a random audit by the Service?

Notes and Questions

1. In both Cesarini and the contractor find discussed above, the find at issue involved cash. Should the tax consequences be different if the find is property? As we explore in the problems below, this became a huge issue when Mark McGwire was about to break Roger Maris’s home run record. The record-breaking ball was thought to be worth at least $1,000,000. For an in-depth and interesting discussion see Lawrence Zelenak and Martin McMahon, Jr., Taxing Baseballs and Other Found Property, 84 Tax Notes 1299 (Aug. 30, 1999)(arguing against taxation of the ball); Joseph M. Dodge, Accessions to Wealth, Realization of Gross Income, and Dominion and Control: Applying the “Claim of Right Doctrine” to Found Objects, including Record-Setting Baseballs, 4 Fla. Tax Rev. 685 (2000).

2. It happened again – or did it? In another baseball story, New York Yankees short stop Derek Jeter reached a baseball milestone by getting 3,000 hits. The baseball was caught by Christian Lopez who gave (returned) the ball to Mr. Jeter. The fan received Yankee’s memorabilia and tickets to future Yankee’s games. Think about the fan when you answer the questions below.

3. The Alternative Argument. Although the taxpayers in Cesarini maintained that they had no gross income from the treasure inside the piano, they argued in the alternative that if the treasure was indeed taxable that it should have been included in gross income on the 1957 tax return. Why do they make this argument? See §6501(a).

Practice Pointer

Facts matter. Read this story from the New York Times. How would you creatively argue that Mr. Lopez was not subject to tax on everything he received from the Yankees?
Problem 3–1

For each of the situations described below, determine whether the taxpayer has gross income and, if so, the amount that should be included in gross income on the taxpayer's federal income tax return.

(a) The taxpayer finds $500 cash in an envelope behind an old appliance in the taxpayer's home.

(b) The taxpayer finds a diamond ring in the attic of the taxpayer's home.

(c) The taxpayer purchases a personal residence and finds a valuable painting left behind in the attic.

(d) In the year after the facts in part (c) occur, the artist who created the painting dies, and the painting increases in value by $10,000.

(e) The taxpayer purchases a piano for $15 at a garage sale, but in fact the piano is a rare collectible worth $10,000.

Problem 3–2

On September 8, 1998, Mark McGwire, the first baseman for the St. Louis Cardinals, hit his 62nd home run of the season, surpassing the single-season home run record established by Roger Maris in 1961. The ball was retrieved by Tim Forneris, a 22 year-old grounds crewman at Busch Stadium. In a ceremony following the game, Forneris stepped up to the microphone and said, “Mr. McGwire, I have something here that belongs to you.” He then handed the ball to McGwire.

We know that Barry Bonds later broke Mark McGwire’s record. Similar questions arose when Bonds broke the record. Since people weren’t buying balls for $1,000,000 when Roger Maris broke the record, we decided to stick with the first person who did so in the modern era.

In the days leading up to the game, several sports memorabilia collectors stated that the record-breaking ball would likely fetch at least $1
Chapter 3 The Meaning of “Gross Income”

million if sold at auction. For his actions, Forneris received a souvenir Rawlings bat and a 1999 red minivan (with a license plate that read “NO 62”) from his employer. He was presented with a key to his home town of Collinsville, Illinois, a free dinner and souvenir items from the All-Star Café in New York City, a free trip to Disney World in Florida, and hundreds of one-dollar bills by mail from baseball fans from around the world.

(a) Do either McGwire or Forneris have gross income based on these facts? If so, how much?

(b) Suppose Forneris kept the ball and placed it in his dresser drawer, never selling the ball despite firm offers of $1 million for the ball. Does Forneris have gross income?

(c) Suppose Forneris keeps the ball, and three years later Barry Bonds breaks McGwire’s record. What are the tax consequences if the value of the ball plummets?

(d) Would the answer to either (a) or (b) be different if Forneris was not an employee of Busch Stadium but instead a fan, like Christian Lopez discussed in note two, who paid admission to sit in the left field bleachers?

Problem 3–3

Seymore Skinner, an elementary school principal, receives free textbooks from publishers. After reviewing the books, Skinner is allowed to keep them for his personal use.

(a) Does Skinner have gross income from the receipt of the books?

(b) How would the answer to (a) change if, upon receipt of the textbooks, Skinner donates them to the school library and claims a charitable contribution deduction on his federal income tax return equal to the value of the books?
(3.) Barter and Imputed Income

Revenue Ruling 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.

See It

We didn’t make this one up. Watch the true story.

Problem 3-4

George and Leslie order steamed clams at a restaurant and pay $10 for the clams.

George bites into one of the clams and hurts his tooth. It turns out that there was a purple pearl in the clam. The pearl was valued at approximately $25,000. What are the tax consequences to George and Leslie?

What’s That?

A revenue ruling is published by the Service and provides taxpayers with information regarding how the Service will treat a situation for federal tax purposes. A revenue ruling is the Service’s view of the correct treatment of a transaction. The Service will not take a position that is contrary to a revenue ruling, and taxpayers may rely on a revenue ruling for purposes of avoiding the imposition of penalties on understatements of income.
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.

Notes and Question

1. More on Revenue Rulings. Taxpayers who seek binding advice from the Internal Revenue Service as to the proper tax treatment of a transaction may, for a fee, request a private ruling from the Service. The ruling binds only the Service and the requesting party; a private ruling may not be cited or relied upon as precedent. The Service may, however, in its discretion, redact the text of a private ruling and issue it as a “revenue ruling,” one that is applicable to all taxpayers. The numbering system for revenue rulings corresponds to the year in which they are issued. Thus, for example, Revenue Ruling 79–24 was the twenty-fourth revenue ruling issued in 1979. Revenue Rulings are published in the weekly Internal Revenue Bulletin (cited “I.R.B.”) and then again semi-annually in the Cumulative Bulletin (cited “C.B.”). The Cumulative Bulletin is generally the preferred source for citing a revenue ruling.

2. How much weight should be placed on a Revenue Ruling? In United States v. Mead Corp., 533 U.S. 218 (2001), the Supreme Court held that a Tariff Classification published by the Secretary of Treasury were entitled to some deference. The Court rejected the notion that Chevron deference would apply, but instead determined that the ruling is “eligible to claim respect according to its persuasiveness.” This type of deference is referred to as “Skidmore deference.”

3. Distinguishing Imputed Income from Barter Exchanges. In Revenue Ruling 79–24, a lawyer had gross income from a barter exchange where the lawyer received painting services in exchange for legal services. If the lawyer had painted his or her own home, however, no gross income would result. This is because so-called imputed income, benefits resulting from a taxpayer’s personal efforts, has never been considered part of the federal income tax base. While imputed income would be taxable if the Haig–Simons definition of income were strictly applied to the federal income tax (because imputed income is either consumed or enhances the taxpayer’s net worth), Congress and the Service apparently recognize the insurmountable practical obstacles inherent in enforcing its taxation. Thus, benefits from growing one’s own garden vegetables, owning one’s own home, or (in the case of a lawyer, at least) writing one’s own will are not subject to taxation.

If, in Situation 1 of the ruling, the lawyer had performed his or her own legal services, and if the painter had painted his or her own home, each would have non-taxable imputed income. Yet the barter exchange between them is taxable. Why? To the extent you have performed services for others in exchange for their services (child care in exchange for home repair, for instance), have you been a delinquent taxpayer?

3. Why did the Service do this? We all exchange services with each other on a regular basis. We carpool, watch a neighbor’s house when they are gone, or invite friends over for dinner. Why did the Service feel the need to publish a revenue ruling on this subject?
Problem 3–5

Henrietta lives in a small cottage and is an expert quilt-maker. Her next door neighbor, X, works in construction and repair. When Henrietta’s roof started leaking, X offered to fix the problem.

(a) Using some basic materials Henrietta already had on hand, X patched the roof. X did not want to charge Henrietta his normal $300 fee for three hours of work, but when she insisted on paying him, X asked for one of Henrietta’s special quilts. Henrietta normally sold her quilts for $300, so she happily made the trade. Do either Henrietta or X have gross income on these facts?

(b) Suppose that X’s normal fee for the services he performed for Henrietta is $500. How does the answer to (a) change?

(c) Assume instead that Henrietta fixed her own roof. Would she have gross income? From a policy perspective, should the answer here be different than the answer in (a)?

Problem 3–6

On the television show “Trading Spaces,” neighbors agree to switch homes for 48 hours and completely redecorate one room in the other’s house. They are assisted by a professional designer and a carpenter. The designer and the neighbors are limited to a budget of $1,000, furnished by the producers of the show.

Suppose that Ricky and Lucy Ricardo, a married couple, agree to appear on the show with their neighbors, Fred and Ethel Mertz, also married. Ricky and Lucy remodeled the kitchen in the Mertz home with the assistance of designer Laurie Hickson-Smith. Meanwhile, Fred and Ethel remodeled the living room in the Ricardo home.

Go Online

Sometimes fact is stranger than fiction. Check out some of the interesting tax issues facing contestants on ABC’s Extreme Makeover.
with the idle assistance of designer Doug Wilson. Amy Wynn Pastor served as the carpenter for both projects.

Because of Laurie's expert eye and good taste, and because of the Herculean efforts of Ricky and Lucy, the Mertz home increased in value by $5,000. On the other hand, Doug's awkward sense of style and penchant for clashing colors caused the value of the Ricardo home to increase by only $1,000, the cost of the materials used to make the "improvements." Without the skills of Amy Wynn, the Ricardo home might have even lost value!

Assuming that Laurie and Doug both charge their normal customers $10,000 for two full days of advice and assistance, what are the federal income tax consequences to Ricky, Lucy, Fred, and Ethel?

(4.) Illegal Income

*James v. United States*

United States Supreme Court, 1961.
366 U.S. 213, 81 S.Ct. 1052, 6 L.Ed.2d 246.

Mr. Chief Justice Warren announced the judgment of the Court and an opinion in which Mr. Justice Brennan, and Mr. Justice Stewart concur.

The issue before us in this case is whether embezzled funds are to be included in the "gross income" of the embezzler in the year in which the funds are misappropriated.

The facts are not in dispute. The petitioner is a union official who, with another person, embezzled in excess of $738,000 during the years 1951 through 1954 from his employer union and from an insurance company with which the union was doing business. Petitioner failed to report these amounts in his gross income in those years and was convicted for willfully attempting to evade the federal income tax due for each of the years 1951 through 1954 in violation of §7201 of the Internal Revenue Code of 1954. He was sentenced to a total of three years' imprisonment. The Court of Appeals affirmed. Because of a conflict with this Court's decision in Commissioner of Internal Revenue v. Wilcox, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752, a case whose relevant facts are concededly the same as those in the case now before us, we granted certiorari.

In Wilcox, the Court held that embezzled money does not constitute taxable income to the embezzler in the year of the embezzlement. Six years later,
this Court held, in Rutkin v. United States, 343 U.S. 130, 72 S.Ct. 571, 96 L.Ed. 833, that extorted money does constitute taxable income to the extortionist in the year that the money is received * * *. In Rutkin, the Court did not overrule Wilcox, but stated:

“We do not reach in this case the factual situation involved in Commissioner of Internal Revenue v. Wilcox, 327 U.S. 404, 66 S.Ct. 546, 90 L.Ed. 752. We limit that case to its facts. There embezzled funds were held not to constitute taxable income to the embezzler under §22(a).”

However, examination of the reasoning used in Rutkin leads us inescapably to the conclusion that Wilcox was thoroughly devitalized.

The basis for the Wilcox decision was “that a taxable gain is conditioned upon (1) the presence of a claim of right to the alleged gain and (2) the absence of a definite, unconditional obligation to repay or return that which would otherwise constitute a gain. Without some bona fide legal or equitable claim, even though it be contingent or contested in nature, the taxpayer cannot be said to have received any gain or profit * * *.” Since Wilcox embezzled the money, held it “without any semblance of a bona fide claim of right,” and therefore “was at all times under an unqualified duty and obligation to repay the money to his employer,” the Court found that the money embezzled was not includible within “gross income.” But, Rutkin’s legal claim was no greater than that of Wilcox. It was specifically found “that petitioner had no basis for his claim * * * and that he obtained it by extortion.” Both Wilcox and Rutkin obtained the money by means of a criminal act; neither had a bona fide claim of right to the funds. Nor was Rutkin’s obligation to repay the extorted money to the victim any less than that of Wilcox. The victim of an extortion, like the victim of an embezzlement, has a right to restitution. Furthermore, it is inconsequential that an embezzler may lack title to the sums he appropriates while an extortionist may gain a voidable title. Questions of federal income taxation are not determined by such “attenuated subtleties.” Thus, the fact that Rutkin secured the money with the consent of his victim * * * is irrelevant. Likewise unimportant is the fact that the sufferer of an extortion is less likely to seek restitution than one whose funds are embezzled. What is important is that the right to recoulement exists in both situations.

* * *

It had been a well-established principle, long before either Rutkin or Wilcox, that unlawful, as well as lawful, gains are comprehended within the term “gross income.” Section II B of the Income Tax Act of 1913 provided that “the net income of a taxable person shall include gains, profits, and income * * * from * * * the transaction of any lawful business carried on for gain or profit, or gains or
profits and income derived from any source whatever * * *.” When the statute
was amended in 1916, the one word “lawful” was omitted. This revealed, we
think, the obvious intent of that Congress to tax income derived from both legal
and illegal sources, to remove the incongruity of having the gains of the honest
laborer taxed and the gains of the dishonest immune. Thereafter, the Court held
that gains from illicit traffic in liquor are includible within “gross income.” And,
the Court has pointed out, with approval, that there “has been a widespread and
settled administrative and judicial recognition of the taxability of unlawful gains
of many kinds.” * * *

The starting point in all cases dealing with the question of the scope of what
is included in “gross income” begins with the basic premise that the purpose of
Congress was “to use the full measure of its taxing power.” And the Court has
given a liberal construction to the broad phraseology of the “gross income” definitio-

n statutes in recognition of the intention of Congress to tax all gains except
those specifically exempted. The language of * * * §61(a) of the 1954 Code, “all
income from whatever source derived,” [has] been held to encompass all “acces-
sions to wealth, clearly realized, and over which the taxpayers have complete
dominion.” Commissioner of Internal Revenue v. Glenshaw Glass Co., 348 U.S. 426,
431, 75 S.Ct. 473, 477, 99 L.Ed. 483. A gain “constitutes taxable income when
its recipient has such control over it that, as a practical matter, he derives read-
ily realizable economic value from it.” Rutkin v. United States, supra, 343 U.S. at
page 137, 72 S.Ct. at page 575. Under these broad principles, we believe that
petitioner’s contention, that all unlawful gains are taxable except those resulting
from embezzlement, should fail.

When a taxpayer acquires earnings, lawfully or unlawfully, without the consen-
sual recognition, express or implied, of an obligation to repay and without
restriction as to their 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 equiva-

at page 615. In such case, the taxpayer has “actual command over the property
taxed—the actual benefit for which the tax is paid.” This standard brings wrongful
appropriations within the broad sweep of “gross income;” it excludes loans. When
a law-abiding taxpayer mistakenly receives income in one year, which receipt is
assailed and found to be invalid in a subsequent year, the taxpayer must nonev-
less report the amount as “gross income” in the year received. We do not believe
that Congress intended to treat a law-breaking taxpayer differently. Just as the
honest taxpayer may deduct any amount repaid in the year in which the repay-
ment is made, the Government points out that, “If, when, and to the extent that
the victim recovers back the misappropriated funds, there is of course a reduction
in the embezzler’s income.” Brief for the United States, p. 24.

* * *
We believe that Wilcox was wrongly decided and we find nothing in congressional history since then to persuade us that Congress intended to legislate the rule. Thus, we believe that we should now correct the error and the confusion resulting from it, certainly if we do so in a manner that will not prejudice those who might have relied on it. We should not continue to confound confusion, particularly when the result would be to perpetuate the injustice of relieving embezzlers of the duty of paying income taxes on the money they enrich themselves with through theft while honest people pay their taxes on every conceivable type of income.

But, we are dealing here with a felony conviction under statutes which apply to any person who “willfully” fails to account for his tax or who “willfully” attempts to evade his obligation. Willfulness “involves a specific intent which must be proven by independent evidence and which cannot be inferred from the mere understatement of income.” *Holland v. United States*, 348 U.S. 121, 139, 75 S.Ct. 127, 137, 99 L.Ed. 150.

We believe that the element of willfulness could not be proven in a criminal prosecution for failing to include embezzled funds in gross income in the year of misappropriation so long as the statute contained the gloss placed upon it by Wilcox at the time the alleged crime was committed. Therefore, we feel that petitioner's conviction may not stand and that the indictment against him must be dismissed.

Since Mr. Justice Harlan, Mr. Justice Frankfurter, and Mr. Justice Clark agree with us concerning Wilcox, that case is overruled. Mr. Justice Black, Mr. Justice Douglas, and Mr. Justice Whittaker believe that petitioner's conviction must be reversed and the case dismissed for the reasons stated in their opinions.

Accordingly, the judgment of the Court of Appeals is reversed and the case is remanded to the District Court with directions to dismiss the indictment.

It is so ordered.

Reversed and remanded with directions.

* * *

Mr. Justice Whittaker, whom Mr. Justice Black and Mr. Justice Douglas join, concurring in part and dissenting in part.

* * * The language of the Sixteenth Amendment as well as our prior controlling decisions, compels me to conclude that the question now before us—whether an embezzler receives taxable income at the time of his unlawful taking—must be
answered negatively. Since the prevailing opinion reaches an opposite conclusion, I must respectfully dissent from that holding, although I concur in the Court's judgment reversing petitioner's conviction. I am convinced that Commissioner of Internal Revenue v. Wilcox, which is today overruled, was correctly decided on the basis of every controlling principle used in defining taxable income since the sixteenth Amendment's adoption.

The Chief Justice's opinion, although it correctly recites Wilcox's holding that "embezzled money does not constitute taxable income to the embezzler in the year of the embezzlement," fails to explain or to answer the true basis of that holding. Wilcox did not hold that embezzled funds may never constitute taxable income to the embezzler. To the contrary, it expressly recognized that an embezzler may realize a taxable gain to the full extent of the amount taken, if an when it ever becomes his. The applicable test of taxable income, i.e., the "presence of a claim of right to the alleged gain," of which Wilcox spoke, was but a correlative statement of the factor upon which the decision placed its whole emphasis throughout, namely, the "absence of a definite, unconditional obligation to repay or return (the money)." In holding that this test was not met at the time of the embezzlement, the Wilcox opinion repeatedly stressed that the embezzler had no "bona fide legal or equitable claim" to the embezzled funds; that the victim never "condoned or forgave the taking of the money and still holds him liable to restore it;" and that the "debtor-creditor relationship was definite and unconditional." These statements all express the same basic fact—the fact which is emphasized most strongly in the opinion's conclusion explaining why the embezzler had not yet received taxable income: "Sanctioning a tax under the circumstances before us would serve only to give the United States an unjustified preference as to part of the money which rightfully and completely belongs to the taxpayer's employer."

However, Wilcox plainly stated that "if the unconditional indebtedness is cancelled or retired taxable income may adhere, under certain circumstances, to the taxpayer." More specifically, it recognized that had the embezzler's victim "condoned or forgiven any part of the (indebtedness), the (embezzler) might have been subject to tax liability to that extent," in the tax year of such forgiveness.

* * *

An embezzler, like a common thief, acquires not a semblance of right, title, or interest in his plunder, and whether he spends it or not, he is indebted to his victim in the full amount taken as surely as if he had left a signed promissory note at the scene of the crime. Of no consequence from any standpoint is the absence of such formalities as (in the words of the prevailing opinion) "the consensual recognition, express or implied, or an obligation to repay." The law readily implies whatever "consensual recognition" is needed for the rightful owner to assert an
immediately ripe and enforceable obligation of repayment against the wrongful take. These principles are not “attenuated subtleties” but are among the clearest and most easily applied rules of our law. They exist to protect the rights of the innocent victim, and we should accord them full recognition and respect.

The fact that an embezzler’s victim may have less chance of success than other creditors in seeking repayment from his debtor is not a valid reason for us further to diminish his prospects by adopting a rule that would allow the Commissioner of Internal Revenue to assert and enforce a prior federal tax lien against that which “rightfully and completely belongs” to the victim. The Chief Justice’s opinion quite understandably expresses much concern for “honest taxpayers,” but it attempts neither to deny nor justify the manifest injury that its holding will inflict on those honest taxpayers, victimized by embezzlers, who will find their claims for recovery subordinated to federal tax liens. Statutory provisions, by which we are bound, clearly and unequivocally accord priority to federal tax liens over the claims of others, including “judgment creditors.”

* * *

B. Compensation for Services

(1.) Payments to Third Parties


Section 61(a)(1) specifically provides that all forms of compensation for services must be included in gross income. In most cases, compensation is received by the taxpayer directly from the party for whom the services were performed.
But taxable compensation does not necessarily need to be received directly by the taxpayer, as the following cases illustrate.

Old Colony Trust Co. v. Commissioner
United States Supreme Court, 1929.
279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918.

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

* * *

* * * The petitioners are the executors of the will of William M. Wood, deceased. On June 27, 1925, before Mr. Wood’s death, the Commissioner of Internal Revenue notified him by registered mail of the determination of a deficiency in income tax against him for the years 1919 and 1920 * * *.

The facts certified to us are substantially as follows:

William M. Wood was president of the American Woolen Company during the years 1918, 1919, and 1920. In 1918 he received as salary and commissions from the company $978,725, which he included in his federal income tax return for 1918. In 1919 he received as salary and commissions from the company $548,132.87, which he included in his return for 1919.

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

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

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

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

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

<table>
<thead>
<tr>
<th>Year and Period</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxes for 1918 paid in 1919</td>
<td>$681,169.88</td>
</tr>
<tr>
<td>Taxes for 1919 paid in 1920</td>
<td>$351,179.27</td>
</tr>
</tbody>
</table>

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

The question certified by the Circuit Court of Appeals for answer by this Court is: “Did the payment by the employer of the income taxes assessable against the employee constitute additional taxable income to such employee?”

* * *

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

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

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

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

**McCann v. United States**

*United States Court of Claims, 1981.*

81–2 USTC para. 9689.

PER CURIAM

Opinion

**Make the Connection**

This case was filed in the United States Court of Claims. Remember from the Introduction that the Court of Claims is one of three different courts where a taxpayer can dispute a tax liability. In Tax Court the taxpayer does not need to pay first and then seek a refund. In District Court and the Court of Claims, the taxpayer must pay first and then sue for a refund.
other expenses of Mr. and Mrs. McCann in connection with attendance at the Las Vegas seminar were paid by Security.

In filing their joint income tax return for 1973, the McCanns did not include in their gross income any amount reflecting the cost to Security of paying the McCanns’ expenses on the Las Vegas trip.

The Internal Revenue Service, upon auditing the McCanns’ 1973 income tax return, decided that the fair market value of the Las Vegas trip should have been included in the McCanns’ gross income, determined the amount of the fair market value of the trip, and issued a deficiency notice.

Mr. and Mrs. McCann paid the deficiency, amounting to $199.16, plus accrued interest of $64.97.

Thereafter, the McCanns filed a claim for refund; and, when relief from the Internal Revenue Service was not forthcoming, the McCanns instituted the present litigation.

Security is engaged in the sale of life, burial, and accident insurance. Security’s best-selling policy is a burial policy with a face amount of $600, which provides merchandise and services necessary for a complete funeral at one of the several funeral homes with which Security has contractual relationships. Many of Security’s policyholders are religious people who live in rural areas of Louisiana.

* * *

Ever since 1950, Security has sponsored what is commonly referred to as an annual sales seminar at some place outside the State of Louisiana. These seminars have been held in (among other places): Biloxi, Mississippi; Miami Beach, Florida; Washington, D. C.; New York, New York; San Francisco, California; Houston, Texas; Atlanta, Georgia; Las Vegas, Nevada; and Mexico City, Mexico. The purpose and format of the seminars have been the same through the years.

An agent qualifies to attend a seminar if he or she achieved a specified net increase in sales during the preceding calendar year. The required net increase was $600 for a number of years, including the year involved in the McCann case, but the qualification standard was later raised, when the inflationary cycle hit the country.

* * *

Each agent, staff manager, or district manager who qualifies to attend a seminar is entitled to take along his or her spouse, or another family member. An employee who doubles the qualification requirement for attendance at a seminar
is entitled to take along, in addition to the person mentioned in the preceding sentence, one guest couple; and if the qualification requirement is tripled, the employee is entitled to take along two guest couples. All travel and other expenses of employees and their guests attending seminars are paid by Security. However, agents and other employees who qualify for seminars are not required to attend; and their promotional opportunities are not adversely affected if they fail to attend.

Security emphasizes the pleasure aspects of seminars. The company schedules sightseeing tours; furnishes participants with lists of tennis courts and golf courses at, and descriptive travel brochures concerning, seminar sites; and chooses locations which (in the opinion of the company) will have “excitement” and “charisma” for qualifying employees. New Orleans, Louisiana, has never been chosen as a seminar site because of the familiarity of company personnel with New Orleans.

* * * A total of 74 of Security’s employees qualified to attend the seminar in Las Vegas. This total included 47 agents, or 11.7 percent of the 400 agents employed by the company in 1973. A total of 66 employees, out of the 74 who qualified, actually attended the seminar in Las Vegas; and the number attending included 40 agents, out of the 47 who qualified.

The total cost to Security of the Las Vegas seminar amounted to $68,116.96. This amount included all the expenses (airfare, lodging, meals, cocktail parties, sightseeing tours, shows, local transportation, and gratuities) of each individual who attended the seminar.

As previously indicated, Mr. and Mrs. McCann attended the Las Vegas seminar in 1973. Mrs. McCann qualified for attendance by achieving the required net increase in sales during the calendar year 1972; and Mr. McCann went along as her guest in accordance with Security’s policy of permitting a qualifying employee to take along a spouse or other family member. All the travel and other expenses of Mr. and Mrs. McCann were paid by Security.

As the program for the seminar in Las Vegas was typical of the programs at other seminars sponsored by Security, it will be outlined in some detail.

The official program for the Las Vegas seminar began with a cocktail party at 5:00 p.m. on June 17, 1973. Senior officers of Security and their spouses greeted the other participants at the door. The cocktail party was followed by a dinner of prime ribs, served with wine. E. J. Ourso, president and chief executive officer of Security, delivered a welcoming address; and housekeeping announcements were made. The dinner was followed by a show at the Circus Maximus, featuring singer Diana Ross and “topless” dancers. The remainder of the evening was free time. Some of the participants went to a second show, but the younger participants spent the free time in dancing, drinking, and carousing.
On June 18, there was a group breakfast at 8:00 a.m. There was no formal program at the breakfast; and only housekeeping announcements (such as those relating to lost baggage, the location of certain rooms, and the agenda for the day) were made. The breakfast was followed by a business meeting from 9 to 11 a.m. This meeting featured a panel discussion, the panel being composed of leading agents and one spouse and being moderated by a district manager. The panel discussion was followed by a question-and-answer session and concluding remarks by Mr. Ourso. Employees of Security, but not their guests, were required to attend the business meeting. The business meeting was followed by lunch and a trip to Boulder Dam in the afternoon. At 5:30 p.m. there was a cocktail party and group meeting at the Dunes, followed by dinner and a stage show, “Casino de Paris,” which featured “topless” dancers. Alcoholic beverages were served at the dinner and show.

On June 19, there was a group meeting and breakfast at 9:00 a.m.; and this was followed by free time until 11:00 a.m. (the program suggested that the free time be spent “sunning in the Garden of the Gods, playing tennis, or just relaxing”). Lunch was held from 11:00 a.m. to 12:00 noon. There was no formal program at either breakfast or lunch; and only housekeeping announcements were made. Lunch was followed by a tour of the Mint Hotel beginning at 2:00 p.m. At 6:00 p.m., there was a “Farewell to Las Vegas” cocktail party and group meeting. There was no formal program at this function. A banquet was held beginning at 7:00 p.m., and wine was served with the dinner. Mr. Ourso made a speech, reviewing the activities of the company during the preceding year, and then he bestowed an award on each agent, staff manager, and district manager in attendance. The banquet concluded with a guest speaker, an attorney for Security, who spoke of his pride in being associated with the company.

The first question to be decided is whether, as determined by the Internal Revenue Service, the McCanns should have included in their 1973 income tax return, as part of their gross income, an amount based upon the cost to Security of defraying their travel and other expenses on the trip to Las Vegas.

* * *
The all-expenses trip to Las Vegas—with its airfare, lodging, meals, cocktails, sightseeing tours, shows, local transportation, and gratuities—which Mr. and Mrs. McCann received from Security was obviously an economic benefit to them. Moreover, they received this benefit as a reward for Mrs. McCann's good work in increasing her net sales by a specified amount during the preceding calendar year (1972). Only 47 agents, out of 400 agents employed by Security, qualified for the 1973 seminar in Las Vegas by achieving the required net increase in sales during 1972. The 47 agents (or so many of them as wished to make the trip) were rewarded by receiving from Security the all-expenses trip to Las Vegas for themselves and their spouses, or other family members. The 353 agents who failed to achieve the specified net increase in sales during 1972 did not receive the reward.

Therefore, the reward to Mrs. McCann, although not in the form of money, was clearly compensation to her for the services that she had rendered to Security during 1972, and was within the meaning of income, as that term is used in 26 U.S.C. §61(a).

It should also be noted that 26 U.S.C. §74(a) specifically provides that “gross income includes amounts received as prizes and awards.” It has been concluded previously in the opinion that the Las Vegas trip which Mr. and Mrs. McCann received from Security was a reward to Mrs. McCann for her good work during 1972. In other words, it was an award given by Security to Mrs. McCann for a job well done, and, therefore, constituted part of the McCanns’ gross income under 26 U.S.C. §74(a).

When services are paid for in a form other than in money, it is necessary to determine the fair market value of the thing received. Treas. Reg. §1.61–2(d)(1).

In the present case, the Internal Revenue Service decided that the fair market value of the Las Vegas trip which Mr. and Mrs. McCann received from Security was equivalent to the cost of the trip to Security. At the trial, the plaintiff did not introduce any evidence challenging the correctness of the administrative determination on this point. Accordingly, in view of the presumption of legality which supports official administrative actions * * *, the determination of the Internal Revenue Service concerning the fair market value of the Las Vegas trip which Mr. and Mrs. McCann received from Security will be accepted by the court as correct.

Then Governor and Vice-Presidential candidate Sarah Palin came under fire for amounts paid by the State of Alaska for travel for her husband and children. She failed to include allowances for their travel in income. Later she was criticized for not including $150,000 in clothes she received from the Republican National Committee. We will discuss clothes later in this Chapter, but high ranking public
employees often have a difficult time separating their public and private lives. A governor’s family may be a legitimate part of helping a governor succeed, and we certainly wouldn’t want to tax the President on Secret Service protection for his or her children, or tax him or her on the expense to drive them to school. Should public employees with incomes under $200,000 really be taxed on these types of expenditures? If not, what would be the authority for excluding them? See if this next case helps you at all.

United States v. Gotcher

United States Court of Appeals, Fifth Circuit, 1968.
401 F.2d 118.

THORNBERRY, Circuit Judge.

In 1960, Mr. and Mrs. Gotcher took a twelve-day expense-paid trip to Germany to tour the Volkswagen facilities there. The trip cost $1,372.30. His employer, Economy Motors, paid $348.73, and Volkswagen of Germany and Volkswagen of America shared the remaining $1,023.53. Upon returning, Mr. Gotcher bought a twenty-five percent interest in Economy Motors, the Sherman, Texas Volkswagen dealership, that had been offered to him before he left. Today he is President of Economy Motors in Sherman and owns fifty percent of the dealership. Mr. and Mrs. Gotcher did not include any part of the $1,372.30 in their 1960 income. The Commissioner determined that the taxpayers had realized income to the extent of the $1,372.30 for the expense-paid trip and asserted a tax deficiency of $356.79, plus interest. Taxpayers paid the deficiency, plus $82.29 in interest, and thereafter timely filed suit for a refund. The district court, sitting without a jury, held that the cost of the trip was not income or, in the alternative, was income and deductible as an ordinary and necessary business expense. We affirm the district court’s determination that the cost of the trip was not income to Mr. Gotcher ($686.15); however, Mrs. Gotcher’s expenses ($686.15) constituted income and were not deductible.

Section 61 of the Internal Revenue Code of 1954 (hereinafter referred to by section number only) defines gross income as income from whatever source derived and specifically includes fifteen items within this definition. The court below reasoned that the cost of the trip to the Gotchers was not income because an economic or financial benefit does not constitute income under section 61 unless it is conferred as compensation for services rendered. This conception of gross income is too restrictive since it is well-settled that section 61 should be broadly interpreted and that many items, including noncompensatory gains, constitute gross income.
Sections 101–123 specifically exclude certain items from gross income. Appellant argues that the cost of the trip should be included in income since it is not specifically excluded by sections 101–123, reasoning that Section 61 was drafted broadly to subject all economic gains to tax and any exclusions should be narrowly limited to the specific exclusions. This analysis is too restrictive since it has been generally held that exclusions from gross income are not limited to the enumerated exclusions. * * *

In determining whether the expense-paid trip was income within section 61, we must look to the tests that have been developed under this section. The concept of economic gain to the taxpayer is the key to section 61. H. Simons, Personal Income Taxation 51 (1938); J. Sneed, The Configurations of Gross Income 8 (1967). This concept contains two distinct requirements: There must be an economic gain, and this gain must primarily benefit the taxpayer personally. In some cases, as in the case of an expense-paid trip, there is no direct economic gain, but there is an indirect economic gain inasmuch as a benefit has been received without a corresponding diminution in wealth. Yet even if expense-paid items, as meals and lodging, are received by the taxpayer, the value of these items will not be gross income, even though the employee receives some incidental benefit, if the meals and lodging are primarily for the convenience of the employer. 

* * *

The trip was made in 1959 when VW was attempting to expand its local dealerships in the United States. The “buy American” campaign and the fact that the VW people felt they had a “very ugly product” prompted them to offer these tours of Germany to prospective dealers. The VW story was related by Mr. Horton, who is Manager of Special Events for VW of America. His testimony was uncontradicted and unimpeached. He stated that VW operations were at first so speculative that cars had to be consigned with a repurchase guarantee. In 1959, when VW began to push for its share of the American market, its officials determined that the best way to remove the apprehension about this foreign product was to take the dealer to Germany and have him see his investment first-hand. It was believed that once the dealer saw the manufacturing facilities and the stability of the “new Germany” he would be convinced that VW was for him. Furthermore, VW considered the expenditure justified because the dealer was being asked to make a substantial investment of his time and money in a comparatively new product. Indeed, after taking the trip, VW required him to acquire first-class facilities. It was hoped that this would be accomplished by following the international architectural plans that VW had for its dealerships. It was also hoped that the dealer would adopt VW’s international plan for the sales and services department. Mr. Horton testified that VW could not have asked that this upgrading be done unless it convinced the dealer that VW was here to stay. Apparently these trips have paid off since VW’s sales have skyrocketed and the dealers have made their facilities top-rate operations under the VW requirements for a standard dealership.
Chapter 3 The Meaning of “Gross Income”

The activities in Germany support the conclusion that the trip was oriented to business. The Government makes much of the fact that the travel brochure allocated only two of the twelve days to the touring of VW factories. This argument ignores the uncontradicted evidence that not all of the planned activities were in the brochure. There is ample support for the trial judge’s finding that a substantial amount of time was spent touring VW facilities and visiting local dealerships. VW had set up these tours with local dealers so that the travelers could discuss how the facilities were operated in Germany. Mr. Gotcher took full advantage of this opportunity and even used some of his “free time” to visit various local dealerships. Moreover, at almost all of the evening meals VW officials gave talks about the organization and passed out literature and brochures on the VW story.

Some of the days were not related to touring VW facilities, but that fact alone cannot be decisive. The dominant purpose of the trip is the critical inquiry and some pleasurable features will not negate the finding of an overall business purpose. Since we are convinced that the agenda related primarily to business and that Mr. Gotcher’s attendance was prompted by business considerations, the so-called sightseeing complained of by the Government is inconsequential. Indeed, the district court found that even this touring of the countryside had an indirect relation to business since the tours were not typical sightseeing excursions but were connected to the desire of VW that the dealers be persuaded that the German economy was stable enough to justify investment in a German product. We cannot say that this conclusion is clearly erroneous. Nor can we say that the enthusiastic literary style of the brochures negates a dominant business purpose. It is the business reality of the total situation, not the colorful expressions in the literature, that controls. Considering the record, the circumstances prompting the trip, and the objective achieved, we conclude that the primary purpose of the trip was to induce Mr. Gotcher to take out a VW dealership interest.

The question, therefore, is what tax consequences should follow from an expense-paid trip that primarily benefits the party paying for the trip. In several analogous situations the value of items received by employees has been excluded from gross income when these items were primarily for the benefit of the employer. Section 119 excludes from gross income of an employee the value
of meals and lodging furnished to him for the convenience of the employer. Even
before these items were excluded by the 1954 Code, the Treasury and the courts
recognized that they should be excluded from gross income. Thus it appears that
the value of any trip that is paid by the employer or by a businessman primarily
for his own benefit should be excluded from gross income of the payee on similar
reasoning.

In the recent case of *Allen J. McDonell*, 26 T.C.M. 115, Tax Ct. Mem. 1967–18,
a sales supervisor and his wife were chosen by lot to accompany a group of contest
winners on an expense-paid trip to Hawaii. In holding that the taxpayer had
received no income, the Tax Court noted that he was required by his employer to
go and that he was serving a legitimate business purpose though he enjoyed the
trip. The decision suggests that in analyzing the tax consequences of an expense-
paid trip one important factor is whether the traveler had any choice but to go.
Here, although taxpayer was not forced to go, there is no doubt that in the reality
of the business world he had no real choice. The trial judge reached the same
conclusion. He found that the invitation did not specifically order the dealers to
go, but that as a practical matter it was an order or directive that if a person was
going to be a VW dealer, sound business judgment necessitated his accepting
the offer of corporate hospitality. So far as Economy Motors was concerned, Mr.
Gotcher knew that if he was going to be a part-owner of the dealership, he had
better do all that was required to foster good business relations with VW. Besides
having no choice but to go, he had no control over the schedule or the money
spent. VW did all the planning. In cases involving noncompensatory economic
gains, courts have emphasized that the taxpayer still had complete dominion
and control over the money to use it as he wished to satisfy personal desires or
needs. Indeed, the Supreme Court has defined income as accessions of wealth
over which the taxpayer has complete control. Clearly, the lack of control works
in taxpayer's favor here.

*McDonell* also suggests that one does not realize taxable income when he is
serving a legitimate business purpose of the party paying the expenses. The cases
involving corporate officials who have traveled or entertained clients at the com-
pany's expense are apposite. Indeed, corporate executives have been furnished
yachts, taken safaris as part of an advertising scheme, and investigated business
ventures abroad, but have been held accountable for expenses paid only when the
court was persuaded that the expenditure was primarily for the officer's personal
pleasure. On the other hand, when it has been shown that the expenses were paid
to effectuate a legitimate corporate end and not to benefit the officer personally,
the officer has not been taxed though he enjoyed and benefited from the activity.
Thus, the rule is that the economic benefit will be taxable to the recipient only
when the payment of expenses serves no legitimate corporate purpose. The deci-
sions also indicate that the tax consequences are to be determined by looking
to the primary purpose of the expenses and that the first consideration is the
intention of the payor. The Government in argument before the district court agreed that whether the expenses were income to taxpayers is mainly a question of the motives of the people giving the trip. Since this is a matter of proof, the resolution of the tax question really depends on whether Gotcher showed that his presence served a legitimate corporate purpose and that no appreciable amount of time was spent for his personal benefit and enjoyment. See United Aniline Co., 1962, 21 T.C.M. 327.

Examination of the record convinces us that the personal benefit to Gotcher was clearly subordinate to the concrete benefits to VW. The purpose of the trip was to push VW in America and to get the dealers to invest more money and time in their dealerships. Thus, although Gotcher got some ideas that helped him become a better dealer, there is no evidence that this was the primary purpose of the trip. Put another way, this trip was not given as a pleasurable excursion through Germany or as a means of teaching taxpayer the skills of selling. He had been selling cars since 1949. The personal benefits and pleasure were incidental to the dominant purpose of improving VW’s position on the American market and getting people to invest money.

The corporate-executive decisions indicate that some economic gains, though not specifically excluded from section 61, may nevertheless escape taxation. They may be excluded even though the entertainment and travel unquestionably give enjoyment to the taxpayer and produce indirect economic gains. When this indirect economic gain is subordinate to an overall business purpose, the recipient is not taxed. We are convinced that the personal benefit to Mr. Gotcher from the trip was merely incidental to VW’s sales campaign.

As for Mrs. Gotcher, the trip was primarily a vacation. She did not make the tours with her husband to see the local dealers or attend discussions about the VW organization. This being so the primary benefit of the expense-paid trip for the wife went to Mr. Gotcher in that he was relieved of her expenses. He should therefore be taxed on the expenses attributable to his wife. Nor are the expenses deductible since the wife’s presence served no bona fide business purpose for her husband. Only when the wife’s presence is necessary to the conduct of the husband’s business are her expenses deductible under section 162. Also, it must be shown that the wife made the trip only to assist her husband in his business. A single trip by a wife with her husband to Europe has been specifically rejected as not being the exceptional type of case justifying a deduction.

Affirmed in part; reversed in part.

**John R. Brown, Chief Judge (concurring):**

I concur in the result and in the opinion. * * *
Attributing income to the little wife who was neither an employee, a prospective employee, for the value of a trip she neither planned nor chose still bothers me. If her uncle had paid for the trip, would it not have been a pure gift, not income? Or had her husband out of pure separate property given her the trip would the amount over and above the cost of Texas bed and board have been income? I acquiesce now, confident that for others in future cases on a full record the wife, as now does the husband, also will overcome.

* * *

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**Problem 3–7**

Skipper owes Gilligan $2,000 for services Gilligan performed in repairing Skipper’s boat, the S.S. Minnow. Skipper takes Thurston and Lovey (a married couple) out for a three-hour tour on the Minnow. Skipper normally charges $2,000 for a three-hour boat tour, so he asks Thurston and Lovey to pay the $2,000 to Gilligan (and not to Skipper). The couple does so. Who has gross income under these facts, and how much?

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**(2.) Meals and Lodging Furnished on Employer’s Premises**

**Code:** IRC §119(a)–(b)(4), (d).

**Regs:** Treas. Reg. §1.119–1.

Some forms of compensation, while generally includible in gross income under §61(a)(1), are nonetheless excluded from gross income by operation of a specific statutory provision. Most exclusions are set forth in §§101–139. **Section 119(a),** for instance, excludes both meals and lodging furnished to employees (or
their spouses or dependents) if certain conditions are met. A careful reading of §119(a) shows the several elements that must be present for exclusion:

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<td>• employee required to accept as a condition of employment</td>
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Although the individual elements of §119(a) are easy to tease out of the statute, there are some complicated issues of construction, as the following cases show.

**Commissioner v. Kowalski**

United States Supreme Court, 1977. 434 U.S. 77, 98 S.Ct. 315, 54 L.Ed.2d 252.

Mr. Justice Brennan delivered the opinion of the Court.

This case presents the question whether cash payments to state police troopers, designated as meal allowances, are included in gross income under §61(a) of the Internal Revenue Code * * * and, if so, are otherwise excludable under §119 of the Code.

The pertinent facts are not in dispute. Respondent is a state police trooper employed by the Division of State Police of the Department of Law and Public Safety of the State of New Jersey. During 1970, the tax year in question, he received a base salary of $8,739.38, and an additional $1,697.54 designated as an allowance for meals.

The State instituted the cash meal allowance for its state police officers in July 1949. Prior to that time, all troopers were provided with mid-shift meals in kind at various meal stations located throughout the State. A trooper unable to eat at an official meal station could, however, eat at a restaurant and obtain reimbursement. The meal-station system proved unsatisfactory to the State because it required troopers to leave their assigned areas of patrol unguarded for extended periods of time. As a result, the State closed its meal stations and instituted a cash-allocation system. Under this system, troopers remain on call in their assigned patrol areas during their mid-shift break. Otherwise, troopers are not restricted in any way
with respect to where they may eat in the patrol area and, indeed, may eat at home if it is located within that area. Troopers may also bring their mid-shift meal to the job and eat it in or near their patrol cars.

The meal allowance is paid biweekly in advance and is included, although separately stated, with the trooper's salary. The meal-allowance money is also separately accounted for in the State's accounting system. Funds are never commingled between the salary and meal-allowance accounts. Because of these characteristics of the meal-allowance system, the Tax Court concluded that the "meal allowance was not intended to represent additional compensation."

Notwithstanding this conclusion, it is not disputed that the meal allowance has many features inconsistent with its characterization as a simple reimbursement for meals that would otherwise have been taken at a meal station. For example, troopers are not required to spend their meal allowances on their midshift meals, nor are they required to account for the manner in which the money is spent. With one limited exception not relevant here, no reduction in the meal allowance is made for periods when a trooper is not on patrol because, for example, he is assigned to a headquarters building or is away from active duty on vacation, leave, or sick leave. In addition, the cash allowance for meals is described on a state police recruitment brochure as an item of salary to be received in addition to an officer's base salary and the amount of the meal allowance is a subject of negotiations between the State and the police troopers' union. Finally, the amount of an officer's cash meal allowance varies with his rank and is included in his gross pay for purposes of calculating pension benefits.

On his 1970 income tax return, respondent reported $9,066 in wages. That amount included his salary plus $326.45 which represented cash meal allowances * * *. The remaining amount of meal allowance, $1,371.09, was not reported. On audit, the Commissioner determined that this amount should have been included in respondent's 1970 income and assessed a deficiency.

Respondent sought review in the United States Tax Court, arguing that the cash meal allowance was not compensatory but was furnished for the convenience of the employer and hence was not "income" within the meaning of §61(a) and that, in any case the allowance could be excluded under §119. In a reviewed decision, the Tax Court, with six dissents, held that the cash meal payments were income within the meaning of §61 and, further that such payments were not excludable under §119. The Court of Appeals for the Third Circuit, in a per curiam opinion, held that its earlier decision in Saunders v. Commissioner of Internal Revenue, 215 F.2d 768 (1954), which determined that cash payments under the New Jersey meal-allowance program were not taxable, required reversal. We granted certiorari to resolve a conflict among the Courts of Appeals on the question. We reverse.
II

A

The starting point in the determination of the scope of “gross income” is the cardinal principle that Congress in creating the income tax intended “to use the full measure of its taxing power.” * * * In the absence of a specific exemption, therefore, respondent’s meal-allowance payments are income within the meaning of §61 since, like the payments involved in Glenshaw Glass Co., the payments are “undeniable[y] accessions to wealth, clearly realized, and over which the [respondent has] complete dominion.”

Respondent contends, however, that §119 can be construed to be a specific exemption covering the meal-allowance payments to New Jersey troopers. Alternatively, respondent argues that notwithstanding §119 a specific exemption may be found in a line of lower-court cases and administrative rulings which recognize that benefits conferred by an employer on an employee “for the convenience of the employer”—at least when such benefits are not “compensatory”—are not income within the meaning of the Internal Revenue Code. In responding to these contentions, we turn first to §119. Since we hold that §119 does not cover cash payments of any kind, we then trace the development over several decades of the convenience-of-the-employer doctrine as a determinant of the tax status of meals and lodging, turning finally to the question whether the doctrine as applied to meals and lodging survives the enactment of the Internal Revenue Code of 1954.

B

Section 119 provides that an employee may exclude from income “the value of any meals * * * furnished to him by his employer for the convenience of the employer, but only if * * * the meals are furnished on the business premises of the employer * * *.” By its terms, §119 covers meals furnished by the employer and not cash reimbursements for meals. This is not a mere oversight. As we shall explain at greater length below, the form of §119 which Congress enacted originated in the Senate and the Report accompanying the Senate bill is very clear: “Section 119 applies only to meals or lodging furnished in kind.” S. Rep. No. 1622, 83d Cong., 2d Sess., 190 (1954). See also Treas. Reg. §1.119–1(c)(2). Accordingly, respondent’s meal-allowance payments are not subject to exclusion under §119.

C

The convenience-of-the-employer doctrine is not a tidy one. * * * [The Court’s extended summary of the doctrine is omitted. Ed.]
Even if we assume that respondent's meal-allowance payments could have been excluded from income under the [common law “convenience of the employer” doctrine], we must nonetheless inquire whether such an implied exclusion survives the 1954 recodification of the Internal Revenue Code. * * *

In enacting §119, the Congress was determined to “end the confusion as to the tax status of meals and lodging furnished an employee by his employer.” However, the House and Senate initially differed on the significance that should be given the convenience-of-the-employer doctrine for the purposes of §119. As explained in its Report, [H.R. Rep. No. 83-1337, 4042 VII(I), 1954 WL 6063], the House proposed to exclude meals from gross income “if they [were] furnished at the place of employment and the employee [was] required to accept them at the place of employment as a condition of his employment.” Since no reference whatsoever was made to the concept, the House view apparently was that a statute “designed to end the confusion as to the tax status of meals and lodging furnished an employee by his employer” required complete disregard of the convenience-of-the-employer doctrine.

The Senate, however, was of the view that the doctrine had at least a limited role to play. After noting the existence of the doctrine and the Tax Court’s reliance on state law to refuse to apply it * * *, the Senate Report [S. Rep. 83-1622, VII(J), 1954 WL 6064] states:

“Your committee believes that the House provision is ambiguous in providing that meals or lodging furnished on the employer’s premises, which the employee is required to accept as a condition of his employment, are excludable from income whether or not furnished as compensation. Your committee has provided that the basic test of exclusion is to be whether the meals or lodging are furnished primarily for the convenience of the employer (and thus excludable) or whether they were primarily for the convenience of the employee (and therefore taxable). However, in deciding whether they were furnished for the convenience of the employer, the fact that a State statute or an employment contract fixing the terms of the employment indicate the meals or lodging are intended as compensation is not to be determinative. This means that employees of State institutions who are required to live and eat on the
premises will not be taxed on the value of the meals and lodging even though the State statute indicates the meals and lodging are part of the employee’s compensation.” S. Rep. No. 1622, *supra*, at 19.

In a technical appendix, the Senate Report further elaborated:

“Section 119 applies only to meals or lodging furnished in kind. Therefore, any cash allowances for meals or lodging received by an employee will continue to be includible in gross income to the extent that such allowances constitute compensation.” *Id.*, at 190–191.

After conference, the House acquiesced in the Senate’s version of §119. Because of this, respondent urges that §119 as passed did not discard the convenience-of-the-employer doctrine, but indeed endorsed the doctrine * * *. Respondent further argues that, by negative implication, the technical appendix to the Senate Report creates a class of noncompensatory cash meal payments that are to be excluded from income. We disagree.

* * *

As the last step in its restructuring of prior law, the Senate adopted an additional restriction created by the House and not theretofore a part of the law, which required that meals subject to exclusion had to be taken on the business premises of the employer. Thus §119 comprehensively modified the prior law, both expanding and contracting the exclusion for meals and lodging previously provided, and it must therefore be construed as its draftsmen obviously intended it to be—as a replacement for the prior law, designed to “end [its] confusion.”

Because §119 replaces prior law, respondent’s further argument—that the technical appendix in the Senate Report recognized the existence under §61 of an exclusion for a class of noncompensatory cash payments—is without merit. If cash meal allowances could be excluded on the mere showing that such payments served the convenience of the employer, as respondent suggests, then cash would be more widely excluded from income than meals in kind, an extraordinary result given the presumptively compensatory nature of cash payments and the obvious intent of §119 to narrow the circumstances in which meals could be excluded. Moreover, there is no reason to suppose that Congress would have wanted to recognize a class of excludable cash meal payments. * * *

* * *

Finally, respondent argues that it is unfair that members of the military may exclude their subsistence allowances from income while respondent cannot. While this may be so, arguments of equity have little force in construing the boundaries
of exclusions and deductions from income many of which, to be administrable, must be arbitrary. In any case, Congress has already considered respondent’s equity argument and has rejected it in the repeal of §120 of the 1954 Code. That provision as enacted allowed state troopers like respondent to exclude from income up to $5 of subsistence allowance per day. Section 120 was repealed after only four years, however, because it was “inequitable since there are many other individual taxpayers whose duties also require them to incur subsistence expenditures regardless of the tax effect. Thus, it appears that certain police officials by reason of this exclusion are placed in a more favorable position tax-wise than the other individual income taxpayers who incur the same types of expense....”

Reversed.

Mr. Justice BLACKMUN, with whom The Chief Justice joins, dissenting.

More than a decade ago the United States Court of Appeals for the Eighth Circuit, in *United States v. Morelan*, 356 F.2d 199 (1966), held that the $3–per-day subsistence allowance paid Minnesota state highway patrolmen was excludable from gross income under §119 * * *. It held, alternatively, that if the allowance were includable in gross income, it was deductible as an ordinary and necessary meal-cost trade or business expense under §162(a)(2) of the Code. I sat as a Circuit Judge on that case. I was happy to join Chief Judge Vogel’s opinion because I then felt, and still do, that it was correct on both grounds. Certainly, despite the usual persistent Government opposition in as many Courts of Appeals as were available, the ruling was in line with other authority at the appellate level at that time. * * *

* * *

I have no particular quarrel with the conclusion that the payments received by the New Jersey troopers constituted income to them under §61. I can accept that, but my stance in *Morelan* leads me to disagree with the Court’s conclusion that the payments are not excludable under §119. The Court draws an in-cash or in-kind distinction. This has no appeal or persuasion for me because the statute does not speak specifically in such terms. It does no more than refer to “meals ... furnished on the business premises of the employer,” and from those words the Court draws the in-kind consequence. I am not so sure. In any event, for me, as was the case in *Morelan*, the business premises of the State of New Jersey, the trooper’s employer, are wherever the trooper is on duty in that State. The employer’s premises are statewide.

The Court in its opinion makes only passing comment, with a general reference to fairness, on the ironical difference in tax treatment it now accords to the paramilitary New Jersey state trooper structure and the federal military. The dis-
tinction must be embarrassing to the Government in its position here, for the Internal Revenue Code draws no such distinction. * * *

I fear that state troopers the country over, not handsomely paid to begin with, will never understand today’s decision. And I doubt that their reading of the Court’s opinion—if, indeed, a layman can be expected to understand its technical wording—will convince them that the situation is as clear as the Court purports to find it.

Adams v. United States


PER CURIAM:

The issue in this tax refund suit is whether the fair rental value of a Japanese residence furnished the plaintiffs by the employer of plaintiff Faneuil Adams, Jr., is excludable from their gross income under Section 119 of the Internal Revenue Code of 1954.

* * * In 1970 and 1971, Faneuil Adams [hereinafter “plaintiff”] was president of Mobil Sekiyu Kabushiki Kaisha (“Sekiyu”), a Tokyo-based Japanese corporation which was wholly owned by Mobil Oil Corporation (“Mobil”). During those years, Sekiyu employed about 1,500 persons in Japan with sales between $400–700 million each year. It had several thousand service stations in Japan and was also involved in two joint ventures with Japanese companies which owned and operated four refineries.

In order to attract qualified employees for foreign service and to maintain an equitable relationship between its domestic and American foreign-based employees, thereby preventing any employee from gaining a benefit or suffering a hardship from serving overseas, Mobil maintained a compensation policy for its American employees assigned outside the United States. One of the components of the policy involved the procurement by Mobil of housing for such employees, regardless of their position or duties. Mobil first calculated a “U.S. Housing Element” for each American foreign-based employee, based on a survey of the Bureau
of Labor Statistics, which reflected the approximate average housing costs in the United States at various family sizes and income levels. Mobil then subtracted from that employee's salary the amount of his particular U.S. Housing Element. If Mobil provided housing to the employee, the employee would include in his gross income for federal tax purposes the U.S. Housing Element amount. If the employee instead obtained his own housing abroad, Mobil reimbursed him for the full amount, subject to certain predetermined limitations based upon reasonableness, and the employee would then include the full amount reimbursed in his gross income.

Pursuant to the above policy, Mobil provided plaintiff with a residence for the years in question. The three-level house, which was built and owned by Sekiyu, was 3 miles from headquarters and consisted of a large living room, dining room, pantry and kitchen, three bedrooms, a den, two bathrooms, two maid's rooms, two garage areas, and a garden and veranda. By American standards the house was not large, but it was apparently choice. Sekiyu felt that it was important to house its chief executive officer in prestigious surroundings because, particularly in Japan, there is less of a distinction than in the United States between business activities and social activities. The effectiveness of a president of a company in Japan is influenced by the social standing and regard accorded to him by the Japanese business community. If the president of Sekiyu had not resided in a residence equivalent to the type provided the plaintiff, it would appear that he would have been unofficially downgraded and slighted by the business community and his effectiveness for Sekiyu correspondingly impaired. Sekiyu, therefore, provided such a house to plaintiff and required him to reside there as a matter of company policy.

The house was also designed so that it could accommodate the business activities of the plaintiff. The den was built specifically for the conduct of business, and the kitchen and living room were sufficiently large for either business meetings or receptions. Plaintiff worked in the house in the evenings and on weekends and held small meetings there for mixed business and social purposes. He regularly used the telephone for business purposes from his home after regular working hours, both for business emergencies and also for communicating with persons in the United States because of the time difference. In addition, he regularly discharged his business entertainment responsibilities in the residence, generally averaging about 35–40 such occasions in a normal year. In 1970 his entertaining declined considerably because of the absence of his wife from Japan for 10 months, but it resumed again in 1971. Plaintiff was provided with two maids, only one of whom was needed for his family's personal requirements.

Plaintiff included in his gross income for federal tax purposes, as the value of the housing furnished him by his employer, the U.S. Housing Element amounts
which had been subtracted from his gross salary. Those amounts which were
designed to approximate the average housing costs of a similarly situated person
in the United States during 1970 and 1971, totaled $4,439 for 1970 and
$4,824 for 1971. However, because
the cost of housing in Tokyo in those
years was considerably higher than
that in the United States, it is agreed by
the parties that the fair rental value of
the residence furnished plaintiff by
Sekiyu was $20,000 in 1970 and
$20,599.09 in 1971. Accordingly,
upon audit of plaintiff’s 1970 and
1971 income tax returns, the Internal
Revenue Service, among other adjust-
ments, increased the amounts reported
by plaintiff as the value of the housing
furnished by Sekiyu to $20,000 in 1970 and
$20,599.09 in 1971. Plaintiff has
filed suit to recover the sum of $914.24 plus assessed interest as a result of the
Internal Revenue Service’s inclusion in his gross income of the amounts in excess
of the U.S. Housing Element for the 2 years in suit.

Gross income means all income from whatever source derived, including
compensation for services. I.R.C. §61(a). It includes income realized in any form.
Section 1.61–2(d)(1) of Treasury Regulations states, “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.”

Presumably, then, if the lodging furnished to plaintiff was compensation to
him, the fair rental value of the lodging would be includable in his gross income
unless excludable under another provision of the Code.

Plaintiff contends that the fair rental value of the residence supplied to him
by Sekiyu in 1970 and 1971 is excludable from his gross income because of
Section 119. Alternatively, plaintiff asserts that the excess of the fair rental value
of the residence over the U.S. Housing Element amount represented a benefit
to his employer and not a benefit to him, and therefore is not gross income to
him. Finally, plaintiff contends that even if the fair rental value of the residence is
income to him, it should be measured by the amount plaintiff would have spent
for housing in the United States, rather than the fair rental value in Japan. Because
we hold that the conditions of Section 119 * * * and the Regulations promulgated
thereunder have been met, we do not address the other arguments of plaintiff.

* * *
It is clear that the first requirement of the statute has been met because the plaintiff was explicitly required to accept the residence provided by Sekiyu as a condition of his employment as president of the company. Sekiyu’s goal was two-fold: first, it wanted to insure that its president resided in housing of sufficiently dignified surroundings to promote his effectiveness within the Japanese business community. Secondly, Sekiyu wished to provide its president with facilities which were sufficient for the conduct of certain necessary business activities at home. Since at least 1954 Sekiyu had required that its chief executive officer reside in the residence provided to plaintiff, as a condition to appointment as president.

With respect to this first test of Section 119, then, this case is as compelling as United States Junior Chamber of Commerce v. United States, 334 F.2d 660, 167 Ct.Cl. 392 (1964). In that case, the court found that it was not necessary for the taxpayer-president to reside in the Chamber’s “White House” during his term of office so long as he lived in the Tulsa area. But, as a practical matter, for the convenience of his employer and as a condition of his tenure, the president was required to live there. Therefore, it was held that the “condition of employment” test was met. The court noted that the “condition of employment” test is met if:

due to the nature of the employer’s business, a certain type of residence for the employee is required and that it would not be reasonable to suppose that the employee would normally have available such lodging for the use of his employer. 334 F.2d at 664, 167 Ct.Cl. at 399.

Here, because the size and style of one’s residence had an important effect upon the Japanese business community, a certain type of residence was both required by Mobil and Sekiyu for the plaintiff and necessary for the proper discharge of his duties in Sekiyu’s best interests.

* * * In the present case, plaintiff was required to accept the housing, and the residence was directly related to plaintiff’s position as president, both in terms of physical facilities and psychic significance. It is held, therefore, that plaintiff was required to accept the lodging in order to enable him properly to perform the duties of his employment.

As to the “for the convenience of the employer” test, in United States Junior Chamber of Commerce v. United States, 334 F.2d at 663, 167 Ct.Cl. at 397, the court stated:

“There does not appear to be any substantial difference between the * * * ‘convenience of the employer’ test and the ‘required as a condition of his employment’ test.”
Since it has already been determined that the condition of employment test has been satisfied, on that basis alone it could be held that the convenience of the employer test has also been met.

In James H. McDonald, supra, 66 T.C. [223 (1976)], the court stated that the convenience of the employer test is satisfied where there is a direct nexus between the housing furnished the employee and the business interests of the employer served thereby. In McDonald, the taxpayer was a principal officer of Gulf who was furnished an apartment by his employer which totaled only about 1,500 square feet of living space. The taxpayer was not required to live in the apartment, and it was found that the only benefit Gulf received in maintaining the apartment was the flexibility it afforded Gulf in personnel transfers. There was no prestige consideration. The court held that there was an insufficient nexus between the apartment and the employer's business interests to meet the convenience of the employer test requirements. Moreover, the court further noted that:

While its practice of maintaining various leasehold interests for assignment to expatriate employees may have accorded Gulf a benefit in terms of flexibility in personnel transfers, that is not to conclude that the assignments of these lodgings to petitioners at a discount similarly served the interests of Gulf; that is, although convenience may have dictated the form in which the leasehold arrangements were structured, the convenience of Gulf did not require it to subsidize the assignments. 66 T.C. at 229.

Here there was a sufficiently direct relationship between the housing furnished the plaintiff by Sekiyu and Sekiyu's business interests to meet the convenience of the employer test. The lodging had been built and was owned by Sekiyu. It was specially identified with the business of Sekiyu, for the house had served as the home of its presidents since at least 1954. If Sekiyu's president had not resided in housing comparable to that supplied plaintiff, Sekiyu's business would have been adversely affected. The house had been designed for this purpose to accommodate substantial business activities, and therefore further served Sekiyu's business interests.

Moreover, the fact that Sekiyu subsidized plaintiff's use of the house was also in its best business interests. Sekiyu was interested in attracting a qualified person as its chief executive officer. Because of the unusual housing situation in Tokyo during the years in question, a person would have had to pay up to four times his U.S. housing costs to obtain comparable housing in Tokyo. Certainly, such a factor would have been a strong deterrent to any qualified person's interest in Sekiyu's presidency, absent a housing subsidy from Sekiyu. Furthermore, it was clearly in Mobil–Sekiyu's best business interests to maintain an equitable compensation relationship between its domestic employees and its American foreign-based ones. The housing subsidy was designed to accomplish that.
* * *

The third and final test is whether the lodging was on the business premises of the employer. Observe first that “[t]he operative framework of [the clause ‘on the business premises’] is at best elusive and admittedly incapable of generating any hard and fast line.” Jack B. Lindeman, 60 T.C. 609, 617 (1973) (Tannenwald, J., concurring). This question is largely a factual one requiring a commonsense approach. The statute should not be read literally. As noted by the Tax Court in Lindeman, supra, 60 T.C. at 614:

[T]he statutory language ordinarily would not permit any exclusion for lodging furnished a domestic servant, since a servant’s lodging is rarely furnished on “the business premises of his employer”; yet the committee report * * * shows a clear intention to allow the exclusion where the servant’s lodging is furnished in the employer’s home.

In the original version of the 1954 Code, as enacted in the House, the term that was used in Section 119 was “place of employment.” * * * The pertinent Treasury regulation similarly provides that “business premises” generally refers to the place of employment of the employee. Treas. Reg. Sec. 1.119–1(c)(1) (1956). The phrase, then, is not to be limited to the business compound or headquarters of the employer. Rather, the emphasis must be upon the place where the employee’s duties are to be performed. * * * The phrase has also been construed to mean either (1) living quarters that constitute an integral part of the business property, or (2) premises on which the company carries on some substantial segment of its business activities. Gordon S. Dole, 43 T.C. 697, 707 (1965), aff’d per curiam, 351 F.2d 308 (1st Cir.1965).

* * * In this case plaintiff, although he had an office at the employer’s headquarters, worked in his residence in the evenings and on weekends, had business meetings and performed required business telephone calls from there which could not be made during normal business hours, and conducted regular business entertaining in the residence. In this sense plaintiff’s residence was a part of the business premises of his employer, for it was a “premises on which the duties of the employee are to be performed,” and a “premises on which the company carries on some of its business activities.”

Take Note

This saves Adams but may be of little help to a lower-ranking employee who receives the same benefit. How would you feel about a rule that excluded this from Adams’s income but did not apply to lower-level employees?
Interpretations of the phrase which are limited to the geographic contiguity of the premises or to questions of the quantum of business activities on the premises are too restrictive. Rather, the statutory language “on the business premises of the employer” infers a functional rather than a spatial unity. In Rev. Rul. 75–540, 1975–2 Cum. Bull. 53, it was determined that the fair rental value of the official residence furnished a governor by the state is excludable from the governor's gross income under Section 119 of the Code. The Ruling noted that the business premises test was met because the residence provided by the state enabled the governor to carry out efficiently the administrative, ceremonial, and social duties required by his office. The governor's mansion, thus, served an important business function in that it was clearly identified with the business interests of the state. It was, in short, an inseparable adjunct. * * * In the present case, even apart from the strictly business activities which took place in plaintiff's residence, the house was a symbol to the Japanese business community of the status of Sekiyu's chief executive officer and a place where he officially entertained for business purposes. As such, it influenced plaintiff's effectiveness in the business community and directly served a business function for Sekiyu.

* * *

We take cognizance of the admonition of Judge Raum to avoid “strained or eccentric” interpretations of the phrase “on the business premises.” Gordon S. Dole, 43 T.C. at 708 (Raum, J., concurring), aff'd per curiam, 351 F.2d 308 (1st Cir.1965). However, we are persuaded that where, as here, (1) the residence was built and owned by the employer, (2) it was designed, in part, to accommodate the business activities of the employer, (3) the employee was required to live in the residence, (4) there were many business activities for the employee to perform after normal working hours in his home because of the extensive nature of the employer's business and the high-ranking status of the employee, (5) the employee did perform business activities in the residence, and (6) the residence served an important business function of the employer, then the residence in question is a part of the business premises of the employer.

The three statutory requisites for exclusion are met. Accordingly, pursuant to Section 119 * * *, the fair rental value of the residence is excludable from plaintiff's gross income. Plaintiffs are entitled to recover * * *. 

Take Note

This logic applies to the homes of university presidents as well.
(3.) Statutory Fringe Benefits

Code: IRC §§132(a)–(e)(1); 132(f)(1)–(5), (7); 132(h)–(j)(1); 132(j)(4).
Skim IRC §§104(a)(3); 105; 106; 125; 127; 129; 137.

Regs: Treas. Reg. §§1.132–2(a), (c); 1.132–3(a)(1)–(4), (e); 1.132–4(a) (1)(i), (a)(1)(iv); 1.132–5(b)(1); 1.132–6(a)–(c); 1.132–6(e). Skim Treas. Reg. §1.132–5(b)(1).

Section 132(a) lists eight types of employee fringe benefits specifically excluded from gross income. Not all tax-advantaged fringe benefits are listed in §132. Indeed, the most significant fringe benefit for most employees—participation in a “qualified” retirement plan—is covered elsewhere in the Code. Under a qualified retirement plan, employers pay a set percentage of the employee’s compensation to the plan before applying the federal wage withholding taxes (thus, amounts passing to qualified plans are referred to as “pre-tax dollars”). The plan trustee(s) then invest the amounts in each employee’s individual account. The growth on the account is entirely income-tax-free and remains so until finally distributed to the employee upon retirement. These deferred compensation plans are governed by §401 et. seq. and are well beyond the scope of this course.

Problem 3–8

Kevin Lomax is an associate at Milton, Chadwick, Waters, a New York City law firm. Because he is expected to work long hours each day, the firm provides Kevin with a daily “meal supplement” of $20 cash. Kevin and his colleagues regularly eat dinner at a restaurant across the street from the firm’s building, using the meal supplements to cover the costs.

(a) Must Kevin include the meal supplement in gross income?

(b) Would the answer to (a) change if, instead of paying the meal supplement to Kevin, the firm paid the restaurant directly?

(c) Would the answer to (a) change if, instead of paying the meal supplement to Kevin, the firm provided him with free dinners at its own cafeteria located on the same floor as Kevin’s office?
There are even more statutory fringe benefit provisions beyond §132, but §132 is the centerpiece of the statutory fringe benefit provisions. Read through the assigned provisions of the statute and try your hand at the following problems.

Self-Assessment Questions

(Solutions to Self-Assessment Questions are set forth in Appendix 3.)

SAQ 3–2. For many years, Employer (who owns and operates a hardware store) had given her employees a ham, turkey or gift basket in the holiday season. Some employees with dietary or religious restrictions complained about these items, so Employer changed her policy and instead gave employees $35 gift certificates redeemable at various local stores during the holiday season. The certificates could not be converted to cash and expired shortly after the holiday season. Can the employees exclude the value of these gift certificates from their gross incomes under §132?

Problem 3–9

Leona is an employee of Luxury, Inc., a corporation that owns luxury hotels. Luxury also owns and operates massage parlors as a separate line of business. No Luxury hotel is within walking distance of any Luxury massage parlor, and only the highest-ranking executives of Luxury are involved with both divisions of Luxury’s business. Leona works as a concierge in Luxury’s hotel division. As an employee, Leona is entitled to free use of Luxury hotel rooms anywhere in the world on a “space-available” basis. Leona is also entitled to a 30–percent discount at all Luxury massage parlors.

(a) Assume that Leona spends one night at no charge in Luxury’s hotel in Las Vegas. Luxury normally charges $100 nightly for each room. Does Leona have gross income?

(b) How, if at all, would the answer to (a) change if Leona were allowed to reserve the room weeks in advance of her stay?

(c) Now assume that Leona receives a massage on a “space-available” basis at Luxury’s New Orleans massage parlor. The parlor normally
Other Statutory Fringe Benefits. In addition to the exclusions offered under §132, employees may qualify for a number of other fringe benefit exclusion

(d) How, if at all, would the answers to (a), (b), and (c) change if Leona was the CEO of Luxury and the only employee entitled to the benefits?

(e) How, if at all, would the answers to (a), (b), and (c) change if the benefits were provided to Leona’s dependent daughters, Paris and Nicky, instead of Leona?

Problem 3–10

Dilbert is an employee of Company. During the current taxable year, Dilbert receives the following benefits from Company. Determine whether each such benefit is included in Dilbert’s gross income.

(a) Company pays round-trip airfare and lodging for Dilbert to attend a work-related conference in Denver.

(b) Company provides Dilbert with a “company car” that Dilbert uses for both business and personal purposes.

(c) Company furnishes all employees, including Dilbert, with a “holiday ham” in December.

(d) Company provides Dilbert with a free bus pass that would normally cost Dilbert $60 per month.

(e) Company reimburses Dilbert for the $230 he pays each month for parking privileges in the private garage located across the street from Company’s premises.

(f) Company permits Dilbert free use of a gymnasium located on Company’s premises. The gym is operated by Company and is available only to Company employees and their families.

charges $100 for a one-hour massage, but Leona pays only $70 because she is an employee. Does Leona have gross income?
provisions. Section 74(c), discussed in Part C of this Chapter, excludes so-called “employee achievement awards” given for length of service or safety achievements. Section 79 excludes group term life insurance benefits provided by an employer. Section 106(a) allows an exclusion for employer-provided accident and health insurance coverage. Sections 79 and 106(a) come up again in Chapter 5.

(4.) Property Received for Services

Code: IRC §§83(a)–(c).

Regs: Treas. Reg. §§1.83–1(a)(1); 1.83–2(a); 1.83–3(c)

Beware of the String Attached.
Sometimes employees receive contingent compensation: consideration the full enjoyment of which is conditioned upon the performance of additional services in the future. Employers like to pay this kind of consideration because it gives employees an incentive to continue their productivity. Contingent compensation frequently comes in the form of stock or an equivalent form of equity interest in the employer. When an employee or other service provider receives contingent consideration, does he or she have gross income at the time of receipt? Or should inclusion in gross income wait until all strings attached to the consideration have been severed?

Section 83 offers some guidance on the timing for inclusion in gross income. As you did with the fringe benefit rules of §132, read through the assigned portions of the statute and apply it to the following Problem.

Problem 3–11

Corky is the president and sole shareholder of a corporation that manufactures and sells rocking chairs. The corporation employs several workers, including Mr. McFeely and Lady Aberlin.

(a) To reward McFeely for his good work and long service, the corporation awarded McFeely 100 shares of the corporation’s stock. McFeely signed a so-called “restrictive stock agreement” that prohibited
C. Gifts and Bequests

**Code:** IRC §§74(a)–(c)(2); 102; 274(j)(3)–(4). Skim IRC §117.

**Regs:** Skim Treas. Reg. §§1.74–1(a); 1.102–1. Skim Proposed Treas. Reg. §§1.74–1(b)–(f); 1.74–2.

**Policy Reasons for the Gift Exclusion.** Some variation of the §102(a) exclusion for gifts and bequests has been in every federal income tax act, leading one to think that there is a compelling policy reason for the exclusion. Curiously, there is no consensus among commentators as to why gifts and bequests should be excluded from gross income. Indeed, many commentators conclude that there is no justification for the exclusion. Compare two taxpayers, A and B, each of whom has $50,000 to spend in the taxable year. A derived the $50,000 as wages, and B (who did not work) received the $50,000 as a gift. Under current law, A will pay federal income tax on his $50,000, but B will pay no federal income tax at all. As this example shows, the gift exclusion violates “horizontal equity,” for those with equal amounts of total receipts are not tax equally on those receipts.

Many reasons have been offered to support the §102(a) gift exclusion. One might conclude that the exclusion is simply a matter of administrative conve-
Chapter 3 The Meaning of “Gross Income”

ni
cence, for it would be difficult for taxpayers to track (and for the Service to check) all gift transactions during the year. If gifts were subject to income tax, taxpayers would have to keep a bookkeeping ledger on hand while opening birthday or other holiday gifts. If the value of the gift was not readily apparent, recipients would have to ask their generous donors how much they paid for the gifts, a tacky way to acknowledge receipt of a gift. Since a significant portion of all gifts occur within the family, the taxation of gifts further interposes the government into family affairs. While society might be a little less comfortable if gifts were subject to taxation, a less expansive gift exclusion could address most of these concerns. The gift exclusion, for example, could be structured so that taxpayers could exclude up to a defined dollar amount that would likely cover most of the intra-family gifts one would likely receive. Of course, establishing the proper dollar amount would be no easy task, for any arbitrarily chosen exclusion ceiling will not be perfectly suitable for all situations. Yet the justification of administrative convenience for the §102(a) exclusion is incomplete at best.

Others might argue that the gift exclusion is appropriate since gifted amounts are already subject to federal wealth transfer taxes in the hands of the donor. Section 2001 imposes on the very wealthy a federal estate tax on the privilege of transferring wealth at death. Similarly, §2501 imposes a federal gift tax on the privilege of making substantial inter vivos wealth transfers. To the extent the donor is (or may be) subject to an excise tax for making a gift, perhaps it is too harsh to impose an additional income tax on the recipient of the gift. This too is an incomplete justification for the gift exclusion, as less than two percent of all taxpayers are subject to the federal estate and gift taxes. If concern for excessive taxation was the principal reason for excluding gifts, the exclusion would be limited to situations where the donor incurs liability for estate or gift taxes as a result of the transfer to the recipient.

Maybe the gift exclusion is really a vehicle to encourage generosity. A donor might be more willing to effect a gift transfer if the donor knows that the recipient will not also receive a liability for federal income tax on the gift. For example, suppose a donor wants a recipient to receive a gift of $100. If the gift were taxable in the hands of the donor, then the donor would have to transfer something more than $100 so that the recipient would have, after tax, $100. If the recipient had to pay a tax of 20 percent on the gift, then, the donor would have to transfer $125 to the recipient ($125 x 20% = $25 tax) in order to make sure the recipient had $100. The extra gift required to cover the income tax bite might discourage the donor from making the transfer. The disincentive is magnified if the donor transfers property instead of cash. If the recipient is taxed on the value of the gifted property, the recipient might have to sell the property to pay the resulting income tax liability.
But while taxing the recipient might create a disincentive to effect a gift, this rationale is also questionable given that there are much better ways to encourage generosity using the federal tax laws. For example, the donor could be allowed to deduct the cost of a gift, providing a tax benefit directly to the donor. Giving the donor a deduction and making the recipient pay tax on the gift, however, would effectively shift the income tax burden from the donor to the recipient. To the extent the typical recipient is in a lower tax bracket than the typical donor, this alternative would probably cause a drain on federal tax revenues.

Ultimately, then, none of the common justifications for the gift exclusion by itself is persuasive. It is the combination of these factors that probably best accounts for this long-standing benefit to gift recipients.

**Tax Consequences to the Donor.** The transfer of property by gift is seen as personal consumption by the donor. As a result, there is no deduction for gift transfers. The good news is that the transfer of appreciated property (where the value of the property at the time of the gift exceeds the price the donor paid to acquire the property) by gift will not give rise to any income tax consequences to the donor. For instance, if the donor purchases property for $100 and then gives it to a recipient when the value of the property is $160, the donor could be taxed on the $60 of appreciation that was consumed in the hands of the donor when the gift transfer is completed. The consumption comes in the form of satisfaction to the donor from providing a $160 gift to the recipient at a cost of only $100. While the consumption of appreciation in value could probably be subject to federal income tax under the Sixteenth Amendment, it is well accepted that donors are not taxed on the appreciation in value of gift property.

**Gifts of Income.** While a gift of property is excluded by §102(a), §102(b) makes it clear that income subsequently derived on gifted property is not excludable, nor are gifts of income. Focus on §102(b) as you answer the following questions.

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**Take Note**

Students often confuse the income tax consequences of a gift with the gift tax consequences. For income tax purposes, a gift is not deductible and receipt of the gift is not taxable. Donors of gifts may be subject to federal gift tax. Since the federal gift tax is thought of as a backstop to the federal estate tax (otherwise people could give everything away and avoid the estate tax), the gift tax is paid by the donor. There is a $13,000 annual exclusion amount (adjusted for inflation) and a unified gift tax credit that allows donors to avoid gift tax in many instances.
Chapter 3 The Meaning of “Gross Income”

Self-Assessment Questions

(Solutions to Self-Assessment Questions are set forth in Appendix 3.)

SAQ 3–3. Donor gives all of Donor’s right, title and interest in an apartment building worth $300,000 to Recipient. Later in the year, Recipient collects $3,000 in rents from the building’s tenants. To what extent can Recipient exclude these amounts from gross income?

SAQ 3–4. Donor gives Recipient a life estate interest in an apartment building worth $300,000. Pursuant to the life estate, Recipient receives rents totaling $3,000 in the year of transfer. To what extent can Recipient exclude these amounts from gross income?

What is a “Gift”? Neither the statute nor the Regulations define what is meant by the term “gift,” so the Supreme Court has stepped in to provide guidance.

Commissioner v. Duberstein

United States Supreme Court, 1960.
363 U.S. 278, 80 S.Ct. 1190, 4 L.Ed.2d 1218.

Mr. Justice Brennan delivered the opinion of the Court.

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

No. 376, Commissioner v. Duberstein. The taxpayer, Duberstein, was president of the Duberstein Iron & Metal Company, a corporation with headquarters in Dayton, Ohio. For some years the taxpayer’s company had done business with Mohawk Metal Corporation, whose headquarters were in New York City. The president of Mohawk was one Berman. * * * From time to time in their telephone conversations, Berman would ask Duberstein whether the latter knew of potential customers for some of Mohawk’s products in which Duberstein’s company itself
was not interested. Duberstein provided the names of potential customers for these items.

One day in 1951 Berman telephoned Duberstein and said that the information Duberstein had given him had proved so helpful that he wanted to give the latter a present. Duberstein stated that Berman owed him nothing. Berman said that he had a Cadillac as a gift for Duberstein, and that the latter should send to New York for it; Berman insisted that Duberstein accept the car, and the latter finally did so, protesting however that he had not intended to be compensated for the information. At the time Duberstein already had a Cadillac and an Oldsmobile, and felt that he did not need another car. Duberstein testified that he did not think Berman would have sent him the Cadillac if he had not furnished him with information about the customers. It appeared that Mohawk later deducted the value of the Cadillac as a business expense on its corporate income tax return.

Duberstein did not include the value of the Cadillac in gross income for 1951, deeming it a gift. The Commissioner asserted a deficiency for the car’s value against him, and in proceedings to review the deficiency the Tax Court affirmed the Commissioner’s determination. * * * The Court of Appeals for the Sixth Circuit reversed. 265 F.2d 28, 30.

No. 546, Stanton v. United States. The taxpayer, Stanton, had been for approximately 10 years in the employ of Trinity Church in New York City. He was comptroller of the Church corporation, and president of a corporation, Trinity Operating Company, the church set up as a fully owned subsidiary to manage its real estate holdings, which were more extensive than simply the church property. His salary by the end of his employment there in 1942 amounted to $22,500 a year. Effective November 30, 1942, he resigned from both positions to go into business for himself. The Operating Company’s directors, who seem to have included the rector and vestrymen of the church, passed the following resolution upon his resignation: “Be it resolved that in appreciation of the services rendered by Mr. Stanton * * * a gratuity is hereby awarded to him of Twenty Thousand Dollars * * *.”

The Operating Company’s action was later explained by one of its directors as based on the fact that, “Mr. Stanton was liked by all of the Vestry personally. He had a pleasing personality. He had come in when Trinity’s affairs were in a difficult situation. He did a splendid piece of work, we felt. Besides that * * * he was liked by all of the members of the Vestry personally.” * * *
The “gratuity” was duly paid. * * *

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

The Government, urging that clarification of the problem typified by these two cases was necessary, and that the approaches taken by the Courts of Appeals for the Second and the Sixth Circuits were in conflict, petitioned for certiorari in No. 376, and acquiesced in the taxpayer’s petition in No. 546. On this basis, and because of the importance of the question in the administration of the income tax laws, we granted certiorari in both cases.

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

*First.* The Government suggests that we promulgate a new “test” in this area to serve as a standard to be applied by the lower courts and by the Tax Court in dealing with the numerous cases that arise. We reject this invitation. We are of opinion that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases. The cases at bar are fair examples of the settings in which the problem usually arises. They present situations in which payments have been made in a context with business overtones—an employer making a payment to a retiring employee; a businessman giving something of value to another businessman who has been of advantage to him in his business. In this context, we review the law as established by the prior cases here.

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6 The Government’s proposed test is stated: “Gifts should be defined as transfers of property made for personal as distinguished from business reasons.”
The course of decision here makes it plain that the statute does not use the term “gift” in the common-law sense, but in a more colloquial sense. This Court has indicated that a voluntarily executed transfer of his property by one to another, without any consideration or compensation therefor, though a common-law gift, is not necessarily a “gift” within the meaning of the statute. For the Court has shown that the mere absence of a legal or moral obligation to make such a payment does not establish that it is a gift. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 730, 49 S.Ct. 499, 504, 73 L.Ed. 918. And, importantly, if the payment proceeds primarily from “the constraining force of any moral or legal duty,” or from “the incentive of anticipated benefit” of an economic nature, it is not a gift. And, conversely, “(w)here the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.” *Robertson v. United States*, 343 U.S. 711, 714, 72 S.Ct. 994, 996, 96 L.Ed. 1237. A gift in the statutory sense, on the other hand, proceeds from a “detached and disinterested generosity,” *Commissioner of Internal Revenue v. LoBue*, 351 U.S. 243, 246, 76 S.Ct. 800, 803, 100 L.Ed. 1142; “out of affection, respect, admiration, charity or like impulses.” *Robertson v. United States*, supra, 343 U.S. at page 714, 72 S.Ct. at page 996. And in this regard, the most critical consideration, as the Court was agreed in the leading case here, is the transferor’s “intention.” *Bogardus v. Commissioner*, 302 U.S. 34, 43, 58 S.Ct. 61, 65, 82 L.Ed. 32. “What controls is the intention with which payment, however voluntary, has been made.” Id., 302 U.S. at page 45, 58 S.Ct. at page 66 (dissenting opinion).

The Government says that this “intention” of the transferor cannot mean what the cases on the common-law concept of gift call “donative intent.” With that we are in agreement, for our decisions fully support this. * * * It scarcely needs adding that the parties’ expectations or hopes as to the tax treatment of their conduct in themselves have nothing to do with the matter.

* * *

Second. The Government’s proposed “test,” while apparently simple and precise in its formulation, depends frankly on a set of “principles” or “presumptions” derived from the decided cases, and concededly subject to various exceptions; and it involves various corollaries, which add to its detail. Were we to promulgate this test as a matter of law, and accept with it its various presuppositions and stated consequences, we would be passing for beyond the requirements of the cases before us, and would be painting on a large canvas with indeed a broad brush. The Government derives its test from such propositions as the following: That payments by an employer to an employee, even though voluntary, ought, by and large, to be taxable; that the concept of a gift is inconsistent with a payment’s...
being a deductible business expense; that a gift involves “personal” elements; that a business corporation cannot properly make a gift of its assets. The Government admits that there are exceptions and qualifications to these propositions. We think, to the extent they are correct, that these propositions are not principles of law but rather maxims of experience that the tribunals which have tried the facts of cases in this area have enunciated in explaining their factual determinations. Some of them simply represent truisms: it doubtless is, statistically speaking, the exceptional payment by an employer to an employee that amounts to a gift. Others are overstatements of possible evidentiary inferences relevant to a factual determination on the totality of circumstances in the case: it is doubtless relevant to the over-all inference that the transferor treats a payment as a business deduction, or that the transferor is a corporate entity. But these inferences cannot be stated in absolute terms. Neither factor is a shibboleth. The taxing statute does not make nondeductibility by the transferor a condition on the “gift” exclusion; nor does it draw and distinction, in terms, between transfers by corporations and individuals, as to the availability of the “gift” exclusion to the transferee. The conclusion whether a transfer amounts to a “gift” is one that must be reached on consideration of all the factors.

* * *

Third. Decision of the issue presented in these cases must be based ultimately on the application of the fact-finding tribunal’s experience with the mainsprings of human conduct to the totality of the facts of each case. The nontechnical nature of the statutory standard, the close relationship of it to the date of practical human experience, and the multiplicity of relevant factual elements, with their various combinations, creating the necessity of ascribing the proper force to each, confirm us in our conclusion that primary weight in this area must be given to the conclusions of the trier of fact.

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

One consequence of this is that appellate review of determinations in this field must be quite restricted. Where a jury has tried the matter upon correct instructions, the only inquiry is whether it cannot be said that reasonable men could reach differing conclusions on the issue. Where the trial has been by a judge without a jury, the judge's findings must stand unless “clearly erroneous.” “A finding is ‘clearly erroneous’ when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed.” United States v. United States Gypsum Co., 333 U.S. 364, 395, 68 S.Ct. 525, 542, 92 L.Ed. 746. * * *

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

As to Stanton, we are in disagreement. To four of us, it is critical here that the District Court as trier of fact made only the simple and unelaborated finding that the transfer in question was a “gift.” To be sure, conciseness is to be strived for, and prolixity avoided, in findings; but, to the four of us, there comes a point where findings become so sparse and conclusory as to give to revelation of what the District Court's concept of the determining facts and legal standard may be. Such conclusory, general findings do not constitute compliance with Rule 52's direction to “find the facts specially and state separately * * * conclusions of law thereon.” While the standard of law in this area is not a complex one, we four think the unelaborated finding of ultimate fact here cannot stand as a fulfillment of these requirements.

Food for Thought
Of the two cases, which transaction seems more like a gift? See how the Court struggles with the facts of each case.
It affords the reviewing court not the semblance of an indication of the legal standard with which the trier of fact has approached his task. For all that appears, the District Court may have viewed the form of the resolution or the simple absence of legal consideration as conclusive. While the judgment of the Court of Appeals cannot stand, the four of us think there must be further proceedings in the District Court looking toward new and adequate findings of fact. In this, we are joined by Mr. Justice Whittaker, who agrees that the findings were inadequate, although he does not concur generally in this opinion.

Accordingly, in No. 376 [Duberstein], the judgment of this Court is that the judgment of the Court of Appeals is reversed, and in No. 546 [Stanton], that the judgment of the Court of Appeals is vacated, and the case is remanded to the District Court for further proceedings not inconsistent with this opinion. It is so ordered.

Mr. Justice Harlan concurs in the result in No. 376. In No. 546, he would affirm the judgment of the Court of Appeals for the reasons stated by Mr. Justice Frankfurter.

Mr. Justice Whittaker, agreeing * * * that whether a particular transfer is or is not a “gift” may involve “a mixed question of law and fact,” concurs only in the result of this opinion.

Mr. Justice Douglas dissents, since he is of the view that in each of these two cases there was a gift under the test which the Court fashioned nearly a quarter of a century ago in Bogardus v. Commissioner, 302 U.S. 34, 58 S.Ct.

Mr. Justice Black, concurring and dissenting.

I agree with the Court that it was not clearly erroneous for the Tax Court to find as it did in No. 376 that the automobile transfer to Duberstein was not a gift, and so I agree with the Court’s opinion and judgment reversing the judgment of the Court of Appeals in that case.

I dissent in No. 546, Stanton v. United States. The District Court found that the $20,000 transferred to Mr. Stanton by his former employer at the end of ten years’ service was a gift and therefore exempt from taxation * * *. I think the finding was not clearly erroneous and that the Court of Appeals was therefore wrong in reversing the District Court’s judgment. While conflicting inferences might have been drawn, there was evidence to show that Mr. Stanton’s long services had been satisfactory, that he was well liked personally and had given splendid service, that the employer was under no obligation at all to pay any added compensation, but
made the $20,000 payment because prompted by a genuine desire to make him a "gift," to award him a "gratuity." The District Court’s finding was that the added payment "constituted a gift to the taxpayer, and therefore need not have been reported by him as income * * *." The trial court might have used more words, or discussed the facts set out above in more detail, but I doubt if this would have made its crucial, adequately supported finding any clearer. For this reason I would reinstate the District Court’s judgment for petitioner.

Mr. Justice Frankfurter, concurring in the judgment in No. 376 and dissenting in No. 546.

As the Court’s opinion indicates, we brought these two cases here partly because of a claimed difference in the approaches between two Courts of Appeals but primarily on the Government’s urging that, in that interest of the better administration of the income tax laws, clarification was desirable for determining when a transfer of property constitutes a "gift" and is not to be included in income for purposes of ascertaining the "gross income" under the Internal Revenue Code. As soon as this problem emerged after the imposition of the first income tax authorized by the Sixteenth Amendment, it became evident that its inherent difficulties and subtleties would not easily yield to the formulation of a general rule or test sufficiently definite to confine within narrow limits the area of judgment in applying it. While at its core the tax conception of a gift no doubt reflected the non-legal, non-technical notion of a benefaction unentangled with any aspect of worldly requital, the diverse blends of personal and pecuniary relationships in our industrial society inevitably presented niceties for adjudication which could not be put to rest by any kind of general formulation.

Despite acute arguments at the bar and a most thorough re-examination of the problem on a full canvass of our prior decisions and an attempted fresh analysis of the nature of the problem, the Court has rejected the invitation of the Government to fashion anything like a litmus paper test for determining what is excludable as a "gift" from gross income. Nor has the Court attempted a clarification of the particular aspects of the problem presented by these two cases, namely, payment by an employer to an employee upon the termination of the employment relation and non-obligatory payment for services rendered in the course of a business relationship. While I agree that experience has shown the futility of attempting to define, by language so circumscribing as to make it easily applicable, what constitutes a gift for every situation where the problem may arise, I do think that greater explicitness is possible in isolating and emphasizing factors which militate against a gift in particular situations.

Thus, regarding the two frequently recurring situations involved in these cases—things of value given to employees by their employers upon the termination of employment and payments entangled in a business relation and occasioned
by the performance of some service—the strong implication is that the payment is of a business nature. The problem in these two cases is entirely different from the problem in a case where a payment is made from one member of a family to another, where the implications are directly otherwise. No single general formulation appropriately deals with both types of cases, although both involve the question whether the payment was a “gift.” While we should normally suppose that a payment from father to son was a gift, unless the contrary is shown, in the two situations now before us the business implications are so forceful that I would apply a presumptive rule placing the burden upon the beneficiary to prove the payment wholly unrelated to his services to the enterprise. The Court, however, has declined so to analyze the problem and has concluded “that the governing principles are necessarily general and have already been spelled out in the opinions of this Court, and that the problem is one which, under the present statutory framework, does not lend itself to any more definitive statement that would produce a talisman for the solution of concrete cases.”

* * *

But I would affirm the decision of the Court of Appeals for the Second Circuit in *Stanton v. United States*. I would do so on the basis of the opinion of Judge Hand and more particularly because the very terms of the resolution by which the $20,000 was awarded to Stanton indicated that it was not a “gratuity” in the sense of sheer benevolence but in the nature of a generous lagniappe, something extra thrown in for services received though not legally nor morally required to be given. * * * The business nature of the payment is confirmed by the words of the resolution, explaining the “gratuity” as “in appreciation of the services rendered by Mr. Stanton as Manager of the Estate and Comptroller of the Corporation of Trinity Church throughout nearly ten years, and as President of Trinity Operating Company, Inc.” The force of this document, in light of all the factors to which Judge Hand adverted in his opinion, was not in the least diminished by testimony at the trial. Thus the taxpayer has totally failed to sustain the burden I would place upon him to establish that the payment to him was wholly attributable to generosity unrelated to his performance of his secular business functions as an officer of the corporation of the Trinity Church of New York and the Trinity Operating Co. Since the record totally fails to establish taxpayer’s claim, I see no need of specific findings by the trial judge.

_____________________________

**Note and Question**

The Court in *Duberstein* expressly refused to adopt a “test” to guide lower courts as to the meaning of a “gift.” And yet, in the very next paragraph, a test is unveiled. Oh well—it was a good idea while it lasted.
Is the standard announced in *Duberstein* the same you would use to describe a gift? Why or why not?

**Gifts to Employees.** Section 102(c) was added to the Code as part of the Tax Reform Act of 1986. That provision makes it clear that no transfer from an employer to or for the benefit of an employee can be excluded as a gift. Of course, just because the §102(a) exclusion does not apply, it does not always follow that such a transfer will be included in the employee’s gross income. The transfer might qualify as an excludable fringe benefit under §132, or it might constitute a non-taxable “employee achievement award” under §74(c).

While the rule contained in §102(c) is quite broad, there are notable limitations. Section 102(c) does not on its face apply to payments made to former employees, non-employees like independent contractors, or survivors of employees. Transfers to these individuals may still qualify for the §102(a) exclusion.

Section 102(c) reflects a presumption that payments of a compensatory nature cannot be made with a “detached and disinterested generosity” sufficient to warrant exclusion, as the following cases suggest.

**Olk v. United States**

536 F.2d 876.

**Sneed, Circuit Judge:**

This is a suit to obtain a refund of federal income taxes. The issue is whether monies, called “tokes” in the relevant trade, received by the taxpayer, a craps
dealer employed by Las Vegas casinos, constitute taxable income or gifts within the meaning of section 102(a). The taxpayer insists “tokes” are non-taxable gifts. If he is right, he is entitled to the refund for which this suit was brought. The trial court in a trial without a jury held that “tokes” were gifts. The Government appealed and we reverse and hold that “tokes” are taxable income.

I.

The Facts.

There is no dispute about the basic facts which explain the setting in which “tokes” are paid and received. The district court’s finding with respect to such facts which we accept are, in part, as follows:

In 1971 plaintiff was employed as a craps dealer in two Las Vegas gambling casinos, the Horseshoe Club and the Sahara Hotel. The basic services performed by plaintiff and other dealers were described at trial. There are four persons involved in the operation of the game, a boxman and three dealers. One of the three dealers, the stickman, calls the roll of the dice and then collects them for the next shooter. The other two dealers collect losing bets and pay off winning bets under the supervision of the boxman. The boxman is the casino employee charged with direct supervision of the dealers and the play at one particular table. He in turn is supervised by the pit boss who is responsible for several tables. The dealers also make change, advise the boxman when a player would like a drink and answer basic questions about the game for the players.

Dealers are forbidden to fraternize or engage in unnecessary conversation with the casino patrons, and must remain in separate areas while on their breaks. Dealers must treat all patrons equally, and any attempt to provide special service to a patron is grounds for termination.

At times, players will give money to the dealers or place bets for them. The witnesses testified that most casinos do not allow boxmen to receive money from patrons because of their supervisory positions, although some do permit this. The pit bosses are not permitted to receive anything from patrons because they are in a position in which they can insure that a patron receives some special service or treatment.

The money or tokes are combined by the four dealers and split equally at the end of each shift so that a dealer will get his share of the tokes received even while he is taking his break. Uncontradicted testimony indicated that a dealer would be terminated if he kept a toke rather than placed it in the common fund.
Casino management either required the dealers to pool and divide tokes or encouraged them to do so. Although the practice is tolerated by management, it is not encouraged since tokes represent money that players are not wagering and thus cannot be won by the casino. Plaintiff received about $10 per day as his share of tokes at the Horseshoe Club and an average of $20 per day in tokes at the Sahara. (footnotes omitted).

Additional findings of fact by the district court are that the taxpayer worked as a stickman and dealer and at all times was under the supervision of the boxman who in turn was supervised by the pit boss. Also the district court found that patrons sometimes give money to dealers, other players or mere spectators at the game, but that between 90–95% of the patrons give nothing to a dealer. No obligation on the part of the patron exists to give to a dealer and “dealers perform no service for patrons which a patron would normally find compensable.” Another finding is that there exists “no direct relation between services performed for management by a dealer and benefit or detriment to the patron.”

There then follows two final “findings of fact” which taken together constitute the heart of the controversy before us. These are as follows:

17. The tokes are given to dealers as a result of impulsive generosity or superstition on the part of players, and not as a form of compensation for services.

18. Tokes are the result of detached and disinterested generosity on the part of a small number of patrons.

These two findings, together with the others set out above, bear the unmistakable imprint of Commissioner v. Duberstein, 363 U.S. 278, 80 S.Ct. 1190, 4 L.Ed.2d 1218 (1960) * * *

II.

Finding Number 18 Is A Conclusion of Law.

The position of the taxpayer is simple. The above findings conform to the meaning of gifts as used in section 102 of the Code. Duberstein further teaches, the taxpayer asserts, that whether a receipt qualified as a non-taxable gift is “basically one of fact,” and appellate review of such findings is restricted to determining whether they are clearly erroneous. Because none of the recited findings are clearly erroneous, concludes the taxpayer, the judgment of the trial court must be affirmed.
We could not escape this logic were we prepared to accept as a “finding of fact” the trial court’s finding number 18. We reject the trial court’s characterization. The conclusion that tokes “are the result of detached and disinterested generosity” on the part of those patrons who engage in the practice of toking is a conclusion of law, not a finding of fact. Finding number 17, on the other hand, which establishes that tokes are given as the result of impulsive generosity or superstition on the part of the players is a finding of fact to which we are bound unless it is “clearly erroneous” which it is not.

The distinction is between a finding of the dominant reason that explains the player’s action in making the transfer and the determination that such dominant reason requires treatment of the receipt as a gift. Finding number 17 is addressed to the former while number 18 the latter. A finding regarding the basic facts, i.e., the circumstances and setting within which tokes are paid, and the dominant reason for such payments are findings of fact, our review of which is restricted by the clearly erroneous standard. Whether the dominant reason justifies exclusion from gross income under section 102 as interpreted by Duberstein is a matter of law. Finding number 18 is a determination that the dominant reason for the player’s action, as found in number 17, justifies exclusion. This constitutes an application of the statute to the facts. Whether the application is proper is, of course, a question of law.

This is a sensible approach. Otherwise an appellate court’s inescapable duty of appellate review in this type of case would be all but foreclosed by a finding, such as in number 18, in which the resolution of the ultimate legal issue was disguised as a finding of fact. The error in insisting that findings numbers 17 and 18 are both findings of fact with respect to the “dominant reason” is revealed when the language of finding number 18 is compared with Duberstein’s statement, “A gift in the statutory sense, on the other hand, proceeds from a ‘detached and disinterested generosity,’ ‘out of affection, respect, admiration, charity or like impulses.’ Their similarity is not coincidental and demonstrates that finding number 18 is but an application of the statutory definition of a gift to all previous findings of fact including finding number 17. Number 18 merely characterizes all previous
findings in a manner that makes classification of the receipt as a gift inevitable. “Detached and disinterested generosity” are, by reason of Duberstein, the operative words of the statutory definition of a gift. To apply them to facts, including a finding with respect to “dominant motive” is to apply the statute to such facts. It is a conclusion of law.

III.

Finding Number 18 and Other Conclusions of Law Based Thereon Are Erroneous.

Freed of the restraint of the “clearly erroneous” standard, we are convinced that finding number 18 and all derivative conclusions of law are wrong. “Impulsive generosity or superstition on the part of the players” we accept as the dominant motive. In the context of gambling in casinos open to the public such a motive is quite understandable. However, our understanding also requires us to acknowledge that payments so motivated are not acts of “detached or disinterested generosity.” Quite the opposite is true. Tribute to the gods of fortune which it is hoped will be returned bounteously soon can only be described as an “involved and intensely interested” act.

Moreover, in applying the statute to the findings of fact, we are not permitted to ignore those findings which strongly suggest that tokes in the hands of the ultimate recipients are viewed as a receipt indistinguishable, except for erroneously anticipated tax differences, from wages. The regularity of the flow, the equal division of the receipts, and the daily amount received indicate that a dealer acting reasonably would come to regard such receipts as a form of compensation for his services. The manner in which a dealer may regard tokes is, of course, not the touchstone for determining whether the receipt is excludable from gross income. It is, however, a reasonable and relevant inference well-grounded in the findings of fact.

* * * Generalizations are treacherous but not without utility. One such is that receipts by taxpayers engaged in rendering services contributed by those with whom the taxpayers have some personal or functional contact in the course of the performance of the services are taxable income when in conformity with the practices of the area and easily valued. Tokes, like tips, meet these conditions. That is enough.

The taxpayer is not entitled to the refund he seeks.

REVERSED.
Chapter 3 The Meaning of “Gross Income”

Go Online

There are lots of stories of service employees receiving large “tips” from customers. Tips, are by definition, in response to a service and therefore are always taxable. The question arises, however, is the transfer at issue really at tip. Check out this wonderful video of a “tip” given to a Pizza Hut waitress. Do you think the transfer is taxable? Why or why not?

Exclusion for Bequests, Devises, and Inheritances. As previously mentioned, the §102(a) exclusion applies not only to inter vivos transfers but also to gifts made at death. Does the same standard of “detached and disinterested generosity” apply to death-time gifts? The following authorities offer an answer to this question.

Wolder v. Commissioner


OAKES, Circuit Judge:

These two cases, involving an appeal and cross-appeal in the individual taxpayers’ case and an appeal by the Commissioner in the estate taxpayer’s case, essentially turn on one question: whether an attorney contracting to and performing lifetime legal services for a client receives income when the client, pursuant to the contract, bequeaths a substantial sum to the attorney in lieu of the payment of fees during the client’s lifetime. In the individual taxpayers’ case, the Tax Court held that the fair market value of the stock and cash received under the client’s will constituted taxable income under §61, and was not exempt from taxation as a bequest under §102 of the Code. From this ruling the individual taxpayers, Victor R. Wolder, the attorney, and his wife, who signed joint returns, appeal. * * *

* * *

There is no basic disagreement as to the facts. On or about October 3, 1947, Victor R. Wolder, as attorney, and Marguerite K. Boyce, as client, entered into a written agreement which, after reciting Mr. Wolder’s past services on her behalf in an action against her ex-husband for which he had made no charge, consisted of mutual promises, first on the part of Wolder to render to Mrs. Boyce “such legal services as she shall in her opinion personally require from time to time as long as both ... shall live and not to bill her for such services,” and second on the part of
Mrs. Boyce to make a codicil to her last will and testament giving and bequeathing to Mr. Wolder or to his estate “my 500 shares of Class B common stock of White Laboratories, Inc.” or “such other ... securities” as might go to her in the event of a merger or consolidation of White Laboratories. Subsequently, in 1957, White Laboratories did merge into Schering Corp. * * *. In a revised will dated April 23, 1965, Mrs. Boyce, true to the agreement with Mr. Wolder, bequeathed to him or his estate the sum of $15,845 and the 750 shares of common stock of Schering Corp. There is no dispute but that Victor R. Wolder had rendered legal services to Mrs. Boyce over her lifetime (though apparently these consisted largely of revising her will) and had not billed her therefor so that he was entitled to performance by her under the agreement, on which she had had a measure of independent legal advice. * * *

Wolder argues that the legacy he received under Mrs. Boyce’s will is specifically excluded from income by virtue of §102(a) * * *. The individual taxpayer, as did dissenting Judge Quealy below, relies upon *United States v. Merriam*, 263 U.S. 179, 44 S.Ct. 69, 68 L.Ed. 240 (1923), and its progeny for the proposition that the term “bequest” in §102(a) has not been restricted so as to exclude bequests made on account of some consideration flowing from the beneficiary to the decedent. In *Merriam* the testator made cash bequests to certain persons who were named executors of the estate, and these bequests were “in lieu of all compensation or commissions to which they would otherwise be entitled as executors or trustees.” The Court held nevertheless that the legacies were exempt from taxation * * *

But we think that *Merriam* is inapplicable to the facts of this case, for here there is no dispute but that the parties did contract for services and—while the services were limited in nature—there was also no question but that they were actually rendered. Thus the provisions of Mrs. Boyce’s will, at least for federal tax purposes, went to satisfy her obligation under the contract. The contract in effect was one for the postponed payment of legal services, i.e., by a legacy under the will for services rendered during the decedent’s life.

Moreover, the Supreme Court itself has taken an entirely different viewpoint from *Merriam* when it comes to interpreting §102(a) * * *. In *Commissioner v. Duberstein*, the Court held that the true test is whether in actuality the gift is a bona fide gift or simply a method for paying compensation. This question is resolved by an examination of the intent of the parties, the reasons for the transfer, and the parties’ performance in accordance with their intentions—“what the basic reason for (the donor’s) conduct was in fact—the dominant reason that explains his action in making the transfer.” There are other cases holding testamentary transfers to be taxable compensation for services as opposed to tax-free bequests.
True, in each of these cases the testator did not fulfill his contractual obligation to provide in his will for payment of services rendered by the taxpayer, forcing the taxpayers to litigate the merits of their claims against the estates, whereas in the case at bar the terms of the contract were carried out. This is a distinction without a difference, and while we could decline to follow them in the case at bar, we see no reason to do so.

Indeed, it is to be recollected that §102 is, after all, an exception to the basic provision in §61(a) that “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including ... (1) Compensation for services, including fees, commissions and similar items ....” The congressional purpose is to tax income comprehensively. A transfer in the form of a bequest was the method that the parties chose to compensate Mr. Wolder for his legal services, and that transfer is therefore subject to taxation, whatever its label whether by federal or by local law may be.

Taxpayer’s argument that he received the stock and cash as a “bequest” under New York law and the decisions of the surrogates is thus beside the point. New York law does, of course, control as to the extent of the taxpayer’s legal rights to the property in question, but it does not control as to the characterization of the property for federal income tax purposes. New York law cannot be decisive on the question whether any given transfer is income under §61(a) or is exempt under §102(a) of the Code. We repeat, we see no difference between the transfer here made in the form of a bequest and the transfer under Commissioner v. Duberstein, supra, which was made without consideration, with no legal or moral obligation, and which was indeed a “common-law gift,” but which was nevertheless held not to be a gift excludable under §102(a).

Revenue Ruling 67–375

Facts: A and B agreed to care for C for the rest of C’s life. C agreed to leave all of C’s personal property to A and B in exchange for these services.

Issue: Must A and B include the amounts received from C’s estate in gross income?

Holding: Yes.

Rationale: C’s transfer was specifically made as payment for services and not from “detached and disinterested generosity.”
Problem 3–12

In Year One, Jerry transferred 100 shares of NBC, Inc., stock to his best friend, George. At the time of the transfer, the stock was worth $5,000. In Year Two, NBC, Inc., declared a cash dividend on its shares. As the owner of the shares, George received a dividend check in the amount of $100 late in Year Two.

(a) Does George have gross income in Year One? In Year Two?

(b) Would the answer to (a) change if, instead of receiving cash, all of the NBC, Inc., shareholders received (in Year Two) two additional shares of NBC, Inc., stock for every share they already own?

Problem 3–13

Pursuant to a trust agreement she created, Elaine transferred title to an apartment building to Cosmo, the trustee. The trust agreement instructed Cosmo to pay the monthly rental income from the apartment building to Susan, Elaine’s friend, for Susan’s life. At Susan’s death, Cosmo is supposed to transfer the apartment building to Elaine’s on-again, off-again beau, David.

(a) Does anyone have gross income at the time Elaine transfers the apartment building to Cosmo?

(b) Suppose Cosmo paid the rents to Susan throughout Year One, and that Susan died at the very beginning of Year Two while licking poisoned envelopes. Cosmo then transferred title to the building to David. Does anyone have gross income in Year One or Year Two?

(c) How would the answers to (a) and (b) change if David is Elaine’s employee (as well as her one true love)?
Problem 3–14

Newman is an employee of the United States Postal Service. Newman receives the following items from his employer. Determine whether each such item is included in Newman’s gross income.

(a) 100 free stamps, worth $40, every month

(b) $50 in flowers upon the death of his father, Paul

(c) A $250 Swatch watch in recognition of completing his first four years at the Postal Service without taking a sick day

(d) Same as (c), except that a watch was given to all employees in recognition of making it through the year without any deaths at any post office branch location in the United States.

Problem 3–15

Late in life, Frank Costanza’s health began to deteriorate. Concerned that he would be unable to care for himself, Frank asked his son, George, if he could move into George’s apartment. George refused the request. Frank turned to George’s childhood friend, Lloyd Braun, for help. Lloyd graciously opened his home to Frank. Until his death, Frank regularly told Lloyd that he would repay Lloyd for Lloyd’s kindness and attention. Frank’s will left his entire estate to Lloyd.

(a) Does Lloyd have gross income?

(b) Is there a way that Frank could have drafted his bequest so that there would be little or no question that it was a gift?

(c) Suppose George contested the will on the grounds that Frank lacked capacity and was unduly influenced by Lloyd. George argued that he was entitled to the entire estate as Frank’s only living heir. If George prevails, does he have gross income when he receives Frank’s estate?
D. Loans and the Cancellation of Debt

**Code:** IRC §§61(a)(4), (a)(12); 108(a)–(b)(2), (c)–(d)(3), (e)(5). *Skim* IRC §§163; 1017.

**Regs:** None.

Though we are admonished to be neither borrowers nor lenders, loan transactions are common in our society. Federal income tax laws must account for the fact that taxpayers frequently serve as both lenders and borrowers. The following axioms provide the basic rules, and they are universally accepted. Most are so fundamental that neither Congress nor the Treasury Department has felt compelled to codify them.

**Axiom #1. A loan is not gross income to the borrower.** In a bona fide loan arrangement, the borrower has the obligation to repay the amount received as a loan. Consequently, the borrower has no accession to wealth from a loan, for while the borrower has received the loan proceeds, the amount of the proceeds are offset by the liability to repay the same amount.

**Axiom #2. The lender may not deduct the amount of the loan.** Suppose a taxpayer loans $100 to an unrelated party in a bona fide transaction. From the lender’s perspective, the loan merely converts one asset (cash) into another asset (a promise of repayment). As Chapter 4 will explain, deductions are typically limited to expenses and are not available when an outlay serves to create a new or different asset.

**Axiom #3. The amount paid to satisfy the loan obligation is not deductible by the borrower.** Although the outlay made to satisfy a repayment obligation does not serve to create a new or different asset, repayment of a loan does not represent a real “cost” to the borrower, for the repayment of the principal amount represents merely a return of the borrowed amount.

**Axiom #4. Repayment of the loan is not gross income to the lender.** The repayment represents merely a return of capital to the lender. In effect, the promise of repayment is converted back to cash, with no accession to wealth by the lender. If the lender gets back something less than the entire amount originally loaned, the lender may be able to deduct the amount of the deficiency, as will be discussed in Chapter 9.
Axiom #5. Interest paid to the lender is included in the lender’s gross income. Section 61(a)(4) requires this result. Interest paid to a lender is compensation for the use of the lender’s money or property and thus represents profit or an accession to wealth in the hands of the lender. Lenders usually cannot avoid gross income simply be charging no interest. Later on, we will see that interest income will even be imputed to the lender in cases where the lender fails to charge a minimum amount of interest on a bona fide loan.

Axiom #6. Interest paid to the lender may be deductible by the borrower. Section 163 governs the deductibility of interest payments. Very generally, as we will see later on, interest paid in connection with the borrower’s business activity will be deductible, while interest paid on loans used for personal activities or expenses will not be deductible (with the major exception of interest paid on a home mortgage).

Cancellation of Debt. If a lender forgives or cancels an outstanding debt, there may be income tax consequences to the borrower, as the following case illustrates.

United States v. Kirby Lumber Co.

United States Supreme Court, 1931.
284 U.S. 1, 52 S.Ct. 4, 76 L.Ed. 131.

Mr. Justice Holmes delivered the opinion of the court.

In July, 1923, the plaintiff, the Kirby Lumber Company, issued its own bonds for $12,126,800 for which it received their par value. Later in the same year it purchased in the open market some of the same bonds at less than par, the difference of price being $137,521.30. The question is whether this difference is a taxable gain or income of the plaintiff for the year 1923. * * * [B]y the Treasury Regula-
tions authorized by §1303, that have been in force through repeated re-enactments, “If the corporation purchases and retires any of such bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is gain or income for the taxable year.” We see no reason why the Regulations should not be accepted as a correct statement of the law.

In *Bowers v. Kerbaugh–Empire Co.*, 271 U.S. 170, 46 S.Ct. 449, 70 L.Ed. 886, the defendant in error owned the stock of another company that had borrowed money repayable in marks or their equivalent for an enterprise that failed. At the time of payment the marks had fallen in value, which so far as it went was a gain for the defendant in error, and it was contended by the plaintiff in error that the gain was taxable income. But the transaction as a whole was a loss, and the contention was denied. Here there was no shrinkage of assets and the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The defendant in error has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here. *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 364, 51 S.Ct. 150, 75 L.Ed. 383.

Judgment reversed.

**Notes and Questions**

1. What is the rationale for concluding that the Kirby Lumber Company has gross income when the debt to its bondholders is partially discharged? There are two valid theories for requiring inclusion in gross income. First, The Court suggests that the cancellation of debt is a “freeing of assets” to the borrower. To the extent a taxpayer no longer must commit funds to the complete repayment of a debt, the taxpayer is now free to use those previously committed funds to other purposes. Put differently, a cancellation of debt is
an accession to wealth. Suppose a taxpayer has $200,000 in total assets and $120,000 in total liabilities. The taxpayer has a “net worth” of $80,000. If one of the taxpayer’s creditors forgives a $5,000 loan to the taxpayer, the taxpayer still has $200,000 in assets, but total liabilities amount to only $115,000. The taxpayer’s net worth thus increases to $85,000, and that increase in net worth is, in essence, an accession to wealth.

A second theory for inclusion of forgiven debts is based on symmetry. The borrower does not have gross income at the time of the loan because of the obligation of repayment. If some portion of that obligation is subsequently cancelled or forgiven, the rationale for precluding inclusion in gross income disappears, so inclusion should result. If the borrower could exclude both the original loan and the subsequent forgiveness of the liability to repay that amount, the borrower would be receiving a double benefit, and the money was never repaid would never be subject to tax in the taxpayer’s hands.

2. Congress codified the result in *Kirby Lumber*. See §61(a)(12).

**Exclusion of COD Income Under §108.** Tax professionals often refer to income from the discharge of indebtedness as “COD” income, standing for “cancellation of debt” income. While §61(a)(12) generally requires inclusion of COD income, §108 offers a limited exclusion for certain forms of COD income. Specifically, §108(a) lists four types of COD income that will qualify for exclusion. The first two types listed in §108(a) are based on the fact that a bankrupt or insolvent taxpayer has no “freeing of assets” if the taxpayer still has a negative net worth after the discharge. The last two types listed provide special rules for taxpayers engaged in certain activities. Is it good tax policy to provide benefits targeted to these discrete groups?

**Problem 3–16**

Determine the federal income tax consequences to Antonio arising from each of the following transactions:

(a) Antonio owed $50,000 to Shylock, an unrelated individual. Antonio, struggling to make a living and feed a family, offered $35,000 cash to Shylock in full satisfaction of the debt. Shylock accepted the cash and retired the debt.

(b) Same as (a), except that at the time Antonio paid $35,000 cash to Shylock, the fair market value of Antonio’s assets was $40,000 less than the amount of Antonio’s total liabilities.
Zarin v. Commissioner

916 F.2d 110.

COWEN, CIRCUIT JUDGE.

David Zarin (“Zarin”) appeals from a decision of the Tax Court holding that he recognized $2,935,000 of income from discharge of indebtedness resulting from his gambling activities, and that he should be taxed on the income. * * *

After considering the issues raised by this appeal, we will reverse.

I.

Zarin was a professional engineer who participated in the development, construction, and management of various housing projects. A resident of Atlantic City, New Jersey, Zarin occasionally gambled, both in his hometown and in other places where gambling was legalized. To facilitate his gaming activities in Atlantic City, Zarin applied to Resorts International Hotel (“Resorts”) for a credit line in June, 1978. Following a credit check, Resorts granted Zarin $10,000 of credit. Pursuant to this credit arrangement with Resorts, Zarin could write a check, called a marker, and in return receive chips, which could then be used to gamble at the casino’s tables.

Before long, Zarin developed a reputation as an extravagant “high roller” who routinely bet the house maximum while playing craps, his game of choice. Considered a “valued gaming patron” by Resorts, Zarin had his credit limit increased at regular intervals without any further credit checks, and was provided a number of complimentary services and privileges. By November, 1979, Zarin’s permanent

2 A “marker” is a negotiable draft payable to Resorts and drawn on the maker's bank.
line of credit had been raised to $200,000. Between June, 1978, and December, 1979, Zarin lost $2,500,000 at the craps table, losses he paid in full.

Responding to allegations of credit abuses, the New Jersey Division of Gaming Enforcement filed with the New Jersey Casino Control Commission a complaint against Resorts. Among the 809 violations of casino regulations alleged in the complaint of October, 1979, were 100 pertaining to Zarin. Subsequently, a Casino Control Commissioner issued an Emergency Order, the effect of which was to make further extensions of credit to Zarin illegal.

Nevertheless, Resorts continued to extend Zarin's credit limit * * * [These actions] effectively ignored the Emergency Order and were later found to be illegal.

By January, 1980, Zarin was gambling compulsively and uncontrollably at Resorts, spending as many as sixteen hours a day at the craps table. During April, 1980, Resorts again increased Zarin's credit line without further inquiries. That same month, Zarin delivered personal checks and counterchecks to Resorts which were returned as having been drawn against insufficient funds. Those dishonored checks totaled $3,435,000. In late April, Resorts cut off Zarin's credit.

Although Zarin indicated that he would repay those obligations, Resorts filed a New Jersey state court action against Zarin in November, 1980, to collect the $3,435,000. Zarin denied liability on grounds that Resorts' claim was unenforceable under New Jersey regulations intended to protect compulsive gamblers. Ten months later, in September, 1981, Resorts and Zarin settled their dispute for a total of $500,000.

The Commissioner of Internal Revenue (“Commissioner”) subsequently determined deficiencies in Zarin's federal income taxes for 1980 and 1981, arguing that Zarin recognized $3,435,000 of income in 1980 from larceny by trick and deception. After Zarin challenged that claim by filing a Tax Court petition, the Commissioner abandoned his 1980 claim, and argued instead that Zarin had recognized $2,935,000 of income in 1981 from the cancellation of indebtedness which resulted from the settlement with Resorts.

Agreeing with the Commissioner, the Tax Court decided, eleven judges to eight, that Zarin had indeed recognized $2,935,000 of income from the discharge of indebtedness, namely the difference between the original $3,435,000 “debt” and the $500,000 settlement. **Zarin v. Commissioner, 92 T.C. 1084 (1989).** Since he was in the seventy percent tax bracket, Zarin's deficiency for 1981 was calculated to be $2,047,245. With interest to April 5, 1990, Zarin allegedly owes the Internal Revenue Service $5,209,033.96 in additional taxes. Zarin appeals the order of the Tax Court.

Zarin claims that at the time he was suffering from a recognized emotional disorder that caused him to gamble compulsively.
II.

The sole issue before this Court is whether the Tax Court correctly held that Zarin had income from discharge of indebtedness. Section 108 and section 61(a)(12) of the Code set forth “the general rule that gross income includes income from the discharge of indebtedness.” I.R.C. §108(e)(1). The Commissioner argues, and the Tax Court agreed, that pursuant to the Code, Zarin did indeed recognize income from discharge of gambling indebtedness.

Under the Commissioner's logic, Resorts advanced Zarin $3,435,000 worth of chips, chips being the functional equivalent of cash. At that time, the chips were not treated as income, since Zarin recognized an obligation of repayment. In other words, Resorts made Zarin a tax-free loan. However, a taxpayer does recognize income if a loan owed to another party is cancelled, in whole or in part. I.R.C. §§61(a)(12); 108(e). The settlement between Zarin and Resorts, claims the Commissioner, fits neatly into the cancellation of indebtedness provisions in the Code. Zarin owed $3,435,000, paid $500,000, with the difference constituting income. Although initially persuasive, the Commissioner's position is nonetheless flawed for two reasons.

III.

Initially, we find that sections 108 and 61(a)(12) are inapplicable to the Zarin/Resorts transaction. Section 61 does not define indebtedness. On the other hand, section 108(d)(1), which repeats and further elaborates on the rule in section 61(a)(12), defines the term as any indebtedness “(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property.” I.R.C. §108(d)(1). In order to bring the taxpayer within the sweep of the discharge of indebtedness rules, then, the IRS must show that one of the two prongs in the section 108(d)(1) test is satisfied. It has not been demonstrated that Zarin satisfies either.

Practice Pointer

Why didn't Zarin argue he was insolvent under §108(a)(1)(B)? Doesn’t that seem like the correct approach? Would we care about this issue and have sympathy for Zarin if he were rich? We don't know why Zarin didn't make the argument below, but he sued his lawyer for malpractice. See Zarin v. Reid & Priest, 184 A.D.2d 385, 583 N.Y.S.2d 379 (N.Y. App. Div. 1992). Zarin lost. The court found that Zarin could not recover because he ultimately won the case.

6 Subsequent to the Tax Court’s decision, Zarin filed a motion to reconsider, arguing that he was insolvent at the time Resorts forgave his debt, and thus, under I.R.C. section 108(a)(1)(B), could not have income from discharge of indebtedness. He did, not, however, raise that issue before the Tax Court until after it rendered its decision. The Tax Court denied the motion for reconsideration. By reason of our resolution of this case, we do not need to decide whether the Tax Court abused its discretion in denying Zarin’s motion.
Because the debt Zarin owed to Resorts was unenforceable as a matter of New Jersey state law, it is clearly not a debt “for which the taxpayer is liable.” I.R.C. §108(d)(1)(A). Liability implies a legally enforceable obligation to repay, and under New Jersey law, Zarin would have no such obligation.

Moreover, Zarin did not have a debt subject to which he held property as required by section 108(d)(1)(B). Zarin’s indebtedness arose out of his acquisition of gambling chips. The Tax Court held that gambling chips were not property, but rather, “a medium of exchange within the Resorts casino” and a “substitute for cash.” Alternatively, the Tax Court viewed the chips as nothing more than “the opportunity to gamble and incidental services ...” Zarin, 92 T.C. at 1099. We agree with the gist of these characterizations, and hold that gambling chips are merely an accounting mechanism to evidence debt.

Gaming chips in New Jersey during 1980 were regarded “solely as evidence of a debt owed to their custodian by the casino licensee and shall be considered at no time the property of anyone other than the casino licensee issuing them.” N.J. Admin. Code §19:46–1.5(d) (1990). Thus, under New Jersey state law, gambling chips were Resorts’ property until transferred to Zarin in exchange for the markers, at which point the chips became “evidence” of indebtedness (and not the property of Zarin).

Even were there no relevant legislative pronouncement on which to rely, simple common sense would lead to the conclusion that chips were not property in Zarin’s hands. Zarin could not do with the chips as he pleased, nor did the chips have any independent economic value beyond the casino. The chips themselves were of little use to Zarin, other than as a means of facilitating gambling. They could not have been used outside the casino. They could have been used to purchase services and privileges within the casino, including food, drink, entertainment, and lodging, but Zarin would not have utilized them as such, since he received those services from Resorts on a complimentary basis. In short, the chips had no economic substance.

Although the Tax Court found that theoretically, Zarin could have redeemed the chips he received on credit for cash and walked out of the casino, Zarin, 92 T.C. at 1092, the reality of the situation was quite different. Realistically, before cashing in his chips, Zarin would have been required to pay his outstanding IOUs. New Jersey state law requires casinos to “request patrons to apply any chips or plaques in their possession in reduction of personal checks or Counter Checks exchanged for purposes of gaming prior to exchanging such chips or plaques for cash or prior to departing from the casino area.” Since his debt at all times equaled or exceeded the number of chips he possessed, redemption would have left Zarin with no chips, no cash, and certainly nothing which could have been characterized as property.
Not only were the chips non-property in Zarin’s hands, but upon transfer to Zarin, the chips also ceased to be the property of Resorts. Since the chips were in the possession of another party, Resorts could no longer do with the chips as it pleased, and could no longer control the chips’ use. Generally, at the time of a transfer, the party in possession of the chips can gamble with them, use them for services, cash them in, or walk out of the casino with them as an Atlantic City souvenir. The chips therefore become nothing more than an accounting mechanism, or evidence of a debt, designed to facilitate gambling in casinos where the use of actual money was forbidden. Thus, the chips which Zarin held were not property within the meaning of I.R.C. §108(d)(1)(B).9

In short, because Zarin was not liable on the debt he allegedly owed Resorts, and because Zarin did not hold “property” subject to that debt, the cancellation of indebtedness provisions of the Code do not apply to the settlement between Resorts and Zarin. As such, Zarin cannot have income from the discharge of his debt.

IV.

Instead of analyzing the transaction at issue as cancelled debt, we believe the proper approach is to view it as disputed debt or contested liability. Under the contested liability doctrine, if a taxpayer, in good faith, disputed the amount of a debt, a subsequent settlement of the dispute would be treated as the amount of debt cognizable for tax purposes. The excess of the original debt over the amount determined to have been due is disregarded for both loss and debt accounting purposes. Thus, if a taxpayer took out a loan for $10,000, refused in good faith to pay the full $10,000 back, and then reached an agreement with the lender that he would pay back only $7,000 in full satisfaction of the debt, the transaction would be treated as if the initial loan was $7,000. When the taxpayer tenders the $7,000 payment, he will have been deemed to have paid the full amount of the initially disputed debt. Accordingly, there is no tax consequence to the taxpayer upon payment.

The seminal “contested liability” case is N. Sobel, Inc. v. Commissioner, 40 B.T.A. 1263 (1939). In Sobel, the taxpayer exchanged a $21,700 note for 100 shares of stock from a bank. In the following year, the taxpayer sued the bank for rescission, arguing that the bank loan was violative of state law, and moreover, that the bank had failed to perform certain promises. The parties eventually settled the

9 The parties stipulated before the Tax Court that New Jersey casino “chips are property which are not negotiable and may not be used to gamble or for any other purpose outside the casino where they were issued.” It could be argued that we are bound by this stipulation to accept the proposition that chips are property. We do not dispute the notion that chips are property, but as discussed above, they are only property in the hands of the casino. The stipulation is consistent with this idea. In fact, both parties agreed in their briefs that chips are property of the casino. Moreover, during oral arguments, both parties agreed that chips were not property when held by the gambler.
case in 1935, with the taxpayer agreeing to pay half of the face amount of the note. In the year of the settlement, the taxpayer claimed the amount paid as a loss. The Commissioner denied the loss because it had been sustained five years earlier, and further asserted that the taxpayer recognized income from the discharge of half of his indebtedness.

The Board of Tax Appeals held that since the loss was not fixed until the dispute was settled, the loss was recognized in 1935, the year of the settlement, and the deduction was appropriately taken in that year. Additionally, the Board held that the portion of the note forgiven by the bank “was not the occasion for a freeing of assets and that there was no gain ...” Id. at 1265. Therefore, the taxpayer did not have any income from cancellation of indebtedness.

There is little difference between the present case and Sobel. Zarin incurred a $3,435,000 debt while gambling at Resorts, but in court, disputed liability on the basis of unenforceability. A settlement of $500,000 was eventually agreed upon. It follows from Sobel that the settlement served only to fix the amount of debt. No income was realized or recognized. When Zarin paid the $500,000, any tax consequence dissolved. 10

* * *

The Commissioner argues that Sobel and the contested liability doctrine only apply when there is an unliquidated debt; that is, a debt for which the amount cannot be determined. * * * Since Zarin contested his liability based on the unenforceability of the entire debt, and did not dispute the amount of the debt, the Commissioner would have us adopt the reasoning of the Tax Court, which found that Zarin's debt was liquidated, therefore barring the application of Sobel and the contested liability doctrine. Zarin, 92 T.C. at 1095 (Zarin's debt “was a liquidated amount” and “[t]here is no dispute about the amount [received].”).

We reject the Tax Court's rationale. When a debt is unenforceable, it follows that the amount of the debt, and not just the liability thereon, is in dispute. Although a debt may be unenforceable, there still could be some value attached to its worth. This is especially so with regards to gambling debts. In most states, gambling debts are unenforceable, and have “but slight potential....” Nevertheless, they are often collected, at least in part. For example, Resorts is not a charity; it would not have extended illegal credit to Zarin and others if it did not have some hope of collecting debts incurred pursuant to the grant of credit.

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10 Had Zarin not paid the $500,000 dollar settlement, it would be likely that he would have had income from cancellation of indebtedness. The debt at that point would have been fixed, and Zarin would have been legally obligated to pay it.
Moreover, the debt is frequently incurred to acquire gambling chips, and not money. Although casinos attach a dollar value to each chip, that value, unlike money’s, is not beyond dispute, particularly given the illegality of gambling debts in the first place. This proposition is supported by the facts of the present case. Resorts gave Zarin $3.4 million dollars of chips in exchange for markers evidencing Zarin’s debt. If indeed the only issue was the enforceability of the entire debt, there would have been no settlement. Zarin would have owed all or nothing. Instead, the parties attached a value to the debt considerably lower than its face value. In other words, the parties agreed that given the circumstances surrounding Zarin’s gambling spree, the chips he acquired might not have been worth $3.4 million dollars, but were worth something. Such a debt cannot be called liquidated, since its exact amount was not fixed until settlement.

To summarize, the transaction between Zarin and Resorts can best be characterized as a disputed debt, or contested liability. Zarin owed an unenforceable debt of $3,435,000 to Resorts. After Zarin in good faith disputed his obligation to repay the debt, the parties settled for $500,000, which Zarin paid. That $500,000 settlement fixed the amount of loss and the amount of debt cognizable for tax purposes. Since Zarin was deemed to have owed $500,000, and since he paid Resorts $500,000, no adverse tax consequences attached to Zarin as a result.\footnote{The Commissioner argues in the alternative that Zarin recognized $3,435,000 of income in 1980. This claim has no merit. Recognition of income would depend upon a finding that Zarin did not have cancellation of indebtedness income solely because his debt was unenforceable. We do not so hold. Although unenforceability is a factor in our analysis, our decision ultimately hinges upon the determination that the “disputed debt” rule applied, or alternatively, that chips are not property within the meaning of I.R.C. section 108.}

V.

In conclusion, we hold that Zarin did not have any income from cancellation of indebtedness for two reasons. First, the Code provisions covering discharge of debt are inapplicable since the definitional requirement in I.R.C. section 108(d)(1) was not met. Second, the settlement of Zarin’s gambling debts was a contested liability. We reverse the decision of the Tax Court and remand with instructions to enter judgment that Zarin realized no income by reason of his settlement with Resorts.

\textit{Stapleton, Circuit Judge, dissenting.}

I respectfully dissent because I agree with the Commissioner’s appraisal of the economic realities of this matter.

Resorts sells for cash the exhilaration and the potential for profit inherent in games of chance. It does so by selling for cash chips that entitle the holder to gamble at its casino. Zarin, like thousands of others, wished to purchase what Resorts
was offering in the marketplace. He chose to make this purchase on credit and executed notes evidencing his obligation to repay the funds that were advanced to him by Resorts. As in most purchase money transactions, Resorts skipped the step of giving Zarin cash that he would only return to it in order to pay for the opportunity to gamble. Resorts provided him instead with chips that entitled him to participate in Resorts’ games of chance on the same basis as others who had paid cash for that privilege. Whether viewed as a one or two-step transaction, however, Zarin received either $3.4 million in cash or an entitlement for which others would have had to pay $3.4 million.

Despite the fact that Zarin received in 1980 cash or an entitlement worth $3.4 million, he correctly reported in that year no income from his dealings with Resorts. He did so solely because he recognized, as evidenced by his notes, an offsetting obligation to repay Resorts $3.4 million in cash. In 1981, with the delivery of Zarin’s promise to pay Resorts $500,000 and the execution of a release by Resorts, Resorts surrendered its claim to repayment of the remaining $2.9 million of the money Zarin had borrowed. As of that time, Zarin’s assets were freed of his potential liability for that amount and he recognized gross income in that amount.

The only alternatives I see to this conclusion are to hold either (1) that Zarin realized $3.4 million in income in 1980 at a time when both parties to the transaction thought there was an offsetting obligation to repay or (2) that the $3.4 million benefit sought and received by Zarin is not taxable at all. I find the latter alternative unacceptable as inconsistent with the fundamental principle of the Code that anything of commercial value received by a taxpayer is taxable unless expressly excluded from gross income.\(^3\) I find the former alternative unacceptable as impracticable. In 1980, neither party was maintaining that the debt was unenforceable and, because of the settlement, its unenforceability was not even established in the litigation over the debt in 1981. It was not until 1989 in this litigation over the tax consequences of the transaction that the unenforceability was first judicially declared. Rather than require such tax litigation to resolve the correct treatment of a debt transaction, I regard it as far preferable to have the tax consequences turn on the manner in which the debt is treated by the parties. For present purposes, it will suffice to say that where something that would otherwise be includable in gross income is received on credit in a purchase money transaction, there should be no recognition of income so long as the debtor continues to recognize an obligation to repay the debt. On the other hand, income, if not

\(^3\) As the court’s opinion correctly points out, this record will not support an exclusion under §108(a) which relates to discharge of debt in an insolvency or bankruptcy context. Section 108(e)(5) of the Code, which excludes discharged indebtedness arising from a “purchase price adjustment” is not applicable here. Among other things, §108(e)(5) necessarily applies only to a situation in which the debtor still holds the property acquired in the purchase money transaction. Equally irrelevant is §108(d)’s definition of “indebtedness” relied upon heavily by the court. Section 108(d) expressly defines that term solely for the purposes of §108 and not for the purposes of §61(a)(12).
earlier recognized, should be recognized when the debtor no longer recognizes
an obligation to repay and the creditor has released the debt or acknowledged its
unenforceability.

In this view, it makes no difference whether the extinguishment of the credi-
tor’s claim comes as a part of a compromise. Resorts settled for 14 cents on the
dollar presumably because it viewed such a settlement as reflective of the odds
that the debt would be held to be enforceable. While Zarin should be given credit
for the fact that he had to pay 14 cents for a release, I see no reason why he should
not realize gain in the same manner as he would have if Resorts had concluded
on its own that the debt was legally unenforceable and had written it off as uncol-
lectible.

I would affirm the judgment of the Tax Court.

Questions

1. Do you agree with the court’s holding in Zarin? Does it represent good tax
policy? In this regard, consider the following observation of Professor Daniel
Shaviro with respect to the Tax Court’s decision of the case (which held that
Zarin had gross income):

Zarin is a perplexing and difficult case, both theoretically and under
existing tax law. On the one hand, few would disagree that if Zarin,
instead of being able to settle, had been forced to pay Resorts the
entire $3,435,000, there would be no good reason to allow him any
deduction. This may suggest that he did have income to the extent
that he was able to do better than this and escape full liability for the
nominal cost of his gambling.

On the other hand, the decision has an undeniable Alice in Won-
derland quality. As all three dissenting opinions asked in one way
or another, how can a gambler have more pleasure from gambling
the more he loses? Was Zarin really $2,935,000 better off at the end
than at the beginning, or was he instead, even before being taxed,
the hapless victim of a pathological disorder that was hardly less
disabling and destructive than, say, an addiction to crack?

Daniel Shaviro, The Man Who Lost Too Much: Zarin v. Commissioner and the
2. As Judge Stapleton’s dissent suggests, the Zarin court might have strained its interpretation of the Code to reach the result it wanted. Could the majority have used a different approach to justify its holding? For example, could the $2,935,000 difference between the amount extended to Zarin as credit and the amount Zarin paid be viewed as a non-taxable bargain purchase? See Mark J. Marion, *Zarin v. Commissioner: Does a Gambler Have Income From the Cancellation of a Casino Debt?*, 27 New Eng. L. Rev. 993 (1993).

E. Gains from Dealings in Property

(1.) The Formula for Computing Gain

**Code:** IRC §§61(a)(3); 109; 1001(a)-(c); 1011(a); 1012; 1017. *Skim* IRC §1016(a). Review IRC §102.

**Regs:** Treas. Reg. §§1.61–6(a); 1.263(a)–2(e); 1.1012–1(c)(1).

*Lions and Tigers and Basis—Oh My!* Assume you just bought a home for $100,000. If you sold the home a few months later for $125,000, how much should you include in gross income? **Section 61(a)(3)** clearly states that gross income includes gains from dealings in property; accordingly, you would include only the $25,000 of profit in gross income. This intuitive concept, that a taxpayer does not have gross income until after he or she has first recovered his or her capital investment in the property exchanged, was first recognized by the Supreme Court in *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 38 S.Ct. 467, 62 L.Ed. 1054 (1918). As the Court stated:

> **It cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not most cases there results a gain that properly may be accounted as a part of the “gross income” received “from all sources”; it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not most cases there results a gain that properly may be accounted as a part of the “gross income” received “from all sources”; it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not most cases there results a gain that properly may be accounted as a part of the “gross income” received “from all sources”; it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not most cases there results a gain that properly may be accounted as a part of the “gross income” received “from all sources”; it cannot be said that a conversion of capital assets invariably produces income. If sold at less than cost, it produces rather loss or outgo. Nevertheless, in many if not most cases there results a gain that properly may be accounted as a part of the “gross income” received “from all sources”;**

*Id.* at 184–185.
Computation of gain and loss is governed by §1001(a). That section defines gain as the excess of the amount realized over the adjusted basis in the property exchanged. Likewise, loss is defined as the excess of the adjusted basis over the amount realized. To perform simple gain and loss computations, then, we need to know what is meant by these two terms. Put in the most pedestrian terms possible, the amount realized is the value of what the taxpayer receives in the exchange, and the adjusted basis is the cost of what the taxpayer gives up in the exchange.

<table>
<thead>
<tr>
<th>Amount Realized</th>
<th>AR</th>
</tr>
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<tbody>
<tr>
<td>- Adjusted Basis</td>
<td>- AB</td>
</tr>
<tr>
<td>Realized Gain</td>
<td>RG</td>
</tr>
<tr>
<td>Adjusted Basis</td>
<td>AB</td>
</tr>
<tr>
<td>- Amount Realized</td>
<td>- AR</td>
</tr>
<tr>
<td>Realized Loss</td>
<td>RL</td>
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</tbody>
</table>

**Amount Realized.** Section 1001(b) says that the amount realized is “the sum of any money received plus the fair market value of the property (other than money) received.” Consider these examples:

- Taxpayer sells a building in exchange for $300,000 cash.

- Taxpayer sells a building in exchange for $250,000 cash and a vehicle worth $50,000.

- Taxpayer sells a building in exchange for $100,000 cash, $100,000 worth of marketable securities, and another building worth $100,000.

In each example, Taxpayer’s amount realized is $300,000. If the amount realized exceeds Taxpayer’s adjusted basis in the building at the time of sale, Taxpayer will realize a gain from the transaction.

Computing the amount realized is usually the easy part. Knowing when a “realization event” has occurred can be more difficult. Recall that in *Eisner v. Macomber, Part A, supra*, Mrs. Macomber did not have gross income even though she received additional shares in Standard Oil Company and even though those additional shares certainly had a value at receipt. Why didn’t Mrs. Macomber have...
gross income under §1001? Because she did not exchange property to receive the additional shares. Section 1001 only applies when there is an exchange and where the taxpayer receives money or other property in the transaction (the “amount realized”). Thus one of the key concepts to understanding a taxpayer’s “amount realized” is to identify when an “exchange” has occurred. Maybe the following case will be helpful in that regard.

**Helvering v. Bruun**

309 U.S. 461, 60 S.Ct. 631, 84 L.Ed. 864 (1940).

**Facts:** The taxpayer leased improved real property to a tenant for a 99–year term. The lease agreement allowed the tenant to tear down any existing improvements and to construct a new building or other improvements on the property, subject to certain conditions not relevant to the case. In the fourteenth year of the lease term, the tenant removed the existing building and constructed a new one on the property. Four years later, the lease was cancelled due to the tenant’s failure to pay rent and taxes according to the lease agreement. Pursuant to the lease agreement, the tenant surrendered the property, including the building and all improvements, to the taxpayer.

The value of the new building as of the date of repossession was $64,245.68. The taxpayer’s adjusted basis in the old building removed by the tenant was $12,811.43. The government thus contended that the taxpayer realized a gain of $51,434.25, the difference between these two amounts.

**Issue:** Did the taxpayer realize a gain upon repossession of the property?

**Holding:** Yes.

**Rationale:** “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 (sic) 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.”

Notes and Questions

1. The Court’s last statement, that gains from property exchanges prove that severability is not a prerequisite to realization, is flawed. In the prototypical property exchange, where two taxpayers exchange assets, severance occurs as each taxpayer surrenders his or her interest in one asset to receive another asset. Indeed, surrender is the ultimate severance. Property exchanges thus bear little resemblance to permanent improvements to capital assets, where a taxpayer does not surrender any interest in the improved asset.

2. Notice that the Court lists four events that trigger realization of gain or loss: (1) a property exchange; (2) relief of a legal obligation owed to a third party; (3) relief of a legal obligation owed to the party receiving property; and (4) “other” profit transactions. This is helpful guidance going forward, but do the facts of Bruun fit snugly within any of these descriptions? The taxpayer in Bruun did not surrender any interest by repossessing the leased property, so Bruun is not an example of a property exchange.

Nor is Bruun an example of a relieved obligation owed to a third party, the second “realization event” listed by the Court. This second event is based upon Old Colony Trust Co. v. Commissioner, Part B(1), supra, generally cited for the proposition that the discharge by a third person of a taxpayer’s obligation to another party is income to the taxpayer. Importantly, the Court in Old Colony Trust made no explicit reference to “realization” and only one reference to “gain,” stating in its holding that:

The payment of the (employee-taxpayer’s federal income) tax (liability) by the employers was in consideration of the services rendered
Chapter 3 The Meaning of “Gross Income”

by the employee and was a gain derived by the employee from his labor.

279 U.S. at 729. The result in Old Colony Trust is justified under two alternate theories. First, the employer's payment of the taxpayer's federal income tax liability is in substance, as the Court states, extra compensation to the taxpayer. Since all forms of compensation for services are included in income, Old Colony Trust is correct. Second, the taxpayer-employee in Old Colony Trust was enriched because he did not have to devote a portion of his cash reserves to pay his federal income tax liability. The employer's satisfaction of his obligation to pay federal income taxes frees assets that would otherwise be paid or sold to meet the obligation.

While Old Colony Trust is correct, it hardly controls the result in Bruun. For one thing, Old Colony Trust was about “gain derived from labor,” not “gain derived from property.” More significantly, Old Colony Trust was really about compensation for services. There is no suggestion in Bruun that the new building was additional rent paid by the tenant. Finally, there was no “freeing of assets” in Bruun, as the taxpayer was not relieved of any liability by repossessing the improved property.

As there was no indebtedness relieved in Bruun, the case cannot be categorized as an example of the third “realization event” described by the Court, relief of debt owed to the party receiving property from the taxpayer. This third event stems from the Court’s holding in United States v. Kirby Lumber Co., Part D, supra, that a corporate taxpayer realized gain by repurchasing its own bonds for a price less than face value. Kirby Lumber articulated the “freeing of assets” justification for realization by explaining that:

the taxpayer made a clear gain. As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct.... The (taxpayer) has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here.

284 U.S. at 3. The taxpayer in Kirby Lumber clearly realized a gain and has the “freed assets” as resources to pay the tax liability associated with the realization event. Kirby Lumber is thus a proper example of realization, and the Court is right to include it in the list of realization events. Again, though, the taxpayer in Bruun did not discharge a liability for less than its full amount.
By elimination, therefore, *Bruun* is the example of an “other profit transaction,” the fourth realization event. In essence, *Bruun* stands for the proposition that a taxpayer realizes profit by receiving an asset with a quantifiably enhanced value in a transaction with another party. In one respect, *Bruun* is a narrow holding—only an example of the fourth realization event. On the other hand, *Bruun* could be read as a dramatic departure from the concept of realization first set forth in *Eisner v. Macomber*, Part A, supra. No longer is “severance” an element of realization. In substance, this may be the same as saying that Congress has the power to tax appreciation in value even in the absence of any transaction. Yet for the practical reasons identified in Part A of this Chapter, Congress has not yet tried to exert its taxing authority to this extent.

3. In evaluating the correctness and significance of *Bruun*, it is helpful to consider how an economically similar transaction would be treated. Suppose that instead of leasing the improved property to the tenant, the taxpayer hired the tenant to remove the existing building and construct a new building on the property. In consideration of the tenant’s performance, the tenant would be permitted to use the building for a stated term of years. The position of the Service is that both parties have income: the tenant has income equal to the fair rental value of the property, and the taxpayer has income equal to the fair market value of the building. See *Rev. Rul. 79–24*, Part A, supra. This result is justified on the ground that if barter transactions are not taxed, individuals could easily circumvent the imposition of tax.

When the facts are cast in terms of a transaction, it is easy to conclude that the taxpayer has income. Is the conclusion any different in the absence of a transaction? The *Bruun* Court might say no, but perhaps the answer should be yes. If two parties enter into a formal transaction, the parties should expect that to the extent they are enriched by the transaction, they have “income” for purposes of the Sixteenth Amendment. Knowing this result, the parties can arrange their affairs so as to be able to pay the tax liability resulting from the transaction. But if a party is simply enriched without entering into a formal transaction, and thus has no ability to arrange his or her affairs in anticipation...
of the tax liability, the party should only have “income” when he or she has
the funds to pay the tax liability associated with the enrichment. Realization
should be a time when the enriched taxpayer has the means to pay the related
tax; it should not force disposition of the received property.

Maybe Bruun is just a bad example of a “profit transaction” realization event.
Bad because there was no formal transaction between the lessor and lessee vis
a vis the improvements, and also because no severance occurred.

4. In response to Bruun, Congress enacted §§109 and 1017. Section 109 allows
the lessor of real property to exclude the value of improvements made by a
tenant. But §1017 then prohibits the taxpayer from adding the value of these
improvements to the taxpayer’s “basis” in the building. The significance of
disallowing an adjustment to basis will become clear very soon. Although the
result of Bruun has been overruled by §§109 and 1017, the broader point of
the case—that the repossession of an asset with an enhanced value from a
transaction with another party is gross income—is probably still valid. But in
what contexts will the Bruun rule apply?

Ethical Issue

Remember the discussion earlier in the text about ABC’s Extreme
Makeover? What do you think about the ethics of ABC taking the tax
position it did? Were the attorneys clever or did they go too far?

Adjusted Basis. Now that we know what is meant by “amount realized,” we
must turn our attention to the other variable in the formula for computing gains
and losses: “adjusted basis.” Section 1011(a) tells us that “adjusted basis” is a
taxpayer’s “basis” as “adjusted.” Thanks for nothing.

“Basis” is defined in §1012 as a taxpayer’s cost in acquiring property, except
as provided in §§1001–1092. For example, we will see later that where a taxpayer
inherits property from another taxpayer, the recipient taxpayer’s basis is the fair
market value of the property at the date of the deceased taxpayer’s death. That rule
is an exception to the regular rule that a taxpayer’s basis is equal to cost.
The taxpayer’s original “cost basis” is then “adjusted” under §1016. We could spend many weeks just looking at the 27 adjustments to basis listed in §1016(a). But at this preliminary point, the concept is more important than the details. Generally, a taxpayer increases basis for improvements to the property and decreases basis for depreciation deductions allowed with respect to such property.

To understand the general rule, consider a taxpayer who owns a personal residence originally acquired for $200,000 cash. If the taxpayer constructs a deck attached to the residence, the cost of the improvement is added to the taxpayer’s basis in the residence. Thus, if the taxpayer spent $25,000 in adding the deck, the taxpayer’s basis in the residence becomes $225,000. Notice that the taxpayer cannot deduct the $25,000 expended for materials. We will see later why this is the case (in fact, there are two reasons why a deduction would not be allowed).

Now suppose a taxpayer spends $10,000 for a photocopier that will be used in her business for probably five years before its useful life expires. Assuming for the moment that the taxpayer can deduct the cost of her photocopier (she can, as we will see), the question becomes whether she can deduct the entire cost up front or whether she has to depreciate the cost over the expected life of the asset. If she must depreciate the asset, she will be entitled to deduct a portion of the cost over a five-year period. As she does so, she should reduce her basis each year by the amount of the depreciation deduction. This makes sense because she is essentially getting her money back in the form of a deduction.

Notice, then, that a taxpayer’s adjusted basis reflects his or her ongoing investment in an asset from a tax perspective. When the asset is sold or exchanged, therefore, the adjusted basis tells us how much unrecovered “cost” the taxpayer continues to have in the property. Only to the extent that the amount realized exceeds the unrecovered cost should the taxpayer have taxable gain.
Just look at this example to get an idea of how depreciation works. You will learn the more technical application of depreciation later in Chapter 4.

$10,000 copier (5 year depreciation assuming equal amounts of depreciation in each year).

<table>
<thead>
<tr>
<th>Year</th>
<th>Initial Cost</th>
<th>Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>$10,000 FMV (original basis)</td>
<td>-$2,000 depreciation</td>
</tr>
<tr>
<td>2</td>
<td>$8,000 adjusted basis</td>
<td>-$2,000 depreciation</td>
</tr>
<tr>
<td>3</td>
<td>$6,000 adjusted basis</td>
<td>-$2,000 depreciation</td>
</tr>
<tr>
<td>4</td>
<td>$4,000 adjusted basis</td>
<td>-$2,000 depreciation</td>
</tr>
<tr>
<td>5</td>
<td>$2,000 adjusted basis</td>
<td>-$2,000 depreciation</td>
</tr>
</tbody>
</table>

Thus the business was able to deduct the cost of the copier, but it only did so after a 5-year period. If after 5 years the taxpayer sells the copier for $1,000, the taxpayer would be taxed on $1,000 of gain (the amount realized ($1,000) minus adjusted basis (-0-)).

**Recognition of Realized Gains.** Section 1001(c) finally states that all realized gains shall be “recognized” except as provided elsewhere in the Code. To “recognize” a gain simply means to include it in computing gross income (and thus pay tax on the gain). There are several exceptions (so-called “non-recognition provisions”) scattered throughout the Code. We will study a
few of them in Chapter 8. For now, it is important to keep in mind that there is an important difference between realized gains and recognized gains: not all realized gains are recognized. If a taxpayer has a realized gain, he or she should hunt for a nonrecognition provision.

**The Concept of Tax Cost.** Section 1012 tells us that a taxpayer’s basis in property is his or her “cost.” This rule works well enough when a taxpayer acquires property by cash purchase. But what is a taxpayer’s basis in property acquired through an exchange? The following case sets forth the only logical answer, albeit cryptically.

**Philadelphia Park Amusement Co. v. United States**

*United States Court of Claims, 1954.*

126 FSupp. 184.

Laramore, Judge, delivered the opinion of the court:

[The taxpayer exchanged its title to the Strawberry Bridge to the City of Philadelphia in exchange for a 10–year extension of the taxpayer’s railway franchise in Fairmount Park. Because the cost of the railway franchise extension would be deducted over its 10–year life, the taxpayer had to determine its basis in the franchise extension. In a refund action, the taxpayer took the position that the basis of the franchise extension should be the same as its basis in Strawberry Bridge (approximately $230,000). The Internal Revenue Service disagreed, disallowing the taxpayer’s claim for a larger depreciation deduction.]

* * *

This brings us to the question of what is the cost basis of the 10–year extension of taxpayer’s franchise. Although defendant contends that Strawberry Bridge was either worthless or not “exchanged” for the 10–year extension of the franchise, we believe that the bridge had some value, and that the contract under which the bridge was transferred to the City clearly indicates that the one was given in consideration of the other. The taxpayer, however, has failed to show that the exchange was one [entitled to] * * * nonrecognition * * * and, therefore, it was a taxable exchange under section 112 (a) of the Code.

The gain or loss, whichever case may have been, should have been recognized, and the cost basis * * * of the 10–year extension of the franchise was the cost to the taxpayer. The succinct statement in §1012 that “the basis of property shall be the cost of such property,” although clear in principle, is frequently difficult in application. One view is that the cost basis of property received in a taxable
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exchange is the fair market value of the property given in the exchange. The other view is that the cost basis of property received in a taxable exchange is the fair market value of the property received in the exchange. As will be seen from the cases and some of the Commissioner’s rulings the Commissioner’s position has not been altogether consistent on this question. The view that “cost” is the fair market value of the property given is predicated on the theory that the cost to the taxpayer is the economic value relinquished. The view that “cost” is the fair market value of the property received is based upon the theory that the term “cost” is a tax concept and must be considered in the light of the * * * prime role that the basis of property plays in determining tax liability. We believe that when the question is considered in the latter context that the cost basis of the property received in a taxable exchange is the fair market value of the property received in the exchange.

When property is exchanged for property in a taxable exchange the taxpayer is taxed on the difference between the adjusted basis of the property given in exchange and the fair market value of the property received in exchange. For purposes of determining gain or loss the fair market value of the property received is treated as cash and taxed accordingly. To maintain harmony with the fundamental purpose of these sections, it is necessary to consider the fair market value of the property received as the cost basis to the taxpayer. The failure to do so would result in allowing the taxpayer a stepped-up basis, without paying a tax therefor, if the fair market value of the property received is less than the fair market value of the property given, and the taxpayer would be subjected to a double tax if the fair market value of the property received is more than the fair market value of the property given. By holding that the fair market value of the property received in a taxable exchange is the cost basis, the above discrepancy is avoided and the basis of the property received will equal the adjusted basis of the property given plus any gain recognized, or that should have been recognized, or minus any loss recognized, or that should have been recognized.

Therefore, the cost basis of the 10-year extension of the franchise was its fair market value on August 3, 1934, the date of the exchange. The determination of whether the cost basis of the property received is its fair market value or the fair market value of the property given in exchange therefor, although necessary to the decision of the case, is generally not of great practical significance because the value of the two properties exchanged in an arms-length transaction are either equal in fact, or are presumed to be equal. The record in this case indicates that the 1934 exchange was an arms-length transaction and, therefore, if the value of the extended franchise cannot be determined with reasonable accuracy, it would be reasonable and fair to assume that the value of Strawberry Bridge was equal to the 10-year extension of the franchise. The fair market value of the 10-year extension of the franchise should be established but, if that value cannot be determined with reasonable certainty, the fair market value of Strawberry Bridge should be
established and that will be presumed to be the value of the extended franchise. This value cannot be determined from the facts now before us since the case was prosecuted on a different theory.

The taxpayer contends that the market value of the extended franchise or Strawberry Bridge could not be ascertained and, therefore, it should be entitled to carry over the undepreciated cost basis of the bridge as the cost of the extended franchise. If the value of the extended franchise or bridge cannot be ascertained with a reasonable degree of accuracy, the taxpayer is entitled to carry over the undepreciated cost of the bridge as the cost basis of the extended franchise. Helvering v. Tex–Penn Oil Co., 300 U. S. 481, 499; Gould Securities Co. v. United States, 96 F. 2d 780. However, it is only in rare and extraordinary cases that the value of the property exchanged cannot be ascertained with reasonable accuracy. We are presently of the opinion that either the value of the extended franchise or the bridge can be determined with a reasonable degree of accuracy. Although the value of the extended franchise may be difficult or impossible to ascertain because of the nebulous and intangible characteristics inherent in such property, the value of the bridge is subject to more exact measurement. Consideration may be given to expert testimony on the value of comparable bridges, Strawberry Bridge's reproduction cost and its undepreciated cost, as well as other relevant factors.

Therefore, because we deem it equitable, judgment should be suspended and the question of the value of the extended franchise on August 3, 1934, should be remanded to the Commissioner of this court for the taking of evidence and the filing of a report thereon.

Notes

There are three morals to the Philadelphia Park case.

1. Following a taxable exchange, the taxpayer's basis in property received in the exchange is always equal to the fair market value of the property received. This is because any gain recognized by the taxpayer in the exchange is part of his or her “cost” to acquire the property received in the exchange. Suppose, for example, that a taxpayer sells a painting that cost $20 to an unrelated individual in exchange for a rug worth $100. The taxpayer realizes and recognizes an $80 gain from the exchange ($100 amount realized, less $20 basis in the painting). If the taxpayer sold the rug the next day for its $100 fair market value, should the taxpayer have to recognize another gain? Of course not! Yet if the taxpayer’s basis in the rug is his or her “cost” of the rug, how can we ensure that a subsequent sale for $100 will produce no taxable gain?
Philadelphia Park teaches us that the taxpayer’s basis in the rug has to be its fair market value at the time of receipt (here, $100). In effect, the taxpayer’s “cost” to acquire the rug is two-fold: (1) giving up a painting that cost $20 (an out-of-pocket cost), and (2) incurring an $80 gain from the exchange of the painting for the rug (a “tax cost”). If we do not reflect the tax cost in the taxpayer’s basis, the $80 gain would be taxed a second time when the rug is sold, and that double taxation of the $80 gain would be manifestly unfair.

2. Every taxable year stands alone. The exchange of the bridge and the railway franchise extension at issue in Philadelphia Park occurred in a year prior to the year in which the taxpayer sought the depreciation deduction that was the subject of the dispute between the taxpayer and the Service. The court concluded that the taxpayer “should have * * * recognized” a gain on the exchange of the bridge in the prior year. For that reason, the court determined that the taxpayer had a fair market value basis in the franchise extension received in the exchange. In fact, however, the taxpayer did not include the gain in gross income! The court knew this, and yet it still concluded that the proper solution was to pretend as if the taxpayer had correctly included the gain in gross income for the prior year. The idea of basing the current year’s tax consequences based upon what should have happened in the prior year (and not necessarily what actually happened in the prior year) is an accepted tenet of the federal income tax. We will study this “every year stands alone” concept in more detail in Chapter 6.

3. Where the taxpayer does not know and cannot readily ascertain the value of the property received in the exchange, the taxpayer may look to the value of the property surrendered in the exchange. Absent facts to the contrary, we assume that all transactions occur at arms’-length. Thus, if you don’t know the value of what you received in the exchange, you can assume that the value of the property is equal to the value of the property you gave in exchange for it. As the Philadelphia Park court observes, it will only be in “rare and extraordinary cases” where the value of the property received cannot be determined with reference to the value of the property surrendered in the exchange. In such cases, the taxpayer may use the basis of the surrendered property as the basis of the acquired property.
Problem 3–17

Anne owns a five-acre lot that she purchased several years ago for $15,000. In the current year, Anne sold two acres to an unrelated purchaser for $10,000.

(a) What are the federal income tax consequences to Anne from the sale?

(b) Would your answer to (a) change if the 3 acres retained by Anne were swamp land, worth only one-third of the value of the 5–acre lot?

Problem 3–18

In Year One, Bob purchased Boeing stock through a discount brokerage firm. Bob purchased 100 shares at a cost of $40 per share. In addition, Bob paid total commissions of $100 to the brokerage firm on the purchase. In Year Three, Bob sold the Boeing shares for $5,000 (or $50 per share). On the sale, Bob paid another $100 in commissions to the brokerage firm. What are the federal income tax consequences of the Year Three sale to Bob?

Problem 3–19

On January 1, Year One, Connie purchased a small office building for $100,000. Of the total purchase price, $80,000 was allocable to the building and $20,000 was allocable to the land. Connie rented out the office space immediately and properly elected to depreciate the building using a 40–year useful life under §168(g). Accordingly, she claimed a depreciation deduction of $2,000 attributable to the building in Year One.

In Year Two, however, because of a math error, Connie only deducted $1,500 in depreciation instead of the $2,000 to which she was entitled.

On January 1, Year Three, Connie spent $60,000 to construct an additional building on the same property. Under §168(g), the annual
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(2.) Special Basis Rules

**Code:** IRC §§1014(a)(1), (b), (e), (f); 1015(a), (d). Skim IRC §1022.

**Regs:** Treas. Reg. §§1.1001–1(e); 1.1015-1; 1.1015-4.

*Basis of Property Received by Gift, Bequest, Devise, or Inheritance.* We know that a taxpayer’s basis in property is his or her cost to acquire such property. See §1012. Taxpayers who receive property by gift or inheritance have incurred no cost, so their cost basis in such property would be zero. Sections 1014 and 1015 contain exceptions to the cost basis rule for these situations.

Section 1015 applies to *inter vivos* gifts. Generally, the donee takes the donor’s adjusted basis in the property. Thus, when Parent gives Child an asset worth $5,000 in which Parent has a basis of $3,000, Child will include nothing in gross income (remember the §102(a) exclusion) but Child’s basis in the asset will be $3,000. This is referred to as a transferred basis or, sometimes, as carryover basis. Since the donor does not pay income tax upon making a gift with appreciated property, it makes sense to preserve any lurking gain with the donee—and a transferred basis does just that.

The same is not true for lurking losses. Suppose that Parent’s basis in the gifted property described above was $8,000. In computing loss from the subsequent sale or exchange of the gifted property, Child’s basis is only $5,000. Can you find the authority for this rule? So while untaxed gains are preserved, undeducted losses are not.

The applicable basis rules under §1015(a) may be summarized as follows:

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depreciation deduction attributable to the new building was $1,500, so Connie claimed a total depreciation deduction of $3,500 in Year Three ($2,000 for the old building and $1,500 for the new one).

On January 1, Year Four, Connie sold the entire property (the land plus the two buildings) to an unrelated purchaser for $160,000 cash. What are the federal income tax consequences of this sale to Connie?
Section 1014 applies to property acquired from a decedent. Under §1014(a), such property shall have a basis to the recipient equal to the value of the property at the date of the decedent’s death. This is referred to as a **stepped-up basis**, since in most cases, the property is worth more than the decedent’s basis and is certainly worth more than the recipient’s cost basis (zero). Of course, it is entirely possible that the fair market value of property at the decedent’s death is less than the decedent’s basis in such property (as we have seen in the recent housing crisis, real estate values sometimes fall). In those cases, basis is “stepped-down” to fair market value. For example, if Decedent dies holding an asset worth $20,000, and if Decedent’s will bequeaths the asset to Beneficiary, Beneficiary’s basis is $20,000, regardless of Decedent’s adjusted basis in the asset.

What is the rationale for the stepped-up basis at death? One explanation is that a carryover basis would be hard to administer with respect to gifts from dead people, for evidence of the donor’s basis may be known only to the now-deceased donor. As a matter of convenience, then, a fair market value basis gives the asset a fresh start in the recipient’s hands. A second justification for a stepped-up basis reflects the thought that the donor is likely not engaging in some notorious form of tax evasion by dying, so there is not a compelling reason to require a carryover basis.

A third justification, now fading, is that there is already an excise tax imposed on the transfer of wealth at death—the federal estate tax. To impose an income tax burden in addition to the estate tax might be excessive. Under current law, however, the federal estate tax applies to very few decedents (recent estimates say less than one percent of decedents pay federal estate tax). Yet the beneficiaries of all decedents get the benefit of a stepped-up basis under §1014. If the existence of the federal estate tax is a central justification for the §1014 basis step-up, should the benefit of §1014 be limited to those who receive bequests and inheritances from estates that actually pay federal estate tax?

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<td>FMV &gt; or = to Donor’s AB at time of gift</td>
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<td>FMV &lt; Donor’s AB at time of gift</td>
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Chapter 3 The Meaning of “Gross Income”

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Problem 3–20

Jack owns Blackacre, a parcel of real property. Jack purchased Blackacre for $10,000 in 1990. Earlier this year, Jack received an unsolicited offer to purchase Blackacre for $50,000. Jack rejected the offer. Discuss the federal income tax consequences of each of the following transactions.

(a) Jack owns a small business. To reward his assistant, Benny, for his many years of loyalty and hard work to the company, Jack gives Blackacre to Benny. Benny, weary of investments in real estate, immediately sells Blackacre to an unrelated purchaser for $50,000.

(b) Jack falls in love with Rose while on a cruise in the Atlantic Ocean. As a symbol of his love, Jack transfers title in Blackacre to Rose. Rose, unimpressed by the gesture, sells Blackacre for $50,000 to an unrelated purchaser.

(c) Same as (b), except that the value of Blackacre when deeded to Rose was only $7,000. Rose sold the property to an unrelated purchaser for $6,000.

(d) Same as (c), except that Rose held on to the property for several months and then sold it to an unrelated purchaser for $8,500.

(e) Jack wanted to transfer Blackacre to his oldest child, Jill, so that she could build a home. Jill insisted on paying for the property, but Jack did not want to charge his child full price. Accordingly, he sold Blackacre to Jill for $20,000. Jill, in need of cash shortly after the purchase, sold Blackacre to an unrelated purchaser for $50,000.

(f) Jack died. In his will, he left Blackacre to Jill. Three months after his death, Jill took advantages of a surge in the real estate market and sold Blackacre to an unrelated purchaser for $60,000.

(g) Here’s a little ditty about Jack and his wife, Diane: upon learning that Diane had a terminal illness, Jack transferred Blackacre to Diane. Diane died eight months later. Under her will, her entire estate (including Blackacre, still worth $50,000) passed to Jack. One month later, Jack sold Blackacre to an unrelated purchaser for $50,000.
(3.) Transfers in Satisfaction of an Obligation

Code: None.

Regs: None.

We know from §1001(b) that a taxpayer’s “amount realized” includes the amount of cash and the fair market value of any property received in an exchange. But other “accessions to wealth” can constitute part of an “amount realized” as well. In Kenan v. Commissioner, 114 F.2d 217 (2d Cir. 1940), the court held that when the trustee of a trust transferred appreciated stock (stock with a value in excess of its cost basis) to a beneficiary in satisfaction of a $5 million pecuniary bequest, the trust had a realized and recognized gain. Notice that the trust did not receive cash or property, but the court still found a “gain.” The United States Supreme Court tackled a similar issue in the following case.

United States v. Davis

370 U.S. 65, 82 S.Ct. 1190, 8 L.Ed.2d 335 (1962).

Facts: In 1955, the taxpayer, Thomas Crawley Davis, transferred 500 shares of stock in the E.I. du Pont de Nemours & Co. to his spouse pursuant to a separation agreement signed in 1954. In exchange, “the then Mrs. Davis” agreed to relinquish all of her claims and marital rights against the taxpayer’s property. The taxpayer’s basis in the 500 shares of stock transferred to his spouse was approximately $75,000, and the transferred shares were worth $82,000.

Issues: (1) Was this transfer of stock in exchange for a release of marital rights a taxable event? (2) If so, what is the taxpayer’s “amount realized” from the transaction?

Holdings: (1) The transfer is a taxable event. (2) The “amount realized” from the exchange is the fair market value of the released marital rights, which in this case would be equal to the value of the stock transferred.

Rationale: The transfer was a taxable event because the taxpayer received consideration from his spouse in exchange for the stock. Under the separation agreement, the taxpayer was required to make a payment to his spouse in exchange for her release. By choosing to discharge that contractual obligation with appreciated property, the taxpayer realizes the benefit of that appreciation. In this case, he was able to discharge an $82,000 obligation to his spouse by transferring property that only cost him $75,000. He thus realizes the benefit of the $7,000 appreciation in making this transfer.
As to the computation of the "amount realized" from the transfer, the Court concluded that the lower court erred: “[The lower court] found that there was no way to compute the fair market value of these marital rights and that it was thus impossible to determine the taxable gain realized by the taxpayer. We believe this conclusion was erroneous. It must be assumed, we think, that the parties acted at arm's length and that they judged the marital rights to be equal in value to the property for which they were exchanged. There was no evidence to the contrary here. * * * To be sure there is much to be said of the argument that such an assumption is weakened by the emotion, tension and practical necessities involved in divorce negotiations and the property settlements arising therefrom. However, once it is recognized that the transfer was a taxable event, it is more consistent with the general purpose and scheme of the taxing statutes to make a rough approximation of the gain realized thereby than to ignore altogether its tax consequences. Moreover, if the transaction is to be considered a taxable event as to the husband, the [lower court's] position leaves up in the air the wife's basis for the property received. In the context of a taxable transfer by the husband, all indicia point to a 'cost' basis for this property in the hands of the wife. Yet under the [lower court's] position her cost for this property, i.e., the value of the marital rights relinquished therefor, would be indeterminable, and on subsequent disposition of the property she might suffer inordinately over the Commissioner's assessment which she would have the burden of proving erroneous. Our present holding that the value of these rights is ascertainable eliminates this problem; for the same calculation that determines the amount received by the husband fixes the amount given up by the wife, and this figure, i.e., the market value of the property transferred by the husband, will be taken by her as her tax basis for the property received.”

Notes and Questions

1. Upset with the result of Davis, Congress enacted §1041. Section 1041 generally provides nonrecognition for all property transfers between spouses (or between former spouses when incident to a divorce, as described in Chapter 9). If §1041 had been effect during the property transfers in Davis, the taxpayer would not have recognized gain upon the transfer of the appreciated stock. Although §1041 effectively overrules the specific result of Davis, the more general principle of the case—that a taxpayer recognizes a gain on the transfer of appreciated property in satisfaction of a legal obligation—is still valid.

2. There has been a lot written about the tax implications to same-sex couples based on the federal tax treatment of their marriages (or on the fact that they
cannot marry), but a lot less has been written on the tax consequences to same-sex couples (married or not) upon dissolution of the relationship. Under DOMA, §1041 does not apply to same-sex couples. Same-sex couples filing for divorce or separation would need to look to Davis to determine the tax treatment of assets transferred in the divorce.

3. Notice that the Court assumes that the ex-husband’s “amount realized” is equal to the value of the securities he surrendered pursuant to the property settlement. This assumption is based upon one of the morals of the Philadelphia Park case.

4. Davis concludes that the amount realized by husband was the amount he surrendered, and requires him to pay tax on the gain that resulted from the transaction. The Court also indicates that the wife’s basis in the property is the cost of the property received by her. The Court apparently wanted to make sure the wife wasn’t stuck with property with a low basis. But what was the wife’s cost in the property? It was what she gave up – her marital rights. And what was her basis in the marital rights? Zero. So why didn’t the wife owe tax on the difference between the amount realized and her basis? Section 1041 rescues us from having to answer these questions, but they would likely be raised again in the context of same-sex couples.

Self-Assessment Question

(Solutions to Self-Assessment Questions are set forth in Appendix 3.)

SAQ 3–5. Consider the facts in United States v. Davis. What basis does “the then Mrs. Davis” have in the stock acquired from her ex-husband? The facts state that the value of the securities at the time of the transfer was approximately $82,000 and that the ex-husband’s basis was about $75,000. Suppose she sold all of the shares for $85,000 one year following the transfer. How much gain should she include in gross income?
F. An Introduction to the Flavor of Income

**Code:** Skim IRC §§1(h); 1221(a); 1222.

**Regs:** None.

Although all persons are created equal, not all income is taxed equally. Save for one brief period from 1986 to 1990, Congress has accorded preferential status to so-called "capital gains" since 1921. You probably know from following current events or from your own financial affairs that certain capital gains receive preferential tax treatment. In a very complex way, §1(h)(1)–(10) sets forth that preference. Very generally, wealthy taxpayers will only pay a tax of 15 percent on net capital gains for the year. Less affluent taxpayers currently pay no tax at all on net capital gains (the tax rate was reduced from five percent to zero percent in 2008, though that particular benefit is scheduled to expire at the end of 2012). Since ordinary income is taxed to the wealthiest taxpayers at 35 percent and to less affluent taxpayers at ten percent, the capital gains preference is quite significant. No wonder most individual taxpayers prefer capital gains to ordinary income.

**Capital Assets.** This, of course, takes us to our first inquiry: what is a “capital gain?” Simply put, a capital gain is the gain from the sale or exchange of a “capital asset.” And the definition of a “capital asset” is set forth in §1221(a). Notice that §1221(a) is another example of a “negative definition:” it defines capital assets by listing eight types of assets which are not capital assets. Anything not described in §1221(a)(1)–(8) is, therefore, a capital asset. As a general rule, property held for investment or personal-use purposes (and not for the conduct of an active business) usually qualifies as a capital asset.

In order to qualify for the preferential tax rates of §1(h), an individual must have a “net capital gain,” defined in §1222(11) as the excess of “net long-term capital gains” over “net short-term capital losses.” In order to have a net long-term capital gain, the taxpayer must have held the capital asset for more than one year. See §1222(1)–(4). Thus, the preferential rates will apply only to gains from the sale or exchange of capital assets held for more than one year. If an individual sells a capital asset for a gain but only held the asset for one year or less, the gain will be taxed as ordinary income.

An extended discussion of the preferential treatment for capital gains awaits us in Chapter 7. For now, it is sufficient to note that taxpayers prefer long-term capital gains to other types of gains.
Reasons for the Preference. Because long-term capital gains are taxed at a lower rate, taxpayers often engage in transactions designed to take advantage of this preference. It is therefore appropriate at this point to ask why long-term capital gains deserve special treatment. Historically, preferential rates were justified on the grounds of inflation. Because basis is not adjusted to take inflation into account, it was thought that a preferential rate for long-term capital gains was necessary to accommodate for the hardships of taxing gains due to inflation instead of real economic growth. Another rationale for the preferential rate relates to the concept of bunching. Very rarely does a capital asset explode in value. In most cases, the gain accrues over the course of the taxpayer's holding period. Yet because of the realization rule, the taxpayer does not recognize this appreciation as it accrues. Instead, when the taxpayer sells the capital asset, all of the gain from the asset is bunched into the year of sale. In a progressive tax system, bunching all of the gain into a single year increases the risk that the gain will be taxed at a higher rate. By limiting the tax rate applicable to long-term capital gains, the rate of tax may better approximate the amount of tax that would have been collected if the gain had been taxed as it accrued. A more modern justification for the preferential tax treatment of long-term capital gains relates to taxpayer behavior. Congress hopes that keeping a low tax rate for capital gains will stimulate savings and investment activities by taxpayers. Furthermore, the lower rate might give a taxpayer an incentive to sell the capital asset instead of holding it until death in order to obtain a stepped-up basis for the taxpayer's beneficiary. Curing this lock-up problem is thought to benefit the economy.

Not everyone accepts these justifications. Some argue that there are better ways to account for inflation than providing preferential tax treatment at the time of sale. Even if a lower tax rate is the best way to account for inflation, there seems to be no reason to limit the preference to gains from capital assets. And the bunching rationale may not be very persuasive considering that taxpayers generally control the timing of the realization event giving rise to the gain. Others challenge the thought that a lower tax rate for long-term capital gains motivates taxpayers to sell capital assets.

But no matter whether the justifications for preferential tax treatment of long-term capital gains are persuasive,

For More Information

some form of special taxation is probably now a permanent feature of the modern federal income tax.

**History of the Preferential Treatment of Capital Gains.** In 1921, Congress limited the tax rate applicable to capital gains held for more than two years to 12.5 percent. The preferential rate was quite significant because the highest marginal rate applicable to ordinary income was 73 percent. In 1934, Congress adjusted the preference from a lower rate to a deduction: the longer the taxpayer held the capital asset, the less the amount of gain subject to taxation. In fact, if a taxpayer held a capital asset for more than a decade, only 30 percent of the gain was subject to taxation. Given that the highest marginal tax rate at that time was 79 percent, the exclusion of 70 percent of the gain from the sale of a capital asset effectively capped the tax rate applicable to entire capital gain to 23.7 percent (30 percent of 79 percent).

By 1938, Congress reverted to taxing the entire gain at a preferential rate. While the maximum marginal tax rate on ordinary income reached 81.1 percent, long-term capital gains were taxed at a mere 15 percent. In 1942, tax rates were increased. The maximum rate for ordinary income grew to 91 percent, and the preferential rate for capital gains grew to 25 percent.

In 1969, Congress again moved away from a preferential rate for capital gains in favor of a deduction. Congress allowed taxpayers to exclude one-half of their net capital gains. Effectively, then, all taxpayers enjoyed a preferential tax rate on capital gains. Taxpayers in the highest tax bracket (70 percent) were able to limit their tax rate on capital gains to 35 percent. In 1978, Congress increased the deduction from 50 percent to 60 percent (meaning taxpayers in the highest tax bracket incurred tax of 28 percent on their capital gains).

The Tax Reform Act of 1986 repealed all preferences for capital gains. The maximum tax rate applicable to both ordinary income and capital gains was set at 28 percent. The preferential rates for capital gains were restored in 1990 when the maximum tax rate on ordinary income grew to 31 percent (despite the millions who read the first President Bush’s lips to say “No new taxes”). Because the 28 percent rate was retained for capital gains, a preference had been reenacted, although it applied only to taxpayers in the highest tax bracket.

The 28 percent preferential rate became even more significant in 1993.
when the maximum rate applicable to ordinary income grew to 39.6 percent. By this point, the preference applied to taxpayers in the three highest brackets (31 percent, 36 percent, and 39.6 percent) but not taxpayers in the lower brackets. In 1997, Congress reduced the capital gains tax rate to 20 percent, and it also gave taxpayers in the 15 percent bracket a preferential rate (10 percent).

In the Jobs and Growth Tax Relief Reconciliation Act of 2003, the preferential tax rate applicable to a taxpayer's “net capital gain” was reduced from 20 percent (10 percent in the case of taxpayers in the lower tax brackets) to 15 percent (five percent in the case of taxpayers in the lower brackets). In addition, the 2003 Act called for the reduction of the five percent rate for taxpayers in the lower brackets to zero percent starting in 2008. Legislation in 2010 extended this benefit through the end of 2012. Absent further action by Congress, the capital gains rates are set to revert to their pre-2003 levels in 2013. Again, a more detailed analysis of the current preferential rate scheme for capital gains will be presented in Chapter 7.

**Extending the Preferential Rates to Dividend Income.** As a result of the 2003 Act, the preferential rates for capital gains now also apply to “qualified dividend income,” defined as most dividends from domestic corporations and even certain dividends from foreign corporations organized in countries that have income tax treaties with the United States. There is no requirement that the dividends come from earnings that were previously subject to tax or from earnings attributable to dates after the enactment of the 2003 Act—all distributions from current or accumulated earnings and profits will qualify for the reduced rates. Just as with the preferential rate for capital gains, the preferential rates for dividends was extended through 2012.

The preferential rate for dividend income is designed to alleviate the “double taxation” of corporate income. As separate legal entities, corporations are also separate taxable entities. Thus, corporations pay federal income on their taxable incomes, just like individuals. See §11. When a corporation distributes its after-tax income to its shareholders, that distribution is considered a “dividend” to the shareholders that must be included in gross income. See §61(a)(7). In effect, then, corporate income is taxed twice: once at the corporate level, and again at the shareholder level upon a dividend distribution.

Though double taxation of corporate profits has long been an accepted feature of subchapter C (the Code provisions applicable to most corporations), increasing political pressure to ease double taxation led to the enactment of the
preferential rates for dividends in §1(h)(11). Of course, double taxation is not unique to corporations. When an employer pays taxable wages to an employee who then uses the after-tax income to pay for other services like day care, home repairs, and the like, the wages are being taxed twice: once to the employee and again in the hands of the service-provider. Because the tax is paid by two different parties, however, the double taxation is an acceptable result. Double taxation is improper where the same taxpayer pays two taxes on the same income. Yet corporations and shareholders are two distinct taxpayers, so the perils of double taxation are less compelling. Still, to the extent other business forms do not experience double taxation, Congress felt the pressure to provide a similar benefit to those who operate in the corporate form, too.

The preferential rate for dividends is an imperfect solution to the double tax problem. There is no requirement that the dividends that receive the preferential rate come from profits that were taxed and effective taxes on corporations are often far below the statutory rate.

The preferential rate has also been justified as equating the tax for dividends and capital gains. If the dividend rate is higher than the capital gains rate companies have an incentive to hold on to the wealth generated by the corporation and thereby increase the value of the corporate stock. Stockholder can sell the stock for capital gain and pay the lower rate. Many argued that this provided a disincentive to corporations to pay dividends and that this disincentive created lock-in problems.

G. An Introduction to the Timing of Income

Code: None.

Regs: None.

It’s About Time. With respect to the concept of “income,” we have nearly come full circle. We know generally what is included and excluded from income (including statutory inclusions and exclusions), as well as a little about the different flavors of income. Put another way, we have considered “what” is income. Except for the realization rule, we have not, until now, considered “when” an item of income arises.

Arguably, the “when” issue is more important than the “what” issue. Although we will cover timing issues in much more detail in Chapter 6, it is appropriate to get a sense of some of the fundamental concepts related to the timing of gross income now. We will consider the claim of right doctrine and the taxation of
advance payments. To understand why these concepts are so important, however, we must begin with a basic discussion of the time value of money.

**Time Value of Money.** Would you rather have one dollar today or one dollar a year from today? Easy—you’ll take the dollar now. If you invest the dollar, you can earn interest and have more than one dollar a year from now. If you use the dollar to buy something that will produce more income down the road, having the dollar now will give you an extra year to make that additional income. If you simply consume the dollar, you get the benefit of that consumption now instead of waiting for a year from now to get the same utility. So no matter what you do with the dollar, it makes more sense to take the current dollar instead of the future dollar.

That is the heart of the time value of money: a current dollar is worth more than a future dollar. When it comes to costs, the opposite rule applies: a future cost is better than a current cost. Suppose you owe one dollar to a friend. If you have the choice to repay the dollar today or one year from today, you would prefer to pay one year from today. Your preference is based on the fact that you know you can hold onto the dollar for another year and use that dollar to make more income. If you have to repay the dollar today, you lose the chance to make the additional cash with that dollar.

For this reason, taxpayers prefer to defer the tax on gross income as long as possible. By deferring the tax, taxpayers can use the funds that will pay the tax for a longer period to make more money. Suppose, for example, that a taxpayer performs $500 in services for another in December of Year One. If the taxpayer receives payment in Year One, the $500 payment will be included in gross income on the Year One return, meaning the tax on that payment will be due and payable on April 15, Year Two. Let’s assume for purposes of this example that the taxpayer is subject to a flat federal income tax of 30 percent. The $150 tax on the $500 of income would be due and payable on April 15, Year Two.

If the taxpayer delays payment until January of Year Two, however, the $500 of income will be reported on the taxpayer’s return for Year Two, meaning the $150 of tax is not paid until April 15 of Year Three. By waiting one more month for the payment, the taxpayer can defer the tax liability for twelve months! The
taxpayer has an extra twelve months to invest the $150 that would otherwise be paid to the federal government. If the taxpayer earns a measly five percent interest on the deferred tax liability of $150 over that twelve months, the taxpayer will earn an extra $7.50 by waiting until Year Two for payment. Add a few zeros to the dollar amount in this example (or increase the interest rate to eight or ten percent, the historical average rate of growth for investments in blue-chip companies over the long term), and the wisdom for deferring gross income becomes even more apparent.

As the enforcer of federal income tax laws, the Service must watch for taxpayers who try to manipulate the timing of their incomes in ways that drain the fisc too easily. The claim of right doctrine and the rules for advance payments are two tools that assist the Service in these efforts.

**Claim of Right Doctrine.** We know that if a taxpayer has an obligation to repay an amount received from another person, the taxpayer does not have gross income. The transaction is properly characterized as a “loan” absent some other facts. What if the obligation to repay is contingent on the occurrence of certain events? Just by coincidence, the following case deals with this very issue.

**North American Oil Consolidated v. Burnet**

United States Supreme Court, 1932.
286 U.S. 417, 52 S.Ct. 613, 76 L.Ed. 1197.

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. The government took an appeal * * * to the Circuit Court of Appeals. In 1920, that court affirmed the decree. In 1922, a further appeal to this Court was dismissed by stipulation.

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. 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. This Court granted a writ of certiorari.

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 * * *

* * *

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. 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. 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.

Affirmed.

Note

The “claim of right” doctrine from North American Oil requires, among other things, that a taxpayer receive income “under a claim of right.” Yet we learned in James v. United States, Part A, supra, that a similar result applies to those who obtain income illegally. The James Court applied the rule from North American Oil, but it had to re-word the rule to make it fit:

When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their 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. North American Oil v. Burnet * * *.”

This has to be the result, or else cheaters prosper. But after James, is it proper to refer to the rule as the “claim of right” doctrine?

Advance Payments and the Issue of Deposits. We will learn in Chapter 6 that advance payments of income are included in gross income even though the payments have not been earned at the time of receipt. For example, if an individual receives an advance payment for services, the full amount of the advance payment is gross income even though the services may extend beyond the year of receipt.
This is true even though financial accounting rules may permit or require deferral of income until the services are performed. But as we saw earlier, “loans” are not gross income. So how are deposits taxed? Some deposits smell like advance payments, and others smell like loans. Of course, the recipient of the deposit will want to treat the deposit like a loan. But hopes don’t always pan out. The following case tackles this tricky issue.

Commissioner v. Indianapolis Power & Light Company

United States Supreme Court, 1990.
493 U.S. 203, 110 S.Ct. 589, 107 L.Ed.2d 591.

Justice Blackman delivered the opinion of the Court.

Respondent Indianapolis Power & Light Company (IPL) requires certain customers to make deposits with it to assure payment of future bills for electric service. Petitioner Commissioner of Internal Revenue contends that these deposits are advance payments for electricity and therefore constitute taxable income to IPL upon receipt. IPL contends otherwise.

IPL is a regulated Indiana corporation that generates and sells electricity in Indianapolis and its environs. It keeps its books on the accrual and calendar year basis. During the years 1974 through 1977, approximately 5% of IPL’s residential and commercial customers were required to make deposits “to insure prompt payment,” as the customers’ receipts stated, of future utility bills. These customers were selected because their credit was suspect. Prior to March 10, 1976, the deposit requirement was imposed on a case-by-case basis. IPL relied on a credit test but employed no fixed formula. The amount of the required deposit ordinarily was twice the customer’s estimated monthly bill. IPL paid 3% interest on a deposit held for six months or more. A customer could obtain a refund of the deposit prior to termination of service by requesting a review and demonstrating acceptable credit. The refund usually was made in cash or by check, but the customer could choose to have the amount applied against future bills.

In March 1976, IPL amended its rules governing the deposit program. Under the amended rules, the residential customers from whom deposits were required were selected on the basis of a fixed formula. The interest rate was raised to 6% but was payable only on deposits held for 12 months or more. A deposit was refunded when the customer made timely payments for either 9 consecutive months, or for 10 out of 12 consecutive months so long as the 2 delinquent months were not
themselves consecutive. A customer could obtain a refund prior to that time by satisfying the credit test. As under the previous rules, the refund would be made in cash or by check, or, at the customer's option, applied against future bills. Any deposit unclaimed after seven years was to escheat to the State.

IPL did not treat these deposits as income at the time of receipt. Rather, as required by state administrative regulations, the deposits were carried on its books as current liabilities. Under its accounting system, IPL recognized income when it mailed a monthly bill. If the deposit was used to offset a customer's bill, the utility made the necessary accounting adjustments. Customer deposits were not physically segregated in any way from the company's general funds. They were commingled with other receipts and at all times were subject to IPL's unfettered use and control. It is undisputed that IPL's treatment of the deposits was consistent with accepted accounting practice and applicable state regulations.

Upon audit of respondent's returns for the calendar years 1974 through 1977, the Commissioner asserted deficiencies. * * * The Commissioner took the position that the deposits were advance payments for electricity and therefore were taxable to IPL in the year of receipt. * * * IPL disagreed and filed a petition in the United States Tax Court for redetermination of the asserted deficiencies.

In a reviewed decision, with one judge not participating, a unanimous Tax Court ruled in favor of IPL. 88 T.C. 964 (1987). * * * It noted, among other things, that only 5% of IPL's customers were required to make deposits; that the customer rather than the utility controlled the ultimate disposition of a deposit; and that IPL consistently treated the deposits as belonging to the customers, both by listing them as current liabilities for accounting purposes and by paying interest. Id., at 976–978.

The United States Court of Appeals for the Seventh Circuit affirmed the Tax Court's decision. 857 F.2d 1162 (1988). The court stated that “the proper approach to determining the appropriate tax treatment of a customer deposit is to look at the primary purpose of the deposit based on all the facts and circumstances....” Id., at 1167. The court appeared to place primary reliance, however, on IPL's obligation to pay interest on the deposits. It asserted that “as the interest rate paid on a deposit to secure income begins to approximate the return that the recipient would be expected to make from 'the use' of the deposit amount, the deposit begins to serve purposes that comport more squarely with a security deposit.” Id., at 1169. Noting that IPL had paid interest on the customer deposits throughout the period in question, the court upheld, as not clearly erroneous, the Tax Court's determination that the principal purpose of these deposits was to serve as security rather than as prepayment of income. Id., at 1170.

* * *
We begin with the common ground. IPL acknowledges that these customer deposits are taxable as income upon receipt if they constitute advance payments for electricity to be supplied. The Commissioner, on his part, concedes that customer deposits that secure the performance of non-income-producing covenants—such as a utility customer’s obligation to ensure that meters will not be damaged—are not taxable income. And it is settled that receipt of a loan is not income to the borrower. * * * IPL, stressing its obligation to refund the deposits with interest, asserts that the payments are similar to loans. The Commissioner, however, contends that a deposit which serves to secure the payment of future income is properly analogized to an advance payment for goods or services. See Rev. Rul. 72–519, 1972–2 Cum. Bull. 32, 33 (“[W]hen the purpose of the deposit is to guarantee the customer’s payment of amounts owed to the creditor, such a deposit is treated as an advance payment, but when the purpose of the deposit is to secure a property interest of the taxpayer the deposit is regarded as a true security deposit”).

In economic terms, to be sure, the distinction between a loan and an advance payment is one of degree rather than of kind. A commercial loan, like an advance payment, confers an economic benefit on the recipient: a business presumably does not borrow money unless it believes that the income it can earn from its use of the borrowed funds will be greater than its interest obligation. Even though receipt of the money is subject to a duty to repay, the borrower must regard itself as better off after the loan than it was before. The economic benefit of a loan, however, consists entirely of the opportunity to earn income on the use of the money prior to the time the loan must be repaid. And in that context our system is content to tax these earnings as they are realized. The recipient of an advance payment, in contrast, gains both immediate use of the money (with the chance to realize earnings thereon) and the opportunity to make a profit by providing goods or services at a cost lower than the amount of the payment.

The question, therefore, cannot be resolved simply by noting that respondent derives some economic benefit from receipt of these deposits. Rather, the issue turns upon the nature of the rights and obligations that IPL assumed when the deposits were made. In determining what sort of economic benefits qualify as income, this Court has invoked various formulations. It has referred, for example, to “undeniable accessions to wealth, clearly realized, and over which the taxpay-

3 This Court has held that an accrual-basis taxpayer is required to treat advance payments as income in the year of receipt. See Schlude v. Commissioner, 372 U.S. 128, 83 S.Ct. 601, 9 L.Ed.2d 633 (1963); American Automobile Assn. v United States, 367 U.S. 687, 81 S.Ct. 1727, 6 L.Ed.2d 1109 (1961); Automobile Club of Michigan v. Commissioner, 353 U.S. 180, 77 S.Ct. 707, 1 L.Ed.2d 746 (1957). These cases concerned payments—nonrefundable fees for services—that indisputably constituted income; the issue was when that income was taxable. Here, in contrast, the issue is whether these deposits, as such, are income at all.
ers have complete dominion.” *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S.Ct. 473, 477, 99 L.Ed. 483 (1955). It also has stated: “When a taxpayer acquires earnings, lawfully or unlawfully, without the consensual recognition, express or implied, of an obligation to repay and without restriction as to their disposition, ‘he has received income....’ ” *James v. United States*, 366 U.S., at 219, 81 S.Ct., at 1055, quoting *North American Oil Consolidated v. Burnet*, 286 U.S. 417, 424, 52 S.Ct. 613, 615, 76 L.Ed. 1197 (1932). IPL hardly enjoyed “complete dominion” over the customer deposits entrusted to it. Rather, these deposits were acquired subject to an express “obligation to repay,” either at the time service was terminated or at the time a customer established good credit. So long as the customer fulfills his legal obligation to make timely payments, his deposit ultimately is to be refunded, and both the timing and method of that refund are largely within the control of the customer.

The Commissioner stresses the fact that these deposits were not placed in escrow or segregated from IPL’s other funds, and that IPL therefore enjoyed unrestricted use of the money. That circumstance, however, cannot be dispositive. After all, the same might be said of a commercial loan; yet the Commissioner does not suggest that a loan is taxable upon receipt simply because the borrower is free to use the funds in whatever fashion he chooses until the time of repayment. In determining whether a taxpayer enjoys “complete dominion” over a given sum, the crucial point is not whether his use of the funds is unconstrained during some interim period. The key is whether the taxpayer has some guarantee that he will be allowed to keep the money. IPL’s receipt of these deposits was accompanied by no such guarantee.

Nor is it especially significant that these deposits could be expected to generate income greater than the modest interest IPL was required to pay. Again, the same could be said of a commercial loan, since, as has been noted, a business is unlikely to borrow unless it believes that it can realize benefits that exceed the cost of servicing the debt. A bank could hardly operate profitably if its earnings on deposits did not surpass its interest obligations; but the deposits themselves are not treated as income. Any income that the utility may earn through use of the deposit money of course is taxable, but the prospect that income will be generated provides no ground for taxing the principal.

The Commissioner’s advance-payment analogy seems to us to rest upon a misconception of the value of an advance payment to its recipient. An advance
payment, like the deposits at issue here, concededly protects the seller against
the risk that it would be unable to collect money owed it after it has furnished
goods or services. But an advance payment does much more: it protects against
the risk that the purchaser will back out of the deal before the seller performs.
From the moment an advance payment is made, the seller is assured that, so long
as it fulfills its contractual obligation, the money is its to keep. Here, in contrast,
a customer submitting a deposit made no commitment to purchase a specified
quantity of electricity, or indeed to purchase any electricity at all.\(^6\) IPL's right to
keep the money depends upon the customer's purchase of electricity, and upon
his later decision to have the deposit applied to future bills, not merely upon
the utility's adherence to its contractual duties. Under these circumstances, IPL's
dominion over the fund is far less complete than is ordinarily the case in an
advance-payment situation.

The Commissioner emphasizes that these deposits frequently will be used
to pay for electricity, either because the customer defaults on his obligation or
because the customer, having established credit, chooses to apply the deposit to
future bills rather than to accept a refund. When this occurs, the Commissioner
argues, the transaction, from a cash-flow standpoint, is equivalent to an advance
payment. In his view this economic equivalence mandates identical tax treatment.

Whether these payments constitute income when received, however, depends
upon the parties' rights and obligations at the time the payments are made. The
problem with petitioner's argument perhaps can best be understood if we imagine
a loan between parties involved in an ongoing commercial relationship. At the
time the loan falls due, the lender may decide to apply the money owed him to
the purchase of goods or services rather than to accept repayment in cash. But this
decision does not mean that the loan, when made, was an advance payment after
all. The lender in effect has taken repayment of his money (as was his contractual
right) and has chosen to use the proceeds for the purchase of goods or services
from the borrower. Although, for the sake of convenience, the parties may com-
bine the two steps, that decision does not blind us to the fact that in substance
two transactions are involved. It is this element of choice that distinguishes an
advance payment from a loan. Whether these customer deposits are the economic
equivalents of advance payments, and therefore taxable upon receipt, must be
determined by examining the relationship between the parties at the time of the
deposit. The individual who makes an advance payment retains no right to insist

\(^6\) A customer, for example, might terminate service the day after making the deposit. Also, IPL's
dominion over a deposit remains incomplete even after the customer begins buying electricity. As has
been noted, the deposit typically is set at twice the customer's estimated monthly bill. So long as the
customer pays his bills in a timely fashion, the money he owes the utility (for electricity used but not
yet paid for) almost always will be less than the amount of the deposit. If this were not the case, the
deposit would provide inadequate protection. Thus, throughout the period the deposit is held, at least
a portion is likely to be money that IPL has no real assurance of ever retaining.
upon the return of the funds; so long as the recipient fulfills the terms of the bargain, the money is its to keep. The customer who submits a deposit to the utility, like the lender in the previous hypothetical, retains the right to insist upon repayment in cash; he may choose to apply the money to the purchase of electricity, but he assumes no obligation to do so, and the utility therefore acquires no unfettered “dominion” over the money at the time of receipt.

* * *

We recognize that IPL derives an economic benefit from these deposits. But a taxpayer does not realize taxable income from every event that improves his economic condition. A customer who makes this deposit reflects no commitment to purchase services, and IPL’s right to retain the money is contingent upon events outside its control. We hold that such dominion as IPL has over these customer deposits is insufficient for the deposits to qualify as taxable income at the time they are made.

The judgment of the Court of Appeals is affirmed.

It is so ordered.

Self-Assessment Question

(Solutions to Self-Assessment Questions are set forth in Appendix 3.)

SAQ 3–6. Mr. Roper is a landlord. Mr. Roper requires tenants to pay a “security deposit” in an amount equal to one month of rent. The lease agreement form used by Mr. Roper clearly states that the deposits will be used to pay for any property damage by a tenant and/or to cover unpaid rent. If a tenant makes all payments on time and causes no property damage, the lease agreement requires Mr. Roper to return the deposit with no interest. In most cases, tenants ask Mr. Roper to apply the deposit to the last month’s rent (or, without making advance arrangements, they simply fail to pay the last month’s rent). As a result, Mr. Roper rarely pays the deposit back to a tenant. Does Mr. Roper have gross income upon receipt of a deposit?
H. Assignment of Income

Code: None.

Regs: None.

Before we leave the concept of income, we must deal with the issue of who must pay tax on income. In the usual case, the proper taxpayer for income is easy to identify. We tax the worker on his or her wages, and we tax the owner of income from capital. But taxpayers, often a clever bunch, devise ways to deflect taxable income to another taxpayer (one usually in a lower tax bracket). Sometimes those techniques should work, but in other cases the tax avoidance motive permeates the technique to the extent that the system would lose credibility if it were respected. The “assignment of income” doctrine tries to determine the proper party to tax income.

Income from Services. Generally, income from services is taxed to the party who performed the services. That rule “stems” from the case of Lucas v. Earl below (you might appreciate the pun more after you read the case).

Lucas v. Earl

United States Supreme Court, 1930.
281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731.

Mr. Justice Holmes delivered the opinion of the Court.

This case presents the question whether the respondent, Earl, could be taxed for the whole of the salary and attorney's fees earned by him in the years 1920 and 1921, or should be taxed for only a half of them in view of a contract with his wife which we shall mention. The Commissioner of Internal Revenue and the Board of Tax Appeals imposed a tax upon the whole, but their decision was reversed by the Circuit Court of Appeals. A writ of certiorari was granted by this court.

By the contract, made in 1901, Earl and his wife agreed “that any property either of us now has or may hereafter acquire * * * in any way, either by earnings (including salaries, fees, etc.), or any rights by contract or otherwise, during the existence of our marriage, or which we or either of us may receive by gift, bequest, devise, or inheritance, and all the proceeds,

Food for Thought

From the facts it appears that Earl engaged in this transaction to save on taxes. But the contract may not have been designed as a tax savings device. First, why do we think the transaction might not be a tax motivated one, and second, what might be the reason for the transaction? For help click here.
issues, and profits of any and all such property shall be treated and considered, and hereby is declared to be received, held, taken, and owned by us as joint tenants, and not otherwise, with the right of survivorship.” The validity of the contract is not questioned, and we assume it to be unquestionable under the law of the State of California, in which the parties lived. Nevertheless we are of opinion that the Commissioner and Board of Tax Appeals were right.

* * * A very forcible argument is presented to the effect that the statute seeks to tax only income beneficially received, and that taking the question more technically the salary and fees became the joint property of Earl and his wife on the very first instant on which they were received. We well might hesitate upon the latter proposition, because however the matter might stand between husband and wife he was the only party to the contracts by which the salary and fees were earned, and it is somewhat hard to say that the last step in the performance of those contracts could be taken by anyone but himself alone. But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Judgment reversed.

The Chief Justice took no part in this case.

**Teschner v. Commissioner**

38 T.C. 1003 (1962).

**Facts:** The taxpayer entered a contest for an education annuity. The contest rules restricted eligibility for the prize to individuals who were under a stipulated age. Because the taxpayer was too old to be eligible for the prize, the taxpayer listed the taxpayer’s daughter as the beneficiary on the contest entry form. Lo and behold, the taxpayer’s entry was selected as a winner.

**Issue:** Who should be taxed on the value of the prize: the taxpayer or the taxpayer’s daughter?

**Holding:** The taxpayer’s daughter should be taxed on the value of the prize.
Rationale: The taxpayer should not be taxed on the income because the taxpayer never had the right to claim to the prize according to the rules of the contest. Thus, the taxpayer had not “earned” the income, even though the taxpayer was the individual that performed the services that gave rise to the right to the income.

Problem 3–21

Olive Greene–Beane prepares federal income tax returns for her clients. In each of the alternative scenarios described below, determine who should be taxed on the fees received.

(a) Olive performs all of the work on the returns, but she asks her clients to pay one-third of the total fee to Olive’s son, Stu. Most of Olive’s clients comply with her request.

(b) Same as (a), except that Stu assists Olive in the completion of every client’s tax return. Olive reasonably estimates that one-third of the total work on each return is performed by Stu, so she asks clients to pay him one-third of the total fee.

(c) Olive performs all of the work on the returns, but she refuses to bill the clients for her work. Many of Olive’s clients feel compelled to pay something for her services, but Olive tells them only to give the money to a good cause. Several of Olive’s clients pay reasonable sums directly to Stu.

* * *

Income from Property. The “fruit-and-tree” metaphor established in Lucas v. Earl was developed further by the Court in Helvering v. Horst, below. Horst is the seminal case relating to the application of the assignment of income doctrine to income from property.
Helvering v. Horst

United States Supreme Court, 1940.
311 U.S. 112, 61 S.Ct. 144, 85 L.Ed. 75.

Mr. Justice Stone delivered the opinion of the Court.

The sole question for decision is whether the gift, during the donor’s taxable year, of interest coupons detached from the bonds, delivered to the donee and later in the year paid at maturity, is the realization of income taxable to the donor.

In 1934 and 1935 respondent, the owner of negotiable bonds, detached from them negotiable interest coupons shortly before their due date and delivered them as a gift to his son who in the same year collected them at maturity. The Commissioner ruled that * * * the interest payments were taxable, in the years when paid, to the respondent donor who reported his income on the cash receipts basis. The circuit court of appeals reversed the order of the Board of Tax Appeals sustaining the tax. We granted certiorari because of the importance of the question in the administration of the revenue laws and because of an asserted conflict in principle of the decision below with that of Lucas v. Earl, 281 U.S. 111, 50 S.Ct. 241, 74 L.Ed. 731, and with that of decisions by other circuit courts of appeals.

The court below thought that as the consideration for the coupons had passed to the obligor, the donor had, by the gift, parted with all control over them and their payment, and for that reason the case was distinguishable from Lucas v. Earl, supra * * *

What’s That?

During the period at issue, when a person bought a bond (remember a bond is a debt instrument), actual pieces of paper (referred to as coupons) would be attached to the bond. These were then detached by the bondholder and presented to the debtor for payment. These bonds were referred to as “coupon bonds” or as “bearer bonds.” In this case, Horst detached the coupons (the interest portion) from the bonds and gave them to his son. For more, check out this article.

The holder of a coupon bond is the owner of two independent and separable kinds of right. One is the right to demand and receive at maturity the principal amount of the bond representing capital investment. The other is the right to demand and receive interim payments of interest on the investment in the amounts and on the dates specified by the coupons. Together they are an obligation to pay principal and interest given in exchange for money or property which was presumably the consideration for the obligation of the bond. Here respondent, as
owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others which constituted an economic gain to him.

Admittedly not all economic gain of the taxpayer is taxable income. From the beginning the revenue laws have been interpreted as defining “realization” of income as the taxable event rather than the acquisition of the right to receive it. And “realization” is not deemed to occur until the income is paid. But the decisions and regulations have consistently recognized that receipt in cash or property is not the only characteristic of realization of income to a taxpayer on the cash receipts basis. Where the taxpayer does not receive payment of income in money or property realization may occur when the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him. Old Colony Trust Co. v. Commissioner, 279 U.S. 716, 49 S.Ct. 499, 73 L.Ed. 918 * * *

In the ordinary case the taxpayer who acquires the right to receive income is taxed when he receives it, regardless of the time when his right to receive payment accrued. But the rule that income is not taxable until realized has never been taken to mean that the taxpayer, even on the cash receipts basis, who has fully enjoyed the benefit of the economic gain represented by his right to receive income, can escape taxation because he has not himself received payment of it from his obligor. The rule, founded on administrative convenience, is only one of postponement of the tax to the final event of enjoyment of the income, usually the receipt of it by the taxpayer, and not one of exemption from taxation where the enjoyment is consummated by some event other than the taxpayer’s personal receipt of money or property. This may occur when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth. The question here is, whether because one who in fact receives payment for services or interest payments is taxable only on his receipt of the payments, he can escape all tax by giving away his right to income in advance of payment. If the taxpayer procures payment directly to his creditors of the items of interest or earnings due him, * * * or if he sets up a revocable trust with income payable to the objects of his bounty, * * * he does not escape taxation because he did not actually receive the money.

Underlying the reasoning in these cases is the thought that income is “realized” by the assignor because he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants. The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.
Although the donor here, by the transfer of the coupons, has precluded any possibility of his collecting them himself he has nevertheless, by his act, procured payment of the interest, as a valuable gift to a member of his family. Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property, would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money’s worth from the disposition of the coupons which he has used as money or money’s worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money’s worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.

In a real sense he has enjoyed compensation for money loaned or services rendered and not any the less so because it is his only reward for them. To say that one who has made a gift thus derived from interest or earnings paid to his donee has never enjoyed or realized the fruits of his investment or labor because he has assigned them instead of collecting them himself and then paying them over to the donee, is to affront common understanding and to deny the facts of common experience. Common understanding and experience are the touchstones for the interpretation of the revenue laws.

The power to dispose of income is the equivalent of ownership of it. The exercise of that power to procure the payment of income to another is the enjoyment and hence the realization of the income by him who exercises it. * * *

* * *

Reversed.

The separate opinion of Mr. JUSTICE McREYNOLDS.

* * *

The unmatured coupons given to the son were independent negotiable instruments, complete in themselves. Through the gift they became at once the absolute property of the donee, free from the donor’s control and in no way dependent upon ownership of the bonds. No question of actual fraud or purpose to defraud the revenue is presented.

* * *
The Chief Justice and Mr. Justice Roberts concur in this opinion.

* * *

Transferring Trees With Ripe Fruit. Horst suggests that while transfers of fruit may not be effective to shift the tax on such fruit to another, transfers of the entire tree may be effective to deflect taxation of the fruit to another. The following case reveals that this rule has limitations.

Salvatore v. Commissioner

United States Tax Court, 1970.  

Featherston, Judge:

Respondent determined a deficiency in petitioner’s income tax for 1963 in the amount of $31,016.60. The only issue presented for decision is whether petitioner is taxable on all or only one-half of the gain realized on the sale of certain real property in 1963.

Findings of Fact

* * *

Petitioner’s husband operated an oil and gas service station in Greenwich, Connecticut, for a number of years prior to his death on October 7, 1948. His will, dated December 6, 1941, [bequeathed all of his estate, including the service station, to Petitioner.]  

* * *

For several years after her husband’s death petitioner’s three sons, Amedeo, Eugene, and Michael, continued operating the service station with the help of her daughter Irene, who kept the books of the business. Sometime prior to 1958, however, Michael left the service station to undertake other business endeavors; and in 1958 Eugene left to enter the real estate business, leaving Amedeo alone to manage and operate the service station.

* * *

The land on which the service station was located became increasingly valuable. Several major oil companies from time to time made purchase proposals,
which were considered by members of the family. Finally, in the early summer of 1963 representatives of Texaco, Inc. (hereinafter Texaco), approached Amedeo regarding the purchase of the service station property. Petitioner called a family conference and asked for advice on whether the property should be sold. Realizing that Amedeo alone could not operate the station at peak efficiency, petitioner and her children decided to sell the property if a reasonable offer could be obtained.

Amedeo continued his negotiations with Texaco and ultimately received an offer of $295,000. During the course of the negotiations Eugene discovered that tax liens in the amount of $8,000 were outstanding against the property. In addition, there was an outstanding mortgage, securing a note held by Texaco, on which approximately $50,000 remained unpaid. The family met again to consider Texaco’s offer.

As a result of the family meeting (including consultation with petitioner’s daughter Geraldine, who lived in Florida), it was decided that the proposal should be accepted and that the proceeds should be used, first, to satisfy the tax liens and any other outstanding liabilities. Second, petitioner was to receive $100,000, the estimated amount needed to generate income for her life of about $5,000 per year—the approximate equivalent of the $100 per week she previously received out of the service station income. Third, the balance was to be divided equally among the five children. To effectuate this family understanding, it was agreed that petitioner would first convey a one-half interest in the property to the children and that deeds would then be executed by petitioner and the children conveying the property to Texaco.

On July 24, 1963, petitioner formally accepted Texaco’s offer by executing an agreement to sell the property to Texaco for $295,000, the latter making a down payment of $29,500. Subsequently, on August 28, 1963, petitioner executed a warranty deed conveying an undivided one-half interest in the property to her five children. This deed was received for record on September 6, 1963. By warranty deeds dated August 28 and 30, 1963, and received for record on September 6, 1963, petitioner and her five children conveyed their interest in the property to Texaco; Texaco thereupon tendered $215,582.12, the remainder of the purchase price less the amount due on the outstanding mortgage.

Petitioner filed a Federal gift tax return for 1963, reporting gifts made to each of her five children on August 1, 1963, of a 1/10 interest in the property and disclosing a gift tax due in the amount of $10,744.35.

After discharge of the mortgage and the tax liens the remaining proceeds of the sale (including the down payment) amounted to $237,082, of which one-half, $118,541, was paid to petitioner. From the other half of the proceeds the gift tax of $10,744.35 was paid and the balance was distributed to the children.
In her income tax return for 1963 petitioner reported as her share of the gain from the sale of the service station property a long-term capital gain of $115,063 plus an ordinary gain of $665. Each of the children reported in his 1963 return a proportionate share of the balance of the gain.

In the notice of deficiency respondent determined that petitioner's gain on the sale of the service station property was $238,856, all of which was taxable as long-term capital gain. Thereafter each of petitioner's children filed protective claims for refund of the taxes which they had paid on their gains from the sale of the service station property.

**Opinion**

The only question is whether petitioner is taxable on all or only one-half of the gain realized from the sale of the service station property. This issue must be resolved in accordance with the following principle stated by the Supreme Court in *Commissioner v. Court Holding Co.*, 324 U.S. 331, 334 (1945):

The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. A sale by one person cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress. * * *

The evidence is unmistakably clear that petitioner owned the service station property prior to July 24, 1963, when she contracted to sell it to Texaco. Her children doubtless expected ultimately to receive the property or its proceeds, either through gifts or inheritance, and petitioner may have felt morally obligated to pass it on to them. But at that time the children “held” no property interest therein. Petitioner's subsequent conveyance, unsupported by consideration, of an undivided one-half interest in the property to her children—all of whom were fully aware of her prior agreement to sell the property—was merely an intermediate step in the transfer of legal title from petitioner to Texaco: Petitioner's children were only “conduit(s) through which to pass title.” That petitioner's conveyance to the children may have been a bona fide completed gift prior to the transfer of title to Texaco, as she contends, is immaterial in determining the income tax consequences of the sale, for the form of a transaction cannot be permitted to prevail
over its substance. In substance, petitioner made an anticipatory assignment to her children of one-half of the income from the sale of the property.

The artificiality of treating the transaction as a sale in part by the children is confirmed by the testimony by petitioner’s witnesses that the sum retained by her from the sale was a computed amount—an amount sufficient to assure that she would receive income in the amount of approximately $5,000 annually. If the sales price had been less, petitioner would have retained a larger percentage of the proceeds; if more, we infer, she would have received a smaller percentage. While the children’s desire to provide for their mother’s care and petitioner’s willingness to share the proceeds of her property with her children during her lifetime may be laudable, her tax liabilities cannot be altered by a rearrangement of the legal title after she had already contracted to sell the property to Texaco.

All the gain from sale of the service station property was taxable to petitioner.

* * *

Decision will be entered for the respondent.

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**Tax Planning Versus Tax Avoidance.** We know from *Horst* that transfers of the rights to income may not be effective in shifting the tax burden to the recipient of the income. Should the same rule apply to situations where the transferred income rights are sold (not gifted) to the recipient? The following case addresses that issue.

**Estate of Stranahan v. Commissioner**


*472 F.2d* 867.

Peck, Circuit Judge.

This appeal comes from the United States Tax Court, which partially denied appellant estate’s petition for a redetermination of a deficiency in the decedent’s income tax for the taxable period January 1, 1965 through November 10, 1965, the date of decedent’s death.

The facts before us are briefly recounted as follows: 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 los-
ing 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 con-
sideration 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.
Dcedent reported this $115,000 payment as ordinary income for the 1964 tax
year and thus was able to deduct the full interest payment from the sum of this
payment and his other income. During decedent’s taxable year in question, divi-
dends 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 rel-
levant 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, there-
fore, 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. Third, a
taxpayer is free to arrange his financial affairs to minimize his tax liability; 2 thus,
the presence of tax avoidance motives will not nullify an otherwise bona fide
transaction. We also note there are no claims that the transaction was a sham, the
purchase price was inadequate or that decedent did not actually receive the full

2 "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to
choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s
taxes.” Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934) (Hand, J. Learned), aff’d 293 U.S. 465, 55
S.Ct. 266, 79 L.Ed. 596 (1935).
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); * * *. 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. As stated previously, tax avoidance motives alone will not serve to obviate the tax benefits of a transaction. Further, the fact that this was a transaction for good and sufficient consideration, and not merely gratuitous, distinguishes the instant case from the line of authority beginning with Helvering v. Horst, supra.

* * *

Hence the fact that valuable consideration was an integral part of the transaction distinguishes this case from those where the simple expedient of drawing up legal papers and assigning income to others is used. The Tax Court uses the celebrated metaphor of Justice Holmes regarding the “fruit” and the “tree,” and concludes there has been no effective separation of the fruit from the tree. Judge Cardozo’s comment that “[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it” (Berkey v. Third Avenue Railway Co., 244 N.Y. 84, 94, 155 N.E. 58, 61 (1926)) is appropriate here,
as the genesis of the metaphor lies in a gratuitous transaction, while the instant situation concerns a transaction for a valuable consideration.

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.

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**Make the Connection**

In other areas, people often sell an actual or potential income stream for a lump-sum payment. This is common with regard to structured settlements (settlements paid over time) and even pending legal suits. Terminal patients also sometimes sell life insurance claims so they can use the life insurance proceeds while they are alive (though this can have negative tax consequences).
The assignment of income doctrine can produce some interesting, and some say unfair, results. The question presented in the following case should be close to the heart – is the portion of a settlement payable to the attorney as a contingency fee includable in income of the plaintiff? In some discrimination cases, attorney's fee provisions allow for relatively high attorney's fee awards and relatively low recoveries for plaintiffs. If the attorney's fees are included in income, a plaintiff can actually be worse off despite winning the case.

**Problem 3–22**

Johnny Applestein was a shareholder in X Inc., a private corporation, for several years prior to Year One. On February 7, Year One, the board of directors of X approved a transaction in which all of the shares in X would be sold to Y Corporation. The stock purchase transaction was scheduled to occur on February 28, Year One. Johnny was pleased to receive news of the proposed stock purchase, for the selling price was substantially in excess of the price he paid for the X shares. On February 21, Year One, Johnny transferred all of his X stock to his children in a part-gift, part-sale transaction. The stock purchase took place as scheduled on February 28, Year One, and Johnny's children all received cash from the transaction. What are the federal income tax consequences of this sale to Johnny and his children?

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**Food for Thought**

In *Riverside v. Rivera*, 477 U.S. 561 (1986), the plaintiff received $33,350 and the attorney received $245,456.25. Assuming Rivera was in the 35% bracket after receiving the award she would owe almost $100,000 in tax. The Court discusses this issue towards the end of the case.

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**Commissioner v. Banks**

**Commissioner v. Banaitis**

United States Supreme Court, 2005.

543 U.S. 426, 125 S.Ct. 826, 160 L.Ed.2d 859.

Justice Kennedy delivered the opinion of the Court.

The question in these consolidated cases is whether the portion of a money judgment or settlement paid to a plaintiff's attorney under a contingent-fee agree-
ment is income to the plaintiff under the Internal Revenue Code * * * . The issue divides the courts of appeals. In one of the instant cases, *Banks v. Comm’r*, 345 F.3d 373 (2003), the Court of Appeals for the Sixth Circuit held the contingent-fee portion of a litigation recovery is not included in the plaintiff’s gross income. The Courts of Appeals for the Fifth and Eleventh Circuits also adhere to this view, relying on the holding, over Judge Wisdom’s dissent, in *Cotnam v. Commissioner*, 263 F.2d 119, 125–126 (CA5 1959). In the other case under review, *Banaitis v. Comm’r*, 340 F.3d 1074 (2003), the Court of Appeals for the Ninth Circuit held that the portion of the recovery paid to the attorney as a contingent fee is excluded from the plaintiff’s gross income if state law gives the plaintiff’s attorney a special property interest in the fee, but not otherwise. Six Courts of Appeals have held the entire litigation recovery, including the portion paid to an attorney as a contingent fee, is income to the plaintiff. Some of these Courts of Appeals discuss state law, but little of their analysis appears to turn on this factor. Other Courts of Appeals have been explicit that the fee portion of the recovery is always income to the plaintiff regardless of the nuances of state law. We granted certiorari to resolve the conflict.

We hold that, as a general rule, when a litigant’s recovery constitutes income, the litigant’s income includes the portion of the recovery paid to the attorney as a contingent fee. We reverse the decisions of the Courts of Appeals for the Sixth and Ninth Circuits.

I

A. Commissioner v. Banks

In 1986, respondent John W. Banks, II, was fired from his job as an educational consultant with the California Department of Education. He retained an attorney on a contingent-fee basis and filed a civil suit against the employer in a United States District Court. The complaint alleged employment discrimination in violation of 42 U.S.C. §§1981 and 1983, Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. §2000e, and Cal. Govt. Code Ann. §12965 (West 1986). The original complaint asserted various additional claims under state law, but Banks later abandoned these. After trial commenced in 1990, the parties settled for $464,000. Banks paid $150,000 of this amount to his attorney pursuant to the fee agreement.

Banks did not include any of the $464,000 in settlement proceeds as gross income in his 1990 federal income tax return. In 1997 the Commissioner of Internal Revenue issued Banks a notice of deficiency for the 1990 tax year. The Tax Court upheld the Commissioner’s determination, finding that all the settlement proceeds, including the $150,000 Banks had paid to his attorney, must be included in Banks’ gross income.
The Court of Appeals for the Sixth Circuit reversed in part. It agreed the net amount received by Banks was included in gross income but not the amount paid to the attorney. Relying on its prior decision in *Estate of Clarks v. United States*, 202 F.3d 854 (2000), the court held the contingent-fee agreement was not an anticipatory assignment of Banks’ income because the litigation recovery was not already earned, vested, or even relatively certain to be paid when the contingent-fee contract was made. A contingent-fee arrangement, the court reasoned, is more like a partial assignment of income-producing property than an assignment of income. The attorney is not the mere beneficiary of the client’s largess, but rather earns his fee through skill and diligence. This reasoning, the court held, applies whether or not state law grants the attorney any special property interest (e.g., a superior lien) in part of the judgment or settlement proceeds.

**B. Commissioner v. Banaitis**

After leaving his job as a vice president and loan officer at the Bank of California in 1987, Sigitas J. Banaitis retained an attorney on a contingent-fee basis and brought suit in Oregon state court against the Bank of California and its successor in ownership, the Mitsubishi Bank. The complaint alleged that Mitsubishi Bank willfully interfered with Banaitis’ employment contract, and that the Bank of California attempted to induce Banaitis to breach his fiduciary duties to customers and discharged him when he refused. The jury awarded Banaitis compensatory and punitive damages. After resolution of all appeals and post-trial motions, the parties settled. The defendants paid $4,864,547 to Banaitis; and, following the formula set forth in the contingent-fee contract, the defendants paid an additional $3,864,012 directly to Banaitis’ attorney.

Banaitis did not include the amount paid to his attorney in gross income on his federal income tax return, and the Commissioner issued a notice of deficiency. The Tax Court upheld the Commissioner’s determination, but the Court of Appeals for the Ninth Circuit reversed. In contrast to the Court of Appeals for the Sixth Circuit, the *Banaitis* court viewed state law as pivotal. Where state law confers on the attorney no special property rights in his fee, the court said, the whole amount of the judgment or settlement ordinarily is included in the plaintiff’s gross income. Oregon state law, however, like the law of some other States, grants attorneys a superior lien in the contingent-fee portion of any recovery. As a result, the court held, contingent-fee agreements under Oregon law operate not as an anticipatory assignment of the client’s income but as a partial transfer to the attorney of some of the client’s property in the lawsuit.

**II**

To clarify why the issue here is of any consequence for tax purposes, two preliminary observations are useful. The first concerns the general issue of deduct-
ibility. For the tax years in question the legal expenses in these cases could have been taken as miscellaneous itemized deductions subject to the ordinary requirements, but doing so would have been of no help to respondents because of the operation of the Alternative Minimum Tax (AMT). For noncorporate individual taxpayers, the AMT establishes a tax liability floor equal to 26 percent of the taxpayer’s “alternative minimum taxable income” (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000. Alternative minimum taxable income, unlike ordinary gross income, does not allow any miscellaneous itemized deductions.

Second, after these cases arose Congress enacted the American Jobs Creation Act of 2004. Section 703 of the Act amended the Code by adding §62(a)(20)]. The amendment allows a taxpayer, in computing adjusted gross income, to deduct “attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination.” The Act defines “unlawful discrimination” to include a number of specific federal statutes, §§62(e)(1) to (16), any federal whistleblower statute, §62(e)(17), and any federal, state, or local law “providing for the enforcement of civil rights” or “regulating any aspect of the employment relationship ... or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law,” §62(e)(18). These deductions are permissible even when the AMT applies. Had the Act been in force for the transactions now under review, these cases likely would not have arisen. The Act is not retroactive, however, so while it may cover future taxpayers in respondents’ position, it does not pertain here.

What’s That?
The Alternative Minimum Tax is an alternative tax system that also applies to taxpayers. It has a very high exemption amount, a broader tax base thus eliminating some deductions, and only two rates – 26% and 28%. Most taxpayers are not subject to AMT because of the large exemption amount provided under the AMT. We will discuss the AMT in Chapter 11.

Make the Connection
Why can’t Banks and Banaitis deduct the attorney’s fees as a cost of earning income and thus create an economic wash (include in income but deduct from income)? Remember miscellaneous itemized deductions are subject to a 2% haircut, so even if the fees could be deducted the result is not a wash. Worse for Banks and Banaitis, miscellaneous itemized deductions are not deductible for purposes of the Alternative Minimum Tax.
Chapter 3 The Meaning of “Gross Income”

III

The Internal Revenue Code defines “gross income” for federal tax purposes as “all income from whatever source derived.” The definition extends broadly to all economic gains not otherwise exempted. Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429–30, 99 L.Ed. 483, 75 S.Ct. 473 (1955); Commissioner v. Jacobson, 336 U.S. 28, 49, 93 L.Ed. 477, 69 S.Ct. 473 (1949). A taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party. Lucas v. Earl, 281 U.S. 111, 74 L.Ed. 731, 50 S.Ct. 241 (1930); Comm’r v. Sunnen, 333 U.S. 591, 604, 92 L.Ed. 898, 68 S.Ct. 715 (1948); Helvering v. Horst, 311 U.S. 112, 116–117, 85 L.Ed. 75, 61 S.Ct. 144 (1940). The rationale for the so-called anticipatory assignment of income doctrine is the principle that gains should be taxed “to those who earn them,” Lucas, supra, at 114, a maxim we have called “the first principle of income taxation,” Comm’r v. Culbertson, 337 U.S. 733, 739–740, 93 L.Ed. 1659, 69 S.Ct. 715 (1949). The anticipatory assignment doctrine is meant to prevent taxpayers from avoiding taxation through “arrangements and contracts however skillfully devised to prevent [income] when paid from vesting even for a second in the man who earned it.” Lucas, 281 U.S. at 115. The rule is preventative and motivated by administrative as well as substantive concerns, so we do not inquire whether any particular assignment has a discernible tax avoidance purpose. As Lucas explained, “no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.” Ibid.

Respondents argue that the anticipatory assignment doctrine is a judge-made antifraud rule with no relevance to contingent-fee contracts of the sort at issue here. The Commissioner maintains that a contingent-fee agreement should be viewed as an anticipatory assignment to the attorney of a portion of the client’s income from any litigation recovery. We agree with the Commissioner.

In an ordinary case attribution of income is resolved by asking whether a taxpayer exercises complete dominion over the income in question. Glenshaw Glass Co., supra, at 431; see also Commissioner v. Indianapolis Power & Light Co., 493 U.S. 203, 209, 107 L.Ed. 2d 591, 110 S.Ct. 589 (1990). In the context of anticipatory assignments, however, the assignor often does not have dominion over the income at the moment of receipt. In that instance the question becomes whether the assignor retains dominion over the income-generating asset, because the taxpayer “who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants.” Horst, supra, at 116–117. Looking to control over the income-generating asset, then, preserves the principle that income should be taxed to the party who earns the income and enjoys the consequent benefits.
In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff’s legal injury. The plaintiff retains dominion over this asset throughout the litigation. We do not understand respondents to argue otherwise. Rather, respondents advance two counterarguments. First, they say that, in contrast to the bond coupons assigned in Horst, the value of a legal claim is speculative at the moment of assignment, and may be worth nothing at all. Second, respondents insist that the claimant’s legal injury is not the only source of the ultimate recovery. The attorney, according to respondents, also contributes income-generating assets—effort and expertise—without which the claimant likely could not prevail. On these premises respondents urge us to treat a contingent-fee agreement as establishing, for tax purposes, something like a joint venture or partnership in which the client and attorney combine their respective assets—the client’s claim and the attorney’s skill—and apportion any resulting profits.

We reject respondents’ arguments. Though the value of the plaintiff’s claim may be speculative at the moment the fee agreement is signed, the anticipatory assignment doctrine is not limited to instances when the precise dollar value of the assigned income is known in advance. Though Horst involved an anticipatory assignment of a predetermined sum to be paid on a specific date, the holding in that case did not depend on ascertaining a liquidated amount at the time of assignment. In the cases before us, as in Horst, the taxpayer retained control over the income-generating asset, diverted some of the income produced to another party, and realized a benefit by doing so. * * * That the amount of income the asset would produce was uncertain at the moment of assignment is of no consequence.

We further reject the suggestion to treat the attorney-client relationship as a sort of business partnership or joint venture for tax purposes. The relationship between client and attorney, regardless of the variations in particular compensation agreements or the amount of skill and effort the attorney contributes, is a quintessential principal-agent relationship. The client may rely on the attorney’s expertise and special skills to achieve a result the client could not achieve alone. That, however, is true of most principal-agent relationships, and it does not alter the fact that the client retains ultimate dominion and control over the underlying claim. The control is evident when it is noted that, although the attorney can make tactical decisions without consulting the client, the plaintiff still must determine whether to settle or proceed to judgment and make, as well, other critical decisions. Even where the attorney exercises independent judgment without supervision by, or consultation with, the client, the attorney, as an agent, is obligated to act solely on behalf of, and for the exclusive benefit of, the client-principal, rather than for the benefit of the attorney or any other party.

The attorney is an agent who is duty bound to act only in the interests of the principal, and so it is appropriate to treat the full amount of the recovery as
income to the principal. In this respect Judge Posner's observation is apt: “[T]he contingent-fee lawyer [is not] a joint owner of his client’s claim in the legal sense any more than the commission salesman is a joint owner of his employer's accounts receivable.” Kenseth, 259 F.3d, at 883. In both cases a principal relies on an agent to realize an economic gain, and the gain realized by the agent's efforts is income to the principal. The portion paid to the agent may be deductible, but absent some other provision of law it is not excludable from the principal's gross income.

This rule applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as these protections do not alter the fundamental principal-agent character of the relationship. State laws vary with respect to the strength of an attorney's security interest in a contingent fee and the remedies available to an attorney should the client discharge or attempt to defraud the attorney. No state laws of which we are aware, however, even those that purport to give attorneys an “ownership” interest in their fees, convert the attorney from an agent to a partner.

Respondents and their amici propose other theories to exclude fees from income or permit deductibility. These suggestions include: (1) The contingent-fee agreement establishes a Subchapter K partnership * * * ; (2) litigation recoveries are proceeds from disposition of property, so the attorney's fee should be subtracted as a capital expense * * * ; and (3) the fees are deductible reimbursed employee business expenses under §62(a)(2)(A) * * *. These arguments, it appears, are being presented for the first time to this Court. We are especially reluctant to entertain novel propositions of law with broad implications for the tax system that were not advanced in earlier stages of the litigation and not examined by the Courts of Appeals. We decline comment on these supplementary theories. * * *

IV

The foregoing suffices to dispose of Banaitis' case. Banks' case, however, involves a further consideration. Banks brought his claims under federal statutes that authorize fee awards to prevailing plaintiffs' attorneys. He contends that application of the anticipatory assignment principle would be inconsistent with the purpose of statutory fee shifting provisions. See Venegas v. Mitchell, 495 U.S. 82, 86, 109 L.Ed. 2d 74, 110 S.Ct. 1679 (1990) (observing that statutory fees enable "plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail"). In the federal system statutory fees are typically awarded by the court under the lodestar approach, and the plaintiff usually has little control over the amount awarded. Sometimes, as when the plaintiff seeks only injunctive relief, or when the statute caps plaintiffs' recoveries, or when for other reasons damages are substantially less than attorney's fees, court-awarded attorney's fees can exceed a plaintiff's monetary recovery. See, e.g., Riverside v. Rivera, 477 U.S.
561, 564–565, 106 S.Ct. 2686, 91 L.Ed. 2d 466 (1986) (compensatory and punitive damages of $33,350; attorney’s fee award of $245,456.25). Treating the fee award as income to the plaintiff in such cases, it is argued, can lead to the perverse result that the plaintiff loses money by winning the suit. Furthermore, it is urged that treating statutory fee awards as income to plaintiffs would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general.

We need not address these claims. After Banks settled his case, the fee paid to his attorney was calculated solely on the basis of the private contingent-fee contract. There was no court-ordered fee award, nor was there any indication in Banks’ contract with his attorney, or in the settlement agreement with the defendant, that the contingent fee paid to Banks’ attorney was in lieu of statutory fees Banks might otherwise have been entitled to recover. Also, the amendment added by the American Jobs Creation Act redresses the concern for many, perhaps most, claims governed by fee-shifting statutes.

For the reasons stated, the judgments of the Courts of Appeals for the Sixth and Ninth Circuits are reversed, and the cases are remanded for further proceedings consistent with this opinion.

It is so ordered.

The Chief Justice took no part in the decision of these cases.

Notes and Questions

1. As the Court indicates, the facts of the two cases at bar would fit squarely under new §62(a)(20), enacted as part of the American Jobs Creation Act of 2004. Consequently, the attorney’s share of the award would be an above-the-line deduction, sparing it both from the two-percent haircut of §67 (discussed in Chapter 2) and the alternative minimum tax (a topic explored in Chapter 11). Lest you think §62(a)(20) renders the issue moot, keep in mind that Banks is still precedent for those contingent fee arrangements not eligible for an above-the-line deduction. These would include claims for defamation and invasion of privacy. Perhaps a claim for tortious interference with contract would also present this issue. Section 62(a)(20) does not change the adverse result faced by these (likely few) plaintiffs.

2. The Court expressly refused to comment on the theories advanced for the first time by the parties and by outsiders. Perhaps one or more of these theories would work for parties still affected by the issue. Are any of the “new” theories persuasive?
3. By deciding the issue on the basis of federal law (assignment of income) and not on the interpretation of state attorney lien statutes, the Court provided a uniform answer for all taxpayers regardless of residency. That tactic also allowed the Court to dodge a more direct discussion of why the attorney lien statutes were of no consequence in deciding the case.

4. The Court left open the question regarding the tax treatment of court-ordered attorney's fee under fee shifting statutes. In those cases, it can be argued that Congress has created attorney's fee provisions to encourage the bringing of suits and the policing of the law. Those fees may also be an independent claim by the attorney. Should statutorily granted fees be treated differently, or is that also a matter for Congress to confront?

Problem 3–23

Emily Employee was fired by Evil Employer in Year One. Emily believed that she was wrongfully terminated, so she consulted with Laverne Lawyer. Laverne agreed to commence litigation against Evil at no cost to Emily in exchange for a one-third interest in all amounts recovered in the lawsuit or any related settlement. Emily signed a contingent fee agreement consenting to these terms. Laverne filed suit alleging employment discrimination in Year Two, and by the end of the year, the parties settled. Evil agreed to pay $900,000 to Emily, which it did at the beginning of Year Three. Emily then paid $300,000 to Laverne.

Who has gross income, in what amounts, and when?

What if Emily's claim was for defamation instead of for employment discrimination?

(c) How would the answer to (a) change if Emily was not fired but was instead injured on the job because of Evil's negligence, and the amount paid in Year Three was in settlement of a physical injury claim? See §104(a)(2).