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TAXATION OF

INDIVIDUAL INCOME

EIGHTH EDITION

▪

2009 SUPPLEMENT

J. Martin Burke

Michael K. Friel

LexisNexis

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CHAPTER 1: INTRODUCTION TO FEDERAL INCOME TAXATION

Pages 12-18:

In several places in these pages, the text and footnotes state various inflation-adjusted amounts for the year 2007. This Supplement notes the inflation-adjusted amounts for the year 2009.

Page 12:

Footnote 1: The basic standard deduction for 2009 on a joint return is $11,400. Rev. Proc. 2008-66, 2008-2 C.B. 1107.

Page 17:

Footnote 3: For 2009, the applicable amounts are $166,800 and $83,400, respectively. Rev. Proc. 2008-66, *supra.*

Footnote 5: For 2009, the inflation-adjusted personal exemption is $3,650. Rev. Proc. 2008-66, *supra.*

Footnote 6: On joint returns, the threshold amount for 2009 is $250,200. Rev. Proc. 2008-66, *supra.*

Page 18:

The text notes on this page, under the heading Tax Rates, that the § 1(a) preliminary tax liability for 2007 on a joint return with taxable income of $179,700 is $39,308.50. Applying the 2009 rate tables to the same taxable income, the § 1(a) preliminary tax liability would be $38,579. (For 2009, the tax on a joint return on the first $137,050 of taxable income is $26,637, with the excess $42,650 of taxable income taxed at a rate of 28%, or $11,942.)

Footnote 9: The tax rate tables for 2009 are in Rev. Proc. 2008-66, *supra.*

Page 19:

The text notes that the regular § 1(a) tax for 2007 on taxable income of $63,700 is $34,828.50. Using the 2009 rate tables, the tax on that amount would be $34,099. The text further notes that the § 1(h) tax on the $16,000 of net capital gain is $2,400. For 2009, this would result in a total § 1 tax liability of $36,499.

CHAPTER 2: GROSS INCOME: CONCEPTS AND LIMITATIONS

Page 51:

The last word of the last full paragraph on this page should be “investment”, followed by closing quotation marks. Thus, the words in quotation on the last line of the last full paragraph should read as follows: “enrichment through increase in value of capital investment.”

CHAPTER 3: THE EFFECT OF AN OBLIGATION TO REPAY

Pages 58-59:

The Third Circuit Court of Appeals, by a split vote of 2-1, affirmed the decision in *Karns Prime & Fancy Food, Ltd.,* holding that the funds provided to the taxpayer in return for executing a supply agreement and a promissory note constituted taxable income rather than a loan. 494 F.3d 404 (3rd Cir. 2007). In so doing, the Third Circuit majority explicitly stated its disagreement with the Ninth Circuit decision in *Westpac Pacific Food v. Commissioner*, included in the materials beginning at page 75**.**

Nonetheless, despite its victory at the Tax Court level in *Karns*, the Service announced in Revenue Procedure 2007-53, 2007-2 C.B. 233, issued immediately prior to the Third Circuit affirmance in *Karns*, that it would follow the Ninth Circuit decision in *Westpac*. Revenue Procedure 2007-53 provides, in effect, that the Service will not treat the payment of a qualifying advance trade discount as gross income. (Under the revenue procedure, a qualifying advance trade discount is one where the period within which the taxpayer agrees to purchase a minimum amount of merchandise does not exceed 5 years; the supplier's payment to the taxpayer is intended to be a discount to the price of the merchandise; the taxpayer is obligated to repay the payment to the extent the purchase commitment is not met; and the taxpayer does not treat the payment as a payment for services in its applicable financial statements. The revenue procedure applies to accrual method taxpayers required to use the inventory method of accounting and maintain inventories.) The taxpayer's position in *Westpac* has thus been accepted by the Service.

CHAPTER 6: SALE OF A PRINCIPAL RESIDENCE

Page 124:

In December of 2007, Congress amended Section 121(b) by adding (b)(4) addressing a situation of considerable concern to some individuals selling a home not long after the death of a spouse. Consider the following example:

> **Example:** Bill's wife, Martha, died September 1, 2006. On December 31, 2006, Bill sold the home he and Martha had jointly owned and lived in for almost fifty years. Bill realized $450,000 of gain on the sale of the home. [Note: Bill would have been entitled to a stepped-up basis for Martha's one-half of the home under Section 1014(a)(9).] Pursuant to Section 6013, Bill was allowed to file a joint return for Martha and himself for 2006, the year of Martha's death. He, however, could not file a joint return thereafter unless he remarried. Because Bill was entitled to file a joint return for 2006, all $450,000 of the gain from the sale of the home may be excluded under Section 121(b)(2). In the alternative, assume Bill sold the home two days later - on January 2, 2007. Bill obviously may not file a joint return with Martha for 2007. As a result, Bill could only exclude $250,000 of the gain on the sale of the home.

As the above example illustrates, where a taxpayer decided to sell the family home after the death of his spouse, the timing of the sale could make a huge difference in terms of the amount of the exclusion available. To prevent a widowed spouse from having to rush to complete a sale within the same year as the death of the spouse, Congress enacted Section 121(b)(4) effective for sales or exchanges after December 31, 2007. This provision allows a widowed taxpayer who has not remarried to sell or exchange his principal residence and claim an exclusion of up to $500,000 if the sale or exchange occurs *not later than 2 years after the date of death of the taxpayer's spouse and the requirements of Section 121(a)(2)(A) were met immediately before the date the spouse's death.* Thus, in the above example, if Bill's sale of the home occurred January 2, 2008 (or for that matter, any time before September 1, 2008), Bill would have the benefit of an exclusion of up to $500,000.

Page 126:

As part of the Housing Assistance Act of 2008, Congress added § 121(b)(5), which provides that the § 121 exclusion shall not apply to the gain allocated to periods of "nonqualified use." The gain allocation is based on the ratio which nonqualified use periods bear to the period the taxpayer has owned the property. Generally speaking, a period of nonqualified use is a period (after 2008) during which the property was not used as the taxpayer's principal residence (or the principal residence of the taxpayer's spouse or former spouse). § 121(b)(5)(C)(i). However, there are three exceptions, including an exception for any portion of the 5-year period in § 121(a) which is after the last date the property was used as a principal residence by the taxpayer or the taxpayer's spouse. § 121(b)(5)(C)(ii)(I).

Example. Mary owned her home from January 1, 2009 to December 31, 2014, when she sold it at a gain of $150,000. Mary occupied her home as her principal residence only for

the period from January 1, 2009 to December 31, 2012. She rented out the home from January 1, 2013 to December 31, 2014, the date of the sale. At first glance, it appears that during the 6-year period of Mary's ownership (January 2009 - December 2014) there were two years of nonqualified use (January 2013 - December 2014). If so, this would mean that 33% of the gain (2 years out of 6 years), or $50,000, was allocated to a period of nonqualified use and was not excludable under § 121. However, under the exception noted above, a period of nonqualified use does not include any portion of the § 121(a) 5-year period which is after the last date the property was used as the taxpayer's principal residence. As a result, there is no period of nonqualified use in this example, and the entire $150,000 gain is excludable.

Note, however, that if the taxpayer was allowed depreciation deductions during the rental period, the gain allocable to the depreciation is not excluded. § 121(d)(6). Section 121(b)(5)(D) provides that the nonqualified use rule is to be applied after § 121(d)(6), and that the allocation of gain to a period of nonqualified use is made without regard to § 121(d)(6).

CHAPTER 7: SCHOLARSHIPS AND PRIZES

Page 135:

The Sixth Circuit has held that stipends received by medical residents do not constitute excludable scholarships or fellowships. U.S. v. Detroit Medical Center, ___ F.3d ____ (6th Cir. 2009). Basing its holding on the *quid pro quo* analysis of *Bingler v. Johnson,* the court emphasized that the medical residents were required to provide both patient care and teaching services. In addition, the court noted the medical residents were not candidates for a degree nor were the stipends used to pay for tuition or related educational expenses. Under these circumstances, the stipends they received did not constitute scholarships or fellowships excludable under § 117.

CHAPTER 9: DISCHARGE OF INDEBTEDNESS

Page l64:

Add § 108(h) to assigned reading in the Internal Revenue Code and skim § 108(i).

Page 164:

In Problem 2(e) assume Kevin did not make an election under § 108(c)(3).

Page 174:

Insert the following new section:

[C] Discharge of Indebtedness on Principal Residence Before January 2013

As a result of the subprime mortgage crisis, home foreclosure sales have become common. In many cases, because of a slump in housing prices, the proceeds of a foreclosure sale were inadequate to cover the balance of the outstanding mortgage on the foreclosed home. Given the financial condition of the borrower, lenders often simply forgave the remaining indebtedness. For the unfortunate borrower/taxpayer who had lost their home another problem loomed: the amount of forgiven indebtedness would normally constitute discharge of indebtedness income under Section 61(a)(12). Late in 2007, Congress enacted the Mortgage Forgiveness Debt Relief Act of 2007 to provide relief to these taxpayers. Specifically, Congress added new subsection (a)(1) (E) to Section 108 providing an exclusion for indebtedness discharged *on or after January 1, 2007 and before January 1, 2010* that is "qualified principal residence indebtedness. In the Emergency Economic Stabilization Act of 2008, Congress extended the benefit of § 108(a)(1)(E) to cover indebtedness which is discharged before January 1. 2013. [Note that the provision is not limited to foreclosure sales but rather is applicable to the discharge of any qualified principal residence indebtedness so long as the discharge is directly related to a decline in the value of the residence or to the financial condition of the taxpayer. Section 108(a)(1)(E) and 108(h)(3).] "Qualified principal residence indebtedness" is defined as up to $2 million of indebtedness secured by the taxpayer's principal residence so long as the indebtedness is acquisition indebtedness, i.e., indebtedness incurred in constructing, acquiring or substantially improving the residence. Section 108(h)(2) and (3). Section 108(h)(5) provides that the term "principal residence" shall have the same meaning as it does for purposes of the Section 121 exclusion. (See Chapter 6.) The new exclusion provision takes precedence over the insolvency exclusion unless the taxpayer otherwise elects. Section 108(a)(2)(C).

A taxpayer taking advantage of the exclusion under Section 108(a)(1)(E) must reduce (but not below zero) her basis in her principal residence by the amount excluded. Section 108(h)(1). In this regard, consider two situations. First, assume a situation where the lender

does not foreclose but the lender and borrower renegotiate the loan terms including monthly payments and the amount of the loan. Although excluded by Section 108(a)(1)(E), the amount of indebtedness discharged as a result of the renegotiation will reduce the borrower's/taxpayer's basis in his principal residence. Second, assume a foreclosure sale. For purposes of computing gain on that sale, the borrower's/taxpayer's basis will be reduced by the amount of the Section 108(a)(1)(E) exclusion. Of course, in the case of a foreclosure sale, the Section 121 exclusion is available to the taxpayer so long as he satisfies the ownership, use and other requirements of that provision.

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Page 176:

Add the following ruling to the assigned materials:

Revenue Ruling 2008-34

2008-2 C.B. 76

Law school loan repayment assistance programs. This ruling clarifies that a law school loan made under a Loan Repayment Assistance Program (LRAP) generally satisfies the requirements of section 108(f)(1) of the Code, and is a "student loan" within the meaning of section 108(f)(2).

ISSUE

Do the terms of a loan made under the Loan Repayment Assistance Program (LRAP) described below satisfy the requirements of § 108 (f) (1) of the Internal Revenue Code, and is the LRAP loan a "student loan" within the meaning of § 108 (f) (2)?

FACTS

A, an individual, attended law school and has student loan debt. Neither the loans nor the underlying loan documents addressed whether any of the indebtedness would be forgiven if A worked in a particular profession for a specified period of time.

A's law school offers a Loan Repayment Assistance Program (LRAP) to help reduce the student loan debt of graduates who engage in public service. The LRAP is designed to encourage graduates to enter into public service in occupations or areas with unmet needs. Under the LRAP, the law school makes loans that refinance the graduates' original student loan (s). To qualify for an LRAP loan, a graduate must work in a law-related public service position for, or under the direction of, a tax-exempt charitable organization or a governmental unit, including a position in (1) a public interest or community service organization, (2) a legal aid office or clinic, (3) a prosecutor's office, (4) a public defender's office, or (5) a state, local, or federal government office. The amount of the LRAP loan is based on the graduate's

outstanding student loan debt and annual income. After the graduate works for the required period in a qualifying position, the law school will forgive all or part of the graduate's LRAP loan.

After *A* graduates from law school, A signs an LRAP promissory note and accepts the terms and conditions of the law school's LRAP loan. The LRAP loan provides that the indebtedness will be forgiven if *A* works for a certain minimum period of time in a qualifying law-related public service position.

LAW

Section 61 (a) provides that gross income means all income from whatever source derived. Section 61 (a) (12) provides that gross income includes income from the discharge of indebtedness.

Section 108 (f) (1) provides that in the case of an individual, gross income does not include any amount which (but for § 108 (f)) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the individual worked for a certain period of time in certain professions for any of a broad class of employers.

Section 108 (f) (2) defines "student loan" for purposes of § 108 (f) to include any loan to an individual to assist the individual in attending an educational organization described in § 170 (b) (1) (A) (ii) made by (A) the United States, or an instrumentality or agency thereof, (B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or (C) certain tax-exempt public benefit corporations. The Taxpayer Relief Act of 1997 (1997 Act), Pub. L. 105-34, added § 108 (f) (2) (D), which amended and expanded the definition of "student loan" to include loans made by the educational organizations themselves if the loans were made either:

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501 (c) (3) and exempt from tax under section 501 (a).

The 1997 Act further amended § 108 (f) (2) to provide that the term "student loan" includes any loan made by an educational organization described in section 170 (b) (1) (A) (ii) or by an organization exempt from tax under section 501 (a) "to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in

subparagraph (D) (ii)."[1] The legislative history to the 1997 Act explains that, in the case of loans made or refinanced by educational organizations (and loans refinanced by certain tax-exempt organizations), the student's work must fulfill a "public service requirement." *See* H.R. Conf. Rep. No. 105-220, at 375-76 (1997).

ANALYSIS

The terms of *A*'s LRAP loan provide for loan forgiveness only if *A* works for a certain minimum period of time in a qualifying law-related public service position. This requirement is consistent with the requirement in §108 (f) (1) to work in certain professions for a certain period of time.

Additionally, the law school's LRAP is designed to encourage its students to engage in public service in occupations or areas with unmet needs. All of the positions listed in the LRAP are for, or under the direction of, a governmental unit or a tax-exempt charitable organization. Further, the LRAP loan was made to refinance *A*'s original student loans. Therefore, the LRAP loan meets the definition of a "student loan" in § 108 (f) (2).

HOLDING

The terms of the loan made under the LRAP satisfy the requirements of § 108 (f) (1), and the LRAP loan is a "student loan" within the meaning of § 108 (f) (2).

Page 179:

Add the following decision to the assigned materials:

PAYNE v. COMMISSIONER
T.C. Memo 2008-66

HAINES, *Judge*: Respondent determined a deficiency of $5,410 in petitioners' Federal income tax for 2004. The sole issue for decision is whether petitioners should have included $16,678 of discharge of indebtedness income on their 2004 Federal income tax return. We hold that they should have done so and therefore sustain respondent's determination.

FINDINGS OF FACT:

At the end of 1992 petitioner Ancil N. Payne, Jr. (Mr. Payne), opened a credit card account with MBNA America Bank. Mr. Payne used the credit card to pay hospital bills and receive cash advances during periods of unemployment. By April 26, 2004, Mr. Payne had

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[1] A technical correction clarified that gross income does not include amounts from the forgiveness of loans made by educational organizations and certain tax-exempt organizations to refinance any existing student loan (and not just loans made by educational organizations). See Pub. L. 105-206, § 6004 (f) (1), and H. R. Rep. No. 356, 105th Cong., 1st Sess. 10 (1997).

accumulated $21,407 of credit card debt. At no time did Mr. Payne challenge the accuracy of this amount. Petitioners were not insolvent in 2004, nor did they file for bankruptcy.

By October 19, 2004, Mr. Payne and MBNA entered into an agreement whereby MBNA agreed to accept $4,592 as a full settlement of the account balance of $21,270, payable in installments over 4 months. Mr. Payne made the necessary payments, and MBNA issued him a Form 1099-C, Cancellation of Debt, reporting $16,678 of discharge of indebtedness income.

On petitioners' 2004 Form 1040, U.S. Individual Income Tax Return, filed jointly in April 2005, petitioners did not report any discharge of indebtedness income. Instead, petitioners attached a statement to their return which disclosed that they received a Form 1099-C from MBNA that reported discharge of indebtedness income of $16,678. The statement also explained that petitioners believed the amount disclosed on the Form 1099-C was not subject to income tax.

Respondent's determination of a deficiency in petitioners' Federal income tax for the taxable year 2004 was attributable to petitioners' failure to report the discharge of indebtedness income.

OPINION

Section 61 generally defines gross income as "all income from whatever source derived". Section 61(a)(12) specifically provides that gross income includes income from the discharge of indebtedness. See also *Gitlitz v. Comm'r*, 531 U.S. 206, 213, (2001); *United States v. Kirby Lumber Co.*, 284 U.S. 1(1931). Respondent determined that MBNA's agreement with Mr. Payne to accept $4,592 in full settlement of the undisputed account balance of $21,270 resulted in $16,678 of discharge of indebtedness income to petitioners. Petitioners bear the burden of proving respondent's determination incorrect.

I. *Reduction of Purchase Price*

Petitioners contend that their settlement with MBNA did not result in the discharge of indebtedness but was rather a retroactive reduction of the rate of interest charged by MBNA and thus a reduction of the "purchase price" of the loans under section 108(e)(5). Although the record does not indicate that MBNA agreed to retroactively reduce the rate of interest of its loans to petitioners, petitioners have nevertheless painstakingly calculated the various interest rates that applied to their outstanding balances from October 1994 through October 2004 and attempt to show that by the time of their settlement they had paid back all of the principal they had borrowed from MBNA.

Section 108(e)(5) provides an exception to section 61(a)(12) where the buyer of property negotiates with the seller/creditor for a discharge of all or part of the purchase money indebtedness. Commonly such a discharge reflects a decline in the value of the property. The

resulting discharge of indebtedness is characterized not as taxable income but in effect as a retroactive reduction of the purchase price. Where, however, the only relationship between the parties is that of debtor and creditor, "The rule of Kirby Lumber is clearly applicable". *OKC Corp. & Subs. v. Commissioner*, 82 T.C. 638, 647 (1984).

Petitioners argue that the lending of money in a generic credit card transaction constitutes the sale of "property" under section 108(e)(5). Petitioners are mistaken. MBNA effectively lent petitioners money to be used for health care costs and general living expenses.[5] The only relationship between the parties was that of debtor and creditor, and thus section 108(e)(5) does not apply. See *OKC Corp. & Subs. v. Commissioner*, *supra* at 647.

II. *Discharge of Indebtedness for Interest Payments*

Petitioners also allege that no income arises from the discharge of indebtedness for interest payments. In support of this proposition, petitioners reference *Earnshaw v. Comm'r*, T.C. Memo 2002-191.

Generally, when a solvent debtor's fixed obligation is reduced or canceled, the amount of the reduction or cancellation constitutes income. Sec. 61(a)(12); *United States v. Kirby Lumber Co.*, *supra*. In *Earnshaw v. Comm'r*, *supra*, we concluded that there had been a legitimate dispute between the debtor and creditor regarding the amount of the debtor's obligation. We held that the taxpayer recognized discharge of indebtedness income from the settlement, but the amount was based on the account balance that the taxpayer admitted to rather than the higher amount the Commissioner alleged. *Earnshaw* does not stand for the principle that discharge of indebtedness income does not include the cancellation of debt attributable to interest payments.

As no exclusion applies and the amount of petitioners' obligation was clearly fixed, petitioners should have included $16,678 of discharge of indebtedness income in their gross income on their 2004 tax return.

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[5] Insofar as petitioners used the credit card to buy merchandise, the Commissioner treats debt forgiveness in third-party lender cases as a purchase price adjustment only if the forgiveness is directly related to an aspect of the sale, as where a seller inflates the purchase price by misrepresentation. Rev. Rul. 92-99, 1992-2 C.B. 35.

CHAPTER 10: COMPENSATION FOR PERSONAL INJURY AND SICKNESS

Page 182:

Add the following case to the Materials:

MURPHY v. U.S.

493 F.3d 170 (D.C. Cir. 2007)
Cert. Den. 2008 U.S. Lexis 3544 (April 2008)

GINSBURG, *Chief Judge*: Marrita Murphy brought this suit to recover income taxes she paid on the compensatory damages for emotional distress and loss of reputation she was awarded in an administrative action she brought against her former employer. Murphy contends that under § 104(a)(2) of the Internal Revenue Code her award should have been excluded from her gross income because it was compensation received "on account of personal physical injuries or physical sickness." She also maintains that, in any event, her award is not part of her gross income as defined by § 61 of the IRC. Finally, she argues that taxing her award subjects her to an unapportioned direct tax in violation of Article I, Section 9 of the Constitution of the United States.

We reject Murphy's argument in all aspects. We hold, first, that Murphy's compensation was not "received ... on account of personal physical injuries" excludable from gross income under § 104(a)(2). Second, we conclude gross income as defined by § 61 includes compensatory damages for non-physical injuries. Third, we hold that a tax upon such damages is within the Congress's power to tax.

[**Authors' note:** In this excerpt, we include only the court's discussion of the first two issues raised by Ms. Murphy.]

I. Background

In 1994 Marrita Leveille (now Murphy) filed a complaint with the Department of Labor alleging that her former employer, the New York Air National Guard (NYANG), in violation of various whistle-blower statutes, had "blacklisted" her and provided unfavorable references to potential employers after she had complained to state authorities of environmental hazards on a NYANG airbase. The Secretary of Labor determined the NYANG had unlawfully discriminated and retaliated against Murphy, ordered that any adverse references to the taxpayer in the files of the Office of Personnel Management be withdrawn, and remanded her case to an Administrative Law Judge "for findings on compensatory damages."

On remand Murphy submitted evidence that she had suffered both mental and physical injuries

as a result of the NYANG's blacklisting her. A psychologist testified that Murphy had sustained both "somatic" and "emotional" injuries, basing his conclusion in part upon medical and dental records showing Murphy had "bruxism," or teeth grinding often associated with stress, which may cause permanent tooth damage. Noting that Murphy also suffered from other "physical manifestations of stress" including "anxiety attacks, shortness of breath, and dizziness," and that Murphy testified she "could not concentrate, stopped talking to friends, and no longer enjoyed 'anything in life,'" the ALJ recommended compensatory damages totaling $70,000, of which $45,000 was for "past and future emotional distress," and $25,000 was for "injury to [Murphy's] vocational reputation" from having been blacklisted. None of the award was for lost wages or diminished earning capacity.

In 1999 the Department of Labor Administrative Review Board affirmed the ALJ's findings and recommendations. On her tax return for 2000, Murphy included the $70,000 award in her "gross income" pursuant to § 61 of the IRC. As a result, she paid $20,665 in taxes on the award.

Murphy later filed an amended return in which she sought a refund of the $20,665 based upon § 104(a)(2) of the IRC, which provides that "gross income does not include ... damages ... received ... on account of personal physical injuries or physical sickness." In support of her amended return, Murphy submitted copies of her dental and medical records. Upon deciding Murphy had failed to demonstrate the compensatory damages were attributable to "physical injury" or "physical sickness," the Internal Revenue Service denied her request for a refund. Murphy thereafter sued the IRS and the United States in the district court.

In her complaint Murphy sought a refund of the $20,665, plus applicable interest, pursuant to the Sixteenth Amendment to the Constitution of the United States, along with declaratory and injunctive relief against the IRS pursuant to the Adminstrative Procedure Act and the Due Process Clause of the Fifth Amendment. She argued her compensatory award was in fact for "physical personal injuries" and therefore excluded from gross income under § 104(a)(2). In the alternative Murphy asserted taxing her award was unconstitutional because the award was not "income" within the meaning of the Sixteenth Amendment. The Government moved to dismiss Murphy's suit as to the IRS, contending the Service was not a proper defendant, and for summary judgment on all claims.

The district court .... rejected all of Murphy's claims on the merits and granted summary judgment for the Government and the IRS.

Murphy appealed the judgment of the district court with respect to her claims under § 104(a)(2) and the Sixteenth Amendment. In *Murphy v. IRS*, 460 F.3d 79 (2006), we concluded Murphy's award was not exempt from taxation pursuant to § 104(a)(2), but also was not "income" within the meaning of the Sixteenth Amendment, and therefore reversed the decision of the district court. The Government petitioned for rehearing *en banc*, arguing for the first time that, even if Murphy's award is not income, there is no constitutional impediment to

taxing it because a tax on the award is not a direct tax and is imposed uniformly. In view of the importance of the issue thus belatedly raised, the panel sua sponte vacated its judgment and reheard the case. .... In the present opinion, we affirm the judgment of the district court based upon the newly argued ground that Murphy's award, even if it is not income within the meaning of the Sixteenth Amendment, is within the reach of the congressional power to tax under Article I, Section 8 of the Constitution.

II. Analysis
....
B. Section 104(a)(2) of the IRC

Section 104(a) ("Compensation for injuries or sickness") provides that "gross income [under § 61 of the IRC] does not include the amount of any damages (other than punitive damages) received ... on account of personal physical injuries or physical sickness." Since 1996 it has further provided that, for purposes of this exclusion, "emotional distress shall not be treated as a physical injury or physical sickness." The version of § 104(a)(2) in effect prior to 1996 had excluded from gross income monies received in compensation for "personal injuries or sickness," which included both physical and nonphysical injuries such as emotional distress.... In *Commissioner v. Schleier*, 515 U.S. 323 (1995), the Supreme Court held that before a taxpayer may exclude compensatory damages from gross income pursuant to § 104(a)(2), he must first demonstrate that "the underlying cause of action giving rise to the recovery [was] 'based upon tort or tort type rights.'" The taxpayer has the same burden under the statute as amended.

Murphy contends § 104(a)(2), even as amended, excludes her particular award from gross income. First, she asserts her award was "based upon ... tort type rights" in the whistle-blower statutes the NYANG violated--a position the Government does not challenge. Second, she claims she was compensated for "physical" injuries, which claim the Government does dispute. Murphy points both to her psychologist's testimony that she had experienced "somatic" and "body" injuries "as a result of NYANG's blacklisting [her]," and to the American Heritage Dictionary, which defines "somatic" as "relating to, or affecting the body, especially as distinguished from a body part, the mind, or the environment." Murphy further argues the dental records she submitted to the IRS proved she has suffered permanent damage to her teeth. ... Murphy contends that "substantial physical problems caused by emotional distress are considered physical injuries or physical sickness."

Murphy further contends that neither § 104 of the IRC nor the regulation issued thereunder "limits the physical disability exclusion to a physical stimulus." In fact, as Murphy points out, the applicable regulation, which provides that § 104(a)(2) "excludes from gross income the amount of any damages received (whether by suit or agreement) on account of personal injuries or sickness," 26 C.F.R. § 1.104-1(c), does not distinguish between physical injuries stemming from physical stimuli and those arising from emotional trauma; rather, it tracks the pre-1996 text of § 104(a)(2), which the IRS agrees excluded from gross income compensation

both for physical and for nonphysical injuries.

For its part, the Government argues Murphy's focus upon the word "physical" in § 104(a)(2) is misplaced; more important is the phrase "on account of." In *O'Gilvie v. United States*, 519 U.S. 79 (1996), the Supreme Court read that phrase to require a "strong[] causal connection," thereby making § 104(a)(2) "applicable only to those personal injury lawsuit damages that were awarded by reason of, or because of, the personal injuries." The Court specifically rejected a "but-for" formulation in favor of a "stronger causal connection." The Government therefore concludes Murphy must demonstrate she was awarded damages "because of" her physical injuries, which the Government claims she has failed to do.

Indeed, as the Government points out, the ALJ expressly recommended, and the Board expressly awarded, compensatory damages "because of" Murphy's nonphysical injuries. The Board analyzed the ALJ's recommendation under the headings "Compensatory damage for emotional distress or mental anguish" and "Compensatory damage award for injury to professional reputation," and noted such damages compensate "not only for direct pecuniary loss, but also for such harms as impairment of reputation, personal humiliation, and mental anguish and suffering." In describing the ALJ's proposed award as "reasonable," the Board stated Murphy was to receive "$45,000 for mental pain and anguish" and "$25,000 for injury to professional reputation." Although Murphy may have suffered from bruxism or other physical symptoms of stress, the Board focused upon Murphy's testimony that she experienced "severe anxiety attacks, inability to concentrate, a feeling that she no longer enjoyed 'anything in life,' and marital conflict" and upon her psychologist's testimony about the "substantial effect the negative references had on [Murphy]." The Board made no reference to her bruxism, and acknowledged that "[a]ny attempt to set a monetary value on intangible damages such as mental pain and anguish involves a subjective judgment," before concluding the ALJ's recommendation was reasonable. The Government therefore argues "there was no direct causal link between the damages award at issue and [Murphy's] bruxism."

Murphy responds that it is undisputed she suffered both "somatic" and "emotional" injuries, and the ALJ and Board expressly cited to the portion of her psychologist's testimony establishing that fact. She contends the Board therefore relied upon her physical injuries in determining her damages, making those injuries a direct cause of her award in spite of the Board's labeling the award as one for emotional distress.

Although the pre-1996 version of § 104(a)(2) was at issue in *O'Gilvie*, the Court's analysis of the phrase "on account of," which phrase was unchanged by the 1996 Amendments, remains controlling here. Murphy no doubt suffered from certain physical manifestations of emotional distress, but the record clearly indicates the Board awarded her compensation only "for mental pain and anguish" and "for injury to professional reputation." Although the Board cited her psychologist, who had mentioned her physical aliments, in support of Murphy's "description of her mental anguish," we cannot say the Board, notwithstanding its clear statements to the contrary, actually awarded damages because of Murphy's bruxism and other physical

manifestations of stress. At best--and this is doubtful--at best the Board and the ALJ may have considered her physical injuries indicative of the severity of the emotional distress for which the damages were awarded, but her physical injuries themselves were not the reason for the award. The Board thus having left no room for doubt about the grounds for her award, we conclude Murphy's damages were not "awarded by reason of, or because of, ... [physical] personal injuries." Therefore, § 104(a)(2) does not permit Murphy to exclude her award from gross income.

C. Section 61 of the IRC

Murphy and the Government agree that for Murphy's award to be taxable, it must be part of her "gross income" as defined by § 61(a) of the IRC, which states in relevant part: "gross income means all income from whatever source derived." The Supreme Court has interpreted the section broadly to extend to "all economic gains not otherwise exempted." ... *Comm'r v. Glenshaw Glass Co....*"Gross income" in § 61(a) is at least as broad as the meaning of "incomes" in the Sixteenth Amendment.

Murphy argues her award is not a gain or an accession to wealth and therefore not part of gross income. Noting the Supreme Court has long recognized "the principle that a restoration of capital [i]s not income; hence it [falls] outside the definition of 'income' upon which the law impose[s] a tax," ... Murphy contends a damage award for personal injuries-including nonphysical injuries--should be viewed as a return of a particular form of capital--"human capital," as it were. In her view, the Supreme Court in *Glenshaw Glass* acknowledged the relevance of the human capital concept for tax purposes. There, in holding that punitive damages for personal injury were "gross income" under the predecessor to § 61, the Court stated:

> The long history of ... holding personal injury recoveries nontaxable on the theory that they roughly correspond to a return of capital cannot support exemption of punitive damages following injury to property .... Damages for personal injury are by definition compensatory only. Punitive damages, on the other hand, cannot be considered a restoration of capital for taxation purposes.

By implication, Murphy argues, damages for personal injury are a "restoration of capital."

As further support, Murphy cites various administrative rulings issued shortly after passage of the Sixteenth Amendment that concluded recoveries from personal injuries were not income, such as this 1918 Opinion of the Attorney General:

> Without affirming that the human body is in a technical sense the "capital" invested in an accident policy, in a broad, natural sense the proceeds of the policy do but substitute, so far as they go, capital which is the source of future periodical income. They merely take the place of capital in human ability which was destroyed by the accident. They

are therefore "capital" as distinguished from "income" receipts.

31 Op. Att'y Gen. 304, 308; See Sol. Op. 132, I-1 C.B. 92, 93-94 (1922) ("[M]oney received ... on account of ... defamation of personal character ... does not constitute income within the meaning of the sixteenth amendment and the statutes enacted thereunder"). She also cites a House Report on the bill that became the Revenue Act of 1918. ("Under the present law it is doubtful whether amounts received ... as compensation for personal injury ... are required to be included in gross income"); *see also Dotson v. United States*, 87 F.3d 682, 685 (5th Cir. 1996) (concluding on basis of House Report that the "Congress first enacted the personal injury compensation exclusion ... when such payments were considered the return of human capital, and thus not constitutionally taxable 'income' under the 16th amendment").

Finally, Murphy argues her interpretation of § 61 is reflected in the common law of tort and the provisions in various environmental statutes and Title VII of the Civil Rights Act of 1964, all of which provide for "make whole" relief. If a recovery of damages designed to "make whole" the plaintiff is taxable, she reasons, then one who receives the award has not been made whole after tax. Section 61 should not be read to create a conflict between the tax code and the "make whole" purpose of the various statutes.

The Government disputes Murphy's interpretation on all fronts. First, noting "the definition [of gross income in the IRC] extends broadly to all economic gains," the Government asserts Murphy "undeniably had economic gain because she was better off financially after receiving the damages award than she was prior to receiving it." Second, the Government argues that the case law Murphy cites does not support the proposition that the Congress lacks the power to tax as income recoveries for personal injuries. In its view, to the extent the Supreme Court has addressed at all the taxability of compensatory damages, it was merely articulating the Congress's rationale at the time for not taxing such damages, not the Court's own view whether such damages could constitutionally be taxed.

Third, the Government challenges the relevance of the administrative rulings Murphy cites from around the time the Sixteenth Amendment was ratified; Treasury decisions dating from even closer to the time of ratification treated damages received on account of personal injury as income. Furthermore, administrative rulings from the time suggest that, even if recoveries for physical personal injuries were not considered part of income, recoveries for nonphysical personal injuries were. Although the Treasury changed its position in 1922, *see* Sol. Op. 132, I-1 C.B. at 93-94, it did so only after the Supreme Court's decision in *Eisner v. Macomber*, 252 U.S. 189 (1920), which the Court later viewed as having established a definition of income that "served a useful purpose [but] was not meant to provide a touchstone to all future gross income questions." *Glenshaw Glass*, 348 U.S. at 430-31. As for Murphy's contention that reading § 61 to include her damages would be in tension with the common law and various statutes providing for "make whole" relief, the Government denies there is any tension and suggests Murphy is trying to turn a disagreement over tax policy into a constitutional issue.

Finally, the Government argues that even if the concept of human capital is built into § 61, Murphy's award is nonetheless taxable because Murphy has no tax basis in her human capital. Under the IRC, a taxpayer's gain upon the disposition of property is the difference between the "amount realized" from the disposition and his basis in the property, defined as "the cost of such property," adjusted "for expenditures, receipts, losses, or other items, properly chargeable to [a] capital account. The Government asserts, "The Code does not allow individuals to claim a basis in their human capital"; accordingly, Murphy's gain is the full value of the award. *See Roemer v. Commissioner*, 716 F.2d 693, 696 n.2 (9th Cir. 1983) ("Since there is no tax basis in a person's health and other personal interests, money received as compensation for an injury to those interests might be considered a realized accession to wealth") (dictum).

Although Murphy and the Government focus primarily upon whether Murphy's award falls within the definition of income first used in *Glenshaw Glass*, coming within that definition is not the only way in which § 61(a) could be held to encompass her award. Principles of statutory interpretation could show § 61(a) includes Murphy's award in her gross income regardless whether it was an "accession to wealth," as *Glenshaw Glass* requires. For example, if § 61(a) were amended specifically to include in gross income "$100,000 in addition to all other gross income," then that additional sum would be a part of gross income under § 61 even though no actual gain was associated with it. In other words, although the "Congress cannot make a thing income which is not so in fact," it can *label* a thing income and tax it, so long as it acts within its constitutional authority, which includes not only the Sixteenth Amendment but also Article I, Sections 8 and 9.... Accordingly, rather than ask whether Murphy's award was an accession to her wealth, we go to the heart of the matter, which is whether her award is properly included within the definition of gross income in § 61(a), to wit, "all income from whatever source derived."

Looking at § 61(a) by itself, one sees no indication that it covers Murphy's award unless the award is "income" as defined by *Glenshaw Glass* and later cases. Damages received for emotional distress are not listed among the examples of income in § 61 and, as Murphy points out, an ambiguity in the meaning of a revenue-raising statute should be resolved in favor of the taxpayer.... A statute is to be read as a whole, however, and reading § 61 in combination with § 104(a)(2) of the Internal Revenue Code presents a very different picture-a picture so clear that we have no occasion to apply the canon favoring the interpretation of ambiguous revenue-raising statutes in favor of the taxpayer.

As noted above, in 1996 the Congress amended § 104(a) to narrow the exclusion to amounts received on account of "personal physical injuries or physical sickness" from "personal injuries or sickness," and explicitly to provide that "emotional distress shall not be treated as a physical injury or physical sickness, thus making clear that an award received on account of emotional distress is not excluded from gross income under § 104(a)(2). As this amendment, which narrows the exclusion, would have no effect whatsoever if such damages were not included within the ambit of § 61, and as we must presume that "[w]hen Congress acts to amend a statute, ... it intends its amendment to have real and substantial effect," the 1996 amendment of

§ 104(a) strongly suggests § 61 should be read to include an award for damages from nonphysical harms. Although it is unclear whether § 61 covered such an award before 1996, we need not address that question here; even if the provision did not do so prior to 1996, the presumption indicates the Congress implicitly amended § 61 to cover such an award when it amended § 104(a).[4]

We realize, of course, that amendments by implication, like repeals by implication, are disfavored. The Supreme Court has also noted, however, that the "classic judicial task of reconciling many laws enacted over time, and getting them to 'make sense' in combination, necessarily assumes that the implications of a statute may be altered by the implications of a later statute."....

This "classic judicial task" is before us now. For the 1996 amendment of § 104(a) to "make sense," gross income in § 61(a) must, and we therefore hold it does, include an award for nonphysical damages such as Murphy received, regardless whether the award is an accession to wealth.....

III. Conclusion

For the foregoing reasons, we conclude (1) Murphy's compensatory award was not received on account of personal physical injuries, and therefore is not exempt from taxation pursuant to § 104(a)(2) of the IRC; (2) the award is part of her "gross income," as defined by § 61 of the IRC .... The judgment of the district court is accordingly

Affirmed.

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Page 186:

Revenue Ruling 56-518 was declared obsolete by Revenue Ruling 2007-14, I.R.B. 2007-12; Revenue Ruling 74-77 was declared obsolete by Revenue Ruling 98-37, 1988-2 C.B. 133.

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[4] As evidence the presumption is well-founded in this case, we note the House Report accompanying the 1996 amendment to § 104 explicitly presumes recoveries for nonphysical injuries would be included in gross income: Part of the section explaining the effect of the amendment is entitled "Include in income damage recoveries for nonphysical injuries." H.R. Rep. No. 104-586, at 143-44 (1996), *reprinted in* 1996-3 C.B. 331, 481-82.

CHAPTER 11: FRINGE BENEFITS

Page 222:

The financial bailout bill passed in October 2008 expanded the types of qualified transportation fringe benefits to include expenses incurred by bicycle commuters. See § 132(f)(1)(D) and § 132(f)(5)(F).

CHAPTER 12: BUSINESS AND PROFIT-SEEKING EXPENSES

Page 255:

The Tax Court decision in *Menards* was reversed by the Seventh Circuit. *Menard, Inc. v. Commissioner* (7th. Cir., March 10, 2009). The corporation paid its chief executive officer, the majority shareholder, $20.6 million in 1998. The bulk of the compensation came from a 5% bonus program established 25 years earlier. The Tax Court allowed the corporation to deduct only $7.1 million of the compensation. The appellate court concluded that the Tax Court erred in disallowing a deduction for the compensation in excess of that amount. In an opinion written by Judge Posner, the Seventh Circuit reasoned:

> All businesses are different, all CEOs are different, and all compensation packages for CEOs are different.... The main focus of the Tax Court's decision ... was on whether Menard's compensation exceeded that of comparable CEOs in 1998 – that is, whether it was objectively excessive....
>
> The CEO of Home Depot was paid that year only $2.8 million, though it is a much larger company than Menards; and the CEO of Lowe's, also a larger company, was paid $6.1 million. But salary is just the beginning of a meaningful comparison, because it is only one element of a compensation package. Of particular importance to this case is the amount of risk in the compensation structure.... A risky compensation structure implies that the executive's salary is likely to vary substantially from year to year – high when the company has a good year, low when it has a bad one. Mr. Menard's average annual income may thus have been considerably less than $20 million – a possibility the Tax Court ignored. Had the corporation lost money in 1998, Menard's total compensation would have been only $157,500 – less than the salary of a federal judge – even if the loss had not been his fault....
>
> Nor did the Tax Court consider the severance packages, retirement plans, or perks of the CEOs with whom it compared Menard (though it did take account of their stock options), even though such differences can make an enormous difference to an executive's compensation.... [The adjustment the Tax Court made to arrive at its conclusion that the compensation in excess of $7.1 million was nondeductible] disregarded differences in the full compensation packages of the three executives being compared, differences in whatever challengers faced the companies in 1998, and differences in the responsibilities and performance of the three CEOs.
>
> We have discussed risk; with regard to responsibilities there is incomplete information about the compensation paid other senior management besides Mr. Menard himself, and no information about the compensation paid the senior management of Home

Depot and Lowe's other than those companies CEOs. The relevance of such information is that it might show that Menard was doing work that in other companies is delegated to staff, or conversely that staff was doing all the work and Menard was, in substance though not if form, clipping coupons. The former inference is far more likely, given the undisputed evidence of Menard's workaholic, micromanaging ways and the fact the Menard's board of directors is a tiny dependency of Mr. Menard. He does the work that in publicly held companies like Home Depot or Lowe's is done by boards that have more than two directors besides the CEO. Of course they are larger companies – Home Depot's revenues were seven times as great as Menard's in 1998 – so we would expect them to have more staff. But we are given no information on how much more staff they had.

We know that besides Menard himself, Menards – already a $3.4 billion company in 1998 – had only three corporate officers. The Tax Court thought it suspicious that they were modestly compensated.... The Tax Court did not consider the possibility, which the evidence supports, that Menard really does do it all himself....

We conclude that in ruling that Menard's compensation was excessive in 1998, the Tax Court committed clear error, and its decision is therefore reversed.

Page 276:

Include the following case excerpt in the Materials:

TOPPING v. COMMISSIONER
T.C. Memo 2007-92

GOEKE, Judge: Respondent determined .... deficiencies in petitioner's Federal income tax.... [The issue for decision is]: (1) Whether petitioner conducts her equestrian and related activities as part of her design business ... and (3) if the activities are for profit, whether the expenses associated with the equestrian activity are ordinary and necessary expenses under section 162(a). We hold that: (1) Petitioner conducts her equestrian and related activities as part of her design business; .... and (3) the equestrian-related expenses associated with her activity are ordinary and necessary expenses.

FINDINGS OF FACT
In 1998, petitioner was 46 years old and in the middle of a bitter divorce. She had no means of supporting herself. Petitioner held no job, had no college degree, and had not had any full-time employment for the past 25 years. Her significant assets consisted of a 16-year-old horse and a debt-encumbered condo in Wellington, Florida.

Forced to make a living to support herself, petitioner developed a plan to use her prominence in the equestrian world to build a business designing horse barns and homes. Her plan was to establish and maintain herself as a peer worthy of trust among the exceptionally wealthy families who participate in the upper realms of the equestrian circuit, own multiple residences, and use interior designers. Even though she had no written business plan, she discussed her plan for her business venture with her certified public accountant, Jeffrey Borofsky (C.P.A. Borofsky). She also discussed her plan with a longtime friend who had successfully started her own business. Petitioner did not conduct a formal market study, nor did she prepare any cashflow projections in anticipation of starting her new business. She did not have any experience in design other than taking a few design courses in college. However, petitioner possessed the artistic ability to draft structural designs freehand. Petitioner also was an experienced equestrian, having ridden horses and competed on an amateur level since she was 12 or 13 years old.

In 1999, petitioner formed a limited liability company, Topping White Design, L.L.C. (Topping White), in Florida. The address of Topping White is in West Palm Beach, Florida, which is also petitioner's place of residence. Petitioner uses her home office to handle all financial aspects of her design business. The assets of petitioner's activities include horses, a truck, a trailer, and an automobile. Petitioner uses the truck, trailer, and automobile for both the equestrian and design activities. In May of 1999, petitioner hired Deborah Martin (Ms. Martin). Ms. Martin's primary responsibilities include general administrative work, such as preparing invoices, dealing with clients, collecting money, ordering supplies, scheduling contractors, and entering information into a computer. Petitioner also relies upon trainers both to refer clients and improve her performance as a competitor. Moreover, petitioner works with architects, electricians, plumbers, furniture manufacturers, and other experts in their trades in order to run the interior design aspect of her business. Every one of the trainers that petitioner has worked with has referred at least one design client to petitioner. Petitioner also engages C.P.A. Borofsky to handle her accounting matters.

Petitioner's business methodology consists of entering in and attending horse shows, and making contacts with prospective clients at the shows. Potential clients develop from horse show contacts, and then petitioner and Ms. Martin meet with the potential client. Early on in her business, petitioner tried to develop clients through her longtime experience playing golf. When golf failed to produce any clients, she dropped her golf club membership.

Petitioner develops her equestrian contact clients for Topping White while competing during the Winter Equestrian Festival, which takes place at the Jockey Club. The Jockey Club is an elite, private club, which is not open to the general public. The Jockey Club consists of a large concentration of extraordinarily wealthy people. Most of the attendees in the Jockey Club own horses, and all come to watch the equestrian competition on either side of the competing rings. The Jockey Club has up to 90 tables with six seats per table. These tables are reserved at the beginning of the season. During the period 1999 through 2001, the cost of a table reservation was $5,000 for the 7-week season. Since then, the price has climbed to $25,000. Petitioner

originally owned a table at the Jockey Club, but when the cost of a table increased, she initially split the cost with one client, and then later split the cost with two clients.

At the Jockey Club there is a rectangular tent situated between two competing rings -- the DeNemethy Ring, where petitioner sometimes competes, and the Grand Prix Ring, where petitioner frequently competes. The rings contain large leaderboards that are visible throughout the Jockey Club. The events are announced over the loudspeaker, which can be heard throughout the Jockey Club. When petitioner enters the Grand Prix Ring during competition, her name is flashed on the leaderboards and announced over the loudspeaker as the owner of the horse and once again as the rider. She rides her horses in the Grand Prix Ring where the amateur-owner classes are held. The Grand Prix Ring is a grass field where riders compete with jumps that can exceed 4 to 6 feet in height. Those who compete must finish within a prescribed period without any faults to be successful. Those who successfully complete the first round advance to the second round. When petitioner advances to the second round, upon entry into the ring, her name is once again flashed on the leaderboards and called over the loudspeaker. If she finishes in the ribbons class, her name is displayed yet again on the leaderboards and announced over the loudspeaker. Win or lose, petitioner returns to the Jockey Club among competitors and observers, where conversations take place over the just-completed competition. To continue to develop her design business, petitioner believes she cannot rest on her reputation and disappear from the scene, but she must continue her client development efforts on the equestrian circuit.

The membership requirements for the Jockey Club do not necessitate ownership of a horse or to be a competitor. However, petitioner believes that if she were to sell all of her horses or were to give up amateur riding, both current and prospective clients would perceive that she had failed financially, would not rely on her as a designer, and thus not trust her with the keys to their homes and their barns. Petitioner also testified that she has to maintain the reputation she has cultivated as a skilled competitor in order to keep her existing relationships and to cultivate new ones. We find petitioner's testimony plausible in this regard.

Petitioner does not advertise her interior design business through advertising media such as equestrian-related magazines, Web sites, or newspapers. In addition, she does not display banners or sponsor any events through Topping White. Petitioner intentionally rejects this type of advertising because the ethos of the Jockey Club and its members perceive that kind of generic advertising of a personal service business as tacky or gauche. In addition, petitioner does not want to convey the impression that she is desperate for or needs the work. Rather, petitioner relies on her exposure and reputation as both a rider and owner, and also her popularity among the members of the Jockey Club. Instead of actively seeking new clients, petitioner adopts a more subtle approach to attracting prospective clients by making herself available at the Jockey Club during key times in order for prospective clients to find her. In addition, petitioner also relies on word of mouth and referrals by members of the Jockey Club.

The normal evolution of a design project involves a prospective client's contacting petitioner at

a horse show. Normally, the Monday after the horse show, Ms. Martin arranges a meeting between petitioner and the prospective client. The meeting typically takes place at the design site with the potential client, petitioner, and Ms. Martin. In most meetings, approximately half of the discussion is design-related to the actual project, while the other half consists of discussion on equestrian-related subjects. For each of her clients, petitioner has designed at least one horse barn. Petitioner's clients, often very wealthy, entrust her with the keys to their home, even after the projects are completed.

Petitioner uses her general knowledge of horses and specifically her knowledge of the idiosyncracies of each of her client's horses to evolve her barn designs. For example, her knowledge of a horse's particular injury or temperament leads her to design a barn with stalls tailored to each horse's individual needs. Interior design of a client's home often requires knowledge related to horses. Though generally most families do not want an equestrian theme of decoration in their homes, the designing process requires petitioner to know the needs of the families who are essentially "horse people". Some of the designs incorporate mudrooms and expanded storage for boots, saddles, and other equipment. In addition, in the interior design process, petitioner has to consider bringing "the outside lifestyle as coming to the inside" by testing fabrics for durability, cleaning ability, and recovery relative to the client's everyday livability.

Petitioner keeps records for her horse barn/interior design activities. All of the files relating to client development and design implementation are kept together by year. Petitioner maintains records that keep an inventory of expenses related to both interior design and equestrian-related activities. Initially, petitioner used a manual accounting system, but then upgraded to Excel and then QuickBooks. Petitioner uses QuickBooks to keep records for both the equestrian and interior design activities on a consolidated basis. Petitioner does not keep records of training costs or costs associated exclusively with horse shows for the purposes of projecting a budget. Nor does she or C.P.A. Borofsky prepare monthly budgets or cashflow projections for either the interior design or equestrian activities. According to petitioner, that is because there is no way to predict what those costs will be from month to month, and that the equestrian circuit is not her business but is part of her overall plan to develop her interior design clientele. At trial, petitioner produced documentary evidence of a profit or loss statement prepared by C.P.A. Borofsky that tracked expenses for both her equestrian and interior design activities.

Petitioner also invested in some horses with one of her clients. Petitioner and her client formed a partnership to make these investments. The choice of horses to invest in was based on the recommendations of trainers, at least one of whom was a world champion. The horses petitioner invested in were sold at an overall tax gain because of the depreciation, but the majority resulted in a substantial economic loss on petitioner's investment.

On August 26, 2004, respondent mailed to petitioner a notice of deficiency ...[disallowing] some of the expenses associated with petitioner's horse barn/interior design activity,

explaining:

> It has been determined that adjustments are warranted to correct your claimed Schedule C expenses from your Interior Decorating Activity for the tax years ending 12/31/1999 and 12/31/2000. The adjustments are a result of a disallowance of expenses. The expenses have been disallowed because you have not established that these amounts were incurred, or, if incurred, paid by you during the taxable year for ordinary and necessary business purposes, or that these expenses were deductible under the provisions of the Internal Revenue Code. Accordingly, your taxable income is increased by the adjustment amounts.

Petitioner timely filed her petition with this Court. In her petition, petitioner assigned error to respondent's segregation of the equestrian and interior design activities and also for all other disallowed expenses related to her interior design and equestrian activities.

OPINION

....

Petitioner's Equestrian Expenses Are Ordinary and Necessary in Carrying On the Activities of Topping White

Section 162(a) of the Internal Revenue Code allows the deduction of "all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 83(1992) (citing sec. 162(a)). Respondent argues .... petitioner failed to establish all the equestrian expenses were ordinary and necessary. To be "necessary", an expense must be appropriate and helpful to the taxpayer's business. See Welch v. Helvering, 290 U.S. 111, 113 (1933) .... To be "ordinary", the transaction giving rise to the expense must be of common or frequent occurrence in the type of business involved. Deputy v. Dupont, 308 U.S. 488, 495(1940). Even if it is determined that the expenses are ordinary and necessary, they are deductible under section 162 only to the extent that they are reasonable in amount.

Respondent asserts that the expenses of petitioner's equestrian activities are unreasonable and are not ordinary and necessary because they represent personal expenditures of petitioner. See sec. 262(a). Respondent relies on Henry v. Commissioner, 36 T.C. 879 (1961), to support his argument. In that case, the taxpayer, a C.P.A., sought to deduct the expenses for his boat, upon which he flew a flag bearing the numerals "1040". He asserted that the flag provoked inquiries to which he would reply that he was a C.P.A. and a lawyer experienced in tax law. In disallowing the expenses of the boat, the Court held that the taxpayer failed to prove that the flag made his yacht expenditures "necessary" to his practice. He failed to show exactly how and under what circumstances his boating activities produced a single client. Further, the taxpayer failed to prove that it was ordinary for people in his profession to incur such expenses.

While we are mindful that expenses for personal pursuits do not become deductible expenses simply because they afford contacts with possible future clients, the situation in this case is entirely different from the facts in Henry. Petitioner has proven that her equestrian activities are necessary to her success as an interior designer. The unique nature of petitioner's design business made it an ordinary expense to partake in equestrian-related activities to achieve the peer acceptance to attract clients. We have found that petitioner's design and equestrian activity is part of an integrated business plan and that petitioner's clientele is almost exclusively derived from her equestrian contacts. Petitioner also offered corroborating testimony that individuals in service businesses who use conventional advertising evoke a negative reaction from the people at the Jockey Club. Respondent's arguments focus on petitioner's means to an end, but neglect the most important fact of all -- petitioner's plan worked. Her startup business was a success from the beginning and continues to be successful, despite a slight loss in 2004. Petitioner has credibly demonstrated that the measures she takes to build her client base are both ordinary and necessary.

The evidence does not establish and respondent has not argued convincingly that any particular expense was unnecessary or excessive. Obviously, keeping and maintaining horses is expensive. Petitioner demonstrated that she has done what she can to keep costs down, from choosing less expensive travel to sharing the cost of a table at the club. Respondent offers numerous ratios of the expenses associated with the equestrian activities to the profit from Topping White. Petitioner does what is necessary to maintain her reputation in the equestrian world, and we find that she does not do so in an extravagant manner. The fact remains that petitioner's design business depends heavily on her equestrian-related activities for its success. We therefore find and hold that not only are petitioner's equestrian expenses ordinary and necessary, but that they are reasonable in amount.

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CHAPTER 13: CAPITAL EXPENDITURES

Page 287-88:

The proposed regulations regarding capitalization of costs of tangible property, issued in 2006, were withdrawn and reproposed in significantly different form in 2008. Accordingly, delete the paragraph that begins at the bottom of page 287 with the words "The proposed regulations, issued in 2006 ....." and that continues over onto page 288. Replace that paragraph with the following:

The resulting proposed regulations under § 263(a), issued originally in 2006 and then withdrawn and reproposed in 2008, address a wide range of matters regarding capitalization of costs of tangible property. They require the capitalization of amounts paid to acquire or produce real or personal tangible property, of amounts paid to improve real or personal tangible property, and of amounts paid to acquire or create interests in land. They also generally require the capitalization of selling expenses. The proposed regulations further provide a new definition of materials and supplies, including a 12-month useful life rule and a $100 de minimis rule, and they coordinate these capitalization rules with the deduction rules for materials and supplies under Reg. § 1.162-3. With respect to amounts paid to improve tangible property, the proposed regulations provide general rules for determining the appropriate unit of property to which the improvement regulations apply, and they require capitalization of amounts paid to bring about a betterment to a unit of property, to restore a unit of property, or to adapt a unit of property to a new or different use. The proposed regulations also contain a safe harbor rule for routine maintenance and an optional accounting method for taxpayers in industries subject to regulatory accounting rules. Comments have been invited on the proposed regulations, which will generally apply only to taxable years beginning on or after publication of final regulations.

Page 288:

Revenue Ruling 94-38 was clarified by Revenue Ruling 2004-18, 2004-1 C.B. 509, to the effect that Revenue Ruling 94-38 was intended to address the question of whether the costs of the clean-up were required to be capitalized under § 263(a) - concluding they did not need to be capitalized thereunder - but was not intended to address whether such costs must be included in inventory costs under §263A.

CHAPTER 14: DEPRECIATION

Page 298:

Add to the Internal Revenue Code assignment: § 168(k)(1), (2)(A), and (D)(iii).

Page 309:

Substitute the following for parts (a) - (d) of Problem 2:

(a) **Disregarding any application of §§ 179 and 168(k),** answer the following questions:
(1) How much depreciation may Liz claim with respect to the piece of new equipment in Year 1?
(2) How much depreciation may she claim in Year 2?
(3) What is the equipment's adjusted basis at the beginning of Year 3?
(4) What will the equipment's adjusted basis be at the beginning of year 7 assuming Liz continues to own and use the piece of equipment in her engineering business?
(5) How much depreciation may Liz claim with respect to the equipment in Year 3 if she sells it on August 15 of that year and what will her adjusted basis be in the equipment for purposes of computing the gain or loss on the sale of the equipment?

(b) How would your answer to part (a)(1) change if Liz purchased the equipment in December of Year 1?

(c) How would your answer to part (a)(1) change if Year 1 is 2009 and Liz elected to deduct $150,000 of the equipment's cost under § 179? (In answering this question, again disregard any application of § 168(k).)

(d) How would your answer to part (a)(1) change if Year 1 is 2009 and Section 168(k) applied to allow Liz to deduct additional first year depreciation? (In answering this question, again disregard any application of § 179.)

(e) How would your answer to part (a)(1) change if Year 1 is 2009 and Liz elected to deduct $150,000 of the equipment's cost under § 179 **and Liz also took** advantage of the additional depreciation deduction allowed by § 168(k)?

****

Page 321:

With the economy teetering on recession, Congress as part of the Economic Stimulus Tax Act of 2008 amended § 168 to provide "bonus depreciation" (or "additional first year depreciation") for certain property acquired after December 31, 2007 and placed in service before January 1, 2009. The American Recovery and Reinvestment Tax Act of 2009 extended this bonus depreciation to property placed in service before January 1, 2010. The following quote from the legislative history to the 2008 Act (*Joint Committee Technical Explanation,* JCX-16-08) describes the operation of § 168(k):

> The provision (§ 168(k)) allows an additional first-year depreciation deduction equal to 50 percent of the adjusted basis of qualified property....The basis of the property and the depreciation allowances in the year the property is placed in service and later years are appropriately adjusted to reflect the additional first-year depreciation deduction....The taxpayer may elect out of additional first-year depreciation for any class of property for any taxable year.
>
> The interaction of the additional first-year depreciation allowance with the otherwise applicable depreciation allowance may be illustrated as follows. Assume that in 2008, a taxpayer purchases new depreciable property and places it in service. The property's cost is $ 1,000, and it is five-year property subject to the half-year convention. The amount of additional first-year depreciation allowed under the provision is $ 500. The remaining $ 500 of the cost of the property is deductible under the rules applicable to five-year property. Thus, 20 percent, or $ 100, is also allowed as a depreciation deduction in 2008. The total depreciation deduction with respect to the property for 2008 is $ 600. The remaining $ 400 cost of the property is recovered under otherwise applicable rules for computing depreciation.
>
> In order for property to qualify for the additional first-year depreciation deduction it must meet all of the following requirements. First, the property must be (1) property to which the Modified Accellerated Cost Recovery System (MACRS) applies with an applicable recovery period of 20 years or less.... Second, the original use of the property must commence with the taxpayer after December 31, 2007. Third, the taxpayer must purchase the property within the applicable time period. Finally, the property must be placed in service after December 31, 2007, and before January 1, 2009 [before January 1, 2010, pursuant to the 2009 Act noted above]..
>
> ....
>
> *Effective Date.*
>
> The provision is effective for property placed in service after December 31, 2007.

****

Page 324:

In an effort to stimulate the economy, Congress, as part of the Economic Stimulus Tax Act of 2008, expanded the limits under Section 179 for 2008. The American Recovery and Reinvestment Tax Act of 2009 extended the expanded limits to include 2009.

Thus, for *any taxable year beginning in 2008 or in 2009*, the amount that can be expensed under § 179(b)(1) is increased to $250,000. [Note that, but for the 2008 and 2009 Acts, the § 179(b)(1) expense deduction limitation as indexed for inflation would have been $133,000 in 2009.] In addition, the 2008 and 2009 Acts also amended § 179(b)(2) to provide that, *for taxable years beginning in 2008 or in 2009*, the maximum amount deductible under § 179 would be reduced by the cost of qualifying property in excess of $800,000 placed in service during the taxable year. [Note that, but for these Acts, the reduction in the maximum § 179 deduction would be triggered if the taxpayer placed in service in 2009 more than $530,000 of qualifying property - that is, the § 179(b)(2) limitation as indexed for inflation.]

****

CHAPTER 15: LOSSES AND BAD DEBTS

Page 352:

There is a typo in the assigned regulation provisions at the bottom of the page. Delete the reference to Reg. § 1.167-1(g) and substitute Reg. § 1.167(g)-1.

Page 375:

Revenue Ruling 2009-9
2009-14 I.R.B. 735

ISSUES:

(1) Is a loss from criminal fraud or embezzlement in a transaction entered into for profit a theft loss or a capital loss under § 165 of the Internal Revenue Code?

(2) Is such a loss subject to either the personal loss limits in § 165 (h) or the limits on itemized deductions in §§ 67 and 68?

(3) In what year is such a loss deductible?

(4) How is the amount of such a loss determined?

....

FACTS

A is an individual who uses the cash receipts and disbursements method of accounting and files federal income tax returns on a calendar year basis. B holds himself out to the public as an investment advisor and securities broker.

In Year 1, A, in a transaction entered into for profit, opened an investment account with B, contributed $100x to the account, and provided B with power of attorney to use the $100x to purchase and sell securities on A's behalf. A instructed B to reinvest any income and gains earned on the investments. In Year 3, A contributed an additional $20x to the account.

B periodically issued account statements to A that reported the securities purchases and sales that B purportedly made in A's investment account and the balance of the account. B also issued tax reporting statements to A and to the Internal Revenue Service that reflected purported gains and losses on A's investment account. B also reported to A that no income was earned in Year 1 and that for each of the Years 2 through 7 the investments earned $10x of income (interest, dividends, and capital gains), which A included in gross income on A's federal income tax returns.

At all times prior to Year 8 and part way through Year 8, B was able to make distributions to investors who requested them. A took a single distribution of $30x from the account in Year 7.

In Year 8, it was discovered that B's purported investment advisory and brokerage activity was in fact a fraudulent investment arrangement known as a "Ponzi" scheme. Under this

scheme, B purported to invest cash or property on behalf of each investor, including A, in an account in the investor's name. For each investor's account, B reported investment activities and resulting income amounts that were partially or wholly fictitious. In some cases, in response to requests for withdrawal, B made payments of purported income or principal to investors. These payments were made, at least in part, from amounts that other investors had invested in the fraudulent arrangement.

When B's fraud was discovered in Year 8, B had only a small fraction of the funds that B reported on the account statements that B issued to A and other investors. A did not receive any reimbursement or other recovery for the loss in Year 8. The period of limitation on filing a claim for refund under § 6511 has not yet expired for Years 5 through 7, but has expired for Years 1 through 4.

B's actions constituted criminal fraud or embezzlement under the law of the jurisdiction in which the transactions occurred. At no time prior to the discovery did A know that B's activities were a fraudulent scheme. The fraudulent investment arrangement was not a tax shelter as defined in § 6662 (d) (2) (C) (ii) with respect to A.

LAW AND ANALYSIS

Issue 1. Theft loss.

Section 165 (a) allows a deduction for losses sustained during the taxable year and not compensated by insurance or otherwise. For individuals, § 165 (c) (2) allows a deduction for losses incurred in a transaction entered into for profit, and § 165 (c) (3) allows a deduction for certain losses not connected to a transaction entered into for profit, including theft losses. Under § 165 (e), a theft loss is sustained in the taxable year the taxpayer discovers the loss. Section 165 (f) permits a deduction for capital losses only to the extent allowed in §§ 1211 and 1212. In certain circumstances, a theft loss may be taken into account in determining gains or losses for a taxable year under § 1231.

For federal income tax purposes, "theft" is a word of general and broad connotation, covering any criminal appropriation of another's property to the use of the taker, including theft by swindling, false pretenses and any other form of guile. Edwards v. Bromberg, 232 F.2d 107 (5th Cir. 1956); see also § 1.165-8 (d) of the Income Tax Regulations ("theft" includes larceny and embezzlement). A taxpayer claiming a theft loss must prove that the loss resulted from a taking of property that was illegal under the law of the jurisdiction in which it occurred and was done with criminal intent. Rev. Rul. 72-112, 1972-1 C.B. 60. However, a taxpayer need not show a conviction for theft. Vietzke v. Commissioner, 37 T.C. 504, 510 (1961), acq., 1962-2 C.B. 6.

The character of an investor's loss related to fraudulent activity depends, in part, on the nature of the investment. For example, a loss that is sustained on the worthlessness or disposition of stock acquired on the open market for investment is a capital loss, even if the decline in the value of the stock is attributable to fraudulent activities of the corporation's officers or directors, because the officers or directors did not have the specific intent to deprive the shareholder of money or property. See Rev. Rul. 77-17, 1977-1 C.B. 44.

In the present situation, unlike the situation in Rev. Rul. 77-17, B specifically intended to,

and did, deprive A of money by criminal acts. B's actions constituted a theft from A, as theft is defined for § 165 purposes. Accordingly, A's loss is a theft loss, not a capital loss.

Issue 2. Deduction limitations.

Section 165 (h) imposes two limitations on casualty loss deductions, including theft loss deductions, for property not connected either with a trade or business or with a transaction entered into for profit.

Section 165 (h)(1) provides that a deduction for a loss described in § 165 (c) (3) (including a theft) is allowable only to the extent that the amount exceeds $100 ($500 for taxable years beginning in 2009 only).

Section 165 (h) (2) provides that if personal casualty losses for any taxable year (including theft losses) exceed personal casualty gains for the taxable year, the losses are allowed only to the extent of the sum of the gains, plus so much of the excess as exceeds ten percent of the individual's adjusted gross income.

Rev. Rul. 71-381, 1971-2 C.B. 126, concludes that a taxpayer who loans money to a corporation in exchange for a note, relying on financial reports that are later discovered to be fraudulent, is entitled to a theft loss deduction under § 165 (c) (3). However, § 165 (c) (3) subsequently was amended to clarify that the limitations applicable to personal casualty and theft losses under § 165 (c) (3) apply only to those losses that are not connected with a trade or business or a transaction entered into for profit. Tax Reform Act of 1984, Pub. L. No. 98-369, § 711 (1984). As a result, Rev. Rul. 71-381 is obsolete to the extent that it holds that theft losses incurred in a transaction entered into for profit are deductible under § 165 (c) (3), rather than under § 165 (c) (2).

In opening an investment account with B, A entered into a transaction for profit. A's theft loss therefore is deductible under § 165 (c) (2) and is not subject to the § 165 (h) limitations.

Section 63 (d) provides that itemized deductions for an individual are the allowable deductions other than those allowed in arriving at adjusted gross income (under § 62) and the deduction for personal exemptions. A theft loss is not allowable under § 62 and is therefore an itemized deduction.

Section 67 (a) provides that miscellaneous itemized deductions may be deducted only to the extent the aggregate amount exceeds two percent of adjusted gross income. Under § 67 (b) (3), losses deductible under § 165 (c) (2) or (3) are excepted from the definition of miscellaneous itemized deductions.

Section 68 provides an overall limit on itemized deductions based on a percentage of adjusted gross income or total itemized deductions. Under § 68 (c) (3), losses deductible under § 165 (c) (2) or (3) are excepted from this limit.

Accordingly, A's theft loss is an itemized deduction that is not subject to the limits on itemized deductions in §§ 67 and 68.

Issue 3. Year of deduction.

Section 165 (e) provides that any loss arising from theft is treated as sustained during the

taxable year in which the taxpayer discovers the loss. Under §§ 1.165-8 (a) (2) and 1.165-1 (d), however, if, in the year of discovery, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss for which reimbursement may be received is sustained until the taxable year in which it can be ascertained with reasonable certainty whether or not the reimbursement will be received, for example, by a settlement, adjudication, or abandonment of the claim. Whether a reasonable prospect of recovery exists is a question of fact to be determined upon examination of all facts and circumstances.

A may deduct the theft loss in Year 8, the year the theft loss is discovered, provided that the loss is not covered by a claim for reimbursement or other recovery as to which A has a reasonable prospect of recovery. To the extent that A's deduction is reduced by such a claim, recoveries on the claim in a later taxable year are not includible in A's gross income. If A recovers a greater amount in a later year, or an amount that initially was not covered by a claim as to which there was a reasonable prospect of recovery, the recovery is includible in A's gross income in the later year under the tax benefit rule, to the extent the earlier deduction reduced A's income tax. See § 111; § 1.165-1 (d) (2) (iii). Finally, if A recovers less than the amount that was covered by a claim as to which there was a reasonable prospect of recovery that reduced the deduction for theft in Year 8, an additional deduction is allowed in the year the amount of recovery is ascertained with reasonable certainty.

Issue 4. Amount of deduction.

Section 1.165-8 (c) provides that the amount deductible in the case of a theft loss is determined consistently with the manner described in § 1.165-7 for determining the amount of a casualty loss, considering the fair market value of the property immediately after the theft to be zero. Under these provisions, the amount of an investment theft loss is the basis of the property (or the amount of money) that was lost, less any reimbursement or other compensation.

The amount of a theft loss resulting from a fraudulent investment arrangement is generally the initial amount invested in the arrangement, plus any additional investments, less amounts withdrawn, if any, reduced by reimbursements or other recoveries and reduced by claims as to which there is a reasonable prospect of recovery. If an amount is reported to the investor as income in years prior to the year of discovery of the theft, the investor includes the amount in gross income, and the investor reinvests the amount in the arrangement, this amount increases the deductible theft loss.

Accordingly, the amount of A's theft loss for purposes of § 165 includes A's original Year 1 investment ($100x) and additional Year 3 investment ($20x). A's loss also includes the amounts that A reported as gross income on A's federal income tax returns for Years 2 through 7 ($60x). A's loss is reduced by the amount of money distributed to A in Year 7 ($30x). If A has a claim for reimbursement with respect to which there is a reasonable prospect of recovery, A may not deduct in Year 8 the portion of the loss that is covered by the claim.
....

****

Note: The I.R.S. has provided an optional safe harbor arrangement whereby a taxpayer who is

the victim of fraudulent activity such as that noted in the above ruling may, under certain conditions, deduct a theft loss in the year the loss is discovered. Rev. Proc. 2009-20, 2009 IRB Nexis 141.

CHAPTER 16: TRAVEL EXPENSES

Page 381:

The taxpayer in *Wilbert v. Commissioner* (7th Cir., January 21, 2009) worked for Northwest Airlines. He owned and maintained a home in Wisconsin close to his work in Minneapolis. In 2003, to avoid being laid off, he exercised his contractual "bumping" rights, based on seniority, to obtain work assignments in various cities other than Minneapolis. (He did not have the option to continue working for the airline in Minneapolis.) Rather than move his family for what turned out to be short-term assignments, he continued to maintain the family home in Wisconsin. As a result, he incurred significant additional living expenses in connection with the short-term assignments in other cities, expenses which he sought to deduct.

The Seventh Circuit upheld the denial of the deduction, even though acknowledging "it would hardly have been realistic to expect him to pull up stakes and move to Anchorage and then to Chicago and then to New York and then back to Anchorage." According to the Seventh Circuit:

> The problem with a test that focuses on the reasonableness of the taxpayer's decision not to move is that it is bound to prove nebulous in application.... We are sympathetic to Wilbert's plight and recognize the artificiality of supposing that, as the government argues, he made merely a personal choice to "commute" from Minneapolis to Anchorage, and Chicago, and New York, as if Minneapolis were a suburb of those cities. But the statutory language, the precedents, and the considerations of administrability that we have emphasized persuade us to reject the test of reasonableness. ... [W]e fall back on the rule of Flowers and Hantzis that unless the taxpayer has a business rather than a personal reason to be living in two places he cannot deduct his traveling expenses if he decides not to move.

CHAPTER 18: EDUCATION EXPENSES

Page 439:

The cite at the top of this page should read as follows: Reg. § 1.162-5(b)(3)(ii), Ex. (4).

Page 439:

In *Foster v. Commissioner*, T.C. Summary Opinion 2008-22, the court distinguished *Allemeier v. Commissioner* and concluded that the expenses incurred by a taxpayer in earning an MBA were non-deductible personal expenses. The court explained:

> [P]etitioner's counsel relies on *Allemeier v. Commissioner*, where the taxpayer was already performing sales, marketing, and management functions before receiving his M.B.A. and continued to do so while studying for and after receiving it. In that case, we held that the M.B.A. expenses were not conditions precedent to his employment and also did not qualify him for a new trade or business. The M.B.A. did improve his business, marketing, and sales skills, but the M.B.A. did not qualify him to perform tasks and activities significantly different from those he could perform before the M.B.A. In contrast to the taxpayer in *Allemeier*, petitioner has not demonstrated her involvement in nonengineering management before receiving her M.B.A.; rather, her M.B.A. qualifies her for the trade or business of business management. Likewise, petitioner has not proven that her engineering roles included marketing duties; yet, her position as vice president of marketing indicates that she was so qualified after the M.B.A.

As this decision and the decision in *Allemeier* indicate, the determination of whether MBA expenses will be deductible educational expenses turns on the taxpayer's specific circumstances.

Page 442:

The American Recovery and Reinvestment Tax Act of 2009 made a number of amendments to the Hope Scholarship Credit, amendments which apply to years beginning in 2009 or 2010. The amended credit is called the American Opportunity Tax Credit. Among other things, the amendments increase the amount of the Hope Scholarship Credit to a maximum of $2,500; make the Hope credit available to the first four years of post-secondary education, rather than the first two; broaden qualifying expenses to include required course materials [this broadening applies to the Lifetime Learning Credit as well]; and significantly increase the adjusted gross income eligibility limits for the Hope credit.

Page 443:

Section 222 is currently scheduled to expire at the end of 2009.

CHAPTER 21: HOME OFFICES, VACATION HOMES AND OTHER DUAL USE PROPERTY

Page 506:

Footnote 11: In Revenue Procedure 2009-24, I.R.B. 2009-17, the Service announced the following limitations on depreciation of passenger automobiles placed in service in 2009 for which the 50-percent additional first year depreciation deduction of § 168(k) does not apply: First tax year – $2,960; Second tax year – $4,800; Third tax year – $2,850; Each succeeding tax year – $1,775. In the same revenue procedure, the Service also announced the following limitations on depreciation of passenger automobiles placed in service in 2009 for which the 50-percent additional first year depreciation deduction of § 168(k) applies: First tax year – $10,960; Second tax year – $4,800; Third tax year – $2,850; Each succeeding tax year – $1,775.

CHAPTER 23: THE DEDUCTION FOR TAXES

Page 531:

The Emergency Economic Stabilization Act of 2008 extended the optional deduction for sales taxes to taxable years beginning before January 1, 2010. The American Recovery and Reinvestment Act of 2009 provides a deduction for "qualified motor vehicle taxes" which include any state or local sales or excise tax imposed on the purchase of a "qualified motor vehicles." Section 164(b)(6).

CHAPTER 24: CASUALTY LOSSES

Page 547:

Note that the nondeductible floor for each casualty loss is $500 for tax years beginning in 2009, reverting to $100 for tax years beginning after 2009. § 165(h)(1).

CHAPTER 26: CHARITABLE DEDUCTIONS

Page 582:

The Tenth Circuit has held, affirming the Tax Court, that an attorney was not entitled to a charitable deduction for a contribution of discovery material relating to his representation of his client, Timothy McVeigh. Jones v. Commissioner (10th Cir., March 27, 2009). The Tenth Circuit reasoned as follows:

> In July 2004 the Commissioner of Internal Revenue (Commissioner) issued a notice of deficiency to Petitioners Sherrel and Leslie Stephen Jones for the years 2000 and 2001.... The basis for the deficiency was the Commissioner's determination that Petitioners improperly claimed a large income tax deduction for a charitable contribution of discovery material that Leslie Stephen Jones acquired while serving as lead defense counsel in the Oklahoma City Bombing trial. Petitioners contested the deficiency notice in United States Tax Court, and now appeal the tax court's judgment upholding the Commissioner's determination. ... Although our rationale differs from the tax court, we affirm.
>
> Taxpayer Leslie Stephen Jones was lead defense counsel for Timothy McVeigh in the Oklahoma City Bombing trial. During the course of his representation, the Government provided Taxpayer with voluminous discovery material related to the prosecution of McVeigh.... After McVeigh was convicted in August 1997, Taxpayer withdrew as lead defense counsel. Subsequently, in December 1997, Taxpayer donated the discovery material to the Center for American History at the University of Texas.
>
> Prior to the donation, Taxpayer had the discovery material appraised by an expert at a value of$294,877.00. Taxpayer claimed a deduction for the material on his 1997 income tax return. The excess amount of the deduction was carried over to subsequent tax years. ...
>
> As noted, the tax court held that Taxpayer was not entitled to claim a deduction on the donation of the discovery material for two reasons: (1) Taxpayer did not own the discovery material, and (2) the discovery material was not a capital asset. Because we hold that the discovery material is not a capital asset, we need not decide whether Taxpayer owned the discovery material under Oklahoma law. As the following discussion demonstrates, however, our rationale for determining that the discovery material is not a capital asset differs from that of the tax court.
>
> The value of a charitable contribution of property[, and thus the value that can be deducted from an income tax return, is reduced by "the amount of gain which would not have been long term capital gain if the property had been sold by the taxpayer at its fair market value." § 170(e)(1)(A). ... In other words, if a Taxpayer has no basis in a piece of property, the gross and net return on a hypothetical sale of that property would

be the same, i.e., the full sale price. Thus, unless the property was a long term capital asset, § 170(e)(1)(A) would require that the deduction for donating that property be reduced by the property's *entire* value – leaving the taxpayer with no deduction at all. ...

As noted, the tax court ruled that if Taxpayer owned the discovery material, it was excluded under the IRC's definition of a capital asset pursuant to 26 U.S.C. § 1221(a)(3)(A). Specifically, the tax court held that the discovery material qualified as "letters, memoranda, or similar property created by the taxpayer's own efforts." ... The record, however, clearly demonstrates – and the Commissioner appears to concede – that the property which Taxpayer claimed as a charitable contribution was *not* created by his own personal efforts. Thus, we believe the tax court incorrectly applied § 1221(a)(3)(A) to the discovery material. Nevertheless, for the reasons articulated below, we hold that § 1221(a)(3)(B) encompasses the discovery material donated by Taxpayer, thereby excluding it from the IRC's definition of a capital asset. Accordingly, we affirm the tax court's ruling, albeit on alternative grounds. ...

Under § 1221(a)(3)(B) of the IRC, property described as a "letter, memorandum, or similar property" that is "prepared or produced" for a taxpayer, is excluded from the IRC's definition of "capital asset." ... Thus, the hypothetical sale of such property provides only ordinary income – meaning the allowable income tax deduction for donating the item to charity is limited to the taxpayer's basis in the property. ... Because Taxpayer's lack of basis in the property here is undisputed, the central question before us is whether the discovery material qualifies as "letter[s], memorand[a], or similar property, [held by] a taxpayer for whom such property was prepared or produced." § 1221(a)(3)(B). If the answer is yes, Taxpayer cannot claim an income tax deduction for donating the discovery material....

The items Taxpayer donated consisted of copies of FBI memoranda, lab reports, computer discs and photographs – all containing information related to the investigation and prosecution of Timothy McVeigh.... We have no trouble concluding, therefor, nor does Taxpayer seriously contest, that the discovery material is properly characterized as "letter[s], memorand[a], or similar property."

We next consider whether the property was "prepared or produced" for Taxpayer. The dictionary is a helpful basis for determining the plain and ordinary meaning of a statute's terms.... [W]e believe the discovery material falls under 26 U.S.C. § 1221(a)(3)(B)'s plain language. The Government made numerous copies of memoranda, investigative reports, photographs, etc., specifically for Taxpayer. Subsequently, they organized and categorized all the material for the benefit of Taxpayer and his client. The Government then placed the discovery material in banker's boxes and prepared letters for Taxpayer explaining the contents of each box. ... [T]he discovery material was provided to Taxpayer only because of his position as lead counsel for McVeigh, and it was the type of material typically produced for defense counsel in the course of a criminal trial. ... Accordingly, we hold that the discovery material donated by Taxpayer falls within the plain language of 26 U.S.C. §

1221(a)(3)(B) – thereby limiting the charitable deduction amount to Taxpayer's basis in the property.... Because Taxpayer had no basis in the discovery material, he is precluded from claiming any income tax deduction for his charitable donation.

CHAPTER 28: CASH METHOD ACCOUNTING

Page 652:

The § 409A regulations have been finalized. The regulation referenced on this page should be changed to read Reg. § 1.409A-1(f)(2).

CHAPTER 29: ACCRUAL METHOD ACCOUNTING

Page 677:

Skim the examples in Reg. 1.461(g)(8).

Page 681:

The cite to the *Commercial Solvents* case should read 42 T.C. 455 (1964)(acq.).

Page 683:

Revenue Ruling 74-607, cited on this page, was clarified by Revenue Ruling 83-84, 1983-1 C.B. 446, and declared obsolete by Revenue Procedure 94-29, 1994-1 C.B. 616. Nonetheless, it remains true that, under the accrual method, all the events that fix the right to receive income generally occur when (1) the payment is earned through performance, (2) payment is due to the taxpayer, or (3) payment is received by the taxpayer, whichever occurs earliest. Rev. Rul. 84-31, 1984-1 C.B. 127. *Schlude v. Commissioner*, 372 U.S. 128 (1963).

Page 684:

Delete the reference at the bottom of the page to *"See* Proposed Reg. §1.61-8(b)."

Page 693:

Footnote 7: Revenue Procedure 2000-22 has been modified and superseded by Revenue Procedure 2001-10, 2001-1 C.B. 272.

Page 704:

The heading on this page should read Revenue Ruling 2007-3 instead of Revenue Procedure 2007-3.

Page 707:

TRINITY INDUSTRIES, INC. AND SUBSIDIARIES v. COMMISSIONER

132 T.C. No. 2 (2009)

... [I]n 2002 Trinity contracted to build barges for two established customers [Florida Marine and Flowers]. Part of the purchase price was deferred until 18 months after the delivery

of each barge. The two customers later claimed damages allegedly caused by defects in barges that they had previously purchased from Trinity under earlier contracts. They sought to offset their unpaid deferred obligations under the later contract against claimed damages arising under the earlier contracts.

For the taxable year ending December 31, 2002, [the petitioner (assume that Trinity is the petitioner), an accrual basis taxpayer, included in income] ... payments received for barges that Trinity delivered in 2002 but excluded the deferred payments. ... The issues for decision are: (1) Whether [the taxpayer] properly excluded the withheld payments from its 2002 income; and (2) if [taxpayer] was required to accrue the withheld payments in 2002, whether it may deduct the withheld payments in 2002 pursuant to section 461(f).
....

Income Tax Reporting

Petitioner used the accrual method of accounting for all relevant periods. With respect to barges delivered under the second contract in 2001, petitioner accrued the full amount of the sales, including deferred payments, and reported these amounts as income in 2001. With respect to barges delivered under the second contract in 2002, however, petitioner reported as income only the amounts received during 2002; it excluded the $ 4,520,000 of deferred payments as to which Florida Marine and Flowers asserted rights of offset.

OPINION

1. *Accrual Method of Accounting*

The primary issue is whether petitioner, as an accrual basis taxpayer, was required to accrue in 2002 deferred payments for barges that Trinity delivered under the second contract in 2002, with respect to which the obligors claimed rights of offset for damages allegedly arising with respect to barges that they had previously purchased under the first contracts.

Under the accrual method of accounting, income is generally recognized when all the events have occurred that fix the right to receive the income, and the amount of the income can be determined with reasonable accuracy. Secs. 1.446-1(c)(1)(ii)(A), 1.451-1(a), Income Tax Regs. Consequently, "An accrual basis taxpayer * * * must report income in the taxable year in which the last event occurs which unconditionally fixes the right to receive the income and there is a reasonable expectancy that the right will be converted to money." ...

Trinity's delivery of each barge to Flowers or Florida Marine unconditionally fixed its right to receive the full contract price under the second contract. Absent the offset claims by Flowers and Florida Marine, there would appear to be no dispute that petitioner was required to accrue the full contract price of each barge, including deferred payments, in the year of delivery. ...

For barges delivered under the second contract in 2002 ... petitioner accrued only the payments received upon delivery and excluded the deferred payments. Petitioner contends that it was not required to accrue these deferred payments in 2002 because of Florida Marine's and Flowers' claims of rights to offset the deferred payments under the second contract against damages allegedly arising under the first contracts. Petitioner relies upon a line of cases which stands generally for the proposition that in certain circumstances an accrual basis taxpayer need not accrue unpaid income if the obligor disputes the validity of the claim..... [A]ll of the cases

upon which petitioner relies involve situations in which obligors disputed the fact or amount of their liability with respect to the item to be accrued.

By contrast, insofar as the record shows, neither Flowers nor Florida Marine ever disputed the fact or amount of its obligation to Trinity under the second contract. To the contrary, their filings in the commercial litigation expressly acknowledged their obligations to Trinity under the second contract and indicated that they were setting the withheld amounts aside in "escrow" or as "collateral security" to offset whatever damages Trinity might ultimately be determined to owe them with respect to their claims under the first contracts.

In *Commissioner v. Hansen*, 360 U.S. 446, 79 S. Ct. 1270, 3 L. Ed. 2d 1360, 1959-2 C.B. 460 (1959), the Supreme Court considered a somewhat analogous situation in which buyers withheld a portion of the sales price to satisfy potential claims against the taxpayer seller. More particularly, in *Hansen* auto dealers entered into a financing arrangement whereby they sold customers' installment notes to finance companies, which withheld a portion of the purchase price as security to cover possible losses on the notes. The Supreme Court held that the auto dealers were required to accrue the withheld amounts as income when the notes were sold. The Court rejected the dealers' argument that accrual was excused by their present inability to compel the finance companies to pay them the reserved amounts. "[T]he question is not whether the taxpayers can presently recover their reserves, for * * * it is the time of acquisition of the *fixed right to receive* the reserves and not the time of their *actual receipt* that determines whether or not the reserves have accrued and are taxable." *Id.* at 464.

The Court noted that although the reserves were subject to being offset by the dealers' contingent liabilities to the finance company, "only the obligations * * * arising from those liabilities may be offset against a like amount in the dealer's reserve account." *Id.* at 465. Consequently, the Court reasoned, any use of the reserves in paying those obligations would amount to the dealers' receiving something of value. The Court stated: "In any realistic view we think that the dealer has 'received' his reserve account whether it is applied, as he authorized, to the payment of his obligations to the finance company, or is paid to him in cash." *Id.* at 466. The Court concluded that the dealers must contemporaneously accrue the withheld amounts, even if those funds were not available for paying the resulting tax liability, stating: "it is a normal result of the accrual basis of accounting and reporting that taxes frequently must be paid on accrued funds before receipt of the cash with which to pay them".
...

The instant case presents a stronger argument, we believe, for requiring accrual of income than *Commissioner v. Hansen* .... [Unlike *Hansen* and the other cases cited by petitioner]the instant case does not involve any question as to whether the right to receive income was vitiated by a contractual provision for withholding a portion of the sales price. Rather, as previously discussed, under the second contract petitioner had a fixed and absolute right to the deferred payments as soon as each barge was delivered. Pursuant to the claims of offset asserted by Flowers and Florida Marine, the withheld payments were to be applied only in satisfaction of Trinity's or petitioner's alleged obligations to them arising under the first contracts. Petitioner effectively received the withheld amounts when, pursuant to the settlement agreement, they were applied in compromise of Flowers' and Florida Marine's claims. In the final analysis, then, the offset claims affected only the timing of petitioner's receipt of income under the second contract and not its right to receive the income.

Petitioner's contentions might be broadly construed as turning upon doubts as to the

collectibility of Flowers' and Florida Marine's debts for the deferred payments. Petitioner does not contend that it is entitled to a bad debt deduction with respect to these debts and has offered no proof that the debts were wholly or partially worthless so as to meet the requirements under section 166 for claiming a bad debt deduction. Nevertheless, petitioner seems to suggest broadly that, apart from any question about deductions, doubts about the collectibility of the debts justify postponing the accrual of the income. In *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 184, 54 S. Ct. 644, 78 L. Ed. 1200, 1934-1 C.B. 281 (1934), the Supreme Court squarely rejected such a contention as having "no merit". The Court stated:

> Keeping accounts and making returns on the accrual basis, as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. * * *
>
> * * * If such accounts receivable become uncollectible, in whole or part, the question is one of the deduction which may be taken according to the applicable statute. * * * That is the question here. It is not altered by the fact that the claim of loss relates to an item of gross income which had accrued in the same year. [*Id.* at 184-185.]

Pursuant to these principles, an accrual basis taxpayer generally must accrue income once the all-events test is satisfied, even though payment may be postponed until a subsequent year. *Harmont Plaza, Inc. v. Commissioner*, 64 T.C. 632, 648, 649 (1975), affd. 549 F.2d 414 (6th Cir. 1977); *Georgia School-Book Depository, Inc. v. Commissioner*, 1 T.C. 463, 468 (1943). As a limited exception to this rule, accrual may not be required if the income was of doubtful collectibility or it was reasonably certain that it would not be collected as of the time the taxpayer's right to receive the income arose.... The income-accrual exception is narrowly applied so not to "be allowed to swallow up the fundamental rule upon which it is engrafted" requiring accrual. Georgia School-Book Depository, Inc. v. Commissioner, *supra* at 469. The exception has typically been applied where the debtor is "insolvent or in fact bankrupt."...

Petitioner does not contend and the evidence does not show that Flowers or Florida Marine was insolvent or bankrupt or that the collectibility of their debts was otherwise called into question by their respective financial conditions. In any event, Flowers and Florida Marine asserted their claims of offset only after the barges were delivered under the second contract and petitioner's right to the income had become fixed. In fact, insofar as the record shows, Florida Marine did not assert its offset claims until March 2003, after the close of the taxable year in which petitioner's right to the income under the second contract had arisen. In these circumstances, postponing accrual of the income is not justified.

In conclusion, in 2002 petitioner was required to accrue the deferred payments due on the barges delivered that year under the second contract.

2. *Deductibility of Withheld Payments Under Section 461(f)*

Alternatively, petitioner claims that pursuant to section 461(f) it is entitled to deduct $4,520,000 in 2002 on the ground that it "transferred" this amount to Flowers and Florida Marine in satisfaction of their disputed claims for damages with respect to allegedly defective barges that Trinity delivered under the first contracts.

An accrual basis taxpayer generally may take a liability into account only in the taxable year in which all events have occurred to allow the fact and amount of the liability to be determined with reasonable accuracy and economic performance has occurred with respect to the liability. Sec. 1.461-1(a)(2), Income Tax Regs. If a liability is contingent on the outcome of a contested lawsuit, then it generally may not be taken into account until the dispute is resolved. See *Willamette Indus., Inc. v. Commissioner*, 92 T.C. 1116, 1121 (1989), affd. 149 F.3d 1057 (9th Cir. 1998). Section 461(f) provides a limited exception to this general rule by permitting a taxpayer to deduct a contested liability, provided the taxpayer has transferred assets in the same tax year to satisfy the claimed liability.... The burden of proof is on petitioner to show that it satisfies all four requirements of section 461(f).

The parties disagree primarily as to whether petitioner meets the second requirement listed above that there be a transfer of money or other property in satisfaction of the asserted liability. Petitioner contends that it transferred property to Flowers and Florida Marine "when Flowers and Florida Marine withheld payment under the Second Contract as an offset against their alleged damages". The record shows, however, that the $ 4,520,000 of deferred payments as to which petitioner claims a deduction came due under the second contract in 2003 and 2004. Flowers and Florida Marine cannot meaningfully be said to have withheld the deferred payments before they came due. At most, Flowers and Florida Marine threatened in 2002 to withhold the deferred payments, although as previously discussed the record does not establish that Florida Marine even asserted its offset claim before 2003.

Section 461(f) allows a deduction only for "the taxable year of the transfer." Consequently, even if we were to agree with petitioner that the withheld payments represented transfers of funds to Flowers or Florida Marine, we would conclude that the transfers occurred in 2003 and 2004, so that petitioner would not be entitled to the claimed deduction under section 461(f).

More fundamentally, we disagree with petitioner's contention that the withholding of the deferred payments by Flowers and Florida Marine represented a transfer by petitioner within the meaning of section 461(f). The regulations require that the taxpayer transfer "money or other property beyond his control * * *. * * * In order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property." Sec. 1.461-2(c)(1), Income Tax Regs. As a necessary corollary, and as common sense dictates, before a taxpayer may transfer money or other property beyond its control or authority, it first must have the money or other property within its control or authority.

Obviously, the deferred payments were not in petitioner's control or authority, at least not so long as Flowers and Florida Marine withheld them. By withholding the deferred payments, Flowers and Florida Marine merely perpetuated their own control over these funds. Although, as previously discussed, Trinity possessed contractual rights to the withheld payments sufficient to require accrual of the income, neither Trinity nor petitioner relinquished those rights, at least not in 2002, but instead vigorously disputed the claimed rights of offset.
...
In sum, we conclude and hold that in 2002 petitioner did not transfer money or other property in satisfaction of Flowers' and Florida Marine's asserted liabilities and consequently is entitled to no deduction pursuant to section 461(f).

CHAPTER 30: ANNUAL ACCOUNTING

Page 726:

Note that § 172(b)(1)(H) provides a special carryback rule for 2008 net operating losses of eligible small businesses.

CHAPTER 31: CAPITAL GAINS AND LOSSES

Page 765:

Footnote 20: The cite should read Notice 87-68 instead of Notice 87-69.

Page 790:

At the end of the first full paragraph, note that the Second Circuit and Eleventh Circuit have joined the Tax Court and the Third, Ninth and Tenth Circuits in holding that the sale of future lottery payments results in ordinary income, not capital gain. *Prebola v. Commissioner*, 482 F.3d 610 (2d Cir. 2007); *Womack v. Commissioner*, 510 F.3d 1295 (11th Cir. 2007).

CHAPTER 32: QUASI-CAPITAL ASSETS: SECTION 1231

Note that references in this Chapter to §1221(1), (2), (3), (4) or (5) should read § 1221(a)(1), (a)(2), (a)(3), (a)(4), or (a)(5), as the case may be.

CHAPTER 33: RECAPTURE OF DEPRECIATION

Note that references in this Chapter to § 1221(2) should read § 1221(a)(2).

Page 805:

In the Assignment, the first Code provision assigned should read § 1(h)(6) instead of § 1(h)(7).

CHAPTER 34: ASSIGNMENT OF INCOME

Page 818:

The Ninth Circuit has reversed the Tax Court's decision in *Dunkin v. Commissioner*. Consider the following excerpt from the Ninth Circuit's decision (500 F.3d 1065 (2007)):

> Of course, pension payments typically do not come due until the employee spouse has retired. Further, the employee spouse alone may decide whether and when to retire. In *Gillmore* [citation omitted], the California Supreme Court recognized that an employee's ability to unilaterally delay retirement, and thereby deprive the non-employee of his or her interest in a pension, presented an opportunity for abuse. As a result, in California, if an employee spouse chooses to continue to work following divorce, the non-employee spouse may demand reimbursement for his or her share of the benefits that would have been forthcoming if the employee spouse had retired.
>
> .... The court calculated the community's interest as $4,123.43 per month--the benefit that would have been forthcoming had John retired on the date of trial--and Julie's share as $2,072. Julie exercised her rights under *Gillmore*, and John was ordered to reimburse his ex-spouse for the amounts she lost as a result of his decision to continue working. The court also ordered the pension board to make similar payments to Julie following John's retirement. Because these payments were related to Julie's community property interests and were not alimony, there was no provision for their cessation upon her death or remarriage. Instead, John was required to make payments until he retired, and the pension board was ordered to make payments for as long as benefits were payable, even if Julie died in the interim, in which case benefits would flow to her designated beneficiaries. [As you will study in Chapter 37, because these payments represented property division and not alimony, John would not be entitled to any deduction for amounts paid to his ex-spouse.]
>
> In 2000, John paid $25,511 to Julie pursuant to the divorce court's order. While he was free to use any property at his disposal, he funded the payments out of the wages he earned in exchange for his continued employment with the L.A.P.D. ... [T]he United States Tax Court ... allowed him to "reduce" his income by $25,511.

Under the Internal Revenue Code, income taxes are assessed based on a person's "taxable income," defined as gross income less deductions allowed by the Code. Broadly speaking, the question in this case is whether John was entitled to exclude from gross income the $25,511 in wages that he paid over to Julie in 2000.....

The first step in arriving at taxable income is to determine an individual's "gross income." Although the term is defined broadly (and somewhat circularly) to include "all income from whatever source derived," certain accessions to wealth that would ordinarily constitute income may be excluded by statute or other operation of law. However, given the clear Congressional intent to "exert . . . the full measure of its taxing power," *Comm'r v. Glenshaw Glass Co.....*, exclusions from gross income are construed narrowly in favor of taxation. *Merkel v. Comm'r*, 192 F.3d 844, 848 (9th Cir. 1999).

There is no statutory provision that could plausibly be said to exclude from gross income the accessions to wealth at issue in this case, i.e., the wages paid by the L.A.P.D. to John during the year 2000. Indeed, wages received in exchange for labor are the very paradigm of income. Although John owed a debt to Julie which he satisfied out of his monthly wages, standing alone, this is not a reason to exclude the wages from his gross income.... ("It is not true that one's paycheck is . . . excludable from gross income whenever it is 'spoken for' by creditors.").

Although the mere fact that John used a portion of his wages to satisfy a debt does not justify any exclusions from his income, the fact that the payments were made to his ex-spouse under the direction of a divorce court makes this case seem difficult. Federal tax is imposed on the income "of" individuals. In *Poe v. Seaborn*, the Supreme Court, noting that " 'of' denotes ownership," held that where the community property laws of a state create in married persons "vested property right[s] in the . . . income of the community, including salaries or wages of either husband or wife, or both," each has taxable income in the amount of one-half of such inflows.

Under *Seaborn* and its progeny, if a portion of the wages John earned in 2000 was community property under California law, then the correct tax treatment would be to attribute half of that income to John and half to Julie. Put another way, it would be correct to exclude from John's gross

income the fifty percent paid over to his ex-spouse. In the instant case the Tax Court seems to have reasoned that because John's obligation arose out of an exercise of Julie's *Gillmore* rights, the funds at issue belonged to Julie and not John under California community property law and were therefore not income to John under the logic of *Seaborn*.

Unfortunately for John, the Tax Court was wrong. Under California law, "[a]fter entry of a judgment of legal separation of the parties, the earnings or accumulations of each party are the separate property of the party acquiring the earnings or accumulations." ... The wages at issue in this case were clearly "earnings or accumulations" acquired by John after legal separation.

In *Gillmore*, the California Supreme Court did not create a new species of community property consisting of those postdivorce wages earned by an employee spouse that displace a stream of pension income that would have flowed to the community had the employee retired. Instead, the Court noted that when an employee spouse facing a *Gillmore* election chooses to continue working, he may "use *separate property* to reimburse" the non-employee spouse. The Court continued,

> [the employee spouse's] situation is not unlike that faced by a couple ordered to divide a house that they own as community property. If one of the spouses chooses to keep the house, he or she is free to use separate property to purchase the other's interest. Here, [the employee spouse] must divide his retirement benefits with [the non-employee spouse]. If [the employee spouse] does not wish to retire, he must pay . . . an amount equivalent to [the non-employee spouse's] interest.

... *Eatinger v. Commissioner*,[does not provide] any support for John's position. [That case] addressed the tax consequences of actual distributions of pension benefits in the context of community property division. [It] held that a non-employee spouse's share of such distributions would be taxable to him or her notwithstanding the fact that the payments were first distributed to the employee spouse who then, acting as a conduit, turned the funds over to the non-employee.... *Eatinger* [is] readily distinguishable. There is no question that under California law, actual distributions of pension benefits earned during marriage are community property. It follows under *Seaborn* that such distributions are taxable to

the spouses in proportion to their community property shares. In this case, however, the pension board made no distributions whatsoever in the year [in question]. Rather, John made the choice to continue working and made the additional choice to satisfy [his ex-spouse's] demand for reimbursement out of his wages. Because those wages were unquestionably John's separate property under California law, *Seaborn* [and] *Eatinger* ... do not apply.

****

CHAPTER 37: TAX CONSEQUENCES OF DIVORCE

Page 861:

Add to Treasury Regulation assignment Reg. § 1.152-4.

Page 865:

In *Sperling v. Commissioner*, T.C. Memo 2009-141, the court, applying *Webb*, concluded that the fact payments are made simultaneously with or immediately before the issuance of a court decree or the execution of an agreement is irrelevant in determining whether § 71(b)(1)(D) is applicable.

In *Stedman v. Commissioner*, T.C. Memo 2008-239, the court concluded that the court-ordered payment of ex-spouse's attorney's fees doesn't give rise to a deduction under § 215 because nothing in either the divorce agreement or state law would cause the payment to terminate on the death of the payee spouse.

Page 867:

The reference to *Shepard v. Commissioner*, in the first full paragraph, should read *Shepherd v. Commissioner*.

Where a taxpayer was required to make installment payments to an ex-spouse and each payment consisted of both alimony and child support, § 71(c)(3) required that any installment payment in an amount less than that ordered, would be applied first to the child support (an any arrearages in child support) and then any balance would be treated as alimony. *Haubrick v. Commissioner*, T.C. Memo 2008-299.

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CHAPTER 38: NONRECOURSE DEBT

Page 892:

It should be noted that the Tax Court's decision in *Catalano v. Commissioner* was reversed by the Ninth Circuit on different grounds. 279 F.3d 682 (2002).

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CHAPTER 39: LIKE KIND EXCHANGE

Page 921:

Include Rev. Proc. 2008-16 (reprinted below) in the Materials.

Page 924:

Revenue Ruling 75-515 was declared obsolete by Revenue Ruling 2003-99, 2003-2 C.B. 388.

Page 925:

The citation for *California Federal Life Ins Co.* should read 79 T.C. 107.

Page 933:

The citation for *Jordan Marsh Co. v. Comm.* should read 269 F.2d 435 (2d Cir. 1959).

Page 957:

Revenue Procedure 2004-51, 2004-2 C.B. 294 provides that Rev. Proc. 2000-37 does not apply if the taxpayer owns the property intended to qualify as replacement property before initiating a qualified exchange accommodation arrangement (QEAA). The Service and Treasury Department were aware some taxpayers believed they could treat as a like-kind exchange a transaction in which they transferred property to an exchange accommodation titleholder and received that same property as replacement property in a purported exchange for other property they owned. As noted in Rev. Proc. 2004-51, "an exchange of real estate owned by a taxpayer for improvements on land owned by the same taxpayer does not meet the requirements of § 1031. Moreover, Rev. Rul. 67-255, 1967-2 C.B. 270, holds that a building constructed on land owned by a taxpayer is not of a like kind to involuntarily converted land of the same taxpayer. Rev. Proc. 2000-37 does not abrogate the statutory requirement of § 1031 that the transaction be an exchange of like-kind properties." Rev. Proc. 2004-51 therefore provides that Rev. Proc. 2000-37 "does not apply to replacement property held in a QEAA if the property is owned by the taxpayer within the 180-day period ending on the date of transfer of qualified indicia of

ownership of the property to an exchange accommodation titleholder.”

Page 957:

Revenue Procedure 2008-16
2008 IRB LEXIS 143

SECTION 1. PURPOSE

This revenue procedure provides a safe harbor under which the Internal Revenue Service (the "Service") will not challenge whether a dwelling unit qualifies as property held for productive use in a trade or business or for investment for purposes of § 1031 of the Internal Revenue Code.

SECTION 2. BACKGROUND

.01 Section 1031 (a) provides that no gain or loss is recognized on the exchange of property held for productive use in a trade or business or for investment (relinquished property) if the property is exchanged solely for property of like kind that is to be held either for productive use in a trade or business or for investment (replacement property). Under § 1.1031 (a) - (1) (a) (1) of the Income Tax Regulations, property held for productive use in a trade or business may be exchanged for property held for investment, and property held for investment may be exchanged for property held for productive use in a trade or business.

.02 Rev. Rul. 59-229, 1959-2 C.B. 180, concludes that gain or loss from an exchange of personal residences may not be deferred under § 1031 because the residences are not property held for productive use in a trade or business or for investment.

.03 Section 2.05 of Rev. Proc. 2005-14, 2005-1 C.B. 528, states that § 1031 does not apply to property that is used solely as a personal residence.

.04 In *Moore v. Comm'r,* T.C. Memo. 2007-134, the taxpayers exchanged one lakeside vacation home for another. Neither home was ever rented. Both were used by the taxpayers only for personal purposes. The taxpayers claimed that the exchange of the homes was a like-kind exchange under § 1031 because the properties were expected to appreciate in value and thus were held for investment. The Tax Court held, however, that the properties were held for

personal use and that the "mere hope or expectation that property may be sold at a gain cannot establish an investment intent if the taxpayer uses the property as a residence."

.05 In *Starker v. United States,* 602 F.2d 1341, 1350 (9th Cir. 1979), the Ninth Circuit held that a personal residence of a taxpayer was not eligible for exchange under § 1031, explaining that "[it] has long been the rule that use of property solely as a personal residence is antithetical to its being held for investment."

.06 The Service recognizes that many taxpayers hold dwelling units primarily for the production of current rental income, but also use the properties occasionally for personal purposes. In the interest of sound tax administration, this revenue procedure provides taxpayers with a safe harbor under which a dwelling unit will qualify as property held for productive use in a trade or business or for investment under § 1031 even though a taxpayer occasionally uses the dwelling unit for personal purposes.

SECTION 3. SCOPE

.01 In general. This revenue procedure applies to a dwelling unit, as defined in section 3.02 of this revenue procedure, that meets the qualifying use standards in section 4.02 of this revenue procedure.

.02 Dwelling unit. For purposes of this revenue procedure, a dwelling unit is real property improved with a house, apartment, condominium, or similar improvement that provides basic living accommodations including sleeping space, bathroom and cooking facilities.

SECTION 4. APPLICATION

.01 In general. The Service will not challenge whether a dwelling unit as defined in section 3.02 of this revenue procedure qualifies under § 1031 as property held for productive use in a trade or business or for investment if the qualifying use standards in section 4.02 of this revenue procedure are met for the dwelling unit.

.02 Qualifying use standards.

(1) Relinquished property. A dwelling unit that a taxpayer intends to be relinquished property in a § 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately before the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately preceding the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately preceding the exchange ends on the day before the exchange takes place (and begins 12 months prior to that day) and the second 12-month period ends on the day before the first 12-month period begins (and begins 12 months prior to that day).

(2) Replacement property. A dwelling unit that a taxpayer intends to be replacement property in a § 1031 exchange qualifies as property held for productive use in a trade or business or for investment if:

(a) The dwelling unit is owned by the taxpayer for at least 24 months immediately after the exchange (the "qualifying use period"); and

(b) Within the qualifying use period, in each of the two 12-month periods immediately after the exchange,

(i) The taxpayer rents the dwelling unit to another person or persons at a fair rental for 14 days or more, and

(ii) The period of the taxpayer's personal use of the dwelling unit does not exceed the greater of 14 days or 10 percent of the number of days during the 12-month period that the dwelling unit is rented at a fair rental.

For this purpose, the first 12-month period immediately after the exchange begins on the day after the exchange takes place and the second 12-month period begins on the day after the first 12-month period ends.

.03 Personal use. For purposes of this revenue procedure, personal use of a

dwelling unit occurs on any day on which a taxpayer is deemed to have used the dwelling unit for personal purposes under § 280A (d) (2) (taking into account § 280A(d)(3) but not § 280A(d)(4)).

.04 Fair rental. For purposes of this revenue procedure, whether a dwelling unit is rented at a fair rental is determined based on all of the facts and circumstances that exist when the rental agreement is entered into. All rights and obligations of the parties to the rental agreement are taken into account.

.05 Special rule for replacement property. If a taxpayer files a federal income tax return and reports a transaction as an exchange under § 1031, based on the expectation that a dwelling unit will meet the qualifying use standards in section 4.02 (2) of this revenue procedure for replacement property, and subsequently determines that the dwelling unit does not meet the qualifying use standards, the taxpayer, if necessary, should file an amended return and not report the transaction as an exchange under § 1031.

...

SECTION 5. EFFECTIVE DATE

This revenue procedure is effective for exchanges of dwelling units occurring on or after March 10, 2008. No inference is intended with respect to the federal income tax treatment of exchanges of dwelling units occurring prior to the effective date of this revenue procedure.

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CHAPTER 41: INSTALLMENT SALES

Page 987:

Add §§ 453(f)(7) and 1271(a)(1) to the reading assignment.

CHAPTER 43: ORIGINAL ISSUE DISCOUNT

Page 1059:

Footnote 20: For 2009, the inflation-adjusted limit for the § 1274A(c)(2)(A) stated principal amount is $3,665,500. Rev. Rul. 2008-52, 2008-49 I.R.B. 1233.

Page 1060:

Footnote 21: For 2009, the inflation-adjusted limit for the §1274A(b) stated principal amount is $5,131,700.

CHAPTER 45: THE ALTERNATIVE MINIMUM TAX

Page 1088:

For 2009, the exemption amount is $70,950 on joint returns (or for surviving spouses), $46,700 for an individual not married and not a surviving spouse, and $35,475 for married individuals filing separately. For example, if a single taxpayer in had an alternative minimum taxable income of $76,700, none of which consisted of net capital gain, the tentative minimum tax would be 26% of a taxable excess of $30,000 ($76,700 less the $46,700 exemption amount) or $7,800. If the taxpayer's regular liability were less than $7,800, the alternative minimum tax would be applicable.

Page 1089:

With respect to adjustments for depreciation, see § 168(k)(2)(G) allowing the special "additional first year depreciation" afforded by § 168(k)(1) for certain qualified property to be used in determining alternative minimum taxable income under § 55.