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"INCOME" FOR U.S. TAX PURPOSES - A MODEL FOR EUROPEAN TAXATION?

American wit tells that there are only two certainties in life - death and taxes. The latter ones fall within the scope of this article. It intends to introduce, in particular, but not limited to, foreign jurists to the meaning of "income" as the foundation of U.S. tax law. For those who are or will be involved in international business and investment transactions, it is crucial to have some basic understanding of the U.S. income tax system.

The article treads the thorny path of defining "income" for purposes of federal income taxation. It attempts to address foreign practitioners, in particular European ones, and those who are not very familiar with U.S. tax law at all, providing an introduction to the starting point of federal (and state) income taxation. The accomplishment of such a purpose involves, first, a selective determination of basic principles and concepts, and second, a decision of the manner and depth of treatment of matters that are deemed fundamental.

The introductory part of the article (1.) reveals the base of the federal income tax, paying attention to current "flat tax" proposals, and sets the constitutional framework.

The second part (2.) analyses the various attempts to define "income" throughout this century. The prevailing definition of income under common law is that any item that increases a taxpayer's net worth is gross income. One's "net worth" is the difference between assets and liabilities. This conception of income as an increase in "net worth" (or "realized gains" or "net gain") appears to hold water. Gross income includes the receipt of any financial benefit which is not a mere return of capital, nor accompanied by a contemporaneously acknowledged obligation to repay and not excluded by a specific statutory provision.

While the borderline content of "income" must be determined case by case, it would be surprising if anything for which there was a reasonable basis to tax under the income tax, almost any accretion to wealth, were found today to be beyond Congress' constitutional competence to tax. The "what is income" question is a matter of statutory interpretation rather than constitutional adjudication.

The third part (3.) turns to specific exclusions of income. Here the fundamental rule is that according to the broad scope of §61 IRC the taxpayer has to find an applicable express authority either statutory, judicial, or administrative, for an exclusion to be allowed. The rule of doubt includes the item in gross income.

The forth part (4.) discusses specific inclusions. Problems and authorities to be found there may illuminate further the central issue of determining "income". The topic of the paper is strictly limited to "gross income" disregarding the analysis of deductions, i.e. those amounts that are subtracted from gross income to arrive at net income.

A brief conclusion (5.) summarizes the findings of the analysis.

1. INTRODUCTION

1.1 The Tax Base of the U.S. Tax System

A tax base may be defined as the asset or transaction that a government seeks to tax. In the United States, the principal tax collected by the federal government is levied on *income*. Thus, income is the tax base for federal taxation.

In the U.S. tax system, an individual's taxable income for any year is intended to reflect three factors[1]: "[t]he taxpayer's economic income; the extent to which the taxpayer has earned tax benefits by engaging in tax-favored behavior; and the extent to which Congress believed that the imposition of tax might impose an undue hardship on the taxpayer." The U.S. income tax employs an "accretion model" rather than a "consumption model", although it does not go so far as the Haig/Simons[2] conceptualization in taxing all of a person's economic income. Unrealized gain, gifts made, imputed income from self-service and many other economic gains are not included in the U.S. income tax base.

Some recent reform proposals[3] are based on a "comprehensive tax base theory", i.e. a tax policy concept that prefers to eliminate various exclusions from gross income such as imputed income, gifts, etc., on the theory that taxes should be levied on the taxpayer's ability to pay, but at reduced rates. In its pure form, a "flat tax" would eliminate all exclusions, deductions, and credits and impose a one-rate tax on gross income[4].

1.2 Alternative Tax Bases Considerations

A *consumption* tax, unlike an income tax, does not take into account changes in an individual's savings. This means that the taxpayer does not have to include profits from investments in the tax base, and also gets no deduction for losses. Many economists favor consumption taxation because it encourages people to save and invest rather than to borrow and spend[5].

Wealth taxes are assessed on the value of assets a taxpayer owns. Property taxes, such as real property taxes that many localities use throughout the United States, are wealth taxes. The federal estate, gift, and generation-skipping transfer taxes also are wealth taxes, limited in their effect to the wealthiest one percent of all Americans. The principal purpose of wealth taxation is to redistribute society's resources by breaking up the largest fortunes, thereby promoting at least one conception of social justice.

Next to the income tax, the most important source of federal government revenue is the tax on *wages* from employment or self-employment, otherwise known as the "social securities taxes" under the Federal Insurance Contributions Act (FICA). These fall on income from labor, as opposed to investment income.

1.3 The Income Tax in General and Its Historical Background

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1 Joshua D. Rosenberg, *Tax Avoidance and Income Measurement*, 87 Mich. L. Rev. 365 (1987)

2 "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question." (named after Robert M. Haig and Henry C. Simons); see HENRY C. SIMONS, PERSONAL INCOME TAXATION 50 (1938).

3 Several presidential candidates have favored a "flat tax". See the cover story of TIME magazine by Nancy Gibbs, *Does a Flat Tax Make Sense?*, TIME, Jan. 29, 1996 at 22.

4 BLACK'S LAW DICTIONARY 639 (6th ed. 1990).

5 Value-added-taxes, used in the European Union, and sales taxes, used in many federal states, are in essence consumption taxes.

The federal income tax is considered to be a direct tax[6] and serves several functions in addition to financing federal government expenditures. It allocates resources, encourages or discourages economic and social behavior, redistributes wealth, stimulates or stabilizes economic growth, helps maintain federalism, helps solve some specific social problems such as pollution and urban decay, and shapes the free market economy.

A federal income tax was briefly introduced during the Civil War in 1862 and terminated 1871. In 1894 a flat 2 % income tax was reenacted, but it was held unconstitutional by the U.S. Supreme Court in 1895[7].

In 1913 the States ratified the Sixteenth Amendment to the U.S. Constitution and thus empowered the Congress to tax, marking the starting point of modern taxation. The first codification of tax law took place in editing the U.S.C.A. in 1939.

Wholesale revision of the internal revenue laws was first accomplished in 1954, yielding the Internal Revenue Code of 1954. After several amendments during the years it was replaced by the Internal Revenue Code of 1986, which was to be broad-based, simple, fair, and revenue neutral. The tax reform should reduce budget deficits, prevent erosion of the tax base by sheltering tax activities, insure all taxpayers pay a fair share of tax burden, and improve administration and efficiency to the tax system.

However, the Omnibus Revenue Reconciliation Act of 1993 increased taxes for high income individuals by adding a new 36 % marginal bracket on taxable incomes in excess of $140,000[8] for married taxpayers filing jointly and in excess of $115,000 for unmarried individuals. High income married and single taxpayers also are subject to a 10 % surtax, which is implemented by applying a 39.6 % rate to taxable income in excess of $250,000 for all taxpayers. The maximum rate on net long-term capital gains (from dealings in property) remained capped at 28 %. Thus, the U.S. tax system is *not* a unitary one unlike predominant in most European countries, e.g. France, Germany, Austria, in which a taxpayer's income from all sources is aggregated and subject in total to a single rate of tax. The U.S. tax system distinguishes between ordinary income and capital gain[9].

<u>1.4 The Income Tax and the United States Constitution</u>

The U.S. CONST. art. I, § 8, cl. 1 provides that Congress "[s]hall have power to lay and collect taxes ..." However, "[n]o capitation, or other direct, tax shall be laid unless in proportion to the census ..." under U.S. CONST. art. I, § 9, cl. 4 and art. I, § 2, cl. 3. Thus a direct tax has to be apportioned among the states so that a state with 1 % of the population will bear 1 % of the tax. Therefore, in *Pollock*, *supra* note 5, an income tax statute was struck down as an unapportioned direct tax. In the same case, the Court also held a federal tax on the interest from state or municipal bonds unconstitutional. For this and other reasons, such interest is mostly still not subject to federal taxation[10].

The requirement of apportionment among the states made a federal income tax completely impractical. However, this problem was solved by the adoption in 1913 of the Sixteenth Amendment, which states: "The Congress shall have power to lay and

[6] See *Pollock v. Farmers' Loan & Trust Co*., 157 U.S. 429 (1895), *reh'g granted* 158 U.S. 601 (1895)
[7] *Pollock, id.* at 558
[8] All marginal brackets are indexed up annually.
[9] See Nohel B. Cunningham, *Tax Case for a Capital Gains Preference*, 48 Tax L. Rev. 319 (1993)
[10] However, in 1988 the Supreme Court overruled *Pollock* and upheld the constitutional power of the federal government to tax interest on state and local bonds under *South Carolina v. Baker*, 485 U.S. 505 (1988). Thus, §310 (b) (1), which taxes state bearer bonds, was held constitutional.

collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census of enumeration." Since the adoption of the Sixteenth Amendment, constitutional issues have been of much less importance. In the outstanding case since 1913, *Eisner v. Macomber*[11], the government had attempted to tax a dividend of common stock distributed to existing holders of common stock. The Court held that the Sixteenth Amendment requires a realization, an element lacking in a stock dividend.

In *Edwards v. Cuba Railroad Co.*[12], the Supreme Court held that a subsidy paid by the Cuban government to a railroad company to aid and induce it to develop a system in Cuba was not income, but a reimbursement for capital expenditures or a contribution to capital assets. In a rare and gratuitous holding the Court stated that the payments were not income under the Sixteenth Amendment. Thus if an item is not "income" within the meaning of the Constitution, it cannot be taxed under the income tax no matter what Congress may try to do. Later on the Cuba Railroad rule about contributions to capital of a corporation was codified in §118 IRC[13].

1.5 The Sources of Tax Law

1.5.1 The Internal Revenue Code of 1986

The Internal Revenue Code of 1986[14] is the codification, as amended, of federal statutes pertaining to taxation. It is fair to say that in the area of tax the Code is the ultimate authority because tax law is a statutory creation and has no common law background[15]. Thus, its legislative history consisting of House reports, transcripts of committee hearings, Congressional debates and other materials dealing with the enactment of statutes is very important and often useful in interpreting a statute.

A tax treaty can supersede a provision of the Internal Revenue Code because the treaty is considered the supreme law of the land, along with laws made in pursuance of the Constitution and the Constitution itself.

[11] 252 U.S. 189 (1920)
[12] 268 U.S. 628 (1925)
[13] Unless otherwise specified, all §§ refer to the "Code", i.e. the Internal Revenue Code of 1986 as amended (IRC).
[14] Commonly referred to as the "Code". Its section numbers correspond to sections of Title 26 U.S.C.
[15] It must be emphasized that federal taxation is *not* a common law subject but statutory born. However, when a statutory term is general, a body of case law soon grows around it which is not unlike the growth of common law and so it is with the determination of "income" that is subject of discussion in this paper.

1.5.2 Treasury Regulations

The “Treasury Regulations” are administrative pronouncements by the Treasury Department which either interpret, construe or explain various provisions of the ("interpretive regulations" under §7805) or supply rules in accordance with statutory guidelines and Congressional directives ("legislative regulations" under specific statutory provisions). They have a heavy presumption of correctness, but courts will ignore them if they believe they reach results at odds with what Congress intended. All regulations are found in Title 26 of the Code of Federal Regulations (C.F.R.).

1.5.3 Judicial Decisions

The taxpayer may choose not to pay the tax deficiency (in which event interest will accrue) and to petition within a 90 days period to the *United States Tax Court* seeking judicial review.

The *United States Claims Court* is an alternative forum for refund suits, i.e. when the government owes the taxpayer money.

The taxpayer can seek judicial remedy in the regular federal court system in *Federal District Court*. Only here fact issues will be determined by a jury if the plaintiff demands a jury trial.

Tax decisions of the federal district courts, the Tax Court and the Claims Court can be appealed to the *Court of Appeals for the Federal Circuit*[16].

The *United States Supreme Court* is the court of last resort for tax appeals. Many tax decisions in the Supreme Court represent that Court's determination (upon petition for certiorari) to settle a point on which the courts of appeal have taken divergent positions. Its jurisdiction is discretionary rather than mandatory.

2. IDENTIFICATION OF INCOME SUBJECT TO TAXATION

2.1 Computation of Taxable Income

In the case of an *individual taxpayer*, taxable income is "adjusted gross income" reduced by the sum of "deductions for personal exemptions" provided by §151 and either the "itemized deductions" under §63 (a) *or* the "standard deductions" provided by §63 (c) for individuals who do not itemize under §63 (b).

Chart 1: Computing Taxable Income of Individuals

Gross Income	G I	(§61 IRC)
- Deductions	- DD	(Above-the-Line Deductions)
Adjusted Gross Income	AGI	(§62 IRC)
- Other Deductions	- DD	(Itemized or Standard Deductions)
Taxable Income	TI	(§63 IRC)

Taxable Income (TI) x **Tax Rate** (§1 IRC) = Amount of Tax
\- Credits
Tax Due (or **Refund**)

“Gross Income” addresses income from whatever source derived with all statutory inclusions but without all the provided exclusions[17].

"Deductions" (DD) label general trade and business deductions, trade and business deductions of employees, any allowable long-term capital-gains deduction,

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[16] There are 13 federal intermediate appellate courts known as the United States courts of appeals. Each court covers a particular geographical area called a *circuit* (see 28 U.S.C. § 41 [1996]).

[17] This paper is limited to an analysis of gross income.

deductions for losses from the sale or exchange of property and other categories, mainly (not exclusively) business or profit-related deductions for the cost of producing income.

"Adjusted gross income" can be commonly referred to as “net income”.

"Other deductions" include the deductions for "personal exemptions" under §151 and the "itemized deductions" under §63 (d). Those taxpayers who do not elect to itemize can claim "standard deductions" under §63 (c) instead of the itemized deductions.

2.2 Definition of Gross Income

2.2.1 The Scope of Section 61 IRC

"Gross income" is defined by §61 (a) as "… all income from whatever source derived ..." The statute goes on to list fifteen items that are included in gross income. The list includes such things as compensation for services, gains derived from dealings in property, interest and dividends. The list is not exhaustive, the statute adds. On the other hand some items may be expressly excluded from income by statutory exclusions found in §§ 101 to 137. Statutory inclusions and exclusions are also found in §§ 79 to 90.

As §61 (a) in its broad language does not really give a definition of (gross) "income", what fits the definition of gross income has been a rich source of litigation. Cases, regulations and rulings must be consulted to apply §61 (a).

2.2.2 Judicial Definitions of Income

In *Eisner v. Macomber*, *supra* note 11 at 207, the Supreme Court once defined income as "the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets ...". This early definition does cover e.g. salaries, fees, wages, interest, rents, dividends, business and investment profits etc.

In *Commissioner v. Glenshaw Glass Co.*[18] the Court broadened the definition and ruled that windfalls, such as exemplary damages for fraud and the punitive two-thirds portion of a treble damage anti-trust recovery, are income to the recipient. *Glenshaw Glass* provides the best and most authoritative non-legislative definition of income: "Gross income means undeniable accession to wealth, clearly realized, and over which the taxpayers have complete dominion". In other words, income in its broadest sense includes almost everything that is received or "realized" and represents a gain to the recipient.

In *Glenshaw Glass* the Court also stated that the language of §61 (a) was used by Congress to exert in this field "the full measure of its taxing power". If Congress exercises its powers to tax income to the limits imposed by the Constitution, then (gross) income (except as otherwise provided) in §61 (a) is identical to "income" in the meaning of the Sixteenth Amendment.

2.2.3 The Law Concept of Income

2.2.3.1 Receipt of an Economic Benefit

"Accession to wealth" indicates that the taxpayer has to be economically better off after receiving the gain. Income may consist of money, property, or services, e.g. cash, stock, meals, accommodations, services etc.[19] Income is not the same as gross

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[18] 348 U.S. 426 (1955)
[19] See Reg. § 1.61-1 (a)

receipts, which are the total amount received as for sale of goods. Income, then, means a receipt that is, or to the extent it is, a gain to the recipient. A mere return of capital, e.g. lender receiving back the loan, or capital receipts is not income because it does not increase net worth[20]. The interest paid to the lender for the use of his money is income.

Under *Cesarini v. United States*[21] income includes treasure-trove, such as money found in a purchased used piano, taxable in the year the taxpayer actually discovered the money[22]. Income can be an irregular or unexpected receipt; even not periodic or earned.

Pursuant to *Old Colony Trust Co. v. Commissioner*[23] if an employer pays his employee's taxes or discharges his debts, the employee realizes income. Satisfying the legal obligations of another person is gross income for that person[24].

Even gain from illegal activities is included in gross income. Under *James v. United States*[25] the Court held that "[i]t had been a well-established principle … that unlawful, as well as lawful gains are comprehended within the term 'gross income'". It was the evasion of income tax laws that led to the conviction and imprisonment of gangster Al Capone in 1931. In addition, as a pickpocket's daily take is gross income, his failure to report it ultimately on his tax return using Form 1040 is itself a crime under §§7201 and 7206.

Moreover, the fact that the criminal may be subject to return the money or property to someone such as the victim of his extortion, blackmail, or embezzlement will not alter his taxability. Under *North American Oil Consolidated v. Burnet*[26] the Court established the "claim-of-right doctrine" by holding that a taxpayer did have income when he held property under a "claim of right" that was disputed by others.

2.2.3.2 Realization Requirement

Not all gain is taxable when it happens. The requirement of a realization is firmly embedded in non-statutory tax law. In *Eisner v. Macomber*, *supra* note 11 at 217, the Supreme Court held that gain had not been realized (by the shareholders) when a corporation declared and issued a stock dividend to its shareholders. The gain has to come in, be derived, that is, "received or drawn by the recipient (the taxpayer) for his separate use, benefit and disposal". The Court considered realization even to be a constitutional requirement[27].

There has to be a realization event, i.e. a title pass or title change. The undisputed possession of the taxpayer determines therefore the time of income reporting as in the case of *Cesarini*. For example, no ownership takes place by mere valuation or depreciation. Only actual income is gross income not potential income.

The requirement of realization does not mean that property must be sold for cash before income is realized. An exchange of property for other property (not cash) can constitute a realization, as might a mere gift or other disposition of property, under some special circumstances. Thus income need not to be cash.

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[20] See *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203 (1990)
[21] 269 F.Supp. 3 (N.D. Ohio 1969), *aff'd per curiam*, 428 F.2d 812 (6th Cir. 1970)
[22] See also Reg. § 1.61-14 (a)
[23] 279 U.S. 716 (1929)
[24] See Reg. § 1.61-12
[25] 366 U.S. 213, 218 (1961); emphasizing the so called "moral neutrality of the Code"
[26] 286 U.S. 417 (1932)
[27] However, for purposes of taxing imputed interest under §§483,1274 and 7872, the realization requirement is thinned out to the mere economic time value of money as a "deemed realization event" that allows taxation.

Under *Helvering v. Horst*[28] the Court held that where the taxpayer does not receive payment of income in money or property realization may occur "[w]hen the last step is taken by which he obtains the fruition of the economic gain which has already accrued to him."

In any event, the realization rule usually involves a "now or later" timing question about taxing income, not a "now or never" question.

2.2.3.3 Requirement of Complete Dominion

Due to the "concept of entitlement" the taxpayer must have complete dominion over the received gain in order to realize income.

An item received involuntarily is not taxable until the taxpayer indicates that he intends to retain it. Under *Haverly v. United States*[29] unsolicited books received from a publisher and then donated to charity are income, if the taxpayer took a charitable deduction for their value.

2.2.4 Income Without Receipt of Property

"Imputed income" is a form of non-cash income, income in kind. It consists of the flow of benefits or satisfactions that result from the use and enjoyment of property owned by the taxpayer, or from goods produced and consumed or used by him, or from services performed by others or by him on his own behalf. In short, imputed income includes any gain, benefit or satisfaction from a non-market transaction or event. Though it is income under the economists' conception, generally,[30] it is not taxed, partly because of the administrative and compliance problems involved. An "unstated exclusion" shelters it from tax, e.g. the value of the services of one's spouse or children is imputed income. If a tax lawyer prepares his own tax return this "self imputed income" is not taxable either.

Under *Helvering v. Independent Life Insurance Co.*[31] the Court held that the rental value of the building used by the owner did not constitute income within the meaning of the Sixteenth Amendment.

On the other hand, in *Dean v. Commissioner*[32] the court held that if the property owner and the taxpayer were not synonymous, as when a rental property held in the name of a corporation of which the taxpayer and his wife were the sole shareholders, the fair rental value of the property was to be included in the taxpayer's gross income. Therefore, if there is an exchange of services between two taxpayers, both will have income. The amount of income equals the "fair market value" (FMV) of the property or service taken in payment[33]. The "fair market value" is defined in an estate tax regulation as "the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of the relevant facts".[34]

However, even if one renders services to himself and an employment relationship is also involved, the courts have held that the benefit produced is income, e.g. an insurance salesman was taxed on insurance commissions either paid to him on policies written on his own life or credited to him so as to reduce the net price he had to pay for them under *Commissioner v. Minzer*[35]. An employed real estate broker's

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[28] 311 U.S. 112, 115 (1940)
[29] 513 F.2d 224 (7th Cir. 1975)
[30] Note the statutory exceptions of §§483, 1274 and 7872 for imputed interest.
[31] 292 U.S. 371 (1934)
[32] 187 F.2d 1019 (1951)
[33] See Reg. § 1.61-2 (2) (1) and Rev. Rul. 79-24, 1979-1 C.B. 60
[34] See Reg. § 20.2031-1 (b)
[35] 279 F.2d 338 (5th Cir. 1960)

salesman who bought property through his employer to get a reduced price was taxed on the amount of the commission he would have received for procuring a buyer for the property under *Williams v. Commissioner*[36].

3. EXCLUSIONS FROM GROSS INCOME

3.1 Introduction

In certain sections of the Internal Revenue Code, Congress has expressly removed specified receipts from the reach of the tax law's definition of gross income. Some of these excluded items would be income within §61 (a), if the exclusionary sections were repealed. Other items were of doubtful status when the exclusions were enacted but probably would be considered constitutionally taxable as income today. And, they probably would be held to fall within the embrace of §61 (a) as a matter of statutory interpretation. Or, even if Congress could include them in gross income, §61 (a) might be construed not to comprehend them, until amended. Thus, the broad concept of gross income under §61 is carved out by several types of exclusions[37]:

The *statutory exclusions* (§§71-90 et al.) differ in historical origin, policy, defensibility and economic effect. They share several characteristics, one of which is their income-variant effect, i.e. the tax saving that an exclusion affords to a taxpayer varies with his or her marginal rate of tax, which depends on total taxable income. An exclusion saves the amount of tax that would be collected if the receipt were not excluded, and that amount is a function of the graduated income tax rates and the taxpayer's top rate or rates. In the legislative process, through lobbying pressure groups try to influence the rule making and sometimes are successful in creating specific statutory exclusions.

Administrative exclusions are less stronger than the statutory exceptions and can be either formal as treasury regulations or informal through the Service's enforcement policy prescribed in the Internal Revenue Manual (IRM)

Judicial exceptions embedded in case law and revenue rulings as sources to rely on in later disputes constitute *precedential exclusions*.

An attorney can make a *legal argument* by pleading the analogy or fairness of an exclusion ("… ought to be exempted") by expanding an existing rule to fit one's factual situation[38].

3.2 Gifts and Inheritances

The reasons for this statutory exclusion may be that other transfer taxes cover these transactions, historically gifts and inheritances were not deemed to be income or, not least, mere sentimentality[39].

3.2.1 Gifts

There is an entirely subjective standard test on determining what is a "gift" for income tax purposes. The "factual determination" of the donor's intent (or motivation) contains under *Commissioner v. Duberstein*[40] the following tests:

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[36] 64 T.C. 1085 (1975)

[37] The following exclusions are demonstrative rather than exhaustive. However, the discussion attempts to reveal the basic concept that the taxpayer has to find an applicable express authority either statutory, judicial, or administrative, for an exclusion to be allowed. The rule of doubt includes the item in gross income.

[38] Note that in practice before the IRS, lawyers are professionally responsible pursuant to Circular 230.

[39] "Don't sell granny's watch to pay the tax for it!"

[40] 363 U.S. 278 (1960)

(1) "*a detached and disinterested generosity*": nothing economic to gain, no financial gain, no economic intent; or
(2) "*out of affection, respect, admiration, charity or like impulses*": no business motive, no quid pro quo motives; or
(3) "*consideration of the transferor's intention*": critical is the dominate reason for transfer at the time of the gift, which the taxpayer has to prove to the IRS.

If there are mixed motives, the "primary" motive controls[41]. The concept of a "gift" is narrowly construed for income tax purposes. §102 (a) applies regardless the label of the transferred property.

Although the property transferred is a gift, all income derived from the gift is taxable to the donee under §101 (b) (1), e.g. dividend of donated stocks is gross income. And all money received from a gift of future income is taxable to the donee under §101 (b) (2) , e.g. transferring only the right to receive dividends (by not actually giving the underlying property).

A problem arises when a payment is made without a legal obligation to one who has rendered services to the payor. The donor's primary motivation will determine the taxability. Under §102 (c) payments by an employer to an employee are *not* gifts. An attempted deduction by the donor does not rule out a gift.

Death benefits to a surviving spouse are not gifts if they are motivated by the deceased having been undercompensated[42].

Tips and gratuities are *not* gifts because the customer gives in appreciation for service; nor in most cases are strike benefits paid by a union.

Where a property is sold for less than fair value, the excess value may be a gift depending on the seller's motive[43]. However, *bargain purchases* by an employee from an employer generally produce income.

3.2.2 Inheritance

Any payment "referable" to an inheritance, bequest or devise is excluded, e.g. money received in settlement of a will contest, etc. §102 (a) applies regardless the label of the transaction, i.e. regardless of testate or intestate.

Under *Lyeth v. Hoey*[44] the taxpayer, an heir of a decedent, contested the decedent's will and eventually reached a settlement. The Court held that property received by an heir pursuant to an agreement settling a contest of the validity of a will is considered inheritance and is not taxed as income.

Under *Wolder v. Commissioner*[45] pursuant to a written agreement, the taxpayer, an attorney, received stock from a client's estate after the client died. The stock was compensation for legal services provided during the client's lifetime. The court held that a transfer in the form of a bequest is considered income when the bequest is merely a method of compensation for services rendered during the decedent's lifetime.

3.3 Limitations in Employment Relationships

[41] See also *United States v. Stanton*, 287 F.2d 876 (2d Cir. 1961) and *United States v. Kaiser*, 363 U.S. 299 (1960)
[42] The first $5,000 are automatically excluded in any event under §101 (b)
[43] See Regs. §§ 1.1015-1, 1.1015-4 for these "part sale/part gift" transactions.
[44] 305 U.S. 188 (1938)
[45] 493 F.2d 608 (2d Cir. 1974)

Under §102 (c) payments by an *employer to* an *employee* are *not gifts*. Payments from an employee to his employer can satisfy the gift exclusion under §102 (a) if they satisfy the subjective *Duberstein* tests, *supra* note 45.

Bargain purchases by an employee from an employer generally produce income for compensation *unless* qualified employee discounts under §132 (c) .

If the *employee* paid for medical or disability insurance and deducted the medical expenses under §213 (a) IRC and later was *reimbursed by the employer*, these reimbursements must be included in income.

In general *fringe benefits* are gross income from compensation *unless* they are particularly *excluded*. §132 (a) expressly excludes the following fringe benefits from gross income:

(1) "<u>no-additional-cost services</u>": e.g. airline seat for free to employee under §132 (b)[46].
(2) "<u>qualified employee discounts</u>": e.g. clothing store employee gets 20 % off on any clothing under §132 (c). However, there is an implied limit to this exception:
    (a) In the case of services the exclusion may not exceed 20 % of the price at which the services are offered by the employer to customers under §132 (c) (1) (B)
    (b) The maximum discount for property is essentially the employer's "gross profit percentage" on goods in the employee's line of business under §132 (c) (1) (A). The gross profit percentage equals the aggregate sales price reduced by cost divided by the aggregate sales price, i.e. figuring out the employer's profit margin.
(3) "<u>working condition fringes</u>": the employee had expenses that would be deductible for him but the employer paid for them, e.g. pencils provided by the employer under §132 (d). They would have to be ordinary deductible business expenses.
(4) "<u>qualified transportation fringes</u>", e.g. vanpool, municipal railway pass, commuter checks, etc. under §132 (f).
(5) "<u>de minimis fringes</u>": "so small as to make accounting for [them] unreasonable or administratively impracticable" under §132 (e), e.g. coffee and doughnuts furnished to employees.
(6) "<u>qualified moving expense reimbursements</u>": to the extent of expenses the employee would have been allowed to deduct if paid himself, e.g. relocation money under §132 (g).
(7) "<u>health and safety fringes</u>": e.g. doctor at the mine, gyms and other facilities *on* the business premises under §132 (j) (4).

Under § 132 (h) the term "employee" includes an employee's spouse or dependent child. It also includes a former employee who has retired or is disabled.

Under the "*non-discrimination rule*" of §132 (j) (1) the fringe benefits may be made available tax-free to officers, owners, or highly compensated employees only if the benefits are also provided on substantially equal terms to other employees. Different treatment arising out of the period working for the company, etc. may be not discriminatory as opposed to relying merely on the amount of salary. The "non-discrimination rule" applies only to the no-additional-cost services and the qualified employee discounts.

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[46] This appears to be a rare incident, in which the tax consequences are determined by the cost for the person offering the free service. In general, it is sought to tax the value another (reasonable) person would pay for the service or property.

3.4 Meals and Lodging

Under §119 the value of meals and lodging furnished by the employer to the employee and his family "in kind" for the "convenience of the employer" is excluded if it is furnished on the employer's "business premises". Under §119 (a) the employee's spouse and his dependents are included in the definition of "employee".

Under the Treas. Regs. §§ 1.119-1 (a) (2), (b) the "*convenience of the employer*" requires a "substantial noncompensatory business reason", e.g. logging camp for building Alaska pipeline, army camp; prison guard, oil platform workers, crew of cruise ships, etc. The job has to require that meals and lodging are provided.

Therefore, meals and lodging have to be a general necessity of the job and must not lie in the person of the employee according to the "convenience of the employer doctrine". Under §119 (a) (1) it is sufficient if the employer requires as part of the contract that *meals* are furnished. On the other hand, *lodging* has to be necessary for the job performance, e.g. counselor in a summer camp, and not merely a clause of the contract under §119 (a) (2).

Meals and lodging must be furnished *on the employer's business premises*. In the case of lodging, it must be accepted as a condition of the employment, e.g. meals and quarters furnished to firefighters at the station house. The employer's "business premises" is his actual working place.

Only meals and lodging *furnished "in kind"* are excluded. Giving groceries is not considered to furnish "meals". Reimbursements in cash must be included in income.

In *Commissioner v. Kowalski*[47] police officers in New Jersey were given cash allowances for meals so that they would not have to leave their patrol areas at mealtime. The Supreme Court held that Congress intended a very broad definition of gross income, including all gains, except those specifically exempted. The payments are not excludable under §119, which exempts from gross income the value of meals furnished by an employer for the convenience of the employer only if the meals are furnished *on* the business premises. §119, by its terms, covers meals furnished by the employer, but not cash allowances for meals[48].

3.5 Certain Prizes and Awards

In general, prizes and awards are included in gross income under §74 (a), *unless* they are excluded under §74 (b) satisfying all of the following requirements:

(1) certain types of activity: prizes and awards made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement[49];
(2) no action by the recipient must be required: selected passively;
(3) no requirement of substantial future services: e.g. traveling around and holding speeches about the honored scientific project as a condition of the award would make the award taxable; and
(4) transferred by the payor on behalf of the winner to a third party: e.g. giving the prize to a charity organization

[47] 434 U.S. 77 (1977)

[48] The *dissent* held that §119 made no distinction between in-cash and in-kind payments. Because this section did no more than refer to "meals" and the business premises were state-wide, it should apply; thus, cash allowances for meals should not be considered taxable income.

[49] Note that sports is not expressly mentioned, but athletic awards could be argued under "civic achievements".

Thus, it appears that the only way to exclude an award or prize from gross income is by not keeping them.

3.6 Scholarships and Fellowships

Under §117 (a) gross income does not include "*qualified scholarships*". To be excluded, the amount (including the value of contributed services and accommodations) received as a scholarship must not exceed the individual's "qualified tuition and related expenses". Under §117 (b) (2) "qualified tuition and related expenses" are limited to

(1) tuition and fees required for the enrollment or attendance at an educational organization (as defined in §170 (b) (1) (A) (ii)); or
(2) fees, books, supplies, and equipment required for the course of instruction at such an educational organization.

However, to the extent that the amount of scholarship grant received by an individual exceeds his qualified tuition and related expenses, the excess must be included in his gross income.

Therefore, the test is to where the money goes, i.e. for educational means, *not* board and lodging, transportation, etc. However, there is *no* "tracing requirement", i.e. $ 10,000 qualified scholarship can be used for paying the credit card bills and still remain tax exempt. If a grant fails under §117 because it is not a "qualified scholarship", shelter can be sought for it under §102 as a gift, or under §74 (b).

To qualify as a "*fellowship*" under §117, a grant must be made for the primary purpose of aiding a degree candidate in pursuit of his studies or in research ("degree requirement"). Thus, (even qualified) fellowships are no longer really exempt from gross income[50].

3.7 Life Insurance and Annuities

A "life insurance" contract shifts the risk of premature death to the insurance company. Under §101 (a) amounts paid by reason of insured's death are excluded. Death benefits paid by an employer are entitled only to a limited exemption under §101 (b). Where a creditor takes out insurance on a debtor, the amount received by the creditor is *not* excludable life insurance. This money is treated as a payment of a debt.

Under §72 (a) an exclusion is generally available to a recipient or *collector of* insurance *proceeds*, regardless of who paid the premiums.

Under §101 (a) (2) *purchasers of existing policies* do *not* qualify for the life insurance exclusion, *unless* the purchaser is the insured, his partnership, or a corporation in which the insured is a shareholder or officer.

Benefits payable in installments are taxed to the extent that they represent interest on the unpaid balance under §§101 (c) and (d).

Under §79 *group term life insurance premiums* up to $ 50,000 per employee paid by the employer are not included in the employee's income, if the benefits are provided to all employees on a "nondiscriminatory basis".

Under §72 the portion of an *annuity payment* that represents the taxpayer's investment in the policy is exempt as a return of capital. The portion excluded is computed by dividing the consideration paid for the policy by the period over which the payment is to be made.

3.8 Medical Insurance and Private Disability Payments

[50] At least in the author's opinion. See also Marci L. Kelly, *Financing Higher Education: Federal Income Tax-Consequences*, 17 J.C. & U.L. 307 (1991)

Under §104 (a) (3) IRC where the *employee paid for the medical or disability insurance*, any benefit payments received under the policy are excluded from income. However, if the employee deducted the medical expenses and then was reimbursed for them, these reimbursements must be included in income.

Under §106 if the employer *pays for health and accident insurance for employees*, the employees are not taxed on the premiums. Nor are they taxed on direct payments of medial expenses by the employer if the payments are made pursuant to a "nondiscriminatory plan" under §§105 (d) and 105 (g).

3.9 Damage Payments

For tax purposes the mechanism of collection, e.g. law suit, settlement, etc. does not change the taxability of the underlying items. In general, all compensatory damages are excluded from gross income[51].

3.9.1 Personal Injuries

Until 1996 under §104 (a) (2) damages received in lump sum or periodic payments, as a result of a judgment or settlement on account of personal injuries are excluded. "Personal injuries" are injuries to the person and include any interference with personal or family rights. This provision raised several issues. In particular, in cases involving injury to reputation or job discrimination, the line between a tax-free personal injury recovery and a taxable business injury recovery has been heavily litigated.

Under *Threlkeld v. Commissioner*[52] the court announced a new approach, allowing exclusion whenever the injury violated "rights that an individual is granted by virtue of being a person in the sight of the law." Accordingly, the court held that §104 (a) (2) excludes from gross income damages received by a taxpayer for injury to his professional reputation as they are arising out of personal injuries.

In *Clark v. Commissioner*[53] the taxpayer's tax counsel reimbursed him for an avoidable federal income tax payment owed due to the counsel's carelessness in making certain irrevocable elections. The Board of Tax Appeals ruled that the payment only returned the taxpayer to where he would have been if the counsel had given good advice. If the taxpayer had sought and obtained a refund, the money received from the government would not have been taxable income. *Clark* can be seen as an extension of the *Threlkeld* rule in a case where a tax advisor's negligence made the refund unobtainable.

On the other hand, in *United States v. Burke*[54] the Supreme Court determined that violations of Title VII of the Civil Rights Act 1964, which prohibits employment discrimination, do not qualify as personal injuries and are therefore not excludable from gross income under §104 (a) (2). However, the Court emphasized the narrow scope of relief under the Act at the time the taxpayer received the award, before the amendments by the Civil Rights Act of 1991, hence prior to protection against sexual harassment on the working place.

Therefore, to be excludable from gross income, personal injuries must give rise to the damages received according to the "*on account of*"-doctrine that comes from the language of §104 (a) (2).

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51 The exclusion covers all damages received through prosecution of a legal claim "based on tort or tort-type rights" pursuant to Reg. § 1.104-1 (c).

52 848 F.2d 81, 89 (6th Cir. 1988)

53 40 B.T.A. 333 (1939).

54 504 U.S. 229 (1992)

However, in *Commissioner v. Schleier*[55] the Supreme Court extended its holding in *Burke* to damages recovered under the Age Discrimination in Employment Act (ADEA), ruling that the recovery constituted taxable income. The Court made clear that even if a statutory scheme provides a tort or tort-type right to victims entitled to bring damages suits (which is not even the case under the ADEA), the recovery must still be on account of personal injuries. The Supreme Court, in *Commissioner v. Schleier*, adopted a two-part test to determine the excludability from taxation of damages received under federal statutes. This test did not provide a bright-line rule upon which lower courts can rely in order to issue consistent holdings that will further the policy of fairness to all taxpayers. Moreover, this decision would require that damages that traditionally had been excluded from gross income (such as compensatory damages received from non-physical common law personal injury claims and punitive damages received from physical injury claims) be included in gross income.

The judicial expansion of §104 (a) (2) has led to varied interpretations of the section across the country. As a result, §104 (a) (2) has been expanded far beyond its original purpose of excluding damages received for physical injuries. Accordingly, several suggestions were made that Congress should amend and rewrite the exclusion to reflect more accurately its intended purpose and to eliminate inconsistent judicial interpretations.[56]

Unsurprisingly, the Small Business Job Protection Act of 1996 amended §104 (a) (2) to tighten the requirements for exclusion from income. Now, a victim will be able to exclude a recovery from income only if the award is "on account of personal physical injuries or physical sickness." Moreover, "emotional distress shall not be treated as physical injury or physical sickness." This new language seems to require taxation both of damages awards for psychological or dignitary injury and of that portion of awards for physical injuries that does not compensate for tangible harm.

3.9.2 Damages for Business Injuries

The recovery for damage to goodwill was originally held excludable[57], but it was later held taxable to the extent that it exceeds the basis of the goodwill under §186. The leading case involving business injuries was *Raytheon Production Corp. v. Commissioner*.[58] In determining that damages to compensate for injuries caused by antitrust violations constituted includible income, the court held that the *payment constitutes a replacement for earnings that would have been taxable*. The court held, however, that the taxpayer remained free to prove that a portion of the recovery represented compensation for investments in the injured business for which no tax allowances previously had been made.

As a practical consequence through *Raytheon Production Corporation v. Commissioner* the prior approach was questioned and widely carved out by fragmenting the damage award into different elements, making it partly taxable. However, damages for lost profits are income.

Under §186 (b) damages for patent infringement, breach of fiduciary duty, or antitrust violations are expressly excluded. Under §186 (c) the amount excludable is

[55] 115 S.Ct. 2159 (1995).
[56] See *R.C.Harvey*, Commissioner v. Schleier: An Unfair Interpretation of Section 104 (a) (2), 30 U.S.F.L. Rev. 313 (1995).
[57] In *Farmers & Merchants Bank v. Commissioner*, 59 F. 2d 912 (6th Cir. 1932) the court excluded damages for injuries to business goodwill under the "return of capital" doctrine.
[58] 144 F.2d 110 (1st Cir.1944), *cert. denied*, 323 U.S. 779 (1944).

the compensatory amount of the unrecovered losses, *whichever is less*. Thus, the effect is an exclusion if there was no benefit from the prior losses.

3.9.3 Punitive Damages

The taxability of the punitive component of personal injury damages has been controversial. In a case prior to 1989 the Supreme Court held that punitive damages did not come with the §104 (a) (2) exclusion, even if the injury involved tangible physical harm.

The 1989 amendment to §104 (a) (2) specifically stated that the exclusion from income did not apply to punitive damages awarded in a case involving non-physical injuries or sickness. Therefore, it was made clear that, in the case of defamation, discrimination, and other intangible injuries, punitive damages would be taxed. However, in cases where a physical injury was involved, the statute was more ambiguous, which lead to litigation. In *O'Gilvie v. United Stat*es[59] the taxpayers, a father and his minor children, sued the manufacturer of a product that caused their wife and mother, respectively, to die from toxic shock. In 1988 they recovered more than $1,500,000 in actual damages and $10,000,000 in punitive damages. The Court held that punitive damages were not "*on account* of personal injuries or sickness," because they were not intended to compensate victims.

The Government position was affirmed: Even after the 1989 amendment to §104 (a) (2), the government could still argue that a punitive damages award for physical injury was included in income unless it was intended to compensate for a *personal injur*y. This argument was accepted by the Supreme Court in dictum in *O'Gilvi*e.

Nevertheless in 1996, Congress responded to the *O'Gilvie* case by amending §104 (a) (2) again to clarify that punitive damages are excluded from income only if the particular tort law allows no other form of damages as compensation for a physical injury or sickness. And it took *all* damages from non-physical personal injuries out of the exclusion altogether. This amendment seems to bolster the inference that even for awards made between 1989 and 1996, includibility will be the norm absent a very unusual state tort law that forbids all other forms of compensation for a physical injury.

3.10 Lessee's Improvements

Under *Helvering v. Bruun*[60] the taxpayer realized gain from the forfeiture of a leasehold because the tenant had erected a new building upon the premises. The Court applied the "possession as realization method" and held that when a landowner regains possession of land with permanent improvements made by a tenant that add ascertainable value, the fair market value of the improvements made by the tenant must be reported as gain in the year of the lease forfeiture because the termination of the rental agreement was a realization event.

Congress later reversed the result in *Bruun* by enacting §109, which defers recognition of gain or loss until the landlord sells the building[61]. However, these improvements will increase the lessor's basis in the property under §1019.

4. INCLUSIONS IN GROSS INCOME

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[59] 117 S. Ct. 452 (1996).

[60] 309 U.S. 461 (1940)

[61] Thus, finally the "ultimate sale method" prevailed. However, as an indication of the realization concept's flexibility, *Bruun* remains valid law.

4.1 Introduction

Since the initial definition of gross income under case law is very broad, any item of income not expressly excluded is deemed to be included under §61. However, certain includable items merit special consideration[62].

4.2 Compensation for Services Rendered

Irrespective of the form of the payments, compensation for services rendered is includible in gross income under §61 (a) (1).

The *payment of an employee's income taxes* or another legal obligation, e.g. rent, alimony, damages, etc. by an employer increases the employee's salary, and thus is taxable income under *Old Colony Trust Co.*, supra note 28.

Reimbursement for travel and entertainment costs is *not* income if the employee is primarily engaged in the employer's business under §274 (e) (4). The basic test focuses on the employer's motive. If the motive was to award additional compensation to the employee, the reimbursement or expense payment is taxable to the employee[63].

Employee's fringe benefits address the question: "What else does come with the job?". They are generally taxable[64]. However, there is a broad exhaustive list of exclusions as discussed in 3.3 above.

[62] Again, what follows is not a catch all list but a flash out of the underlying concepts. Some inclusions are reflecting exceptions to the exclusion rules described in 3. above.

[63] See *Rudolph v. United States*, 291 F.2d 841 (5th Cir. 1961), *aff'd,* 370 U.S. 269 (1962), as opposed to *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968)

[64] See *Old Colony Trust Co.*, *supra* note 27, and §132

4.3 Income from Cancellation of Indebtedness

4.3.1 General Rule

Unless within a statutory exception[65], *or unless* the taxpayer had no net economic
benefit, cancellation of debts is treated as income.

Under *United States v. Kirby Lumber Co*.[66] the taxpayer issued bonds, then later that year repurchased some of the bonds in the open market at less than par. The Court held that if a corporation purchases and retires bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price is taxable gain because the discharge of debt is an accession to income.

The reduction or cancellation of a person's debts increases his net worth. Therefore, it is generally treated as income. In the *Kirby Lumber* case the corporate taxpayer's assets went down but its liabilities went down more - creating an increase in net worth and hence taxable income.

Under *Zarin v. Commissioner*[67] a casino hotel sued the taxpayer to recover $3,435,000 of gambling debts. The taxpayer settled the suit by agreeing to make payments totaling $500,000. The Commissioner sought to tax the difference between the debt obligations and the settlement amount of $2,935,000 as income from forgiveness of indebtedness. The debt instruments, markers for gambling chips, were not enforceable under local state law. The discharge of indebtedness rules refer to debts "for which the taxpayer is liable" or debt "subject to which the taxpayer holds property".

First, the court held that a debt that was unenforceable was not one "for which the taxpayer is liable". Cancellation of such did does not give rise to forgiveness of debt income. Second, the court held that the gambling chips were not property. Rather, they were an accounting mechanism to evidence debt. Consequently, reduction of liability incurred to obtain gambling chips should be treated as settlement of contested liability, which did produce recognizable income in the amount actually paid to the casino[68].

For tax purposes, thus, the satisfaction of a debt is *not* income, *but* discharge of indebtedness constitutes gross income. In general, discharge of indebtedness does not require basis adjustments.

4.3.2 Special Rules

If the *cancellation* is a *gift to the debtor*, there is no income. There is rarely a gift motive, i.e. reason for discharge is donative[69], unless there is a personal or family relationship[70]. Debtor takes creditor's basis in the property as a "carry-over basis".

A *reduction in purchase money debt* by the *seller* is treated as a reduction in the basis, *not* as debt cancellation income, e.g. item purchased for a lower price. For a reduction of debt to be treated as a purchase price adjustment under §108 (e) (5), the debt must be that of a purchaser of property to the seller that arose from the purchase.

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65 See §108, discussed in 4.3.2 below.

66 284 U.S. 1 (1931)

67 916 F.2d 110 (3d Cir. 1990)

68 The *dissent* held that the taxpayer received either $3.435,000 in cash or cash equivalent entitlement for the exhilaration and profit potential of gambling. This would be income when received, were it not for the fact that the taxpayer was obligated to repay it. When the debtor no longer recognizes an obligation to repay and the creditor has released the debt, the income must be recognized.

69 In the meaning of *Duberstein*, *supra* note 45.

70 See *Commissioner v. Jacobson*, 336 U.S. 28 (1949)

Cash substitute is not "property" within the meaning of this section. The forgiven debt reduces the basis and thus, what one really paid for the property is his basis when he sells it, i.e. a cost basis under §1012.

Under §§108 (a), (d) (3) no income exists to the extent that a *debtor is insolvent or bankrupt* before the debt cancellation. When the taxpayer sells the assets on which the debts are forgiven his basis has to be reduced first under §1017 ("tax attributes"), i.e. the discharge amounts will be wiped out first and then the basis will be adjusted[71].

Under §108 (e) (2) income is not recognized upon cancellation of a debt to the extent that *payment of the debt would have given rise to a deduction*[72].

§108 (f) excludes the *discharge of a student loan* from income if the discharge results from a provision of the loan allowing the student to work off his debt "in certain professions for any of a broad class of employers", e.g. if the taxpayer borrowed money to go to medical school and the loan contained a term forgiving the debt if he worked for four years in a rural Alaskan area, the discharge would not constitute gross income.

4.4 Alimony and Child Support

4.4.1 Introduction

Since alimony and child support are treated completely differently for income tax purposes, taxpayers have tried to disguise alimony payments incident to a divorce as child support and vice versa. In addition, under §1041 no gain or loss is recognized on sales or other transfers between spouses or former spouses if the sale or transfer is incident to a divorce. Therefore, taxpayers have an additional incentive to disguise an alimony agreement as property settlement, e.g. husband pays monthly one tenth of the house over ten years to his wife.

In the Tax Reform Act of 1984 Congress responded to this abuse potential by introducing a "source rule", i.e. treating only payments that are substitute for (spousal) support as alimony under §71. In general, lump sum payments trigger property settlement treatment[73] whereas periodic payments, e.g. monthly, quarterly, etc. are referred to as support. If the payments are extended for less than 10 years they are property settlements, otherwise supportive. However, the payor's deductions are available for both alimony and property settlement payments.

4.4.2 Spousal Support (Alimony or Separate Maintenance Payments)

§71 (b) defines "alimony" for income tax purposes. In addition, the recipient of spousal support is required to furnish his/her social security number to the payor of alimony. Failure to furnish the number, or to disclose it on the return, will trigger a $50 penalty. The requirement of furnishing identification numbers under §§215 (c) and 6676 (c) helps the IRS to cross-check these support deductions and income[74]. Under §71 (a) a cash payment by a separated or divorced spouse to the other spouse is

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[71] Note that other tax benefits are correspondingly reduced.

[72] The Tax Court, in *Zarin v. Commissioner*, 92 T.C. 104 (1989), ruled that because the settlement took place in a different year from the losses, §165 (d) forbade the use of the earlier losses to offset the later discharge-of-indebtedness income. The court did not consider §108 (e) (2), which provides a "looser" approach: if the casino had forgiven the debts in the years in which the taxpayer had run them up, he would have had deductible losses. The Court of Appeals, however, avoided the issue altogether by ruling that no discharge-of-indebtedness income had occurred.

[73] See recently Betsy K. Eike, *No Alimony After Death of Payee Spouse*, 27 The Tax Adviser 75 (1996)

[74] The so named "consistency requirement" in reporting alimony deduction and alimony income

generally taxable to the recipient and deductible "above the line" to the payor under §215 (a).

Under §71 (b) "alimony payment" means any payment if

(1) in "*cash or cash equivalent*", i.e. *no* property and *no* labor;
(2) "*by or on behalf of a spouse*", i.e. directly to a spouse or through a third party (e.g. paying spouse's rent to the landlord or payments to a trustee), thus, indirect alimony is permitted
(3) under a "*divorce or separation instrument*", i.e. defined in §71 (b) (2) as either
    (a) a judicial decree of divorce or separate maintenance, i.e. a support decree given by a court
    (b) a written agreement incident to a divorce or written separation agreement
    (c) a judicial decree for temporary support, i.e. interim support payments ordered by a court before the support decree is given.

    This element allows "private ordering", i.e. under §71 (b) (1) (B) the instrument can designate that otherwise taxable and deductible payments will not be taxable and deductible. This "opt out provision" gives the spouses flexibility in negotiating the treatment of support payments to a certain extent ("limited contractual freedom"). Only "qualified alimony"[75] can be treated by the spouses as not being alimony if they do it *mutually* ("checking the box"). Both spouses have to be consistent in their treatment of the alimony.
(4) "*cessation at death*", i.e. however, the payments will not be deductible and taxable *unless* payments cease upon the recipient's death. Moreover, there cannot be any liability to make payments after the recipient's death as a substitute for payments cut off because of his/her death under §71 (b) (1) (D). Thus, if the payments continue after death, they are deemed no alimony anymore, which establishes a kind of source rule[76].

If the alimony payments arise out of a private agreement, the "spouses must *not* be members of the same household" under §71 (b) (1) (C), i.e. a payment is not deductible to the payor nor taxable to the payee if the parties are living in the same household after being legally divorced ("non-cohabitation requirement"). They have to be physically separated, e.g. even physical division in the same condominium is not sufficient to satisfy this very strict requirement. However, if the alimony payments arise on account of a judicial decree, cohabitation is allowed.

Under §71 (f) when the amount paid in the first year exceeds average second- and third-year payments by more than $15,000, the excess is recaptured in the third year. Similarly, if second-year payments exceed third-year payments by more than $15,000, the excess is recaptured in the third year. The term "recapture" means that the amount is ordinary income to the payor and a deduction to the payee ("recomputation of front-loaded alimony"). However, there are several recapture exceptions under §71 (f) (5), e.g. in case of death or remarriage.

4.4.3 Child Support Payments

[75] As defined in §71 (b) (1) (B)
[76] At least in the author's opinion.

In *Commissioner v. Lester*[77] the taxpayer made periodic payments to his ex-wife pursuant to an agreement. The agreement did not specify what portion of the payments was for child support, although it did state that the payments would be reduced by one-sixth when each child became emancipated, married, or died. The Court held that where an agreement included payments for child support but does not specify or "fix" the sum or percentage of the payment to be used for child support, the entire amount is considered alimony and is deductible to the payor[78]. Therefore, prior to 1984 child support had to be identified as such in an agreement to be treated as "child support" and not as "alimony".

Child support payments are not deductible to the payor or taxable to the recipient.

Under §71 (c) (1) "child support" is any amount that the divorce or "separation instrument"[79] designates as for the support of a child. However, even if the payments are not labeled as child support they still can qualify for "child support" and *vice versa*[80]. However, pursuant to a firmly embedded non-statutory principle, local state law does not determine federal tax law[81].

Under §71 (c) (2) any amount that is reduced upon the happening of a contingency related to the child or at a time associated with such a contingency is deemed child support. Thus, if payments decline around the time the child reaches majority or gets married, they are treated as child support no matter how the instrument describes them.

Therefore, the payments are alimony if they are not classified as child support, which again gives way to disguise alimony by naming it "child support". All things considered it seems safe to say that to a certain extent the Tax Reform Act of 1984 failed in matrimonial tax reform[82].

5. CONCLUSION

The U.S. CONST. Amend. XVI, authorizes Congress to tax " … incomes, from whatever source derived, …" §61 defines the term "gross income" as meaning "income from whatever source derived", but does not define the term "income" in the same way.

The Supreme Court seems to have acknowledged the futility of trying to capture the *concept of income* and confine it in a definition. Instead cases show the Court's descriptions and generalizations about income changing as the Court's attitude toward the income tax itself has changed. The expansive language in *Glenshaw Glass*, *supra* note 22 at 431, about realized accessions to wealth under the taxpayer's dominion would make almost any value coming into the taxpayer's possession subject to taxability as income. Thus, the taxpayers are left with guidelines but no self-executing standard.

However, the catch all concept of income has been carved out. *Exclusions* are rules that state that an item of consumption or wealth increase does not constitute

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[77] 366 U.S. 299 (1961)

[78] The *concurrence* held that Congress had specifically required that a specified amount for child support be included in an agreement; thus, any remedy must be achieved though legislation, not litigation.

[79] As defined in §71 (b) (2)

[80] Thus, §71 (c) changed the *Lester* rule.

[81] See *Lyeth v. Hoey*, 305 U.S. 188 (1938) et al.

[82] See Marci L. Kelly, *Calling a Spade a Club: The Failure of Matrimonial Tax Reform*, 44 The Tax Law. 787 (1991)

gross income. Exclusions can be found throughout the Code. Many of these provisions cover only partial exclusions, for example, only up to a certain amount.

Inclusions are rules that state that an otherwise ambiguous item of consumption or wealth increase does constitute gross income. The statutory rules in the Code were often meant to overrule, confirm, or modify a judicial or administrative decision about the taxability of a particular transaction. However, an item does not have to be covered by a specific inclusion provision to be considered gross income, but the existence of such provision does strengthen the government's case for taxing an item.

Chart 2: Inclusions in and Exclusions from Gross Income

INCLUSIONS	**EXCLUSIONS**
Et cetera, i.e. if doubtless the item is included under the scope of §61 (*Glenshaw Glass* rule)	*No* doubt rule, i.e. no presumption of exclusion!
§61 (a) *descriptive* list: compensation for services, including fees, commissions, fringe benefits, and similar items; interest; rents; royalties; dividends; alimony; income from life insurance and endowment contracts; gain derived from dealings in property	*No* list of exclusions!
Other Statutory Inclusions: • §71 (a) alimony received • §74 prizes and awards • §102 (c) gifts from employer to employee • §132 (a) e contrario non qualified fringe benefits • §79 group-term life insurance for employees • §85 unemployment compensation • §86 social security benefits	Statutory Exclusions: • §71 (c) child support • §101 (a) life insurance proceeds • §101 (b) qualified death benefits • §102 (a) gifts or inheritances • §117 (a) qualified scholarships • §119 (a) qualified meals and lodging • §132 (a) (1)-(6) qualified fringe benefits
Judicial or Conceptual Inclusions: • illegal income (*James v. United States*) • windfalls, treasure troves (*Cesarini v. United States*) • discharge of indebtedness (*United States v. Kirby Lumber Co.*) • barter goods (reciprocal self imputed income) • non-cash (*Old Colony Trust Co. v. Commissioner*) • exchange of services (*Dean v. Commissioner*) • non essential meals and lodging (*Commissioner v. Kowalski*)	Judicial or Conceptual Exclusions: • unrealized income (*Eisner v. Macomber*) • mere return of capital, e.g. loan paid back (*Commissioner v. Indianapolis Power & Light*) • bargain element in sales, e.g. car purchase (factual determination under *Commissioner v. Duberstein; United States v. Stanton*; *United States v. Kaiser*) • self imputed income (*Helvering v. Independent Life Insurance Co.*) • property received by heir pursuant to settlement in contesting validity of a will (*Lyeth v. Hoey*)