Notes on the Answers
Taxation, Fall 1992

I.

Question 1.

The general rule is that when someone finds property, he (or she) has income to the amount of the fair market value of that property. Under that rule, Betty would have income of $10 million in year 1. [Please note: the gain from finding treasure trove is "realized" when dominion is exercised over it. Betty exercised dominion when she took the coins home from the beach. The *Eisner v. Macomber* issue arises when assets already being held appreciate in value.]

Despite the general rule, I think it is improper to tax Betty in year 1 on more than she reasonably understands to be the f.m.v. of the coins. She reasonably believes the coins are worth $250,000 each ($2 million/8) – having been so told by her step-father, who is claiming to be speaking on the basis of an expert appraisal. Thus, in year 1, I think she should have income of $2 million on the coins given to Malcolm and $500,000 on the coins she kept in her sock drawer, for a total of $2.5 million. There is a depreciation deduction to take with respect to the metal detector – although acquired by gift, she has a carryover basis in it to depreciate, and it appears that she used it to earn income. In any event, she could take deductions up to the gain under IRC § 183.

In year 2, when Malcolm sells the coins, he should have embezzlement income of $6 million. (Perhaps he embezzled the money in year 1, but I think he had to convert the money to his own use before becoming an embezzler.) The payment into the trust is a reasonable way of holding the money for the benefit of Betty, so I think it should have no tax consequences. (Note: there is some argument that the trust payment frees the parents of some part of their support obligations, in states that treat a college education as a responsibility of the parents, but even so, the transfer should not have any tax effects). Alice and Malcolm have a carryover basis of $1 million in the estate (house and horses).

The answer above is not the only possible one, and I have not seen any cases on point. The harshest result would be to hold that Betty has taxable income of $10 million in year 1. If that result were reached, she would be entitled to a casualty theft loss in year 2, when her step-father embezzled $6 million. But she wouldn't know about the embezzlement so she wouldn't know to take the loss. (Casualty losses can be taken when the loss is first discovered.)

Question 2

To get a business expense deduction, Ted must show that he is engaged in business. Perhaps he is not so engaged. See *McKinney*. I would distinguish that case on the ground that Ted actually intends an ongoing business, not some one shot theft or embezzlement. In any event, Ted and Shifty appear to have entered into a transaction for profit within meaning of IRC §§ 212 and 165(c)(2). I would argue that a deduction is allowable under either IRC §§ 162 or 212 (doesn't matter which one wins for Ted) in that I think the loss arose from purchase of "improper" equipment and not from a decline in its value. (For example, paying postage to return a book ordered for a law firm's library seems to me to be a business expense, not a business loss.)

Ted and Shifty were about to enter into an illegal business, not withstanding Shifty's claims to the contrary. In general, the expenses of running an illegal business are deductible. See *Tellier*. The legislative history of IRC § 162 strongly suggests that the public policy argument against deductions is limited to the specific provisions of that Code section. No limitation in that section is applicable to the facts of this case. It is certainly not illegal to buy a copier.

The Commissioner might be tempted to invoke *Mazzei* (casualty loss denied to individual who attempted to counterfeit money using phony black box.) But that case should not be extended to cover this case. First of all, Ted's loss arose from his decision to get out of the counterfeiting business, and getting out is not against public policy. Second, *Mazzei* applies to casualty losses, and the Tax Court explicitly acknowledged that it did not have the authority to block a deduction under IRC § 162 on public policy grounds. It probably does not have that authority with respect to deductions claimed under IRC §§ 165(c)(2) or 167, but the law is not so clear. [Note: I agree with the result in *Mazzei* because I think the issue under the casualty loss rules is different from the issue under IRC §§ 162, 212, 165(c)(2), and 167.]

I would limit Ted's deduction to $400 – the amount of the loss actually suffered. Ted is apparently arguing that in effect he paid $500 and Shifty gave him $100 as a gift. I doubt he can prove the underlying facts. The gift claim seems bogus. Ted probably paid less of the restocking fee because Shifty agreed that he was more responsible than Ted for the mess up. Ted cannot get depreciation. Depreciation cannot be taken until the printer is put into service, and that never happened. In addition, depreciation with respect to an asset should not be allowed in the year of its disposition. [Note: I read in a computer journal about the governments of U.S. and Japan requiring Canon to install the currency-recognition chip.]

Question 3

The problem for the taxpayer in *Zarin* is that he could not use his large gambling losses in year 1 to offset his cancellation of indebtedness income in year 2. A nice legislative solution would be to allow his gambling losses to be carried forward, but only for the purpose of offsetting future cancellation of the gambling debts arising from those losses. (Note: the courts could not reach the suggested result because the rule on non-carryforward of gambling debts is clear in the statute.)

To implement my suggestion, I would add to IRC § 108(e) an additional exception to the effect that a taxpayer does not have cancellation of indebtedness income when gambling debts are cancelled to the extent of related gambling losses from prior years. to overturn *Zarin*, I would amend IRC § 108(d) to provide that gambling debts are debts for purposes of that section whether or not they are legally enforceable under the state law.

The point of the change would be to protect gamblers like Mr. Zarin who have lost money and otherwise would be taxable as if they had won money. The opinion of the Third Circuit should be overturned to make clear that the courts are not to open Pandora's Box by fudge the definition of indebtedness.

Question 4a.

This is an installment sale. Ace has realized gain on the sale of $20,000 ($50,000 amount received minus $30,000 basis). For computing gain, the formula is:

$$\frac{\text{gross profit}}{\text{total contract price}} \times \text{payment}$$

The alleged fair market value of the annuity received is $20,000, so the taxable gain is $8,000 ($20,000/$50,000 x $20,000). There is also interest of $1,600, but I was not concerned with the interest income in this question.

Question 4b.

The formula for determining the amount of an annuity payment to exclude is:

$$\frac{\text{basis of annuity}}{\text{expectancy}} \text{ x payment}$$

The basis is $20,000, which is the amount that was taxable in Q4a. The expectancy is $1,000 x 15 = $15,000. Thus the exclusion ratio is $20,000/$15,000. this ratio is larger than one, so all of the payment can be excluded.

Note that the annuity is a bad deal for Ace. No one would knowingly pay $20,000 to acquire an annuity that is expected to pay $15,000 over a 15-year period. I think there is some basis for claiming a loss each year, but I doubt that it would be allowed and I have no authority for or against my position. (I reserved one point for a good discussion of the loss issue – otherwise Q4a and Q4b were each worth 3 points.)

Question 5.

(a)	$1,000	IRC § 163(a) and (h)(2)(A). Business interest is not personal.
(b)	$0	IRC § 263A(f)(1) (perhaps) or § 263(a). Interest on construction loans generally must be capitalized.
(c)	$0	IRC § 265(a)(2). Interest used to carry tax exempts is not deductible.
(d)	$1,000	IRC § 163(d) (Note it is the total investment income, not the dividends from the particular assets.
(e)	$0	IRC § 163(h)(1). Not entirely clear what result a court would reach. It think it falls in the residual "personal" category because the proceeds of the loan were not used for business (intent should be irrelevant).
(f)	$0	IRC § 163(h). Clear case of personal interest.
(g)	$100	IRC § 163(h)(3)(A)(ii). This is a home equity loan.
(h)	$0	IRC § 163(h)(3)(C) and (h)(3)((B)Ii)(II). Interest paid on a second home can qualify as "qualified residence interest" but only if the home is secured by the mortgage. Here we are told to assume that it is not secured. For same reason, the loan is not a home equity loan.