2

Taxable Income

This chapter addresses the starting point of any income tax: the definition of income as the base of the tax (the subject matter on which the tax is imposed).

First, we discuss the two main concepts of taxable income, source concept and accretion concept, and the two main ways used by countries with income taxes to define the tax base, by exclusion (a "global" definition of income) or by inclusion (a "schedular" definition).

The chapter then reviews some of the major problems of defining income in the U.S. income tax system and juxtaposes the U.S. solutions against those used by other countries.

Finally, we discuss the realization requirement, which has been described as the "Achilles' heel" of the income tax.[1]

I. TAXABLE INCOME DEFINITION: GLOBAL vs. SCHEDULAR AND SOURCE vs. ACCRETION

The definition of taxable income can be based upon either the accretion concept or the source concept.[2]

The *accretion* concept derives from the so-called "Haig/Simons" definition of income, under which a person's annual income is the value of what she could consume in that year while keeping her wealth constant. Equivalently, it is equal to actual consumption plus the change

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[1] William D. Andrews, *The Achilles Heel of the Comprehensive Income Tax*, *in* NEW DIRECTIONS IN FEDERAL TAX POLICY FOR THE 1980s, at 278, 280–85 (Charles E. Walker & Mark A. Bloomfield eds., 1983).

[2] VICTOR THURONYI, COMPARATIVE TAX LAW 233 (Kluwer 2003) distinguishes between accretion, source, and trust concept. *See also* Paul Hahn Wueller, *Concepts of Taxable Income I*, 53 POLIT. SCI. Q., 1938, 83; KEVIN HOLMES, THE CONCEPT OF INCOME. A MULTI-DISCIPLINARY ANALYSIS(Amsterdam: IBFD, 2001).

in wealth.[3] This concept has been adopted in the **United States,**[4] where any realized accession of wealth is income unless it is specifically excluded.

The *source* concept of income has been developed by the Italian economists De Viti De Marco and Quarta, and it has been adopted by **Italy** and many other civil law countries.[5] It has also been adopted by certain common law countries such as the **United Kingdom.** The source concept of income provides that a certain item is income only when it derives from a specific source, most likely an economic one.

Another important distinction exists with regard to the definitional structure of taxable income. Any tax system can define taxable income in a global way (e.g., **United States**) or in a schedular way (e.g., **Italy**). Taxable income is defined in a global way when any item of income is included in taxable income unless specifically excluded. Taxable income is defined in a schedular way when an item of income is not taxable income unless specifically included in a specific schedule.

One may think that income tax systems that define taxable income in a global way would follow the accretion concept (as is the case in the **United States** and **Brazil**), while a tax system that defines taxable income in a schedular way would rather prefer the source concept (as is the case in **France, Germany, Italy, Spain,** and the **United Kingdom**). The logic works as follows: in a schedular system, income is taxable only if there is a specific "scheduled" source for such income. On the other hand, global systems will not look for a specific source for the income. All that matters is the accumulation of income (the source of which does not matter). Hence, "accretion" is the key concept here. As much as we would have liked to end this description now, the source/schedule vs. accretion/global distinction is much generalized, many times misleading. In fact, both **Australia** and **Canada** define income in

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[3] *See* ROBERT M. HAIG, THE CONCEPT OF INCOME—ECONOMIC AND LEGAL ASPECTS, THE FEDERAL INCOME TAX 59 (Columbia University Press 1921); HENRY C. SIMONS, PERSONAL INCOME TAXATION: THE DEFINITION OF INCOME AS A PROBLEM OF FISCAL POLICY 5 (Chicago University Press 1938).

[4] For a comparison between the U.S. and the Italian way to define taxable income and for a comparison of the different concepts of income, *see* Nicola Sartori, *La nozione di reddito d'impresa negli Stati Uniti d'America: profili di diritto comparato*, RIVISTA DI DIRITTO FINANZIARIO E SCIENZA DELLE FINANZE 587, part I, (2007).

[5] *See* ORONZO QUARTA, COMMENTO ALLA LEGGE SULLA IMPOSTA DI RICCHEZZA MOBILE 111, vol. I (Società Editrice Libraria 1902); ORONZO QUARTA, OSSERVAZIONI SUL CONCETTO DI REDDITO IN FINANZA (Italgrafica 1932), also published in *Opere giuridiche* (F. Forte e C. Longobardi eds.,1962); ANTONIO DE VITI DE MARCO, PRINCIPI DI ECONOMIA FINANZIARIA 192 (Einaudi 1939).

a global way yet adopt a source concept of taxable income.[6] **Japan** defines income in a schedular way yet adopts an accretion concept of taxable income.

It is worth noting that there are no countries that define income in either a purely global or purely schedular way, and there are none that have adopted a pure source or accretion concept: this is because, as we will show, there has been a considerable convergence process in these matters. Nevertheless, every income tax system will necessarily address these two issues (definitional structure and the concept of taxable income).

In the **United States**, the Code[7] defines the base of the tax imposed by Section 1 by reference to "gross income." Gross income is defined in circular fashion in § 61 as "all income from whatever source derived." Since 1955, this language has been interpreted by the U.S. Supreme Court as applying to all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."[8] This means that the United States employs a "global," or all-encompassing, definition of income based on the accretion concept: any accession to wealth is presumed to be income unless Congress specifically *excludes* it.[9]

In **Brazil,** taxable income is legally defined as the product from capital or labor (or a combination of both), and any increase in the net worth of the taxpayer (*proventos de qualquer natureza*), which may not be a product of capital or labor.[10] For purposes of defining taxable income, the name given to the revenue or income, its location, legal status or nationality of the source, its origin, or how it is perceived, are irrelevant.[11]

Other countries begin their definition of the tax base differently. In the **United Kingdom,** as well as in many other countries (e.g., **China, France, Germany, Italy, Japan**), income is only subject to tax if it is listed in a particular schedule, and each type of taxable income has its own schedule (which may also include a separate rate or a different taxing mechanism such as withholding vs. tax return filing). Thus, there is a schedule for wages, for dividends, for interest, and so on. This system

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[6] This is because the Australian and Canadian systems were originally schedular systems in which each schedule represented a different source of income.

[7] All references to the "Sections," "Code," and "Regulations" are to the U.S. Internal Revenue Code of 1986, as amended, and to the U.S. Treasury Regulations promulgated thereunder.

[8] Commissioner v. Glenshaw Glass Co., 348 U.S. 426 (1955).

[9] Internal Revenue Code § 61 states: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived. . . ."

[10] See Article 43 of the National Tax Code (Law No. 5,172, Oct. 25, 1966—hereinafter "NTC")

[11] See Article 43, § 1°, of the NTC.

is therefore called "schedular," and under it, no item of income is taxable unless the policy maker specifically *includes* it in the tax base. In addition, deductions are applied to specific schedules, and losses cannot be carried over from one schedule to another, unless specifically permitted by the policy maker.

What difference does it make if a tax system is global or schedular? The difference is at the margin, for those items of income that are not enumerated.

In the U.S. system, Code § 61 states that gross income includes, but is not limited to, a long list of enumerated items.[12] This means that if an item does not appear on the list, it is still taxable if it meets the criteria set out in *Glenshaw Glass*.[13] Such definition is based on the accretion concept. For example, the Supreme Court held that punitive damages for antitrust violations were taxable even though they did not have a "source" in any activity of the taxpayer.

In a schedular system, on the other hand, items of income that are not enumerated in a schedule are simply not taxable.

For example, in **Italy,** the realized capital gain on the private sale of a piece of art is not taxable, since it is not listed under any particular "schedule".

In the **United Kingdom,** as well as in other commonwealth countries, capital gains were not taxable until a separate tax was enacted to reach them.[14]

Interestingly, tax historians[15] have shown that even the **U.S.** system was originally conceived as being more similar to a schedular system, based on the source concept. The references to "sources" of income in Code § 61 (which dates back to the original Revenue Act of 1913) was understood at the time as referring to a series of particular sources from which income flowed. Therefore, if income had no source, it could not be taxed (just as if it was not included in a schedule). Thus, in 1920, the Supreme Court held that "income may be defined as the gain derived from labor, from capital, or from both combined."[16] This definition

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[12] (1) Compensation for services, including fees, commissions, fringe benefits, and similar items; (2) Gross income derived from business; (3) Gains derived from dealings in property; (4) Interest; (5) Rents; (6) Royalties; (7) Dividends; (8) Alimony and separate maintenance payments; (9) Annuities; (10) Income from life insurance and endowment contracts; (11) Pensions; (12) Income from discharge of indebtedness; (13) Distributive share of partnership gross income; (14) Income in respect of a decedent; and (15) Income from an interest in an estate or trust. Most of the categories enumerated as examples in Code § 61 have their own schedule in tax systems.

[13] See footnote n. 8.

[14] *See* Chapter 6.

[15] STEVEN A. BANK, *Mergers, Taxes, and Historical Realism*, 75 TUL. L. REV. 1 (2000).

[16] Eisner v. Macomber, 252 U.S. 189 (1920).

embodied a schedular notion of income as deriving from one of these three possible sources and was interpreted (correctly) as implying that gains that did not derive from these three sources should not be taxed. However, by 1955, the time that *Glenshaw Glass*[17] was decided, the Court had moved from this schedular idea toward a more global notion of the concept of income. This has been the U.S. definition ever since.

In the sections below, we will offer examples of items of income in which the differences between global and schedular systems—and source and accretion concepts—manifest themselves.

However, as many commentators have noted, over time, there has been considerable convergence between the global and schedular approaches, as well as between source and accretion concepts.

As Eric Zolt[18] has shown, the **U.S.** system contains significant schedular elements, and the definition of income every so often follows the source concept. For example, from the beginning, capital gains have been subject to a separate rate structure from the outset. This has persisted despite the 1986 attempt to abolish the capital gain preference. Similarly, capital losses are treated separately from other losses, and certain types of deductions, such as investment interest and passive activity losses, are also segregated from other losses and deductions.

In schedular systems, as we will discuss below in greater detail, the adoption of catch-all "miscellaneous income" schedules and the possibility of moving losses from one schedule to another have led to the inclusion of most items of income that are subject to tax in the **U.S.** system. This has created a partial convergence of schedular systems toward global systems.

In **Italy,** for example, there are six schedules of income, one of which is the "other income" schedule. This schedule is not a residual category, but it includes many items of income that are not includable in the other schedules.

In **Israel,** the Income Tax Ordinance counts nine schedules of income. However, eight of them refer to particular sources of income, and the ninth lists "income from any other source." This is a good example for a schedular system adopting a global approach.

China also offers a good example of a schedular system that converged toward a global one. The Chinese individual income tax system is still essentially schedular. There are many taxable items of individual income tax,[19] including wages and salaries; income derived by individual industrial and commercial households from production or business

[17] *See* footnote n. 8.

[18] Eric M. Zolt, *The Uneasy Case For Uniform Taxation*, 16 VA. TAX REV. 39 (1996).

[19] *See Regulations for the Implementation of the Individual Income Tax Law of the People's Republic of China*, *available at* http://www.chinatax.gov.cn/n6669073/n6669088/6888494.html (last visited on November 19, 2009).

operation, income from contracted or leased operation of enterprises or institutions, remuneration from personal services, author's remuneration, royalties, interests, dividends, bonuses, income from lease of property, income from transfer of property, contingent income, and other income specified as taxable by China's Ministry of Finance. To a certain extent, the possibility for the Chinese Ministry of Finance to specify if an item of income becomes taxable makes the Chinese income tax system similar to a global system. In fact, new items of income can be rapidly (but not immediately) added as taxable items of income.

The reverse (global systems converging toward schedular ones) is also true. For example, the **United States** follows a global approach, but there are so many excluded items of income in the U.S. Code that it is possible to say that the system partially converged toward a schedular system. The most obvious example is the different treatment of labor (i.e., "ordinary") income as compared to capital gains. Both are, in essence, "income" but are taxed differently, each under it own "schedule," each defined according to the source from which it is derived.

Despite this considerable convergence, there are still differences at the margin between global and schedular systems, and there persists some tendency to tax items in the former that are excluded in the latter. New forms of income arise over time as the economy changes (e.g., income from derivative financial instruments). When courts confront the question of whether such new items should be taxed, their decision to tax depends on whether the system they operate in is global or schedular. This example illustrates a broader phenomenon that underlies the whole topic of comparative taxation and gives it some of its appeal.

It is also important to note that "source" remains highly relevant even in global systems due to the international nature of business transactions. In an international transaction, even where only "global" systems are involved, source will define which jurisdiction gets the priority in taxation and will also affect the classification on the transaction for tax purposes (for example, as an interest or a dividend payment).

At least from a functional perspective, the design problems facing an income tax are, to a significant extent, identical across jurisdictions. Therefore, it is not surprising to find a degree of convergence that makes all income tax systems look alike, even without any showing of conscious borrowing (although that exists as well in some areas, such as international tax). However, jurisdictions also differ in their underlying history and legal culture, and thus it is understandable that convergence will never be complete.[20] In fact, the widespread phenomenon of

[20] This is generally true for all comparative legal studies, as suggested by studies on the convergence or divergence of the common and civil law traditions. Mathias Reimann, *The Progress and Failure of Comparative Law in the Second Half of the Twentieth Century*, 50 AM. J. COMP. L. 671 (2002).

cross-border tax arbitrage depends on the persistence of differences between the tax rules of different countries, even if they all attempt to tax income. In essence, tax arbitrage refers to the exploitation by taxpayers of the differences among tax systems to lower their overall tax liability.

II. TAXATION OF FRINGE BENEFITS

No income tax system can focus exclusively on cash compensation paid to employees without raising significant efficiency and fairness issues. If only cash compensation is taxed, workers would tend to ask for noncash compensation. A negative twofold result follows: workers would receive noncash fringe benefits instead of other items upon which they place greater value, which is inefficient; also, workers with similar incomes would be taxed differently depending on whether they received income in cash or in other form, which is unfair.

Different countries have responded to this issue in different ways, depending on the fringe benefits involved.

As a general matter, in most systems (the **United States** included), fringe benefits are included in income. Specifically, they are included in the employee's income and usually deductible for the employer.[21] From a *fairness* perspective, this is probably the best solution because horizontal equity requires that similarly situated taxpayers be treated alike.

Despite this general concept, in most (if not all) tax systems, some fringes are excluded (which again raises fairness questions with respect to these specific fringes). This is one area in which the global vs. schedular issue matters: under schedular systems, fringes must be specifically included or they are not taxable, while in the **United States** and other global systems, all fringes are taxable unless specifically excluded (I.R.C. § 132; § 119). These marginal differences are discussed below with reference to specific fringes.

Admittedly, taxing noncash fringe benefits is difficult. There is the issue of valuation, which is frequently difficult to perform; especially when the items are restricted (the value in such a case is obviously less than fair market value, but by how much?). The general valuation rules of the law apply to the valuation of the benefits in kind. The valuation process becomes even more complicated in countries that do not have a set of detailed rules for performing valuations. Another issue with

[21] As it will be shown, the Australian tax system constitutes an exception on this regard.

fringe benefits is that the business and personal aspects of a fringe benefit, such as use of a company car, may be difficult to separate.

Before commencing in analyzing the various ways in which different tax systems approach the problems presented by fringe benefits, one notable exception to the general rule (i.e., that fringe benefits are taxable to the employer) must be emphasized: the **Australian** tax system, which applies a comprehensive system of surrogate taxation with respect to fringe benefits. In general, under Australian law, any benefit provided by an employer to an employee with respect to the employment is included in the *employer's* income.[22]

The major advantage of this approach is administrative simplification: the problem of valuation is shifted from employee to employer, and it is much easier to audit employers than employees because of their limited numbers. The major disadvantage is that the wrong person is taxed, and there is always the concern as to whether the tax is passed onto employees in the form of lower wages (which depends on market conditions). In general, Australian economists have concluded that it took awhile for the new fringe benefit tax to be reflected in wages.

As noted, however, in most other countries, fringe benefits are taxed to employees, and the main challenge is dealing with the administrative and valuation difficulties raised by this method. In most countries, the value of fringe benefits is measured through a comparison to fair market value or retail prices.

For example, in **Russia,** the law requires only that goods and services be valued at the market price of similar goods and services, increased by the appropriate amount of value-added tax (VAT) and excise duties. However, the fair market value of many fringes is hard to establish, especially in the case of fringes provided for the use of multiple employees (such as company retreats).

If one does not adopt the Australian approach of shifting the burden to the well-informed (and better regulated) employer, one might try to take the valuation difficulties head-on by trying to prescribe statutory rules for valuation.

For example, in **Brazil,** benefits in kind are fully taxable and valued at their cost to the employer or at market value,[23] except those which are specifically exempted, such as food and transportation vouchers, and uniforms or special clothing for work, freely provided by the employer, or the difference between the price charged and the market value of the goods.

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[22] See *Fringe Benefit Tax: A guide to employers and tax professionals*, published by the Australian Tax Office (2006), at http://www.ato.gov.au/content/downloads/N1054.PDF; HUGH J. AULT AND BRIAN J. ARNOLD, COMPARATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS 174–176 (Kluwer 2004).

[23] IBDF. Latin-American Taxation: Brazil. http://ip-online.ibfd.org/la/.

The **Canadian** system prescribes a complex and comprehensive set of rules to value the benefits of employer-provided automobiles.[24]

Under **Chinese** tax law, if the benefit received is in the form of physical asset (car, dwelling, etc.), the amount of taxable income is calculated according to the price specified in the purchase documentation or as determined by tax authorities. The taxable value of the benefits may be incorporated into the taxation of employees' wages on an average monthly basis of the employees' required service period. The payment of income tax by an employer on behalf of an employee is also regarded as a taxable remuneration. The employee is taxed on the grossed-up amount.[25]

A *middle way* to deal with the valuation problem is to simply attach a standard value to certain fringes ("valuation tables") and include it in the employee's income. This method is applied in **Italy**[26] for company-provided cars and in the **United States,**[27] **the United Kingdom, Sweden,** and **Germany** for fringes such as company cars, meals, and lodging. A similar approach is taken in **Israel:** each year the Tax Authority publishes a "value of use" table which specifies the amount to be added to employees' income for each type of vehicle provided by the employer.

The valuation problem may lead countries to omit hard-to-value or small fringes for simplicity reasons,[28] but excluding fringes altogether leads to a violation of horizontal equity. Suppose, for example, that A gets taxable income of 10,000 and an excluded fringe of 1000, while B gets 11,000 in taxable income and buys the fringe with after-tax money. Assuming a flat tax rate of 30 percent, A is left with 7000 cash (10,000 taxable income taxed at a 30 percent rate) plus the fringe at hand, while B remains with 6700 cash (11,000 taxable income taxed at the 30 percent rate minus the 1000 spent to purchase the fringe) plus the fringe.

The valuation problem can also lead to a violation of vertical equity, for example, by a nontaxed fringe given only to senior, highly paid employees.

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[24] AULT & ARNOLD, *supra* note 22, at 173. The **French** system is similar.

[25] IBDF. Asia-Pacific Taxation: China. http://www.ibfd.org/portal/Product_tiap.html.

[26] FRANCESCO TESAURO, ISTITUZIONI DI DIRITTO TRIBUTARIO. PARTE SPECIALE 67 (Utet 2008). What the author underlines as fringe benefits are generally taxed in Italy for two main reasons: anti-avoidance purposes and efficiency (improve the productivity of employees or to develop faithful employees).

[27] AULT & ARNOLD, *supra* note 22, at 172–74; Treas. Reg. 1.61-21; 1.132-1–8; *see* KBS p. 51.

[28] Both administrative and compliance costs would be lower.

Possible solutions to the fairness issues include the U.S. method of limiting the exclusion for highly paid employees.[29]

The **French** system uses certain coefficients to value the benefit included, depending on the employee's income level. Thus, if a certain fringe benefit is given to both low-income and high-income taxpayers, the low-income taxpayer will include less in her income than her high-paid counterpart.

The fact that most countries generally include noncash benefits in income provokes the following intriguing comparative questions: What are the exceptions? How broad is the exclusion? And specifically, what kind of benefits escapes taxation? Are fringes of different character excluded in different countries? A few examples are worth mentioning.

A major fringe in some countries is health-care expenses or insurance paid by the employer. In the United States, these are excluded or deferred to a certain extent by the employee and immediately deductible to the employer.[30]

However, in other countries with developed health-care systems, such as Sweden, this fringe is included in income (or not included but also not deductible to the employer).[31]

This contrast is understandable given the different background conditions (weak health care outside the employment context in the **United States,** strong in **Sweden**) and provides a striking example as to how different political contexts (private versus state-supported health care) create variations in tax rules.

Such differences can provide us with a methodological rallying point from which to launch a comparative discussion. A functional approach would start by questioning what the social function is, which the above-discussed laws are intended to fulfill. Presumably, the theoretical discussion would go that countries wish to maintain the health of their citizens. From a comparative perspective, such research would try to evaluate whether the best way to achieve this goal is to give tax preferences or to grant free state-sponsored health care. On the other hand, the cultural perspective would not address it as a question of functional efficiency but rather as a question of cultural societal difference. It would try to identify the societal values that have grown state-sponsored health-care systems in one place and health-related tax subsidies in another. It may well be, according to such an approach, that both solutions are right, each in its localized context. Finally, a critical approach would try to expose which political or sectorial interests are advanced by each approach and to explain how other interests are

[29] *See* Code § 132(j).

[30] Code § 106(a), § 162(a).

[31] AULT & ARNOLD, *supra* note 22, at 172.

marginalized in the process. Namely, who are the beneficiaries of each system, and how did they affect the creation of such systems? For example, who would be on the "receiving side" of a privately held health care system, and what arguments does such a party make when reforms are considered?

Another context-dependent example involves certain working conditions related to fringes. It is plausible to argue that a tax system reflects different cultural and social values by the benefits it chooses to exclude. For example, one may compare the benefits excluded by Code §132 in the United States to the benefits excluded in other countries.

In **Germany,** social policy dictates that cash payments for birth of a child, extra pay for overtime work on holidays, and "happy work force" payments are all excluded, while in **Japan,** length of service gifts are excluded.[32] No similar excluded fringes can be found in the **United States.**

In **China,** wages and salaries do not include allowances and subsidies paid by employers in accordance with state regulations.

III. IMPUTED INCOME FROM OWNER-OCCUPIED HOUSING

We must start by tackling the very basic definition of income imputation, since such concept is almost completely neglected in the U.S. Code. Imputed income is income that a taxpayer derives from providing goods or services to herself. For example, when a person lives in her own house, she is providing the value of housing to herself, and at the same time saving the amount she would otherwise have to pay as rent. When she tends her own garden, she earns as imputed income what she would otherwise have to pay a gardener. Under the Haig/Simons definition of income, imputed income should be taxed, since it clearly represents a wealth accretion.

Nevertheless, most countries do not tax most forms of imputed income, primarily because to do so would be both administratively difficult (because of valuation issues) and politically unpopular.[33] However, in many countries, there has been some attempt to tax imputed income because omitting it altogether would create a harsh distinction between, for example, homeowners and renters.

[32] AULT & ARNOLD, *supra* note 22, at 171.

[33] Administrative difficulty is, in essence, a functional argument, while political impropriety is a cultural-comparative one.

The **United States, Canada, Brazil,** and **China** never seriously considered taxing the imputed income of owner-occupied homes.

A simple example can clarify the consequences of not taxing imputed income: Assume A and B both have 100k of after-tax money. A buys a house for 100k and then lives there. At the end of the year, A sells the house to a third party for 103k. B invests the 100k in bonds which pay 8k a year but also rents a practically identical house to A's house for 5k a year. Both earn 50k a year.

At the end of year 1:		
	A	B
Taxed investment yields:	3 (house appreciation)	8 (interest)
Nontaxed imputation:	5 (rent saved)	0
Salary earned:	50k	50k
Taxable income:	53k	58k
Nondeductible rent paid:	0	(5)

Clearly, B is taxed more heavily than A, even though—from a pure financial perspective—they are in the same situation. In other words, refraining from taxing A's imputed income clearly creates an unbalance in horizontal equity. This scenario represents a policy choice to encourage home ownership over residential leasing.

Two straightforward solutions to bring A and B to equality would be to either (1) include as income the imputed rent saved by A, comparing his income to B's 58, or (2) deduct the rent paid by B, thus comparing his taxable income to A's 53. The first would simply rebalance the equities while the latter would represent a shift in policy choices toward inducing residential leasing rather than ownership.

There are various reasons why imputed income from owner-occupied housing is not taxed in the United States.

Valuation difficulties—Since in many countries, houses are being valued for other purposes such as property and estate taxes,[34] one may think that valuation difficulty is not a sufficient reason to exclude imputed income from tax. However, many countries have taxed imputation in the past but abandoned it at least partially due to administrative reasons. For example, in 1987, **Germany** tried and abandoned a tax on the imputed value of homes, finding that rental valuation was seldom accurate and often undervalued. Since interest and maintenance costs were deductible against imputed rent, losses were generated

[34] It is certainly arguable that from a financial perspective, the very levy of property taxes is a crude form of imputation.

by taxpayers, which were used to offset other income.[35] **Australia** and **France** abandoned a tax on the imputed value of homes for similar reasons. Similarly, **Israel** abolished the taxation of imputed income from home ownership in 1963. So it seems that valuation plays at least a partial role in the justification for nontaxation of imputed income, but given the ubiquity of valuing housing, it cannot be a complete explanation.

Political (and historical) considerations—Given the fact that valuation difficulties alone do not justify nontaxation, other simple explanations come to mind: imputed income was never taxed, so why tax it now? Indeed, one could easily imagine the political outcry which would arise if imputed income taxation were presented suddenly in **Canada** or the **United States**. But this is not a good tax policy argument.

Freedom of choice—Another justification is that B could simply buy a house, just as A did; if B did not have the money to purchase a house, he could borrow it and be in the same position, given the deductibility of mortgage interests. However, again, this rationale is not tax related. Even if fairness is not a problem under this argument, we may encourage investment in housing.

Under such circumstances, where it can be plausibly argued that there is no good justification from a pure tax perspective for nontaxation of imputed income, it is not surprising that other countries have found various ways to tax imputed income from owner-occupied houses. This thus diminishes, at least to a certain extent, the negative results in the example described above. As we shall see, the solutions were partly affected by policy considerations. Methods of taxation of imputed income include the direct taxation and the indirect taxation of imputed income.

Direct taxation of imputed income—In many European countries, tax is levied on the ownership of residential homes.

In **Italy**, *"reddito fondiario,"* the imputed income from the ownership of land and buildings, is taxable, with an exception for the first residential house, according to Art. 26, Presidential Law Degree n. 917/1986 (*"Testo Unico delle Imposte sui Redditi"* or *"TUIR"*). The amount of imputed income is based on a cadastral system. In the case of rented property, the taxable income is the greater of the imputed income or the actual rental income. The taxable income so determined has to be summed up to the amount of income emerging from the other categories of income and will be subject to individual income tax (IRPEF).

In **Belgium,** "all real estate is assigned a notional rental income, known as 'cadastral' income, which is determined by estimating the potential annual rental income of the property at a given date.

[35] AULT & ARNOLD, *supra* note 22, at 181.

A property tax of 30% to 50% (depending on the location of the property) of the cadastral income is payable . . . annually by all property owners."[36]

Consider this method with respect to the above example, in which the notional income is 5k:

	A	B
Taxed investment yields:	3 (house appreciation)	8 (interest)
Taxed imputation:	5 (notional income)	0
None deductible rent paid:	0	(5)
Salary earned:	50k	50k
Taxable income:	58k	58k

Generally, the **Belgian** system adopts a straightforward approach in comparing A's and B's statuses (although B would still have less after tax money since his rent is paid out of after-tax money). Interest on loans is deductible if the loans were taken for the purpose of acquiring a residential home.

Other systems tax the imputed income with reference to standard values. **Sweden** uses the home value rather than calculating the notional value of rent. Home owners are taxed at a nominal rate of 1 percent of 75 percent of the home value. Going back to our initial example, where A had 53k of taxable income, and B had 58k, if both A and B are in a 20 percent tax bracket, B would pay 11.6k in taxes, while A (if it wasn't for the imputed income tax) would only pay 10.6k. Under the Swedish system, A still owes taxes of imputed income of an amount equals to (1 percent)*(75 percent)*($100k) = 750, bringing his total tax paid to 11.35k, substantially reducing the inequality with B.

Although the general notion that imputed income taxation is directed at equalizing the status of renters to the preferable status of home owners, imputed income taxation may be triggered by the exact opposite consideration.

In **The Netherlands,** the taxation of imputed income was presented in order to induce home ownership in a country of renters.[37] While imputed

[36] Deloitte, *Real Estate Guide—Belgium*, *available at* http://www.deloitte.com/dtt/article/0,1002,sid%253D5214%2526cid%253D104818,00.html.

[37] AULT & ARNOLD, *supra* note 22, at 182.

income is taxed, the valuation of imputed rent is set at deliberately low values and may be offset by mortgage interest, thus generating a loss which may be used to shelter other income. Going back to our example, let's assume now that A and B both borrowed 100k, at an annual interest of 5 percent. A used his proceeds to buy his house, and B used it to invest in a bond. Also assume the notional (low) imputed rent is only 2.5 percent. Under the Dutch system, the results are as follows:

	A	B
Taxed investment yields:	3 (house appreciation)	8 (interest)
Taxed imputation:	2.5 (notional income)	0
None deductible rent paid:	0	(5)
Deductible mortgage interest:	5	0
Salary earned:	50k	50k
Taxable income:	50.5k	58k

Thus, the Dutch system is heavily aimed at inducing borrowing for home purchase.

Indirect taxation of imputed income—In **Japan**, the general rule is that home owning imputation is not taxed. However, Japan's unique system of depreciation gives an economic effect as if it does. Home owners must adjust the basis in their homes as if they took depreciation deductions, but, actually, they are not allowed to utilize any of the deduction on a yearly basis. It cannot be used to shield income from other sources. The sole purpose of the deductions is to decrease the basis in the house. The effect is that the value of imputation is taxed but deferred until disposition. Going back to our example, let's assume that A deducted 5k of the adjusted basis of the house.

	A	B
Taxed investment yields:	8 (3k house appreciation+ 5k deduction recapture)	8 (interest)
Nontaxed imputation:	5 (rent saved)	0
Nondeductible rent paid:	0	(5)
Salary earned:	50k	50k
Taxable income:	58k	58k

Although at a first glance the system might look fair, consider what happens if A (as expected) does not sell his house after one year but rather after five years. So, at the end of year 5:

	A	B
Taxed investment yields:	41 (16k[38] house appreciation + 25k deduction)	8 (interest)
Nontaxed imputation:	5(rent saved)	0
Nondeductible rent paid:	0	(5)
Salary earned:	50k	50k
Taxable income:	91k	58k

This form of concentrating the entire taxation at once creates a "lock-in effect" that makes people less inclined to move. This is a particular policy choice for which comparables are hard to find.

In summary, there seem to be no good tax policy reasons behind the **U.S.** approach of ignoring imputed income from housing, and there are various ways of actually taxing such income. It is obvious that the choice not to tax imputed income is not tax driven and that the tax system is being used to advance (as in many other cases) nontax goals. Nevertheless, it seems unlikely that the **United States** tax system will change in this regard, given the likely political outcry. Even the mortgage interest deduction, which is less defensible, has survived reform efforts.

IV. WINDFALLS

Under **U.S.** tax law, windfalls (e.g., a $20 bill found on the street) are taxable income under the general concept of accretion of wealth and taxing all income "from whatever source derived."

Similarly, under **Brazilian** law, taxable income also includes any increase in the taxpayer's net wealth that is not a product of labor or capital, or a combination of the two.

These solutions are compatible with the accretion concept of income. However, from a comparative perspective, this straightforward treatment (adopted by both the United States and Brazil) of windfalls is quite unique.

In most other systems, windfalls are excluded from income. This is understandable for schedular systems since windfalls typically fall outside the schedules. But windfalls tend to be excluded even in global tax systems that define taxable income as any item of income with a source. In fact, windfalls do not have a "source."[39]

[38] Taking into account 3 percent appreciation a year.

[39] This is similar to the U.S. treatment before *Glenshaw Glass*.

In **Canada, Australia,** and the **United Kingdom**, common law countries that historically began as schedular tax systems, personal windfalls are not included in taxable income. The justification for such exclusion is based on the notion that if economic gain is to be defined as "income," it must have a "source":

> Over forty years after Glenshaw Glass, the Supreme Court of Canada has recently confirmed in a number of cases that accretions to wealth such as windfalls that lack a source do not have the character of income for tax purposes. Indeed, the concept of income adopted by the U.S. Supreme Court in Glenshaw Glass explains the different organization of material found in basic Canadian tax texts compared to their American counterparts. In Canada we are familiar with texts and casebooks that divide the discussion of income into the traditional sources of employment, property, business, and capital gains; basic American texts are much more likely to discuss the characteristics of a global concept of gross income and then discuss separately deductions and the recognition of gains and losses.[40]

Indeed, **Canadian** cases such as *Queen vs. Cranswick* (40 N.R. 296) employ a strict approach, according to which "income from a source will be that which is typically earned by it or which typically flows from it as the expected return." Obviously, windfalls do not typically produce income nor expected return.[41]

It is likely that this quest for source reflects the fact that the systems derived from the United Kingdom were originally schedular systems, in which each schedule represented a different source of income. Thus, although schedular and global systems have converged in many aspects, and previously, schedular countries have adopted global regimes, the origins of each system can still be perceived in the treatment of items such as windfalls.

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[40] Kim Brooks, *Book Review: Tax Stories: An In-Depth Look at Ten Leading Federal Income Tax Cases Paul L. Caron, Ed. New York: Foundation Press, 2003*, 28 Queen L. J. 705 (2003).

[41] In the *Carnswick* case, the respondent owned shares in a Canadian corporation, which the majority of its shares were owned by a U.S. company. Pursuant to a plan of acquisition of the Canadian corporation by a third party, and in order to please dissenting shareholders of the Canadian corporation (including the plaintiff), the U.S. parent company offered to buy the shares of the Canadian corporation or, as an alternative, to pay the minority shareholders $3.35 per share. The plaintiff elected to keep his shares and received $2,144 from the U.S. company. The issue was whether this amount was income in the respondent's hands. The Federal Court of Appeal held that it wasn't, that since the payment "was of an unusual and unexpected kind, one could not set out to earn as income from shares, and it was from a source to which the respondent had no reason to look for income from his shares." In the United States, such a payment would clearly be income.

Another interesting example with this respect is the **Israeli** system. Even though windfalls are generally excludable under Israeli law, the Income Tax Ordinance particularly addresses so-called "random business income" and prescribes that it is taxable if it is of "the nature of trade." Israeli courts have struggled quite a bit over the years to define "the nature of trade," but it is quite clear that income such as the one described in the Canadian *Carnswick* case *would have been* taxable in Israel. Israeli courts developed a series of characteristics that, when present, will tend to cause the windfalls to be includable. Generally, any income that is derived from the investment of either human or monetary capital, made with the anticipation of making profits while taking risk that is economic in nature, will be taxable. Thus, compensation paid for a plaintiff, for example, as a result of a successful class action, was ruled to be includable in income.[42] Since in *Carnswick*, the taxpayer derived the income as a result of equity investment in a corporation, she would have been taxable in **Israel.** In **Israel,** probably, only literal windfalls (such as money found on the street), which had almost no chance of reoccurring, may escape taxation.

The idea stemming from this comparison is that even in systems in which windfalls are not taxed, there may be a spectrum of opinions as to what exactly "windfalls" are from an income taxation perspective.

As noted above, in a schedular system, one must point to a specific schedule in which windfall is included, in order to make it income. Attaching a windfall to an identifiable "schedule" is indeed a task for the creative and inspired. The result is that in most schedular systems, windfalls aren't taxed unless they can be classified under a specific schedule (**The Netherlands**), or if the windfall was derived in a business setting (**Germany**) such as money found in the business premises, or if the windfalls are listed in the other income category (**Italy**).[43]

One unique schedular system that found a way to tax windfalls is the **Japanese** system, in which windfall income is taxed under the schedule of "occasional income." Such a broad residual category moves the Japanese system further toward a global regime, since almost any non-scheduled item can fall into the residual schedule. This phenomenon indicates that some degree of convergence can indeed be found between global and schedular regimes.

V. DAMAGE AWARDS[44]

This subchapter addresses two basic issues: (1) taxation of damage awards for personal injury, which presents the general issue of

[42] ITA 1109/04 *Keren Haim v. Dan District Assessment Officer* (PM, 11/19/2006).
[43] For instance, lottery wins are listed and therefore taxable, while money found in the street is not listed and therefore is not taxable.
[44] *See generally* THE WEB GUIDE BOOK FOR PERSONAL INJURY COMPENSATION IN

distinguishing true compensation from taxable income; and (2) the "damage awards" that receive favorable treatment—only compensation for physical injuries or also nonphysical injuries.

A. Taxation of damage awards

The general question of taxation of damage awards revolves around two issues: (1) the general treatment of damage awards (are damage awards includable?) and (2) the case of deferred damage compensation.

1. The treatment of damage awards

Under **U.S.** Code § 104 and the U.S. case law, compensatory damage awards are excluded from income, while punitive damages are included. Arguably, from a pure tax perspective, the policy embedded in Code § 104 seems to be incorrect. Code § 104 excludes *all* (nonpunitive) damage awards (we will deal with the definition of damage awards later). Such a broad exclusion is not compatible with basic income tax principles. Namely, such awards usually represent, at least in part, compensation for lost income that otherwise would have been taxable. One might argue that at least the portion of the award attributable to "otherwise earned income" should be taxed. On the other hand, social values may support the current policy.[45]

Similarly, under **Brazilian** law, the following payments related to damage awards are exempt from income tax[46]: compensation for injury, disability, or death or an asset damaged or destroyed as a result of an accident, until the limit of judicial condemnation, except for payment of continuing obligation in relation to the accident; and compensation for accidents at work. The following are also not taxable: compensation for repairing damaged property due to termination of contract, payments made to civil servants as an incentive to adhere to voluntary employment termination programs,[47] compensation paid and the notice for dismissal

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EUROPE, published by the *Pan-European Organization of Personal Injury Lawyers*, and available on its Web site at http://www.peopil.com/pdf/WebGuideBook1.pdf?id=978%0F%22uctname=Personal. [Hereinafter: THE GUIDE] An extended hard-cover version of THE GUIDE was also published as by Kluwer Publishing under the title PERSONAL INJURY COMPENSATION IN EUROPE: A COMPARATIVE GUIDE TO COMPENSATION PAYABLE IN EUROPEAN COUNTRIES TO VICTIMS OF ACCIDENTS (M. Bona & P. Mead eds., 2003).

[45] For a comprehensive discussion on tax policy considerations with respect to damage awards *see* Douglas A. Kahn, *Compensatory and Punitive Damages For A Personal Injury: To Tax Or Not To Tax?*, 2 FLA. TAX REV. 327 (1994).

[46] Art. 39 (IX) Brazilian Income Tax Law. https://www.planalto.gov.br/ccivil_03/decreto/D3000.htm.

[47] Although the law states that only payments made by state-owned companies to its employees are tax exempt, the courts has extended that right to employees that adhere to employment termination programs carried out by

or termination of employment contract, and compensation received for settlement of loss or theft on insured goods.

On the other hand, in several tax systems, the portion of the award representing loss of income is taxed as ordinary income.

For example, according to the **Italian** system, damage awards are taxable to the extent that they compensate for the loss of taxable income and are included in the same category of income that they compensate for. On the other hand, damage awards that compensate patrimonial losses (*dammus emergens*) are not taxable.[48]

Belgium has adopted a similar approach: "Under Belgian law . . . [The] part of the personal injury award which replaces any loss of income is taxed. Generally, loss of future earnings is calculated on the basis of net wages . . . Personal injury awards for pecuniary losses are taxed in the same manner as the income they replace."[49]

Israel takes also a similar approach. The Supreme Court clearly stated that damage awards are only taxable as long as they compensate for the loss of otherwise taxable income[50] (note that any excess compensation may still be taxed, as we have seen, as income with the nature of trade).

The **Dutch** system is somewhere in between a total exemption of damage awards and the taxation of all awards replacing lost earnings. "When calculating loss of earnings, the starting point is the net income of the victim, after deduction of tax, social insurance and pension contributions. Where the net loss is known, the influence of taxation is minimal."[51]

Consider the following example: A was injured and was awarded damages by a court order. Due to his injuries, he was absent from work for a month, a period in which he would have earned 10,000 Euros. His tax rate is 50 percent, which would have left him with 5000 Euros net income for that month. Assume A received $20,000 in damage awards—how much (if any) is taxable under the **U.S., Italian, Belgian** and the **Dutch** systems? In the **United States,** under § 104, the entire amount is excludable. Under the **Italian** and **Belgian** systems, $10,000 is includable since it represents lost income. Under the **Dutch** system, only $5000, the net loss after tax, is taxable. The idea behind the **Dutch** system is

companies. The rationale is that the employee is giving up his right and, therefore, the payment is not an accession to wealth (or income for that matter), but a simple reimbursement of the employee's net worth.

[48] Article 6, paragraph 2, TUIR.

[49] The Guide, *supra* note 44, at p.13.

[50] CA 171/67 The Assessment Officer of Large Businesses v. Gordon 21 P.D. 186 (1967).

[51] The Guide, *supra* note 44, at p.74.

still to tax awards given in lieu of lost earnings, but in a favorable way, reflecting the type of social values underlying the **U.S.** approach.

2. The issue of deferred damage compensation

An interesting issue, which may exemplify the difference between different tax systems, arises in cases where damages are paid in the form of an annuity. Periodic payments resemble periodic income and thus are more "suspect" of being "pure" income rather than damage restoration. § 104(a)(2) of the U.S. I.R.C. actually induces periodic payments by excluding the entire periodic amount (even though such payments may include an interest component). Thus, a periodic payment may be even more favorable for the taxpayer than a single payment.

In **Germany,** however, the concept of taxing damages replacing lost income extends to deferred payments as well, but the application of the tax is narrower. Under the German tax system, "annuities for damages will only be subject to income tax where they are paid as compensation for other taxable income." The German system further provides that "Annuities covering additional expenditure . . . are therefore not taxable pursuant to § 22 (1) Income Tax Act (EStG) as annuities or other recurrent payments **although from their outer appearance they are recurrent benefits. . . .** [T]hese principles will also apply to payments for pain and suffering. . . ."[52]

The **French** system goes beyond the German one to include any periodic payments for damage awards in income, as such payments reflect a periodic concept of income.[53] Indeed, it can be argued that periodic payments for damage are less likely "recovery of human capital," because if the payment is aimed at making a person "whole" again, one should expect that an injured person would prefer to be "whole" as soon as possible and not defer his recovery.

In **Brazil,** as mentioned above, compensation for injury, disability, or death, or an asset damaged or destroyed as a result of an accident (until the limit of judicial condemnation), is not taxable except for payment of continuing obligation in relation to the accident.

B. Which "damages" receive favorable treatment? physical? mental? reputation?

Section 104 of the U.S. Code specifically states that only awards for physical damages are excluded from income. This is a result of a change made by Congress in 1997 (previously, all nonpunitive damages

[52] THE GUIDE, *supra* note 44, at p.44., emphasis added.
[53] AULT & ARNOLD, *supra* note 22, at 192.

were excluded). The issue was discussed in the much publicized *Murphy* case. In *Murphy*, a three-judge panel of the U.S. Court of Appeals for the DC circuit held that including damages for nonphysical injuries in income was unconstitutional because such damages were not "income" under the Sixteenth Amendment. The result in *Murphy* launched an intense debate over the question, with most academic commentators sharply criticizing the outcome of the case. This eventually led the DC Circuit Court, sitting *en banc*, to reverse the decision.[54]

Indeed, other systems (e.g., **Belgium**) allow for the exclusion of damages for nonphysical injuries. It can be argued that the **U.S.** system is generous on one hand (excluding even damages paid in lieu of lost income) and tight on the other hand (excluding only physical damages awards). Other systems balance it the other way: wide definitions for excludable damages (including damages for mental injuries) but a narrower scope of exclusion (only "punitive" damages excludable).

In general, the **European** approach (including damages in lieu of income and excluding nonphysical nonincome damages) seems more accurate from both tax and tort perspectives. The **U.S.** approach, as expressed in *Murphy*, is a distortion of tort principles, which in turn is a result of a prior distortion of tax principles. Two wrongs may offset each other a bit and give us a better result in the *aggregate*, but it does not make it right from a pure tax policy perspective (and gives us a wrong result in individual cases).

VI. CANCELLATION OF INDEBTEDNESS

The discussion on income resulting from cancellation of indebtedness revolves around two focal points: whether discharge of indebtedness constitutes taxable income, and, provided that the answer is positive, what exceptions, if any, should be allowed in special cases (such as bankruptcy and insolvency).

A. Inclusion of debt relief in gross income

When a taxpayer borrows, the loan proceeds are not treated as income because of the offsetting obligation to repay the debt. If the debt is cancelled, the offsetting obligation no longer exists, and the taxpayer

[54] *See, e.g.*, Russell F. Romond, *Income, Taxes And The Constitution: Why The D.C. Circuit Court Of Appeals Got It Right In Murphy*, 12 Fordham J. Corp. & Fin. L. 587 (2007); Elisabeth A. Rose, *Murphy's Mistakes: How The Circuit Court Should Analyze Section. 104(A)(2) Upon Rehearing*, 60 Tax Law. 533 (2007); *But see* Gregory L. Germain, *Taxing Emotional Injury Recoveries: A Critical Analysis Of Murphy v. Internal Revenue Service*, 60 Ark. L. Rev. 185 (2007).

realizes a net accretion to wealth. As stated by the U.S. Supreme Court in *Kirby Lumber*,[55] the result is realization of taxable income (see Code § 61(a)(12)).

However, as simple as the principle may seem, the mentioned tax problem is approached very differently by global and schedular income tax jurisdictions.

Most countries defining income based on the global model consider cancellation of indebtedness taxable income (similar to any other accretion of wealth), unless a specific exception applies.

Most countries defining taxable income based on the schedular model consider cancellation of indebtedness taxable income only if it is specifically included in a taxable schedule.[56]

Very broadly, it has been observed, with some exceptions, that in schedular systems, income from the cancellation of indebtedness is taxable only if the debt is related to the production of business income. On the contrary, cancellation of personal indebtedness (which is indebtedness unrelated to the production of business income) does not constitute taxable income. The principle behind this tax solution is similar to the principle guiding the tax treatment of windfalls. Since the taxpayer expectation at the time the loan is made is to repay the debt, debt relief can be seen as an unexpected "windfall." As long as this sort of windfall cannot be attributed to a specific schedule, it remains untaxed.

Although a relatively bright line can be drawn between schedular and global systems in this context, there are some exceptions. Notably, the tax systems of commonwealth countries (**Australia, United Kingdom**, and **Canada**) treat forgiveness of indebtedness along the same lines of the distinction between capital and ordinary gains. Cancellation of debt in the context of business income, such as accounts payable, will always be treated as ordinary business income. However, in the capital gains context, the cancellation is applied to reduce tax attributes (such as capital losses, carry-over basis, credits, etc.).

For example, in the **United Kingdom,** cancellation of indebtedness is taxed only in very specific cases, such as when the debtor and the borrower are related parties. Any other relief is not taxable, but it reduces tax attributes of the taxpayer. Even if the relief is in excess of the tax attributes, there is no taxable income.[57]

In **Canada,** only half of the relief is included in taxable income. This approach does not treat debt relief on investments as a realization event but also takes the necessary measures to prevent debt relief from

[55] United States v. Kirby Lumber Co., 284 US 1 (1931).

[56] AULT & ARNOLD, *supra* note 22, at 189.

[57] AULT & ARNOLD, *supra* note 22, at 190.

becoming a tax-evasion strategy (by deferring the tax to when the assets whose basis was reduced are sold).

B. Exceptions to inclusion

Even though cancellation of indebtedness is taxed in most countries as a general rule, both schedular and global systems adopt exceptions when the taxpayer is bankrupt or insolvent. This is a good example of tax policy convergence.

In the **United States,** Code § 108 provides for attribute reductions in cases of bankruptcy or insolvency, similar to the treatment generally granted by the **United Kingdom** outside of the bankruptcy context. Indeed, most countries give some sort of relief to taxpayers in financial duress. Even if the extent of this relief may vary, generally the nontaxation of this debt relief is accompanied by a reduction of tax attributes.

The rationale for such easement is quite straightforward: if a taxpayer is unable to settle a debt due to financial hardship, he or she will not be able to pay the tax on any income derived from relief from the debt. If the aim of any relief from debt is to allow the borrower to "start over" and be financially rehabilitated, the rationale is that the tax system should not impede such attempts.

However, a remarkable exception is offered by the **French** system, under which any cancellation of business indebtedness is included in gross income, even if the taxpayer is insolvent.[58] It may well be argued that such an approach may hamper any attempt to recover a distressed business, but it may also serve as a powerful anti-avoidance tool.

VII. GIFTS AND BEQUESTS

The treatment of gifts and inheritances, as we shall see, are places where redistributive ideologies and taxes are intertwined. Political ideologies and political cultures greatly affect taxes on gifts and bequests. The key tax issue involving gifts and bequests is who (if anyone) bears the tax appreciation of the gift or deducts the loss if a gift is depreciated relatively to the donor's basis.

There are at least three approaches to taxing gifts and bequests from an income tax perspective[59]: (1) no inclusion for the transferee and no deduction for the transferor, (2) inclusion for the transferee and

[58] AULT & ARNOLD, *supra* note 22, at 190.

[59] AULT & ARNOLD, *supra* note 22, at 183. We ignore estate taxes for this purpose, although they are obviously relevant from a broader social perspective.

deduction for the transferor (there is also the possibility here to treat the gift as a simple realization event in which the transferor would have to include any appreciation of the gift in his hands), (3) any combination of the first two that would not stand in line with pure tax theory but would encourage other ends or be more administratively feasible.

As in most systems, we shall deal separately with personal gifts and commercial gifts, since the issues raised by each are different.

A. Personal gifts and bequests

In the **U.S.,** under Code § 102 and § 1015, gifts are not deductible and are excluded from income. Thus, gift appreciation is carried over and taxed to the donee, but losses are not carried over under Code § 1015. In the case of bequests, Code § 1014 provides for a stepped-up basis, and therefore the appreciation is not taxed to either transferor or transferee.

Some countries adopted systems similar to the U.S. one. For example, in **Brazil,** gifts and inheritances received by resident individuals are exempt from income tax.[60]

However, it should be noted that in a schedular system, the issue is raised a bit differently.[61] The issue of income inclusion would arise only if the receipt falls within a particular schedule.

Thus, in **The Netherlands,** for example, the carryover of tax attributes of the gift happens only if such a transaction would have been taxable had it not been a gift. Otherwise, this issue is simply ignored.

The **U.S.** system of no inclusion/no deduction can be justified by the argument that the appreciation will ultimately be taxed. The U.S. approach prevents the possibility of income shifting through "loss gifts" and does not create negative incentives for "real" gifts made out of pure affection. The Code § 1014 rule is based on the argument that it makes it administratively easy to determine basis, rather than looking for historic basis of the deceased. This is a "mixed" system, since appreciation would always be taxed while losses may be unusable for tax purposes. It is also inconsistent with Haig/Simons (which would include gifts and bequests in income).

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[60] IBDF. Latin-American Taxation: Brazil. http://ip-online.ibfd.org/la/and Art 39 (XV) of Brazilian Tax Law. Regulations. Nevertheless, in order not to be subject to income tax, the beneficiary of the gift or inheritance must keep the historical value that the goods or rights inherited/donated had in the hand of the donor/deceased. If the beneficiary chooses to valuate the goods or rights received at market value, she will be subject to capital gains tax at the amount of the positive difference between the two amounts.

[61] AULT & ARNOLD, *supra* note 22, at 183.

The U.S. solution has also some disadvantages: the case of gifts raises administrative difficulties in determining the basis of the donor in a gift (if it has been a long time since the gift was transferred until the date of disposition by the transferee). Most obviously, it defers the tax by not treating the gift as realization, and in the case of bequests, it provides for exemption.

Thus, other systems adopted methods under which gifts, inheritance, or both are taxed. In this respect, countries choose different paths. In most commonwealth countries, gifts are treated as simple realization events. The tax burden, therefore, is laid at the doorstep of the donor.

In **Australia,** for example, any *inter vivos* gift is treated as a realization event. The donor is taken to have received the fair market value (FMV) of the gift and pays tax on the excess of the FMV over the basis.[62] Hence, no appreciation avoids taxation. As a corollary, the donee is attributed with a FMV basis in the gift.

The same method is implemented in the **United Kingdom**[63] and in **Canada.**[64] Inter vivos gifts are treated, albeit with some exceptions,[65] as realization events.

The rules are different for bequests. In **Australia,**[66] any capital gains or losses resulted from a transfer of property at death are generally ignored if the assets are transferred to a "beneficiary," which, according to Australian law, is "a person entitled to assets of a deceased estate. [This person] can be named as a beneficiary in a will or can be entitled to the assets as a result of the laws of intestacy (when a person dies without having made a will)."[67] Due to multiple legislative reforms, the calculation of basis in the hands of the recipient is complex, but the general rule is that the basis carries over. So, unlike the **United States,** no appreciation can avoid tax (even though it may well be deferred, in case of bequests, for a long time).

In **Canada,** however, transfers at deaths, just as *inter vivos* gifts, are treated as realization events. This is probably more "tax accurate," and the least favorable for wealthy families, and can also be understood as a means for redistribution of wealth achieving a higher level of vertical equity.

Other countries, particularly civil law countries, burden the recipient rather than the donor. For example, in **Russia,** there is no inheritance or

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[62] Australian Taxation Office, Guide to Capital Gains Tax 2007, 11 (2007).
[63] HM Revenue and Customs, capital gains manual, CG12922, http://www.hmrc.gov.uk/manuals/CG1manual/CG12922.htm.
[64] Canada Revenue Agency, Gift and Income Tax, P113(E) Rev. 07, http://www.cra-arc.gc.ca/E/pub/tg/p113/p113-e.html.
[65] HM Revenue and Customs, capital gains manual, CG12925, http://www.hmrc.gov.uk/manuals/CG1manual/CG12925.htm.
[66] Australian Taxation Office, Guide to Capital Gains Tax 2007, 95–98 (2007).
[67] *Id.* at 95.

gift tax (provided that such inheritances are not awards payable to a taxpayer for inheritance of intellectual property held by the deceased such as copyrights[68]). However, gifts of immovable property, vehicles, and shares received from individuals other than close relatives (i.e., spouse, parent/child, grandparent/grandchild, or sibling) are subject to income tax under the general provisions. Gifts received from individual entrepreneurs and legal entities are exempt up to RUR 4000 per calendar year. The excess is taxed at the general rates of income tax (13 percent for residents and 30 percent for nonresidents).

Of course, for schedular income tax systems, this is true only if the transaction falls within a particular schedule. Otherwise, it is exempt. This is the case in **Italy,** where gifts are generally not taxable (for income tax purposes), unless appreciated assets are gifted within a business or from a business to a stockholder. In this case, gains are realized and recognized and are part of the business income schedule if certain requirements are met.

In **Germany,** for example, "[T]he gift tax supplements the inheritance tax. It is necessary so that inheritance tax for a future right to inherit cannot be avoided through gifts amongst the living. It therefore corresponds that gifts amongst the living are subjected to the same measures of taxation as acquisition through death."[69] Unlike the commonwealth countries, the tax is levied on the heirs. Every inter vivos gift is subject to a gift tax, payable by the recipient. Taxes are assessed based on the FMV of the gift or bequests,[70] net of any liabilities and expenses incurred in connection with the claim for the inheritance or gift. However, recipients are allowed certain exemptions (for example, 307,000 euros if the recipient is the spouse of the donor), and the tax is levied only on the excess over the exemptions.

China offers another example of a schedular system, where taxable items of individual income tax do not include gifts and inherences.

In **Israel,** gift transactions are exempt as long as the gift is made to the state of Israel or to a relative or when the gift is made "with good faith" with no expectation that the donee will curry favor in return. In most of such cases, the basis simply carries over to the donee.

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[68] §217(18) RTC.

[69] German Ministry of Finance, The Tax Department, The Tax Information Center, INHERITANCE TAX/GIFT TAX, *available at* http://www.steuerliches-nfocenter.de/en/003_menu_links/002_ISt/005_ertunab/054_SchenkErbSt/index.php.

[70] The EC's Taxes in Europe Data Base, GERMANY—CAPITAL TAX—INHERITANCE AND GIFT TAX (updated 2007), *available at* http://ec.europa.eu/taxation_customs/taxinv/getcontents.do?mode=normal&kw1=gift&kw2=-&kw3=-&coll=VERITY_DE+-+Capital+tax+-+Inheritance+and+gift+tax.

Some countries simply ignore gifts or inheritance for tax purposes altogether. **Sweden** abolished both the inheritance and gift tax in 2004.[71] The only relevance for taxation is that basis is being carried over and that recipients step into the shoes of the donors. Thus, no country follows the **U.S.** system, which may itself be subject to change as the estate tax is scheduled for reform.

B. Commercial gifts

In a commercial setting, the differences between countries' approaches to the taxation of gifts (for income tax purposes) are far less apparent. As a general rule, most countries adopt the inclusion/deduction rule, which make sense because in a business environment, gifts are rarely made out of affection, with no valuable consideration expected in return. Thus, most countries treat commercial gifts as a taxable transaction but may allow, in the case of small gifts, certain exemption for the recipients.

In the **United States,** Code § 274(b) is in line with the above principle. The disallowance of deductions makes it clear that one cannot treat a gift as both not included and deductible at the same time. This forces transfers to be either "real gifts" or "real business expenses."

As noted above, this policy is implemented in most countries. It is interesting though, from a cultural perspective, to note what kinds of exemptions/deductions are allowed for commercial gifts and what exactly constitutes a "gift" under local law.

For example, in the United States, Code § 102(c) completely rejects the notion that transfers in an employment relationship can be a "gift."

In **Germany** and **France,** however, gifts are still gifts (even between employer and employee) unless it is shown that the "gift" is directly related to a service rendered (and then it is treated as compensation). Compare Code 274(j) in this respect, which precludes deduction for achievement awards.

Most systems provide de minimis rules where small gifts are not includable for the employee (in the **United States,** it may be covered by Code § 132).

In **The Netherlands** or in **Italy,** small gifts given to employees on special occasions are exempted.

The de minimis amounts gifted to the employees may be even deducted by the employer, which creates double benefits that can be seen as a policy intended to encourage better labor relations (**Canada**—CAD 500; **Germany**—EUR 40).

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[71] Swedish Tax Agency, TAXES IN SWEDEN 11 (2006). In **Israel,** the taxation of inheritances was abolished even earlier—in 1981.

In the **United States,** Code § 274(b) allows de minimis deductions for gifts, made to someone other than employees, if the logo of the donor is shown on the gift. In other words, it is a small subsidy for public relations expenses.

As noted, in **Germany** and **Canada,** the small deduction is allowed only if gifts are made to employees. This is a consequence of the cultural and political differences in the approach to labour relations issues.

VIII. THE REALIZATION REQUIREMENT

Realization has been described as the "Achilles' heel" of the income tax. It is no longer considered a constitutional requirement in the **United States,** and there are several accrual- or mark-to-market–based aspects of the U.S. tax system (e.g., the treatment of dealers in securities under Code § 475 and the elective mark-to-market regime for publicly traded PFICs under Code § 1296). Nevertheless, despite many suggestions to the contrary, the United States has remained largely a realization-based system. Moreover, compared to other countries, the scope of realization events in the United States has been limited to the actual sale or disposition of property, although the "realization trigger" has been lowered under the Supreme Court's decision in *Cottage Savings*[72] to include various deemed realizations (such as debt modifications).

In both common and civil law countries, while the income tax remains a transactional tax and incorporates a realization requirement, the scope of realization events tends to be broader than in the United States. For example, gifts are considered realization events for property in **Australia, Canada,** and The **Netherlands.** Death, which in the **United States** is not a realization event even though it gives rise to a step-up in basis under Code § 1014, is a realization event in **Canada** and **The Netherlands.**

Other realization events involve attempts to police the jurisdictional scope of the income tax. Emigration, which involves for most countries the cessation of personal jurisdiction to tax, is a realization event in **Israel, Australia, Canada,** and **Germany** (for substantial stock holdings). Withdrawal from a business, which involves the end of business level taxation, is a realization event in **Canada, France, Germany, Italy, The Netherlands,** and **Sweden.** Notably, the **United States** has recently (after many years of rejecting such proposals) adopted expatriation as a realization event for high net worth individuals (Code § 877A).

Nevertheless, despite the different scope of defining realization, it is noteworthy that mark-to-market—or accrual-based regimes are quite rare. For example, it has been argued that it would be relatively easy to

[72] Cottage Savings Association vs. Commissioner, 499 US 554 (1991).

adopt such a regime for the stock of publicly traded corporations because in that case, there are no liquidity or valuation concerns (the stock can easily be sold, and its value is established every day). Such a reform could enable countries to abandon the corporate income tax with its attendant complexities and inefficiencies. But no country we are familiar with has adopted this proposal, despite its congruence with the Haig/Simons ideal. It may be that political resistance to paying tax on "phantom income" (which may disappear with the next market downturn) is too entrenched. Realization, it seems, is here to stay.