INTERACTIVE CASEBOOK SERIES

Federal Income Tax

A Contemporary Approach

Samuel A. Donaldson
Donald B. Tobin

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THE INTERACTIVE CASEBOOK SERIES™

FEDERAL INCOME TAX

A Contemporary Approach

By

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Mat #40766988

610 Opperman Drive
St. Paul, MN 55123
1–800–313–9378

Printed in the United States of America

ISBN: 978–0–314–19883–9

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This casebook is dedicated to Professor Arthur W. Andrews, the Dorothy H. and Lewis Rosenstiel Distinguished Professor Emeritus of Law at the University of Arizona James E. Rogers College of Law, and Daniel Posin, formerly the Judge Rene H. Himel Professor of Law at Tulane Law School.

From Professor Donaldson

In his 44 years of law teaching, Professor Andrews introduced thousands of students, including me, to the wonderful complexity and compelling human drama that is federal income taxation. His superb instructional skills and gregarious manner inspired countless disciples, again including me, to pursue an LL.M. in Taxation and a career as a tax attorney. Professor Andrews possessed all of the qualities of a great lawyer: attention to detail, an inquiring intellect, and most importantly, both a sense of humor and a deep compassion for others. Whether he knew it or not, he was a model of professionalism and excellence for his students, again including me.

If I am fortunate enough to teach for 44 years, I doubt I will have the same influence that Professor Andrews has had. For certain, I will never have his classroom presence. Even now, more than a decade since I sat as a student in his class, I can still remember many of his unique expressions and teaching methods. Every day, students walked into a classroom with a whiteboard ***completely*** covered with charts, outlines, diagrams, and summaries. (In fact, he usually reserved the classroom for the hour before his classes just to have the time to prepare the board for each class session.) As if by magic, Professor Andrews turned this mountain of information and numbers into something meaningful and useful for students. Upon the conclusion of each class session, Professor Andrews dismissed the class with his trademark signoff, "Peace." By that time, students had ten pages of notes, a better understanding of the material, and writers' cramp.

It seems most fitting, therefore, that a text created to assist in the learning and teaching of federal income taxation be dedicated to one of the premier tax teachers and scholars. Thanks for all of your support and guidance, Professor Andrews. Peace.

SAD

From Professor Tobin

Professor Posin taught tax for over 32 years touching students at law schools all around the country, including Hofstra, San Diego, Southern Methodist, Catholic University, and Tulane, where he taught for 15 years. He touched many with his sense of humor and his ability to explain complex material in a clear way. He was my mentor in the publishing arena, bringing me on as a co-author of his treatise on federal income tax. I hope that some of Professor Posin's wit and clear thinking lives on in this book.

DBT

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Preface

> In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time.
>
> —Judge Learned Hand, *Thomas Walter Swan*, 57 YALE L. J. 167, 169 (1947).

The Function and Structure of this Book

The primary texts for any course in federal taxation are the Internal Revenue Code and the corresponding regulations issued by the United States Department of the Treasury. This book serves as a supplement to the Code and regulation provisions applicable to the federal income taxation of individuals. It contains various materials designed to explain and analyze the fundamental interpretive issues, doctrines, and public policies at play in this field.

Perhaps most importantly, this book offers structure, the "handle to seize hold" that Judge Hand so desperately sought. The federal income tax laws are marvelously complex, to be sure, but it is certainly possible to walk away from an introductory course in taxation with a sense of the big picture and an appreciation of some of the finer details required to make that big picture work in a complicated society.

Taxation affects all of us and is often the guiding force behind our personal and business transactions. We hate to pay taxes, but we all benefit from the revenues generated. As Oliver Wendell Holmes famously observed, "Taxes are

what we pay for civilized society." With taxes, we buy infrastructure, protection, maintenance and preservation of national parks, and other benefits we all enjoy. We also use the revenues to provide education, Medicare and Social Security benefits, although some of us get more benefit than others from these programs. We even use the tax receipts to service the national debt. Like them or not, without taxes, we revert back to a state described by Thomas Hobbes as "solitary, poor, nasty, brutish, and short."

The most significant source of revenue for the federal government is also the exclusive focus of this book: the individual income tax. General topics to be discussed include the computation of individual tax liability, the nature of gross income, statutory exclusions from gross income, deductions allowed in the computation of taxable income, basic timing and accounting issues, and characterization of income. Journalists might find this description more helpful: This book is about *what* items of income are taxed (and what types of expenses are deductible), *when* such items should be taken into account for tax purposes, *who* is the proper taxpayer to report a particular income or deduction item, *how* different types of income are taxed, and *why* the rules read as they do.

While this book hopefully facilitates your learning of the fundamental concepts related to the federal income taxation of individuals, it is no substitute for reading from the Code and regulation provisions themselves. Mere mention of the Internal Revenue Code invokes chills down many spines. Contemporary political rhetoric paints the Internal Revenue Code as something less approachable than the Old English versions of *Beowulf* and *The Canterbury Tales*. Without ever reading the Code, armchair commentators deem it overly complex and inefficient. Others point to long sentences with technical terms as they decry complexity. These commentators have scared most of us away from trying to understand the basic rules. No doubt several of your peers refuse to enroll in this course because they fear it will be "too technical," "too mathematical," or simply "dull."

There is no denying that the Code contains long sentences, and many sentences do rely upon cross-references for complete understanding. The Code is an intricate set of detailed rules, and we will now shy away from the detail in this text. But like anything in life, one can become proficient with the Code through attentive study and perseverance. By the end of your first tax course, you might even *appreciate* the Code as generally well-written and devoid of unnecessary clutter. What makes the Code so "technical" is its absence of excessive (or, to be more pejorative, "fluffy") terms that reward casual reading. Densely-packed sentences may not be the easiest to read, but they contain more information in fewer words.

Thus far in law school, you have learned how to read complicated cases, law review articles, and some statutes with an increasing degree of speed. It used to

take three or four hours to read 15 pages in a casebook—now you can do it in an hour or less. What makes this subject somewhat different is that you will have to slow back down when you read from the Code or the regulations. You will often need to read a provision twice, three times, maybe more before it makes sense. You will find exceptions to rules, exceptions to the exceptions, and, yes, even exceptions to the exceptions to the exceptions. Then, when you think you have the gist of the statute, you have to apply your understanding to a basic fact pattern. In many cases, this process helps you find the holes in your earlier analysis, and you have to return to the Code (yet *again*) to dig deeper. Reading and applying the Code and regulations is a difficult exercise, not because of the Code's "technicality," but because of the unique skills required in statutory analysis.

Maybe the source of your apprehension lies elsewhere. Some dread studying this subject because of a fear of numbers. Liberal arts majors (like one of your authors) may shy away from taking a tax course because they think they will have to perform complex tax computations. This is simply not true. Oh sure, we will use numbers to illustrate transactions, and we will perform basic computations from time to time (especially early in the book). If you can add, subtract, multiply, and divide, you can successfully complete a basic income tax course. If use of a calculator gives you an added sense of security, then by all means carry one with you. For our purposes, numbers will be used to *help* illustrate basic concepts—they will not be used to obfuscate concepts. We promise.

Let's assume you are now convinced that the Code is not "too technical," and that the course will not be "too mathematical." You may still be concerned that the course will be dull. Rest assured that nothing could be further from the truth. Professor Martin Ginsburg noted that "[b]asic tax, as everyone knows, is the only genuinely funny subject in law school." We will read funny cases, and some fact patterns will stay with you long after the exam. Beyond humor, the study of taxation involves politics, history, sociology, economics, philosophy, drama, and other disciplines. We will see how taxation intersects with corporate law, family law, health law, property law, constitutional law, and estate planning. This may in fact prove to be one of the most interdisciplinary courses you take in law school.

This text has several instructional goals, but most importantly, this book is intended to improve your ability to comprehend and apply complex statutes and regulations. It would be a mistake simply to discuss the current rules in the Internal Revenue Code. For one thing, you will forget substantially all of the rules you learn in this book within a few months. That's not meant to insult you—it's just true that most of us forget black-letter rules within a relatively short time. Besides, taxation is a highly dynamic field of law. Almost every year, Congress amends the Internal Revenue Code. Sometimes, like in 2002, 2004, and 2006, the changes are fairly minor. Other times, like in 1986, 1993, 2001, 2003,

and 2010, Congress changes the playing field dramatically. A book that simply explains the current law would have little long-term value. Regardless of how the law changes, however, a lawyer that possesses the ability to understand and apply the Code and regulations will be better prepared to handle a client's situation. Even if you do not become a tax lawyer (not everyone sees the light!), the ability to read, decipher, and apply complex statutes is an important skill that can be applied in virtually every legal field.

Many aspects of this book are dedicated to the goal of improving your skills in statutory analysis. For example, you will find several **Self-Assessment Questions** throughout the text. These SAQs are designed to measure immediate comprehension of core topics and to let you apply simple Code and regulation provisions outside of class. Answers to SAQs are set forth in Appendix 3, so you can check your answers prior to class and assess whether you need to spend additional time on certain topics. The SAQs also enhance your skills in applying laws to fact patterns.

In addition, each major section of the text contains one or more **Problems** designed for class discussion. The Problems are generally more complicated than the SAQs, and answers to Problems are not contained in the text. Instructors will likely use the Problems as the springboard for classroom discussions, as they help illustrate the Code and regulations in action. Most modern tax casebooks make extensive use of the problem method, and this text intentionally follows that trend.

Finally, consistent with other titles in the Interactive Casebook Series, this book includes hundreds of **links** to help the subject come alive for you. Sure, you can use the links to access the full text of cited cases, statutes, articles, and other materials in the Westlaw database. But you will also find links to relevant videos, photos, articles, audio clips, and other sources. Our hope is that you'll be intrigued enough to check out many of these links as you use the electronic version of this book.

As mentioned above, the other chief goal of this text is to provide you with a sense of the structure of the federal income tax laws. Accordingly, the text is formatted to provide ***three* successive passes through the federal income tax system**, each in somewhat more detail. In addition to building long-term retention, the early runs through the system allow you to see the "big picture" early on.

Part One: A First Glance. The first run through the system introduces the basic tax tables and the fundamental concepts of progressivity, marginal tax rates, and effective tax rates. You will also learn the basic formula for computing the tax liability of individuals. These materials will give you a feel for the concepts of gross

income, deductions, and credits that are developed in more detail throughout the text. The materials in the first part of the text will likely take about one week to cover in class, although instructors may spend more or less time on this material.

Part Two: A Closer Look. The second tour through the system explores the meaning of "gross income" and examines the federal income tax treatment of taxpayer costs. Here, you will read many of seminal cases defining gross income and get the chance to analyze and apply several of the principal exclusion provisions. With respect to taxpayer expenditures, the casebook presents a broad overview of the general rules followed by a detailed look at how taxpayers distinguish between business, investment, and personal activities, as well as distinguishing deductible expenses from non-deductible capital expenditures. The materials in this part of the casebook will likely consume about four to five weeks of class.

Part Three: A Hard Stare. The third trip through the system, which consumes the rest of the casebook, contains detailed examination of timing principles, characterization issues, personal deductions, and other more advanced topics. Instructors have the flexibility to mix and match the materials in this part of the casebook to customize their courses as they choose to fill the remaining four to nine weeks of class (depending upon whether the class is taught under a semester or quarter system).

Instructors teaching a very introductory (2 credit) course in federal income taxation can provide a sufficient overview simply by covering Parts One and Two of the book. If the federal income tax course is spread out over more than one term, an instructor can save many of the topics in Part Three for the second course. The text should thus be easily adaptable for all instructors.

Suggested Study Approach

Some of you might be wondering how to approach your study for this course. As a very busy law student, you want the most "bang for your buck," so to speak. You can get the most from your reading time by following this general approach for each assignment:

(1) Skim the assigned readings in the casebook. Try to get a sense of the main topic(s) covered in the assignment. Skimming the assignment lets you judge the time required to complete the assignment and helps you to budget that time effectively.

(2) Read the assigned Code and regulation provisions carefully. Relevant provisions of the Internal Revenue Code and corresponding Treasury regulations

are set forth under each major heading in the book. You should read the assigned provisions carefully, except where the book tells you merely to skim the provisions.

(3) Read the materials in the casebook, looking for connections that help explain or develop the assigned Code and regulation provisions. Answer the Self-Assessment Questions as you encounter them in the text, and read the answers in Appendix 3 (or, if you are reading the electronic version of the book, click on the link for each question to read the answer).

(4) Write out complete answers to the "Problems." Be sure to include Code, regulation, case, or other authority for your answers where appropriate. By writing out the answers, you force yourself to articulate the rules as they apply to the fact pattern contained in the Problem. You will also get practice in writing answers to questions, which will be of great help come time for exams.

(5) Go over the answers to the Problems with one or more colleagues before class. This will not only save you from the possible embarrassment of saying something blatantly wrong in class, but will also help you see other perspectives of the Problems that you may have missed.

By following these steps for every assignment, you should be well prepared for class.

Formatting

Deleted material from cases, rulings, and other original sources is replaced with asterisks (* * *). Exceptions to this procedure involve case and statute citations, as well as footnotes. These items were omitted without any specification. Footnote numbers used in cases are retained as they appear in the original opinions. Thus, the footnotes may not run consecutively.

Acknowledgments

Many current and former students at the University of Washington School of Law contributed hours and hours to review and test drive this text, and their comments were especially helpful in reaching this final product. Special thanks go to Shawn Barrett, Audra Dineen, Emily Fountain, Daniel Jenkins, and Ilesa McAuliffe for their help with collecting cases, reviewing problems, checking citations, and endless proofreading.