

FEDERAL INCOME TAXATION

PRINCIPLES AND POLICIES

REVISED FOURTH EDITION

MICHAEL J. GRAETZ
DEBORAH H. SCHENK

UNIVERSITY CASEBOOK SERIES

FEDERAL INCOME TAXATION

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REVISED FOURTH EDITION

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To our students

M.J.G.

D.H.S.

PREFACE TO THE REVISED FOURTH EDITION

This whole book is but a draught—nay, but the draught of a draught. Oh, Time, Strength, Cash and Patience!

—Herman Melville,
Moby Dick, ch. 32.

Even with more time, strength, cash, and patience, the Congress, the courts, and the Internal Revenue Service all collaborate to ensure that any book designed for teaching a basic course in Federal Income Taxation will never be more than a draft of a draft. Today, no area of law seems more susceptible to change than federal taxation. Consider the following facts reported by the Staff of the Joint Committee on Taxation: In the period from the enactment of the Tax Reform Act of 1986 until the end of the year 2000, Congress enacted nearly 100 different laws amending the Internal Revenue Code, not counting legislation affecting Social Security, railroad retirement, unemployment compensation, tariffs or customs duties, or the public debt limit. The Code currently contains about 700 provisions affecting individuals and more than 1,500 provisions affecting businesses.

As of May 2000, the Code contained 1.4 million words, making it more than six times longer than *Crime and Punishment* and considerably harder to parse. The regulations contained another 8.6 million words, spanning almost 20,000 pages. During calendar year 2000, the Treasury and IRS published 60 Treasury Decisions (containing final and temporary regulations), 45 sets of proposed regulations, 58 Revenue Rulings, 49 Revenue Procedures, 64 Notices, 100 Announcements, 2,400 Private Letter Rulings and Technical Advice Memoranda, 10 Actions on Decisions, 240 Field Service Advice documents, and a partridge in a pear tree.

For 1999 an individual filing the income tax Form 1040 could file a return with 79 lines, with 11 schedules totaling 443 lines. The schedules refer you to 19 additional worksheets. The instructions to the Form 1040 filled 144 pages of rather small type. In addition to Form 1040, 18 additional forms are commonly used by individuals.

Meanwhile, the courts have decided tens of thousands of tax cases. In 1999 alone, nearly a thousand tax bills were introduced in the Congress. And hardly a day passes without a new proposal for replacing the income tax either with some form of consumption tax or a broader-based, flatter-rate income tax.

Obviously it is impossible—and we think unwise—for a course introducing the income tax to try to instruct students about each of these devel-

opments. This book is about the fundamental concepts and forces shaping the income tax, not current events. That is why this edition reflects a remarkable continuity with its ancestor edition, Griswold's *Cases on Federal Taxation*. That book, initially published more than sixty years ago in 1940, was the first law school coursebook devoted exclusively to federal taxation. It appeared at a time when most of the operative statutory provisions were phrased in general terms and many of the basic concepts of federal taxation had not yet matured. Most law schools taught federal taxation only as part of a course that also covered state and local taxation. Nevertheless, this text retains the same overarching organization that Erwin Griswold first brought to the subject. The subsequent adoption of this structure by most income tax coursebooks is a great tribute to Griswold's insights into how the subject of federal taxation should be taught.

The mass of detail that has been added to the statute and the regulations and the burgeoning case law in the intervening six decades has required a substantial rethinking of the purposes of an introductory course in federal taxation and, hence, of this coursebook. For one thing, these details have become so voluminous and the changes so frequent that the student must necessarily strive to understand basic concepts rather than to memorize particular rules. The practice of tax law has become more specialized, and most law schools offer a number of advanced courses in taxation. The student in an introductory course therefore must attain some familiarity not only with the statute, the regulations, and the cases but also with the trends in the tax law, the prospects for change, and the fundamental policy issues that inform such changes. Successful tax lawyering inevitably will involve responding to new and unforeseeable rules and therefore will demand a basic conceptual understanding of income tax principles and policies. Likewise, the nonspecialist needs to be introduced to these fundamental concepts of income taxation, if only to be able intelligently to recognize and monitor his or her clients' tax problems.

The composition of this book has also been influenced by the increasing use of the tax law as an instrument of social and economic policy. The income tax is not merely a revenue-raising device to finance the goods and services provided by the government. The decisions of what to tax, and when, increasingly affect the direction, growth, and overall condition of our economy and the allocation and distribution of resources within our society.

For these reasons, this volume devotes substantial attention to the general principles and policies of federal taxation. Thus, cases have been supplemented with excerpts from congressional reports, administrative pronouncements, and commentaries and analyses of tax issues. In addition, there are explanatory notes introducing fundamental concepts of tax law and shorter notes following the principal cases.

This edition nevertheless continues to reflect the central pedagogical perspective developed in Erwin Griswold's original volume, the preface of which stated:

Here is an opportunity, almost unique * * *, to study a complete and self-contained system. Here is an opportunity to come into contact with perhaps our most experienced administrative agency. Here is an oppor-

tunity to deal with a statute, not as some excrescence on the common law, but as the law, to trace its growth, to learn how it is given meaning and how that meaning changes. Here is an opportunity to deal with authoritative judicial decisions—or at least, and perhaps more important, to consider how far they are authoritative * * * Here as elsewhere it is understanding and knowledge of the process that is sought.

These opportunities are no less present in this volume than they were in its ancient predecessor.

This edition retains the basic chapter organization of its predecessors. The first chapter contains the basic policy and procedural aspects of income taxation. This chapter includes a brief history of taxation in the United States, an introduction to income tax terminology, and a discussion of the roles of Congress, the executive, and the courts. Subsequent chapters explore the topics “What Is Income?,” “Deductions and Credits,” “Whose Income Is It?,” “Capital Gains and Losses,” and “When Is It Income?”. Of course, tax problems rarely can be placed into such discrete categories. Hence, there is some overlap of subjects within the chapters. Chapter 7 provides a brief description of the individual minimum tax. Chapter 8, new with this edition, contains an introduction to corporate tax shelters. We have also moved the materials on the ethical responsibilities of tax lawyers to this chapter, thereby providing an appropriate context for their analysis and discussion. The Appendix contains tables of present values.

As every teacher of taxation knows, it has become increasingly difficult to teach an introduction to federal taxation in a single semester, even in a 60-hour course. Compromises between breadth of coverage and treating at least some materials in depth are ever more necessary. Most instructors have learned to maintain limited expectations as to what can reasonably be accomplished in the first course and to assume that students with a genuine interest in taxation will take additional courses in the subject.

This volume continues the layered approach of the prior editions. By selecting from the materials available here, teachers can decide which aspects of income tax law and policy to emphasize and which to skim or even omit in an introductory course. This volume contains enough material to teach not only a four-hour basic course in federal income taxation, but also an additional three-hour course designed to pursue certain issues in greater detail than is possible in the basic course. This means that the instructor must exercise considerable selectivity in teaching any single course from this book. For example, one of us tends to emphasize Chapters 2 and 3, the first two sections of Chapter 4, the first three sections of Chapter 5, and a brief selection from Chapter 6. Another professor, who taught these materials in a two-semester course, skipped certain aspects of Chapters 2 and 3 and used only the introductory sections of Chapters 4 and 5 in the basic course, with the balance of materials used in the second course. Instructors who wish to cover more ground might consider relying on students to read some of the more straightforward materials without classroom discussion.

Designing courses inherently involves personal priorities and choices. The precise materials assigned will depend upon the teacher’s individual

choices of where to delve deeply into substantive law and policy issues as well as how to trade off in-depth discussions and general coverage. We have attempted here to provide sufficiently comprehensive, interesting, and flexible materials to allow teachers to make a wide variety of satisfactory selections.

Federal income taxation is, of course, primarily a statutory course. In addition to this text, the student will need a current edition of the Internal Revenue Code and probably will also wish to refer to the Income Tax Regulations from time to time. A number of publishers now produce one volume editions of selected statutory and regulatory provisions that may be used along with this text.

Citations and footnotes have been freely omitted and footnotes renumbered from court decisions. Dissenting and concurring opinions frequently have been omitted; however, the existence of these opinions generally has been noted to enable students to find them by consulting the original sources. When brief excerpts from opinions have been used, the page reference has often been omitted.

Preparation of a book of this sort produces many debts. Of course, we are tremendously indebted to Erwin Griswold, whose first six editions of the predecessor book were used by a substantial number of American law students. We also wish to thank both the students and faculty who have used prior editions; their comments and criticisms greatly influenced this edition. In addition to all of those who labored on prior editions to whom we remain indebted, special thanks are due to Edward Vargas, a student at New York University Law School, and to Barbara Ortiz at NYU, who worked with unfailing good humor through the preparation of this manuscript.

MICHAEL J. GRAETZ
DEBORAH H. SCHENK

July 2002

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