



West Federal Taxation

Individual Income Taxes

HOFFMAN

SMITH

WILLIS

2001
EDITION



West Federal Taxation

INDIVIDUAL INCOME TAXES

2001

E D I T I O N

General Editors

William H. Hoffman, Jr. , J.D., Ph.D., C.P.A.

James E. Smith , Ph.D., C.P.A.

Eugene Willis , Ph.D., C.P.A.

Contributing Authors

James H. Boyd
Ph.D., C.P.A.
Arizona State University

William H. Hoffman, Jr.
J.D., Ph.D., C.P.A., Retired
University of Houston

W. Eugene Seago
J.D., Ph.D., C.P.A.
Virginia Polytechnic
Institute and State University

D. Larry Crumley
Ph.D., C.P.A.
Louisiana State University

David M. Maloney
Ph.D., C.P.A.
University of Virginia

James E. Smith
Ph.D., C.P.A.
College of William and Mary

Steven C. Dilley
J.D., Ph.D., C.P.A.
Michigan State University

William A. Raabe
Ph.D., C.P.A.
Samford University

Eugene Willis
Ph.D., C.P.A.
University of Illinois at Urbana

Mary Sue Gately
Ph.D., C.P.A., Emeritus
Texas Tech University

Boyd C. Randall
J.D., Ph.D.
Brigham Young University



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Acquisitions Editor:	Scott Person
Developmental Editor:	Rebecca von Gillern
Marketing Manager:	Jennifer Codner
Production Editor:	Rebecca von Gillern
Manufacturing Coordinator:	Doug Wilke
Internal Design:	Carolyn Deacy Design, San Francisco
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Preface

For twenty-three years running, the WFT (*West Federal Taxation*) series has helped more than one million students discover the intricacies and master the ever-changing nature of Federal taxation. This 2001 Edition continues to offer comprehensive coverage that is unparalleled, while also presenting information in a manner students find accessible and understandable. Often emulated but never duplicated, WFT grew from a single textbook on Corporations, Partnerships, Estates, and Trusts with an accompanying solutions manual to include four major textbooks and a package of more than 50 outstanding ancillaries. With the 2001 Edition, South-Western College Publishing continues to build on the quality of the materials and to add timely innovations that improve on instruction and make learning more engaging.

WFT: Individual Income Taxes has, in its more than two decades, served as an ideal basis for a first course in Federal taxation for undergraduate or graduate accounting, business, and law students. Simple modification in the coverage of the materials also allows the book to be used in a survey course on Federal taxation for undergraduate or graduate students. Because of the book's numerous clarifying examples and real-world problems, many find it to be a valuable tool for self-study.

This 2001 Edition is thoroughly up to date in its incorporation of the recommendations of the Accounting Education Change Commission (AECC) and the American Institute of Certified Public Accountants (AICPA). The enhanced pedagogical features that support these recommendations assist students in the learning process, helping them to see beyond textbook examples to the *real* application of the tax law presented. (See the Enhanced Pedagogical Plan section for more information on these features.)

As important as it is to incorporate the recommendations of the AECC and AICPA, it is equally essential to provide you with the most up-to-date information relative to statutory, judicial, and administrative changes in the Federal tax law. While this edition was up to date at its printing, the ever-changing nature of the law requires that it be continually updated as to changes. Our WFT Web site, <http://tax.swcollege.com> offers instant access to updates; in addition, hard copies of the updates will be sent out to all adopters of this text, ensuring that an important change in Federal tax law will not be overlooked.

Though the primary emphasis of the textbook is on basic tax concepts and the income taxation of individuals, Chapter 20 provides an overview of the Federal income taxation of other forms of business organization (corporations and partnerships). This chapter could be of particular significance to students who do not plan to take a second course in Federal taxation. For others, Chapter 20 may serve as a lead-in to *WFT: Corporations, Partnerships, Estates, and Trusts*.

ENHANCED PEDAGOGICAL PLAN

The outstanding pedagogical features in WFT not only serve to improve student comprehension of topics presented, but do so while addressing the recommendations of the AECC. From key terms to complex projects to the incorporation of multimedia, WFT's pedagogy is unrivaled in its range of exercises, problems, and issues presented.



- **NEW! WebTutor** is now available with the 2001 Edition. Take full advantage of the in-depth, on-line resource WebTutor offers. Post course materials, purchase and download study guide chapters, expand knowledge and skills with on-line quizzing, and much more. Visit our Web site at <http://tax.swcollege.com> today and learn about how WebTutor can improve your overall tax course experience!
- Solutions to **Research Problems** can be prepared using either the *RIA OnPoint System 6 Student Version CD-ROM* or the *CCH U.S. Master Tax Guide Plus™* on-line. The RIA CD-ROM is an abbreviated version of the highly acclaimed professional computerized tax research library. It contains all the necessary cases, Revenue Rulings, and Revenue Procedures to provide learners with a realistic environment for the tax research process. The *CCH U.S. Master Tax Guide Plus* offers content similar to the RIA Student Version CD-ROM with the convenience of on-line access anytime, anywhere. Both the *RIA OnPoint System 6 Student Version CD-ROM* and *CCH's U.S. Master Tax Guide Plus* are available to be packaged with the 2001 Edition.
- **International Implications.** This exciting addition to the WFT series underscores the fact that all taxpayers and entities operate in a global environment and economy. These interesting features enlighten and inform the reader of other countries' approaches to key taxation issues and the possible implications on U.S. and, in some cases, foreign taxpayers.
- **On-Line Tutorials.** Additional support material is available for students at our WFT Web site: <http://wft.swcollege.com>.
- **Tax Planning Considerations.** Since the early 1980s, WFT has recognized and emphasized the importance of careful tax planning. As a result, most chapters include this separate section which calls attention to this ever-growing area. Additionally, tax planning applications and suggestions appear throughout each chapter.
- **Internet Exercises.** Some questions found in the Research Problems for each chapter require the use of the tax resources on the Internet. These exercises are identified with a "globe and computer mouse" icon.
- **Communication Assignments.** Identified items in the Problem Materials include a written communication component, reflecting the increased emphasis on communication in accounting and tax education. Selected Problems, Cumulative Problems, and Research Problems are identified as communication assignments with a "scroll" icon and require the preparation of a tax client letter, a memorandum for the tax files, or other written materials. An illustration of a client letter and memo is included in Chapter 2.
- **Ethical Considerations.** Many issues do not have just one correct answer. Because of this, Ethical Considerations present thought-provoking situations related to chapter topics. The questions raised should spark discussion and offer an opportunity for oral debate, leading to an examination of various value systems. The *Instructor's Guide with Lecture Notes* contains guidance for discussions by identifying issues raised in Ethical Considerations and, where appropriate, recommends a solution or alternate solution.
- **Decision-Making Problems.** These are designed to enhance analytical skills and are part of the Problem Materials. Decision-Making Problems are earmarked with a "scales" icon.
- **Issue Recognition Questions.** The Problem Materials include questions designed to help identify important tax issues. The questions, noted by a "light bulb" icon, are multifaceted and generally have no single right answer.
- **Team Projects: Arthur Andersen Tax Challenge Cases.** This feature offers a valuable opportunity to work as part of a team to solve complex, real-world

tax problems. Each year four cases and their solutions are available at no cost through your South-Western representative. Cases may be reproduced as necessary for classroom use.

- **Learning Objectives.** Each chapter begins with helpful learning objectives that provide guidance in learning key concepts and principles.
- **Chapter Outlines.** Material in each chapter is highlighted by a topical outline, complete with page references that allow ready access to each topic.
- **Chapter Introductions.** Material in the current chapter often is linked to those preceding it through the introductions, which frequently include real-world examples that convey the relevance of the material.
- **Margin Notes.** To serve as a guide through the chapter, learning objectives appear in the margins where the related material is introduced.
- **Tax in the News.** Drawn from today's business and popular press headlines, this boxed feature enlivens text discussion by presenting current issues that highlight the chapter material.
- **Key Terms.** Whenever a key term is introduced in a chapter, it is presented in bold print and is later defined in the Glossary (Appendix C). A list of key terms with page references appears before the Problem Materials in each chapter.

SPECIAL FEATURES

A variety of other pedagogical tools are used to assist in the learning process. Although content is key, in the 2001 edition we continue to stress readability. The text and its supplements are further improved to make them even more readable and understandable. Features that enhance the readability of the text include:

- Bold print to highlight key terms the first time each is used. Key terms are defined in the Glossary.
- Italicized key words emphasize their importance.
- Avoidance of legal terminology except where necessary.
- Concept Summaries in chart or tabular form to synthesize important concepts.
- Exhibits, Figures, and Tables to enhance and simplify material.
- Frequent use of examples to illustrate the tax concept being discussed.

Today's environment requires a mastery of the methodology of tax research and the ability to utilize it with skill. Because of this increased emphasis on research, Chapter 2 and Appendix E are devoted to this methodology. Also, most chapters contain Research Problems that require the use of various research tools. While we feel it is important that a basic course in Federal taxation include coverage of tax research procedures, instructors who wish to do so can omit this subject without impairing the continuity of the text's remaining materials.

Although WFT is not oriented toward the preparation of tax returns, some familiarity with tax forms is helpful. For this reason, the text includes tax return problems in chapters where appropriate. For the reader's convenience, Appendix B contains a full reproduction of most of the available tax forms frequently encountered in actual practice. These problems can be solved manually or by using the tax return preparation software (*Tax Preparation with TurboTax® for Windows®*) separately available to those who use the text.

Two newly developed comprehensive tax return problems are included in Appendix F. These problems are ideal for use as term projects as they reflect many of the issues encountered in everyday situations. Solutions to the problems in

Appendix F are in the *Instructor's Guide with Lecture Notes* as well as on our Web site in the instructor's resource section.

Most tax texts are published in the spring, long before tax forms for the year are available from the IRS. To allow the user exposure to the most current tax forms, we provide adopters with new problems along with blank tax forms and solutions on the latest forms. Shortly after the beginning of 2001, the *Tax Legislation Update and Forms Problems Supplement* will be issued containing these tax return problems solved on 2000 forms.

SUPPLEMENTS

WFT offers more supplements and educational ancillaries than any other publisher. Because of this, our ancillary package provides you and your students a total solution.

Instructor Supplements

- The *Instructor's Guide with Lecture Notes* contains lecture notes for each chapter, comments on the Ethical Considerations posed in the text, materials on the Arthur Andersen Tax Challenge Cases, and solutions to Research Problems and Comprehensive Tax Return Problems. The lecture notes are in the form of a lecture outline that the professor can use as the basis for the classroom presentation. The lecture notes also have material not covered in the text and various teaching aids. The lecture notes also are available on disk and on the WFT Web site.
- *WFT On-Line* (<http://wft.swcollege.com>) offers immediate access to current information as soon as it is available. Qualified adopters can log on and gain instant access to the most recent tax information available, including the Code and Regulations, case citations, new court rulings, and other newsworthy items. This information can be transferred to word processing programs for editing, printout, and classroom use. Instructors can also access the *Instructor's Guide with Lecture Notes*, *Solutions Manual*, *PowerPoint slides*, and extra test questions.
- The *Solutions Manual* features problem solutions arranged in accordance with the sequence of the material in the chapter. A matrix labels the problems by topical coverage and also reflects which are new, modified, or unchanged from the prior edition. The matrix also includes the prior edition's problem number for the unchanged and modified problems. At least 20 percent of the problems in the 2001 edition are new or modified. The solutions are referenced to the relevant pages in the text. The solutions manual also is available on disk and on the WFT Web site.
- The *Test Bank* contains questions and solutions arranged in accordance with the sequence of the material in the chapter. To help in putting together an examination, a matrix labels the questions by topical coverage and reflects which are new, modified, or unchanged from the prior edition. The matrix includes the question number for the unchanged and modified questions in the prior edition. Approximately 20 percent of the questions in the 2001 edition are new or modified. Ten additional multiple-choice questions per chapter also are available on our Web site.
- *Examview® Testing Software* allows the instructors to generate tests with their IBM-compatible computer.
- *Solutions Transparency Masters* for selected problems aid in understanding how problems are solved, step by step.

- *PowerPoint Presentation Software* allows qualified adopters to create interactive lectures and manipulate graphs, charts, and figures during in-class lectures. The package contains over 30 slides per chapter consisting of alternate figures, outlines, and key points.
- *Teaching Transparency Acetates* contain the key charts and tables from the PowerPoint package for instructors who wish to use traditional overheads.
- *Team Projects: Arthur Andersen Tax Challenge: Cases and Solutions* is a separate manual that includes four of the recent Arthur Andersen Tax Challenge cases and their solutions. This manual is available to adopters with permission to copy the case for classroom use as Team Projects (found at the end of Problem Materials). These cases are also available on our Web site.
- *WFT Individual Practice Sets* cover all the common forms that a tax practitioner would use for the average client.

Student Supplements

- *The Student Study Guide* provides a valuable tool to boost student understanding. It includes a chapter review of key concepts and self-evaluation tests with solutions that are referenced to the text.
- *West's Internal Revenue Code of 1986 and Treasury Regulations: Annotated and Selected, 2001 Edition*, permits the student to reference the Code and the Regulations through the convenience of a single-volume book. This ancillary contains useful annotations that help in working with and understanding the tax law.
- Powerpoint slides which give a mini-review of each chapter are available for viewing on our Web site.
- Tax legislation articles and updates are regularly posted to our Web site and can be viewed by students.
- Check out our on-line tutorials created to give you more information on relevant topics. You can see them on our Web site at <http://wft.swcollege.com>.

ADDITIONAL MATERIALS AVAILABLE AS SUPPLEMENTS TO THE TEXT

RIA ONPOINT SYSTEM 6, STUDENT VERSION, CD-ROM

The *RIA OnPoint System 6, Student Version, CD-ROM* provides an extensive tax library which ties directly to the cases and rulings cited throughout the text. This CD-ROM also includes the Federal Tax Coordinator, a valuable practitioner resource providing additional analysis, commentary, and practice aids for Federal income, estate and gift, excise, and employment taxes, as well as a full review of the taxation of foreign income.

This excellent tool also allows a search of the full text of thousands of other primary sources of the tax law, including the Code and its legislative history since 1954, Regulations and committee reports, Revenue Rulings and Procedures, current-year tax cases and countless watershed cases, and many IRS publications. Fully integrated with Windows®, the OnPoint Student Version allows the user to copy and paste information to a personal word processor, save documents on a disk, and link from one document to another, with precision and ease-of-use.

The *RIA OnPoint System 6, Student Version* is available to bundle with this text. Order a review copy of this award-winning research product today by calling our Academic Resource Center at (800) 423-0563. Or, simply place your order through your campus bookstore or contact our Customer Service Department at (800) 354-9706.

CCH U.S. MASTER TAX GUIDE PLUS

The *CCH U.S. Master Tax Guide Plus* on-line federal tax research database offers access to thousands of primary source documents with unprecedented ease and speed. With the convenience of using the Internet, the *CCH U.S. Master Tax Guide Plus* makes it easier than ever to conduct tax research.

TAX PREPARATION SOFTWARE



As the computer has become an essential tool in tax return preparation, the WFT instructional package offers *Tax Preparation with TurboTax® for Windows®*. TurboTax, the tax preparation software by Intuit, illustrates the preparation of more than 80 forms, schedules, and worksheets and automatically performs all mathematical calculations and data transfers. The powerful and easy-to-use *Tax Preparation with TurboTax* supplement, available as a separate purchase, includes a 200-page workbook containing exercises and problems and the TurboTax software program on CD-ROM. The 2001 edition contains numerous tax return problems, identified in the text by a computer symbol, that lend themselves to computerized solutions. The software runs on IBM PCs and compatibles.

TAX LAW UPDATES

Since the original edition was issued, we have followed a policy of annually revising the text material to reflect statutory, judicial, and administrative changes in the Federal tax law and to correct any errors or other shortcomings. Our annual update, published in early spring, also includes new comprehensive tax return problems using the latest tax forms.

ACKNOWLEDGMENTS

Special thanks to Gary A. McGill, Ph.D., CPA, of the University of Florida, for his work in developing the International Implications feature. These items document that tax planning and tax compliance increasingly are global endeavors. They are an important edition to the pedagogy of this text. Thanks to James C. Young, George Mason University, for continuing to provide us with his inflation adjustments, which are available prior to the release of the official amounts by the IRS.

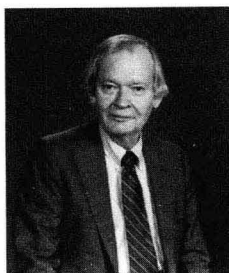
We are most appreciative of the many suggestions that we have received for revising the textbook, many of which have been incorporated in past editions and in the 2001 edition. The WFT philosophy is not only to encourage user input, but also to actively seek the advice of users as the basis for improving the textbook. We would also like to thank the people who have painstakingly worked through all the problems and test questions and generally acted as problem checkers to ensure the accuracy of the book and ancillary package. They are Tracey A. Anderson, Indiana University at South Bend; Frank Linton, University of Scranton; Mark B. Persellin, St. Mary's University; Debra L. Sanders, Washington State University; Randall K. Serrett, University of Houston-Downtown; Thomas Sternburg, University of Illinois at Urbana; Donald R. Trippeer, East Carolina University; and Raymond F. Wacker, Southern Illinois University at Carbondale.

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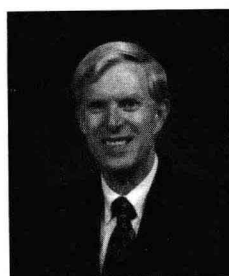
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James E. Smith
Eugene Willis

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About the Editors



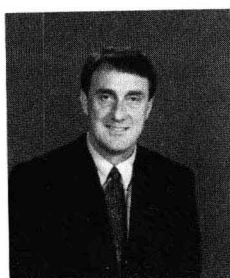
William H. Hoffman, Jr., earned B.A. and J.D. degrees from the University of Michigan and M.B.A. and Ph.D. degrees from The University of Texas. He is a licensed CPA and attorney in Texas. His teaching experience includes: The University of Texas (1957–1961), Louisiana State University (1961–1967), and the University of Houston (1967–1999). Professor Hoffman has addressed many tax institutes and conferences and has published extensively in academic and professional journals. His articles appear in *The Journal of Taxation*, *The Tax Adviser*, *Taxes—The Tax Magazine*, *The Journal of Accountancy*, *The Accounting Review*, and *Taxation for Accountants*.



James E. Smith is the John S. Quinn Professor of Accounting at the College of William and Mary. He has been a member of the Accounting Faculty for thirty years. He received his Ph.D. degree from the University of Arizona.

Professor Smith has served as a discussion leader for Continuing Professional Education programs for the AICPA, Federal Tax Workshops, and various state CPA societies. He has conducted programs in over 40 states for approximately 25,000 CPAs. He has been the recipient of the AICPA's Outstanding Discussion Leader Award and the American Taxation Association/Arthur Andersen Teaching Innovation Award.

Other awards received by him include the Virginia Society of CPAs' Outstanding Accounting Educator Award and the James Madison University's Outstanding Accounting Educator Award. He was the President of the Administrators of Accounting Programs Group (AAPG) in 1991–1992. He was the faculty adviser for the William and Mary teams that received first place in the Arthur Andersen Tax Challenge in 1994, 1995, and 1997.



Eugene Willis is the Arthur Andersen Alumni Professor of Accountancy at the University of Illinois (Urbana-Champaign). He joined the Illinois faculty in 1975 after receiving his Ph.D. from the University of Cincinnati. He serves as Head of the department. His articles have appeared in leading academic and professional journals, including the *Accounting Review*, *The Journal of the American Taxation Association*, *The Journal of Accountancy*, and *The Journal of Taxation*. Professor Willis is co-director of the National Tax Education Program, a continuing education program co-sponsored by the American Institute of CPAs and the University of Illinois.

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PART THREE

DEDUCTIONS

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