

Understanding

FEDERAL INCOME TAXATION

THIRD EDITION



J. Martin Burke
Michael K. Friel

UNDERSTANDING FEDERAL INCOME TAXATION

Third Edition

J. Martin Burke
Regents Professor of Law
University of Montana School of Law

Michael K. Friel
Professor of Law and Director, Graduate Tax Program
University of Florida College of Law



LexisNexis®

ISBN: 978-1-4224-7915-5

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is sold with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional services. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

LexisNexis, the knowledge burst logo, and Michie are trademarks of Reed Elsevier Properties Inc, used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

Copyright © 2008 Matthew Bender & Company, Inc., a member of the LexisNexis Group.
2001

All Rights Reserved.

No copyright is claimed in the text of statutes, regulations, and excerpts from court opinions quoted within this work. Permission to copy material exceeding fair use, 17 U.S.C. § 107, may be licensed for a fee of 25¢ per page per copy from the Copyright Clearance Center, 222 Rosewood Drive, Danvers, Mass. 01923, telephone (978) 750-8400.

NOTE TO USERS

To ensure that you are using the latest materials available in this area, please be sure to periodically check the LexisNexis Law School web site for downloadable updates and supplements at www.lexisnexis.com/lawschool.

Editorial Offices

744 Broad Street, Newark, NJ 07102 (973) 820-2000

201 Mission St., San Francisco, CA 94105-1831 (415) 908-3200

www.lexisnexis.com

MATTHEW  BENDER

The *Understanding* Series

Many professors recommend these concise yet comprehensive *Understanding* treatises to their students for additional insight:

Administrative Law	International Criminal Law
Antitrust and Its Economic Implications	International Business and Financial Transactions
Bankruptcy	International Law
Capital Punishment Law	Juvenile Law
Civil Procedure	Labor Law
Conflict of Laws	The Law of Terrorism
Constitutional Law	Law of Zoning and Land Use Controls
Contracts	Lawyers' Ethics
Copyright Law	Local Government
Corporate Law	Modern Real Estate Transactions
Corporate Taxation	Negotiable Instruments and Payment Systems
Criminal Law	Nonprofit and Tax Exempt Organizations
Criminal Procedure: Investigation	Partnership and LLC Taxation
Criminal Procedure: Adjudication	Patent Law
Disability Law	Products Liability Law
Employment Discrimination	Property Law
Employment Law	Remedies
Environmental Law	Sales and Leases of Goods
Evidence	Secured Transactions
Family Law	Securities Law
Federal Courts and Jurisdiction	Torts
Federal Income Taxation	Trademark Law
The First Amendment	Trusts and Estates
Immigration Law	White Collar Crime
Insurance Law	

Visit your campus bookstore to order any of these titles. Information about all LexisNexis publications is available at www.lexisnexis.com/lawschool-store.

**UNDERSTANDING
FEDERAL INCOME
TAXATION
Third Edition**

LEXISNEXIS LAW SCHOOL ADVISORY BOARD

Charles P. Craver

Freda H. Alverson Professor of Law
The George Washington University Law School

Richard D. Freer

Robert Howell Hall Professor of Law
Emory University School of Law

Craig Joyce

*Andrews Kurth Professor of Law &
Co-Director, Institute for Intellectual Property and Information Law*
University of Houston Law Center

Ellen S. Podgor

*Professor of Law &
Associate Dean of Faculty Development and Electronic Education*
Stetson University College of Law

Paul F. Rothstein

Professor of Law
Georgetown University Law Center

Robin Wellford Slocum

*Professor of Law & Director,
Legal Research and Writing Program*
Chapman University School of Law

Charles J. Tabb

Alice Curtis Campbell Professor of Law
University of Illinois College of Law

David I. C. Thomson

LP Professor & Director, Lawyering Process Program
University of Denver, Sturm College of Law

Judith Welch Wegner

Professor of Law
University of North Carolina School of Law

DEDICATION

To Jackie and Jonathan
and My Mother and Father
— MKF

To My Mother and Father
and My Eleven Brothers and Sisters
— JMB

PREFACE

As experienced tax professors, we know that students encountering the complexities of the tax code for the first time are often frustrated by its difficulties and look to their casebooks or to supplemental material for an adequate overview of the principles and policies underlying federal income tax law and for a detailed explanation of the interpretation and application of pertinent provisions of the Internal Revenue Code. Thus, such overviews and explanations have been principle features of the authors' casebook, *Taxation of Individual Income*. This book in turn adapts material from *Taxation of Individual Income* for those students using other casebooks who seek such supplemental material to assist them in their study. We have specifically designed this book to supplement other casebooks used in traditional courses in federal individual income taxation.

This book consists of forty-four chapters with each chapter addressing a basic topic in individual income taxation, e.g., the taxation of personal injury awards, the interest deduction, installment sales. Because the provisions of the Internal Revenue Code are necessarily at the heart of tax study, we have included in each chapter a part or all of the Code section(s) pertinent to the specific topic. Likewise, the chapters contain summaries of leading cases and relevant administrative rulings as well as numerous examples explaining the application of the law.

For students in law schools or business programs, we suggest that, before turning to this book, students first read the cases and other materials assigned by their professors. With that reading as background, students should then read the corresponding materials in this book to acquire a broader overview of the area including the development of the law related to a specific topic.

While this book is designed primarily for students, we recognize that it may also prove valuable to the general practitioner. Before representing a client in a divorce or some property transaction, the attorney may be well advised to read the chapter(s) relevant to the representation. Not only will this book provide the attorney with helpful overviews of the tax law related to a client matter, it will also serve as a tool for locating cases and other relevant authority.

In sum, we have written this book as a basic guide for students studying the tax law for the first time and for general practitioners handling transactions with an individual income tax dimension. A word of caution: neither this guide nor any casebook or supplemental material should be viewed as a substitute for careful reading of the Internal Revenue Code. Lawyers and accountants must ultimately base their decisions on the Code and the judicial and administrative interpretations of the Code. Our hope is that this book will aid in the study of the Code and the application of its provisions.

ACKNOWLEDGMENTS

We are indebted to a number of people for their assistance in the development of this book. We have benefitted greatly from the comments and suggestions by our colleagues and our students at the University of Montana School of Law and the University of Florida College of Law, and we wish to acknowledge their help and that of our tax colleagues at other schools. We are also indebted to Linda Kirby of the University of Florida College of Law and to Wendy Owens of the University of Montana School of Law. Their assistance and support in the preparation of this manuscript were indispensable, and for that we are most grateful and appreciative.

TABLE OF CONTENTS

CHAPTER 1.	INTRODUCTION TO FEDERAL INCOME TAX	1
§ 1.01	A BRIEF HISTORY OF FEDERAL INCOME TAX	1
§ 1.02	RESOLUTION OF TAX ISSUES THROUGH THE JUDICIAL PROCESS	2
[A]	Trial Courts	2
[1]	The Tax Court	2
[2]	Federal District Courts	3
[3]	The United States Court of Federal Claims	3
[B]	Appeals	3
[C]	Selection of Forum	4
§ 1.03	COMPUTATION OF TAX LIABILITY	4
[A]	Basic Questions Addressed by an Income Tax System	4
[B]	Evaluating Tax Liability	4
[1]	Gross Income	5
[2]	The Concept of Adjusted Gross Income	6
[3]	Deductions	8
[4]	Calculating Adjusted Gross Income	10
[5]	Taxable Income	10
[a]	Itemize or Elect Standard Deduction	10
[b]	Section 67: The 2% Floor on Miscellaneous Itemized Deductions	11
[c]	The Section 68 Overall Limitation on Itemized Deductions	11
[d]	Personal Exemptions	12
[e]	Calculating Taxable Income	13
[6]	Tax Rates	13
[7]	Credits	14
§ 1.04	CONCLUSION	14
CHAPTER 2.	GROSS INCOME CONCEPTS AND LIMITATIONS	15
§ 2.01	THE SEARCH FOR A DEFINITION OF INCOME	15
§ 2.02	INCOME REALIZED IN ANY FORM	18
§ 2.03	REALIZATION, IMPUTED INCOME AND BARGAIN PURCHASES	19
[A]	The Realization Requirement	19
[B]	Imputed Income	21
[C]	Bargain Purchases	24

TABLE OF CONTENTS

CHAPTER 3.	THE EFFECT OF AN OBLIGATION TO REPAY	27
§ 3.01	LOANS	27
§ 3.02	CLAIM OF RIGHT	28
§ 3.03	ILLEGAL INCOME	30
§ 3.04	DEPOSITS	32
CHAPTER 4.	GAINS DERIVED FROM DEALINGS IN PROPERTY .	35
§ 4.01	COMPUTING GAIN DERIVED FROM DEALINGS IN PROPERTY	35
§ 4.02	TAX COST BASIS	37
§ 4.03	IMPACT OF LIABILITIES	38
[A]	Impact on Basis	38
[B]	Impact on Amount Realized	40
§ 4.04	BASIS OF PROPERTY ACQUIRED IN TAXABLE EXCHANGE	41
CHAPTER 5.	GIFTS, BEQUESTS AND INHERITANCE	45
§ 5.01	EXCLUSION OF GIFTS FROM INCOME	45
[A]	The Nature of a Gift	45
[1]	Employer-Employee “Gifts”	46
[2]	Business Gifts	47
[B]	The Nature of a Bequest or Inheritance	47
[C]	Statutory Limitations on the Exclusion—Section 102(b) . . .	49
§ 5.02	BASIS OF PROPERTY RECEIVED BY GIFT, BEQUEST OR INHERITANCE	50
[A]	Gifts of Appreciated Property	51
[B]	Gifts of Property—Basis in Excess of Fair Market Value . .	52
[C]	Basis of Property Received by Bequest or Inheritance	54
§ 5.03	PART-GIFT, PART-SALE	57
CHAPTER 6.	SALE OF A PRINCIPAL RESIDENCE	59
§ 6.01	SECTIONS 1034 AND 121 BEFORE THE TAXPAYER RELIEF ACT OF 1997	59
§ 6.02	SECTION 121 AFTER THE TAXPAYER RELIEF ACT OF 1997	61
[A]	Ownership and Use Requirements	61
[B]	Amounts Excludable	64
[C]	Exclusion for Taxpayers Failing to Meet Certain Requirements	67

TABLE OF CONTENTS

[D]	Limitation on Exclusion for Depreciation Claimed	69
[E]	Principal Residence	69
[F]	Conclusion	71
CHAPTER 7.	SCHOLARSHIPS AND PRIZES	73
§ 7.01	PRIZES AND AWARDS	73
[A]	Prizes and Awards Generally Taxable	73
[B]	Employee Achievement Awards Exempt	74
§ 7.02	QUALIFIED SCHOLARSHIPS	76
[A]	Limitation of Exclusion	77
[B]	Scholarships as Compensation	78
[C]	Tuition Reduction	79
[D]	Educational Assistance Programs	79
[E]	Gifts	80
CHAPTER 8.	LIFE INSURANCE, ANNUITIES, AND INDIVIDUAL RETIREMENT ACCOUNTS	81
§ 8.01	LIFE INSURANCE	81
[A]	Exclusion of Mortality Gains	81
[B]	Death of the Insured	84
[C]	Accelerated Death Benefit	84
[D]	Surrender for Value	84
[E]	Interest Income	85
[F]	Transfer for Value	87
[G]	Group-term Life Insurance	88
§ 8.02	ANNUITIES	88
§ 8.03	INDIVIDUAL RETIREMENT ACCOUNTS	91
[A]	Deductible IRAs	92
[B]	Nondeductible IRAs	92
[C]	Roth IRAs	93
CHAPTER 9.	DISCHARGE OF INDEBTEDNESS	95
§ 9.01	HISTORICAL BACKGROUND	91
§ 9.02	SPECIFIC RULES GOVERNING EXCLUSION	97
[A]	Discharge of Indebtedness When Taxpayer Is Insolvent . . .	97
[1]	Case Law Pre-1980 Bankruptcy Tax Act	97
[2]	The Insolvency Exclusion Under Section 108	98
[B]	Discharge of Qualified Real Property Business Indebtedness	100

TABLE OF CONTENTS

[C]	Discharge of Indebtedness on Principal Residence Before January 2010	101
[D]	Purchase-Money Debt Reduction for Solvent Debtors . . .	101
[E]	Acquisition of Indebtedness by Person Related to Debtor .	103
[F]	Discharge of Deductible Debt	104
§ 9.03	DISPUTED OR CONTESTED DEBTS	105
§ 9.04	DISCHARGE OF INDEBTEDNESS AS GIFT, COMPENSATION, ETC.	106
§ 9.05	INAPPLICABILITY OF SECTION 108 TO GAIN REALIZED ON TRANSACTIONS INVOLVING DISCHARGE OF INDEBTEDNESS	107
CHAPTER 10.	COMPENSATION FOR PERSONAL INJURY AND SICKNESS	109
§ 10.01	INTRODUCTION	109
§ 10.02	DAMAGES	109
[A]	Business or Property Damages	109
[B]	Damages Received on Account of Personal Physical Injuries or Sickness	111
[C]	Supreme Court Limitations on the Pre-1996 Version of Section 104(a)(2)	113
[1]	What is a “Personal Injury”?	113
[2]	When are Damages Received “On Account Of” a Personal Injury?	114
[D]	Exclusion for Personal Physical Injury or Sickness: The 1996 Amendments to Section 104	115
[1]	Distinction Between Physical and Non-Physical Injuries	115
[2]	Section 67 and Alternative Minimum Tax Issues	117
[E]	Punitive Damages	120
[F]	Allocation of Awards	121
[G]	Periodic Payments	122
§ 10.03	PAYMENT UNDER ACCIDENT AND HEALTH INSURANCE POLICIES	123
§ 10.04	PREVIOUSLY DEDUCTED MEDICAL EXPENSES	125
§ 10.05	WORKERS’ COMPENSATION	126
§ 10.06	CERTAIN DISABILITY PENSIONS	126

TABLE OF CONTENTS

CHAPTER 11.	FRINGE BENEFITS	129
§ 11.01	MEALS AND LODGING	129
[A]	The Treatment of Meals and Lodging Prior to 1954	129
[B]	Section 119—Meals or Lodging Furnished for the Convenience of the Employer	130
§ 11.02	FRINGE BENEFITS AND SECTION 132	132
[A]	No-Additional-Cost Service	133
[B]	Qualified Employee Discount	136
[C]	Working Condition Fringe	139
[D]	De Minimis Fringe Benefits	140
[E]	Qualified Transportation Fringe	141
[F]	On-Premises Gyms and Other Athletic Facilities	142
§ 11.03	VALUATION	142
CHAPTER 12.	BUSINESS AND PROFIT SEEKING EXPENSES	143
§ 12.01	BUSINESS DEDUCTIONS—SECTION 162	143
[A]	The Expense Must be “Ordinary and Necessary”	144
[1]	Is the Expense “Ordinary”?	144
[2]	Is the Expense “Necessary”?	148
[a]	“Reasonable” Salaries	149
[b]	Certain Excessive Remuneration	151
[c]	Public Policy Considerations	151
[d]	Lobbying Expenses	152
[B]	“Carrying On a Trade or Business”	153
[1]	What Constitutes a “Trade or Business”?	153
[2]	The “Carrying On” Requirement	154
[3]	Section 195 and the Amortization of Certain Pre-Operational or Start-Up Costs	156
[4]	Application of the “Carrying On” Requirement to Employees	158
§ 12.02	SECTION 199—DEDUCTION RELATING TO INCOME ATTRIBUTABLE TO DOMESTIC PRODUCTION ACTIVITIES	160
§ 12.03	SECTION 212 DEDUCTIONS	160
CHAPTER 13.	CAPITAL EXPENDITURES	163
§ 13.01	DEDUCTIBLE EXPENSE OR CAPITAL EXPENDITURE?	163
§ 13.02	DEFINING CAPITAL EXPENDITURES— <i>INDOPCO</i> ...	164
§ 13.03	SELECTED CATEGORIES OF CAPITAL	

TABLE OF CONTENTS

	EXPENDITURES	167
[A]	Cost of Acquisition and Costs Incurred in Perfecting and Defending Title	167
[B]	Retirement and Removal	169
[C]	Repair or Improvement	169
[D]	Intangible Assets	174
[E]	Expansion Costs	176
[F]	Advertising Expenses	177
§ 13.04	PURCHASE OR LEASE	178
CHAPTER 14.	DEPRECIATION	181
§ 14.01	DEPRECIATION	181
[A]	Depreciable Property	181
[B]	Recovery Period—The Useful Life Concept	183
[1]	Historical Development	183
[2]	Current Recovery Periods—Modified Accelerated Cost Recovery System (MACRS)	184
[C]	Depreciation Methods	186
[D]	Conventions	188
§ 14.02	COMPUTING THE DEPRECIATION DEDUCTION	190
§ 14.03	AMORTIZATION OF INTANGIBLES—SECTION 197	192
§ 14.04	RELATIONSHIP BETWEEN BASIS AND DEPRECIATION	192
§ 14.05	ECONOMIC STIMULUS ACT OF 2008: ADDITIONAL FIRST YEAR DEPRECIATION	193
§ 14.06	SECTION 179—EXPENSING TANGIBLE PERSONAL PROPERTY	194
§ 14.07	ECONOMIC STIMULUS ACT OF 2008: INCREASE IN SECTION 179 LIMITS FOR 2008	197
§ 14.08	THE RELATIONSHIP OF DEBT TO DEPRECIATION	197
CHAPTER 15.	LOSSES AND BAD DEBTS	203
§ 15.01	LOSSES	203
[A]	The Business or Profit Requirement for Individuals	203
[1]	Personal Losses Not Deductible	203
[2]	Conversion of Personal Use Property to Income Producing Property	205
[B]	When Is a Loss Sustained?	206
[1]	Worthless Securities	207
[2]	Theft Losses	208

TABLE OF CONTENTS

[C]	Amount of the Deduction	208
[1]	Reimbursement	208
[2]	Post-Conversion Losses	209
[D]	Disallowed Losses	210
§ 15.02	BAD DEBTS	210
[A]	Bona Fide Debt Requirement	210
[B]	Worthlessness	210
[C]	Business or Nonbusiness Debts	211
[D]	Amount Deductible	214
[E]	Guarantees	214
§ 15.03	BAD DEBTS AND LOSSES: THE INTERPLAY BETWEEN SECTIONS 166 AND 165	215
CHAPTER 16.	TRAVEL EXPENSES	217
§ 16.01	COMMUTING	217
§ 16.02	OTHER TRANSPORTATION EXPENSES	221
§ 16.03	EXPENSES FOR MEALS AND LODGING WHILE IN TRAVEL STATUS	222
§ 16.04	WHERE IS THE TAXPAYER'S "HOME" FOR SECTION 162(a)(2) PURPOSES?	223
§ 16.05	OTHER CONSIDERATIONS	227
[A]	Travel Expenses of Spouse	227
[B]	Reimbursed Employee Expenses	228
[C]	Business-Related Meals	229
[D]	Limitations on Foreign Travel	229
[E]	Relationship to Section 212	229
[F]	Substantiation Requirements	230
CHAPTER 17.	ENTERTAINMENT AND BUSINESS MEALS	231
§ 17.01	BUSINESS OR PLEASURE?	231
[A]	Historical Background	232
[B]	Percentage Cutback	233
§ 17.02	ENTERTAINMENT ACTIVITIES	234
[A]	"Directly Related" Entertainment	235
[B]	"Associated with Entertainment"	235
[C]	Business Meals	236
§ 17.03	ENTERTAINMENT FACILITIES	237
§ 17.04	SUBSTANTIATION REQUIREMENTS	239
§ 17.05	EXCEPTIONS	240
§ 17.06	BUSINESS MEALS	241

TABLE OF CONTENTS

CHAPTER 18.	EDUCATIONAL EXPENSES	245
§ 18.01	CATEGORIZATION OF EDUCATIONAL EXPENSES ..	245
§ 18.02	THE SKILL-MAINTENANCE OR EMPLOYER- REQUIREMENT TESTS	246
§ 18.03	THE MINIMUM EDUCATIONAL REQUIREMENTS AND NEW TRADE OR BUSINESS TESTS	248
§ 18.04	TRAVEL EXPENSES	251
§ 18.05	EDUCATION TAX INCENTIVES	251
CHAPTER 19.	OTHER DEDUCTIBLE PERSONAL EXPENSES	255
§ 19.01	MOVING EXPENSES	255
§ 19.02	CHILD CARE EXPENSES	260
§ 19.03	LEGAL EXPENSES	262
§ 19.04	CLOTHING EXPENSES	263
CHAPTER 20.	HOBBY LOSSES	265
§ 20.01	HISTORICAL DEVELOPMENT	265
§ 20.02	SECTION 183 ACTIVITIES	266
§ 20.03	DEDUCTIONS ALLOWABLE UNDER SECTION 183 ...	269
CHAPTER 21.	HOME OFFICES, VACATION HOMES AND OTHER DUAL USE PROPERTY	273
§ 21.01	HOME OFFICE DEDUCTIONS	273
[A]	General Background— <i>Bodzin v. Commissioner</i>	274
[B]	Enactment of Section 280A	276
[C]	Principal Place of Business	277
[D]	Convenience of Employer	278
[E]	Limitation on Amount of Deduction	279
§ 21.02	VACATION HOME DEDUCTIONS	281
§ 21.03	OTHER DUAL USE PROPERTY	283
[A]	Computers and Other “Listed Property”	283
[B]	Passenger Automobiles	286
§ 21.04	CONCLUSION	289
CHAPTER 22.	THE INTEREST DEDUCTION	291
§ 22.01	WHAT CONSTITUTES INTEREST?	291
§ 22.02	DEDUCTION OF PERSONAL INTEREST	292
[A]	Trade or Business Interest	294