

FEDERAL INCOME TAXATION

CASES AND MATERIALS

FOURTH EDITION

PAUL R. MCDANIEL

HUGH J. AULT

MARTIN J. MCMAHON, JR.

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UNIVERSITY CASEBOOK SERIES

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FOURTH EDITION

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PREFACE

This text deals with fundamental income taxation principles: What is income? What expenditures are deductible? When are income and deductions items properly taken into account? Who is the appropriate taxpayer? This fourth edition is a significant revision of the material in the third edition, reflecting the enactment of the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997, as well as the myriad judicial and administrative developments in the past few years.

Because the detail and complexity of the Internal Revenue Code and Treasury Regulations continue to increase, this edition, like the third edition, is selective rather than encyclopedic. Our guiding philosophy in selecting and structuring the materials has been to organize the materials to facilitate selective assignments for a three or four hour basic course that demonstrate the overall structure and policies of federal income taxation and provide in depth analysis of representative important issues. In their entirety the materials provide sufficient scope and depth for a sequence of two or more courses ranging from five to nine hours, depending on whether the courses are at the J.D. or LL.M. level. As a result, it is not possible to cover the entire volume in a single three or four hour course in Basic Federal Income Taxation.

Like its predecessor editions and its companion volumes, *FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS*, 2D ED., *FEDERAL INCOME TAXATION OF CORPORATIONS*, and *FEDERAL INCOME TAXATION OF PARTNERSHIPS AND S CORPORATIONS*, 2D ED., this book charts a course between those books that employ primarily textual explanation and those that rely for the most part on cases. Most chapters and sections of chapters are introduced by a textual discussion or outline of the basic issues and structure of the statute governing treatment of the particular item or transaction covered in the chapter or section. Principal cases have been included to illustrate key concepts not governed by a detailed statutory provision, as well as to illustrate how the courts have utilized the technical tools at their disposal. We recognize, however, that in recent years detailed statutory rules have come to dominate analysis of certain issues. Accordingly, in a significant number of chapters and sections, the "principal case" is an excerpt from a congressional committee report, which helps the student understand the reasons for the change in the statute as well as providing a road map to assist in mastering the detailed statutory provisions.

In the *Illustrative Material*, which follows the principal cases, we have attempted to provide sufficient discussion of rulings and cases to give an insight into the endless variety of factual situations to which the highly technical provisions of the Internal Revenue Code must be applied. The *Illustrative Material* also provides important historical background and discussion of sequential amendments to particular provisions of the Code and Regulations necessary to understand the significance of particular provisions. The breadth and detail of the *Illustrative Material* is such that most instructors will wish to assign only portions of it depending on the scope of their particular course. To assist in selective use of *Illustrative Material*, we have tried to arrange the *Illustrative Material* to begin with the general and move to the more specific and technical issues as the outline format progresses.

The Internal Revenue Code and Treasury Regulations are the centerpiece of any course in federal taxation. This volume is intended to be used in conjunction with either a complete set of the Code and Regulations or one of the several available edited versions of the Code and Regulations. The statutory and regulatory references at the head of each topic are not intended to be exhaustive. Rather, they represent only the essential sections of the Code and Regulations which the student must understand to obtain the framework for the cases and materials under the particular topic. We have not undertaken completely to explain the operation of the Code and Regulations in the textual notes and *Illustrative Material*. The student must work with the statute and regulatory material before undertaking the examination of its application in the materials in this volume.

This text is divided into nine broad Parts and thirty-six chapters. Most basic tax courses will cover some of the material in each principal Part of the text, but it is unlikely that all of the material in any one Part will be covered. Each Chapter is organized in an outline format. This arrangement in both the subdivisions within the Chapters and the *Illustrative Material* is intended to facilitate the assignment of only selected portions of the material to provide an overview of some topics, while at the same time providing detailed discussion of complex issues for consideration in advanced courses.

As to editorial matters, the statutory references throughout are to the 1986 Code, except where the text expressly indicates otherwise. References in the cases and other primary sources to the 1954 and 1939 Codes and prior statutes have been edited to conform them to the 1986 Code. Generally the practice is to omit the earlier citation and instead refer to the matter as "the former version," or "the predecessor," or to give the current relevant 1986 Code section if there has been no significant change in the statutory language. But if a significant change has occurred, that fact is noted and the prior language is given. In general, references to the Code and Regulations are current as of December 31, 1997. Citations to cases and rulings also are current as of December 31, 1997. In some instances, however, later references have been utilized where the materials were particularly important to the topic. Footnotes in cases and materials very frequently have been omitted. Where retained the original numbering of the footnotes has

been kept so that, in many instances, the footnote numbers are not consecutive. Editorial footnotes for cases and materials are so designated and are indicated by an asterisk. References to Tax Court Memorandum decisions are to the number assigned by the Tax Court and not to any particular commercial publication.

We are indebted to Robert Gray and Linda DuPuis, University of Florida College of Law, LL.M. 1998, for research and editorial assistance for aid in preparing the manuscript.

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April, 1998

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INSTRUCTOR'S NOTE

Basic Philosophy

In preparing this edition of **FEDERAL INCOME TAXATION, CASES AND MATERIALS**, we have been mindful that the complexity of the Internal Revenue Code and Treasury regulations make it impossible in a four hour course in basic income taxation to cover all of the fundamental principles in depth. Nevertheless, it is important to acquaint students with the full range of general principles. Thus, each instructor must choose those topics to cover in depth and those topics with respect to which only the general principles will be covered. The choice of which topics should be examined in depth and which topics should be covered only generally is individualistic. Furthermore, any particular instructor may wish to vary the coverage from year to year. Thus, rather than provide a text that dictates the scope and depth of the course, we have prepared a set of materials from which any instructor can draw to fit his or her particular needs.

Our guiding philosophy in selecting and structuring the materials has been to organize the materials to facilitate selective assignments for a three or four hour basic course that demonstrate the overall structure and policies of federal income taxation and provide in depth analysis of representative important issues. In their entirety the materials provide sufficient scope and depth for a sequence of two or more courses ranging from five to nine hours, depending on whether the courses are at the J.D. or LL.M. level. It is not possible to cover the entire volume in a single three or four hour course in Basic Federal Income Taxation.

The book is divided into nine broad Parts and thirty-six chapters, which are further subdivided into sections to facilitate selective use to suit the particular courses. Most chapters and sections of chapters are introduced by a textual discussion or outline of the basic issues and structure of the statute governing treatment of the particular item or transaction covered in the chapter or section. Most sections include a principal case (or cases) to illustrate key concepts not governed by a detailed statutory provision or to illustrate how the courts have utilized the technical tools at their disposal. Because detailed statutory rules dominate analysis of certain conceptual issues, in a significant number of sections the "principal case" is an excerpt from a congressional committee report, which helps the student understand the reasons for the change in the statute as well as providing a road map to assist in mastering the detailed statutory provisions.

The *Illustrative Material* that follows the principal cases provides discussion of rulings and cases to give an insight into the endless variety of factual situations to which the highly technical provisions of the Internal Revenue Code must be applied. The *Illustrative Material* also provides important historical background and discussion of sequential amendments to particular provisions of the Code and Regulations necessary to understand the significance of particular provisions. The breadth and detail of the *Illustrative Material* is such that most instructors will wish to assign only portions of it, depending on the scope of their particular course. To assist in selective use of *Illustrative Material*, it is arranged from the general to the more specific as the outline format progresses.

In very practical terms, the organization of the book means that the instructor will assign only the introductory material and the principal case for those areas in which he or she wishes to cover only the basic principles. In areas where some greater depth of detail is desired, the first one or two divisions of the *Illustrative Material* also will be assigned. In those areas where the instructor wishes to expose the students to the full range of technical details — as worked out in regulations, rulings and court decisions — the entire *Illustrative Material* would be assigned. The text thus provides the desired level of detail the instructor seeks as to any particular topic.

Organization

The materials generally have been sequentially organized on a conceptual rather than a transactional basis.

Part I (Chapter 1) provides an introduction to Federal Income Taxation. It describes the history of the income tax and the tax system, i.e., the relevant administrative and judicial processes and authorities, gives a brief survey of income tax procedure, tax penalties, and ethical considerations in tax practice, and ends with an overview of the most important tax policy issues. This is broad background material and although the Chapter is lengthy, we expect that most instructors will assign it in its entirety even though much of the material may not be discussed directly in class.

Part II (Chapters 2-11) covers the definition of gross income, including recognition of gain in basic property transactions. (More complex property transactions are covered in Part IV). The organizational theme of this Part is that receipts in any form that are not a return to capital ought to be included in the tax base. Chapters 2-4 thus focus on the significance, if any, of the form of or reason for the receipt, while Chapters 6-8 focus of the return of capital concept. Chapters 9 (relationship of basis to income recognition—primarily §§ 1014, 1015, and 691) and 10 (cancellation of indebtedness income) are covered toward the end of the Part to emphasize at that point in the course the theoretical idea that consumption ought to be paid for with tax-paid dollars. The Part ends with a discussion of tax expenditure analysis in Chapter 11. Most of this material will be covered in any basic income taxation course. Some sections of chapters, however, might be omitted by instructors who prefer to devote more time to deductions, timing issues, or complex property transactions. To facilitate such omissions, items

such as prizes and awards and nonshareholder contributions to capital, for example, are assigned to separate sections that an instructor may elect not to assign.

Part III (Chapters 12-17) covers business deductions and credits. The organizational theme of this Part is that the cost of earning receipts ought to be excluded from the tax base. This Part begins by examining the treatment of items that clearly have been incurred in a business or profit-seeking context. Chapter 11 deals primarily with the “ordinary and necessary expense” concept and limitations on the deduction of current profit-seeking expenses, including a section on “tax penalties”—the analog of tax expenditures. Most of the material in this chapter typically is covered in a basic tax course, although some of the detailed discussion, for example, some of the tax penalties *Illustrative Material*, may be omitted. Chapters 13 through 15 deal with capital expenditures and recovery of basis through depreciation and loss deductions. Most instructors will cover most of the material in these chapters, although some Chapter sections, such as the one dealing with natural resources, easily may be omitted. Chapter 16 covers the limitations on the deduction of interest, and Chapter 17 deals with business tax credits.

Part IV, Chapters 18 and 19, discusses the treatment of expenses that combine both business or profit seeking aspects and personal living expense aspects. These chapters deal with the problem of determining whether an expenditure was incurred for a profit-seeking purpose or a personal purpose. The placement of this material after coverage of unambiguous profit-seeking deductions in Part III, like the placement of Chapters 9 and 10 in Part II, is intended to emphasize the idea that consumption should be purchased with after-tax income. Because all of the sections in Chapter 18 present variations on a common theme, many instructors may choose to cover only a few sections in detail, leaving the remaining sections to generalized coverage.

Part V, consisting of Chapters 20 and 21, deals with deductions and credits for personal living expenses and presents issues raised by tax expenditure analysis. Again, we expect that most instructors in basic income taxation courses will elect to cover most of the topics in this Part. However, most instructors in a three or four hour basic course will want to omit portions of the *Illustrative Material* that deal with less commonly encountered issues.

Part VI deals comprehensively with property transactions, including debt financing, deferred recognition, leasing transactions, capital gains, and tax shelters. We expect that many instructors in basic courses will cover only selected portions of this Part. For example, Chapter 24, dealing with leasing transactions might be omitted entirely. Chapters 23 (deferred recognition) and Chapters 25 and 26, which deal comprehensively with the treatment of capital gains, can be selectively covered. For example, an instructor may choose to omit portions of the *Illustrative Material* dealing with section 1221(1), to cover only a few of the several cases dealing with judicial limitations on the definition of capital asset, to cover the “sale or exchange”

requirement only at the most elementary level, and to omit entirely some of the more technical aspects of capital gains covered in the latter sections of the Chapter. The portions of Chapter 22 (debt financing) dealing with structural aspects of tax shelter transactions and Chapter 27, dealing with administrative, judicial, and legislative responses to tax shelters, also may be included only selectively.

Alternatively, Part VI provides sufficient material for an advanced 2 hour course in taxation of property transactions at either the J.D. or LL.M. level. It may be combined with the portions of Part IV relating to tax accounting rules for property transactions in a three hour course covering taxation of property transactions.

Part VII covers timing and other tax accounting issues. Most instructors in basic courses will cover selected portions of Chapters 28 (accounting methods) and 29 (annual accounting), but may wish to omit Chapter 30 (deferred compensation). Chapters 31 (installment sales) and 32 (original issue discount) also will be covered only selectively in most basic courses. Part VII, standing alone however, if covered comprehensively, provides sufficient material for a two hour advanced course in tax accounting at either the J.D. or LL.M. level. Parts VI and VII, with some omissions, easily may be combined as the basis for a three hour advanced income taxation course at the J.D. level by instructors who choose to cover Parts I through V comprehensively in a three hour basic federal income taxation course.

Part VIII covers the taxable unit and assignment of income issues. We expect that most instructors will include all of Chapter 33 (taxable unit and divorce) in the basic income tax course. Most instructors also will include selected material from Chapter 34 (assignment of income). Chapter 35, dealing with trusts, is more suitable for inclusion in advanced courses.

Part IX deals with the alternative minimum tax. Many instructors may wish to devote a day to this material to familiarize students generally with the concept and to explore the policy implications of the need for the alternative minimum tax as a way of "capping-off" the basic income tax course.

The Appendix provides a discussion of the fundamental principles of time value of money for use at any time an instructor wishes to introduce the technical aspects of the analysis. Certain chapters of the text, particularly Chapter 14 on cost recovery allowances, include detailed time value of money analysis of the operation of particular provisions of the Code.

Because teachers approach their courses with different objectives and use different techniques for handling the materials, the materials have been designed to be flexible and easily adapted to whatever approach the teacher wishes to adopt—an intensive technical analysis, a problem oriented method, a consideration of the policies that underlie the technical tax structure, or a survey of the principal elements of the federal income tax structure. Accordingly, the text does not contain sets of questions or problems within the materials because the nature of the questions that will be appropriate will vary greatly with the type of course for which the materials are being used. Most instructors, we believe, prefer to use questions that have

been tailored to their own technique and scope of coverage. In addition, we believe that the selection of principal cases and the numerous examples discussed in the *Illustrative Material*, in effect, serve as problems for students and class discussions.

*

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