

Federal Income Tax

Sixth Edition

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Wolters Kluwer

Law & Business

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An Introductory Note to Students

If you're considering buying this book, you've probably already purchased a casebook. Most casebooks contain some explanatory text, as well as cases, and those explanations are usually pretty good. (Of course, at least one of us thinks the best explanations are found in the Klein, Bankman, Shaviro casebook.) There are also a number of excellent treatises and student aids on the market.

What this book does — and other books generally do not do — is teach the subject through a question-and-answer approach. For each topic, we provide a summary of most of what you will cover in class. You should integrate these summaries with classroom discussion and the reading assigned in your tax course. We then ask a series of questions (called “examples”) on each topic and provide you with answers to the questions (called “explanations”).

The question-and-answer format is the heart of the book. Although, in practice, many questions do not have clear or simple answers, we have tried to draft discrete questions for which there are clear answers so that you can actively test your grasp of each specific rule or concept. If you can answer the questions correctly, you can be confident that you have mastered the basic rules and concepts covered in the introductory tax course. (Think of it as a “programmed learning” guide to tax rules and concepts.) This sixth edition incorporates changes made by various recent federal statutes, including the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “2010 Tax Relief Act”), the Small Business Jobs Act of 2010 (the “2010 Small Business Act”), the 2010 Patient Protection and Affordable Care Act (“PPACA,” as amended by the Health Care and Education Reconciliation Act of 2010), the Hiring Incentives to Restore Employment Act (the “2010 HIRE Act”), and the American Recovery and Reinvestment Act of 2009 (“ARRA”).

The book is designed to supplement, rather than supplant, the class and class reading. Although some of the answers to the questions in this book can be gleaned from the topic summaries, other questions can be answered correctly only after you carefully read the Internal Revenue Code and Treasury Regulation sections assigned for the topic. Note that, by deliberately breaking a complex subject into discrete questions, we unavoidably

An Introductory Note to Students

underplay the importance of issue spotting. You must develop issue-spotting skills by studying cases, participating in class discussion, and trying to answer more complex “real-world” questions. In order to give you an opportunity to answer some complex questions, we have included a diverse sample of actual law school exams, with suggested answers, at the end of the book.

We have tried to include material on just about any topic that might be covered in your tax course. Most tax courses do not cover every topic in this book. For each topic assigned in your course, you can locate the corresponding material in this book by looking at the table of contents in the front or the table of Code sections, table of cases, and topical index in the back.

The first five editions of this book have received rave reviews from students. In this new edition, we have further refined the examples and explanations and added new material to address recent changes in the tax law. We hope this sixth edition will help you become proficient in your tax course. (And who knows? You, like many of our students, may be shocked to discover that you actually like tax.)

Joseph Bankman
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Introduction

The income tax is the largest source of revenue for the federal government. In recent years, total income tax revenue has varied from around \$1.1 to \$1.5 trillion, about \$900 billion to \$1.2 trillion of which has been collected from individuals. Around \$150 billion to \$300 billion a year has been collected from corporations, which are generally separate taxpaying entities. The determination of taxable income is similar for individuals and corporations; however, some provisions apply specifically to either individuals or corporations. A much smaller amount of income tax is raised from estates and trusts.

Vying with the income tax for the dubious honor of being the greatest federal government revenue-raiser is what is commonly referred to as the payroll tax. (Although most of this tax revenue is used to fund social security benefits, a portion of it is used to fund Medicare health benefits.) The social security tax is levied on both employees and employers and is calculated as a percentage of salary income. Other sources of revenue for the federal government include excise taxes on fuel, alcohol, tobacco, firearms, and certain imports, and estate and gift taxes levied on the transferor (or the estate of the transferor) of significant wealth.

The income tax is also an important source of revenue for state and local governments. The determination of taxable income for the purpose of state and local income taxes is for the most part identical to the determination of taxable income under the federal income tax. Knowledge of the federal income tax therefore translates into knowledge of state and local income taxes. Sales and property taxes account for most of the revenue of state and local governments. The precise mix of income, sales, and property taxes varies from state to state. Some states, for example, have no income tax; other states tax individual or corporate income but not both.

A. INTRODUCTION TO TERMINOLOGY AND STRUCTURE

The starting point in computing a taxpayer's tax liability for the year is the taxpayer's *gross income*. In Chapter 2 we will discuss the concept of gross income at length; for now, note the items expressly included in or excluded from gross income in Internal Revenue Code §61 and §§71-140. (If you look at the table of contents at the front of your Code, you will see a list of the items covered in §§71-140.) Many of the items included in gross income are straightforward; for example, salary from a job is included in gross income. However, a couple of the §61 gross income items are not really "gross" income items.

For example, §61(a)(2) provides that gross income includes "[g]ross income derived from business." However, in this context, "gross" does not really mean "gross" because a taxpayer's gross income from business means the gross receipts from the business less the cost of the taxpayer's inventory sold. In Chapter 5 we will explore the rules for determining a taxpayer's inventory costs.

Also look at §61(a)(3), which states that gross income includes "[g]ains derived from dealings in property." Appreciation in the value of property is taxed when the gain is *realized*, for example when the property is sold or exchanged. When a taxpayer sells or exchanges property, the taxpayer must compute the gain or loss she realizes on the disposition of the property. The taxpayer realizes a gain if the taxpayer receives for the property more than the taxpayer's unrecovered investment in the property (in the simplest case, what the taxpayer paid for the property); the taxpayer realizes a loss if the taxpayer receives for the property less than the taxpayer's unrecovered investment in the property. The Code calls the amount the taxpayer receives on the sale or exchange the *amount realized*. §1001(a). The Code calls the taxpayer's unrecovered investment in the property *adjusted basis*. §§1011-1016. So, technically, a taxpayer's realized gain equals the amount realized less the taxpayer's adjusted basis in the property sold, and a taxpayer's realized loss equals the taxpayer's adjusted basis less the taxpayer's amount realized. In other words, a taxpayer's gross income from "dealings in property" is net of the taxpayer's unrecovered investment in the property.

For example, assume that in year 1 Betsy buys raw land as an investment for \$400,000. In year 10, Betsy sells the land for \$2 million. Betsy's amount realized is \$2 million and her adjusted basis is \$400,000, so her realized gain from the sale is \$1.6 million. She will include \$1.6 million in gross income under §61(a)(3). If Betsy had instead bought property with a limited useful life, such as an apartment building, she would be allowed to depreciate the property, meaning that she would be allowed to deduct, for purposes of