FEDERAL INCOME TAXATION

A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS

FIFTH EDITION

MARVIN A. CHIRELSTEIN

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By

MARVIN A. CHIRELSTEIN
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PREFACE

This book is intended as a study aid for law students taking the basic course in federal income taxation, and it is therefore largely an explanation of how the income tax affects individuals. A systematic treatment of the taxation of corporations and shareholders—usually the subject of an advanced course, and in any event requiring an entire volume to itself—is not included. Certain fundamental elements of the corporate-shareholder system are referred to at various points, but this is done only as an incident of some other discussion and never in any real detail. The focus here is on the individual income tax and on the case and statutory materials that are likely to be covered in an introductory law-school course.

My approach, I should also state, is anything but comprehensive. All sorts of topics are omitted which the student may encounter in the classroom and desire more information about, while other topics of no greater intrinsic importance are discussed at length. But I have not attempted to write a treatise, or a summary of Code sections, or a manual which can be used to answer specific questions about the tax law. Instead, my aim has been to disclose the structural characteristics of the income tax mechanism—how the plumbing works, what's at stake in the controversies that arise, what elements of internal consistency or inconsistency can be detected, and so on. Accordingly, I have used whatever legal materials seemed best to illustrate the *technical* components of the system. I have tried to sketch the outline of the house—or at least one wing of it—but have made no effort to furnish all the rooms. This concept has led to a selective coverage of the law (to put it mildly), but it has also made possible a higher level of coherence and connectedness than could have been attained if more detail had been included.

The organization of the work—Income, Deductions, Attribution, etc.—roughly mirrors that of the various casebooks now in general use in the law schools. Although they differ among themselves in many ways, the casebooks also exhibit a great many elements of similarity, and I think it safe to say that the resemblances vastly outnumber the differences. Large subject-matter headings are, of course, alike. In addition, the casebooks generally employ the same "great" landmark cases to carry the tax story from one topic to another: the sixty-or-so well-known Supreme Court decisions are always presented, and even the lesser gleanings from the lower courts and the Service are often the same. The notes that follow the cases, as well as the independent editorial materials, are very different in emphasis and style, and there are many differences in organization which are of real importance. But, again, the *lists* of leading cases and administrative rulings are remarkably uniform.

This aspect of agreement among the editors, on cases as well as subject-matter, has encouraged me to try to write a book which tracks the casebooks—follows them like a reproach, as it were—without really having to develop a closer relationship to any one than any other. I have used the landmark decisions as vehicles for explanation whenever possible because the casebooks do so, and where the casebooks diverge, I have tried to invent hypotheticals which abstract from the cases in such a way as to merge the elements that seem to be common to all. My hope is that this book can be used as a kind of universal supplement, therefore, and that the discussion it contains will have roughly equal relevance for all students taking the basic tax course, no matter what the identity of their primary course materials. So as not to seem to claim too much, however, I should state again that by no means every casebook subject is taken up in detail; and some are omitted entirely.

Preface to the Fifth Edition

The Tax Reform Act of 1986 profoundly affects the substance of the introductory tax course and has made it necessary to rewrite and restructure this book at many points. The Act sharply reduces individual (and corporate) tax rates, flattens the rate structure itself, eliminates the preferential treatment of capital gains, and effects other changes of real importance throughout the length and breadth of the Internal Revenue Code. From the standpoint of a student taking the introductory course, these changes should make life a little easier. Certain of the subject-matter areas that have generally been viewed as "most difficult"—assignment of income, for example, and the capital asset definition—have been greatly reduced in importance and no doubt many instructors will choose to give them less attention than in the past. They do survive as residual presences, however, and so, to be on the safe side, I have continued to cover those topics at about the same length as formerly.

In general, I have tried to reflect the 1986 Act changes in a way that is consistent with the approach taken in earlier editions, that is, by emphasizing structural elements of the tax law rather than detail. I think, or I hope, that students will find it more useful to have the system described in larger terms than smaller, but readers should be warned that various sub-topics are treated briefly or not at all.

The Omnibus Budget Reconciliation Act of 1987 contains a few additional tax provisions that are important and relevant to the introductory course. These are mentioned briefly in footnotes to the present text. I apologize for that—footnotes are otherwise used chiefly for citations to cases and commentary—but at some point the process of up-dating has to have a halt.

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Columbia University
January, 1988

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FEDERAL INCOME TAXATION

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INTRODUCTION: TERMINOLOGY, TIMING AND RATES

A brief presentation of income tax terminology may be useful by way of introduction:

The computation of an individual's tax liability begins with a determination of his *gross income*. This term is defined in Code § 61 as encompassing "all income from whatever source derived" except as otherwise provided by the statute. For most taxpayers gross income is made up of wages and salaries, dividends, interest and rents, and gains from the sale of investments such as securities and real estate. The definition of gross income is broad enough, however, to include receipts from other, less familiar sources as well. The statutory exceptions to the reach of § 61, which are fairly numerous, are usually referred to as *exclusions* from gross income (sometimes the term *exemption* is used). A well-known example is interest on state and municipal bonds, which is specifically excluded from gross income by Code § 103(a). Excluded items simply do not enter into the computation of tax. Thus, an individual with $50,000 of salary plus $5,000 of interest on bonds issued by the State of New York has a gross income of only $50,000. Quite obviously, the effect of the exclusion is to tax the excluded item at a rate of zero. The benefit to an individual taxpayer depends on his own applicable tax bracket, which in turn depends on how much income he receives from taxable sources. If the taxpayer just mentioned would otherwise be taxed at a rate of 28% on the last $5,000 of non-excludable income, the dollar value of the exclusion from his standpoint is 28% of $5,000, or $1,400. If his bracket rate were only 15%, the dollar value of the exclusion would be nearly halved as well.

Having determined his gross income under § 61, the taxpayer next subtracts all the outlays and expenditures which are allowed by the Code as *deductions*. Deductible items include the taxpayer's business expenses—wages paid to employees, depreciation on business equipment, fees paid to investment advisers, etc.—which represent the cost of earning the gross income determined above. In addition, while personal living expenses (food, apartment rent) are generally disallowed, the Code does permit certain items—for example, charitable contributions—to be deducted, even though plainly in the category of personal rather than business expense. As a matter of tax arithmetic the dollar value of a deduction from gross income is the same as that of an exclusion. If a 28% taxpayer contributes $5,000 to charity, the value of the deduction from his standpoint is obviously $1,400. The effect is just the same whether the amount of the charitable gift is excluded from his gross income in the first instance, or included but then allowed as a deduction.

Once gross income has been reduced by allowable deductions, including personal and dependency exemptions, the figure that remains is the taxpayer's *taxable income.*[1] Taxable income is the residual or net amount on which the taxpayer's tax liability is based. Having selected the appropriate rate schedule from § 1 (depending on whether he is married, single, or a "head of household"), the taxpayer then determines his tax by fitting his taxable income into the schedule in the manner indicated below. The tax liability that results may be reduced by statutory *credits—e.g.,* for retirement income—which are subtracted directly from the tax due. While the dollar-value of a *deduction* depends on the particular taxpayer's applicable tax rate (so that the value is greater for higher than for lower-bracket taxpayers), a credit has the same dollar-value for all taxpayers entitled to use it. This is so because a credit is a dollar-for-dollar reduction of the tax itself rather than being a subtraction from gross income.

Income tax returns are filed and taxes are paid on an *annual* basis, which for almost all individual taxpayers simply means the calendar year. Accounting rules are employed to allocate income and deduction items to one taxable year or another, with most individuals using the *cash method* of accounting and many businesses using the *accrual method.* The timing of income and deductions is important, because taxpayers strongly prefer to pay their taxes later rather than sooner. Money in the bank or invested in government bonds earns interest—at the present writing quite a bit—so that if given a choice between paying $1,000 of taxes today and paying $1,000 of taxes a year from now, the taxpayer will always choose the later date. Assuming interest at a rate of 8% after tax, the present value—the value today—of $1,000 due in one year is only $926. Put differently, the sum of $926 invested at 8% today will grow to $1,000 at the end of one year. If (because of accounting or other legal rules) the $1,000 tax is not due until a year from now, the taxpayer can meet that obligation by currently setting aside the sum of $926. But if the tax is due today, the full $1,000 will have to be surrendered. It follows that a year's delay is worth $74 ($1,000 - $926) to the taxpayer in hard cold cash. The government, of course, sees the matter in opposite terms: a year's delay "costs" the Treasury

1. An intermediate calculation between gross income and taxable income called *adjusted gross income* is necessary in computing the various personal expense allowances and for certain other purposes. See discussion at 7.06.

exactly the same amount. As suggested in Part A and elsewhere, the question of "pay now or pay later" is at the heart of many of the legal controversies that arise in the tax field, though this fact is not always apparent to the naked eye.[2]

Coming finally to the significant subject of tax rates, it may be illuminating to compare the "new" rate schedule—that adopted by the Tax Reform Act of 1986—with the old schedule which it replaced. A major purpose of the 1986 Act was to cut individual rates and flatten out the rate structure itself. Under prior law, the rate schedule began with a so-called zero-bracket amount of \$3,670 (1986) for married couples, \$2,480 for single persons. In effect, all taxpayers were permitted to receive income up to those levels at a tax rate of zero. Under the new law, the zero-bracket—now, or again, called the *standard deduction*—is increased to \$5,000 for couples, \$3,000 for singles. Even more important, especially for lower-income people, the personal exemption is raised to \$2,000 (for 1989), nearly double the amount allowed under prior law. Combining the standard deduction with personal exemptions, a family of four can receive up to \$13,000 (\$5,000 plus 4 × \$2,000) tax-free in 1989. For a single person the tax-free amount is \$5,000—the \$3,000 standard deduction plus one \$2,000 personal exemption. Comparable figures for 1986 were \$7,990 and \$3,560.

Once the standard deduction amount is exceeded the positive rates take hold. Under prior law, the positive rates began at 11% and rose through fourteen successive (but uneven) steps, called *income brackets*, to a top rate of 50%, which applied to taxable income above \$175,250 (for married couples). The resulting rate structure was classically "progressive," or graduated, which simply meant that as income increased an individual's tax liability also increased but at a greater rate. By custom, under a progressive rate structure the applicable rate at each bracket level is called the *marginal* rate of tax, while the rate that is applicable to

2. The same point—that postponing his tax payments favors the taxpayer—can be made in another way. In the example above, if the \$1,000 tax is not due for one year, the taxpayer (rather than the government) will earn the stipulated after-tax return of 8% during that period. The taxpayer will then have 80 "extra" dollars of his own when the year is over. But if the \$1,000 has to be paid to the Treasury immediately, the return on that money will belong to the government. Viewed as of the *end* of the year, therefore, there is \$80 at stake. While the text suggests that the amount at stake is only \$74, that is because the text is looking at the problem from the *beginning* of the year. Really, the \$74 mentioned in the text and the \$80 mentioned in this note are the same quantities. Thus, \$74 is the present value (again, at 8%) of \$80 due a year from now; \$80 is just \$74 one year later.

For convenience, an explanation of the concept of "present value," together with related Tables, is provided in the Appendix.

the taxpayer's income as a whole is called the *average* or *effective* rate. A married couple, for example, with $60,000 of taxable income in 1986 was subject to a marginal rate of 11% on their first $2,270 of taxable income (above the zero bracket amount), and to gradually increasing marginal rates on each additional increment, until a rate of 38% was reached on their last $10,580 of taxable income. Their total tax liability was $14,564. This figure represented the sum of the taxes computed at each bracket level by multiplying the dollars of income that fell within that bracket by the applicable marginal rate. Although the couple's topmost marginal rate was 38%, their effective rate was less than 25% (14,564/$60,000). Above the first bracket, the effective rate was bound to be lower than the marginal rate on the taxpayer's last dollar of income because the effective rate is simply a weighted average of all the prior marginal rates. Putting the same point differently, the effective rate on taxable income could never quite reach the top marginal rate of 50%. The reason, of course, was that the successive marginal rates on the first $175,250 of taxable income of even the richest couple were less than 50%.[3]

The new rate schedule—applicable to 1988 and subsequent years—contains only two brackets: 15% on taxable income up to $29,750 (above personal exemptions and the increased standard deduction amount) and 28% on taxable income in excess of $29,750. This does not quite end the matter, however, because an *additional* rate of 5% is imposed on taxable income between $71,900 and $149,250 plus $11,200 for each personal exemption—following which the 28% rate again takes over. The object of the 5-point rate adjustment is to confine the benefit of both the 15% bracket and the personal exemptions to low and middle-income taxpayers and, correspondingly, to phase out (and finally deny) such benefit to higher income taxpayers. In effect, the difference between a 15% tax and a 28% tax on the first $29,750 of taxable income—$3,867.50—and, likewise, the difference between zero and a 28% tax on each $2,000 personal exemption—$560—is recaptured by taxing income within the affected range at a marginal rate of 33%. Taxpayers at very high income levels will therefore pay tax at a flat rate of 28% on *all* their income in excess of the standard deduction amount—not just that portion above the personal exemptions and the 15% break-point. The effective rate (28%) finally catches up with the marginal rate (also 28%) once the 5% phaseout adjustment has done its work.

3. See Bittker, *Effective Tax Rates: Fact or Fancy,* 122 U.Pa.L.Rev. 780 (1974).