
Second Edition

**FUNDAMENTALS
OF INCOME
TAXATION**

James F. Ivers III, Editor



The American College
Bryn Mawr, Pennsylvania

Huebner School Series

***Fundamentals of
Income Taxation***
Second Edition

Edited by James F. Ivers III

The American College/Bryn Mawr, Pennsylvania

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To my mother
Natalie Ann Gormley Ivers

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James F. Ivers III

About the Editor

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Access to Sources of Tax Law and New Legislation

James F. Ivers III and Deborah A. Jenkins *

Our tax code is so long it makes *War and Peace* seem breezy.

Steven LaTourette

Chapter Outline

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INTRODUCTION

A student or financial services professional will frequently need information regarding a particular issue or new piece of legislation in the area of federal income taxation. This chapter will ease the process of basic tax research as well as point out means of access to new law and related explanatory material.

Effective research of court decisions involves techniques whose explanations are beyond the scope of this chapter. However, the use of the basic tax services, encyclopedias, periodicals, and material published on new law is addressed.

For the tax practitioner, the basic services and encyclopedias are well worth their substantial cost. This cost includes annual charges for periodic revisions. However, unless the student is a specialist in taxation, he or she is likely to use these services at a library.

The remainder of this chapter explains how to acquire the most current tax information.

* Deborah A. Jenkins, MLS, is assistant librarian at The American College.

MAJOR TAX SERVICES AND RESEARCH TOOLS

Two of the major reporting services in the area of federal income tax are

- *Federal Tax Coordinator 2d*, published by The Research Institute of America (RIA)
- *Standard Federal Tax Reporter*, published by Commerce Clearing House (CCH)

Each of these services consists of multivolume sets with updates provided regularly in the form of replacement sheets or add-ons for the loose-leaf format each service uses.

Each includes the Internal Revenue Code sections and the current regulations promulgated thereunder. In addition, each includes explanatory material and case citations or annotations that summarize court decisions and provide references to the full text of opinions related to a particular subject or issue.

The RIA service is organized by topic, and volumes run alphabetically in sequence. To find the explanatory material for a particular topic, the researcher can consult either the *Topic Index* or *Finding Tables* volumes.

The CCH service is organized by sequential treatment of Internal Revenue Code sections. CCH also contains a thorough subject index volume.

It may be easier for the fledgling researcher to use the RIA service, since it is organized by subject and contains lengthy explanatory text. The RIA service offers a *Practice Aids* volume, which contains tax ideas along with reprints of IRS audit manuals. It also provides two volumes of proposed regulations as well as reprints of recent revenue rulings and revenue procedures.

The CCH service, on the other hand, offers more verbatim reprints of various elements of primary-source tax law. It also offers more extensive annotations of court decisions. CCH also offers a two-volume *Citor* that shows where each listed decision has been cited and discussed in later court decisions.

Each service has its own advantages and character. The researcher will likely become more familiar with one and will develop a preference based on that familiarity. Both services (and others) can be found in most law libraries as well as in other selected libraries.

The researcher should note that these services are referenced by paragraph number, not page number. The upper corner of each page contains the paragraph numbers, while the page number appears in the bottom corner of the page.

Both the CCH and RIA services are also available on CD-ROM.

A major encyclopedia-type multivolume tax treatise is Rabkin and Johnson, *Federal Income, Gift, and Estate Taxation*. Rabkin and Johnson is a multivolume treatise organized by subject and is characterized by its economy of language and its clear explanatory material. It is supplemented monthly. Rabkin and Johnson includes congressional committee reports to inform the researcher of legislative history with respect to various Code sections. It is also available in

a single-volume desk edition, which is a condensed version of the full encyclopedia.

PERIODICALS

There are a host of periodicals that publish tax articles, and this chapter is not intended to recommend a selective list over any others.

Commerce Clearing House publishes *Federal Tax Articles*, a comprehensive list of tax-related articles published in all types of professional journals.

Among the periodicals devoted exclusively to taxation are the *Journal of Taxation*, *Taxes—The Tax Magazine*, *Tax Notes*, and the *Monthly Digest of Tax Articles*.

The *Journal of Financial Service Professionals* also publishes many tax-related articles in addition to other articles of interest. Numerous other periodicals include tax articles of interest to the financial services professional.

NEW LEGISLATION AND RELATED MATERIAL

Each of the major tax services publishes verbatim reprints of new tax legislation and accompanying legislative history, explanatory material, and analysis. These separate volumes can be obtained by contacting the publishers.

Within the basic tax services are sections covering current developments. A volume of CCH, entitled *New Matters*, contains new legislation, recent cases, and rulings that have not yet been incorporated into the main body of the Service. It also includes a cumulative index to new developments. Additional volumes of CCH provide advance sheets on court decisions in tax cases in the federal courts.

The RIA service contains a tab section at the end of each volume entitled “Developments.” This section features decisions, rulings, and other developments occurring since the last periodic revision. The new developments are referenced by way of specific paragraph numbers to the main body of the service.

In addition to materials published by the major tax services, major accounting firms also publish summaries of each new piece of federal tax legislation both in printed form and on the Internet. These are generally easy to read, although depth of coverage is not comparable to the publications of the major services. However, these summaries can be quite satisfactory for an overview of the highlights of new tax legislation. They are generally available by contacting the local office or Web site of major accounting firms shortly after new tax legislation is signed by the president.

Various government Web sites on the Internet, such as the “Thomas” site, also provide text of new legislation, committee reports, and related material.

The leading printed report for the latest tax developments is the *Daily Tax Report* published by the Bureau of National Affairs (BNA). The *Daily* is

thorough, well written, and appropriate not only for the tax specialist but also for the financial planner. It is also available as an online service.

CCH has an Internet service that provides quick access to the latest developments in all areas of tax law. This service is called "OMNITAX." For information regarding features, cost, and computer compatibility, contact the publisher. The LEXIS database service also offers a tax research library called FEDTAX. RIA also has an Internet product available by subscription called "Checkpoint" that provides information comparable to *Federal Tax Coordinator 2d*.

CONCLUSION

A few trips to the tax section of a law library will make the student familiar with the ways in which tax law is developed and reported. Researchers who prefer working by computer can also develop effective researching skills that way. In view of the importance of tax matters in virtually every aspect of the financial planning process, basic research techniques should be of interest to the student.

A History of the Income Tax Law and a Glance at the Sources of Current Law

James F. Ivers III and Stephan R. Leimberg*

What at first was plunder assumed the softer name of revenue.

Thomas Paine

That most delicious of all privileges—spending other people's money.

John Randolph

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* Stephan R. Leimberg, JD, CLU, is a former professor of taxation and estate planning at The American College.

EARLY TAX LAW

The tax history of the United States mirrors the general history of this country. Under the Articles of Confederation, the first governing instrument adopted by the Continental Congress in 1777, the federal government had no taxing power or right to collect custom duties. Several attempts to amend the Articles and give Congress a power to tax failed.

Because the Articles of Confederation proved to be too weak, the Constitution, written in 1787 and ratified in 1789, enlarged the powers of the federal government. However, the framers of the Constitution feared that the accumulation of power by the federal government would result in tyranny similar to the absolute monarchy of King George III of England. Therefore the government was divided into three coequal branches of government (legislative, executive, and judicial) with a system of checks and balances. The original taxing power of the federal government under the Constitution was sharply limited by the uniformity and apportionment clauses—Article I, Sections 8 and 9, of the Constitution. A detailed explanation is beyond the scope of this chapter, but it is sufficient to say, in retrospect, that these clauses precluded the federal government from imposing an income tax.

INCREASED PRESSURE FOR REVENUES

The high cost of the Civil War brought about the first governmental attempt to collect a tax on income. The tax soon expired, but by 1894 governmental needs for revenue led to the adoption of another income tax. Within a year, the constitutional validity of this tax was tested. In the famous case of *Pollock v. Farmers' Loan and Trust Company*, the U.S. Supreme Court held that the tax was neither apportioned among the states nor uniform and was therefore unconstitutional, as Pollock had claimed.

Congressional reaction to the *Pollock* decision was shaped by the increasing pressures as well as the demands for a steady and sufficient source of revenue. The result was a political compromise in 1909 that levied a tax on corporations. However, even while the constitutionality of the Revenue Act of 1909 was being considered, Congress realized the need for a broader tax base.

THE 16TH AMENDMENT

In 1909, the 16th Amendment to the Constitution, which nullified the *Pollock* decision, was adopted by Congress. After appropriate action by the states, it was declared ratified on February 25, 1913. The 16th Amendment says the following:

The Congress shall have the power to lay and collect taxes on income, from whatever source derived, without apportionment

among the several States, and without regard to any census or enumeration.

It is this amendment that dispensed with the apportionment requirement and therefore became the foundation for the basic framework of our modern tax law. The broad and sweeping language that permitted "income, from whatever source derived" to be taxed pervades the entire income tax law and has far-reaching implications.

Congress quickly utilized the newly sanctioned revenue source. The corporate income tax created by the Revenue Act of 1909 was discontinued. Individuals, as well as corporations, then became subject to the broad new income tax introduced by Congress in 1913.

THE CODE

The Revenue Act of 1913 was quickly followed by a series of additional revenue acts. In 1939 the entire federal tax law was codified and entitled the Internal Revenue Code of 1939. The crucial need to raise revenue to finance World War II turned the income tax from a tax on wealthy taxpayers to a tax on the majority of the population. This period also saw the introduction of the withholding provisions for employees. After the war the Code provisions were rearranged and revised. The result was the Internal Revenue Code of 1954. The Code is now called the Internal Revenue Code of 1986, however, as a result of the voluminous changes wrought by the Tax Reform Act of 1986. Numerous additional changes have been made since 1986.

FUNCTIONS OF THE INCOME TAX SYSTEM

Revenue-Producing Function

The income tax law originated as a revenue-producing mechanism to supply money for the administration and operation of the federal government. The bulk of the government's net receipts are still produced by the federal income tax. Congress, however, does not enact tax laws solely to raise revenue. The tax law also serves economic, social, and regulatory functions.

Economic Function

The Internal Revenue Code plays an important role in the management of the nation's economy. According to current economic thinking, greater taxes result in lower spending by consumers. The reasoning concludes that by reducing consumer spending (without increasing governmental expenditures) the income tax system can be used to reduce inflationary trends. Conversely, the use of tax incentives or lower tax rates leaves consumers with more cash that, in

turn, translates into increased spending, saving, and investment. The hoped-for result is an increase in the national product that will increase the demand for new workers and thus reduce unemployment. Thus the tax system can prevent or reduce the impact of recessions.

Some economic experts feel that the very nature of a progressive income tax will automatically perform both antiinflationary and antirecessionary functions without Congress actually changing the rates. The theory is that when more dollars (through increased salaries) are available to consumers, their income taxes will increase more than proportionately, resulting in a dampening of their ability to make inflationary expenditures with their increased incomes. During a recession the amount of money collected through the federal income tax decreases more than proportionately as the amount of a taxpayer's income decreases. Thus the relative reduction in income available to taxpayers is less than the reduction in their wages and salaries. Consequently, recessionary forces should be smaller than they otherwise would be. However, at the present time, recessionary signs are not coupled with a reduction in salaries. The value of the dollar is continually being eroded. Salary increases push the taxpayer into increasingly higher tax brackets, leaving less spendable income than before. As a result, our progressive tax structure does not automatically provide an anti-inflationary function during the type of combined recession-inflation that the United States encountered in the 1980s.

Further, the Code used incentives to encourage economic activity at the taxpayer level. For example, liberal depreciation rules as well as an investment credit encouraged taxpayers to invest capital in their businesses that, in turn, created more jobs for the nation. These incentives are now being questioned.

Social Function

As the tax base grew wider and rates became higher, Congress found that in addition to producing revenue, the tax structure could be used as a method of effectuating governmental policy. For example, the income tax, as a progressive tax, could be used to redistribute the national wealth. A progressive tax is one in which the amount of tax increases more than proportionately as the amount of the taxpayer's taxable income increases. Therefore in theory, if not in practice, by taking a higher proportion of tax dollars from higher incomes rather than from lower incomes (and using those dollars for governmental expenditures that benefit lower income taxpayers), the distribution of national wealth could be changed significantly. The social function of the income tax has been increasing in importance.

Regulatory Function

The income tax system performs a regulatory function as well as the revenue and social functions mentioned above. Two extreme examples of this use of the