

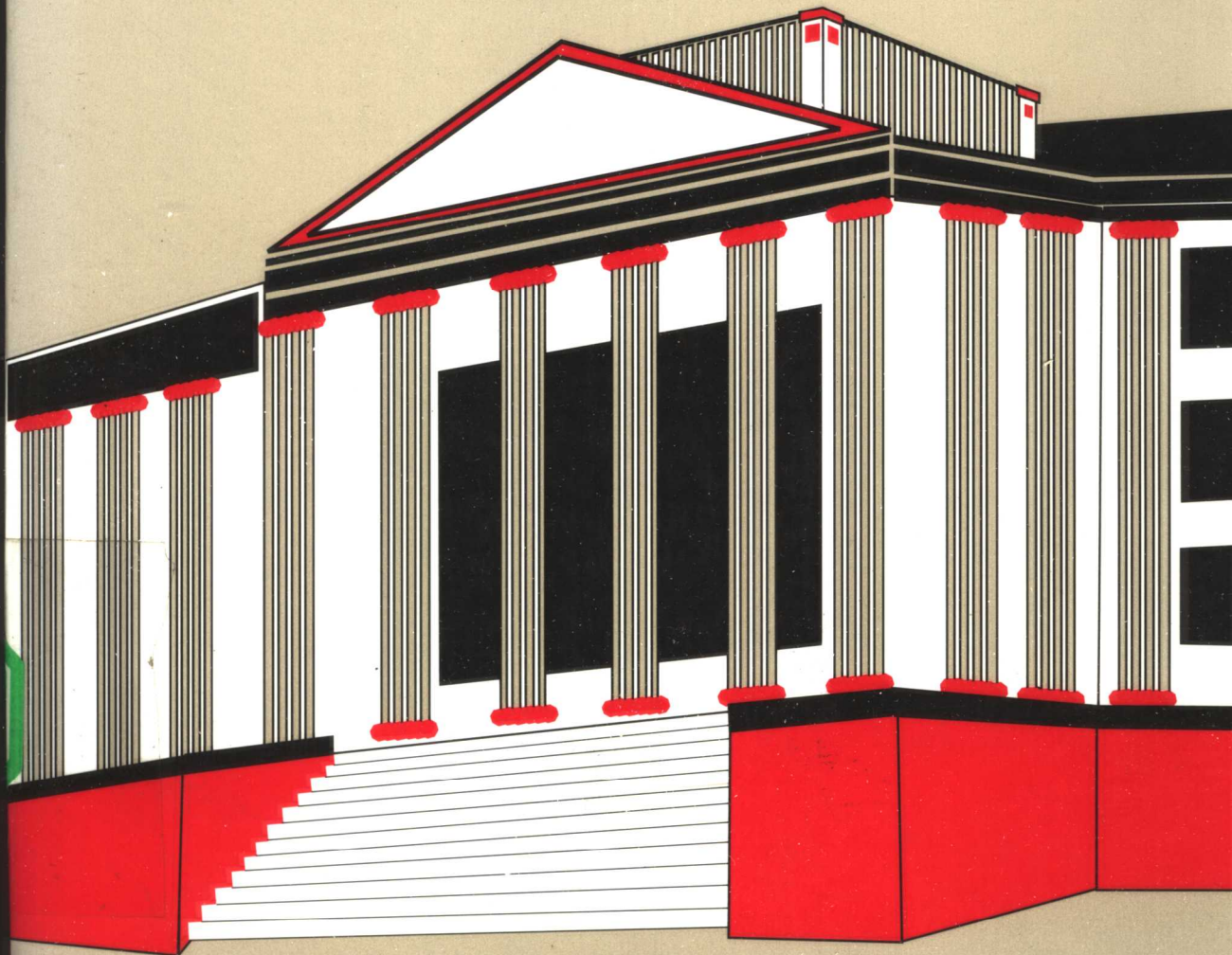


ASPEN LAW & BUSINESS

FEDERAL INCOME TAX

EXAMPLES AND EXPLANATIONS

Joseph Bankman
Thomas D. Griffith
Katherine Pratt



FEDERAL INCOME TAX

Examples and Explanations

Joseph Bankman

Professor of Law

Helen L. Crocker Faculty Scholar

Stanford University

Thomas D. Griffith

Professor of Law

University of Southern California

Katherine Pratt

Visiting Associate Professor of Law

Loyola Law School, Los Angeles



ASPEN LAW & BUSINESS
Aspen Publishers, Inc.

Copyright © 1996 by Joseph Bankman, Thomas D. Griffith,
and Katherine Pratt

All rights reserved. No part of this book may be reproduced in any form or by any electronic or mechanical means including information storage and retrieval systems without permission in writing from the publisher, except by a reviewer who may quote brief passages in a review.

Library of Congress Catalog Card No. 95-82170

ISBN 0-316-08040-3



Published by Aspen Law & Business
Formerly published by Little, Brown & Company

Printed in the United States of America

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 casebook.) There are also a number of excellent treatises and student aids on the market.

What this book does—and those other books 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.) We have also included numerous policy questions throughout the book.

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 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

An Introductory Note to Students

“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 of the book or the Code section and topical indexes in the back of the book.

Most of the examples and explanations in this book have been used, in unpublished form, by students for over a decade. The material in this book has been assigned, recommended, or made available to students at many law schools, including UCLA, Capitol, NYU, USC, Loyola (Los Angeles), Miami, and Stanford. Student comments and anonymous reviews of the material have been uniformly favorable. Even those (fortunately few) students who panned our tax classes gave rave reviews to the material that now comprises this book.

Joseph Bankman
Thomas Griffith
Katherine Pratt
January 1996

Acknowledgments

Thanks to all of our students, whose enthusiastic questions prompted us to write these examples and explanations, and to George Demos and the scores of research assistants who worked on this book. Thanks also to Professors William Blatt, Barbara Fried, and Nancy Kaufman for contributing to the sample exam appendix.

Summary of Contents

<i>Contents</i>	<i>vii</i>
<i>An Introductory Note to Students</i>	<i>xi</i>
<i>Acknowledgments</i>	<i>xiii</i>

Chapter 1. Introduction	1
Chapter 2. Some Characteristics of Gross Income	31
Chapter 3. Problems of Timing	123
Chapter 4. Personal Deductions, Exemptions, and Credits	195
Chapter 5. Deductions for the Costs of Earning Income	247
Chapter 6. Mixed Personal and Business Expenditures	361
Chapter 7. Income Shifting	411
Chapter 8. Capital Gains and Losses	443

<i>Exam Appendix</i>	<i>483</i>
<i>Table of Cases</i>	<i>569</i>
<i>Table of Internal Revenue Code Sections</i>	<i>573</i>
<i>Table of Treasury Regulations</i>	<i>581</i>
<i>Table of Revenue Rulings</i>	<i>583</i>
<i>Table of Revenue Procedures</i>	<i>585</i>
<i>Topical Index</i>	<i>587</i>

Contents

An Introductory Note to Students

xi

Acknowledgments

xiii

Chapter 1. Introduction	1
A. Introduction to Terminology and Structure	2
B. Time Value of Money and the Value of Deferring Tax	12
C. Tax Administration and Litigation	18
D. Tax Legislation	23
E. Tax Research	25
Chapter 2. Some Characteristics of Gross Income	31
A. The Haig-Simons Definition of Income	31
B. Noncash Compensation: Fringe Benefits	33
1. Employer-Provided Meals and Lodging	33
2. Employer-Provided Insurance and Health, Accident, and Death Benefits	41
3. The Section 132 Exclusion for Miscellaneous Fringe Benefits	44
C. Imputed Income	58
D. Windfalls, Gifts, Scholarships, Prizes, and Transfer Payments	62
1. Windfalls	62
2. Gifts and Bequests	63
3. Scholarships, Prizes, and Awards	72
4. Transfer Payments	73
E. Selected Recovery of Capital Issues: Partial Sales, Annuities, Insurance Policies, Life Estates, and Remainder Interests	75
1. Partial Sales	75
2. Annuities	77
3. Life Insurance	86
4. Gambling Winnings and Losses	89
5. Life Estates and Remainder Interests	89

Contents

F. Annual Accounting	91
G. Personal Injury Recoveries	98
H. Transactions Involving Loans and Income from Discharge of Indebtedness	111
I. Tax-Exempt Bonds	120
Chapter 3. Problems of Timing	123
A. Gains and Losses from Investment in Property	124
1. Realization of Gains and Losses	124
2. Recognition of Gains and Losses	126
a. Like-Kind Exchanges	126
b. Other Nonrecognition Rules	136
B. Transfers Incident to Marriage and Divorce	141
C. Installment Sale and Open Transaction Reporting	150
D. Original Issue Discount	156
E. The Cash Method of Accounting	164
F. Section 83 Transfers	170
G. The Accrual Method of Accounting	180
H. Alternative Tax Bases: Consumption Tax and Value Added Tax	188
Chapter 4. Personal Deductions, Exemptions, and Credits	195
A. Introduction	195
B. Casualty Losses	201
C. Extraordinary Medical Expenses	210
D. Charitable Contributions	221
E. Personal Interest	235
F. Taxes	242
Chapter 5. Deductions for the Costs of Earning Income	247
A. The Statutory Framework	248
B. Current Expenses versus Capital Expenditures	250
C. Repair and Maintenance Expenses	258
D. Inventory Accounting	262
E. Rent Payments versus Installment Purchase	273
F. Goodwill and Other Intangible Assets	278
G. "Ordinary and Necessary" Expenses	280
1. The Scope of "Ordinary and Necessary"	280
2. Reasonable Compensation	283
3. Costs Associated with Illegal or Unethical Activities	285

Contents

H. Depreciation and the Accelerated Cost Recovery System	287
I. Depletion Deductions	305
J. Tax Shelters	308
1. The Tax Shelter Problem	308
2. The Judicial Response to Tax Shelters	310
3. The Congressional Response to Tax Shelters	318
a. The Investment Interest Limitation of §163(d)	318
b. The Passive Loss Rules of §469	323
c. The At-Risk Rules of §465	336
d. The Limitations on §§264 and 265	343
e. The Accuracy-Related Penalties of §6662	346
4. Sale and Leaseback Transactions	346
5. Alternative Minimum Tax	353
6. Additional Review Examples	355
Chapter 6. Mixed Personal and Business Expenditures	361
A. Controlling the Abuse of Business Deductions	362
1. Hobby Losses	362
2. Rental of a Dwelling Used by the Taxpayer	369
3. Home Offices, Computers, and Automobiles	377
B. Travel and Entertainment Expenses	384
C. Child Care Expenses	393
D. Commuting Expenses	398
E. Clothing Expenses	402
F. Legal Expenses	404
G. Educational Expenses	407
Chapter 7. Income Shifting	411
A. Income from Services and Property	411
B. Trusts	423
C. Grantor Trusts	427
D. Family Partnerships	433
E. Below-Market Loans	437
Chapter 8. Capital Gains and Losses	443
A. The Tax Treatment of Capital Gains and Losses	443
B. Policy Rationale for the Treatment of Capital Gain and Loss	448
C. The Definition of "Capital Asset"	450

Contents

D. Section 1231 and Depreciation Recapture	464
E. Substitutes for Ordinary Income	470
F. The Sale of a Business	477
G. Connected Current and Prior Transactions	482

<i>Exam Appendix</i>	483
<i>Table of Cases</i>	569
<i>Table of Internal Revenue Code Sections</i>	573
<i>Table of Treasury Regulations</i>	581
<i>Table of Revenue Rulings</i>	583
<i>Table of Revenue Procedures</i>	585
<i>Topical Index</i>	587

1

Introduction

The income tax is the largest source of revenue for the federal government. Income tax revenue exceeds \$750 billion a year, most of which is collected from individuals. However, over \$150 billion a year is 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. Moreover, corporations are subject to a maximum tax rate that is just slightly lower than the top rate for individuals. 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 social security 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 a payroll tax 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. In recent years income taxes on individuals, estates, trusts, and corporations have accounted for over a quarter of state and local tax revenues. 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

1. Introduction

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. In recent years each of these taxes has accounted for approximately 35 percent of total revenue. The precise mix of taxes varies from state to state. Some states, for example, have no income tax; other states tax individual income but not corporate income.

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 71-136. (If you look at the table of contents at the front of your Code, you will see a list of the items covered in §§71-136.) 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 a 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 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

1. Introduction

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 one 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 that would decline in value over time, such as an apartment building, she would be allowed to depreciate the property, meaning that she would be allowed to deduct, for purposes of computing the tax she owes, part of the cost of the property each year during the time she owned it. If, for example, Betsy were allowed to take \$100,000 of depreciation deductions, her unrecovered investment in the property is no longer \$400,000; since she recovered, for tax purposes, \$100,000 of her investment through depreciation deductions, her unrecovered investment is \$300,000. In this variation her original basis is \$400,000, but her adjusted basis is \$300,000. §1016. If she sold the apartment building for \$2 million, her realized gain on the sale would be \$1.7 million.

Not all realized gains from dealings in property are included in gross income. A realized gain is included in gross income only if the gain is also *recognized*. The general rule is that a realized gain is recognized and included in income. §1001(c). However, a realized gain is not recognized if a *nonrecognition* rule in the Code applies to the sale or exchange. There are a number of such nonrecognition rules in the Code. They generally apply to transactions in which the taxpayer has exchanged property but has continued her investment in another form. If one of the specific nonrecognition rules applies to a transaction, the tax on the gain realized in the transaction is deferred until the taxpayer sells the property received in the nonrecognition transaction.

Suppose that Teresa owns land in Hilton Head worth \$1 million that is held for investment. Her unrecovered investment in the land, or adjusted basis, is \$300,000. She exchanges this land for land in Tampa, worth \$1 million, that she will also hold for investment. Teresa's realized gain on the exchange of the Hilton Head property is \$700,000, the \$1 million amount realized less her \$300,000 adjusted basis in the property. However, that gain will not be recognized because the exchange was of like-kind property held for investment so the "like-kind exchange" nonrecognition rule of §1031 applies. (We will consider

1. Introduction

§1031 in some detail in Chapter 3.) The realized gain will be deferred until Teresa sells the Tampa property. Teresa's basis in the Tampa land will be \$300,000, the basis of the property exchanged for the Tampa property. For now, note that, although Teresa realized a gain on the exchange, the gain is not included in her gross income because it is not recognized.

After computing the taxpayer's gross income, the next step is to compute the taxpayer's adjusted gross income. Section 62 defines *adjusted gross income* as gross income less certain costs of earning income and a hodgepodge of other items, such as alimony paid by the taxpayer.

The next step is to compute the taxpayer's taxable income. Section 63 defines *taxable income* as the taxpayer's adjusted gross income less the sum of (i) the taxpayer's *personal exemptions* plus (ii) the greater of (a) the taxpayer's *standard deduction* or (b) the taxpayer's *itemized deductions*. The personal exemption amount is adjusted each year for inflation and was \$2,500 in 1995. A taxpayer is allowed one personal exemption deduction for each of the following: (i) the taxpayer; (ii) the taxpayer's spouse; and (iii) each of the taxpayer's dependents. §151. The standard deduction amount is also adjusted for inflation; in 1995 it was \$6,550 for married taxpayers filing a joint return, \$5,750 for heads of households, and \$3,900 for unmarried individuals. The standard deduction ensures that lower-income taxpayers do not have to pay tax and frees many taxpayers from having to keep records of their itemized deductions. Itemized deductions include all deductions other than the personal exemption deduction and the deductions allowable in computing adjusted gross income under §62. §63(d). For example, itemized deductions include the deductions for state and local income and property taxes, charitable contributions, and home mortgage interest.

Many types of expenses incurred in business or in the production of income (for example, rent and utility bills paid by a business) are deducted in full in the year in which they are incurred. However, if an expense creates an asset that will last beyond the year in which the expense is incurred, the expense cannot be deducted in full in the year in which it is incurred; this type of expense must instead be *capitalized*. If the expense is incurred to purchase an income-producing asset that will be used in the business and has a limited useful life, the taxpayer's expense for the asset is allocated across the years in which the asset is expected to produce income. Each year during the useful life of the asset, the taxpayer will deduct a portion of the cost of the asset, in the

1. Introduction

form of *depreciation* deductions. If the asset purchased by the taxpayer does not have a limited useful life (for example, raw land), the taxpayer is not permitted to recover her investment in the asset until she sells or exchanges it, at which time the taxpayer's amount realized for the asset is reduced by her adjusted basis in the asset.

After computing the taxpayer's taxable income, the next step is to compute the amount of tax due on the taxpayer's taxable income. Taxable income of individuals is taxed at rates specified in §1(a)-(d) of the Code. The §1 rates are *progressive*, meaning that as the taxpayer's income increases, the rate of tax increases. The rate applicable to the last dollar of income earned by the taxpayer is the taxpayer's *marginal rate*. The taxpayer's *effective rate* is his tax liability for the year divided by his taxable income for the year; it is the same as the taxpayer's average rate. A rate schedule exists for each of four possible filing statutes: married filing a joint return; head of household; individual; and married filing separately. There is also an implicit zero rate since a taxpayer does not owe tax if her taxable income does not exceed the sum of her personal exemptions and standard or itemized deductions. The top nominal rate in §1 is 39.6 percent, but the top rate is really higher because personal exemptions and certain itemized deductions are phased out as a taxpayer's income increases beyond certain threshold amounts. The dollar amounts for the brackets in the §1 rate schedule are indexed annually for inflation. §1(f).

Individuals, estates, and trusts pay a maximum tax rate of 28 percent on long-term *capital gain*, which is gain from the sale or exchange of a capital asset held by the taxpayer for more than a year. §§1(h), 1222. A capital asset is, loosely speaking, an investment asset as opposed to an asset used in an operating business. For example, §1221 provides that inventory and depreciable property used in a business are not capital assets. The characterization of assets as capital or ordinary will be discussed further in Chapter 8 where we will see that this characterization is sometimes difficult to determine. For now, note that high bracket taxpayers pay less tax on capital gain than on ordinary gain, so they prefer to characterize gain as capital. For example, a taxpayer whose marginal tax rate is 36 percent owes \$360,000 of tax on \$1 million of gain if the gain is ordinary. If the gain is instead capital, the taxpayer will owe \$280,000 of tax on the gain, thus saving \$80,000 of tax. You can see why the taxpayer would prefer to characterize the gain as capital.

In addition, the progressivity of the income tax encourages high bracket taxpayers to attempt to shift income to family members in

1. Introduction

lower rate brackets. In Chapter 7 we will consider the congressional and judicial responses to various income shifting techniques employed by taxpayers. For now, note that unearned income (that is, income not from personal services) of a child under age 14 is taxed at the parent's higher tax rate under §1(g), the so-called "kiddie tax." Also note that the income of spouses filing a joint return is aggregated so that attribution of income between the spouses is irrelevant.

Most married couples file jointly because doing so saves them tax. The §1 rates for spouses filing a joint return are the lowest in §1. Married couples with only one income earner pay less tax than they would have if they were not married and each spouse were taxed individually. However, married couples with two income earners pay more tax than they would have if they were not married and each spouse were taxed individually. Why? Because each of the two earners would have benefited from the progressivity of the rates. The added tax owed by two income earners who marry is referred to as the *marriage penalty*.

C corporations are treated as separate taxpaying entities and are taxed at progressive rates specified in §11 of the Code. A *C corporation* is any corporation that is not an *S corporation*. A corporation is an *S corporation* only if it meets certain eligibility requirements and elects to be an *S corporation*. §§1361, 1362. (The names are derived from subchapter designations in the Code: *S corporations* are subject to the provisions of subchapter S of Chapter 1 of the Code and corporations are generally subject to the provisions of subchapter C of Chapter 1 of the Code.) The special §1(h) 28 percent capital gain rate does not apply to corporate taxpayers. §1201.

After applying the appropriate tax rates to the taxpayer's taxable income, the next step is to reduce the tax due by the credits for which the taxpayer is eligible. A *credit* is a direct reduction in tax. A deduction or exclusion, on the other hand, reduces the taxpayer's taxable income; it reduces the tax due from the taxpayer by an amount equal to the product of multiplying the deduction or exclusion by the taxpayer's tax rate. For example, a \$1,000 deduction saves a taxpayer in the 30 percent tax bracket \$300 of tax; a \$1,000 credit, on the other hand, saves the same taxpayer \$1,000 of tax. There are a number of credit provisions in the Code. The most generally applicable is the credit for taxes withheld from the taxpayer's wages. §31. If the taxpayer's credits exceed the taxpayer's tax due, the taxpayer receives a tax refund. If the taxpayer's tax due exceeds the taxpayer's credits, the taxpayer owes tax.