

FUNDAMENTALS OF
FEDERAL INCOME
TAXATION

CASES AND MATERIALS

ELEVENTH EDITION

JAMES J. FREELAND

DANIEL J. LATHROPE

STEPHEN A. LIND

RICHARD B. STEPHENS

UNIVERSITY CASEBOOK SERIES

CASES AND MATERIALS

Fundamentals

FUNDAMENTALS OF FEDERAL INCOME TAXATION

ELEVENTH EDITION

by

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*This book is dedicated to our co-author
RICHARD B. STEPHENS
in appreciation for all that he taught us about taxation,
about writing and about life itself.*

PREFACE

During the lifespan of the Sixth Edition of this book, our co-author, RICHARD B. STEPHENS, died. This book is dedicated to him. Dick's gift with words is demonstrated by the Preface that he wrote to the Sixth Edition which is substantially republished as the Preface to this Edition. Dick's words, cogent and timely then, remain so today:

Tar, pitch, and turpentine, all begins with a. Look again. Tricky, isn't it? The federal income tax law is tricky, too. Confronted by protesting students, a colleague used to say, "It's the law that's tricky, not I." You are about to begin to enjoy learning some of the tricks.

The Internal Revenue Code, the glue that holds together the pages of this book, is complex. Perhaps it is the Rubik's Cube of legislation. But even the marvels of the prestidigitator lose their mystery when some of his methods are disclosed.

Tax books are perishable—not much affected by freeze but fragile when it comes to political heat. The law has been called evanescent, fleeting. And in some respects the description is apt when Congress changes its mind as often as it has in the past decade or so. If we could we would call: "Time out!" But that is why we are here soon after an earlier edition, at the beginning of the Sixth Edition of this book, which is responsive to very comprehensive legislation that makes it no longer possible to "Take the Fifth."

If tax law is tricky, complex, and perishable, do we suggest despair? By no means! For one thing, our national fiscal system, at least until such time as we can adopt a better one, has a very great need for lawyers who are competent in the area of taxation. A plug here for "the arts:" We think the best professional is one who has had a broad education, followed by comprehensive legal study, capped by technical tax training. But whatever! The object of this book is to aid in your technical tax training.

Moreover, the *fundamentals* of federal taxation have a very long shelf life: One *could* profitably study now the First Edition of this book. *Basic* concepts of income, deduction, rates, and credits appear there in some cases with astonishing similarity and in all cases in a manner that would aid in the understanding of today's concepts. Although we watch frequent additions, corrections, and

amendments, they are rather like hanging meat on the skeleton of the Brontosaurus; underneath the structure remains much the same.

As its title indicates, the purpose of this book is to aid in the teaching of the fundamentals of the federal income tax. The accomplishment of such a purpose involves, first, a selective determination of basic principles and concepts and, second, a decision of the manner and depth of treatment of the matters that are deemed fundamental. There is wide room for disagreement on both points. Nevertheless, the authors are confident that a thoughtful study of the materials presented in this book will afford the student a good income tax foundation. Those who do not proceed beyond the fundamentals may not be “tax experts,” but at least they will have a useful awareness of how the federal income tax impinges on practically everything that goes on in our society and economy. Others will have a good basis for enlarging their tax knowledge through advanced law school courses, or graduate study, or practice, or some combination of all three.

Although the major tax legislation of 1986 is called “reform,” it [and we would add, subsequent legislation] moves us further away from the dream of simplicity, even fails to effect any simplification. The demands made of the tax lawyer are heavy; but legal educators need to keep in mind that a practitioner must be a lawyer first and a tax lawyer only second. The tax lawyer should receive the bulk of his specialized training either through graduate study or, in the time-honored tradition of the legal profession, through his own scholarly efforts in practice. In law school some tax study may be essential for all, but not to the point that law school becomes trade school at the expense of the study of jurisprudence, comparative law and other courses needed to develop perspective.

The approach taken in this book to various aspects of the income tax varies from one of great attention to detail to one of very general descriptive notes. These differences are not haphazard. For one thing, the authors, although aware of time limitations, are certain that to present a uniformly general survey approach to income taxation would be a meaningless exercise, a serious disservice to students and a waste of faculty energy and time. A substantial amount of detailed study and analysis, selectively presented, is the only way to achieve a basic understanding of what federal taxation is all about.

What we have done is attempt to make the detailed study portions of the book serve a second purpose of giving the student a tight grasp of tax concepts and principles that are of wide application and importance. For example, the “gotcha” (I.R.C. Section 1245, the first broad recapture provision which makes its appearance in Chapter 22) is examined closely both as to purpose and effect, because both it and other related recapture provisions crop

up repeatedly, and they frequently affect all types of taxpayers, individuals, trusts, partnerships, corporations, and so forth. Section 1245 is primarily a characterization provision and although the concept of characterization is not as significant as in the past, it still retains some vitality. On the other hand, with regard to restrictions on deductions (considered in Chapter 17) the effect of illegality or impropriety on the deductibility of an expenditure, although it has been the subject of several interesting and highly “teachable” Supreme Court decisions, is largely relegated to an explanatory note that discusses the cases, because the problem is of far less frequent occurrence. We are content to present the constitutional status of the income tax by way of a note. When the modern income tax was first enacted in 1913, almost every conceivable constitutional objection was raised against it; and various objections dealt with in the note should be known to the student, even though they do not have much current importance. There is a current need to guard against constitutional tax principles falling into a state of innocuous desuetude.

Students should also have some understanding of tax procedure, which they can get from Chapters 28, 29 and 30, presented as text, even if busy instructors find no class time for this material.

There are some matters that must be classified as important which are not dealt with in detail. For example, deferred compensation arrangements, touched on in Chapter 20, affect the lives of millions of taxpaying employers and employees. And the tax rules applicable to trusts, partnerships, and corporations accorded only sparing recognition in Chapter 13 with regard to problems of assignment of income, also must be classified as important on the basis of any similar numerical test. Nevertheless, it simply cannot all be done in a basic course. And so, of necessity, some important matters are alluded to in notes but not considered in detail and are left for development in additional income tax courses at the J.D. or LL.M. level. The first edition of this book anticipated this trend which continues. A study of the taxation of individuals is the beginning, and it will serve as the cornerstone on which additional income tax courses can rest.

Brief note treatment of some matters not presented in detail reflects an effort to resist the academic compulsion to appear erudite. The purpose of such notes is only to create a general awareness. We know more about some of these matters, but it is more than we choose to tell. In this spirit we have resisted the inclination to let the book “grow.” Nevertheless, references are often included to more nourishing books and articles that may be of assistance if, at another time, the student would undertake his own detailed exploration of an area.

The authors have attempted to take account of the fact that students arrive at their first law school tax course with a wide vari-

ety of educational and other experiences. Those who have little accounting background are apprehensive and likely to feel they “will not like tax.” This attitude, as we know, is not fully justified, and experience has shown that many of these people will find a new dimension in tax law. Nevertheless, in many instances in which instruction is bound to encroach on the domain of the accountant, an effort is made, sometimes through informative comment such as the note on depreciation in Chapter 14 and on inventories in Chapter 19, to render the material manageable regardless of the student’s background knowledge. Sometimes we are sneaky too, for example, by using the caption “Timing,” rather than the intimidating term “Accounting.” Moreover if, partly due to past lack of experience, the present study seems to get off to a slow beginning, the student may anticipate a quickening pace as later chapters unfold. In fact, most students will discern a mounting crescendo with something in the nature of fireworks at the end of the show. If an instructor deems procedure (Chapters 28 through 30) too unlike fireworks, one can select one’s own high note on which to end.

Many of the judicial opinions and other documents quoted in this work have fallen prey to our editorial license. Deletions are indicated conventionally by the use of ellipses and asterisks, and editorial additions are bracketed. Where necessary, footnotes are renumbered to take account of omissions. In general, the materials included are based on the status of the law [at the end of 1997.]

The authors acknowledge an indebtedness to the hundreds of law students who have passed through their classes over a combined teaching period approaching 100 years. Not only have these young men and women served as guinea pigs for various experiments; their perception and insight have been a part of the continuing education of their instructors, making former students substantial contributors to the form and substance of this book.

RICHARD B. STEPHENS

June, 1987

During the lifespan of the Eighth Edition of this book, JAMES J. FREELAND ended his long and distinguished teaching career along with his participation in co-authoring this book. Both his humorous and clever classroom teaching and his humorous input and substantial contributions to this text will be sorely missed. Happily, however, because this book involves Fundamentals much of both Dick and Jack’s insight and humor remain in this Eleventh Edition.

It’s lonely updating a book alone, and although Professor Patricia Dille at the University of Florida (in the area of Deferred Compensation) and Professor Patricia Morgan at Georgia State University (in the area of Tax

Proceduce) provided valuable assistance on the Tenth edition of the book, it comes as a great relief to welcome a new co-author, DANIEL J. LATHROPE, to the Eleventh and future Editions of the "FUNDAMENTALS." Although I described Dan as a "new" co-author, in fact we have worked together on several other books. Based on those experiences, I am confident that Dan will be a wonderful replacement for Dick and Jack and that he will add a breath of fresh air to the "FUNDAMENTALS."

Over the years, numerous intelligent and industrious students at law schools where the authors were teaching have served as assistants in the preparation of the several prior editions of this book. It may not be sufficient but we seek to preserve a sign of our gratitude to them by listing their names at the end of this preface. Students who have worked with us on this edition and to whom my thanks are due are: Brad Arnold, Adam Halperin, Lorne Maltenfort, and Amy Shelf.

Students to whom our thanks are due for assistance on prior editions are: Jeff Anthony, Steven Arsenault, Bernie Barton, Bart Bassett, Craig Bornell, David Bowen, Mike Brittingham, David Brownhill, David Clark, Andrew Coblenz, Scott Collins, Walt Davis, Chris Detzel, Nat Doliner, Mary Sue Donsky, Clint Eddy, Bruce Ellisen, Susan Elsey, Alan Friedman, Mari Gaines, John Griffin, John Huntington, Robert Jackson, Paul Johnson, Garo Kalfayan, David Kastanis, Jay Katz, Robin Kaufman, Kevin Keenan, Peter Kirkwood, Mel Knotts, Jack Levine, Mike Little, Steve Looney, Paul Lundberg, Todd Mayo, Tom McLendon, Michael O'Leary, Tim Patterson, Kendall Patton, William Poovey, Stan Riddell, Greg Rovenger, Sharon Selk, Chuck Tallant, Lisa Thomas, Phil Tingle, Steve Voglesang, Kenneth Wheeler and Susan York Janin.

The essential procedure of mind to machine to publisher was accomplished by Sonia E. Starks.

STEPHEN A. LIND

March, 2000

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