FEDERAL INCOME TAXATION

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

FOURTH EDITION

MARVIN A. CHIREL

FOUNDATION PRESS

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By

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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.

* * *

This Fourth Edition contains a larger number of detailed textual changes than any of its predecessors, due chiefly to the fact that two major tax-revision acts—the Tax Equity and Fiscal Responsibility Act of 1982 and the Tax Reform Act of 1984—have been passed since the last edition appeared. Both of these enactments, but especially the 1984 Act, affect the subject-matter of this book at many points and have made it necessary to add new explanatory material. Legislation aside, the Supreme Court has been more than usually active lately in areas of particular concern to students taking the basic tax course: the "realization" requirement, for example, which pretty well pervades the basic course, has been reviewed by the Court on several recent occasions and applied in ways that students need to understand. These (and other) recent cases already appear in the casebook supplements; hence, they are discussed here as well.

As before, my object is to provide a technical analysis of the individual income tax, and to do this by examining the leading decisions in the field, most or all of which can be found in the casebooks that are used in introductory courses. The topics taken up in this edition are, in general, the same as those covered in prior editions, but with the substantial updating referred to above. I have eliminated some material—always a pleasure—and have tried to improve the exposition at various points in response to comments from students and colleagues.

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March, 1985

TABLE OF CONTENTS

FEDERAL INCOME TAXATION

PREFACE vii

INTRODUCTION: Terminology, Rates, and Timing 1

PART A: INCOME **6**

SECTION 1. NON-CASH BENEFITS: MEALS-AND-LODGINGS; IMPUTED RENTS 10
1.01 General Comment 11
1.02 Forced Saving and Forced Consumption—"Convenience of the Employer" 16
1.03 Imputed Income 21

SECTION 2. RECOVERY OF CAPITAL INVESTMENT 25
2.01 General Comment 25
(a) Corporate stock 26
(b) Easements 28
2.02 Annuities 32
2.03 Life Insurance 35
2.04 Damage Awards 39

SECTION 3. INCREASE IN NET WORTH—CANCELLATION OF INDEBTEDNESS 43
3.01 General Comment 43
(a) Effect of inflation 43
(b) Discharge by third parties 45
(c) When is a loan? 48
(d) Mortgages 50
3.02 Cancellation of Indebtedness 50

SECTION 4. GIFTS AND BEQUESTS 54
4.01 Gains and Losses—Realization by Whom? 55
(a) Lifetime gifts 56
(b) Bequests 59
4.02 Divided Interests—Gifts in Trust 60
4.03 Commercial Gifts 65

SECTION 5. THE REALIZATION REQUIREMENT—MACOMBER, BRUUN, AND THE DIVORCE CASES 69
5.01 General Comment 69
5.02 Stock Dividends 71
5.03 Leasehold Termination—Helvering v. Bruun 78

SECTION 5. THE REALIZATION REQUIREMENT—MACOMBER, BRUUN, AND THE DIVORCE CASES—Continued — Page
5.04 Marital Property Settlements—Davis and Farid-Es-Sultaneh 82

PART B: DEDUCTIONS **86**

SECTION 6. BUSINESS EXPENSES 87
6.01 Personal or Business 88
(a) Everday expenses of employment—child-care and commuting 90
(b) Business or pleasure—travel and entertainment 96
6.02 Capital Expenditures 102
(a) Repairs or alterations 103
(b) Lease or purchase 107
(c) Education 110
6.03 "Ordinary and Necessary" 112
6.04 Reasonable Compensation 116
6.05 Losses 121
6.06 Bad Debts 125
6.07 Depreciation—General Background 127
(a) Eligible property 127
(b) Limitation to cost 128
(c) Useful lives 130
(d) Permissible methods 130
6.08 ACRS, ITC, and Leveraged Leases 135
(a) ACRS and ITC 135
(b) Leveraged leases and the transfer of tax benefits 138
(c) Relationship to capital gain 141

SECTION 7. PERSONAL EXPENSE DEDUCTIONS 141
7.01 General Comment 141
7.02 Medical Expenses and Casualty Losses 144
(a) Medical expense 144
(b) Casualty losses 146
7.03 Charitable Contributions 146
7.04 Interest and Property Taxes 148
(a) Home mortgages 148
(b) Special disallowances 151
7.05 Zero Bracket Amount; Personal Exemptions; Retirement Income 154

Page

PART C: ATTRIBUTION OF INCOME 157

SECTION 8. THE EARLY CASES 159
8.01 Gifts of Personal Service Income; Lucas v. Earl; Poe v. Seaborn 159
(a) Redirected salary 159
(b) Services in kind 163
8.02 Assignment of Deferred Income: Helvering v. Eubank 165
8.03 Gifts of Income From Property—Horst, Blair and Schaffner 169
(a) The Horst case 169
(b) Blair and Schaffner 173
8.04 Gifts in Trust—Corliss, Wells and Clifford 175
8.05 Summary of Attribution Principles 180

SECTION 9. STATUTORY TREATMENT OF INCOME ATTRIBUTION 182
9.01 Grantor Trusts 182
(a) Reversionary interests 184
(b) Income for grantor's benefit 184
(c) Revocability and powers to control enjoyment 185
(d) Persons other than grantor treated as owner 187
9.02 Family Business Associations 189
(a) Partnerships 189
(b) Corporations 193
9.03 Joint Returns; Taxation of Married and Single Persons 195
9.04 Alimony and Separate Maintenance 197

PART D: TAX ACCOUNTING 200

SECTION 10. ANNUAL ACCOUNTING 201
10.01 Loss Carryovers and Averaging—Burnet v. Sanford & Brooks 201
10.02 Claim of Right 204
10.03 The Tax Benefit Rule 207

SECTION 11. THE CASH METHOD 209
11.01 Constructive Receipt and Cash Equivalency 210
(a) Constructive receipt 210
(b) Deferred compensation 212
11.02 Prepaid Expenses 215

Page

SECTION 12. THE ACCRUAL METHOD 218
12.01 Recognition of Income and Expenses; Disputed Items 219
(a) Timing of revenues and expenditures 219
(b) Disputed items 221
12.02 Advance Receipts and Reserves for Estimated Expenses 223
12.03 Use of Inventories 226
(a) The "First-in, First-out" (FIFO) method 227
(b) The "Last-in, First-out" (LIFO) method 228
(c) Comparison of principal methods 229

PART E: RECOGNITION OF GAINS AND LOSSES—SELECTED ISSUES 231

SECTION 13. TRANSACTIONS IN MORTGAGED PROPERTY 232
13.01 Debt and the Depreciation Allowance 234
(a) The Crane rule 234
(b) Tax shelters and the "at risk" rule 241
13.02 *Mortgage of Appreciated Property—The Woodsam Case* 242
13.03 Dispositions of Encumbered Assets—Tufts and Diedrich 246
(a) Excessively mortgaged property 246
(b) Conditional gifts 249

SECTION 14. DEFERRED PAYMENT TRANSACTIONS 251
14.01 Installment Sales; Burnet v. Logan 251
(a) The installment method 252
(b) The "fair market value" rule 254
14.02 Private Annuities—Kann's Estate 258

SECTION 15. NON-RECOGNITION TRANSACTIONS 261
15.01 Like-Kind Exchanges 262
15.02 Sale of a Personal Residence 267

PART F: CAPITAL GAINS AND LOSSES 271

SECTION 16. INTRODUCTION 271
16.01 Legislative Purpose 271
16.02 Mechanics of Computation 277

		Page
SECTION 17.	JUDICIAL DEVELOPMENT OF THE CAPITAL ASSET DEFINITION	280
17.01	General Comment	280
17.02	Everyday Business Activities	282
17.03	Substitute for Future Income	287
	(a) Carved-out interests; Hort and Lake	287
	(b) Sale of a life estate	292
	(c) Other contract rights	296
17.04	Fragmentation and Imputed Interest	302
	(a) Sale of an entire business	302
	(b) Bond discount and imputed interest	304
17.05	Recurring Receipts	308
	(a) Contingent payments	309
	(b) Open transactions	312
SECTION 18.	SALES OF BUSINESS PROPERTY	314
18.01	Property Held for Sale to Customers	315
18.02	Fixed Assets: Real and Depreciable Property	319
	(a) § 1231	319
	(b) The recapture principle	320
SECTION 19.	PERSONAL SERVICES	323
19.01	Employee Stock Options	325
19.02	Patents, Copyrights, and Self-Created Property	328
Afterword		332
Note: What Is the True Value of a Tax Preference?		334
Appendix: Present Value		341
Table of Cases		347
Index		351

INTRODUCTION: TERMINOLOGY, RATES, AND TIMING

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 50% on the last $5,000 of non-excludable income, the dollar value of the exclusion from his standpoint is 50% of $5,000, or $2,500. If his bracket rate were only 25%, the dollar value of the exclusion would be 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 50% taxpayer contributes

$5,000 to charity, the value of the deduction from his standpoint is obviously $2,500. 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.

A major complicating factor in the federal income tax is the special deduction for long-term *capital gains.* In computing gain (or loss) from the sale of property, the taxpayer subtracts his cost, or *basis,* for the property sold from the *amount realized* on the transaction. The gain, if any, is recognized and included in his gross income under § 61. If the property sold is a *capital asset*—for example, securities or real estate acquired for investment—and if the property has been held for more than 6 months, then 60% of his net gain is allowed as a deduction and only 40% is subject to tax. As capital gains are thus far more to be desired than the *ordinary* income for which no special deduction is permitted, the scope of the capital asset definition becomes a matter of considerable importance.

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.

As far as individuals are concerned, the schedule of tax rates is *progressive,* or graduated, which simply means that as income increases an individual's tax liability also increases but at a greater rate. The rate schedule for the year 1985 begins with a so-called *zero bracket amount* of $3,540 for married couples, $2,390 for single persons. In effect, all taxpayers are permitted to receive income up to these levels at a tax rate of zero.

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 7.05.

Thereafter, the positive rates take hold, beginning at 11% and rising by successive (but uneven) steps, called *brackets,* to a top rate of 50% . The applicable rate at each bracket level is called the *marginal* rate of tax; the rate that is applicable to the taxpayer's taxable income as a whole is called the *average* or *effective* rate. A married couple with $60,000 of taxable income, for example, is subject to a rate of 11% on their first $2,180 of taxable income (above the zero bracket amount), and to gradually increasing rates on each additional increment, until a rate of 38% is reached on their last $12,330 of taxable income. Their total tax liability is $14,857. This figure represents the sum of the taxes computed at each bracket level by multiplying the dollars of income that fall within that bracket by the applicable marginal rate. Although the couple's topmost marginal rate is 38%, their effective rate of tax is less than 25% ($14,857/ $60,000). Above the first bracket level, the effective rate is bound to be lower than the marginal rate on the taxpayer's last dollar of taxable income because the effective rate is simply an average of all the prior marginal rates.

To illustrate the marginal-effective rate distinction still further, one occasionally hears someone say (usually of someone else): "X doesn't want to earn any more money this year because it will put him in a higher bracket." This statement may mean, simply, that the speaker thinks that X will not care to earn an additional $10,000 if that income will be taxed at a high marginal rate—say 50%. Since X would then net only $5,000 after tax, he may prefer to substitute more leisure for that amount of additional income. This could be a valid surmise, depending on X's personal preferences and the quantity of effort needed to earn the $10,000. But if the quoted comment is supposed to signify that X will sustain an after-tax loss and actually be poorer in consequence of the additional earnings, then the speaker has obviously got his marginal and effective rates mixed up. Taken in this sense the comment could only be true if, by adding the $10,000 to his existing taxable income, the marginal tax rate applicable to the last $10,000 somehow became applicable to X's income overall. But it does not: the lower segments of X's income continue to be taxed at the same marginal rates as previously, *i.e.*, the first $2,180 at 11%, the second $2,190 at 12%, and so on. Hence additional earnings will always involve *some* increase in a taxpayer's after-tax income as long as the highest marginal rate of tax is less than 100%. "Although Zeno's tortoise eventually got to the wall towards which he was crawling, the average [or effective] rate on taxable income never quite reaches the top marginal rate of

[50%]. This is because the rate of tax on the first [$169,020] of taxable income of even the richest couple is less than [50%]." [2]

While not strictly a matter of terminology, the enactment in 1981 of an "indexation" provision can appropriately be mentioned here. Beginning in 1985, the individual rate schedules (and likewise personal exemptions and the zero-bracket amount) are to be revised annually to compensate for the preceding year's inflation. As noted, an individual whose dollar income increases from one year to the next would normally pay tax at higher marginal rates on the increase, this being a natural consequence of the progressive rate structure. If, however, due to inflation the benefit of the increase is wiped out by a corresponding increase in the cost of living, the effect would be a heavier tax burden with no real improvement in the taxpayer's economic position. Wage and salary-earners are especially vulnerable. Although a worker's wages generally go up each year, the raise he gets will be illusory if the prices of consumer goods rise in the same proportion. If his marginal tax rate also increased, the result would actually be a decrease in the taxpayer's real disposable income.

To prevent this, Code § 1(f) provides that the brackets used in the individual rate schedules shall be adjusted, or indexed, at the beginning of each year to reflect the percentage by which the Consumer Price Index exceeds the CPI for the base year 1983. The brackets used for illustrative purposes in the two paragraphs above reflect an indexation adjustment for the year 1985 of about 4.1%. Thus, for example, in 1984 the zero bracket amounts were $3,400 for married couples and $2,300 for single persons. For 1985, as indicated, the zero bracket amounts are $3,540 and $2,390, respectively.

A separate schedule of tax rates is provided for corporations. Corporations are treated by the Code as taxpaying entities, and are subject to a five-step tax schedule under § 11. The first $100,000 of taxable income is divided into four $25,000 segments which are taxed, respectively, at rates of 15%, 18%, 30% and 40%. Taxable income in excess of $100,000 is taxed at a flat rate of 46% . The lower rates on incomes of $100,000 and below are intended to benefit small, family-owned businesses, which are thus enabled to accumulate their profits and reinvest them in additional business assets at a relatively low tax cost. Under the Tax Reform Act of 1984, the benefit of the lower rates is phased out for corporations with taxable incomes in

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

excess of $1 million; hence, it is roughly accurate to say that big, publicly-held corporations now pay tax at the single 46% flat rate. Taxable income is computed in much the same way for corporations as it is for individuals—roughly, gross income less business expenses—except, of course, that the personal expense deductions and dependency exemptions allowed to individuals do not apply.

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 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.[3]

3. 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.

Part A: INCOME

Code § 61, which contains the definition of "gross income," is the starting point for a study of the federal income tax. The section begins with a catch-all clause—"gross income means all income from whatever source derived"—and then proceeds to enumerate more than a dozen specific classes of receipts which are regarded as within the income definition. The enumeration is extensive; it picks up most or all of the common classes of income—salaries, wages, business profits, dividends, interest, rents and royalties—and includes as well a good many special kinds of benefits, such as alimony, annuities, income from discharge of indebtedness, and income in respect of a decedent. The intent is plain: to the extent that there might be doubt about one or another of the items enumerated—alimony, say—the desire of Congress to bring that item within the definition of income is made clear and unmistakable. But the enumeration is not designed to be exhaustive. The forms which commercial dealings can take in the modern world, and the labels which can be assigned to income from different sources, are simply too various for any listing to fully comprehend. Accordingly, the catch-all clause is expected to supplement the enumeration by including any non-enumerated items which can properly be defined as "income." In that way it plays an important, if subordinate, role in determining the scope of the provision.

Unavoidably, perhaps, the language employed by § 61 is somewhat tautological—". . . gross *income* means all *income* . . ."—and in the old days, at least, there was considerable preoccupation with the question of how much ground the catch-all clause was actually intended to cover. Was the quoted phrase—"*all* income . . ."—as sweeping, as embracing as it sounded, or were there certain inbuilt criteria which might actually operate to exclude some forms of enrichment from the tax base? In *Eisner v. Macomber*,[1] decided in 1920, the Supreme Court stated that "income may be defined as the gain derived from labor, from capital, or from both combined," a construction which could be taken to mean that *unless* the factor of labor or capital were present in a given case, the income definition would not encompass the item in question, and the income tax would not apply to it. One was therefore invited to speculate about the status under the law of such things as "give-away" prizes ($25,000 for catching the fish with the adver-

1. 252 U.S. 189 (1920).