

Problems and Materials in FEDERAL INCOME TAXATION

Fourth Edition

SANFORD M. GUERIN

Professor of Law
Arizona State University College of Law

PHILIP F. POSTLEWAITE

Professor of Law
Northwestern University School of Law



LITTLE, BROWN AND COMPANY
Boston New York Toronto London

**Copyright © 1994 by Sanford Michael Guerin;
and Alan R. Abbott and Elizabeth A. Abbott, Trustees**

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. 92-73822

ISBN 0-316-36373-1

Fourth Edition

MV NY

Published simultaneously in Canada
by Little, Brown & Company (Canada) Limited

Printed in the United States of America

PREFACE

This text differs from most current income tax casebooks in a number of respects. Many tax texts, with their particularized analysis of the law's subtle twists, are more akin to treatises than casebooks. Unfortunately, when inundated by detail on entering the complex world of income taxation, readers often become confused and frustrated. This text seeks to mitigate that problem by focusing on major concepts and their underlying policies.

The text stresses a problem-solving approach through the use of numerous, short problems interspersed among the relevant materials. This problem-solving approach parallels a “real world” experience and thus helps to develop legal and analytic skills. Moreover, the text and problems focus on property transactions and their attendant tax consequences. Because federal income taxation is a prerequisite to other tax courses, such as corporate or partnership taxation, the taxation of property transactions — an essential building block for the advanced tax courses — has been emphasized.

Although much of the study of federal income taxation focuses on acquiring a technical knowledge of the tax system, one should also be able to integrate this information and its intended policy into a broader social context. Toward that goal, Chapter 1 presents a broad introductory overview of the federal income tax system. It does so by offering a collection of readings that highlight the components of the taxing system. Thus, the major considerations of the tax system are confronted — constitutionality, economic impact, revenue generation, administration, and illegality and ethical concerns. It should also be noted that the selections of Chapter 1 reflect the various “sources” of the tax law — case law (Tax Court and circuit court decisions), governmental studies, legislative histories, and law review articles.

Starting with Chapter 2, the text follows the taxing formula, beginning with gross income and then moving through tax deductions and credits to tax rates and tax returns. The statutory taxing formula begins with gross income, a concept encompassing the “accessions to wealth” on which an individual is taxed. This is discussed in Chapter 2. Although “gross income” is a broad concept, Congress has narrowed its scope by excluding various specific items on policy grounds. These exclusions are discussed in Chapter 3. Additional gross income issues, including *to whom* gross income is attributed and *when* a particular item of gross income is includable, are presented in Chapters 4 and 5 respectively.

After determining gross income, taxable income is calculated by subtracting statutorily prescribed deductions. Issues involving deductions are discussed in Chapters 6 through 9. The permissible deductions fall into four classes: (1) those associated with the conduct of the taxpayer’s trade or business, (2) those associated with an activity that, while not a trade or business, is engaged in for the production of income, (3) those not within the first two categories (i.e., personal expenses that typically would be denied deductibility) but that, for specific policy reasons, Congress has authorized as deductions, and (4) artificial deductions (those for which the taxpayer did not expend funds but that are allowed in support of various other policies, for example, the personal exemption).

Issues involving the calculation of taxable income and the different tax rates are discussed in Chapter 10. In addition, the Code authorizes various credits that may be subtracted and, in limited cases, mandates additional taxes that must be added to the regular tax liability. These issues are also presented in Chapter 10.

The material in this text and its accompanying teacher’s manual, both of which are current through November 1, 1993, reflect the valuable assistance of a variety of people to whom the authors express their thanks. Initially, the authors wish to thank the fine staffs of their respective institutions, Arizona State University College of Law and Northwestern University School of Law, as well as our publisher, Little, Brown and Company. All have been particularly helpful and cooperative, in particular Kay Winn. Without their assistance, the project would still be in its embryonic stage. We further wish to thank the members of our Federal Income Taxation classes at Arizona State and Northwestern, on whom we inflicted various drafts of this text. That usage, accompanied by student comments and reactions to the materials, permitted a far better refinement of the product than we would have attained operating in a vacuum. Particular thanks are due Professors David L. Cameron and Dennis S. Karjala, faculty members at the Willamette University and Arizona State University Schools of Law, who reviewed earlier drafts of the book and made valuable and insightful comments that assisted us in improving the product. Finally, we wish to thank those research assistants who assisted in constantly modifying the text to incorporate the unrelent-

ing barrage of recent congressional enactments. In this regard, particular thanks are extended to George C. Little, Jr., Edward Niestat, and David Weinberg.

In order to ease the reading of the cases, some citations have been omitted without the use of ellipses, and in some instances footnotes in cases and other quoted material have been eliminated without indication. Any footnotes that were not edited retain their original numbers, while footnotes of the editors are indicated by an asterisk.

In this text, the word “section” or a section symbol (§) refers to sections of the Internal Revenue Code and the Regulations promulgated thereunder; Regulations or Reg., Proposed Regulations or Prop. Reg. refers to Treasury Department Regulations; Revenue Ruling or Rev. Rul. refers to Rulings published by the Internal Revenue Service; Revenue Procedure or Rev. Proc. refers to Service-published Procedures; and Private Letter Ruling or Priv. Let. Rul. refers to Private Rulings (without precedential value) issued by the Service.

Sanford M. Guerin
Philip F. Postlewaite

ACKNOWLEDGMENTS

We would like to thank the following authors and copyright holders for permission to use their works.

American Bar Association, Ethics Committee's Formal Opinion 85-352, on Tax Return Advice (1985). The opinion was prepared by the Standing Committee on Ethics and Professional Responsibility, the members of which were Robert O. Hetlage, David R. Almond, Samuel Dash, Angus Goetz, F. Evans Harvill, Zona F. Hostetler, Seth Rosner, and Richard Sinkfield.

Association of the Bar of New York, *The Lawyer's Role in Tax Practice*, 36 Tax Law. 865 (1983). The article was prepared by the Special Committee on the Lawyer's Role in Tax Practice, the members of which were John H. Alexander, David E. Watts, M. Bernard Aidinoff, Renato Beghe, D. Bret Carlson, M. Carr Ferguson, Jr., Marjorie E. Gross, Gordon D. Henderson, Boris Kostelanetz, Jerome Kurtz, James B. Lewis, Mitchell E. Menaker, John C. Richardson, Sidney I. Roberts, James R. Rowen, David Sacks, and George G. Tyler, Copyright © American Bar Association.

Augustyn, *Research in Federal Income Taxation*, 38 U. Fla. L. Rev. 767 (1986). Copyright © 1986 by the University of Florida Law Review. Reprinted with permission.

Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform, 80 Harv. L. Rev. 925 (1967). Copyright © 1967 by the Harvard Law Review.

Bittker, *Effective Tax Rates: Fact or Fancy?*, 122 U. Pa. L. Rev. 780 (1974). Copyright © 1974 by Boris I. Bittker.

Note, *Realizing Appreciation without Sale: Accrual Taxation of Capital Gains on Marketable Securities*, 34 Stan. L. Rev. 857 (1982).

Pine, *Everyone's a Critic of U.S. Tax System*, Washington Post, Mar. 31, 1978 at 8, col. 1.

Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures, 83 Harv. L. Rev. 705 (1970). Copyright © 1970 by the Harvard Law Review.

Will, Morality and the "Martini Lunch," Newsweek, Oct. 17, 1977. Copyright © 1977 by Newsweek, Inc. All rights reserved. Reprinted by permission.

SUMMARY OF CONTENTS

<i>Preface</i>	xxvii
<i>Acknowledgments</i>	xxx
Chapter 1. Introduction	1
Chapter 2. The Concept of Gross Income	49
Chapter 3. Items Excluded from Gross Income	133
Chapter 4. Choosing the Proper Taxpayer	243
Chapter 5. Timing of Gross Income	305
Chapter 6. Deductions for Trade or Business Expenses	449
Chapter 7. Capital Gains and Losses	571
Chapter 8. Investment and Personal Deductions	691
Chapter 9. Timing of Deductions and Tax Shelters	795
Chapter 10. Computing Tax Liability	903
<i>Table of Cases</i>	951
<i>Table of Revenue Rulings and Procedures</i>	955
<i>Index</i>	957

TABLE OF CONTENTS

<i>Preface</i>	xxvii
<i>Acknowledgments</i>	xxxi

CHAPTER 1 INTRODUCTION 1

A. Constitutional Development of the Income Tax	1
<i>Hellermann v. Commissioner</i>	3
B. The Progressive Rate Structure	5
1. Introduction	5
Pine, Everyone's a Critic of U.S. Tax System	6
2. Tax Policy: Equity and Efficiency Goals	8
Joint Committee on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform	9
C. The Economics of Income Taxation	14
Tax Incentive Act of 1981	15
D. Other Means of Revenue Generation	18
E. Administration of the Internal Revenue Code	19
Subchapter H — Internal Revenue Practice	19
F. Illegality and Ethical Considerations	26
<i>United States v. Greenberg</i>	26
1. Rules and Regulations Restraining Unethical Behavior	28
2. Illegal Tax Protests	29

3. Realization	90
<i>Cottage Savings Association v. Commissioner</i>	91
Realizing Appreciation without Sale:	
Accrual Taxation of Capital Gains on	
Marketable Securities	97
Problem 2-22	101
4. Imputed Income	102
<i>Commissioner v. Daehler</i>	104
Problems 2-23, 2-24	105
D. Disposition of Property	106
1. Gains on the Disposition of Property	106
2. Taxable Exchanges of Property	108
Problems 2-25 through 2-27	110
3. Debt Incurred in the Acquisition of Property	110
<i>Crane v. Commissioner</i>	111
Problem 2-28	116
4. Debt Incurred after Property Acquisition	116
5. Amounts Realized from Debt Relief	118
a. Nonrecourse Indebtedness	118
<i>Commissioner v. Tufts</i>	121
b. Recourse Indebtedness	129
Rev. Rul. 90-16	129
Problems 2-29 through 2-31	131

C H A P T E R 3
ITEMS EXCLUDED FROM GROSS INCOME **133**

A. Overview	133
B. Gifts and Bequests	134
1. Introduction	134
<i>Olk v. United States</i>	136
Note on Gift versus Compensation	140
Problems 3-1 through 3-5	141
2. Section 1015 — Basis for Property Received as a Gift	141
Problem 3-6	144
3. Part Sale/Part Gift Transactions	145
<i>Diedrich v. Commissioner</i>	146
Problem 3-7	150
4. Basis of Property Acquired by Inheritance or Devise	150
Problem 3-8	152

K. Tax Policy	231
Bittker, A "Comprehensive Tax Base" as a Goal of Income Tax Reform	231

C H A P T E R 4

CHOOSING THE PROPER TAXPAYER 243

A. Assignment of Income — Services	243
1. The Concept of Income Splitting	243
2. Shifting Income by Gratuitous Transfer	246
<i>Teschner v. Commissioner</i>	246
3. Shifting Income by Compensatory Arrangement	252
<i>Fritschle v. Commissioner</i>	252
4. Shifting Income to a Related Corporation	255
<i>Johnson v. Commissioner</i>	255
Problems 4-1 through 4-3	258
B. Assignment of Income — Property	259
1. Appreciated Property Transferred by Gift	259
2. Transfers of Income from Property	260
<i>Helvering v. Horst</i>	260
3. Property and Income Transfers Compared	264
4. Substance versus Form Analysis	266
<i>Estate of Applestein v. Commissioner</i>	266
5. Dividends on Stock	270
6. Assignments of Income for Consideration	271
<i>Estate of Stranahan v. Commissioner</i>	271
7. Grantor Trusts and Gifts to Minors	274
a. Grantor Trusts	274
b. Gifts to Minors	277
c. Unearned Income of Children under Age Fourteen	278
Problems 4-4, 4-5	279
C. Below-market and Interest-free Loans	280
1. Interest-free Loans as an Income-shifting Device	280
Joint Committee on Taxation, Explanation of the Tax Reform Act of 1984	282
2. The Mechanics of §7872	292
Problems 4-6 through 4-8	294
D. Divorce and Alimony	295
1. Alimony versus Property Settlements	296
2. Tax Reform Acts of 1984 and 1986	297

d.	Prepayment for Services	355
	<i>RCA v. United States</i> , 499 F. Supp. 507 (S.D.N.Y. 1980)	356
	<i>RCA v. United States</i> , 664 F.2d 881 (2d Cir. 1981)	365
	Note	367
	Rev. Proc. 71-21	368
	Problems 5-8 through 5-12	372
D.	Judicial Exceptions Postponing Inclusion	373
1.	Security Deposits	374
	<i>Commissioner v. Indianapolis Power & Light Co.</i>	375
	Problem 5-13	380
2.	Options	381
	<i>Kitchin v. Commissioner</i>	382
	Note	384
	Problem 5-14	385
E.	Deferred Payment Sales of Property	385
1.	Closed Transaction Reporting	386
	<i>Warren Jones Co. v. Commissioner</i>	387
	Problem 5-15	392
2.	Open Transaction Reporting	392
	<i>Burnet v. Logan</i>	393
	Problem 5-16	395
3.	Installment Reporting	395
	Installment Sales Revision Act of 1980	398
	Problem 5-17	405
	Note on Disposition of Installment Obligations	405
	<i>United Surgical Steel Co. v. Commissioner</i>	407
	Note on Pledges of Installment Obligations	410
	Problem 5-18	411
	Note on Installment Sales of Encumbered Property	411
	Problems 5-19 through 5-21	413
F.	Nonrecognition of Gross Income	415
1.	Like-Kind Exchanges	415
	<i>Click v. Commissioner</i>	417
	Note on the Basis of Acquired Property	420
	Rev. Rul. 79-44	423
	Installment Sales Revision Act of 1980	426
	Problems 5-22 through 5-24	427
2.	Involuntary Conversions	430
	<i>Liant Record v. Commissioner</i>	432

2.	Entertainment Expenses	506
a.	General Requirements for the Deduction	507
	<i>Walliser v. Commissioner</i>	508
b.	Entertainment Facilities	513
c.	Substantiation Requirements and the 50 Percent Limitation	513
	Problems 6-14 through 6-16	515
3.	Business Meals	516
	Will, Morality and the “Martini Lunch”	517
	Note	519
a.	Requirements for the Deduction	520
	<i>Moss v. Commissioner</i>	521
b.	Amount of the Deduction	524
	Problem 6-17	525
4.	Education Expenses	525
a.	Education versus Personal Expenses	525
	Problems 6-18 through 6-20	527
b.	Minimum Education Requirements	528
	<i>Wassenaar v. Commissioner</i>	528
	Note	531
c.	New Trade or Business Limitation	532
	Problems 6-21 through 6-23	533
5.	Legal Expenses	534
	<i>United States v. Gilmore</i>	535
	Note	538
	Problems 6-24 through 6-26	539
E.	Depreciation and Cost Recovery	539
1.	The Concept of Depreciation	540
2.	The Accelerated Cost Recovery System	543
	Tax Reform Act of 1986	544
	Note	547
3.	Mixed-Use Assets — Section 280F	547
	Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984	548
4.	Amortization of Intangible Assets	554
	Revenue Reconciliation Act of 1993	554
	Problems 6-27, 6-28	557
F.	Limitations on Business Expenses	557
1.	Business Use of Personal Residence — Home Offices	558
	<i>Commissioner v. Soliman</i>	559
	Problems 6-29 through 6-31	565
2.	Illegality and Public Policy	565
	<i>Tucker v. Commissioner</i>	566
	Problem 6-32	569

	<i>Foy v. Commissioner</i>	645
	Problem 7-21	651
H.	Recapture of Depreciation	653
1.	General Principles	653
	Legislative History of §1245	655
2.	Installment Sales	656
	Problems 7-22, 7-23	657
I.	Sale of Business	658
	<i>Williams v. McGowan</i>	659
	Problem 7-24	662
J.	Section 1237 — Statutory Immunity for Subdivided Real Property	662
	<i>Pointer v. Commissioner</i>	663
	Problem 7-25	666
K.	Original Issue Discount and Imputed Interest	666
1.	Statutory Framework	669
2.	Reporting OID	669
3.	Application of §1274	671
4.	Determining Adequate Stated Interest	671
	Joint Committee on Taxation, Staff	
	Pamphlet Describing Tax Treatment of Imputed Interest on Deferred Payment Sales of Property	672
	Problems 7-26 through 7-29	683
L.	Policy Considerations	684
	Treasury Report on Tax Simplification and Reform	684

C H A P T E R 8

INVESTMENT AND PERSONAL DEDUCTIONS 691

A.	Introduction	691
B.	Investment Activity	694
1.	Production of Income Expenses	694
2.	Personal versus Investment Expense	696
	Rev. Rul. 84-113	696
	Note	698
3.	Capital Expenditure Limitation	700
	Rev. Rul. 86-71	700
	Note on Legal Expenses and Pre-opening Costs	701
	Problems 8-1, 8-2	704

F. Floor on Miscellaneous Deductions and Overall Limitation on Itemized Deductions	781
Problems 8-29, 8-30	782
G. The Standard Deduction	782
Problems 8-31, 8-32	783
H. Policy Issues	783
Surrey, Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures	784

C H A P T E R 9

TIMING OF DEDUCTIONS AND TAX SHELTERS

795

A. Introduction	795
B. Cash Method Accounting	797
1. Payment versus Promise to Pay	797
Rev. Rul. 76-135	799
<i>Chapman v. United States</i>	800
Rev. Rul. 78-38	802
2. The Capital Expenditure Limitation	803
Problems 9-1 through 9-3	804
C. Accrual Method Accounting	805
1. Reasonable Accuracy Test	806
2. All Events Tests	806
<i>United States v. Hughes Properties</i>	807
3. Economic Performance Requirement	815
Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984	815
4. Contested Liabilities	822
Problems 9-4 through 9-7	823
D. Repayments of Items Previously Included in Income	824
1. Claim of Right Doctrine	824
<i>United States v. Lewis</i>	825
2. Application of §1341	826
3. The <i>Arrowsmith</i> Doctrine	828
<i>Arrowsmith v. Commissioner</i>	828
Problems 9-8 through 9-10	829
E. Transactions between Related Parties	831
1. Sales or Exchanges between Related Parties	831
<i>McWilliams v. Commissioner</i>	833
Note	836

Note on Support Requirements in Specified Settings	909
Problems 10-1 through 10-4	912
C. Rates and Returns	914
1. Policy Considerations	914
Joint Committee on Taxation, Analysis of Proposals Relating to Comprehensive Tax Reform	915
2. Filing Status	922
Rev. Rul. 84-89	923
Problems 10-5, 10-6	925
3. The Marriage Penalty	925
<i>Druker v. Commissioner</i>	926
<i>Boyter v. Commissioner</i>	930
4. Unearned Income of a Minor	934
Problem 10-7	935
5. Net Capital Gain Rate Differential	935
Problem 10-8	936
6. Tax Rates	936
Bittker, Effective Tax Rates: Fact or Fancy?	936
7. Alternative Minimum Tax	945
D. Tax Credits	946
1. Introduction	946
2. Child Care Credit	947
Problem 10-9	948
3. Earned Income Credit	949
Problem 10-10	950
<i>Table of Cases</i>	951
<i>Table of Revenue Rulings and Procedures</i>	955
<i>Index</i>	957