

West's Federal Taxation

1996 Edition

**INDIVIDUAL
INCOME
TAXES**

Hoffman Smith Willis

**CD-ROM
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1996 ANNUAL EDITION

WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES

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West Publishing Company

Minneapolis/St. Paul • New York • Los Angeles • San Francisco

Copyediting: Patricia A. Lewis
Composition: Carlisle Communications, Ltd.
Text Design: LightSource Images
Cover Design: David Farr, *ImageSmythe*
Index: Catalyst Communication Arts

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610 Opperman Drive
P.O. Box 64526
St. Paul, MN 55164-0526

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Printed in the United States of America

02 01 00 99 98 97 96 95 8 7 6 5 4 3 2 1 0

Library of Congress Cataloging-in-Publication Data

Main entry under title:

West's Federal Taxation.

Includes index.

1. Income tax—United States—Law

I. Hoffman, William H. III. Willis, Eugene

ISBN 0-314-04548-1, 0-314-06264-5

KF6369.W47 343'.73'052 77-20656

ISSN 0272-0329

1996 ANNUAL EDITION

PREFACE

This text is intended as a basis for a first course in Federal taxation for undergraduate or graduate accounting, business, and law students. With certain modifications in the coverage of the materials, the text may be used in a survey course on Federal taxation for undergraduate or graduate students. The materials may also be valuable as a tool for self-study, since they contain numerous clarifying examples adaptable to such an approach.

Tax policy considerations and historical developments are introduced in the text only to the extent that they shed light on the reason for a particular rule. The many simple and straightforward examples further clarify the materials by showing how a particular tax rule applies in an actual situation.

Since the original edition was issued in 1978, we have followed a policy of annually revising the text material to reflect statutory, judicial, and administrative changes in the Federal tax law and to correct any errors or other shortcomings. Not only do we encourage user input, we actively seek the advice of users as the basis for improving the text.

We expect tax legislation to be enacted in 1995. If any significant tax legislation is enacted in 1995, we will provide you with supplements on a timely basis.

Though the primary emphasis of the text is on the income taxation of individuals, Chapter 20 provides an overview of the Federal taxation of other forms of business organization (corporations and partnerships). This chapter could be of particular significance to students who do not plan to take a second course in Federal taxation. For others, Chapter 20 may serve as a lead-in to *West's Federal Taxation: Corporations, Partnerships, Estates, and Trusts*.

ENHANCED PEDAGOGICAL PLAN

In the 1996 edition, we have continued to enhance the pedagogy to assist the student in the learning process and to address the recommendations of the Accounting Education Change Commission (AECC).

- *Learning Objectives.* Each chapter begins with student learning objectives for the chapter. These behavioral objectives provide the students with guidance in learning the key concepts and principles.
- *Chapter Outline.* The learning objectives are followed by a topical outline of the material in the chapter. Page references appear in the outline to provide the student with ready access to each topic.
- *Chapter Introductions.* The introductions link the material in the current chapter to previous chapters and demonstrate its relevance. Frequently, the chapter introduction includes a “real world” illustration to help convey the relevance of the material.

- *Margin Notes.* Each of the learning objectives appears in the margin where the related material is introduced and helps to guide the student through the chapter.
- *Tax in the News.* Tax in the News items appear in each chapter as a boxed feature to enliven the text discussion. These items are drawn from today's business press and present current issues that are relevant to the chapter material.
- *Ethical Considerations.* Ethical Considerations features appear in each chapter presenting thought-provoking issues related to the chapter topics. In response to the recommendations of the AECC, they also demonstrate that many issues do not have a single correct answer. The questions raised in the Ethical Considerations were selected to provoke discussion and provide opportunities for debate (oral communication) based on the student's value system rather than to provide a defensible answer. To assist the professor in providing guidance for the discussion, material is included in the *Instructor's Guide with Lecture Notes* on each Ethical Consideration. This material identifies the issues raised in the Ethical Consideration, and where appropriate, recommends a solution or alternate solutions.
- *Key Terms.* Located before the Problem Materials in each chapter is a list of key terms to assist student learning. When the key term is introduced in the chapter, it appears in bold print. The list of key terms includes page references to the chapter coverage. In addition, each key term is defined in the Glossary (Appendix C).
- *Communication Assignments.* In recognition of the increasing emphasis in accounting and tax education on communication, identified items in the Problem Materials now include a written communication component. Selected Problems, Cumulative Problems, and Research Problems are identified as communication assignments with a "scroll" icon. These problems ask the student to prepare a tax client letter, a memorandum for the tax files, or other written materials. The discussion of the tax research process in Chapter 2 includes an illustration of the client letter and the memo.
- *Decision-Making Problems.* The Problem Materials include decision-making problems that are designed to enhance the student's analytical skills. These problems are identified with a "scales" icon.



SPECIAL FEATURES

A variety of other pedagogical devices are used to assist the student in the learning process. We recognize the importance of readability and continue to strive to make our text and supplements even more readable and understandable. The following features enhance the readability of the text:

- Including three levels of headings to aid in organization.
- Using bold print in the text to identify key terms the first time each term is used.
- Italicizing other key words to emphasize their importance to the student.
- Avoiding legal terminology except where it is beneficial.
- Using Concept Summaries to synthesize important concepts in chart or tabular form.
- Using Exhibits, Figures, and Tables to enhance presentations.
- Organizing the material in lists with bullets rather than presenting it in lengthy sentences.
- Using examples frequently to help the student understand the tax concept being discussed.

- Using a larger page size to provide a more open, accessible, and student-friendly textbook.

Once knowledge of the tax law has been acquired, it needs to be used. The tax minimization process, however, normally requires careful planning. Because we recognize the importance of planning procedures, most chapters include a separate section (called *Tax Planning Considerations*) illustrating the applications of these procedures to specific areas.

We believe that any basic course in Federal taxation should offer the reader the opportunity to learn and utilize the methodology of tax research. This knowledge is requisite in today's environment with its increased emphasis on the concept of "learning to learn." Chapter 2 and Appendix E are devoted to this methodology. Also, most chapters contain *Research Problems* that require the use of research tools. Solutions to these Research Problems can be found in the *Instructor's Guide*. The effectiveness of the text does not, however, depend on the coverage of tax research procedures. Consequently, the treatment of this subject may be omitted without impairing the continuity of the remaining textual materials.

Although it is not our purpose to approach taxation from the standpoint of preparing tax returns, some familiarity with forms is necessary. Because 1995 forms will not be available until later in the year, most tax return problems in this edition are written for tax year 1994. The 1994 problems may be solved manually, or many may be solved using the tax return preparation software (*TurboTax* or *MacInTax*) that may be purchased by students who use this text.

Appendix F contains two comprehensive tax return problems written for tax year 1994. Each of these problems lends itself for use as a term project because of the sophistication required for satisfactory completion. Solutions to the problems in Appendix F appear in the *Instructor's Guide*.

For the reader's convenience, Appendix B contains a full reproduction of most of the 1994 tax forms frequently encountered in actual practice.

Most tax textbooks are published in the spring, long before tax forms for the year of publication are available from the government. We believe that students should be exposed to the most current tax forms. As a result, we develop some new problems and provide adopters with reproducible copies of these problems, along with blank tax forms and solutions on the new forms. Shortly after the beginning of 1996, adopters will receive a *Forms Problems Supplement* containing these tax return problems solved on 1995 forms.

WEST'S FEDERAL TAXATION ON CD-ROM

For the first time this year, West will be offering this text on CD-ROM. It includes the entire text of the printed version of **WEST'S FEDERAL TAXATION: INDIVIDUAL INCOME TAXES, 1996 EDITION** as well as the full text of all referenced cases, code sections, regulations, revenue procedures, and revenue rulings, and all tax forms, tables and schedules from the Appendixes. Students can jump directly from the text they're reading to the full text of any of the references included on the disc.

Other features include "notebook" capabilities which allow students to cut and paste from the text, type in their own comments, and convert the text and notes into other word processing packages. Records are kept of all queries which allows viewing and editing of past queries. Each disc has an electronic "bookmark" feature which marks the spot where the student left off and returns to the last page that was viewed when the project is resumed. **WFT on CD-ROM** is fully supported by West's CD-ROM Customer Service Technicians and Research Attor-

neys. Professors and students can call for any technical or research assistance their projects require.

System requirements include an IBM or compatible PC with a 286, 386, or Pentium processor; DOS version 3.3 or higher; 400K of available conventional RAM (after loading all memory-resident software including device drivers and the Microsoft CD-ROM extensions (MSCDEX); 5 MB of available hard disc space; a locally attached CD-ROM drive using Microsoft CD-ROM Extensions (MSCDEX) version 2.1 or higher (compatible CD-ROM drives must meet the ISO 9660 standard). To print images off the CD, 1.5MG RAM on your printer is required.

SUPPLEMENTS

New to this edition are the Arthur Andersen Tax Challenge Cases, a set of four capstone cases and their solutions provided to the instructor for classroom use. The cases encompass both tax compliance and tax planning, and provide an opportunity for a team approach in solving tax issues and recommending tax strategies.

Other products in our 1996 instructional package include the following:

- The *Instructor's Guide with Lecture Notes* contains lecture notes for each chapter, materials on the Ethical Considerations found in the text, and solutions to Research Problems and Comprehensive Tax Return problems found in the text. The lecture notes consist of a lecture outline that the professor can use as the basis for his or her classroom presentation. These lecture notes include not only material covered in the text, but also cases and other relevant material and teaching aids. The lecture notes are also available on disk in ASCII files.
- A *Solutions Manual* that has been carefully checked to ensure that it is error-free. The problems are arranged in accordance with the sequence of the material in the chapter. All problems are labeled by topical coverage in a matrix that also indicates which problems are new, modified, or unchanged in the new edition. The matrix also includes the problem number for the unchanged and modified problems in the prior edition. Approximately 20 percent of the problems in the 1996 edition are new or modified. The solutions are referenced to pages in the text. The solutions manual is also available on disk in ASCII files.
- A *Test Bank* with questions and solutions referenced to pages in the text. The questions are arranged in accordance with the sequence of the material in the chapter. To assist the professor in selecting questions for an examination, all questions are labeled by topical coverage in a matrix that also indicates which questions are new, modified, or unchanged in the new edition. The matrix includes the question number for the unchanged and modified questions in the prior edition. Approximately 20 percent of the questions in the 1996 edition are new or modified.
- *Westest*, a microcomputer test generation program for IBM PCs and compatibles and the Macintosh family of computers.
- *West CD-ROM Federal Tax Library* (Compact Disk with Read-Only Memory) provides a complete tax research library on a desktop. The Federal Tax Library is a set of compact disks with a software package that reads the disks through a PC. Each disk has a remarkable storage capacity—roughly 1,000 times more than a single-sided floppy disk. A brief list of the library contents includes the complete IRS Code and Regulations, 1986 Tax Reform Act with Amendments and Legislative History, Federal Court Cases on Tax, Tax Court Cases, Revenue Rulings, and Revenue Procedures. The library is available to qualified adopters.

- A *Student Study Guide* prepared by Gerald E. Whittenburg, San Diego State University, includes a chapter review of key concepts and self-evaluation tests with solutions that are page referenced to the text.
- *Solutions Transparency Masters* for selected complex and cumulative problems, with a larger typeface for greater readability.
- *Astound Presentation Software* allows qualified adopters to create interactive lectures and manipulate graphs, charts, and figures during in-class lectures. The package contains approximately 25 transparency masters per chapter consisting of alternate figures, outlines, and key points.
- *Teaching Transparency Masters* include most screens from the Astound package reproduced as transparency masters for instructors who may wish to use traditional transparencies.
- *Teaching Transparency Acetates* contain the key charts and tables from the *Teaching Transparency Masters* package.
- A *Student Note-Taking Guide* includes selected screens from the Astound package consisting of chapter outlines and key points. This unique guide provides students with the core chapter information, so they can concentrate in class on learning key concepts instead of copying basic lecture outlines and transparencies. These have been printed and bound in a manner similar to accounting working papers. The pages include all the information from the Astound screens while still leaving room for student notes.
- *Instructor's Resource Notebook*—this three-ring binder can be used to house all or portions of the supplements and text that we will continue to offer in looseleaf form so you can reorganize the book and incorporate your supplemental materials to fit your course lectures.
- *WIT Individual Practice Sets*, 1995–96 edition, prepared by John B. Barrack, University of Georgia, is designed to cover all the common forms that a tax practitioner would use for the average client.
- Limited free use to qualified adopters of WESTLAW, a computer-assisted tax and legal research service that provides access to hundreds of valuable information sources.
- *West's Internal Revenue Code of 1986 and Treasury Regulations: Annotated and Selected 1996 Edition* by James E. Smith, College of William and Mary. This provides the opportunity for the student to be exposed to the Code and the Regulations in a single-volume book, which also contains useful annotations that help the student work with and understand the Code.
- *WFT On-Line Electronic Bulletin Board* puts the most current information in your hands as soon as it is available. Qualified adopters can log onto the Bulletin Board from their home or office via a toll-free phone number and immediately gain access to the most recent taxation information available, including the Code and Regulations, case citations, new court rulings, and other newsworthy items. This information can then be transferred to a word-processing program for editing, printout, and classroom use while the information is still topical.

TAX PREPARATION SOFTWARE

The trend toward increased use of the computer as an essential tool in tax practice has accelerated. To ensure that the West's Federal Taxation instructional package continues to set the pace in this important area, the following products are available to be used with the 1996 edition:

- *TurboTax* © Personal/1040 for DOS version 94.01 by Intuit is a commercial tax preparation package. It teaches students how to prepare over 80 forms,

schedules, and worksheets, and automatically performs all mathematical calculations and data transfers. *TurboTax* also assists students with tax planning and helps them prepare “anticipated” tax returns. The *TurboTax* package, available for student purchase, includes disks bound with a 200-page workbook containing exercises and problems. The software runs on IBM PCs and compatibles with 512K memory. *MacInTax*® and *TurboTax*® for *Windows* are also available.

These software products are powerful, easy to learn, and easy to use. We believe that tax education can be raised to a higher level through the use of computers and well-designed software. These software packages take the drudgery out of performing the complex computations required to solve difficult tax problems.



To enable students to take advantage of these new software products, the 1996 edition contains numerous tax return problems. Problems that lend themselves to computerized solutions are identified by a computer symbol.

ACKNOWLEDGMENTS

We are most appreciative of the many suggestions that we have received for revising the text, many of which have been incorporated in past editions and in the 1996 edition. We would also like to thank the people who have painstakingly worked through all the problems and test questions and generally acted as problem checkers to ensure the accuracy of the book and ancillary package. They are Tracey A. Anderson, Indiana University at South Bend; Caroline K. Craig, Illinois State University; Mark B. Persellin, St. Mary's University; Debra L. Sanders, Washington State University; Randall K. Serrett, Fort Lewis College; Thomas Sternburg, University of Illinois at Urbana; and Raymond F. Wacker, Southern Illinois University at Carbondale.

Finally, this 1996 edition would not have been possible without the technical assistance of and manuscript review by Bonnie Hoffman, CPA, Freda Mulhall, CPA, and Nora Smith, M.Ed. We are indebted to them for their efforts.

William H. Hoffman, Jr.
James E. Smith
Eugene Willis

April 1, 1995

P • A • R • T

I

INTRODUCTION AND BASIC TAX MODEL

Part I provides an introduction to taxation in the United States. Although the primary orientation of this text is income taxation, other types of taxes are also discussed briefly. The purposes of the Federal tax law are examined, and the legislative, administrative, and judicial sources of Federal tax law, including their application to the tax research process, are analyzed. Part I concludes with the introduction of the basic tax model for the individual taxpayer.

Chapter 1

An Introduction to Taxation and Understanding the Federal Tax Law

Chapter 2

Working with the Tax Law

Chapter 3

Tax Determination; Personal and Dependency Exemptions;
An Overview of Property Transactions

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