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West's Federal Taxation

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1999 Edition

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Smith  
Willis

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West's Federal Taxation

# INDIVIDUAL INCOME TAXES

1999 Edition

## General Editors

**William H. Hoffman, Jr.**, J.D., Ph.D., C.P.A.

**James E. Smith**, Ph.D., C.P.A.

**Eugene Willis**, Ph.D., C.P.A.

## Contributing Authors

**James H. Boyd**

Ph.D., C.P.A.

*Arizona State University*

**William H. Hoffman, Jr.**

J.D., Ph.D., C.P.A.

*University of Houston*

**W. Eugene Seago**

J.D., Ph.D., C.P.A.

*Virginia Polytechnic Institute  
and State University*

**D. Larry Crumbley**

Ph.D., C.P.A.

*Louisiana State University*

**David M. Maloney**

Ph.D., C.P.A.

*University of Virginia*

**James E. Smith**

Ph.D., C.P.A.

*College of William and Mary*

**Steven C. Dilley**

J.D., Ph.D., C.P.A.

*Michigan State University*

**William A. Raabe**

Ph.D., C.P.A.

*Samford University*

**Eugene Willis**

Ph.D., C.P.A.

*University of Illinois  
at Urbana*

**Mary Sue Gately**

Ph.D., C.P.A.

*Texas Tech University*

**Boyd C. Randall**

J.D., Ph.D.

*Brigham Young University*



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# PREFACE

**T**he publication of the 1999 Edition marks the twenty-second year of *West's Federal Taxation* (WFT). From a single textbook on Corporations, Partnerships, Estates, and Trusts with an accompanying solutions manual, the WFT series has grown to five major textbooks and a package of more than 50 ancillaries. During this period, WFT has made every effort to improve the quality of the materials and has consistently added attractive innovations. With sales surpassing the one million level, WFT looks forward to continued success in the future in serving you.

This textbook 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 textbook 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 textbook 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 textbook.

Tax legislation may be enacted in 1998 or early 1999. If any significant tax legislation is enacted during this period, we will provide you with supplements on a timely basis.

Though the primary emphasis of the textbook 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 1999 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, the *Instructor’s Guide with Lecture Notes* includes material 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.
- *Issue Recognition Questions.* The Problem Materials include questions that are designed to require the student to identify tax issues. With this issues orientation, such questions can be multifaceted and have no single right answer. These questions are identified with a “lightbulb” icon.
- *Team Projects: Arthur Andersen Tax Challenge Cases.* This feature at the end of the Problem Materials gives students experience working as a team to solve complex, real world tax issues. The two cases referenced in the text, along with two additional cases and the solutions, are available to adopters in a separate manual. Instructors may make copies of this material for classroom use; no additional permission is required. Case Notes for the instructor can be found in the *Instructor’s Guide*.





- The Research Problems heading now includes a CD-ROM icon to emphasize that solutions to all the research problems can now be prepared using the RIA OnPoint System 4 Student Version CD-ROM available with this text.
- *Internet exercises*. Included as part of the Research Problems for each chapter are questions which require the use of the tax resources of the Internet. These exercises are identified with a globe and computer mouse 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 textbook 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. Key terms are defined in the Glossary (Appendix C).
- 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. While tax planning applications and suggestions appear *throughout* the chapter, this separate section at the end of the chapter calls the student's attention to the importance of tax planning.

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 1998 forms will not be available until later in the year, most tax return problems in this edition are written for tax year 1997. For the reader's convenience, Appendix B contains a full reproduction of most of the 1997 tax forms frequently encountered in actual practice. The 1997 problems may be solved manually, or many may be solved using the tax return preparation software (*TurboTax*®) that may be purchased by students who use this textbook.

Appendix F contains two comprehensive tax return problems written for tax year 1997. 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*.

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 1999, adopters will receive a *Forms Problems Supplement* containing these tax return problems solved on 1998 forms.

### RIA ONPOINT SYSTEM 4, STUDENT VERSION, CD-ROM

As a result of a partnership with RIA and West/South-Western College Publishing, this ultimate tax research tool is now available for student use. RIA OnPoint System 4, Student Version, offers an abbreviated version of this extensive and respected tax database. The OnPoint System 4, Student Version, offers detailed analysis and coherent explanation of the tax law by RIA's in-house experts, treatises written by renowned outside authors, primary source materials, practice aids, and more!

RIA OnPoint lets you access a complete and fully integrated tax law database with accuracy, precision, and ease. Check out these additional features:

- Over 600 watershed court cases and private letter rulings.
- The Federal Tax Coordinator.
- In-depth analysis, expert commentary and practical guidance for income, estate and gift tax, excises taxes, employment taxes, and U.S. taxation of foreign income.
- Internal Revenue Code, including complete legislative history since 1954.
- Treasury Regulations, including proposed regulations.
- Code arranged Committee Reports.
- Revenue Rulings, Procedures and Notices from 1954 to present, with headnotes and Internal Revenue Code classifications.
- Full text of current year American Federal Tax Reports (AFTR) cases.
- Over 230 of the most frequently requested IRS publications.

This item can be shrinkwrapped with the text and used by students to conduct computerized tax research.

### SUPPLEMENTS

West is continuing to publish 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. As a technique for further integrating the cases with the textbook coverage of the tax topics in the cases, page references to two of the cases appear at the end of each chapter.

Other products in our 1999 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 textbook, materials on the two Arthur Andersen Tax Challenge Cases that are page referenced to the textbook, and solutions to Research Problems and Comprehensive Tax Return problems found in the textbook. 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 textbook, but also cases and other relevant material and teaching aids. The lecture notes are also available on disk and on our Web site.

- 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 1999 edition are new or modified. The solutions are referenced to pages in the textbook. The solutions manual is also available on disk and on our Web site.
- A *Test Bank* with questions and solutions referenced to pages in the textbook. 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 1999 edition are new or modified.
- ITP World Class Test™, a microcomputer test generation program for IBM PCs and compatibles.
- 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 textbook.
- *Solutions Transparency Masters* for selected complex and cumulative problems, with a larger typeface for greater readability.
- *PowerPoint Presentation Software* allows qualified adopters to create interactive lectures and manipulate graphs, charts, and figures during in-class lectures. The package contains approximately 30 transparency masters per chapter consisting of alternate figures, outlines, and key points.
- *Teaching Transparency Acetates* contain the key charts and tables from the *PowerPoint* package for instructors who wish to use traditional overheads.
- *Arthur Andersen Tax Challenge: Cases and Solutions* is a separate manual that includes four of the Arthur Andersen Tax Challenge cases and their solutions. This manual is available to adopters with permission to copy the cases for classroom use as Team Projects (found at the end of Problem Materials).
- *WFT Individual Practice Sets*, 1998-99 edition, prepared by Mark Nixon, Bentley College, 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 1999 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.
- The WFT WEB SITE puts the most current information and supplements in the user's hands as soon as it is available. Adopters can log onto the web site (swcollege.com or wft.swcollege.com) and gain access to key information and supplements before they are available in print. The web site also includes

extra problem materials and quizzes, topical news items, the latest news of West's Federal Tax supplements and publications, and more.

## TAX PREPARATION SOFTWARE

The trend toward using 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 tax software product is available to be used with the 1999 edition:

- *TurboTax*® for Windows 97.01 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. The *TurboTax* package, available for student purchase, includes the software bound with a 200-page workbook containing exercises and problems. The software runs on IBM PCs and compatibles.

This software product is 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. This software package takes the drudgery out of performing the complex computations required to solve difficult tax problems.



To enable students to take advantage of this software product, the 1999 edition contains numerous tax return problems. Problems that lend themselves to computerized solutions are identified by a computer symbol.

## ACKNOWLEDGMENTS

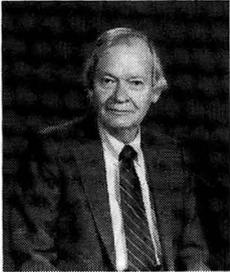
We are most appreciative of the many suggestions that we have received for revising the textbook, many of which have been incorporated in past editions and in the 1999 edition. We would also like to thank the people who have painstakingly worked through all the problems and text questions and generally 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; Frank Linton, University of Scranton; 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.

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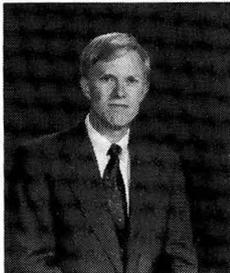
William H. Hoffman, Jr.  
James E. Smith  
Eugene Willis

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# ABOUT THE EDITORS



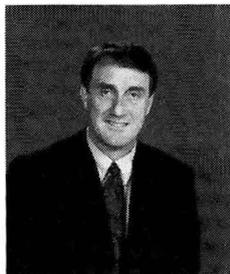
William H. Hoffman, Jr., earned B.A. and J.D. degrees from the University of Michigan and M.B.A. and Ph.D. degrees from The University of Texas. He is a licensed CPA and attorney in Texas. His teaching experience includes: The University of Texas (1957–1961), Louisiana State University (1961–1967), and the University of Houston (1967 to present). Professor Hoffman has addressed many tax institutes and conferences and has published extensively in academic and professional journals. His articles appear in *The Journal of Taxation*, *The Tax Adviser*, *Taxes—The Tax Magazine*, *The Journal of Accountancy*, *The Accounting Review*, and *Taxation for Accountants*.



James E. Smith is the John S. Quinn Professor of Accounting at the College of William and Mary. He has been a member of the Accounting Faculty for twenty-eight years. He received his Ph.D. degree from the University of Arizona.

Jim has served as a discussion leader for Continuing Professional Education programs for the AICPA, Federal Tax Workshops, and various state CPA societies. He has conducted programs in over 40 states for approximately 25,000 CPAs. He has been the recipient of the AICPA's Outstanding Discussion Leader Award.

Other awards received by Jim include the Virginia Society of CPAs' Outstanding Accounting Educator Award and the James Madison University's Outstanding Accounting Educator Award. He was the President of the Administrators of Accounting Programs Group (AAPG) in 1991–1992. He was the faculty adviser for the William and Mary teams that received first place in the Arthur Andersen Tax Challenge in 1994, 1995, and 1997.



Eugene Willis is the Arthur Andersen Alumni Professor of Accountancy at the University of Illinois (Urbana-Champaign). He joined the Illinois faculty in 1975 after receiving his Ph.D. from the University of Cincinnati. He serves as Head of the department. His articles have appeared in leading academic and professional journals, including the *Accounting Review*, *The Journal of the American Taxation Association*, *The Journal of Accountancy*, and *The Journal of Taxation*. Professor Willis is co-director of the National Tax Education Program, a continuing education program co-sponsored by the American Institute of CPAs and the University of Illinois.

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