

QUESTIONS & ANSWERS:
Federal Income Tax

*Multiple Choice and Short Answer
Questions and Answers*

By

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PREFACE

Although most law professors sincerely believe that the course or courses they teach are the most important in the curriculum and to one's future as an attorney, it is undoubtedly true that tax issues permeate all fields involving the practice of law. The percentage of all lawyers who might classify themselves as a "tax lawyer" is small, but the percentage of lawyers who encounter tax problems on a daily basis is great. Certainly all transactional business lawyers, whether they specialize in such areas as corporate, real estate, or bankruptcy law, need to understand the tax implications of various alternative legal structures. Litigators too need to understand the tax implications of the remedies sought in various types of actions and how the tax results for parties on both sides of the table might be used to negotiate a mutually acceptable settlement. Even family lawyers need to appreciate the tax implications of marriage, divorce, death, and children.

Unfortunately, income taxation is frequently viewed as one of the most difficult courses in law school. Students often suggest a number of reasons for this, although they often boil down to the following four. First, students believe that tax involves numbers, and numbers necessarily involve math. This perception presents a problem because many law students may have studiously avoided math courses since high school and are not about to change now. It is true that tax problems frequently involve numbers. For example, the determination of the amount of a taxpayer's gross income, the depreciation the taxpayer is entitled to, and the annual gain on an installment sale. All involve the use of numbers. But, fortunately, the math that students encounter in a tax course is limited to addition, subtraction, multiplication, and division. Indeed, the use of numbers can be a benefit because if a student can manipulate the numbers to reach the correct answer, the student must understand the underlying concepts. If not, our student needs to study the concepts a bit longer.

Second, students believe that tax law is inordinately complex. It is, but probably not anymore so than a lot of other courses in law school. The problem in tax, as in these other courses, is to "keep your head above water," staying with the material as it is presented in class and working to put all of the little pieces into a bigger picture. Students also suggest frustration because of the perception that the tax law is always changing. Again, it is true that hardly a week goes by when a report of a new tax proposal is not in the headlines. So why study tax law that might not even exist in the near future? Fortunately, the income taxes course in law school that is the subject of this study guide cover's basic tax concepts that are seldom the topic of significant legislative change. In tax law, as in most other areas of the law, the change that occurs is at the margins and not in the core concepts.

Third, some students feel that they are at a disadvantage when compared with those students who may have undergraduate backgrounds in business or accounting. Again, it is true that these students may have a temporary edge because they already know the vocabulary and some of the rules of tax. But frequently students with business and accounting backgrounds know little of the law — the Internal Revenue Code ("the Code"), the Regulations, the judicial decisions, and the

Service rulings — that serve as the basic material in a course concerned with tax law. And in tax, as in all areas of the law, the ambiguities of the law, not the widely understood rules, are the most important for study and discussion.

Fourth, students bring a lot of “baggage” to tax class. Law students, like most citizens, have strong feelings about the hand of government in our pockets. Some students may believe that current levels of taxation are too high and feel that much of the tax system is illegitimate. Others may be more concerned with how government spends its tax revenues and whether greater or lesser government spending is desirable. Still others may be concerned about the distribution of the tax burden and whether higher or lower income taxpayers are paying their “fair share.” These are undoubtedly important policy issues and have a place in a tax course. But before a knowledgeable discussion of these issues can take place and before changes in the tax law can be considered to effectuate policy goals, one needs an understanding of the existing law. Do not let your normative view of what the law should be clouding your attempt to understand what the law is.

Despite these problems, the study of income taxation is stimulating and fun. First, tax is probably the most immediately applicable course that any law student might take. Almost every student has personally confronted the income tax, if only by completing a 1040-EZ form. Second, although few people have opinions about rules of evidence or the UCC, everyone has an opinion about taxation. And after taking a tax course, one’s opinion is better informed by an appreciation for the goals of and problems in structuring and administering a tax system. Finally, the tax law is ubiquitous. Students can better appreciate the almost daily debate in the newspapers and news magazines with a basic understanding of tax issues.

But now to work. The purpose of this book is to test your understanding of the tax law and to assist you in preparing for a tax examination. Although you can learn something from reading the questions and answers presented, this book is not intended to provide a comprehensive explanation of tax concepts in the same nature as a casebook or hornbook. Consequently, this book should be used only as a supplement to class materials.

The structure of this book follows the taxing formula, the same structure that the majority of casebooks follow. The taxing formula is a useful organizational framework in which to make sense of the various tax concepts that you will encounter. The taxing formula is presented below:

- Gross Income
- § 62 Deductions
- Adjusted Gross Income
- Standard Deduction or Itemized Deductions
- Personal Exemptions
- Taxable Income
- x Tax Rate
- Tax Liability
- Tax Credits

+ Alternative Minimum Tax
Final Tax Liability

In order to determine a taxpayer's tax liability, one first needs to determine the taxpayer's gross income. Section 61 of the Code broadly defines gross income, but a number of statutorily-authorized exclusions, such as gifts and bequests (§ 102¹), exist to limit a taxpayer's taxable gross income. Adjusted gross income ("AGI") is then determined by subtracting so-called "§ 62 deductions" (because they are listed in § 62 of the Code) from gross income. Section 62 deductions generally include expenses attributable to generating income in a trade or business. In one sense, AGI is a taxpayer's net income available for personal purposes. A taxpayer's AGI is important because certain itemized deductions may be disallowed in whole or in part depending on the amount of the taxpayer's AGI.

AGI is then reduced by either the standard deduction or the taxpayer's itemized deductions, whichever is greater, under § 63. Itemized deductions represent personal expenses, such as mortgage interest (§ 163(h)), property taxes (§ 164), and charitable contributions (§ 170), that Congress has concluded should reduce a taxpayer's AGI in order to implement social or policy goals. AGI is also reduced by personal exemptions for the taxpayer, the taxpayer's spouse, and any dependants (§ 151). Personal exemptions and itemized deductions (or the standard deduction) produce an amount of income that is effectively insulated from tax. The taxpayer's taxable income is the amount remaining after the taxpayer's AGI is reduced by itemized deductions or the standard deduction and personal exemptions. The taxable income is then multiplied by the taxpayer's tax rate (§ 1) to determine the taxpayer's tax liability. Unfortunately, the taxpayer's tax rate is not necessarily one rate but several, each of which may be applicable to a different type of income included in taxable income, such as net capital gain and various forms of net capital gain. Finally, Congress has authorized various types of credits that might reduce a taxpayer's tax liability such as the earned income tax credit (§ 32), the dependent care credit (§ 21), and the Hope Scholarship and Lifetime Learning Credits (§ 25A). In order to ensure that high income taxpayers pay an appropriate amount of tax, Congress has also instituted an alternative minimum tax (§ 55) that may increase a taxpayer's tax liability in certain instances.

This book is divided into eight topics, followed by a comprehensive Practice Final Exam. Topics 1 and 2 cover gross income and the exclusions from gross income. Topic 3 covers business and investment deductions. Topic 4 covers personal deductions that comprise the principal types of itemized deductions. Topics 5 and 6, Selecting the Proper Taxpayer and the Timing of Income and Deductions, are not explicitly articulated in the taxing formula but are concepts that must be addressed in applying the taxing formula to a particular taxpayer and for a particular taxable year. Topic 7 covers the characterization of gains and losses which is important in determining a taxpayer's net capital gain which may be subject to preferable tax rates. Finally, Topic 8 covers the remaining aspects of the taxing formula, tax rates, credits, and the alternative minimum tax, necessary to compute a taxpayer's tax liability.

¹Throughout this book, when you see section or the section symbol (§), the author is referring to a section of the Internal Revenue Code.

I would like to thank the numerous students with whom I have spent countless hours both inside and outside the classroom. Their questions and, more importantly, their willingness to expose areas of confusion, are reflected in the questions presented in this book and hopefully will help others to avoid similar confusion in the future.

Professor David L. Cameron
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