

# **The Fundamentals of Federal Taxation**



# The Fundamentals of Federal Taxation Problems and Materials

FIFTH EDITION

**John A. Miller**

WELDON SCHIMKE DISTINGUISHED PROFESSOR OF LAW  
UNIVERSITY OF IDAHO COLLEGE OF LAW

**Jeffrey A. Maine**

MAINE LAW FOUNDATION PROFESSOR OF LAW  
UNIVERSITY OF MAINE SCHOOL OF LAW



CAROLINA ACADEMIC PRESS  

---

Durham, North Carolina

Copyright © 2018  
John A. Miller and Jeffrey A. Maine  
All Rights Reserved

eISBN 978-1-53101-109-3  
ISBN 978-1-5310-1108-6  
LCCN 2018944089

Carolina Academic Press, LLC  
700 Kent Street  
Durham, North Carolina 27701  
Telephone (919) 489-7486  
Fax (919) 493-5668  
[www.cap-press.com](http://www.cap-press.com)

Printed in the United States of America

*To Maggie, Ben and Alex*

—*Jack Miller*

*To My Mother and Father*

—*Jeff Maine*



# Summary of Contents

---

|                             |      |
|-----------------------------|------|
| Preface and Acknowledgments | xxix |
|-----------------------------|------|

## **Part I: Basic Structure of the Income Tax**

|  |     |
|--|-----|
| Chapter 1 · Introduction   | 3   |
| Chapter 2 · Gross Income   | 19  |
| Chapter 3 · Gains and Losses from Dealings in Property   | 37  |
| Chapter 4 · Gifts and Inheritances   | 55  |
| Chapter 5 · Discharge of Indebtedness  | 71  |
| Chapter 6 · Fringe Benefits  | 85  |
| Chapter 7 · Business and Investment Expense Deductions   | 103 |
| Chapter 8 · Capital Expenditures   | 127 |
| Chapter 9 · Depreciation and Amortization  | 145 |
| Chapter 10 · Deductible Personal Expenses: Casualty and Theft Losses   | 165 |
| Chapter 11 · Other Deductible Personal Expenses: Interest, Taxes,<br>Charitable Gifts, and Medical Expenses      | 183 |
| Chapter 12 · The Deduction Hierarchy: Adjusted Gross Income,<br>the Standard Deduction, and the Dependency Rules | 195 |
| Chapter 13 · Timing Rules and Related Principles   | 207 |
| Chapter 14 · Ordinary Tax Rates and Taxpayer Classification  | 227 |
| Chapter 15 · Tax Credits   | 239 |
| Chapter 16 · First Review Problem  | 247 |

## **Part II: Characterization of Gains and Losses from Property**

|  |     |
|--|-----|
| Chapter 17 · Capital Gains and Losses              | 251 |
| Chapter 18 · Quasi-Capital Assets                  | 273 |
| Chapter 19 · Recapture of Depreciation             | 283 |
| Chapter 20 · The Charitable Contribution Deduction | 291 |
| Chapter 21 · Second Set of Review Problems         | 313 |

## **Part III: Real Estate Taxation**

|                                      |     |
|--------------------------------------|-----|
| Chapter 22 · Residential Real Estate | 315 |
| Chapter 23 · Hobby Losses            | 335 |
| Chapter 24 · Like Kind Exchanges     | 347 |
| Chapter 25 · Involuntary Conversions | 361 |

|   |     |
|---|-----|
| Chapter 26 · Installment Sales  | 369 |
| Chapter 27 · Limitations on Deductions                                    | 381 |
| <b>Part IV: Intellectual Property Taxation</b>                            |     |
| Chapter 28 · Intellectual Property Development and Acquisitions           | 395 |
| Chapter 29 · Intellectual Property Sales and Licenses                     | 417 |
| <b>Part V: Family Taxation</b>  |     |
| Chapter 30 · Assignment of Income   | 435 |
| Chapter 31 · Alimony and Support  | 457 |
| Chapter 32 · Transfers of Property Between Spouses or Incident to Divorce | 465 |
| Chapter 33 · Education Benefits and Costs                                 | 481 |
| <b>Part VI: Tax Consequences of Litigation</b>                            |     |
| Chapter 34 · Personal Injury Recoveries and Punitive Damages              | 493 |
| Chapter 35 · Attorney's Fees  | 517 |
| <b>Part VII: Deferred Compensation</b>                                    |     |
| Chapter 36 · Retirement Resources and Deferred Compensation               | 537 |
| <b>Part VIII: Business Entity Taxation</b>                                |     |
| Chapter 37 · Overview of Entity Taxation                                  | 553 |
| Chapter 38 · Corporate Formations   | 569 |
| Chapter 39 · Partnership Formations                                       | 579 |
| <b>Part IX: International Taxation</b>                                    |     |
| Chapter 40 · Overview of International Income Taxation                    | 595 |
| <b>Part X: Estate and Gift Taxation</b>                                   |     |
| Chapter 41 · Overview of Estate and Gift Taxation                         | 609 |
| <b>Part XI: Tax Practice and Procedure</b>                                |     |
| Chapter 42 · Tax Practice and Procedure                                   | 623 |
| Table of Internal Revenue Code Sections                                   | 647 |
| Table of Treasury Regulations   | 661 |
| Table of Administrative Pronouncements                                    | 665 |
| Table of Cases  | 667 |
| Index   | 677 |



# Contents

---

|                             |      |
|-----------------------------|------|
| Preface and Acknowledgments | xxix |
|-----------------------------|------|

## Part I: Basic Structure of the Income Tax

|   |    |
|---|----|
| <b>Chapter 1 • Introduction</b>                 | 3  |
| I. Problems                                     | 3  |
| II. Overview                                    | 4  |
| A. Tax Policy                                   | 5  |
| 1. Fairness                                     | 5  |
| 2. Efficiency                                   | 6  |
| 3. Neutrality                                   | 6  |
| B. Tax Expenditures                             | 6  |
| C. Structure of Current Income Tax System       | 7  |
| Computational Overview                          | 8  |
| D. Tax Reference Resources and Authorities      | 8  |
| 1. Internal Revenue Code                        | 8  |
| 2. Treasury Regulations                         | 9  |
| 3. IRS Rulings and Procedures                   | 10 |
| 4. Case Law                                     | 11 |
| 5. Legislative History                          | 12 |
| Tax Research Caveats                            | 12 |
| E. The Structure of This Book and How to Use It | 13 |
| III. Materials                                  | 14 |
| <i>Mayo Foundation v. United States</i>         | 14 |
| <b>Chapter 2 • Gross Income</b>                 | 19 |
| I. Assignment                                   | 19 |
| II. Problems                                    | 19 |
| III. Overview                                   | 20 |
| A. The Definition of Gross Income               | 20 |
| 1. The Realization Requirement                  | 21 |
| 2. Statutory Exclusions from Gross Income       | 21 |
| 3. Long-Standing Administrative Practices       | 22 |
| B. Gross Income May Be Realized in Any Form     | 24 |
| C. A Note on “Basis”                            | 26 |
| D. Impact of Obligations to Repay               | 26 |

|  |    |
|--|----|
| IV. Materials  | 27 |
| <i>Commissioner v. Glenshaw Glass Co.</i>                              | 27 |
| <i>Cesarini v. United States</i>                                       | 30 |
| <i>Old Colony Trust Co. v. Commissioner</i>                            | 33 |
| V. Related Matters   | 35 |
| <b>Chapter 3 • Gains and Losses from Dealings in Property</b>          | 37 |
| I. Assignment  | 37 |
| II. Problems   | 37 |
| III. Overview  | 38 |
| A. Sale or Other Disposition   | 39 |
| B. Computation of Gain or Loss Realized                                | 39 |
| Gain Realized  | 40 |
| Loss Realized  | 40 |
| 1. Amount Realized   | 40 |
| 2. Adjusted Basis  | 40 |
| C. “Recognition” of Realized Gain or Loss                              | 42 |
| D. Impact of Liabilities in Property Transactions                      | 43 |
| 1. General Framework   | 43 |
| 2. Specialized Aspects of Debt in Property Transactions                | 44 |
| IV. Materials  | 45 |
| <i>Philadelphia Park Amusement Co. v. United States</i>                | 45 |
| <i>Crane v. Commissioner</i>   | 47 |
| V. Related Matters   | 52 |
| <b>Chapter 4 • Gifts and Inheritances</b>                              | 55 |
| I. Assignment  | 55 |
| II. Problems   | 55 |
| III. Overview  | 57 |
| A. General Exclusionary Rule for Gifts and Inheritances — § 102(a)     | 57 |
| 1. Exclusion for Inter Vivos Gifts                                     | 57 |
| 2. Exclusion for Bequests, Devises, and Inheritances                   | 57 |
| 3. Policy Reasons Behind Section 102(a)                                | 58 |
| B. Statutory Limitations on the Exclusion — § 102(b) and § 102(c)      | 58 |
| C. Basis of Property Received by Gift, Bequest, Devise, or Inheritance | 59 |
| 1. Property Acquired by Gift   | 59 |
| 2. Property Acquired by Inheritance                                    | 60 |
| 3. Basis and Tax Planning  | 61 |
| D. Part Sale, Part Gift Situations                                     | 61 |
| IV. Materials  | 62 |
| <i>Commissioner v. Duberstein</i>                                      | 62 |
| <i>Wolder v. Commissioner</i>  | 66 |
| V. Related Matters   | 68 |

|   |     |
|---|-----|
| <b>Chapter 5 • Discharge of Indebtedness</b>  | 71  |
| I. Assignment   | 71  |
| II. Problems  | 71  |
| III. Overview   | 72  |
| A. “Contested Liability” or “Disputed Debt” Exception                               | 73  |
| B. Bankruptcy and Insolvency Exceptions   | 73  |
| C. Debt Discharge Outside the Scope of Debt Discharge Rules                         | 74  |
| D. Discharge of Recourse Debt in Property Transactions                              | 75  |
| E. Tax Treatment of the Lender  | 76  |
| IV. Materials   | 76  |
| <i>United States v. Kirby Lumber Co.</i>  | 76  |
| <i>Preslar v. Commissioner</i>  | 77  |
| V. Related Matters  | 83  |
| <b>Chapter 6 • Fringe Benefits</b>  | 85  |
| I. Assignment   | 85  |
| II. Problems  | 85  |
| III. Overview   | 86  |
| A. The Major Exclusions under Section 132   | 87  |
| 1. No Additional Cost Services and Qualified Employee Discounts                     | 88  |
| 2. Working Condition and De Minimis Fringe Benefits                                 | 88  |
| B. Meals or Lodging for the Employer’s Convenience                                  | 89  |
| C. Employment Related Payments from Third Parties                                   | 90  |
| D. Employer Provided Health Care Benefits   | 90  |
| E. The Strange Cases of Frequent Flyer Miles, Free Meals and Other Untaxed Benefits | 91  |
| IV. Materials   | 91  |
| <i>J. Grant Farms, Inc. v. Commissioner</i>   | 91  |
| <i>Charley v. Commissioner</i>  | 97  |
| V. Related Matters  | 100 |
| <b>Chapter 7 • Business and Investment Expense Deductions</b>                       | 103 |
| I. Assignment   | 103 |
| II. Problems  | 103 |
| III. Overview   | 105 |
| A. The Main Provisions  | 105 |
| B. Some Limitations   | 105 |
| C. Section 162(a) — General Principles  | 106 |
| 1. Ordinary and Necessary   | 106 |
| 2. What Is an “Expense”?  | 107 |
| 3. Carrying On  | 107 |
| 4. Trade or Business  | 108 |
| D. Substantiation   | 108 |

|   |     |
|---|-----|
| E. Section 162(a)(1) — Reasonable Salaries                                    | 108 |
| F. Section 162(a)(2) — Travel Expenses  | 109 |
| 1. Where Is Home?   | 109 |
| 2. Commuting Expenses   | 110 |
| 3. The Sleep or Rest Rule   | 110 |
| 4. Temporary Reassignments  | 111 |
| G. Section 163(j) — Business Interest   | 111 |
| H. Section 280E — The Curious Case of Legalized Marijuana                     | 112 |
| I. Entertainment, Meal and Transportation Expenses                            | 112 |
| J. Section 199A — Deduction for Qualified Business Income                     | 112 |
| K. Section 212 — Investment Expenses  | 113 |
| IV. Materials   | 113 |
| <i>Welch v. Helvering</i>   | 113 |
| <i>Jenkins v. Commissioner</i>  | 115 |
| <i>Henderson v. Commissioner</i>  | 119 |
| V. Related Matters  | 124 |
| <b>Chapter 8 • Capital Expenditures</b>                                       | 127 |
| I. Assignment   | 127 |
| II. Problems  | 127 |
| III. Overview   | 128 |
| A. Section 263(a)   | 129 |
| 1. In General   | 129 |
| 2. Distinguishing Deductible Expenses from Nondeductible Capital Expenditures | 129 |
| a. Case Law   | 129 |
| b. Administrative Rulings   | 130 |
| c. Treasury Regulations   | 131 |
| 3. Capitalization Rules Governing Tangible Property                           | 131 |
| a. Amounts Paid to Acquire Tangible Property                                  | 131 |
| b. Amounts Paid to Construct Tangible Property                                | 132 |
| c. Amounts Paid to Sell Tangible Property                                     | 133 |
| d. Amounts Paid to Defend or Perfect Title to Tangible Property               | 133 |
| e. Amounts Paid to Improve Tangible Property                                  | 133 |
| 4. Capitalization Rules Governing Intangible Assets                           | 135 |
| a. Amounts Paid to Acquire Intangible Property                                | 135 |
| b. Amounts Paid to Create Intangible Property                                 | 135 |
| c. Transaction Costs  | 136 |
| B. Section 263A   | 137 |
| IV. Materials   | 138 |
| <i>Midland Empire Packing Co. v. Commissioner</i>                             | 138 |
| <i>Mt. Morris Drive-In Theatre Co. v. Commissioner</i>                        | 140 |
| V. Related Matters  | 143 |

|   |         |
|---|---------|
| <b>Chapter 9 • Depreciation and Amortization</b>                                | 145     |
| I. Assignment   | 145     |
| II. Problems  | 145     |
| III. Overview   | 146     |
| A. Depreciation of Tangible Property  | 147     |
| 1. Applicable Recovery Period   | 147     |
| 2. Applicable Depreciation Method   | 148     |
| Determining the Straight-Line Percentage  | 148     |
| 3. Applicable Convention  | 149     |
| 4. Example of ACRS Depreciation   | 149     |
| B. Bonus Depreciation   | 151     |
| 1. Section 179  | 151     |
| Planning Pointer  | 152     |
| 2. Section 168(k)   | 153     |
| C. Amortization of Intangible Property  | 153     |
| IV. Materials   | 154     |
| <i>Simon v. Commissioner</i>  | 154     |
| Revenue Procedure 87-56 (Excerpt)   | 161     |
| Revenue Procedure 87-57 (Excerpt)   | 162     |
| V. Related Matters  | 164     |
| <br><b>Chapter 10 • Deductible Personal Expenses: Casualty and Theft Losses</b> | <br>165 |
| I. Assignment   | 165     |
| II. Problems  | 165     |
| III. Overview   | 166     |
| A. A Look at the Tax Treatment of Business, Investment,<br>and Personal Losses  | 166     |
| B. The Personal Casualty Loss Deduction   | 167     |
| 1. Temporary Definition   | 167     |
| 2. The Traditional Definition   | 168     |
| C. Rationale for the Deduction  | 168     |
| D. Proof of Causation   | 169     |
| E. Measuring the Loss   | 169     |
| 1. Effect of Reimbursements   | 169     |
| 2. Examples   | 170     |
| F. Restrictions on the Deduction  | 170     |
| 1. The \$100 Threshold  | 170     |
| 2. The Ten Percent of Adjusted Gross Income Threshold                           | 171     |
| G. Adjustments to Basis for Casualty Loss Deduction and Reimbursements          | 171     |
| IV. Materials   | 172     |
| <i>Chamale v. Commissioner</i>  | 172     |
| <i>Blackman v. Commissioner</i>   | 178     |
| V. Related Matters  | 181     |

|  |     |
|--|-----|
| <b>Chapter 11 • Other Deductible Personal Expenses: Interest, Taxes, Charitable Gifts, and Medical Expenses</b>          | 183 |
| I. Assignment  | 183 |
| II. Problems   | 183 |
| III. Overview  | 184 |
| A. Qualified Residence Interest  | 185 |
| B. State and Local Taxes   | 187 |
| C. Charitable Contributions  | 187 |
| D. Medical Expenses  | 188 |
| IV. Materials  | 189 |
| Revenue Ruling 87-106  | 189 |
| Revenue Ruling 2003-57   | 192 |
| V. Related Matters   | 193 |
| <br><b>Chapter 12 • The Deduction Hierarchy: Adjusted Gross Income, the Standard Deduction, and the Dependency Rules</b> | 195 |
| I. Assignment  | 195 |
| II. Problems   | 195 |
| III. Overview  | 197 |
| A. Itemized Deductions versus the Standard Deduction   | 197 |
| B. Miscellaneous Itemized Deductions   | 198 |
| Getting to Taxable Income  | 199 |
| C. Personal and Dependency Exemptions  | 200 |
| 1. Qualifying Child  | 200 |
| a. Tie Breakers  | 201 |
| b. Children of Divorced Parents  | 201 |
| 2. Qualifying Relative   | 201 |
| 3. Phase Out Rules   | 202 |
| D. Section 199A Deduction for Qualified Business Income  | 202 |
| IV. Materials  | 203 |
| Form 8332  | 203 |
| V. Related Matters   | 205 |
| <br><b>Chapter 13 • Timing Rules and Related Principles</b>  | 207 |
| I. Assignment  | 207 |
| II. Problems   | 207 |
| III. Overview  | 208 |
| A. Introduction  | 208 |
| B. The Cash Method   | 209 |
| 1. Income under the Cash Method  | 209 |
| a. The Doctrine of Cash Equivalence and the Related Principle of Economic Benefit  | 210 |
| b. The Doctrine of Constructive Receipt  | 210 |

|  |     |
|--|-----|
| 2. Deductions under the Cash Method  | 212 |
| a. Prepayment of Expenses  | 212 |
| b. The Special Rule for Interest Expenses  | 213 |
| C. The Accrual Method  | 213 |
| 1. Income under the Accrual Method   | 213 |
| a. Inclusion Based on Financial Accounting Treatment                                 | 213 |
| b. Prepayments   | 213 |
| 2. Deductions under the Accrual Method   | 214 |
| a. Inventory Accounting  | 214 |
| b. Exception for Small Businesses with Inventory                                     | 216 |
| D. Principles Applicable to Both the Cash Method and the<br>Accrual Method           | 216 |
| 1. The Claim of Right Doctrine   | 216 |
| 2. The Tax Benefit Rule  | 217 |
| 3. The Ancillary Effects of Paying Expenses with Services or<br>Appreciated Property | 217 |
| IV. Materials  | 218 |
| <i>Ames v. Commissioner</i>  | 218 |
| <i>Schlude v. Commissioner</i>   | 222 |
| V. Related Matters   | 226 |
| <b>Chapter 14 • Ordinary Tax Rates and Taxpayer Classification</b>                   | 227 |
| I. Assignment  | 227 |
| II. Problems   | 227 |
| III. Overview  | 228 |
| A. Introduction  | 228 |
| Computing a Final Tax Liability  | 229 |
| B. The Rate Structure for Ordinary Income  | 229 |
| 1. The Basic Rates   | 229 |
| 2. The Principle of Progressivity  | 229 |
| C. Taxpayer Classifications  | 230 |
| 1. Marital Status  | 231 |
| 2. Surviving Spouse  | 233 |
| 3. Head of Household   | 233 |
| D. Alternative Minimum Tax   | 234 |
| IV. Materials  | 235 |
| Section 1(j)(2) 2018 Tax Rate Schedules for Individuals                              | 235 |
| V. Related Matters   | 236 |
| <b>Chapter 15 • Tax Credits</b>  | 239 |
| I. Assignment  | 239 |
| II. Problems   | 239 |
| III. Overview  | 240 |
| Computing a Final Tax Liability  | 240 |

|  |         |
|--|---------|
| A. Non-Refundable Credits  | 241     |
| 1. The Dependent Care Credit   | 241     |
| 2. The Child Tax Credit and the Partial Credit for Other Dependents        | 241     |
| 3. The Hope Scholarship Credit and the Lifetime Learning Credit            | 242     |
| B. Refundable Credits  | 243     |
| 1. The Credit for Withholding on Wages                                     | 243     |
| 2. The Earned Income Credit  | 244     |
| C. Ordering Rules  | 244     |
| IV. Related Matters  | 244     |
| <br><b>Chapter 16 • First Review Problem</b>                               | <br>247 |
| <br>Part II: Characterization of Gains and Losses from Property            |         |
| <b>Chapter 17 • Capital Gains and Losses</b>                               | 251     |
| I. Assignment  | 251     |
| II. Problems   | 251     |
| III. Overview  | 253     |
| A. The Mechanics of Capital Gains  | 254     |
| Net Capital Gain   | 254     |
| Net Long Term Capital Gain   | 254     |
| Net Short Term Capital Loss  | 254     |
| 1. The Sale or Exchange Requirement  | 255     |
| 2. The Capital Asset Requirement   | 255     |
| a. Inventory and Inventory-Like Property — Section 1221(a)(1)              | 255     |
| b. Trade or Business Property — Section 1221(a)(2)                         | 256     |
| c. Self-Created Property — Section 1221(a)(3)                              | 256     |
| d. Accounts Receivable for Service or Inventory —<br>Section 1221(a)(4)    | 257     |
| e. Federal Publications — Section 1221(a)(5)                               | 257     |
| f. Hedging Transactions — Section 1221(a)(7)                               | 257     |
| g. Supplies Used in a Trade or Business — Section 1221(a)(8)               | 258     |
| 3. The Holding Period Requirement  | 258     |
| 4. Special Characterization Provisions                                     | 258     |
| 5. Determining the Appropriate Capital Gains Rate on<br>“Net Capital Gain” | 259     |
| B. The Mechanics of Capital Losses   | 260     |
| IV. Materials  | 262     |
| <i>Bynum v. Commissioner</i>   | 262     |
| <i>Williams v. McGowan</i>   | 268     |
| V. Related Matters   | 270     |
| <br><b>Chapter 18 • Quasi-Capital Assets</b>                               | <br>273 |
| I. Assignment  | 273     |
| II. Problems   | 273     |



|  |     |
|--|-----|
| III. Overview  | 274 |
| A. Transactions to Which Section 1231 Applies                    | 274 |
| B. The Mechanics of Section 1231                                 | 275 |
| C. Recapture of “Net Ordinary Loss”                              | 277 |
| D. Summary   | 278 |
| Section 1231 Checklist   | 278 |
| IV. Materials  | 278 |
| <i>Wasnok v. Commissioner</i>                                    | 278 |
| V. Related Matters   | 281 |
| <b>Chapter 19 • Recapture of Depreciation</b>                    | 283 |
| I. Assignment  | 283 |
| II. Problems   | 283 |
| III. Overview  | 284 |
| A. Recapture under Section 1245 for Certain Depreciable Property | 284 |
| 1. An Overview   | 284 |
| 2. The Statutory Mechanics                                       | 284 |
| a. Amount Recaptured as Ordinary Income                          | 284 |
| b. Meaning of “Section 1245 Property”                            | 285 |
| c. Meaning of “Disposed Of”                                      | 285 |
| B. Recapture under Section 1250 for Certain Depreciable Realty   | 286 |
| C. Characterization under Section 1239                           | 287 |
| IV. Materials  | 288 |
| Revenue Ruling 69-487  | 288 |
| V. Related Matters   | 288 |
| <b>Chapter 20 • The Charitable Contribution Deduction</b>        | 291 |
| I. Assignment  | 291 |
| II. Problems   | 291 |
| III. Overview  | 292 |
| A. Introduction  | 292 |
| B. The Structure of the Code: Sluices and Gates                  | 294 |
| 1. Defining Terms  | 294 |
| 2. Section 170(e)  | 294 |
| 3. Sections 170(b)(1)(A) & (B)                                   | 295 |
| 4. Section 170(b)(1)(C)  | 295 |
| 5. Section 170(b)(1)(D)  | 296 |
| The Charitable Deduction Summarized                              | 296 |
| C. Gifts of Intellectual Property: Section 170(m)                | 297 |
| D. Bargain Sales to Charities                                    | 298 |
| E. Substantiation  | 298 |
| F. Tax Policy and the Charitable Deduction                       | 299 |
| G. Tax Planning and the Charitable Deduction                     | 300 |

|  |     |
|--|-----|
| IV. Materials  | 300 |
| <i>Sklar v. Commissioner</i>   | 300 |
| V. Related Matters   | 312 |
| <b>Chapter 21 • Second Set of Review Problems</b>                    | 313 |
| <b>Part III: Real Estate Taxation</b>                                |     |
| <b>Chapter 22 • Residential Real Estate</b>                          | 315 |
| I. Assignment  | 315 |
| II. Problems   | 315 |
| III. Overview  | 317 |
| A. Home Office Deductions  | 317 |
| B. Vacation Home Deductions  | 320 |
| 1. Use as a Residence  | 320 |
| 2. Deductible Expenses and Their Limits                              | 320 |
| C. Exclusion of Gain on Sale of Residence                            | 322 |
| 1. Ownership and Use Requirements                                    | 323 |
| 2. One Sale Every Two Years Limitation                               | 323 |
| 3. Amount of Exclusion   | 324 |
| 4. Principal Residence   | 325 |
| 5. Tax Planning  | 326 |
| IV. Materials  | 326 |
| <i>Popov v. Commissioner</i>   | 326 |
| <i>Guinan v. United States</i>                                       | 329 |
| V. Related Matters   | 331 |
| <b>Chapter 23 • Hobby Losses</b>                                     | 335 |
| I. Assignment  | 335 |
| II. Problems   | 335 |
| III. Overview  | 336 |
| A. Distinguishing Hobbies from Business or Profit-Seeking Activities | 337 |
| B. Allowable Deductions  | 338 |
| Section 183 Checklist  | 339 |
| IV. Materials  | 340 |
| <i>Nickerson v. Commissioner</i>                                     | 340 |
| V. Related Matters   | 346 |
| <b>Chapter 24 • Like Kind Exchanges</b>                              | 347 |
| I. Assignment  | 347 |
| II. Problems   | 347 |
| III. Overview  | 349 |
| A. Introduction  | 349 |
| B. Determining Like Kindness   | 349 |

|  |     |
|--|-----|
| C. Planning the Exchange                                   | 350 |
| D. The Mechanics of Section 1031                           | 351 |
| 1. Exceptions and Timing                                   | 351 |
| 2. Boot and Recognition of Gains and Losses                | 351 |
| 3. Basis in New Property and in Boot Received              | 351 |
| Aggregate Basis under § 1031(d)                            | 352 |
| Basis of Like Kind Property Received                       | 352 |
| 4. Holding Period  | 352 |
| E. Assumptions of Liability                                | 352 |
| F. Illustrations   | 353 |
| G. Mixed-Use Property                                      | 355 |
| IV. Materials  | 355 |
| Revenue Ruling 77-297                                      | 355 |
| Revenue Procedure 2008-16                                  | 357 |
| V. Related Matters   | 360 |
| <b>Chapter 25 • Involuntary Conversions</b>                | 361 |
| I. Assignment  | 361 |
| II. Problems   | 361 |
| III. Overview  | 362 |
| A. Involuntary Conversions                                 | 362 |
| B. Similar or Related in Service or Use                    | 363 |
| C. When Replacement Must Occur                             | 364 |
| D. Basis and Holding Period of Replacement Property        | 364 |
| IV. Materials  | 365 |
| <i>Clifton Inv. Co. v. Commissioner</i>                    | 365 |
| Revenue Ruling 64-237                                      | 367 |
| V. Related Matters   | 368 |
| <b>Chapter 26 • Installment Sales</b>                      | 369 |
| I. Assignment  | 369 |
| II. Problems   | 369 |
| III. Overview  | 370 |
| A. Introduction  | 370 |
| B. The Mechanics of Section 453 and the Defined Terms      | 371 |
| Gross Profit Ratio Formula                                 | 371 |
| C. Dispositions of Installment Notes: Section 453B         | 374 |
| D. Contingent Payment Sales                                | 375 |
| E. Installment Sales with Unstated or Understated Interest | 376 |
| IV. Materials  | 377 |
| Revenue Ruling 79-371                                      | 377 |
| V. Related Matters   | 379 |

|  |     |
|--|-----|
| <b>Chapter 27 • Limitations on Deductions</b>                      | 381 |
| I. Assignment  | 381 |
| II. Problems   | 381 |
| III. Overview  | 383 |
| A. Introduction  | 383 |
| B. The At Risk Rules   | 384 |
| 1. The At Risk Limitation  | 384 |
| 2. The Effect of Losses and Distributions on the At Risk Amount    | 384 |
| 3. Qualified Non-Recourse Financing Exception                      | 385 |
| 4. Recapture of Prior Deductions under Section 465(e)              | 385 |
| 5. Examples  | 385 |
| C. The Passive Loss Rules  | 386 |
| 1. In General  | 386 |
| 2. The Statutory Framework   | 386 |
| 3. Special Exception for Mom and Pop Rental Real Estate Activities | 387 |
| 4. The Effects of Dispositions of Passive Activities               | 387 |
| 5. The Definition of “Activity”                                    | 388 |
| 6. Coordination between Sections 465 and 469                       | 388 |
| D. Why Does the Tax Law Use These “Basket” Approaches?             | 388 |
| E. Limitation on Excess Business Losses                            | 389 |
| IV. Materials  | 390 |
| Excerpt From Senate Report 99-313                                  | 390 |
| V. Related Matters   | 393 |

#### Part IV: Intellectual Property Taxation

|   |     |
|---|-----|
| <b>Chapter 28 • Intellectual Property Development and Acquisitions</b>        | 395 |
| I. Assignment   | 395 |
| II. Problems  | 395 |
| III. Overview   | 396 |
| A. Intellectual Property Development  | 397 |
| 1. Deductibility under Section 162 — Ordinary and Necessary Business Expenses | 397 |
| a. Section 263 Override   | 397 |
| b. Section 263A Override  | 398 |
| 2. Deductibility under Section 174 — Research and Experimental Expenditures   | 399 |
| a. Research and Experimental Expenditures                                     | 399 |
| b. In Connection with a Trade or Business                                     | 400 |
| 3. Section 41 Research Credit for Increasing Research Activities              | 401 |
| B. Intellectual Property Acquisitions   | 401 |
| 1. Purchase Costs   | 402 |
| a. Amortization under Section 197   | 402 |
| b. Amortization under Section 167   | 404 |
| 2. Licensing of Intellectual Property   | 406 |

|   |     |
|---|-----|
| IV. Materials   | 406 |
| Field Service Advice 200125019  | 406 |
| Revenue Procedure 2000-50   | 413 |
| V. Related Matters  | 415 |
| <b>Chapter 29 • Intellectual Property Sales and Licenses</b>            | 417 |
| I. Assignment   | 417 |
| II. Problems  | 417 |
| III. Overview   | 418 |
| A. Sales and Exclusive Licenses of Intellectual Property                | 419 |
| 1. General Characterization Provisions                                  | 419 |
| 2. Special Characterization Provisions                                  | 421 |
| a. Section 1235: Transfers of All Substantial Rights to Patents         | 421 |
| b. Section 1253: Transfers of Trademarks and Trade Names                | 423 |
| 3. Treatment of Deferred Payment Sales and Contingent Payments          | 424 |
| B. Nonexclusive Licenses of Intellectual Property                       | 425 |
| IV. Materials   | 426 |
| <i>Watson v. Commissioner</i>   | 426 |
| <i>Stern v. United States</i>   | 429 |
| V. Related Matters  | 433 |
| <b>Part V: Family Taxation</b>  |     |
| <b>Chapter 30 • Assignment of Income</b>                                | 435 |
| I. Assignment   | 435 |
| II. Problems  | 435 |
| III. Overview   | 437 |
| A. Introduction   | 437 |
| B. Assignments of Earned Income   | 438 |
| 1. The Basic Rule and the Community Property Twist                      | 438 |
| Practice Pointer  | 439 |
| 2. More on Principals and Agents and a Note about Disclaimers           | 439 |
| 3. The <i>Teschner</i> Twist  | 440 |
| C. Assignments of Income from Property                                  | 440 |
| 1. Gratuitous Assignments   | 440 |
| 2. Grantor Trusts, the Kiddie Tax, and the Rate Structure for Entities  | 441 |
| 3. Assignments after Realization or Accrual                             | 441 |
| 4. Allocations of Basis for Gratuitous Assignments in Trust             | 442 |
| 5. Anticipatory Assignments for Value                                   | 442 |
| D. Assignments Designed to Transmute Ordinary Income into Capital Gains | 443 |
| E. The Special Case of Gift Loans                                       | 445 |
| F. Assignments of Income to Entities                                    | 445 |
| IV. Materials   | 446 |
| <i>Lucas v. Earl</i>  | 446 |

|   |     |
|---|-----|
| <i>Helvering v. Horst</i>   | 447 |
| <i>Estate of Stranahan v. Commissioner</i>  | 451 |
| V. Related Matters  | 454 |
| <b>Chapter 31 • Alimony and Support</b>   | 457 |
| I. Assignment   | 457 |
| II. Problems  | 457 |
| III. Overview   | 458 |
| A. Introduction   | 458 |
| B. Alimony (Before 2019)  | 459 |
| 1. Alimony Requirements   | 459 |
| 2. Disguised Property Settlements: Section 71(f)  | 460 |
| Second Year Excess Payments (E.P.) Formula: IRC § 71(f)(4)                                    | 460 |
| First Year Excess Payments Formula: IRC § 71(f)(3)  | 460 |
| 3. Indirect Payments  | 461 |
| 4. Expenses to Obtain Alimony and to Defend against Those Claims                              | 461 |
| C. Child Support  | 462 |
| 1. Failure to Pay   | 462 |
| 2. Expenses to Obtain Child Support   | 462 |
| IV. Materials   | 462 |
| V. Related Matters  | 462 |
| <b>Chapter 32 • Transfers of Property between Spouses or Incident to Divorce</b>              | 465 |
| I. Assignment   | 465 |
| II. Problems  | 465 |
| III. Overview   | 466 |
| A. Property Settlements   | 466 |
| B. Transfers Incident to Divorce  | 467 |
| C. Transfers to Third Parties   | 467 |
| D. Incorporated Family Businesses   | 468 |
| E. Assignment of Income Doctrine and Division of Pensions and<br>Other Ordinary Income Rights | 469 |
| F. Policies Supporting Section 1041   | 470 |
| IV. Materials   | 470 |
| <i>Craven v. United States</i>  | 470 |
| Revenue Ruling 2002-22  | 475 |
| V. Related Matters  | 479 |
| <b>Chapter 33 • Education Benefits and Costs</b>  | 481 |
| I. Assignment   | 481 |
| II. Problems  | 481 |
| III. Overview   | 483 |
| A. Business Education   | 483 |
| B. Scholarships and Fellowships   | 484 |

|  |     |
|--|-----|
| C. Employer-Provided Educational Assistance                                  | 484 |
| 1. Qualified Tuition Reductions  | 484 |
| 2. Educational Assistance Programs   | 485 |
| 3. Working Condition Fringe Benefits   | 485 |
| D. Education Loans   | 485 |
| 1. Deductibility of Interest   | 485 |
| 2. Forgiveness of Student Loans  | 486 |
| E. Special Credits and Deduction for Qualified Tuition and Related Expenses  | 486 |
| F. Charitable Deduction for Tuition Payments to a Church School              | 487 |
| G. Saving for Higher Education   | 488 |
| 1. Section 135: Income from U.S. Savings Bonds to Pay Higher Education Costs | 488 |
| 2. Section 529: Qualified Tuition Programs                                   | 488 |
| 3. Section 530: Coverdell Educational Savings Accounts                       | 489 |
| H. Coordination Rules  | 489 |
| IV. Materials  | 490 |
| Revenue Ruling 2008-34   | 490 |
| V. Related Matters   | 492 |

## Part VI: Tax Consequences of Litigation

|   |     |
|---|-----|
| <b>Chapter 34 • Personal Injury Recoveries and Punitive Damages</b> | 493 |
| I. Assignment   | 493 |
| II. Problems  | 493 |
| III. Overview   | 494 |
| A. Damages Received on Account of Personal Injuries or Sickness     | 495 |
| Planning Note   | 497 |
| B. Punitive Damages   | 497 |
| Planning Note   | 498 |
| C. Structured Settlements   | 498 |
| D. Accident or Health Insurance Proceeds                            | 499 |
| IV. Materials   | 499 |
| Private Letter Ruling 200041022                                     | 499 |
| <i>Amos v. Commissioner</i>   | 503 |
| <i>Stadnyk v. Commissioner</i>                                      | 510 |
| V. Related Matters  | 514 |
| <b>Chapter 35 • Attorney's Fees</b>                                 | 517 |
| I. Assignment   | 517 |
| II. Problems  | 517 |
| III. Overview   | 518 |
| A. Deductibility of Attorney's Fees and Other Litigation Costs      | 518 |
| B. Above or Below the Line Determination                            | 521 |
| C. Contingent Fees  | 522 |

|                                   |     |
|-----------------------------------|-----|
| IV. Materials                     | 523 |
| <i>Fleischman v. Commissioner</i> | 523 |
| <i>Commissioner v. Banks</i>      | 530 |
| V. Related Matters                | 535 |

### Part VII: Deferred Compensation

|  |     |
|--|-----|
| <b>Chapter 36 • Retirement Resources and Deferred Compensation</b> | 537 |
| I. Assignment  | 537 |
| II. Problems   | 537 |
| III. Overview  | 538 |
| A. Savings   | 539 |
| 1. Annuities   | 539 |
| Exclusion Ratio  | 539 |
| Return of Investment in Each Payment                               | 540 |
| 2. Reverse Mortgages   | 540 |
| B. Retirement Plans  | 541 |
| 1. Employer Funded Retirement Plans                                | 541 |
| a. Defined Benefit and Defined Contribution Qualified Plans        | 541 |
| b. Payout  | 542 |
| c. Relative Merits of the Two Approaches                           | 542 |
| 2. Individual Funded Retirement Accounts                           | 543 |
| a. Pre-Tax Contribution Accounts                                   | 543 |
| b. Post-Tax Contribution Accounts                                  | 543 |
| 3. Retirement Planning and Time Value of Money                     | 544 |
| C. Social Security   | 544 |
| 1. Eligibility   | 545 |
| 2. Income Tax Treatment of Benefits                                | 546 |
| 3. Pressures for Reform and Policy Choices Implicated              | 546 |
| IV. Materials  | 546 |
| Revenue Ruling 80-248  | 546 |
| <i>Gee v. Commissioner</i>   | 548 |
| V. Related Matters   | 550 |

### Part VIII: Business Entity Taxation

|   |     |
|---|-----|
| <b>Chapter 37 • Overview of Entity Taxation</b> | 553 |
| I. Assignment                                   | 553 |
| II. Problems                                    | 553 |
| III. Overview                                   | 554 |
| A. Corporations                                 | 554 |
| 1. C Corporations                               | 555 |
| 2. S Corporations                               | 556 |



|  |     |
|--|-----|
| B. Unincorporated Businesses   | 557 |
| 1. General Partnerships, Limited Partnerships, Limited Liability Partnerships, and Limited Liability Companies | 557 |
| 2. Tax Classification of Unincorporated Businesses   | 558 |
| 3. Tax Treatment of Partnership Income   | 558 |
| Maintaining a Partner's Capital Account  | 559 |
| Maintaining a Partner's Outside Basis  | 559 |
| C. Trusts  | 561 |
| 1. Divided Ownership   | 561 |
| 2. The Tax Treatment of Trust Income   | 561 |
| D. The Deduction for Qualified Business Income — Section 199A  | 563 |
| 1. Taxable Income of \$157,500 or Less (\$315,000 for Married Taxpayers)                                       | 563 |
| 2. Taxable Income Greater Than \$157,500 (\$315,000 for Married Taxpayers)                                     | 564 |
| 3. Example   | 565 |
| E. Business Planning with Entities   | 565 |
| F. Estate Planning with Entities   | 566 |
| 1. Trusts  | 567 |
| 2. Closely Held Corporations   | 567 |
| 3. Family Limited Partnerships   | 568 |
| <b>Chapter 38 • Corporate Formations</b>   | 569 |
| I. Assignment  | 569 |
| II. Problems   | 569 |
| III. Overview  | 570 |
| A. A Cautionary Note and a Statement of Relevance  | 570 |
| B. The Fundamental Rules   | 571 |
| C. Some of the Nuances   | 572 |
| 1. Who Is a "Person"?  | 572 |
| 2. What Does "Control" Mean, and How Is "Immediately After" Measured?  | 572 |
| 3. What Happens if Stock Is Received for Services?   | 572 |
| D. Receipt of Boot   | 573 |
| E. Transfers of Liabilities  | 573 |
| F. Conclusion  | 574 |
| IV. Materials  | 575 |
| Revenue Ruling 64-56   | 575 |
| Revenue Ruling 74-477  | 577 |
| V. Related Matters   | 578 |

|   |     |
|---|-----|
| <b>Chapter 39 • Partnership Formations</b>                          | 579 |
| I. Assignment   | 579 |
| II. Problems  | 579 |
| III. Overview   | 580 |
| A. The Fundamental Rules  | 581 |
| B. Some of the Nuances  | 582 |
| 1. What Happens if a Partnership Interest Is Received for Services? | 582 |
| 2. What Happens if a Partnership Later Sells Contributed Property?  | 582 |
| C. Receipt of Boot  | 583 |
| D. Transfers of Liabilities   | 584 |
| E. Capital Accounts   | 585 |
| IV. Materials   | 586 |
| <i>McDougal v. Commissioner</i>                                     | 586 |
| <i>United States v. Frazell</i>                                     | 590 |
| V. Related Matters  | 593 |
| <br><b>Part IX: International Taxation</b>                          |     |
| <b>Chapter 40 • Overview of International Income Taxation</b>       | 595 |
| I. Assignment   | 595 |
| II. Problems  | 595 |
| III. Overview   | 596 |
| A. Taxation of Foreign Income of U.S. Persons                       | 597 |
| 1. General Taxing Rules   | 597 |
| 2. The Foreign Tax Credit   | 598 |
| Foreign Tax Credit Limit Formula                                    | 599 |
| 3. Foreign Earned Income Exclusion                                  | 599 |
| B. Taxation of U.S. Income of Foreign Persons                       | 600 |
| 1. Taxation of Business Income                                      | 600 |
| a. In General   | 600 |
| b. Treaty Exceptions  | 600 |
| 2. Taxation of Non-Business Income from U.S. Sources                | 601 |
| a. “Fixed or Determinable, Annual or Periodical” (FDAP) Income      | 601 |
| b. Treaty Exceptions  | 601 |
| C. Source Rules   | 601 |
| 1. Income Source Rules  | 602 |
| 2. Deduction Allocation and Apportionment Rules                     | 603 |
| D. The Role of Treaties   | 603 |
| E. Section 482: Transactions between Related Parties                | 604 |
| IV. Materials   | 605 |
| <i>Boulez v. Commissioner</i>                                       | 605 |
| V. Related Matters  | 608 |

**Part X: Estate and Gift Taxation**

|  |     |
|--|-----|
| <b>Chapter 41 • Overview of Estate and Gift Taxation</b>         | 609 |
| I. Assignment  | 609 |
| II. Problems   | 609 |
| III. Overview  | 610 |
| A. Introduction  | 610 |
| 1. Why Have Such Taxes?  | 610 |
| 2. Who Pays the Transfer Taxes?                                  | 611 |
| B. Transfer Tax Theory   | 611 |
| C. The Estate Tax in Outline                                     | 611 |
| The Conceptual Structure of the Estate Tax                       | 612 |
| 1. The Gross Estate  | 612 |
| 2. The Taxable Estate  | 613 |
| 3. The Rate Structure  | 613 |
| 4. The Unified Credit  | 613 |
| D. The Gift Tax in Outline                                       | 614 |
| 1. The Annual Exclusion  | 614 |
| 2. Special Valuation Rules                                       | 614 |
| E. Computing the Estate and Gift Taxes                           | 615 |
| 1. The Estate Tax Computation                                    | 615 |
| Estate Tax Computation Worksheet with Statutory Cross-References | 616 |
| 2. The Gift Tax Computation                                      | 617 |
| Gift Tax Computation Worksheet with Statutory Cross-References   | 617 |
| F. The Generation Skipping Transfer Tax (GSTT)                   | 617 |
| 1. The Triggering Event  | 618 |
| 2. Generation Assignment   | 618 |
| 3. Deceased Parent Rule  | 618 |
| 4. The Taxable Amount and Tax Liability                          | 618 |
| 5. The Exemption   | 619 |
| 6. The Annual Exclusion  | 619 |
| 7. The Tax Computation   | 619 |
| 8. Illustration of the GSTT's Application                        | 620 |
| 9. Conclusion  | 621 |
| IV. Materials  | 621 |
| V. Related Matters   | 621 |

**Part XI: Tax Practice and Procedure**

|  |     |
|--|-----|
| <b>Chapter 42 • Tax Practice and Procedure</b> | 623 |
| I. Assignment                                  | 623 |
| II. Problems                                   | 623 |
| III. Overview                                  | 624 |
| A. Tax Returns                                 | 624 |
| B. The Examination Process and Settlements     | 625 |

|   |     |
|---|-----|
| C. Tax Litigation                             | 626 |
| D. Assessment Process                         | 627 |
| E. Tax Collection Process                     | 628 |
| F. Providing Tax Advice and Opinions          | 629 |
| 1. General Professional Ethics Rules          | 629 |
| 2. Circular 230                               | 629 |
| 3. Code and Regulations (Statutory Penalties) | 630 |
| IV. Materials                                 | 631 |
| V. Related Matters                            | 644 |
| Table of Internal Revenue Code Sections       | 647 |
| Table of Treasury Regulations                 | 661 |
| Table of Administrative Pronouncements        | 665 |
| Table of Cases                                | 667 |
| Index   | 677 |

# Preface and Acknowledgments

---

This edition brings the text current to February 2018 and reflects changes made by recent tax acts, including the Tax Cuts and Jobs Act of 2017 (TCJA). The TCJA is the most sweeping change in the income tax in nearly 30 years, but many of its changes for individual taxpayers are temporary, and the Act merely suspends rather than repeals prior law. Most of those suspensions of prior law are slated to end in 2026, and most of the positive provisions that replaced them are slated to sunset at that same time. This leads to some necessity for the student to appreciate both the present and the suspended law. In this edition we have married our discussion of present law with a description of prior and suspended law as appropriate.

It has been said that the hardest thing about writing a good book is knowing what to leave out. That is certainly true of a book about the law of taxation. The Internal Revenue Code and the regulations interpreting it extend for many thousands of pages. An introduction to its labyrinthian nature must necessarily leave a great deal out. In the materials that follow, we have sought to highlight those parts of federal tax law that are most relevant to the every-day experiences of life in the United States. The level of coverage is not entirely uniform because part of appreciating the law of taxation is seeing its varying depths. Though our approach has been far from encyclopedic, we have tried to make the study of taxation engaging, concrete and specific through examples and problems. By the same token, we have made a consistent effort to delineate the policies that underlie our tax system and to note deviations from generally accepted principles of sound tax policy. Because most people who study taxation do so in order to serve a client, we have also emphasized planning principles.

We have broken the subject matter of this book into many more chapters than is typical of law casebooks. The purpose for this approach is simply to make the book easier for teachers to assign and for students to read. The typical chapter can be covered in one or two class periods. If the instructor chooses to omit a topic, she or he need only direct the student to skip the appropriate chapter. The assignments are structured to make efficient and effective use of student preparation time by segmenting and prioritizing the material.

As is typical of tax law casebooks, this book is intended to be used in conjunction with selected sections of the Internal Revenue Code and the federal tax regulations. Several publishers produce one volume editions that well serve that purpose.

Jack Miller would like to thank Dean Mark Adams for his generous support for this project. He is deeply grateful for the excellent research assistance of Brian Peterson, Jennifer Hedlund, and Jamie Bjorklund.

Jeff Maine would like to thank Dean Danielle Conway for supporting this project. He would also like to thank Corinne Gagnon, Nathan Brown, Ryan Almy, Heidi Gage, Frances Smith, and Deborah Lorenzen for their superb editorial assistance.