

Federal Income Tax

Federal Income Tax: Doctrine, Structure, and Policy

Text, Cases, Problems

FIFTH EDITION

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Professor Dodge dedicates this book to his life companion, Molly.

Professor Fleming dedicates this book to Linda, sine qui non.

*Professor Lipman dedicates this book to her partner in life, love,
and law, James E. Williamson.*

*Professor Peroni dedicates this book to his loving and wonderful parents,
the late Emil and Betty Peroni, for their tremendous support and
inspiration over the years.*

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Preface to the Fifth Edition

This fifth edition continues our practice of commingling text, primary material, commentary, and problems.

We are pleased that Francine J. Lipman, William S. Boyd Professor of Law, William S. Boyd School of Law, University of Nevada, Las Vegas, has joined the fifth edition team.

The fifth edition, of course, incorporates developments from late 2011 to late 2018. In general, our aim has been to enable the instructor to construct a syllabus suited to his or her priorities. Thus, numerous subdivisions exist within chapters.

Addressing the fundamental differences between income taxation and consumption taxation (or wage taxation) near the beginning of the book allows us to continue this theme throughout. However, we also note competing views of a normative income tax, the Haig-Simons accretion version and the ability-to-pay realization income tax. Exposure to the various normative tax-base constructs leads students to a more sophisticated grasp of the mongrel nature of our current system, as well as a better appreciation of the growing number of tax-arbitrage opportunities that arise from inconsistent premises.

We hope that this book proves to be a useful tool for exploring individual income taxation. As always, we welcome your feedback.

Joseph M. Dodge
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Introduction

Many tax teachers have been confronted by a student who has been told that everyone should take the basic income tax course but who is fearful that a lack of prior exposure to tax or business matters would amount to a serious disadvantage. It would be tempting to ask if this student had the same qualms about taking courses in Constitutional Law or Criminal Procedure before signing up for those classes despite having had little previous, first-hand exposure to those areas of law. The answer surely would be no. Perhaps the difference is that all law students are presumed equally ignorant of these nontax subjects, whereas undergraduate accounting and finance majors are presumed to have a head start in tax. Prospective tax students also are prone to think that tax is a narrow area of extremely technical application using a restricted set of skills that they do not possess or cannot acquire. We think both of these perceptions are in error, and in this Introduction we aim to allay them.

Myth Number One: Those with accounting backgrounds already know this material and, therefore, have an advantage.

It's true that most accountants know how to compute depreciation, and may have learned how to fill out a tax return. But this is not a course in arithmetic or how to fill out a tax return. It certainly is not necessary to have an accounting background, or any other kind of business background, before successfully studying tax law or becoming a skilled tax attorney. Two of the four authors of this book did not have business or accounting backgrounds, and many of our best students in the past similarly have not had any prior exposure to the area (except in their capacity as taxpayers). *Here* is where you are expected to learn this material not before.

Myth Number Two: Tax lawyers wear green eyeshades and crunch numbers for a living. Tax law is a conceptual body of law. Although the concepts sometimes cannot be explored without periodically using some simple numbers and computations for illustrative purposes—nothing more difficult than addition, subtraction, multiplication, and division—the numbers and computations are no more than tools. Both the numbers and the computations are comfortably within the competence of the typical junior high school student.

What, then, is the work of the tax lawyer? While some tax lawyers focus on dispute settlement with the Internal Revenue Service (IRS) or in court, most tax lawyers are transactional lawyers—whether the transaction is a divorce, personal-injury litigation, the creation of a business entity for the entrepreneur, or a corporate merger.

Consequently, the practice of tax law is typically forward-looking and can be very creative. Most tax lawyers are planners who endeavor to ensure that the best tax outcome is combined with what makes sense for other reasons, such as business needs or personal desires.

“Math anxiety” or “lack of a business background” are not excuses for low expectations of performance in the study of tax law. Students will not have trouble subtracting \$40,000 from \$100,000 to reach \$60,000 (a typical example of the level of arithmetic involved in the course). Rather they have difficulty understanding that the statute directs them to subtract \$40,000 from \$100,000. That difficulty has nothing to do with math anxiety or business acumen, but rather with the lack of the skill to carefully read a controlling text. The basic income tax course teaches that skill.

Myth Number Three: The main reason to take this course is because some bar exams have at least one tax question. That reason is far down on the list of good reasons to take the introductory tax course. One of the better reasons to take this course is that it will affect your practice (unless you are absolutely certain that you will spend your entire career on the criminal side of the docket — and tax issues can arise there as well!). Taxation, however, touches virtually everyone in society, from the welfare recipient, to the sole proprietor trying to start a business, to the wealthy investor, to the Fortune 500 corporation. Whether you practice real estate law, corporate law, estate and trust law, tort law, family law, international law, bankruptcy law, and on and on, and whether you practice as a sole practitioner or as a member of a large firm, issues of taxation will undoubtedly arise.¹ You need to be sensitive to them, if only to get a tax lawyer involved at the appropriate time: before the transaction occurs. As stated by Dean Erwin N. Griswold, a tax lawyer, longtime Dean of the Harvard Law School, and former Solicitor General of the United States:

It is high time that tax lawyers rise up to defend themselves against the charge that tax work is narrowing and stifling. On the contrary, it seems difficult to find a field which leads practitioners more widely through the whole fabric of the law. A tort lawyer is a tort lawyer, and a corporation lawyer is a corporation lawyer. But a tax lawyer must deal constantly not only with statutes and committee reports and regulations, but also with questions of property, contracts, agency, partnerships, corporations, equity, trusts, insurance, procedure, accounting, economics, ethics, [and] philosophy. [They] must be broad in [their] background and in [their] outlook, if [they are] to deal with the manifold problems which make up the modern field of tax law.

The basic income tax course may be the first substantive statutory course for many of you. Unlike the common-law jurisprudence of your first-year courses, the

1. See Erwin N. Griswold, *The Need for a Court of Tax Appeals*, 57 HARV. L. REV. 1153, 1183–84 (1944); see also Erik M. Jensen, *The Heroic Nature of Tax Lawyers*, 140 U. PA. L. REV. 367 (1991) (reviewing John Grisham’s *THE FIRM*, where the hero is a tax lawyer).

primary source of tax law is a statute (together with interpretive pronouncements made by the administrators of the statute). Although case law is not unimportant, it is ancillary to the statutory and administrative law to which you will soon be exposed. This is an important point because most law that you will practice today is found in statutes and administrative materials. Much of the common law and law of crimes has been codified. Before you leave law school, you will need to be able to approach the language of a statute that you have never seen before, pull apart its structure, and understand what it is telling you. There is no better course in which to practice this skill than the basic tax course. To this end, we strongly urge that you actually read provisions of statutes and regulations as they are cited from time to time.²

A distinct issue from learning how to read a statute's sometimes convoluted commands is learning how to approach ambiguity or incompleteness in those commands. Where literalism fails (or is inapposite), interpretive techniques come into play. The interpretive techniques acquired in a tax course are "transferable" to other courses relying on text.

A course in federal income taxation exposes you to law shaped by all three branches of government. The primary source of federal tax law is the Internal Revenue Code, enacted by Congress. But the Code is administered by the IRS within the Treasury Department, which is part of the executive branch. Because the Treasury Department promulgates Treasury regulations, and the IRS issues guidance in the form of public and private rulings, all of which have the force of law in varying degrees, the basic tax course is also a course in administrative law. Moreover, the judicial branch decides disputes arising between taxpayers and the government, including whether regulations and other guidance issued by the Treasury Department and the IRS are valid. Consequently, the basic tax course is a study of the interplay between the judiciary, executive branch administrators, and Congress.

Our approach will be to expose you to the basic technical details of the law but in a conceptually anchored way. The detail that we do cover will be used not merely to equip you with the basic mechanics of current law but to illuminate the fundamental ideas underlying the income tax. The detail will inevitably change; a major tax act was enacted nearly every year between 1981 and 1993, and starting in 1996

2. Daniel 5:1-2, 5-7 (King James) says:

In the same hour came forth fingers of a man's hand, and wrote over against the candlestick upon the plaister of the wall of [King Balshazzar's] palace: and the king saw the part of the hand that wrote. Then the king's countenance was changed, and his thoughts troubled him, so that the joints of his loins were loosed, and his knees smote one against another. The king cried aloud to bring in the astrologers, the Chaldeans, and the soothsayers. And the king spake, and said to the wise men of Babylon, Whosoever shall read this writing, and shew me the interpretation thereof, shall be clothed in scarlet, and have a chain of gold about his neck, and shall be the third ruler of the kingdom.

Although compensation rates have gone down since Balshazzar's day, you will still be well-rewarded for learning to extract meaning from difficult language.

virtually every year has seen significant tax legislation. Indeed, the enactment in late 2017 of the Tax Cuts and Jobs Act (2017 TCJA) has prompted us to prepare the Fifth Edition of this book. This legislative activity induces people to over-rate the significance of tax law changes. Although changes cannot be ignored, the income tax is grounded in underlying policies, theories, and principles, which maintain continuity and predictability. The basic tax course emphasizes what does not change, or what changes incrementally.

We believe that learning detail for its own sake is not important, as it may become obsolete, or even if it does not, you are likely to forget it after the final exam. But you will find that, in the real world, being able to cope with detail in solving a problem is an important skill. The only way to gain that skill is to practice it here. Consequently, this book will lead you through an appropriate amount and level of detail so that you can practice that important skill—knowing full well that you will forget some of that detail a year from now. But the skill you acquired in *coping with* detail will remain with you.

In summing up, we hope that four of the things you take with you from this course are an understanding of the fundamental structure of the income tax and its animating policies, the ability to spot questions and deal effectively with them under current law, the ability to deal with new statutory language you have never seen before, and the ability to work with administrative materials from a variety of sources in dealing with a transaction.

Virtually all of the chapters contain explanatory text interspersed with cases and other primary materials, as well as notes and problems. The discussion in class may well revolve around the problems, and you should try your best to answer them in advance of class. You might think of the problems as a sort of legal memorandum exercise, with the text and materials preceding the problems (and in previously covered portions of the book) as being the research base for answering the problems.

We have purposefully included far more material than can be covered in a typical one-semester course. Our reason for doing so is to provide teachers with options for structuring the course so that it addresses the issues that each of them believes are most important. Accordingly, your teacher will inevitably omit some of the material in this book, but you should not be troubled by that fact or feel short-changed.

In any discussion involving policy and theory, people will hold varying opinions. This book necessarily presents our current views. Where these views are likely to be controversial, we note the existence of alternative views.

Cases and other primary materials have been edited, sometimes heavily. For the sake of readability, the editorial deletions (as well as very minor alterations) are sometimes not indicated, although major alterations and other editorial material are usually enclosed in brackets. Original footnote numbers are retained in brackets at the start of the footnote.