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Students reach their full potential with the fresh approach of the

Instead of using the “hide the ball” approach, selected cases illustrate key developments in the law and show how courts develop and apply doctrine. The approachable manner of this series provides a comfortable experiential environment that is instrumental to student success.


Students perform best when applying concepts to real-world scenarios. With assessment features, such as Real Life Applications and Applying the Concepts, the offers many opportunities for students to apply their knowledge.

Ruling or Case Previews and Post-Ruling or Post-Case Follow-Ups— To succeed, law students must know how to deconstruct and analyze cases. Case Previews highlight the legal concepts in a case before the student reads it. Post-Case Follow-Ups summarize the important points.



Innocently enough, *United States v. Lewis* dealt with a taxpayer forced to repay a portion of a bonus. Today, a similarly situated taxpayer could handily escape negative tax consequence by invoking § 1341. Can the same be said of someone forced to repay money they embezzle? We know as a matter of elementary tax law that illegal income is includible in gross income, but what ramifications flow from that reality? If the taxpayer must include embezzled funds in income, can she legitimately claim that she apparently had an unrestricted (albeit potentially temporary) right to the money? An affirmative answer would appear to make the protections of § 1341 available to her at the time she is forced to repay the funds. The *McKinney v. United States*. Court

What theories of deduction



In this case, the Fifth Circuit Court of Appeals rejected the notion that embezzled funds includible in gross income are held by the embezzler under a claim of right. Given that § 1341 applies only to those holding original funds under the belief that they have an unrestricted right to them, the court rationally concluded that § 1341 does not apply to embezzlers forced to repay stolen funds. Under the facts of this case, the embezzler apparently found himself in a tax environment in which application of § 1341 would have offered measurable benefits. Even though the court deprived him of § 1341's protections, the facts of the case do bring to light an oddity (assuming § 1341 applies in a specific situation). Having been required to include income in gross income in a prior period, a given taxpayer might find himself able to take a deduction (on repayment of the funds) in a later period in which tax rates have *increased* substantially (i.e., they get the benefit of a current deduction even if a tax credit would yield a lesser benefit). Add to that the fact that the taxpayer is also spared fines, penalties, and prison time.

Real Life Applications—Every case in a chapter is followed by Real Life Applications, which present a series of questions based on a scenario similar to the facts in the case. Real Life Applications challenge students to apply what they have learned in order to prepare them for real-world practice. Use Real Life Applications to spark class discussions or provide them as individual short-answer assignments.

Four months after celebrating her 85th birthday, Eleanor fell and broke her hip. She moved in with her daughter, Mary Lou, in February of 2017 and has resided there since then. Eleanor has no income, and she relies 100 percent on Mary Lou for her care and support.

What specific Code provision allows Eleanor to satisfy the relationship requirement of § 152(d)(1)(A)?

Is Eleanor Mary Lou's qualifying relative?

Under the same facts, could Mary Lou's uncle (maternal or paternal side of the family) satisfy the relationship requirement of § 152(d)(1)(A)? Please explain.

Since an early age, Gary has been legally blind. He now lives independently, but he relies heavily on his seeing-eye dog, Copernicus. Gary generally provides 100 percent of Copernicus's care, although he pays someone to give the dog his daily walks and to take him to the veterinarian for regular checkups.

Applying the Concepts—These end-of-chapter exercises encourage students to synthesize the chapter material and apply relevant legal doctrine and code to real-world scenarios. Students can use these exercises for self-assessment or the professor can use them to promote class interaction.

Taxpayer A is contemplating a multi-billion-dollar transaction with Taxpayer B. Taxpayer A hires Fernando, a tax attorney, to assist in obtaining a PLR from the IRS.

- a. How will Fernando find out what steps must be taken to secure a PLR?
- b. If Fernando succeeds in obtaining a favorable ruling from the IRS, which taxpayers, in addition to Taxpayer A, can rely on that PLR?

Giovanni, a research assistant at the IRS, is working on a project in taxes.

Assume that you are a research assistant for one of your tax professors. She plans to write an article on IRC § 108(a)(1)(E) and needs you to conduct some preliminary research. See if you can find out when this provision was added to the Internal Revenue Code. Also check to see if there is a House Report or a Senate Report discussing the new provision.

Returning to your office after lunch, you find a litigation partner waiting for you. She informs you that one of her major clients has asked that she litigate a contested liability case in Tax Court. She needs you to find out whether there have been any contested liability cases decided in Tax Court since January 1, 2012. See what you can find and send her a brief e-mail update.

Ensure student success with the Focus Casebook Series.

In a law office, when a new associate attorney is being asked to assist a supervising attorney with a legal matter in which the associate has no prior experience, it is common for the supervising attorney to provide the associate with a recently-closed case file involving the same legal issues so that the associate can see and learn from the closed file to assist more effectively with the new matter. This experiential approach is at the heart of the ***Focus Casebook Series***.

Additional hands-on features, such as Real Life Applications, Applying the Concepts, and Federal Income Taxation in Practice provide more opportunities for critical analysis and application of concepts covered in the chapters. Professors can assign problem-solving questions as well as exercises on drafting documents and preparing appropriate filings.

This casebook focuses on clear communication of federal income tax fundamentals. On completion of the course, students will have not only the comprehensive substantive knowledge base needed for advanced study in the federal tax arena, but also a healthy degree of familiarity with various tax-related resources. The student will emerge with the ability to perform well in a clinical or practice setting.

Chapter 1 is introductory and includes basic background with respect to the constitutional authority to tax income and the roles of Congress, the Treasury Department, and the Internal Revenue Service. The chapter also covers standard tax legislation procedure and key sources of tax law and guidance.

Chapter 2 addresses the concept of realization and the current definition of “income.” It also introduces foundational tax terminology (e.g., basis, realization, recognition, etc.) and the fundamentals of the tax computation process.

Chapter 3 provides coverage of rules regarding gross income inclusions and addresses the diversity of income forms, including windfalls, illegal income, and income from the cancellation of indebtedness. The chapter also explores the contested liability doctrine.

In Chapter 4, the text discusses tax-free basis recovery mechanisms and introduces exclusions from gross income, addressing specific limited exclusions (e.g., gain on the sale of a principal residence).

Chapters 5, 6, and 7 cover specific categorical exclusions. Chapter 5 addresses the treatment of items received by gift, bequest, devise, or inheritance (and specific basis determination rules). With Chapter 6, the focus turns to damages received on account of personal physical injury or physical sickness (while also covering punitive and emotional distress damages). Chapter 7 covers the exclusion of specific fringe benefits, cafeteria plan rules, life insurance contract proceeds, and the treatment of state/local bond interest.

Chapter 8 opens with a discussion of the notion of progressivity before moving on to the standard deduction, itemized deductions (in general terms), tax credits, the meaning of dependent, and the deduction with respect to qualified business income. In Chapter 9, the text transitions decidedly to coverage of specific itemized deductions, starting with the allowance for extraordinary medical expenses (including fertility-related expenses and the characterization and treatment of gender identity disorder).

Chapter 10 continues the coverage of itemized deductions, focusing on the allowance with respect to casualty, theft, and other specific losses by individuals (including the federal disaster limitation with respect to certain losses, the significance of a loss being sustained, and the “suddenness” requirement in the casualty loss context). Public policy considerations are also discussed.

Chapter 11 provides extraordinarily useful background on financing the purchase of a home before devoting focused discussion to the tax treatment of qualified residence interest, including relevant grandfathering rules, the impact of equitable ownership, and application of rules on a per-taxpayer basis. From there, the focus shifts to the treatment of property taxes and state and local income taxes.

With Chapter 12, coverage shifts to a discussion of entities eligible to receive tax-deductible contributions under § 170 and the requirements entities must satisfy to secure tax-exemption under § 501. The chapter addresses the treatment of both standard contributions and quid pro quo transactions in the § 170 context and the role of public policy with respect to tax-exempt entities. Also included is a discussion of private inurement prohibitions.

Chapter 13 focuses on the meaning of “ordinary,” “necessary,” and “carrying on” a “trade or business” and the general treatment of ordinary and necessary business expenses.

With Chapter 14, the text formally introduces the concept of matching and addresses the treatment of capital expenditures. The chapter also includes coverage of depreciation, the amortization of intangibles, and inventory tax accounting.

Chapter 15 is devoted to discussion of timing and related issues, including the time value of money, annual accounting, the claim of right doctrine, the tax benefit rule, NOL carryovers, and deferred compensation (including the § 83(b) election).

Chapter 16 offers coverage of the cash receipts and disbursement method of accounting, constructive receipt, economic benefit, the accrual method of

accounting, and the significance of economic performance. The chapter also includes brief discussion of the installment method of accounting.

In Chapter 17, the text turns to like-kind exchanges of real property and involuntary conversions, providing general discussion of non-recognition and the deferral of gain or loss with respect to a given transaction. Also included is coverage of related basis rules (preserving gain/loss) and the potential impact of boot both on recognition and basis (including the transfer of non-qualifying consideration with built-in gain or loss).

After devoting brief attention to the progressivity of tax rates, Chapter 18 discusses both assignment of income and the transfer of income-producing property as well as the notion of a marriage penalty or marriage bonus.

Chapter 19 focuses on the treatment of various transfers incident to marriage and divorce, including inter-spousal property transfers during marriage, property settlements incident to divorce (e.g., those related to the cessation of the marriage), alimony (including fact-specific deduction and inclusion rules), and child support.

In Chapter 20, we take up the treatment of capital gains and losses. In addition to covering the notion of income character, the chapter covers the definition of capital asset, the sale or exchange requirement, and the treatment of long-term and short-term capital gains/losses. There is also discussion of the meaning of “property” under § 1221 as well as the treatment of § 1231 gains and losses and the rules mandating depreciation recapture.

Chapter 21 covers tax avoidance and tax shelters. In addition to discussing the general meaning of passive activity and passive activity losses, the chapter goes on to address material participation, at-risk limitations, and the economic substance doctrine.

Chapter 22 discusses the alternative minimum tax and aims consciously to communicate substantive essentials.

Chapter 23 concludes primary substantive coverage with discussion of federal withholding, estimated taxes, and worker classification. The chapter addresses the meaning of “wages” both in the income tax and in the employment tax contexts as well as the rules regarding FICA, the FICA Wage Base, estimated tax payments, worker classification (including potential § 530 relief), and the imposition of penalties and interest on underpayments.

Appendices 1 and 2 aim largely to impart a substantial dose of practice-readiness by giving students knowledge useful to them in a clinical or early practice setting. Appendix 1 introduces the student to the fundamentals of tax controversy and litigation, including the notion of assessment (including waivers and extensions), offers in compromise, installment agreements, audits (correspondence, office, and field), closing agreements, no-change letters, information document requests, administrative summons, 30-Day Letters, 90-Day Letters, protests, the IRS Office of Appeals, and various tax litigation venues. The chapter also provides a basic introduction to IRS Circular 230. Appendix 2 focuses on tax research fundamentals, including location of current-year and prior versions of the Internal Revenue Code and Treasury Regulations, non-Code tax provisions, legislative history, the “Bluebook,” tax cases, IRS pronouncements, and additional research resources (e.g., Bloomberg BNA Tax Management Portfolios and

the CCH Standard Federal Tax Reporter). The appendix also references daily tax publications (e.g., CCH Tracker News and the Bloomberg BNA Daily Tax Report) and highlights the importance of monitoring ongoing legal developments. Materials in Appendix 3 come from a publication of the Congressional Budget Office, *Options for Reducing the Deficit: 2021 to 2030*. The materials facilitate discussion of various deficit-reducing tax policy options, including increasing individual and corporate tax rates, changing the treatment of capital gains on inherited assets, and imposing a tax on the emission of greenhouse gases.

Other resources to enrich your class include: *Examples & Explanations for Federal Income Tax*, by Katherine Pratt, Thomas D. Griffith, and Joseph Bankman. Ask your Wolters Kluwer sales representative or visit the Wolters Kluwer website to learn more about building the product package that's right for you.

In addition to thanking my friends and family for ongoing encouragement, I'd like to express my sincere appreciation for the mentorship and support provided by Professor Mitch Crusto of the Loyola University (New Orleans) College of Law and the Late Professor M. Katherine B. Darmer of the Chapman University Fowler School of Law. Let me also add to the roster of my personal heroes the Late Dean Brian Bromberger (Loyola) and Dean Emeritus Parham Williams (Chapman), both of whom brought personal warmth, professional integrity, gentlemanly demeanor, and towering leadership to the helm.

Getting this casebook from idea to reality required considerable input and effort from many. Let me extend my sincere thanks to the entire Wolters Kluwer team not only for the work already done but also for the work that lies ahead. Richard Mixter gets my heartfelt thanks for guiding me through the initial project phase and firmly supporting my addition of Federal Income Taxation to the Focus Casebook portfolio. Special recognition is in order for Jane Hosie-Bounar, my editor (1st Edition), for improving the text overall, surviving twenty-two chapters (and several appendices) of federal income taxation, coordinating the review process, and providing regular encouragement with professionalism and grace. My reviewers provided highly valuable input; without question, the casebook emerges stronger as a result of their constructive criticism and guidance. Although the entire production team at The Froebe Group enhanced the quality of the text and ushered it through the critical final production process, I owe special thanks to Jessica Barmack (Developmental Editor) and Melanie Field (Project Editor). Sarah Hains (Production Editor) also gets special thanks for her work on the first edition. Let me also extend thanks to my Latin expert, Professor James Powell (retired), for supplying the language in the casebook dedication (1st and 2nd Editions).

No list of thanks would be complete without the addition of my students. Hundreds of you have trusted me with your legal education, and by doing so you have undoubtedly shaped the content and style of this casebook. I wrote this textbook so that I could tell you the story of tax the way I would like it told, and I remain hopeful that you will do what so many prior students have done; they have taken up the challenge that is federal income taxation and seized the opportunity to thrive. You have allowed me to rediscover tax time and again, all the while reminding me of what the tax labyrinth looks like through student eyes. Your comments, questions, and creative arguments put a decidedly professional polish on my teaching and ultimately made this casebook that much better.

In drafting the text, I called on many resources, forms and publications of the U.S. Treasury Department (including the Internal Revenue Service), the Congressional Budget Office, and the Joint Committee on Taxation. I further acknowledge

reference to sources cited within the text and occasional consultation of various materials for specific information, including The World Book Encyclopedia, the 2015 Bloomberg BNA Federal Tax Guide, and The Great Courses (The History of the United States, 2nd Edition). In addition to the use of materials within the public domain, I acknowledge the use of specific photographs and document images, the credit lines for which are listed below.

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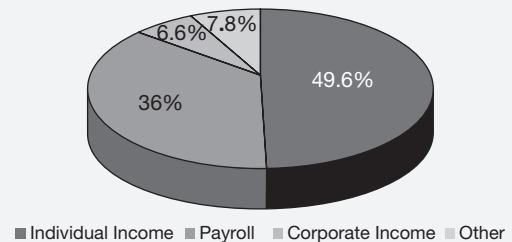
Rate of home ownership in the United States in 2019, by race (graph). Copyright © 2021 Statista.com. Licensed under CC BY-ND license.

The Urgency Behind America's Healthcare Cost Crisis (graph). Copyright © 2019. Licensed under CC BY-ND license.

Intro

According to recent statistics from the U.S Congressional Budget Office, the taxation of corporate and individual income produces trillions of dollars in gross revenue for the United States during a given **federal budget year**. Individuals pay the lion's share of that total, and much of that, in turn, comes from the regular and systematic withholding of taxes on employee wages as they are earned. Thus, even without actually writing a check to the United States Treasury, most students enrolled in this course have probably paid thousands of dollars in federal income taxes over the years. Although opinions may well differ as to whether the federal government collects too much in the way of taxes (or spends far too aggressively once it has the money in hand), most will agree that someone must house and feed the Army, Navy, Air Force, and Marines. And beyond achieving that limited goal, we also have to provide our armed forces with the tools they need to succeed on the battlefield, on the high seas, and in the wild, blue yonder of the skies. We may ultimately enjoy the blessings of liberty and domestic tranquility, but they're not cheap; a combat-ready stealth bomber will easily run you about \$2 billion, and the silent sentinel of national cybersecurity humming quietly in the background is far from free. Even while accepting the reality that taxes are a necessary evil, we can acknowledge that the complex statutory and regulatory system by which we distribute the nation's tax burden should be fair, equitable, and administrable. In this course, we directly engage the rules governing who pays, how much, and why. As a law student, I shouldered modest tax liabilities from my work as a summer associate. I did, however, anticipate landing a job at a big law firm and enrolled in my first

U.S. Federal Tax Revenue by Source
(2019 Fiscal Year - \$3.46 Trillion)



Constitutional authority to lay and collect taxes on income without apportionment
Roles of Congress, the Department of the Treasury, and the Internal Revenue Service
Standard tax legislation procedure
Key sources of tax law and guidance

tax course as part of a larger strategy to minimize future tax liabilities. I soon discovered that Congress had just recently taken away all of the really good stuff, but fortunately, the story has a very good ending. As I made my way through the material, I realized that I had unwittingly stumbled upon an area of law that I found analytically appealing, highly structured, moderately challenging, and yet generally comprehensible; I could navigate the Minotaur's labyrinth and live to tell the tale. Also, I occasionally found tax cases to be deeply entertaining, so I was definitely hooked. My hope is that you too will enjoy a similar experience. Allow me, then, to introduce you to the federal income taxation arena.

The course in federal income taxation typically has a reputation that precedes it, and more often than not, that reputation is a negative one. Many will claim that Federal Income Taxation was the most difficult course they *ever* took in law school. Others will lament that the **Internal Revenue Code** (a collection of the governing statutes) is simply incomprehensible and that the **Treasury Regulations** (which flesh out and further explain the Code provisions) simply complicate matters on a grander scale by using more words, albeit with occasionally helpful examples. And then there is the sin above all sins: Tax apparently involves *math*, a subject reviled by a substantial percentage of law students. The truth, of course, is that the basic tax course has much in common with other law school courses. Some degree of rigor is unavoidable. True to its notorious reputation, tax law does demand rapt attention to precise statutory language. With sufficient focus and diligence, however, a student can readily attain mastery and, over time, some degree of expertise. Indeed, one could say that the course in federal income taxation is largely a “skills” course in that it develops a budding lawyer’s ability not only to interpret and apply statutes but also, and perhaps more importantly, to argue and persuade with respect to points of proper statutory construction. Often, the difference between a good or solid lawyer and an outstanding lawyer boils down to the attorney’s ability to understand complicated laws quickly and, if need be, to convince a decision maker to resolve statutory ambiguities in a manner consistent with the interests of the lawyer’s clients. Even when a statute is clear, applying that statute to a given case may well prove to be an uphill battle for any number of reasons.

The typical law school curriculum includes any number of highly statutory courses, and one might legitimately ask whether studying tax law yields unique skill-development benefits. In my view, the benefits of studying tax law are substantial. Relative to courses focusing almost exclusively on the common law, tax courses more faithfully replicate the actual practice of law by requiring that students focus on and

develop an understanding of governing statutes while giving due regard to administrative regulations, official pronouncements, and guiding precedent. Consistent with best teaching practices, the course in federal income taxation also facilitates student success by developing skills in a substantive arena with which the student likely has some baseline familiarity. Most of you, in all likelihood, already understand the notions of **filing status** (e.g., “single,” “head of household,” or “married filing jointly”) and **progressivity** (i.e., tax rates/brackets get progressively higher as one’s taxable income rises). Similarly, you understand that tax liability is determined on an annual basis, that taxpayers are subject to audit by the Internal Revenue Service (“IRS”), and that failure to pay taxes can result in the imposition of penalties/fines or even criminal indictment. And even if you have yet to incur extraordinary medical expenses, make substantial charitable contributions, or pay mortgage interest, you probably know that these items may give rise to some form of deduction come tax time. In addition to enhancing critical lawyering skills, the study of tax law has a host of practical benefits, wholly aside from allowing an individual to manage and appreciate his or her own tax affairs. Tax expertise is fully billable in the practice setting, and the more seasoned the expertise, the higher one can charge for it. Legal entities, governments, and individuals with sophisticated financial profiles need the assistance of those with knowledge of the tax law, and given the likely perpetuity of the federal taxing apparatus, one can rest assured that there will always be demand for tax attorney services. Attorneys practicing without sufficient knowledge of tax law are flying the trapeze without a net, and they will often find that their substantive shortcoming places their clients in a financially precarious position. Thus, attorneys demonstrating knowledge of and sensitivity to the tax ramifications of a given course of action can more easily navigate tax-related malpractice threats, even if, as a practical matter, such threats remain remote. At the same time, attorneys should be able to display this hallmark of lawyerly sophistication. Today’s clients increasingly come to the table with some degree of tax knowledge, and an attorney who is deficient in that regard may appear to lack full professional competence in a business setting. Tax-savvy attorneys can also spare their clients the headache of finding special tax counsel (and paying multiple retainers). Even if a graduate thinks that he or she can practice law wholly outside the tax arena (e.g., commercial and residential real estate, family law, business law, entertainment law, personal injury law), he or she will quickly find that tax ramifications present at every turn. And this reality should come as no surprise; where money (or property) changes hands (or when financial exigencies present), the IRS will surely take note. Accordingly, attorneys who don’t know the tax ramifications of the transactions they structure tend to draft documents that have to be revised (often substantially) by those who do. Such dereliction enhances both inefficiency and client costs.

Putting modern tax law in the proper context requires that we devote some degree of attention to history. Although today most individuals pay taxes via the periodic



Scribe in ancient Egypt keeping record of geese.
Credit: World History Archive/Alamy Stock Photo.

withholding of taxes on their wages, those who must make direct tax payment to the government for whatever reason typically do so by sending out a check or money order payable to the United States Treasury or by effecting some form of electronic transfer. In ancient times, people had to pay taxes, but electronic payment options did not exist, nor (for some time at least) did coined money or currency. As a result, people paid taxes by handing over physical goods (e.g., cows, grain, geese, etc.) and by rendering services (e.g., manual labor, military service, etc.).

Eventually, the existence of coined money and currency made it possible to pay taxes in that medium, but what is true today was equally true in ancient times; paying taxes has never been pleasant. Indeed, it has often proven decidedly unpleasant. In centuries past, those suffering under particularly heavy or offensive levies (even in response to specific government needs) were quite capable of and rather creative in communicating their discontent. According to legend, Lady Godiva actively protested the heavy taxation imposed by her husband by riding a horse through the streets of Coventry (England) covered only in her hair. Whether that story is more apocryphal than actual, history does record a number of infamous (and well-documented) tax revolts. In early thirteenth century England, barons adamantly resisted King John's effort to impose a heightened **scutage** (i.e., a tax paid in lieu of military service) to fund specific military campaigns. Met finally with armed resistance and faced with a series of demands, the king ultimately signed what we now refer to as the Magna Carta. See DAVID F. BURG, *A WORLD HISTORY OF TAX REBELLIONS* 84–86 (Routledge 2004). Over a century later, a massive peasants' revolt took place in India (circa 1332–1334) when Sultan Muhammad Tughluq substantially increased agrarian taxes. See *id.* at 106–07. After considerable agitation, bloodshed, drought, and famine, the sultan found himself introducing and ultimately implementing programs to support agriculture. See *id.* And if we turn the pages of history just a few centuries forward from there, we will find the common people of France rising up in violent revolution after suffering heavy taxation, an onerous and oppressive financial burden from which the nobility and clergy were largely excused.

As tax revolts go, many more can be found in the annals of history, but none was more spectacular than the American Revolution.

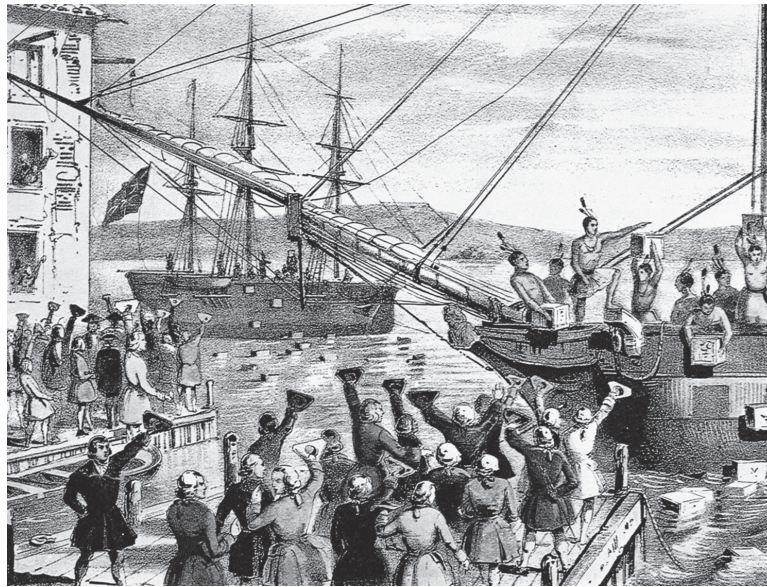
In the immediate aftermath of the French and Indian War (fought to some extent in colonial America), Great Britain found itself burdened with considerable war debt. Accordingly, it sought to impose direct taxes on the colonies, starting with the so-called **Stamp Act**, which required that various documents carry a revenue stamp. Colonists had generally grown accustomed to Great Britain's taxation of imperial commerce on the high seas, but they objected vehemently to its attempt to impose taxes with respect to *internal* colonial affairs; that privilege, they reasoned, had always belonged to their colonial legislatures (e.g., the Virginia House of Burgesses). The colonists had no representatives in Parliament and thus, they complained, "Taxation without representation is tyranny!" Faced with active and vocal colonial opposition, Parliament ultimately repealed the Stamp Act, but it later introduced the so-called **Townshend Acts**, which imposed taxes on various mundane items such as glass, tea, and paper. Not surprisingly, colonial unrest mounted, so much so that it was necessary to dispatch British troops to keep order in Boston, Massachusetts. Unfortunately, rather than restoring and maintaining calm, the British troops regularly harassed and taunted the colonists. In one notable incident, a crowd in Boston, which had gathered to watch a fight involving one of the soldiers, grew unruly and refused to disperse, and at least one soldier at the scene was struck by a club. He and others turned, raised their muskets, and fired into the crowd, resulting in the so-called Boston Massacre.

In the aftermath of the event, Parliament ultimately repealed most of the taxes imposed by the Townshend Acts, but to restate and insist on its right to impose



Boston Massacre (March 5, 1770).

Credit: Science History Images/Alamy Stock Photo.



Boston Tea Party (December 16, 1773).

Credit: Pictorial Press Ltd./Alamy Stock Photo.

taxes on the colonies, it left intact the tax on colonial imports of tea. Rather than rest satisfied with the repeal of most of the Townshend Act taxes and enjoy what was then a relatively cheap cup of tea courtesy of Parliament and the British East India Company, the colonists saw the retention of the tax on tea as an attempt, even if indirect, to secure their acquiescence to and affirmation of Great Britain's asserted right to impose direct taxes on them. They promptly made their opinions known. In a notorious display of outrage and objection, the Sons of Liberty, thinly disguised as Mohawk Indians, boarded ships docked at the port of Boston on the evening of December 16, 1773, and tossed more than 90,000 pounds of tea into the water as Bostonians witnessing the event cheered them on.

Undeterred and enraged, Parliament responded to the event with a series of measures (per the Intolerable Acts) including closing the port of Boston (until the destroyed tea was paid for) and imposing martial law. With a healthy troop presence in Massachusetts and collective colonial resentment rising, it was not long before British redcoats were marching off to Lexington and Concord in search of rebellion leaders and, according to rumor, a stockpile of weapons. The American Revolution was afoot. Years later, of course, in the wake of General Cornwallis's surrender at Yorktown, Virginia, and the signing of the Treaty of Paris of 1783, the American Revolution came to an end, but a host of new problems awaited the fledgling United States of America.

Although the colonies emerged victorious from the American Revolution, it was not without cost. Both the individual states and the federal government found themselves strapped with considerable debt, and although the states could impose



Constitutional Convention of 1787.

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taxes on their citizens to begin the process of clearing their debt, the central federal government found itself in a very real dilemma. In the immediate aftermath of the American Revolution, the United States operated not under the current U.S. Constitution but under the Articles of Confederation, and the Articles did not grant the federal government the power to tax the citizens. To cover its many obligations, the federal government could solicit contributions from the states, but it lacked the power to compel contributions to federal coffers. That reality left the federal government (and, by extension, the collective interests of the states) in a precarious position. Indeed, the eruption of Shays' Rebellion in Massachusetts (circa 1786–1787) exposed the alarming fact that the federal government (lacking proper revenue) could not mount an effective response to a budding insurrection. To address that fiscal handicap and a host of other problems with the Articles of Confederation, the Confederation Congress called a Constitutional Convention in 1787, the end result of which was the adoption and ratification of the U.S. Constitution.

The Founding Fathers assembled at Philadelphia in 1787 accomplished a great deal with the U.S. Constitution, laying the foundation of the new government and cloaking the citizens of the United States with a host of important individual rights and liberties. Having just waged a costly war originating, at least in part, over the question of whether Great Britain had the right to impose taxes on the colonies (notwithstanding their consistent, vocal, and active objection), the Founding Fathers were sure to clarify in the new Constitution above and beyond all doubt that the new federal government would, indeed, have the power to tax the citizens

of the several states. Thus, Article I, § 8 of the Constitution announces the following with abundant clarity:

The Congress shall have power to lay and collect taxes, duties, imposts and excises, to pay the debts and provide for the common defense and general welfare of the United States

To ensure that the collective citizenry of a given state would not face an unfair burden should taxes be imposed, several other provisions require that any direct taxes be apportioned among the states according to their respective populations. Thus, a state with a small population (e.g., Rhode Island) would not be forced to pay the same amount as a state with an immense population (e.g., Virginia), and a decennial census would ensure an accurate, albeit only periodic, count. To accommodate various interests, it was mandated that only three-fifths of slaves be counted, and the Constitution highlighted such altered counting for direct tax purposes. Article I, §§ 2 and 9 provide, in pertinent part, as follows:

Representatives and direct taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole number of free persons, including those bound to service for a term of years, and excluding Indians not taxed, three-fifths of all other persons.

* * *

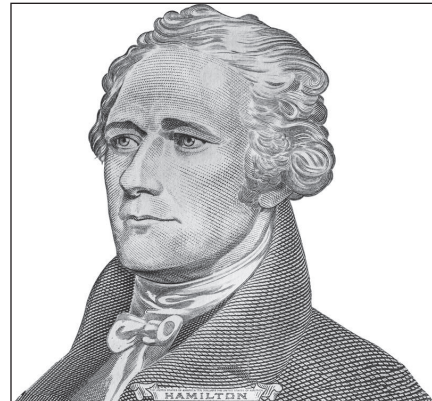
No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration herein before directed to be taken.

Although the Constitution authorized the laying and collecting of taxes generally, the *income* tax as we understand it today did not exist at the time of the Constitution's ratification. When the attempt was made to collect taxes on income, some objected that an income tax was a direct tax and that, as such, apportionment was required. Thus, Congress added the Sixteenth Amendment to the Constitution, and the requisite number of states formally ratified the amendment in February of 1913. Although Congress had the power to lay and collect taxes under the Constitution as originally drafted and ratified, the Sixteenth Amendment merely clarified that taxes on income could be laid and collected *without apportionment* and *without regard to the decennial census*. The Sixteenth Amendment provides, in pertinent part, as follows:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Within the larger federal government, the **Department of the Treasury** resides within the executive branch and is responsible for formulating tax policy and administering

the tax laws. Its leader, the **Secretary of the Treasury**, delegates administration and enforcement of the tax law to the **Internal Revenue Service** (“IRS”), which itself is headed by the **Commissioner of Internal Revenue** (“**Commissioner**”). The IRS has many offices and divisions, each charged with executing a specific function or focusing on a specific group of taxpayers. The IRS’s primary divisions include Large Business and International, Small Business/Self-Employed, Tax-Exempt and Government Entities, and Wage and Investment. Its principal offices include the **Office of Chief Counsel** (which provides guidance and advice regarding the tax laws) and the **Office of Appeals** (which aims to settle tax controversies without litigation). As appropriate, we will discuss these divisions and offices in future chapters. For the moment, recall that as an administrative agency charged with raising federal revenue, the IRS collects trillions of dollars during a given fiscal year. That impressive revenue total reflects the end result of prevailing tax laws and policies, many of which are in a state of flux and the subject of ongoing debate both in the political arena and in scholarly literature. It bears noting, however, that even with gross revenues measured in the trillions, the United States continues to suffer annual multi-billion-dollar budget deficits, prompting some to argue that the nation’s wealthiest taxpayers are asked to pay too little, that loopholes must be closed, and that preferential tax treatment of certain forms of income must be abandoned. Those taxpayers in the top percentiles, in turn, lament not only that they pay the bulk of all federal taxes but also that they are required to pay far too much, and they blame chronic budget deficits largely on profligate federal spending. Whatever the prevailing reality, the tax laws will evolve and change. It can surely be said that by providing for the generation of federal revenue, the Founding Fathers cured one of the more serious defects of the Articles of Confederation, but if recent budget statistics are any indicator, the Constitution’s failure to police federal expenditures with sufficient vigilance has emerged as a glaring flaw.



Alexander Hamilton (*circa* 1757–1804) served as the first Secretary of the Treasury of the United States.

Credit: FrameAngel / Shutterstock.com.

Students and practitioners of tax law find that although fundamental tax principles and core rules change little over time, tax law constantly shifts and evolves. Tax rates change, new rules appear, old rules suffer repeal, and a stream of temporary provisions make their cameos before riding off into the sunset. The Constitution does not attempt to govern every aspect of the tax legislation process, but it does set forth a few ground rules. In addition to the substantive provisions discussed previously, the Constitution requires, per Article I, § 7, that “[a]ll bills for raising revenue . . . originate in the House

of Representatives; but the Senate may propose or concur with amendments as on other bills.” Apparently recalling that the English House of Commons had the exclusive power to originate revenue matters, the Founding Fathers decided that the U.S. House of Representatives should have the same power, even if the Senate held the power of amendment. Traditionally, then, a bill for raising revenue will originate in the House of Representatives and then be assigned to the **House Ways and Means Committee**, a standing committee in the House responsible for addressing tax-related measures. The measure may “die” in committee, but if fortune prevails and the committee reports on the measure favorably (i.e., approves), the measure then proceeds to the floor of the House of Representatives for a vote. If the House passes the measure, the bill proceeds to the Senate, where it is assigned to the **Senate Finance Committee**, which handles tax-related measures as a standing committee of the Senate. Assuming that the committee reports on the measure favorably, it goes to the floor of the full Senate for a vote. The version of a measure approved by the House and the version approved by the Senate will likely have discrepancies that must be worked out before the measure can become law. Accordingly, such a measure goes to the **Conference Committee**, a joint committee comprised of members from both chambers who work together to iron out differences in legislation as originally passed by the House and the Senate. The legislation emerging from the Conference Committee proceeds back to the floor of the House and the Senate, and assuming both chambers approve the (now-identical) measure, it goes to the President for signature. With the President’s approval, the measure becomes law. If the President vetoes it, Congress, having the power to override a presidential veto, can nonetheless enact the measure.

One should note, at this juncture, that as legislation makes its way through Congress, the various committees generate reports that will ultimately constitute part of the measure’s legislative history. Internal Revenue Code provisions may contain ambiguous or perplexing language, making it difficult to ascertain from the face of the statute exactly what Congress intended. Thus, those conducting research in the tax arena can often get a clearer picture of what Congress had in mind when it adopted or amended a given provision of tax law by consulting reports generated during the legislative process. These reports (e.g., the **House Ways and Means Committee Report**, the **Senate Finance Committee Report**, and the **Conference Committee Report**) typically discuss the old law, the reasons for change, and the new law. Consider, for example, the following excerpt from the Senate Report prepared during consideration of what is now § 221 of the Code.

SENATE REPORT NO. 105-33

* * *

3. Deduction for student loan interest (sec. 202 of the bill and new sec. 221 of the Code)

Present Law

The Tax Reform Act of 1986 repealed the deduction for personal interest. Student loan interest generally is treated as personal interest and thus is not allowable as an itemized deduction from income. * * *

Reasons for Change

The [Senate Finance] Committee is aware that many students incur considerable debt in the course of obtaining undergraduate and graduate education. The Committee believes that permitting a deduction for interest on certain student loans will help to ease the financial burden that such obligations represent.

Explanation of Provision

Under the bill, certain individuals who have paid interest on qualified education loans may claim an above-the-line deduction for such interest expenses, up to a maximum . . .

In addition to the House Report and the Senate Report, the Conference Committee Report can be particularly useful because it will indicate whether the final legislation reflects full or partial adoption of the House provision or the Senate's amendment (if either) and why.

Soon after ratification of the Sixteenth Amendment in 1913, Congress passed the Revenue Act of 1913, and in later years, additional revenue measures were enacted. The various revenue measures were eventually pulled together into a single "Internal Revenue Code," and future changes in tax law simply took the form of amendments to the existing Code. From time to time, the Code would undergo substantial revision/amendment, and the entire Code would be reenacted. Thus, one may see reference to the Internal Revenue Code of 1954. More likely, of course, one will encounter reference to the current version of the Code, the **Internal Revenue Code of 1986 (as amended)** (the "**Code**"). Thus, the statutory supplement in use in your class literally contains select provisions from the Internal Revenue Code as it was reenacted in 1986, albeit reflecting various amendments made thereto since 1986. You may also see reference to the original Internal Revenue Code of 1986 as Public Law 99-514 or P.L. 99-514. Note that although most tax statutes appear in the Code, from time to time, Congress will enact a tax provision and make it part of Statutes-at-Large rather than having the provision codified along with other tax statutes. The practice strikes many as odd, but it persists.

As part of the larger body of federal law, the Code exists as Title 26. That Title is, in turn, subdivided into Subtitles, Chapters, Subchapters, Parts, and Subparts; in this course, we devote our attention to Subtitle A, which addresses income taxes. Individual Code sections generally appear within a Part or a Subpart. And as if that's not enough, it gets better. The individual sections have divisions of their own, and here is where

Practice Pointer

Although an attorney may use the most recent version of the Code for current-day planning, he or she must locate and apply the version of the Code *in effect at the time of the relevant prior events or transactions* when addressing an issue with respect to a prior tax year.

focus is most important. A given Code provision such as § 165(h)(3)(A) has multiple divisions, as exemplified by the following:

165	(h)	(3)	(A)
Section	Subsection	Paragraph	Subparagraph

The good news is that there is method in this madness both at the macro- and micro- levels. If Congress seeks to limit the applicability of a given definition or provision, it can use limiting language; you will often see it. Thus, a special definition for a specific term that should apply only in a given section will be preceded by language akin to “For purposes of this section, . . .” Likewise, if a given provision should apply to a range of sections, one might see limiting language akin to “For purposes of this Part, . . .” or “For purposes of this Subpart, . . .” If Congress needs restriction within a section, it can use language such as “For purposes of this subparagraph, . . .” or “For purposes of this subsection, . . .” Finally, if Congress needs to speak somewhat broadly, it can say “For purposes of this subtitle, . . .” or even “For purposes of this title, . . .” Note that even if a particular provision contains language that generally restricts its applicability (e.g., “For purposes of this section”), other provisions may cross-reference that provision to effectively borrow the rules or, perhaps, definitions presented there.

Although Congress has managed over the years to produce a rather lengthy Internal Revenue Code, Congress has not undertaken to anticipate every situation, nor has it attempted to flesh out every revenue provision in baroque detail. Rather, Congress anticipates that the Treasury Department will further interpret and explain the tax law and that, on occasion, courts may be called on for **interstitial law-making** (i.e., filling gaps left by current statutes and regulations). Thus, one should be aware of several important sources of tax “law.”

Often, Congress will enact a Code provision and explicitly direct, as part of the approved legislation, that the Secretary of the Treasury flesh things out further. The Treasury fulfills this mandate by promulgating Treasury Regulations that generally correspond, numerically, with a specific Code provision. Thus, for further explanation of I.R.C. § 165, one would generally consult Treas. Reg. § 1.165-1 et seq. The Treasury Department may also issue regulations without express congressional directive. Treasury Regulations provide useful information and guidance and are entitled to deference. The Treasury Department will occasionally indicate its intent with respect to a given set of regulations by setting forth a preamble to those regulations, and such preambles can prove useful in a research context. Note also that the Treasury Department normally issues regulations first as **Proposed Treasury**

Regulations, which generally serve to provide non-binding but needed taxpayer guidance; only after a public comment period and further administrative procedure are they issued as final Treasury Regulations. The Treasury Department may also issue **Temporary Treasury Regulations** to provide needed rules of immediate applicability, although such regulations are also typically issued in proposed form to elicit feedback and commentary before they are finalized.

Provisions of the Internal Revenue Code and the Treasury Regulations often suffice in terms of clarifying the proper tax treatment of a given transaction or item. The efforts of Congress and the Treasury Department notwithstanding, however, a host of issues may present. If a given provision of the Internal Revenue Code is new, clients may begin pressing their tax advisors for answers before such advisors have the benefit of proposed or temporary Treasury Regulations. Likewise, developments and innovations in any number of arenas (e.g., financial, medical) may have a tax impact, even though in drafting applicable rules as an initial matter Congress did not have those innovations or developments in mind; standard application of the rule might well lead to grossly inappropriate results. Also, in some instances, tax advisors and their clients may have a considerable degree of comfort with respect to the treatment of a given item or transaction, but in light of the significance of the transaction (which might well involve billions of dollars), they seek further assurances from the IRS. Accordingly, from time to time, the IRS will provide guidance by issuing various pronouncements. Some of the more common pronouncements include the following:

Revenue Rulings: This form of pronouncement is the IRS's official position with respect to its treatment of a given transaction or item. One can think of it as the IRS's general indication of its current litigating position, but courts need *not* treat Revenue Rulings as binding, although some may find them persuasive. Note that Revenue Rulings may be amended or superseded by future pronouncements.

Private Letter Rulings ("PLRs"): This form of pronouncement is issued by the IRS to a specific taxpayer with respect to an issue the taxpayer currently faces or an actual transaction the taxpayer contemplates. The ruling confirms how the item or transaction will be treated under the facts as presented by the taxpayer and governing law. Such rulings are binding on the IRS with respect to *that* taxpayer (although the Service does reserve the right to unilaterally revoke a PLR for specific reasons). Other taxpayers may *not* rely on it for their own transactions or cite it as precedent. Note that the IRS is not obligated to rule on every issue, and, in fact, the IRS will often clarify by official announcement that it will not issue PLRs on certain issues.

Revenue Procedures: These pronouncements generally provide guidance with respect to the proper procedure to be followed under varying circumstances. For example, a Revenue Procedure will inform taxpayers about the steps they must take to secure a PLR. Note that Revenue Procedures are subject to amendment and update.

Technical Advice Memoranda: The IRS National Office will issue these pronouncements to fellow IRS personnel as guidance in connection with the examination of a

specific taxpayer. The IRS ultimately makes such memoranda available to the public but in a form that would prevent identification of a specific taxpayer.

Action on Decision: These pronouncements are made in response to tax litigation developments, and they are intended to guide IRS personnel working on the same or similar issues. The pronouncements essentially indicate whether the IRS will defer to the holding in certain cases on issues decided against the government that will not be appealed in that case. The IRS issues an “Acquiescence,” an “Acquiescence in Result Only,” or a “Non-Acquiescence.” Note, in particular, that if the IRS issues a Non-Acquiescence, it indicates that for the moment, it’s throwing in the towel on the issue in a given jurisdiction (e.g., the Ninth Circuit), but vows to fight the issue elsewhere.

In addition to the preceding items, the IRS issues a wide range of pronouncements. In a practice setting, you will become more familiar with the various pronouncement forms, but for now, the key is to note that in providing advice to clients, one often has several sources of guidance beyond the provisions of the Internal Revenue Code and the Treasury Regulations. These official pronouncements lack the impact of Code provisions and final Treasury Regulations, but one should not take them lightly. A pronouncement on a given issue might well give rise to considerable reverberations throughout the tax-planning community.

As is the case in other areas of law, courts must, from time to time, intervene to resolve differences in the tax arena, and relevant cases can come from any number of courts. Taxpayers facing litigation with the IRS may have to make several important decisions, the first being whether they will pay the asserted tax deficiency before the commencement of litigation or whether they will pay, if at all, only after the commencement or completion of litigation. That initial decision will have an impact on what court they may litigate in. If the taxpayer has the financial wherewithal and decides to pay before commencing litigation, they will ultimately sue the “United States” for a refund either in District Court or the Court of Federal Claims; the rules governing binding and persuasive precedent operate as per usual. Assuming they file in District Court, they may later appeal to the relevant Circuit Court of Appeals and ultimately to the United States Supreme Court. If, instead, they file in the Court of Federal Claims, they may later appeal to the Court of Appeals for the Federal Circuit and ultimately to the United States Supreme Court. Taxpayers who pay before the commencement of litigation may have to part with a considerable amount of money, but their payment stops the tolling of interest on the asserted tax deficiency. Having the ability to pay first also gives them maximum flexibility in terms of shopping for the most favorable forum (based on existing precedent).

Taxpayers lacking the financial wherewithal to pay first, or opting to withhold payment until the commencement or completion of litigation, must file suit against the Commissioner of Internal Revenue in **Tax Court**, a court that specializes in tax matters and whose judges have tax expertise. Taxpayers filing in Tax Court

may later appeal to the Circuit Court of Appeals for the federal circuit in which they resided at the time the petition was filed and ultimately to the United States Supreme Court. Whether interest continues to accrue on the asserted deficiency depends on whether the taxpayer voluntarily decides to make a preliminary payment after filing a petition (to stop the tolling of interest) or prefers to wait until the litigation phase is complete (allowing interest to accrue in the interim). Note, in particular, that with respect to a given Tax Court case, the court must defer to the decisions of the relevant Circuit Court of Appeals as *binding* precedent. It is also possible for taxpayers litigating in Tax Court to assert a refund claim, essentially arguing not only that they refuse to pay the asserted deficiency but also that they overpaid as an initial matter and will take the opportunity to pursue a refund.

Article I, § 8 of the U.S. Constitution gives Congress the power to lay and collect taxes for specific purposes.

Article I, § 2 of the U.S. Constitution requires that direct taxes be apportioned among the several states.

Although Article I, § 8 of the Constitution grants Congress the power to lay and collect taxes generally, the Sixteenth Amendment to the U.S. Constitution grants Congress the power to lay and collect taxes on income *without apportionment*.

Under Article I, § 7 of the U.S. Constitution, all bills for raising revenue must originate in the House of Representatives, although the Senate has the power of amendment.

The Department of the Treasury resides within the executive branch, and the Secretary of the Treasury delegates administration and enforcement of the tax law to the Internal Revenue Service; the Commissioner of Internal Revenue leads the IRS.

In the House of Representatives, tax legislation is initially assigned to the House Ways and Means Committee. In the Senate, tax legislation is initially assigned to the Senate Finance Committee. The Conference Committee resolves differences in tax legislation before such legislation is sent for final approval to the House, the Senate, and the President.

The Internal Revenue Code exists as part of the larger body of federal law as Title 26; some tax statutes are noncodified and generally appear in Statutes-at-Large. Although prior versions exist, the Internal Revenue Code in use today is the Internal Revenue Code of 1986 (as amended). Those providing tax advice with respect to *prior* events must use the version of the Internal Revenue Code as it existed at the time of the relevant events.

In addition to consulting the Internal Revenue Code, tax advisors may look to various sources for guidance including Treasury Regulations, IRS pronouncements, and tax cases.

Taxpayers who opt to withhold payment of an asserted deficiency prior to the commencement or close of litigation may proceed only in Tax Court against the

Commissioner of Internal Revenue; decisions of both the United States Supreme Court and the Circuit Court of Appeals in the federal circuit in which the taxpayer resided at the time of the filing of the petition will be binding precedent while the case is in Tax Court. Taxpayers who pay asserted deficiencies prior to the commencement of litigation (or who otherwise seek refund of taxes paid) may proceed against the United States either in District Court or in the Court of Federal Claims.

Taxpayer A is contemplating a multi-billion-dollar transaction with Taxpayer B. Taxpayer A hires Fernando, a tax attorney, to assist in obtaining a PLR from the IRS.

- a. How will Fernando find out what steps must be taken to secure a PLR?
- b. If Fernando succeeds in obtaining a favorable ruling from the IRS, which taxpayers, in addition to Taxpayer A, can rely on that PLR?

Giovanni, a resident of Los Angeles, California, recently received a notice from the IRS indicating that, with respect to 2021, he owes an additional \$2,000 in taxes.

- a. If Giovanni pays the asserted deficiency and then decides to seek a refund, in what trial courts may he proceed?
- b. Who will be the defendant in his refund suit?
- c. What decisions will be binding precedent with respect to his trial court?
- d. If Giovanni refused to pay the asserted deficiency prior to the close of litigation, in what trial court could he proceed? How would you respond to questions (b) and (c) under such altered facts?

Assume that you have been hired as a summer associate at a large law firm and that your first assignment comes from a tax partner in the firm. The partner already has the relevant version of the Internal Revenue Code and Treasury Regulations but needs legislative history, tax cases, and IRS pronouncements on the issue. Ascertain which electronic legal databases contain the resources/materials you need to locate. Are those databases reliable?

Locate Revenue Procedure 2021-1 and find (within it) the start of the general instructions for requesting a letter ruling from the IRS.

You have been retained as tax counsel for a specific matter and are unable to obtain access to an electronic database. Fortunately, you do have access to a law

library. Go to this library and locate the section containing tax research materials. Find resources that would be helpful if you were conducting research under 26 U.S.C. § 165(c).

Use the internet to find and print IRS Form 1040 for the most recently completed calendar year (“Year Y”). Also locate (but do NOT print) the Instructions for the Form 1040. You will use the “Tax Tables” in the Instructions to complete one of the lines on the second page of the Form 1040. You may also have to locate and complete certain other items (e.g., Form 1040 Schedule A). Fill out the Form 1040 using the following information:

Oliva Wynn (SSN 000-00-0001) and Sergio Wynn (SSN 000-00-0002) reside at 123 Maple Lane in Irvine, CA 92622. The couple is married, each is 27 years old, neither is blind, and they file a joint federal income tax return. At this juncture, they have no children or dependents. They plan to have children in the future, so they steadily save money in the hope that college funds and the like will ultimately be needed. The Bank of Orange paid them \$150 in interest in (which they left untouched) in Year Y with respect to their joint savings account.

Oliva and Sergio both teach high school in Irvine, and each earned an annual salary of \$50,000 in Year Y, a real improvement over the \$40,000/year they had made back in Baltimore, MD, in Year X. Accepting the positions in Irvine was somewhat of a no-brainer, even though they were not too happy about having to pay their own moving expenses (\$5,150). Fortunately, Lady Luck intervened to soften the financial blow. Sergio, the perpetual trivia buff, had managed to win \$2,000 as a contestant in a local, popular game show, “Millions!”

In Year Y, Oliva and Sergio had \$12,641 withheld from their pay as federal income taxes and \$3,000 withheld as California income taxes. They also paid the following:

- \$1,000 in real property taxes
- \$5,000 in unreimbursed, uninsured medical expenses related to one of Sergio’s wood shop accidents
- \$5,000 in home mortgage interest
- \$50 to a local charity.

