

3-1-1978

Federal Income Taxation : A Law Student's Guide to the Leading Cases and Concepts

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Recommended Citation

J. Clifton Fleming, *Federal Income Taxation : A Law Student's Guide to the Leading Cases and Concepts*, 1978 BYU L. Rev. 223 (1978).
Available at: <https://digitalcommons.law.byu.edu/lawreview/vol1978/iss1/8>

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BOOK REVIEW

FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS. By Marvin A. Chirelstein.* Mineola, New York: The Foundation Press, Inc. 1977. Pp. xiii, 332. \$10.50.

*Reviewed by J. Clifton Fleming, Jr.***

I.

Many students enter the basic income tax course¹ with a prelaw education that emphasized general understanding rather than precision. Often the student's undergraduate training has taught him that roughly approximate answers are acceptable, that his views are as significant as those of any one else, and that rigorous analysis and writing are not particularly important. His first-year courses expunge some of this. Those courses, however, may leave the misimpression that the law consists wholly of value concepts derived from common experience which, if generally understood and cleverly manipulated, can yield answers to all questions without requiring close attention to limits, distinctions, and details. Thus many students find themselves underprepared for studying an income tax law composed of defined terms and concepts which require precise usage and whose content is often not drawn from ordinary speech. They frequently experience a discouraging encounter when their still-flaccid minds collide with the Internal Revenue Code about which no less than Judge Learned Hand has despairingly written:

In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: Cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave in my mind only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time. I know that these monsters are the result of fabulous industry and ingenuity, plug-

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1. The terms "basic income tax course" and "basic course" refer to the beginning law school federal income tax course that emphasizes fundamental principles and taxation of individuals.

ging up this hole and casting out that net, against all possible evasion; yet at times I cannot help recalling a saying of William James about certain passages of Hegel: that they were no doubt written with a passion of rationality; but that one cannot help wondering whether to the reader they have any significance save that the words are strung together with syntactical correctness.²

Consequently, most students in the basic course need something to reveal what the exercise is all about. Ideally, they would like a comprehensive text that readably summarizes the leading cases, explains the Internal Revenue Code in something approximating plain English, and anticipates the hypotheticals and problems which teachers spin off from the cases and Code sections.

Hitherto their wishes have gone unanswered. The casebooks serve primarily as avenues to investigation and do not pretend to perform any significant explanatory function for the beginner. The only prior text for the basic course that purports to be comprehensive is superficial in spite of its length.³ The available outlines lack the detail and analysis required,⁴ and the major loose-leaf services are impenetrable to a person who does not have a fairly clear idea of the answer before he starts looking. In short, there has been nothing which does for the basic course what the Bittker and Eustice treatise⁵ does for the courses in corporate taxation and corporate reorganizations.

II.

Professor Chirelstein has not produced the long-desired omnibus work for the basic course. He has, however, considerably advanced the cause of student understanding and demystification. Although his *Federal Income Taxation*⁶ covers most major points, it makes no pretensions to comprehensiveness.⁷ The book

2. L. HAND, *THE SPIRIT OF LIBERTY* 213 (I. Dilliard ed. 1952).

3. The text is J. CHOMMIE, *THE LAW OF FEDERAL INCOME TAXATION* (2d ed. 1973).

4. In my opinion the best of them is D. KAHN, *THE SUM AND SUBSTANCE OF LAW: FEDERAL INCOME TAXATION* (4th ed. 1975).

5. B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* (3d ed. 1971).

6. M. CHIRELSTEIN, *FEDERAL INCOME TAXATION: A LAW STUDENT'S GUIDE TO THE LEADING CASES AND CONCEPTS* (1977).

7. *Id.* at vii:

My approach . . . is anything but comprehensive. All sorts of topics are omitted which the student may encounter in the classroom and desire more information about, while other topics of no greater intrinsic importance are discussed at length. But I have not attempted to write a treatise, or a summary of Code sections, or a manual which can be used to answer specific questions about the tax law. Instead, my aim has been to disclose the structural character-

breaks no important new ground, makes no significant theoretical advances. Instead, it explains, better than has been done before, the essential conceptual background. Chirelstein's text is like a set of very good, closely related, explanatory essays.

The book begins with a brief overview of an individual's income tax computation, an explanation of the tax's progressive nature, and an explication of the marginal and effective rate concepts.⁸ Soon thereafter, the matter of tax deferral is broached. Many times in the basic course a student will point out that regardless of how the issue in question is resolved, the taxpayer will ultimately pay tax on the same amount of income.⁹ The student then argues that it is all just a quibble over timing, so why not let the taxpayer pay later instead of sooner as demanded by the Commissioner? At an early point, and periodically thereafter,¹⁰ Chirelstein's book answers this objection by explaining the economics of deferral and the partial tax forgiveness which results therefrom. These discussions are supplemented by an appendix covering the concept of present value.¹¹

The book's organization, although it does not work perfectly, is clear and functional. Teachers of the basic tax course soon learn that there is no indisputable place at which to begin nor order in which to arrange the topics of substantive coverage. One's intuition suggests gross income as the initial subject and virtually everyone starts there. But even that seemingly unassailable approach has its problems. Do the "claim of right" cases¹² belong under the gross-income rubric or do they represent an annual accounting problem, particularly if considered in connection with section 1341? The same question can be raised with respect to the tax benefit rule.¹³ Moreover, it is proper to ask whether the alimony provisions¹⁴ are better explained as a gross income or choice-of-taxpayer matter. Similar problems exist throughout. Consequently, it is no criticism of Professor Chirelstein's book to

istics of the income tax mechanism—how the plumbing works, what's at stake in the controversies that arise, what elements of internal consistency or inconsistency can be detected, and so on.

8. *Id.* at 1-5.

9. Such issues include (1) whether an asset qualifies for accelerated depreciation instead of straight-line depreciation, (2) whether a transaction qualifies for reporting under I.R.C. § 453, and (3) whether an exchange is covered by *id.* § 1031.

10. M. CHIRELSTEIN, *supra* note 6, at 4-5 & 12-16.

11. *Id.* at 319-24.

12. *E.g.*, *United States v. Lewis*, 340 U.S. 590 (1951).

13. *See, e.g.*, *Alice Phelan Sullivan Corp. v. United States*, 381 F.2d 399 (Ct. Cl. 1967).

14. I.R.C. §§ 71, 215, 682.

say that some of its topics might be better explicated if their order were changed¹⁵—this objection is present no matter what ordering is used. The important point is that his arrangement of substantive topics—income, deductions, attribution of income, tax accounting, recognition, and capital gains and losses—is sufficiently similar to the organization of the major casebooks that a student will be able to easily integrate the text with whatever case material he is using.

III.

In my judgment, the most attractive aspect of Professor Chirelstein's book is its discussion of economic implications, numerical examples, judicial inconsistencies, and legal anomalies which a teacher would like to take up in the basic course but which time pressures often crowd out. For example, it is commonly observed that the income tax is biased against savings.¹⁶ Chirelstein succinctly explains this point for the student as follows:

Income, however derived, is taxed to an individual *once* when he earns or receives it. If the amount that remains is expended on consumption goods—food, lodging, entertainment, etc.—no further tax is imposed on the individual with respect to that original receipt. If, however, the individual chooses to “expend” his after-tax income on corporate shares, government bonds or other assets which produce further income, then that further income will of course be subject to a further tax. Savers are thus taxed *twice*; consumers only once.

To illustrate: Assume C and S, individuals, live in a country which at present imposes no income tax whatever. Each earns \$1,000. C, a consumer, chooses to expend his \$1,000 on a vacation. S, a saver, expends his \$1,000 on a 6% bond with a view to receiving annual interest of \$60 to use in future periods. Since they live in a tax-free world, both individuals get what they want for the same dollar expenditure.

Now assume that their country adopts an income tax of 50%. How much must C and S earn in order to acquire, respectively, a \$1,000 vacation and a \$60-a-year income stream? As to C, the answer is obviously \$2,000. Since the vacation is not a deductible expense, it has to be purchased out of after-tax income. With the new 50% income tax in force, C will have to earn

15. For example, the basic discussion of deferred payment sales and the discussion of the capital gains consequences of such sales are approximately 50 pages apart. Compare M. CHIRELSTEIN, *supra* note 6, at 236-46 with *id.* at 294-99.

16. E.g., W. KLEIN, *POLICY ANALYSIS OF THE FEDERAL INCOME TAX* 39-41 (1976); A. PIGOU, *A STUDY IN PUBLIC FINANCE* 118-26 (3d rev. ed. 1947).

\$2,000 in order to have \$1,000 left for his annual trip to Florida. But what about S? The bond purchase *also* is not deductible—taxpayers are no more allowed to deduct amounts expended on “savings” than they are amounts expended on “consumption”. At the same time, however, the interest on S’s bond will *itself* be subject to the 50% income tax. In effect, earnings devoted to the purchase of an income-stream, *and* the income-stream itself, are *both* included in income. This means that S will actually have to earn \$4,000 in order to be in the same position that he occupied before the new tax was enacted. Thus the \$4,000 would be reduced by the 50% tax to \$2,000. The \$2,000 that remained would then be used to buy a 6% bond yielding interest of \$120 a year. The \$120 of annual interest would *also* be taxed at the 50% rate, leaving a net after-tax income-stream of \$60. In this sense, therefore, while C the consumer is required to earn only \$2,000 because he pays the 50% income tax just once, S the saver is required to earn \$4,000 because his savings are subjected to a double imposition.¹⁷

Other examples of this content are an explanation of the problem section 453 was intended to solve, and why the provision goes too far,¹⁸ an explanation of the effects of inflation under the income

17. M. CHIRELSTEIN, *supra* note 6, at 260-61. The example, of course, assumes a constant interest rate. The disparity between consumer and saver following introduction of the income tax would be reduced to the extent the new tax resulted in a higher rate of interest.

18. *Id.* at 237-39:

[S]uppose a taxpayer owns an apartment building with an adjusted basis of \$20,000 and a fair market value of \$100,000. He sells the property to another investor for \$10,000 cash and a \$90,000 mortgage payable in 9 equal annual installments with interest at 8%. Assuming that the fair market value of the mortgage is equal to its face amount, the taxpayer would be treated as having realized \$100,000 in the year of sale, and therefore would recognize and pay tax on his entire gain of \$80,000. In effect, the mortgage debt is viewed as payment for the property sold

The Code thus makes no generic distinction between sales for cash and sales for future payments. . . . Yet despite this general rule, one cannot help, I think, feeling some uneasiness about the idea of treating a “mere” claim to future payments as the equivalent of money. In the first place, the seller may have difficulty obtaining the funds to pay the tax liability which arises from the sale. . . . Second, although a conventional real estate mortgage is easy to value, suppose the deferred payment claim is secured by some relatively unfamiliar type of property—say a patent or a business interest—or is merely a personal obligation of the buyer. Since no active market for such claims exists, the danger of over- or under-valuation is obviously considerable and either the taxpayer or the Treasury may suffer substantially if the value assigned to the claim by appraisal turns out to be wide of the mark.

As might be expected, the tax law has developed a response

. . . Code § 453 permits the seller of real estate and of certain personal property, at his own election, to adopt the installment method of accounting and

tax,¹⁹ a discussion of the economic aspects of depreciation deductions,²⁰ and an explanation of how the "carved out interest" cases in the assignment-of-income and capital gains areas are related to each other.²¹

As previously indicated, the book is not comprehensive. It does, however, provide enough of the foregoing type of coverage so that a tax teacher assigning it to his students will be relieved from providing a substantial amount of explanatory material in lecture form. The book is actually what the note material in the casebook should be but usually is not.

IV.

In his conclusion, Professor Chirelstein states:

The aim of this book is essentially reductionist. The income tax course has a reputation for difficulty, but the fact is that the technical problems which it presents are relatively few in num-

to spread his gain proportionately over the entire payment period. In the illustration above, one-tenth of the total purchase price of the building—\$10,000 out of a total of \$100,000—was received in cash in the year of sale. Accordingly, only \$8,000 of the seller's \$80,000 gain ($1/10 \times \$80,000$) would be taxed in that year. As the mortgage principal is payable at the rate of \$10,000 a year in each of the succeeding 9 years, a like proportion of the gain would be recognized as each installment was received. The seller's tax would of course be payable on the same schedule, *i.e.*, \$2,000 in the year of sale and \$2,000 each year thereafter, assuming a capital gain tax rate of 25%. . . .

The election under § 453 can be made only if payments in the year of sale do not exceed 30% of the total sale price. . . . [T]he 30% requirement imposes a considerable penalty on those who cannot or who inadvertently fail to meet it. If the property-seller in the illustration above pays a tax of \$2,000 a year for 10 years, the present value of his obligation at an after-tax discount rate of 5% is only about \$15,400. By contrast, if the seller somehow fails to make the statutory election, or if election is barred because the down-payment exceeds the 30% limit, the full \$20,000 of tax is payable at once. Non-election thus increases the seller's "tax" by some \$4,600.

The same point, of course, can be made about the installment sale election as a whole. The apparently benign object of § 453 is to make it easier for installment sellers to pay their taxes by associating gain recognition with the receipt of cash. In resorting to the technique of income-deferral, however, the section in effect imposes different burdens on taxpayers who otherwise appear to be similarly situated. Thus, property sellers who desire or are willing to invest in their vendee's installment obligations are taxed at one "rate," while those who sell for cash because they prefer to invest the funds received in securities issued by other borrowers are taxed at another and higher rate, everything else being equal. . . . Discrimination could be avoided if the successive tax payments carried interest. . . . The statute does not require interest, however

19. *Id.* at 43-45.

20. *Id.* at 126-34.

21. *Id.* at 272-81.

ber, and it may be reassuring to the student to perceive that this is so.²²

This statement may give more comfort than is warranted. The basic tax course is primarily the investigation of a complex legislative enactment. Thus in spite of the conceptual elucidation furnished by this book, the student must still confront the difficult and repetitive task of making sense of seemingly incomprehensible statutory language.²³ There is clearly much toil left in the study of income taxation, but Professor Chirelstein has considerably advanced the student's cause.

22. *Id.* at 317.

23. *E.g.*, I.R.C. § 267(c)(5):

Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

And once a student has mastered the language of § 267(c)(5), there still looms ahead an encounter with § 341(e).