Teaching Federal Income Taxation Using Socioeconomics

I. RICHARD GERSHON*

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I. INTRODUCTION

I have very fond memories of sitting around the dining room table at my mother's house in Atlanta, Georgia, and enjoying Shabbat[1] dinner. My older brother had recently become a physician, much to the delight of my father, who was also a doctor. The two of them would eagerly discuss everything from the development of new medical techniques to the business of their profession. It was in these discussions that I had my first introduction to the applications of socioeconomic theory to tax law.[2] I remember my brother saying that he was going to spend money

* Dean and Professor of Law, Charleston School of Law, Charleston, South Carolina. When I started this project I was Dean of Texas Wesleyan University School of Law, in Fort Worth, Texas, and I would like to thank the people at Texas Wesleyan for their help in producing this Article.

1. This is the Jewish Sabbath, which begins with a traditional dinner on Friday night. Actually, my father, who spoke Yiddish with a southern accent, called it Shabbos.

2. The following statement from the AALS Section on Socio-Economics is very

on something he did not need so that he could take a deduction.[3] Economically, he would have been better off keeping his money and paying his taxes,[4] but his reason for making his decision was that he "did not want the government to have the money."

Clearly, my brother's behavior could not have been predicted merely by assessing what was in his best economic interest. Instead, his actions reflected his own beliefs and expectations regarding the nature of the federal tax system. This, in many respects, is a classic example of why it is important to incorporate socioeconomics into the teaching of federal income taxation. Students need to understand that the study of tax is not a study of pure economics, but instead involves many factors. Understanding those factors can better help them to read and apply the Internal Revenue Code (Code) and the Treasury regulations interpreting it. Accordingly, this Article gives examples for using socioeconomic theory to teach taxation.

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useful in explaining what socioeconomics is really about:

> Socio-economics begins with the assumption that [the economy] is not a self-contained system, but is embedded in society, polity, and culture. Drawing upon economics, sociology, political science, psychology, anthropology, philosophy, history, law, and management, socio-economics regards competitive behavior as a subset of human behavior within a societal context that both enables and constrains competition and cooperation. Rather than assume that people act optimally, [or] rationally, or that they pursue only self-interest, socio-economics seeks to advance a more encompassing interdisciplinary understanding of economic behavior open to the assumption that individual choices are shaped not only by notions of rationality but also by emotions, social bonds, beliefs and expectations.
>
> Socio-economics is both a positive and a normative science. Like other social sciences, it is dedicated to the empirical, reality testing approach to knowledge. It respects both inductive and deductive reasoning. But it also openly recognizes the policy relevance of teaching and research and seeks to be self-aware of its normative implications rather than maintaining the mantle of an exclusively positive science. . . . [S]ocio-economics does not entail a commitment to any one paradigm or ideological position, but rather is open to a range of thinking that treats economic behavior as involving the whole person and all facets of society.

Over 120 Law Teachers from 50 Member Schools Sign Petition to Form Section on Law and Socio-Economics, SECTION ON SOCIO-ECONO. NEWSL. (Ass'n of Am. Law Schools, Washington, D.C.), Jan. 1997, at 4.

3. Doctors have always been endowed with some type of mystical, though often incorrect, understanding of the federal tax system. Even after I earned an LL.M. in taxation, my brother and father only rarely heeded my advice, and then only when that advice was supported by the latest edition of *Medical Economics.*

4. For example, assume that he was a taxpayer in the 39.6% tax bracket. On the next dollar he earned, he would pay approximately forty cents in federal income tax. Even if he also had to pay FICA and state taxes on that same dollar, he would still have something left after paying those taxes. If he spends his money in a deductible way, it is true that he will not have to pay federal income tax on that dollar, but he also will not have anything left. Accordingly, rather than spending his money on something he did not need, he would be better off keeping his money and paying the taxes. Then he could buy something he really wanted with what was left over. Deductions are only useful when a taxpayer spends money on something he needs or wants.

II. TAXABLE VERSUS NONTAXABLE TRANSACTIONS

Most courses in federal income taxation begin with a study of what types of income are included in,[5] and what types of income are excluded from,[6] a taxpayer's gross income. I often begin this course of study by polling the students in the following way:

(1) Raise your hand if you would rather have nontaxable income than taxable income.
(2) Now, raise your hand if you would rather have $1000 of nontaxable income than $1,000,000 of taxable income.

As might be expected, the response to the first inquiry is that the students would all rather have nontaxable income than taxable income. They react to the expectation that all nontaxable income is better than all taxable income. The second inquiry is designed to help them to understand that taxability is just one factor in determining an economic benefit to a particular taxpayer. Ultimately, their responsibility to maximize their clients' benefits, or minimize that clients' costs, should not be clouded by preconceived judgments regarding the taxability of income or the deductibility of an expense. The following problem can be used to illustrate this point:

> *Problem*: Mary was an employee of ICU Corporation, a manufacturer of glass ceilings. When Mary died this year, Sue, the CEO of ICU decided that, even though the company did not owe Mary anything, Sue wanted to pay Mary's widower, Max, a one-time cash amount of $15,000. What is the proper income tax treatment of ICU's payment to Max?
>
> *Answer*: The payment is most likely gross income to Max and thus taxable.[7] ICU will probably be entitled to deduct the payment as an ordinary and necessary business expense.[8] Yet, this is a great point to ask whether Max can exclude the payment as a gift[9] and whether it would be in his best interest to do so.

The first reaction is that Max is clearly better off if he can exclude the

5. *See* I.R.C. §§ 61, 71–90 (2000).
6. *See id.* §§ 101–139.
7. *See id.* § 61(a)(1); Treas. Reg. § 1.61-1 (1960).
8. *See* I.R.C. § 162.
9. *See id.* § 102.

payment as a gift. Assuming that he is in the 20% tax bracket,[10] he will be able to keep all $15,000 if he can treat the payment as a gift, while he would only be able to keep $12,000 ($15,000 – ($15,000 x 20%)) if the payment is taxable. The problem with this thinking is that ICU will not be able to deduct the payment to Max if it is a gift. Accordingly, ICU's cost of making this transfer would become significantly greater if Max is allowed to exclude the transfer from his gross income. This point can be illustrated as follows:

Transaction Treated as an Excludible Gift

Benefit to Max: $15,000 (Max is happy).

Cost to ICU (assuming that ICU is in the 50% tax bracket[11]): $15,000 + the tax on $15,000 at 50% = $22,500. Because the transaction is not deductible by ICU, it must still pay the federal income tax on the money it transferred to Max. Accordingly, it will cost ICU $22,500 to create a benefit of $15,000 to Max (ICU is not happy). Given the high cost to benefit ratio of this payment, ICU might be discouraged from making the transfer, which would not be to Max's benefit at all. On the other hand, ICU's cost will be minimized if the payment is deductible, as follows:

Transaction Taxable to Max, Deductible by ICU

Benefit to Max: $15,000 – tax on $15,000 at 20% = $12,000.

Cost to ICU: $7500. This amount is determined by calculating how much ICU could have kept of its $15,000 had it not made the transfer at all. That is, because ICU is in the 50% bracket, 50% of the $15,000 belonged to the government anyway. Accordingly, ICU would have been required to pay $7500 in tax if it had merely kept the money. By making a deductible transfer, ICU is using the government's 50% of its income, in addition to the 50% it could have kept to make the payment to Max.[12] Thus, it will only cost ICU $7500 to generate a $12,000 benefit to Max. If ICU is intent on generating a benefit of $15,000 to Max, it can do so by paying him $19,000 in a taxable transaction. This would leave Max $15,200 after federal income tax ($19,000 – ($19,000 x 20%)) and would cost ICU only $8500 to provide this benefit.

10. I use a mythical 20% tax bracket because I am a product of the Georgia public school system, and it is easier for me to multiply by 20% than by 39.6%, for example. The actual tax rates for individuals are found in I.R.C. § 1.

11. The logic I expressed in note 10 of this Article applies to my use of a mythical 50% bracket as well.

12. The formula for determining cost in a deductible transfer is $X - [(B)(X)]$, where X = amount transferred and B = the taxpayer's tax bracket.

Max's only concern[13] should be his net benefit, and thus he should be even happier with this taxable result than he would have been with the nontaxable amount. Furthermore, by agreeing on the tax treatment, the parties can minimize the likelihood of a challenge by the Internal Revenue Service.

The illustrations above are equally applicable to a discussion of the effects of income taxation on divorce or dissolution of marriage. Section 71 of the Code provides that alimony is included in the gross income of the person receiving it,[14] while section 215 of the Code provides that the payer of alimony is entitled to a deduction.[15] Generally, a person required to pay alimony is in a higher tax bracket than the recipient of that alimony. If that is the case, then both parties should benefit from characterizing the payment as alimony because the cost to the transferor will be lower than the benefit to the transferee. Of course, this assumes that the parties to a divorce are willing to set aside their differences to consider their mutual economic interests. Socioeconomic forces might prevent divorcing parties from approaching these payments in a rational and dispassionate manner. The emphasis here might be that the attorneys for both sides should counsel their clients that taxable alimony is not a bad thing to the recipient because, by minimizing the payer's cost, you increase the payer's ability to make the payments.

III. DEDUCTION FOR CHARITABLE CONTRIBUTIONS

One of the best federal tax topics in which to cover socioeconomic principals is the deduction for charitable contributions.[16] From an economic perspective, it never makes sense to give cash[17] to a charity.

13. Of course, it is true that Max has no real complaint in any event because he is not owed this money.
14. I.R.C. § 71.
15. *Id.* § 215.
16. *Id.* § 170.
17. I distinguish gifts of cash from gifts of property because there can be a greater economic benefit derived by giving a gift of appreciated property to charity. *Id.* § 170(e). In certain circumstances, the amount of the contribution will be the fair market value of the property contributed rather than the taxpayer's basis in the property. *Id.* For example, a taxpayer who bought Coca Cola stock for $5 per share, and then gave it to a charity when it was worth $25 per share, could be allowed to have a contribution of $25 per share. Thus, the taxpayer could possibly be allowed a deduction for the unrealized appreciation in the stock. Under these facts, a taxpayer in the 39.6% tax bracket could, therefore, generate a tax savings of $25 x 39.6% (or $9.90) per share, with a cost of only $5 per share. This creates a huge incentive for taxpayers to make contributions of

While the potential for a tax deduction for such contributions does exist,[18] the taxpayer would be better off financially by keeping the money rather than by giving it away. For example, a taxpayer in the 39.6% bracket who gives $10,000 to Texas Wesleyan University School of Law will save at most $3960 in taxes because of the charitable deduction. The taxpayer's cost in making this gift will be $6040. Therefore, under pure economic theory, no person in his right mind would give money away. Consequently, there must be other, socioeconomic reasons why taxpayers give to charity. The tax deduction is a side benefit to the donor, but it should never be the primary motivation for the gift.

In the classroom, emphasis can be placed on the fact that the government is allowing the taxpayer to choose among desirable causes by allowing the taxpayer to designate otherwise taxable dollars to the charities of his choice. The taxpayer's motivation to give serves the general good of society, and probably makes the taxpayer "feel good," even if the gift is contrary to that taxpayer's financial interests.

IV. I.R.C. § 1(G): THE "KIDDIE TAX"

Another major area of course coverage that is conducive to a treatment of socioeconomic theory is the discussion of the assignment of income principles.[19] This is especially true in relation to the "kiddie tax," which is created by section 1(g) of the Code.[20] A parent can shift income, and the taxation of that income, to a child by transferring property to that child.[21] For example, if the parent gives an apartment building to her child, the child will be taxed on the rents generated by that apartment building subsequent to the transfer.[22] Accordingly, if the parent is in the

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appreciated property rather than cash, once they decide to give their property away instead of keeping it.

18. Even though a taxpayer donates money to charity, the taxpayer is not guaranteed a deduction for that gift. For example, a taxpayer who elects to take the standard deduction under section 63(c) of the Code, rather than itemizing her deductions, will not receive any tax benefit from making the charitable contribution. Furthermore, section 170(b) of the Code limits the deductibility of a taxpayer's annual contributions to a maximum of 50% of the taxpayer's adjusted gross income for the year.

19. The assignment of income principles focus on *who* is the taxpayer. This is important because of the progressive rate structure of the federal income tax system. If taxpayers in high brackets could easily shift their income to taxpayers in lower brackets, there would be very few high bracket taxpayers left by the end of the year. The assignment of income rules, therefore, protect the integrity of the federal tax structure by insuring that the appropriate party is taxed on income. Thus, for example, a parent cannot assign income from his employment to his child and thereby shift the incidence of taxation to that child. *See* Lucas v. Earl, 281 U.S. 111, 114–15 (1930).

20. I.R.C. § 1(g).

21. *See generally* Helvering v. Horst, 311 U.S. 112, 119–20 (1940).

22. I.R.C. § 102(b).

39.6% tax bracket, and the child is in the 15% tax bracket, a significant tax savings could occur when the parent shifts the incidence of taxation to the child. The swing in tax brackets would, in essence, allow the family as a unit to keep 24.9% more of the rent generated by the apartments. Section 1(g) takes away much of the incentive of shifting income to a child through a transfer of property, however, in that it taxes the child at the parent's rate on a substantial portion of the child's unearned income[23] if the child is under the age of fourteen at the end of the taxable year.[24] However, because the kiddie tax only applies to unearned income of the child, the child can be paid a reasonable salary for actual work performed, which would be taxed at her rate. Furthermore, it is possible that the salary paid to the child would be deductible by the parent.[25]

This scenario presents a good opportunity to discuss the benefit derived by having the child receive earned income rather than income generated by a gift of property. In addition to avoiding the sting of section 1(g), the taxpayer would be teaching the child important life lessons about earning money and responsibility.

V. LEGISLATION FOCUSED ON TAXPAYER BEHAVIOR: ASSUMING THE WORST

While the behavior of taxpayers might be informed in part by their cynicism about the operation of our federal government, Congress arguably shares a similar cynicism about taxpayers and their motives. In that regard, I enjoy teaching anti-abuse legislation in my Federal Income Tax class because the existence of such legislation proves that Congress has the expectation that some taxpayers will cheat. My favorite such anti-abuse provision is section 1014(e) of the Code. In general, section 1014 provides that a taxpayer's basis in property acquired from a decedent is the fair market value of that property at the date of death.[26] In other words, a taxpayer inheriting stock with a fair market value of

23. Section 1(g)(4) defines unearned income as income that is not earned income as defined by I.R.C. § 911(d)(2). *Id.* § 1(g)(4). Section 911(d)(2) defines earned income as wages, salaries, professional fees, and other amounts received as compensation for services. *Id.* § 911(d)(2).
24. *Id.* § 1(g)(2).
25. This assumes that the parent could claim that the expense was an ordinary and necessary business expense under section 162. *See id.* § 162.
26. *Id.* § 1014(a).

$1,000,000 at the date of the decedent's death will have a basis of $1,000,000. This is true even if the decedent only paid $1 for the stock. Accordingly, all of the taxable gain that would have been taxable to the decedent had he sold the stock will be forgiven by section 1014.

Section 1014(e)'s anti-abuse provision disallows an increase in basis to fair market value if appreciated property was acquired by the decedent by gift within one year of his death, and then he transferred the property back to the donor, or the donor's spouse upon his death.[27] In other words, Congress is afraid that taxpayers will take advantage of the favorable basis treatment of section 1014 as follows:

> Schemer owns Coca Cola stock, for which he paid $1 per share ten years ago. Due to favorable market conditions, Schemer's stock is now worth $1000 per share. Schemer wants to sell his stock to realize his gain, but he does not want to pay tax on the $999 per share appreciation that has occurred. Accordingly, Schemer decides to give his stock to his Uncle Ancient, who is expected to die sometime this week. Schemer has seen Uncle Ancient's will, and he knows that he is the only beneficiary under that will. Furthermore, Schemer is aware of the benefits of section 1014, and he is excited to get his stock back with a $1000 basis, when Uncle Ancient dies. Unfortunately for Schemer, section 1014(e) will force him to take back his $1 per share basis unless Uncle Ancient lives for at least one year from the time he received the stock. ("Don't pull that plug quite yet!")

The irony of this anti-abuse section, which truly seems to anticipate that taxpayers will behave in the worst possible way, is that it suggests the abuse it seeks to prevent and then creates two very big loopholes for taxpayers. First, the provision does not apply if the decedent lived for more than one year from the date of the gift.[28] Second, the provision only applies if the property is returned to the donor or the donor's spouse.[29] Accordingly, Schemer in the above illustration could take advantage of the benefits of section 1014 simply by having the property pass to his children, rather than to himself or his spouse.

What makes section 1014(e) even more interesting from a socioeconomic perspective is that it assumes, irrefutably, that any transactions falling within its coverage are abusive. There is no relief, therefore, for an innocent and even tragic transaction. For example, assume parents give their minor child some appreciated stock for her birthday. The next day,

27. *Id.* § 1014(e).
28. *Id.* § 1014(e)(1)(A).
29. *Id.* § 1014(e)(1)(B).

she is killed in an automobile accident, and the stock is transferred to the parents under the laws of intestate succession. Because the property was acquired by the decedent by gift within one year of her death, and because it was transferred back to the donors, the section 1014(e) antiabuse provision will prevent the parents from having a fair market value basis. Clearly, there was no abuse present in this situation, and true Schemers can easily escape the coverage of section 1014(e) with proper planning.

In creating section 1014(e), Congress made assumptions about the behavior of taxpayers based upon the possibility of abuse. I like to point out to my class that Congress's assumption is that taxpayers will take advantage, even in an abusive way, of any favorable provision in the Code because it is to their economic advantage to do so. I would argue that financial gain is but one factor in determining the behavior of taxpayers.

VI. CONCLUSION

My father always paid more in taxes than he owed. He was extremely conservative in taking deductions, and he greatly feared an audit. Additionally, he was very grateful to this country and all that it had provided him. He felt it was an honor, as well as a duty, to pay his taxes. This was not surprising, given the fact that he regularly provided free medical care to those who could not afford it. I did not realize it at the time, but my father was a living embodiment of the socioeconomic vision.