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Words! Words! Words!: Teaching the Language of Tax¹

Stephen B. Cohen

The basic course in federal income tax is usually a challenge for both teacher and student because so many different and difficult things are being taught at once: a prolix and opaque statute; complex financial transactions; and economic, political, and social analysis of the effects of the tax law. In addition, I believe that a teacher of tax must be a teacher of language, focusing explicitly and self-consciously on the ambiguous, imprecise, and confusing words that are embedded in tax law and discourse and that constitute a significant obstacle for students taking the basic course in federal income taxation.

The Many Meanings of “Capital”

Perhaps the most confusing term in tax law is “capital” with a multiplicity of different and sometimes contradictory meanings. Even in ordinary usage, “capital” has diverse definitions. Derived from *capitulum*, the diminutive of the Latin word *caput*, meaning “head,” the word capital first entered the English language in the thirteenth century via Old French as an architectural term, referring to the top part of a column.² In later centuries, “capital” acquired a variety of other meanings, including “a capital letter,” “a city serving as a seat of government,” and “property.”³ In these “capacities” capital functions as a noun, but the word also serves as an adjective with a variety of other meanings including: “punishable by death” as in “capital punishment;” “chief in importance” as in “capital importance;” “excellent” as in “capital idea”; and “relating to property” as in “capital account.”⁴

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1. The title of this article is borrowed partly from a lyric by Alan Jay Lerner for the song “Show Me” in the musical play *My Fair Lady* (1956). After “Words, Words, Words,” the lyric continues, “I’m so sick of words. I get words all day through, first from him, now from you! Is that all you blighters can do?”
2. Oxford English Dictionary (2nd ed., Oxford, 1989) (hereinafter OED II).
3. *Id.*
4. *Id.*

In the basic income tax course, this variety of everyday meanings and usages usually does not pose a special problem. Students encountering the word capital in expressions like “capital expenditure” and “capital gain” understand that it is an adjective and does not mean an asset related to the death penalty or of chief importance or of excellent quality. Given the financial context, they usually assume that capital is used in the sense of “relating to property” and thus that a capital expenditure is any expenditure for property.

In fact, however, a capital expenditure for purposes of tax law does not include all expenditures for property but only expenditures expected to produce significant benefits beyond the end of the current year.⁵ A capital expenditure is thereby distinguished from a noncapital (or current) expenditure, which provides no significant benefits beyond the end of the current year. This distinction is critical for the timing of the income tax deduction of business expenditures. Noncapital expenditures are immediately deducted in full, whereas the cost of capital expenditures can only be deducted over a longer period that in principle should correspond to the years during which the expenditure produces significant benefits.⁶

The commonplace distinction between capital and labor often leads students to mistakenly suppose that an expenditure for labor cannot be a capital expenditure. It is however the period of time over which an expenditure produces significant benefits that determines whether the expenditure is capital or noncapital rather than whether it is for property as opposed to labor.⁷ Thus, an expenditure for labor is a capital expenditure if it produces significant benefits beyond the end of the current year. For example, a business makes a capital expenditure (at least in principle) when it pays an employee to engage in long-range planning. A student who pays for the cost of law school also makes a capital expenditure.

Complicating matters further, not all expenditures that are capital expenditures in principle (i.e., that produce significant benefits beyond the end of the current year) are actually treated as capital expenditures by the tax law. For reasons of administrative convenience and feasibility, certain expenditures that produce significant benefits beyond the end of the current year, such as the salary of an employee who does long-run planning, are nevertheless classified and treated as noncapital (or current) expenditures and are therefore immediately

5. *Indopco Inc. v. Comm’r*, 503 U.S. 79, 89 (1992); *Treas. Reg. § 1.446-1(a)(4)(ii)*. All section references are to the Internal Revenue Code, 26 U.S.C., or to Treasury regulations interpreting the Code, 26 C.F.R.

6. 503 U.S. at 84; *IRC §§ 162(a), 263*.

7. See, e.g., *Comm’r v. Idaho Power Co.*, 418 U.S. 1, 14 (1974); *IRC § 263A*.

deductible in full.⁸ The capital expenditures treated as noncapital expenditures also include the costs of research and development⁹ and advertising.¹⁰

Moving from “capital expenditures” to “capital gains,” there are additional opportunities for linguistic confusion. A capital gain is defined by the Internal Revenue Code as the gain arising from a “capital asset,” which in turn is defined as *all* property except for specifically excluded items, most importantly business property and artistic or literary property created by a taxpayer’s own efforts.¹¹

The scope of the capital asset category reflects the policy decision to tax only certain gains on property at much lower rates than other income. Under current law, capital gains are generally taxed a maximum rate of 15 percent while other income is taxed at rates of up to 35 percent.¹² Business property is excluded from the capital asset category because of the decision to deny preferential treatment to most business profits, including those attributable to the sale of business property.¹³ Self-created artistic and literary property is excluded to deny preferential treatment to income from a taxpayer’s labor.¹⁴

It is therefore a mistake to suppose that the adjective capital connotes the same idea in both capital expenditure and capital asset. A capital asset, as contrasted with a capital expenditure, is not defined by the tax law according to whether it produces significant benefits beyond the end of the current year. For example, although expenditures for labor can constitute capital expenditures, gains on property produced by the seller’s labor are excluded from the capital asset category.

Of course, there is a significant overlap between the two categories. A capital expenditure is often the means of acquiring a capital asset, and a capital asset is often acquired by making a capital expenditure. Nevertheless, because the correspondence between capital expenditures and capital assets is far from perfect, it is important for the tax teacher to focus on the precise requirements for each category and to warn students not to assume that the adjective “capital” means the same thing for both categories.

As if intent on compounding linguistic confusion, the drafters of the Internal Revenue Code have created yet another category of property denoted quasi-capital assets.¹⁵ The prefix quasi, from the Latin *quam si*, meaning “as if”

8. See generally, Treas. Reg. § 1.263(a)4.

9. IRC § 197.

10. Rev. Rul. 56-181, 1956-1 C.B. 96.

11. IRC § 1221.

12. IRC § 1(h)-(i).

13. IRC § 1221(a)(1)-(2).

14. IRC § 1221(a)(3).

15. OED II, *supra*, note 2.

or “approximately,” connotes “having some resemblance to,”¹⁶ and thus the term quasi-capital asset might appear to indicate a kind of tax androgyny, such as a noncapital expenditure with capital expenditure characteristics, or vice-versa. In reality, however, the Code defines the quasi-capital asset category to include real or depreciable business property,¹⁷ and, for reasons that are not entirely clear, treats the gain on such property as preferential capital gain, even though it constitutes business income.¹⁸

Tax discourse also uses the word capital as a noun when referring to an amount as the “return of capital.” In this context, “capital” is more or less synonymous with “cost,” as in the following sentence: “In measuring gain on a sale or exchange, an allowance must be made for the return of capital.” The idea is that there can be no gain on the sale of property until the seller has recovered the property’s cost, that is, until there has been a return of capital. Of course, the idea of capital as cost exclusive of gain is antithetical to the idea of capital gain and thus another source of linguistic confusion.

A verb form of “capital” also makes an appearance in the basic tax course in the word capitalize. In everyday usage, to capitalize means “to write with capital letters” or “to take advantage of” as in “capitalize on an opportunity.”¹⁹ In tax discourse, however, the verb capitalize has two very different, specialized meanings. It can refer to treating a cost as a capital expenditure (deductible only over a period of years) rather than as a current expense (immediately deductible in full). Thus, tax lawyers speak of “the need to capitalize expenditures that produce significant benefits beyond the end of the current year.”²⁰ The verb capitalize can also refer to an increase in the price of property that reflects tax benefits accorded to the property. For example, tax lawyers speak of the tax exemption for interest on municipal bonds as being capitalized in the price of the bonds, meaning that the price has increased to reflect the value of the tax exemption.

Other Examples

Although no other tax law term has as many different and confusing meanings as capital, there are nevertheless a number of other words whose diverse meanings are a perennial source of confusion for students.

Personal Property versus Personal Consumption

Preceding the word property, “personal” is an adjective that usually conveys the idea that the property in question does not consist of real property, which

16. *Id.*

17. IRC § 1231(b).

18. See generally Boris I. Bittker and Lawrence Lokken, *Federal Taxation of Income, Estates and Gifts*, ¶ 50.1.1 (3d ed., Boston, 1994).

19. OED II, *supra* note 2.

20. See, e.g., *Comm’r v. Idaho Power Co.*, 418 U.S. at 5-6.

is land or property permanently attached to land. However, in tax law, the adjective personal preceding property may indicate that the property in question is held for personal consumption use rather than for business or investment. Thus, when the tax law refers to personal property, it may be unclear whether the reference is to personal property as contrasted with real property or to personal property as contrasted with business and investment property.

To avoid confusion on this point, in teaching tax I refer to personal (as opposed to real) property as nonreal (or even unreal) property. Similarly, I refer to personal (as opposed to business and investment) property as personal consumption use property. Using the words "nonreal property" and "personal consumption use property" in place of simply "personal property" helps me to clarify what is meant.

An Installment Payment Not Paid in Installments

Ordinarily taxpayers must report gain on the sale of property at the time when the sale occurs.²¹ However, if the terms of the sale provide for deferred payment of the purchase price, that is, payment at some later date or dates, then (provided specified technical requirements are met) the gain from the sale need be reported only as payment is received by the seller.²² Moreover, there need not be several payments; just one payment is enough, as long as it is occurs after the date when the property is sold.²³ For example, if A sells property to B in 1990, and B promises to pay the entire purchase price in 1992, then A need not report the gain until 1992 when A receives the purchase price.

The Internal Revenue Code section providing for this result is anomalously denoted "installment method."²⁴ The word installment in ordinary usage means "one of several payments made at intervals."²⁵ However, the installment method is expressly made available even if there is only one rather than several payments. A more accurate description would therefore be "deferred payment method" rather than "installment method."

Nonrecourse Loans with Recourse

In my experience, one of the harder financial transactions for tax students to understand is the so-called nonrecourse loan. Why, my students ask, would anyone lend money if the lender literally has no recourse against the borrower? In fact, a nonrecourse loan is one in which the borrower pledges property as security but is not personally liable. "Nonrecourse" is a misnomer since the lender does, in case of default, have legal recourse against the property securing the

21. Treas. Reg. § 1.61-6.

22. IRC § 453.

23. IRC § 453(b)(1).

24. IRC § 453.

25. OED II, *supra* note 2.

loan in case of default. It would thus be more accurate to describe the loan as a “nonpersonal liability” rather than a nonrecourse loan.

Teaching the Language of Tax

Experienced tax lawyers deal easily with the ambiguous, imprecise, and confusing terms that pervade tax law and discourse because they understand the intended meaning of a word from its context. For students, however, the subtle ways in which meaning depends on context are far from obvious. It may therefore be critical for the tax teacher to emphasize the extent to which the same words have vastly different meaning depending on the context, as with the words capital and personal, or connote something other than their usual definition as with the words installment and nonrecourse.

The tax teacher can warn of the problems of ambiguous, imprecise, and confusing terms and suggest alternative words that are more precise. The ultimate goal should be to impart fluency not only in these more precise words but also paradoxically in the ambiguous and imprecise terms that are the source of confusion but with which tax lawyers (for better or worse) continue to write and speak.