CHAPTER 1

LEARNING OBJECTIVES

After completing Chapter 1, you should be able to:

LO.1
Realize the importance of revenue needs as an objective of Federal tax law.

LO.2
Appreciate the influence of economic, social, equity, and political considerations on the development of the tax law.

LO.3
Understand how the IRS, as the protector of the revenue, has affected tax law.

LO.4
Recognize the role of the courts in interpreting and shaping tax law.

LO.5
Identify tax law sources—statutory, administrative, and judicial.

LO.6
Locate tax law sources.

LO.7
Assess the validity and weight of tax law sources.

LO.8
Make use of various tax planning procedures.

LO.9
Have an awareness of computer-assisted tax research.
The Whys of the Tax Law

The Federal tax law is a mixture of statutory provisions, administrative pronouncements, and court decisions. Anyone who has attempted to work with this body of knowledge is familiar with its complexity. Commenting on his 48-page tax return, the author James Michener said, “It is unimaginable in that I graduated from one of America’s better colleges, yet I am totally incapable of understanding tax returns.” For the person who has to wade through rule upon rule to find the solution to a tax problem, it may be of some consolation to know that the law’s complexity can be explained. There is a reason for the formulation of every rule. Knowing these reasons, therefore, is a considerable step toward understanding the Federal tax law.

The major objective of the Federal tax law is the raising of revenue. Despite the importance of the fiscal needs of the government, however, other considerations explain certain portions of the law. In particular, economic, social, equity, and political factors play a significant role. Added to these factors is the marked impact the Internal Revenue Service (IRS) and the courts have had and will continue to have on the evolution of Federal tax law. These matters are treated in the first part of this chapter. Wherever appropriate, the discussion is related to subjects covered later in the text.

LO.1

Realize the importance of revenue needs as an objective of Federal tax law.

REVENUE NEEDS

The foundation of any tax system has to be the raising of revenue to absorb the cost of government operations. Ideally, annual outlays should not exceed anticipated revenues. This situation leads to a balanced budget with no deficit. Many states have achieved this objective by passing laws or constitutional amendments precluding deficit spending. Unfortunately, the Federal government has no such prohibition, and the national debt has grown, reaching $7.5 trillion, or more than $25,000 per citizen, in late 2004. Concern about the rising debt has caused Congress to become more deficit-conscious when enacting tax legislation.
When enacting tax legislation, Congress often is guided by the concept of revenue neutrality so that any changes neither increase nor decrease the net revenues raised under the prior rules. Revenue neutrality does not mean that any one taxpayer’s tax liability remains the same. Since this liability depends upon the circumstances involved, one taxpayer’s increased tax liability could be another’s tax saving. Revenue-neutral tax reform does not reduce deficits, but at least it does not aggravate the problem.

ECONOMIC CONSIDERATIONS

Using the tax system to attempt to accomplish economic objectives has become increasingly popular in recent years. Generally, this process involves amending the Internal Revenue Code through tax legislation and emphasizes measures designed to help control the economy or encourage certain activities and businesses.

Control of the Economy. Congress has made use of depreciation write-offs as a means of controlling the economy. Theoretically, shorter asset lives and accelerated methods should encourage additional investments in depreciable property acquired for business use. Conversely, longer class lives and the required use of the straight-line method of depreciation dampen the tax incentive for capital outlays.

Another approach that utilizes depreciation as a means of controlling capital investment is the amount of write-off allowed upon the acquisition of assets. This approach is followed by the § 179 election to immediately expense assets (currently up to $100,000). It also was the approach used by Congress in various provisions that permitted up to 50 percent additional first-year depreciation.

A change in the tax rate structure has a more immediate impact on the economy. When tax rates are lowered, taxpayers are able to obtain additional spendable funds. In the interest of revenue neutrality, however, rate decreases may be

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1The Internal Revenue Code is a compilation of Federal tax legislation that appears in Title 26 of the U.S. Code.
accompanied by a reduction or elimination of deductions or credits. Thus, lower rates do not always mean lower taxes.

**Encouragement of Certain Activities.** Without passing judgment on the wisdom of any such choices, it is quite clear that the tax law does encourage certain types of economic activity or segments of the economy. For example, the desire to foster technological progress helps explain the favorable treatment accorded to research and development expenditures. Under the tax law, such expenditures can be deducted in the year incurred or, alternatively, capitalized and amortized over a period of 60 months or more. In terms of timing the tax saving, such options usually are preferable to a capitalization of the cost with a write-off over the estimated useful life of the asset created.\(^2\)

The encouragement of technological progress can also explain why the tax law places the inventor in a special position. Not only can patents qualify as capital assets, but under certain conditions their disposition automatically carries long-term capital gain treatment.\(^3\)

Are ecological considerations a desirable objective? If they are, it explains why the tax law permits a 60-month amortization period for costs incurred in the installation of pollution control facilities.

Does stimulating the development and rehabilitation of low-income rental housing benefit the economy? The tax law definitely favors these activities by allowing generous tax credits to taxpayers incurring such costs.

Is saving desirable for the economy? Saving leads to capital formation and thus makes funds available to finance home construction and industrial expansion. The tax law provides incentives to encourage saving by giving private retirement plans preferential treatment. Not only are contributions to Keogh (H.R. 10) plans and certain Individual Retirement Accounts (IRAs) deductible, but income from such contributions accumulates on a tax-free basis. As noted in a following section, the encouragement of private-sector pension plans can be justified under social considerations as well.

**Encouragement of Certain Industries.** Who can question the proposition that a sound agricultural base is necessary for a well-balanced national economy? Undoubtedly, this belief can explain why farmers are accorded special treatment under the Federal tax system. Among the benefits are the election to expense rather than capitalize certain expenditures for soil and water conservation and fertilizers and the election to defer the recognition of gain on the receipt of crop insurance proceeds.

The tax law also favors the development of natural resources by permitting the use of percentage depletion on the extraction and sale of oil and gas and specified mineral deposits and a write-off (rather than a capitalization) of certain exploration costs. The railroad and banking industries also receive special tax treatment. All of these provisions can be explained, in whole or in part, by economic considerations.

**Encouragement of Small Business.** At least in the United States, a consensus exists that what is good for small business is good for the economy as a whole. This assumption has led to a definite bias in the tax law favoring small business.

In the corporate tax area, several provisions can be explained by the desire to benefit small business. One provision enables a shareholder in a small business corporation to obtain an ordinary deduction for any loss recognized on a stock investment. Normally, such a loss would receive the less attractive capital loss

\(^2\)If the asset developed has no estimated useful life, no write-off would be available without the two options allowed by the tax law.

\(^3\)A long-term capital gain has a favorable tax advantage for individuals.
treatment. The point of this favoritism is to encourage additional equity investments in small business corporations.\(^4\) Another provision permits the shareholders of a small business corporation to make a special election that generally will avoid the imposition of the corporate income tax.\(^5\) Furthermore, such an election enables the corporation to pass through to its shareholders any of its operating losses.\(^6\)

The tax rates applicable to corporations tend to favor small business in that size is relative to the amount of taxable income generated in any one year. Since a corporate tax rate of 34 percent applies only to taxable income in excess of $75,000, corporations that stay within this limit are subject to lower average tax rates.

For calendar year 2005, Brown Corporation has taxable income of $75,000, and Red Corporation has taxable income of $100,000. Based on this information, the corporate income tax is $13,750 for Brown Corporation and $22,250 for Red Corporation (see Chapter 2). Brown Corporation is subject to an average tax rate of 18.33% ($13,750/$75,000), while Red Corporation is subject to an average rate of 22.25% ($22,250/$100,000).

If a corporation has taxable income in excess of $100,000, the benefits of the lower brackets are phased out until all income is taxed at the maximum rate of 34 percent. Once taxable income reaches $10 million, the rate becomes 35 percent.

One of the justifications for the enactment of the tax law governing corporate reorganizations (see Chapter 7) was the economic benefit it would provide for small businesses. By allowing corporations to combine without adverse tax consequences, small corporations would be in a position to compete more effectively with larger concerns.

**SOCIAL CONSIDERATIONS**

Some of the tax laws, especially those related to the Federal income tax of individuals, can be explained by social considerations. Rather than using loans, grants, and other programs to reach desired goals, Congress often uses the Tax Code to provide incentives and benefits (e.g., the higher education incentives). The following are some notable examples:

- The refundable earned income tax credit. As Congress has deemed it socially desirable to reduce the number of people on the welfare rolls and to cut funding for welfare programs, this credit has come to replace some welfare programs.
- The nontaxability of certain benefits provided to employees through accident and health plans financed by employers. It is socially desirable to encourage such plans, since they provide medical benefits in the event of an employee’s illness or injury.
- The nontaxability to the employee of some of the premiums paid by an employer for group term insurance covering the life of the employee. These arrangements can be justified in that they provide funds to help the family unit adjust to the loss of wages caused by the employee’s death.
- The tax treatment to the employee of contributions made by an employer to qualified pension or profit sharing plans. The contribution and any income it earns are not taxed to the employee until the funds are distributed. Private retirement plans are encouraged because they supplement the subsistence

\(^4\) Known as Section 1244 stock, this subject is covered in Chapter 3.

\(^5\) Known as the S corporation election, the subject is discussed extensively in Chapter 12.

\(^6\) In general, an operating loss can benefit only the corporation incurring the loss through a carryback or carryover to profitable years. Consequently, the shareholders of the corporation usually cannot take advantage of any such loss.
income level the employee would otherwise have under the Social Security system.\textsuperscript{7}

- The deduction allowed for contributions to qualified charitable organizations. The deduction attempts to shift some of the financial and administrative burden of socially desirable programs from the public (the government) to the private (the citizens) sector.

- Various tax credits, deductions, and exclusions that are designed to encourage taxpayers to obtain additional education (e.g., HOPE scholarship credit, lifetime learning credit, and the Coverdell Education Savings Account).\textsuperscript{8}

- The credit allowed for amounts spent to furnish care for certain minor or disabled dependents to enable the taxpayer to seek or maintain gainful employment. Who could deny the social desirability of encouraging taxpayers to provide care for their children while they work?

- The disallowance of a tax deduction for certain expenditures that are deemed to be contrary to public policy. This disallowance extends to such items as fines, penalties, illegal kickbacks, and bribes to government officials. Public policy considerations also have been used to disallow gambling losses in excess of gambling gains and political campaign expenditures in excess of campaign contributions. Social considerations dictate that the tax law should not encourage these activities by permitting a deduction.

- The adoption tax credit of up to $10,000 to cover expenses incurred by individuals who adopt or attempt to adopt a child.

Many other examples could be included, but the conclusion would be unchanged: social considerations do explain a significant part of the Federal tax law.

**EQUITY CONSIDERATIONS**

The concept of equity is relative. Reasonable persons can, and often do, disagree about what is fair or unfair. In the tax area, moreover, equity is generally tied to a particular taxpayer’s personal situation. To illustrate, Ms. Jones may have difficulty understanding why none of the rent she pays on her apartment is deductible, while her brother, Mr. Jones, is able to deduct a large portion of the monthly payments he makes on his personal residence in the form of interest and taxes.\textsuperscript{9}

In the same vein, compare the tax treatment of a corporation with that of a partnership. Two businesses may be of equal size, similarly situated, and competitors in the production of goods or services, but they are not comparably treated under the tax law. The corporation is subject to a separate Federal income tax; the partnership is not. Whether the differences in tax treatment can be logically justified in terms of equity is beside the point. The tax law can and does make a distinction between these business forms.

Equity, then, is not what appears fair or unfair to any one taxpayer or group of taxpayers. It is, instead, what the tax law recognizes. Some recognition of equity does exist, however, and explains part of the law. The concept of equity appears in tax provisions that alleviate the effect of multiple taxation and postpone the recognition of gain when the taxpayer lacks the ability or wherewithal to pay the tax. Equity also helps mitigate the effect of the application of the annual accounting period concept and helps taxpayers cope with the eroding result of inflation.

\textsuperscript{7}The same rationale explains the availability of similar arrangements for self-employed persons (the H.R. 10 or Keogh plan).

\textsuperscript{8}These provisions can also be justified under the category of economic considerations. No one can take issue with the conclusion that a better educated workforce carries a positive economic impact.

\textsuperscript{9}The encouragement of home ownership can be justified on both economic and social grounds. In this regard, it is interesting to note that some state income tax laws allow a form of relief (e.g., tax credit) to the taxpayer who rents his or her personal residence.
Alleviating the Effect of Multiple Taxation. The same income earned by a taxpayer may be subject to taxes imposed by different taxing authorities. If, for example, the taxpayer is a resident of New York City, income might generate Federal, State of New York, and City of New York income taxes. To compensate for this inequity, the Federal tax law allows a taxpayer to claim a deduction for state and local income taxes. The deduction, however, does not neutralize the effect of multiple taxation since the benefit derived depends on the taxpayer’s Federal income tax rate.\(^{10}\)

Equity considerations can explain the Federal tax treatment of certain income from foreign sources. Since double taxation results when the same income is subject to both foreign and U.S. income taxes, the tax law permits the taxpayer to choose either a credit or a deduction for the foreign taxes paid.

The imposition of a separate income tax on corporations leads to multiple taxation of the same income.

**Example 2**

During the current year, Gray Corporation has net income of $100,000, of which $5,000 was received as dividends from stock it owns in IBM Corporation. Assume Gray Corporation distributes the after-tax income to its shareholders (all individuals). At a minimum, the distribution received by the shareholders will be subject to two income taxes: the corporate income tax when the income is earned by Gray Corporation and the individual income tax when the balance is distributed to the shareholders as a dividend. The $5,000 Gray receives from IBM Corporation fares even worse. Because it is paid from income earned by IBM, it has been subjected to a third income tax (the corporate income tax imposed on IBM).\(^{11}\)

For corporate shareholders, for whom triple taxation is possible, the law provides a deduction for dividends received from certain domestic corporations. The deduction, usually 70 percent of the dividends, would be allowed to Gray Corporation for the $5,000 it received from IBM Corporation. (See the discussion in Chapter 2.) For the individual shareholder, recent legislation has reduced the tax on qualified dividends to 15 percent (5 percent for lower-bracket shareholders). By allowing a preferential lower tax rate, the approach is to mitigate (not eliminate) the effect of multiple taxation. (See the discussion in Chapter 4.)

In the area of the Federal estate tax, several provisions reflect attempts to mitigate the effect of multiple taxation. Some degree of equity is achieved, for example, by allowing a limited credit against the estate tax for foreign death taxes imposed on the same transfer. Other estate tax credits are available and can be explained on the same grounds.\(^{12}\)

The Wherewithal to Pay Concept. The wherewithal to pay concept recognizes the inequity of taxing a transaction when the taxpayer lacks the means with which to pay the tax. It is particularly suited to situations when the taxpayer’s economic position has not changed significantly as a result of a transaction.

**Example 3**

White Corporation holds unimproved land as an investment. The land has a basis to White of $60,000 and a fair market value of $100,000. The land is exchanged for a building (worth $100,000) that White will use in its business.\(^{13}\)

\(^{10}\)A tax credit, rather than a deduction, would eliminate the effects of multiple taxation on the same income.

\(^{11}\)This result materializes because under the tax law a corporation is not allowed a deduction for the dividend distributions it makes.

\(^{12}\)See Chapter 17.

\(^{13}\)The nontaxability of like-kind exchanges applies to the exchange of property held for investment or used in a trade or business for property to be similarly held or used.
White Corporation owns a warehouse that it uses in its business. At a time when the warehouse has an adjusted basis of $60,000, it is destroyed by fire. White collects the insurance proceeds of $100,000 and, within two years of the end of the year in which the fire occurred, uses all of the proceeds to purchase a new warehouse.\(^\text{14}\)

Tom, a sole proprietor, decides to incorporate his business. In exchange for the business’s assets (adjusted basis of $60,000 and a fair market value of $100,000), Tom receives all of the stock of Azure Corporation, a newly created corporation.\(^\text{15}\) The Azure stock is worth $100,000.

Rose, Sam, and Tom want to develop unimproved land owned by Tom. The land has a basis to Tom of $60,000 and a fair market value of $100,000. The RST Partnership is formed with the following investments: land worth $100,000 transferred by Tom, $100,000 cash by Rose, and $100,000 cash by Sam. Each party receives a one-third interest in the RST Partnership.\(^\text{16}\)

Amber Corporation and Crimson Corporation decide to consolidate to form Aqua Corporation.\(^\text{17}\) Pursuant to the plan of reorganization, Tera exchanges her stock in Amber Corporation (basis of $60,000 and fair market value of $100,000) for stock in Aqua Corporation worth $100,000.

In all of the preceding examples, White Corporation, Tom, or Tera had a realized gain of $40,000 [$100,000 (fair market value of the property received) – $60,000 (basis of the property given up)].\(^\text{18}\) It seems inequitable to force the taxpayer to recognize any of this gain for two reasons. First, without disposing of the property or interest acquired, the taxpayer would be hard-pressed to pay the tax.\(^\text{19}\) Second, the taxpayer’s economic situation has not changed significantly. To illustrate by referring to Example 5, can it be said that Tom’s position as sole shareholder of Azure Corporation is much different from his prior status as owner of a sole proprietorship?

Several warnings are in order concerning the application of the wherewithal to pay concept. Recognized gain is merely postponed and not necessarily avoided. Because of the basis carryover to the new property or interest acquired in these nontaxable transactions, the gain element is still present and might be recognized upon a subsequent taxable disposition. Referring to Example 5, suppose Tom later sold the stock in Azure Corporation for $100,000. Tom’s basis in the stock is $60,000 (the same basis as in the assets transferred), and the sale results in a recognized gain of $40,000. Also, many of the provisions previously illustrated prevent the recognition of realized losses. Since such provisions are automatic in application (not elective with the taxpayer), they could operate to the detriment of a taxpayer who wishes to obtain a deduction for a loss. The notable exception involves involuntary conversions (Example 4). Here, nonrecognition treatment is elective with the taxpayer and will not apply to a realized loss if it is otherwise deductible.

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\(^{14}\)The nontaxability of gains realized from involuntary conversions applies when the proceeds received by the taxpayer are reinvested within a prescribed period of time in property similar or related in service or use to that converted. Involuntary conversions take place as a result of casualty losses, theft losses, and condemnations by a public authority.

\(^{15}\)Transfers of property to controlled corporations are discussed in Chapter 3.

\(^{16}\)The formation of a partnership is discussed in Chapter 10.

\(^{17}\)Corporate reorganizations are discussed in Chapter 7.

\(^{18}\)Realized gain can be likened to economic gain. However, the Federal income tax is imposed only on that portion of realized gain considered to be recognized under the law. Generally, recognized (or taxable) gain can never exceed realized gain.

\(^{19}\)If the taxpayer ends up with other property (boot) as part of the transfer, gain may be recognized to this extent. The presence of boot, however, helps solve the wherewithal to pay problem, since it provides property (other than the property or interest central to the transaction) with which to pay the tax.
The wherewithal to pay concept has definitely served as a guideline in shaping part of the tax law. Nevertheless, it is not a hard and fast principle that is followed in every case. Only when the tax law specifically provides for no tax consequences will this result materialize.

Mary Jo exchanges stock in Green Corporation (basis of $60,000 and fair market value of $100,000) for stock in Purple Corporation (fair market value of $100,000). The exchange is not pursuant to a reorganization. Under these circumstances, Mary Jo’s realized gain of $40,000 is recognized for Federal income tax purposes.\(^{20}\)

The result reached in Example 8 seems harsh in that the exchange does not place Mary Jo in a position to pay the tax on the $40,000 gain. How can this result be reconciled with that reached in Example 7 when the exchange was nontaxable? In other words, why does the tax law apply the wherewithal to pay concept to the exchange of stock pursuant to a corporate reorganization (Example 7) but not to certain other stock exchanges (Example 8)?

Recall that the wherewithal to pay concept is particularly suited to situations in which the taxpayer’s economic position has not changed significantly as a result of a transaction. In Example 7, Tera’s stock investment in Amber Corporation really continues in the form of the Aqua Corporation stock since Aqua was formed through a consolidation of Amber and Crimson Corporations.\(^{21}\) In Example 8, however, the investment has not continued. Here Mary Jo’s ownership in Green Corporation has ceased, and an investment in an entirely different corporation has been substituted.

Mitigating the Effect of the Annual Accounting Period Concept. For purposes of effective administration of the tax law, all taxpayers must report to and settle with the Federal government at periodic intervals. Otherwise, taxpayers would remain uncertain as to their tax liabilities, and the government would have difficulty judging revenues and budgeting expenditures. The period selected for final settlement of most tax liabilities is one year. At the close of each year, a taxpayer’s position becomes complete for that particular year. Referred to as the annual accounting period concept, the effect is to divide each taxpayer’s life into equal annual intervals for tax purposes.

The finality of the annual accounting period concept can lead to dissimilar tax treatment for taxpayers who are, from a long-range standpoint, in the same economic position.

### Example 9

Rena and Samuel are both sole proprietors and have experienced the following results during the past three years:

<table>
<thead>
<tr>
<th>Year</th>
<th>Profit (or Loss)</th>
<th>Rena</th>
<th>Samuel</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>$50,000</td>
<td>$50,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>2004</td>
<td>60,000</td>
<td>60,000</td>
<td>60,000</td>
</tr>
<tr>
<td>2005</td>
<td>60,000</td>
<td>(40,000)</td>
<td></td>
</tr>
</tbody>
</table>

\(^{20}\)The exchange of stock does not qualify for nontaxable treatment as a like-kind exchange (refer to Example 3).

\(^{21}\)This continuation is known as the continuity of interest concept, which forms the foundation for all nontaxable corporate reorganizations. The concept is discussed at length in Chapter 7.
Although Rena and Samuel have the same profit of $170,000 over the period 2003–2005, the finality of the annual accounting period concept places Samuel at a definite disadvantage for tax purposes. The net operating loss procedure offers Samuel some relief by allowing him to apply some or all of his 2005 loss to the earliest profitable years (in this case 2003). Thus, Samuel, with a net operating loss carryback, is placed in a position to obtain a refund for some of the taxes he paid on the $150,000 profit reported for 2003.

The same reasoning used to support the deduction of net operating losses can be applied to explain the special treatment excess capital losses and excess charitable contributions receive. Carryback and carryover procedures help mitigate the effect of limiting a loss or a deduction to the accounting period in which it is realized. With such procedures, a taxpayer may be able to salvage a loss or a deduction that might otherwise be wasted.

The installment method of recognizing gain on the sale of property allows a taxpayer to spread tax consequences over the payout period. The harsh effect of taxing all the gain in the year of sale is avoided. The installment method can also be explained by the wherewithal to pay concept since recognition of gain is tied to the collection of the installment notes received from the sale of the property. Tax consequences tend to correspond to the seller’s ability to pay the tax.

Example 10

In 2003, Tim sold unimproved real estate (cost of $40,000) for $100,000. Under the terms of the sale, Tim receives two notes from the purchaser, each for $50,000 (plus interest). One note is payable in 2004 and the other note in 2005. Without the installment method, Tim would have to recognize and pay a tax on the gain of $60,000 for the year of the sale (2003). This result is harsh, since none of the sale proceeds will be received until 2004 and 2005. With the installment method, and presuming the notes are paid when each comes due, Tim recognizes half of the gain ($30,000) in 2004 and the remaining half in 2005.

Example 11

Monica, a calendar year taxpayer, is a participant in an H.R. 10 (Keogh) retirement plan. (See Appendix C for a definition of a Keogh plan.) Under the plan, Monica contributes 20% of her net self-employment income, such amount being deductible for Federal income tax purposes. On April 10, 2005, Monica determines that her net self-employment income for calendar year 2004 was $80,000. Consequently, she contributes $16,000 (20% × $80,000) to the plan. Even though the $16,000 contribution was made in 2005, the law permits Monica to claim it as a deduction for tax year 2004. Requiring Monica to make the contribution by December 31, 2004, in order to obtain the deduction for that year would force her to arrive at an accurate determination of net self-employment income long before her income tax return must be prepared and filed.

Similar exceptions to the annual accounting period concept cover certain charitable contributions by accrual basis corporations (Chapter 2), dividend distributions by S corporations (Chapter 12), and the dividend deduction allowed in applying the tax on unreasonable accumulation of corporate earnings and the tax on personal holding companies (Chapter 6).

22Under the installment method, each payment received by the seller represents a return of basis (the nontaxable portion) and profit from the sale (the taxable portion).
Coping with Inflation. During periods of inflation, bracket creep has plagued the working person. Because of the progressive nature of the income tax, any wage adjustment to compensate for inflation can increase the income tax bracket of the recipient. The overall impact is an erosion of purchasing power. Congress recognized this problem and began to adjust various income tax components (the indexation procedure) in 1985, based upon the rise in the consumer price index over the prior year. For example, due to the inflation factor, the amount of a personal and dependency exemption has been increased over the years. Indexation also applies to dollar amounts of other components, including the tax brackets and the standard deduction.

POLITICAL CONSIDERATIONS

A large segment of the Federal tax law is made up of statutory provisions. Since these statutes are enacted by Congress, is it any surprise that political considerations influence tax law? For purposes of discussion, the effect of political considerations on the tax law is divided into the following topics: special interest legislation, political expediency, and state and local influences.

Special Interest Legislation. Unquestionably, certain provisions of the tax law can be explained largely by looking to the political influence some pressure groups have exerted on Congress. For example, is there any other reason why prepaid subscription and dues income is not taxed until earned while prepaid rents are taxed to the landlord in the year received? These exceptions came about because certain organizations (e.g., the American Automobile Association) convinced Congress that special tax treatment was needed to cover income received from multiyear dues and subscriptions.

Special interest legislation is not necessarily to be condemned if it can be justified on economic or social grounds. At any rate, it is an inevitable product of our political system.

Political Expediency. Various tax reform proposals rise and fall in favor, depending upon the shifting moods of the American public. That Congress is sensitive to popular feeling is an accepted fact. Therefore, certain provisions of the tax law can be explained on the basis of the political climate at the time of enactment. Once the general public became aware that certain large and profitable corporations were able to avoid the corporate income tax, Congress responded with an alternative minimum tax. Since a portion of a corporation’s adjusted current earnings has been made a tax preference item, many large corporations no longer escape taxation (see Chapter 6).

Measures that deter more affluent taxpayers from obtaining so-called preferential tax treatment have always had popular appeal and, consequently, the support of Congress. Provisions such as the alternative minimum tax, the imputed interest rules, and the limitation on the deductibility of interest on investment indebtedness can be explained on this basis. In the same vein are the provisions imposing penalty taxes on corporations that unreasonably accumulate earnings or are classified as personal holding companies (see Chapter 6).

The provisions raising income tax rates on more affluent taxpayers and increasing the amount of the earned income credit are also at least partially attributable to political expediency.

State and Local Influences. Political considerations have played a major role in the exclusion from gross income of interest received on state and local obligations. In view of the furor that has been raised by state and local political figures every
time repeal of this tax provision has been proposed, one might well regard it as sacred.

Somewhat less apparent has been the influence state law has had in shaping our present Federal tax law. Of prime importance in this regard has been the effect of the community property system employed in some states. At one time, the tax position of the residents of these states was so advantageous that many common law states actually adopted community property systems. The political pressure placed on Congress to correct the disparity in tax treatment was considerable. To a large extent, this was accomplished in the Revenue Act of 1948, which extended many of the community property tax advantages to residents of common law jurisdictions. Thus, common law states avoided the trauma of discarding the time-honored legal system familiar to everyone. The impact of community property law on the Federal estate and gift taxes is further explored in Chapters 17 and 18.

INFLUENCE OF THE INTERNAL REVENUE SERVICE

The IRS has been influential in many areas beyond its role in issuing administrative pronouncements. In its capacity as the protector of the national revenue, the IRS has been instrumental in securing the passage of much legislation designed to curtail the most flagrant tax avoidance practices (closing tax loopholes). In its capacity as the administrator of the tax laws, the IRS has sought and obtained legislation to make its job easier (administrative feasibility).

The IRS as Protector of the Revenue. Innumerable examples can be given of provisions in the tax law that have stemmed from the direct efforts of the IRS to prevent taxpayers from exploiting a loophole. Working within the letter of existing law, ingenious taxpayers and their advisers devise techniques that accomplish indirectly what cannot be accomplished directly. As a consequence, legislation is enacted to close the loophole that taxpayers have located and exploited. The following examples can be explained in this fashion and are discussed in more detail in the chapters to follow:

- The use of a fiscal year by personal service corporations, partnerships, S corporations, and trusts to defer income recognition to the owners (see Chapters 2, 10, 12, and 19).
- The use of the cash basis method of accounting by certain large corporations (see Chapter 2).
- The deduction of passive investment losses and expenses against other income (see Chapter 11).
- The shifting of income to lower-bracket taxpayers through the use of reversionary trusts (see Chapter 19).

The states with community property systems are Louisiana, Texas, New Mexico, Arizona, California, Washington, Idaho, Nevada, Wisconsin, and (if elected by the spouses) Alaska. The rest of the states are classified as common law jurisdictions. The difference between common law and community property systems centers around the property rights possessed by married persons. In a common law system, each spouse owns whatever he or she earns. Under a community property system, one-half of the earnings of each spouse is considered owned by the other spouse. Assume, for example, Harold and Ruth are husband and wife, and their only income is the $40,000 annual salary Harold receives. If they live in New York (a common law state), the $40,000 salary belongs to Harold. If, however, they live in Texas (a community property state), the $40,000 salary is divided equally, in terms of ownership, between Harold and Ruth.

Such states included Michigan, Oklahoma, and Pennsylvania.

The major advantage extended was the provision allowing married taxpayers to file joint returns and compute the tax liability as if the income had been earned one-half by each spouse. This result is automatic in a community property state since half of the income earned by one spouse belongs to the other spouse. The income-splitting benefits of a joint return are now incorporated as part of the tax rates applicable to married taxpayers.
In addition, the IRS has secured from Congress legislation of a more general nature that enables it to make adjustments based upon the substance, rather than the formal construction, of what a taxpayer has done. One provision, for example, authorizes the IRS to establish guidelines on the thin capitalization issue. This question involves when corporate debt will be recognized as debt for tax purposes and when it will be reclassified as equity or stock (see the discussion of thin capitalization in Chapter 3). Another provision permits the IRS to make adjustments to a taxpayer’s method of accounting when the method used by the taxpayer does not clearly reflect income. The IRS has also been granted the authority to allocate income and deductions among businesses owned or controlled by the same interests when the allocation is necessary to prevent the evasion of taxes or to reflect the income of each business clearly.

Gold Corporation and Silver Corporation are brother-sister corporations (the stock of each is owned by the same shareholders), and both use the calendar year for tax purposes. For the current tax year, each has taxable income as follows: $335,000 for Gold Corporation and $50,000 for Silver Corporation. Not included in Gold Corporation’s taxable income, however, is $10,000 of rent income usually charged Silver Corporation for the use of some property owned by Gold. Since the parties have not clearly reflected the taxable income of each business, the IRS can allocate $10,000 of rent income to Gold Corporation. After the allocation, Gold Corporation has taxable income of $345,000, and Silver Corporation has taxable income of $40,000.26

Also of a general nature is the authority Congress has given the IRS to prevent taxpayers from acquiring corporations to obtain a tax advantage when the principal purpose of the acquisition is the evasion or avoidance of the Federal income tax. The provision of the tax law that provides this authority is discussed briefly in Chapter 7.

Administrative Feasibility. Some of the tax law is justified on the grounds that it simplifies the task of the IRS in collecting the revenue and administering the law. With regard to collecting the revenue, the IRS long ago realized the importance of placing taxpayers on a pay-as-you-go basis. Elaborate withholding procedures apply to wages, while the tax on other types of income may have to be paid at periodic intervals throughout the year. The IRS has been instrumental in convincing the courts that accrual basis taxpayers should pay taxes on prepaid income in the year received and not when earned. This approach may be contrary to generally accepted accounting principles, but it is consistent with the wherewithal to pay concept.

Of considerable aid to the IRS in collecting revenue are the numerous provisions that impose interest and penalties on taxpayers for noncompliance with the tax law. These provisions include penalties for failure to pay a tax or to file a return that is due and the negligence penalty for intentional disregard of rules and regulations. Various penalties for civil and criminal fraud also serve as deterrents to taxpayer noncompliance. This aspect of the tax law is discussed in Chapter 16.

One of the keys to the effective administration of our tax system is the audit process conducted by the IRS. To carry out this function, the IRS is aided by provisions that reduce the chance of taxpayer error or manipulation and therefore simplify the audit effort that is necessary. An increase in the amount of the standard deduction reduces the number of individual taxpayers who will be in a position to claim itemized deductions. With fewer deductions to check, the audit function...
is simplified. The same objective can be used to explain the $345,800 unified gift tax credit in 2005 and the $11,000 annual gift tax exclusion (see Chapter 17). These provisions decrease the number of tax returns that must be filed (as well as reduce the taxes paid) and thereby save audit effort.

**INFLUENCE OF THE COURTS**

In addition to interpreting statutory provisions and the administrative pronouncements issued by the IRS, the Federal courts have influenced tax law in two other respects. First, the courts have formulated certain judicial concepts that serve as guides in the application of various tax provisions. Second, certain key decisions have led to changes in the Internal Revenue Code. Understanding this influence helps explain some of our tax laws.

**Judicial Concepts Relating to Tax Law.** Although ranking the tax concepts developed by the courts in order of importance is difficult, the concept of substance over form would almost certainly be near the top of any list. Various described as the “telescoping” or “collapsing” process or the “step transaction approach,” it involves determining the true substance of what occurred. In a transaction involving many steps, any one step may be collapsed (or disregarded) to arrive directly at the result reached.

In 2005, Mrs. Greer, a widow, wants to give $22,000 to Jean without incurring any gift tax liability. She knows that the law permits her to give up to $11,000 each year per person without any tax consequences (the annual exclusion). With this in mind, the following steps are taken: a gift by Mrs. Greer to Jean of $11,000 (nontaxable because of the $11,000 annual exclusion), a gift by Mrs. Greer to Ben of $11,000 (also nontaxable), and a gift by Ben to Jean of $11,000 (nontaxable because of Ben’s annual exclusion). Considering only the form of what Mrs. Greer and Ben have done, all appears well from a tax standpoint. In substance, however, what has happened? By collapsing the steps involving Ben, it is apparent that Mrs. Greer has made a gift of $22,000 to Jean and therefore has not avoided the Federal gift tax.

The substance over form concept plays an important role in transactions involving corporations.

Another leading tax concept developed by the courts deals with the interpretation of statutory tax provisions that operate to benefit taxpayers. The courts have established the rule that these relief provisions are to be narrowly construed against taxpayers if there is any doubt about their application. Suppose, for example, Beige Corporation wants to be treated as an S corporation (see Chapter 12) but has not satisfied the statutory requirements for making the required election. Because S corporation status is a relief provision favoring taxpayers, chances are the courts will deny Beige Corporation this treatment.

Important in the area of corporate-shareholder dealings (see the discussion of constructive dividends in Chapter 4) and in the resolution of valuation problems for estate and gift tax purposes (see Chapters 17 and 18) is the arm’s length concept. Particularly in dealings between related parties, transactions can be tested by

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27The IRS gave the same justification when it proposed to Congress the $100 per event limitation on personal casualty and theft losses. Imposition of the limitation eliminated many casualty and theft loss deductions and, as a consequence, saved the IRS considerable audit time. Also, an additional limitation equal to 10% of adjusted gross income applies to the total of nonbusiness losses after reduction by the floor of $100 for each loss.

28Particularly in the case of nominal gifts among family members, taxpayer compliance in reporting and paying a tax on such transfers would be questionable. The absence of the $11,000 gift tax exclusion would create a serious enforcement problem for the IRS.

29A great deal of case law is devoted to ascertaining congressional intent. The courts, in effect, ask: What did Congress have in mind when it enacted a particular tax provision?

30The example assumes that Mrs. Greer has exhausted her unified tax credit. See Chapter 17.
questioning whether the taxpayers acted in an “arm’s length” manner. The question to be asked is: Would unrelated parties have handled the transaction in the same way?

The sole shareholder of a corporation leases property to the corporation for a monthly rental of $50,000. To test whether the corporation should be allowed a rent deduction for this amount, the IRS and the courts will apply the arm’s length concept. Would the corporation have paid $50,000 a month in rent if the same property had been leased from an unrelated party (rather than from the sole shareholder)?

The **continuity of interest concept** originated with the courts but has, in many situations, been incorporated into statutory provisions of the tax law. Primarily concerned with business readjustments, the concept permits tax-free treatment only if the taxpayer retains a substantial continuing interest in the property transferred to the new business. Due to the continuing interest retained, the transfer should not have tax consequences because the position of the taxpayer has not changed. This concept applies to transfers to controlled corporations (Chapter 3), corporate reorganizations (Chapter 7), and transfers to partnerships (Chapter 10). The continuity of interest concept helps explain the results reached in Examples 5 through 7 of this chapter. This concept is further discussed in Chapter 7.

Also developed by the courts, the **business purpose concept** principally applies to transactions involving corporations. Under this concept, some sound business reason that motivates the transaction must be present in order for the prescribed tax treatment to result. The avoidance of taxation is not considered to be a sound business purpose.

Beth and Charles are equal shareholders in Brown Corporation. They have recently disagreed about the company’s operations and are at an impasse about the future of Brown Corporation. This shareholder disagreement on corporate policy constitutes a sound business purpose and would justify a division of Brown Corporation that will permit Beth and Charles to go their separate ways. Whether the division of Brown would be nontaxable to the parties depends on their compliance with the statutory provisions dealing with corporate reorganizations. The point is, however, that compliance with statutory provisions would not be enough to ensure nontaxability without a business purpose for the transaction.

The business purpose concept is discussed further in Chapter 7.

**Judicial Influence on Statutory Provisions.** Some court decisions have been of such consequence that Congress has incorporated them into statutory tax law. An illustration of this influence appears in Example 16.

In 1983, Brad claimed a capital loss of $100,000 for Tan Corporation stock that had become worthless during the year. In the absence of any offsetting gains, the capital loss deduction produced no income tax savings for Brad either in 1983 or in future years. In 1986, Brad institutes a lawsuit against the former officers of Tan Corporation for their misconduct that resulted in the corporation’s failure and thereby led to Brad’s $100,000 loss. In settlement of the suit, the officers pay $50,000 to Brad. The IRS argued that the full $50,000 should be taxed as gain to Brad. The Tan stock was written off in 1983 and had a zero basis for tax purposes. The $50,000 recovery Brad received on the stock was, therefore, all gain. The IRS’s position was logical, but not equitable. The court stated that Brad should not be taxed on the recovery of an amount previously deducted unless the deduction produced a tax savings. Since the $100,000 capital loss deduction in 1983 produced no tax benefit, none of the $50,000 received in 1986 results in gain.

The decision reached by the courts in Example 16, known as the **tax benefit rule**, is part of the statutory tax law.
Court decisions sometimes create uncertainty about the tax law. Such decisions may reach the right result but do not produce the guidelines necessary to enable taxpayers to comply. In many situations, Congress may be compelled to add certainty to the law by enacting statutory provisions specifying when a particular tax consequence will or will not materialize. The following are examples of this type of judicial “cause” and the statutory “effect”:

- When a stock redemption will be treated as an exchange or as a dividend (see Chapter 5).
- What basis a parent corporation will have in the assets received from a subsidiary that is liquidated shortly after its acquisition (see Chapter 5).

Some of the statutory provisions can be explained by a negative reaction by Congress to a particular court decision. One decision, for example, held that the transfer of a liability to a controlled corporation should be treated as boot received by the transferor (see Chapter 3). Congress apparently disagreed with this treatment and promptly enacted legislation to change the result.

**SUMMARY**

In addition to its revenue-raising objective, the Federal tax law has developed in response to several other factors:

- **Economic considerations.** Here, the emphasis is on tax provisions that help regulate the economy and encourage certain activities and types of businesses.
- **Social considerations.** Some tax provisions are designed to encourage or discourage certain socially desirable or undesirable practices.
- **Equity considerations.** Of principal concern in this area are tax provisions that alleviate the effect of multiple taxation, recognize the wherewithal to pay concept, mitigate the effect of the annual accounting period concept, and recognize the eroding effect of inflation.
- **Political considerations.** Of significance in this regard are tax provisions that represent special interest legislation, reflect political expediency, and illustrate the effect of state law.
- **Influence of the IRS.** Many tax provisions are intended to aid the IRS in collecting revenue and administering the tax law.
- **Influence of the courts.** Court decisions have established a body of judicial concepts relating to tax law and have, on occasion, led Congress to enact statutory provisions that either clarify or negate their effect.

These factors explain various tax provisions and thereby help in understanding why the tax law developed to its present state. The next step involves learning to work with the tax law.

**Working with the Tax Law—Tax Sources**

Understanding taxation requires a mastery of the sources of tax law. These sources include not only the legislative provisions in the Internal Revenue Code, but also congressional Committee Reports, Regulations, Treasury Department pronouncements, and court decisions. Thus, the primary sources of tax information are the pronouncements of the three branches of government: legislative, executive, and judicial.

The law is of little significance, however, until it is applied to a set of facts and circumstances. A tax researcher must not only be able to read and interpret the
sources of the law but must also understand the relative weight of authority within the rules of law. Learning to work with the tax law involves three basic steps:

1. Familiarity with the sources of the law.
2. Application of research techniques.
3. Effective use of planning procedures.

The remainder of this chapter introduces the sources of tax law and explains how the law is applied to problems and conditions of individual and business transactions. Statutory, administrative, and judicial sources of the tax law are considered first.

**STATUTORY SOURCES OF THE TAX LAW**

**Origin of the Internal Revenue Code.** Before 1939, the statutory provisions relating to taxation were contained in the individual revenue acts enacted by Congress. The inconvenience and confusion that resulted from dealing with many separate acts led Congress to codify all of the Federal tax laws. Known as the Internal Revenue Code of 1939, the codification arranged all Federal tax provisions in a logical sequence and placed them in a separate part of the Federal statutes. A further rearrangement took place in 1954 and resulted in the Internal Revenue Code of 1954.

Perhaps to emphasize the magnitude of the changes made by the Tax Reform Act (TRA) of 1986, Congress redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986. This change is somewhat deceiving since the tax law was not recodified in 1986, as it had been in 1954. TRA of 1986 merely amended, deleted, or added provisions to the Internal Revenue Code of 1954. For example, before TRA of 1986, § 336 provided the general rule that no gain or loss would be recognized by a corporation when it distributed assets in kind to its shareholders in complete liquidation (see Chapter 5). After the effective date of TRA of 1986, § 336 provides that gain or loss will be recognized upon the same distributions.

The following observations will help clarify the significance of the three Codes:

- Neither the 1939, the 1954, nor the 1986 Code changed all of the tax law existing on the date of enactment. Much of the 1939 Code, for example, was incorporated into the 1954 Code. The same can be said for the transition from the 1954 to the 1986 Code. This point is important in assessing judicial and administrative decisions interpreting provisions under prior Codes. For example, a decision interpreting § 61 of the Internal Revenue Code of 1954 will have continuing validity since this provision carried over unchanged to the Internal Revenue Code of 1986.
- Statutory amendments to the tax law are integrated into the existing Code. Thus, the American Jobs Creation Act of 2004 became part of the Internal Revenue Code of 1986.

Do not conclude, however, that the codification and recodification process has made the Internal Revenue Code a simplistic body of laws. To a large extent, the complexity of our current Code can be attributed to its growth.

**The Legislative Process.** Federal tax legislation generally originates in the House of Representatives, where it is first considered by the House Ways and Means Committee. Tax bills originate in the Senate when they are attached as riders to other legislative proposals.\(^3\) If acceptable to the House Ways and Means

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\(^3\)The Tax Equity and Fiscal Responsibility Act of 1982 originated in the Senate; its constitutionality was unsuccessfully challenged in the courts. The Senate version of the Deficit Reduction Act of 1984 was attached as an amendment to the Federal Boat Safety Act.
Committee, the proposed bill is referred to the entire House of Representatives for approval or disapproval. Approved bills are sent to the Senate, where they are referred to the Senate Finance Committee for further consideration.

In the next step, the bill is referred from the Senate Finance Committee to the whole Senate. Assuming no disagreement between the House and the Senate, a bill passed by the Senate is referred to the President for approval or veto. If the bill is approved or if the President's veto is overridden, the bill becomes law and part of the Internal Revenue Code.

When the Senate version of the bill differs from that passed by the House, the Joint Conference Committee resolves these differences. The Joint Conference Committee includes members of the House Ways and Means Committee and the Senate Finance Committee.

Referrals from the House Ways and Means Committee, the Senate Finance Committee, and the Joint Conference Committee are usually accompanied by Committee Reports. These Committee Reports often explain the provisions of the proposed legislation and are therefore a valuable source in ascertaining the intent of Congress. What Congress has in mind when it considers and enacts tax legislation is, of course, the key to interpreting that legislation. Since Regulations normally are not issued immediately after a statute is enacted, taxpayers often look to Committee Reports to ascertain congressional intent.

The typical legislative process dealing with tax bills can be summarized as follows:
The role of the Joint Conference Committee indicates the importance of compromise in the legislative process. The practical effect of the compromise process can be illustrated by reviewing what happened in the Revenue Reconciliation Act (RRA) of 1993 (H.R. 2264) with respect to the amortization of acquired goodwill:

<table>
<thead>
<tr>
<th>House Version</th>
<th>Senate Version</th>
<th>Joint Conference Committee Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amortization of goodwill and other intangible assets over 14 years</td>
<td>Amortization of only 75% of goodwill and other intangible assets over 14 years</td>
<td>Straight-line amortization of goodwill and other intangible assets over 15 years</td>
</tr>
</tbody>
</table>

Some tax provisions are commonly referred to by the number the bill received in the House when first proposed or by the name of the member of Congress sponsoring the legislation. For example, the Self-Employed Individuals Tax Retirement Act of 1962 is popularly known as H.R. 10 (the House of Representatives Bill No. 10) or as the Keogh Act (Keogh being one of the members of Congress sponsoring the bill).

Arrangement of the Code. In working with the Code, it helps to understand the format. Note the following partial table of contents:

Subtitle A. Income Taxes
   Chapter 1. Normal Taxes and Surtaxes
     Subchapter A. Determination of Tax Liability
       Part I. Tax on Individuals
         Sections 1–5
       Part II. Tax on Corporations
         Sections 11–12

In referring to a provision of the Code, the key is usually the Section number. In citing Section 2(a) (dealing with the status of a surviving spouse), for example, it is unnecessary to include Subtitle A, Chapter 1, Subchapter A, Part I. Merely mentioning Section 2(a) will suffice since the Section numbers run consecutively and do not begin again with each new Subtitle, Chapter, Subchapter, or Part. Not all Code Section numbers are used, however. Note that Part I ends with Section 5 and Part II starts with Section 11 (at present there are no Sections 6, 7, 8, 9, and 10).32

Tax practitioners commonly refer to a specific area of income taxation by Subchapter designation. Some of the more common Subchapter designations include Subchapter C (Corporate Distributions and Adjustments), Subchapter K (Partners and Partnerships), and Subchapter S (Tax Treatment of S Corporations and Their Shareholders). Particularly in the last situation, it is much more convenient to describe the subject of the applicable Code provisions (Sections 1361 through 1379) as S corporation status rather than as the “Tax Treatment of S Corporations and Their Shareholders.”

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32When the 1954 Code was drafted, Section numbers were intentionally omitted. This omission provided flexibility to incorporate later changes into the Code without disrupting its organization. When Congress does not leave enough space, subsequent Code Sections are given A, B, C, etc., designations. A good example is the treatment of §§ 280A through 280H.
Citing the Code. Code Sections often are broken down into subparts. Section 2(a)(1)(A) serves as an example.

Broken down as to content, § 2(a)(1)(A) becomes:

Throughout this text, references to Code Sections are in the form just given. The symbols “§” and “§§” are used in place of “Section” and “Sections.” Unless otherwise stated, all Code references are to the Internal Revenue Code of 1986. The format followed in the remainder of the text is summarized as follows:

<table>
<thead>
<tr>
<th>Complete Reference</th>
<th>Text Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 2(a)(1)(A) of the Internal Revenue Code of 1986</td>
<td>§ 2(a)(1)(A)</td>
</tr>
<tr>
<td>Sections 1 and 2 of the Internal Revenue Code of 1986</td>
<td>§§ 1 and 2</td>
</tr>
<tr>
<td>Section 2 of the Internal Revenue Code of 1954</td>
<td>§ 2 of the Internal Revenue Code of 1954</td>
</tr>
<tr>
<td>Section 12(d) of the Internal Revenue Code of 1939</td>
<td>§ 12(d) of the Internal Revenue Code of 1939</td>
</tr>
</tbody>
</table>

Effect of Treaties. The United States signs certain tax treaties (sometimes called tax conventions) with foreign countries to render mutual assistance in tax enforcement and to avoid double taxation. The Technical and Miscellaneous Revenue Act of 1988 provided that neither a tax law nor a tax treaty takes general precedence.

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3Some Code Sections do not have subparts. See, for example, § 482.
4Some Code Sections omit the subsection designation and use, instead, the paragraph designation as the first subpart. See, for example, §§ 212(1) and 1221(1).
5Section 12(d) of the Internal Revenue Code of 1939 is the predecessor to § 2 of the Internal Revenue Code of 1954. Keep in mind that the 1954 Code superseded the 1939 Code.
**CHAPTER 1 Understanding and Working with the Federal Tax Law**

Thus, when there is a direct conflict, the most recent item will take precedence. More than 34 Sections of the Code contain direct references to treaties [e.g., § 245(a)(10)].

<table>
<thead>
<tr>
<th>GLOBAL TAX ISSUES</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PROTECTION AGAINST DOUBLE TAXATION</strong></td>
</tr>
</tbody>
</table>

In order to eliminate the double taxation that a taxpayer might incur if subject to tax in two countries, the United States has entered into treaties with most of the major countries of the world. Often there are multiple treaties with a country covering various tax issues. Treasury Publication 901 entitled “U.S. Tax Treaties” states that treaty provisions are generally reciprocal (apply to both treaty countries). Thus, a U.S. citizen or resident who receives income from a treaty country may refer to tables in this publication to see if a tax treaty might affect the tax to be paid to that foreign country. As part of the proof of entitlement to the treaty benefits, foreign countries sometimes require certification from the U.S. Government that an applicant files an income tax return as a U.S. citizen or resident.

Thus, when there is a direct conflict, the most recent item will take precedence. More than 34 Sections of the Code contain direct references to treaties [e.g., § 245(a)(10)].

| ADMINISTRATIVE SOURCES OF THE TAX LAW |

The administrative sources of the Federal tax law can be grouped as follows: Treasury Department Regulations, Revenue Rulings and Procedures, and various other administrative pronouncements. All are issued either by the U.S. Treasury Department or the IRS. The role played by the IRS in this process is considered in greater depth in Chapter 16.

**Treasury Department Regulations.** Regulations are issued by the U.S. Treasury Department under authority granted by Congress. Interpretative by nature, they provide taxpayers with considerable guidance on the meaning and application of the Code. Although not issued by Congress, Regulations do carry considerable weight. They are an important factor to consider in complying with the tax law. Anyone taking a position contrary to a finalized Regulation must disclose that fact on Form 8275 or Form 8275–R in order to avoid costly penalties.

Since Regulations interpret the Code, they are arranged in the same sequence. Regulations are, however, prefixed by a number that indicates the type of tax or administrative, procedural, or definitional matter to which they relate. For example, the prefix 1 designates the Regulations under the income tax law. Thus, the Regulations under Code § 2 would be cited as Reg. § 1.2, with subparts added for further identification. The numbering of these subparts often has no correlation with the Code subsections. The prefix 20 designates estate tax Regulations; 25 covers gift tax Regulations; 31 relates to employment taxes; and 301 refers to Regulations dealing with procedure and administration. This listing is not all-inclusive.

New Regulations and changes in existing Regulations usually are issued in proposed form before they are finalized. The time interval between the proposal of a Regulation and its finalization permits taxpayers and other interested parties to comment on the propriety of the proposal. Proposed Regulations under Code § 2, for example, would be cited as Prop.Reg. § 1.2.

Sometimes the Treasury Department issues Temporary Regulations relating to elections and other matters where immediate guidance is critical. Temporary Regulations often are needed for recent legislation that takes effect immediately. Temporary Regulations have the same authoritative value as final Regulations and may be cited as precedent for three years. Temporary Regulations also are issued as Proposed Regulations and automatically expire within three years after the date of issuance. Temporary Regulations and the simultaneously issued Proposed...
Regulations carry more weight than traditional Proposed Regulations. An example of a Temporary Regulation is Temp.Reg. § 1.861–9T(g)(3)(i), which clarifies single-category assets in terms of U.S.-source interest.

Proposed, final, and Temporary Regulations are published in the Federal Register and are reproduced in major tax services. Final Regulations are issued as Treasury Decisions (TDs).

Revenue Rulings and Revenue Procedures. Revenue Rulings are official pronouncements of the National Office of the IRS. Like Regulations, Revenue Rulings are designed to provide interpretation of the tax law. However, they do not carry the same legal force and effect as Regulations and usually deal with more restricted problems.

A Revenue Ruling often results from a specific taxpayer’s request for a letter ruling. If the IRS believes that a taxpayer’s request for a letter ruling deserves official publication due to its widespread impact, the holding will be converted into a Revenue Ruling. In making this conversion, names, identifying facts, and money amounts are changed to disguise the identity of the requesting taxpayer. The IRS then issues what would have been a letter ruling as a Revenue Ruling.

Revenue Procedures are issued in the same manner as Revenue Rulings, but deal with the internal management practices and procedures of the IRS. Familiarity with these procedures increases taxpayer compliance and helps make the administration of the tax laws more efficient. Revenue Procedures often involve mechanical rules, but sometimes substantive positions are embedded in them as well. Revenue Rulings and Revenue Procedures serve an important function in that they provide guidance to both IRS personnel and taxpayers in handling routine tax matters.

Both Revenue Rulings and Revenue Procedures are published weekly by the U.S. Government in the Internal Revenue Bulletin (I.R.B.). Semiannually, the bulletins for a six-month period are gathered together and published in a bound volume called the Cumulative Bulletin (C.B.). The proper form for citing Rulings and Procedures depends on whether the item has been published in the Cumulative Bulletin or is available in I.R.B. form. Consider, for example, the following transition:

Temporary Citation  

Permanent Citation  

Note that the page reference of 317 is the same for both the I.R.B. (temporary) and the C.B. (permanent) versions of the Ruling. The IRS numbers the pages of the I.R.B.'s consecutively for each six-month period to facilitate their conversion to C.B. form.

Revenue Procedures are cited in the same manner, except that “Rev.Proc.” is substituted for “Rev.Rul.” Procedures, like Rulings, are published in the Internal Revenue Bulletin (the temporary source) and later transferred to the Cumulative Bulletin (the permanent source).

*Usually, only two volumes of the Cumulative Bulletin are published each year. However, when major tax legislation has been enacted by Congress, other volumes may be published containing the congressional Committee Reports supporting the Revenue Act. See, for example, the two extra volumes for 1984 dealing with the Deficit Reduction Act of 1984. The 1984–3 Cumulative Bulletin, Volume 1, contains the text of the law itself; 1984–3, Volume 2, contains the Committee Reports. There are a total of four volumes of the Cumulative Bulletin for 1984: 1984–1; 1984–2; 1984–3, Volume 1; and 1984–3, Volume 2.
Other Administrative Pronouncements. Treasury Decisions (TDs) are issued by the Treasury Department to promulgate new Regulations, to amend or otherwise change existing Regulations, or to announce the position of the Government on selected court decisions. Like Revenue Rulings and Revenue Procedures, TDs are published in the Internal Revenue Bulletin and subsequently transferred to the Cumulative Bulletin.

Technical Information Releases (TIRs) are usually issued to announce the publication of various IRS pronouncements (e.g., Revenue Rulings, Revenue Procedures).

Letter rulings are issued for a fee by the National Office of the IRS upon a taxpayer’s request and describe how the IRS will treat a proposed transaction for tax purposes. In general, they apply only to the taxpayer who asks for and obtains the ruling, but post-1984 rulings may be substantial authority for purposes of avoiding the accuracy-related penalties.37 This procedure may sound like the only real way to carry out effective tax planning. However, the IRS limits the issuance of letter rulings to restricted, preannounced areas of taxation. Thus, a ruling may not be obtained on many of the problems that are particularly troublesome for taxpayers.38 For example, the IRS will not issue a ruling as to whether compensation paid to shareholder-employees is reasonable (see Chapter 4) or whether § 269 applies (the acquisition of a corporation to evade or avoid income tax [see Chapter 7]). The main reason the IRS will not rule on such matters is that they involve fact-oriented situations.

The IRS must make letter rulings available for public inspection after identifying details are deleted. Published digests of private letter rulings can be found in Private Letter Rulings (published by Research Institute of America), BNA Daily Tax Reports, and Tax Analysts & Advocates Tax Notes. IRS Letter Rulings Reports (published by Commerce Clearing House) contains both digests and full texts of all letter rulings. Letter Ruling Review (Tax Analysts), a monthly publication, selects and discusses the more important of the approximately 200 letter rulings per month.

The National Office of the IRS releases technical advice memoranda (TAMs) weekly. TAMs resemble letter rulings in that they give the IRS’s determination of an issue. Letter rulings, however, are responses to requests by taxpayers, whereas TAMs are issued by the National Office of the IRS in response to questions raised by taxpayers or IRS field personnel during audits. TAMs deal with completed rather than proposed transactions and are often requested for questions relating to exempt organizations and employee plans. Although TAMs are not officially published and may not be cited or used as precedent, post-1984 TAMs may be substantial authority for purposes of the accuracy-related penalties. See Chapter 16 for a discussion of these penalties.

Both letter rulings and TAMs are issued with multidigit file numbers. Consider, for example, Ltr.Rul. 200432002, which under certain circumstances waives the 60-day rollover deadline for a § 401(k) retirement plan that was distributed. Broken down by digits, the file number reveals the following information:

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Ltr.Rul. 2004 32 002
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- 2004 was year of issuance
- 2004 was the 2nd ruling issued during the 32nd week

Letter rulings and TAMs issued before 2000 are often cited with only two-digit years (e.g., Ltr.Rul. 9933108).

Like letter rulings, determination letters are issued at the request of taxpayers and provide guidance concerning the application of the tax law. They differ from individual rulings in that the issuing source is the Area Director rather than the National Office of the IRS. Also, determination letters usually involve completed (as opposed to proposed) transactions. Determination letters are not published and are made known only to the party making the request.

The following examples illustrate the distinction between individual rulings and determination letters:

**EXAMPLE 17**
The shareholders of Black Corporation and White Corporation want assurance that the consolidation of the corporations into Gray Corporation will be a nontaxable reorganization (see Chapter 7). The proper approach is to request from the National Office of the IRS an individual ruling concerning the income tax effect of the proposed transaction.

**EXAMPLE 18**
Gilbert operates a barber shop in which he employs eight barbers. To comply with the rules governing income tax and payroll tax withholdings, Gilbert wants to know whether the barbers working for him are employees or independent contractors. The proper procedure is to request a determination letter on the status of the barbers from the Area Director in Holtsville, New York, or Newport, Vermont, depending on the location of the requesting firm.

**JUDICIAL SOURCES OF THE TAX LAW**

The Judicial Process in General. After a taxpayer has exhausted some or all of the remedies available within the IRS (no satisfactory settlement has been reached at the agent or at the conference level discussed in Chapter 16), the dispute can be taken to the Federal courts. The dispute is first considered by a court of original jurisdiction (known as a trial court) with any appeal (either by the taxpayer or the IRS) taken to the appropriate appellate court. In most situations, the taxpayer has a choice of any of four trial courts: a Federal District Court, the U.S. Court of Federal Claims, the Tax Court, or the Small Cases Division of the Tax Court. The trial and appellate court system for Federal tax litigation is illustrated in Figure 1–1.
The broken line between the Tax Court and the Small Cases Division indicates that there is no appeal from the Small Cases Division. Currently, the jurisdiction of the Small Cases Division of the Tax Court is limited to $50,000 or less. The proceedings of the Small Cases Division are informal, and its decisions are not precedents for any other court decision and are not reviewable by any higher court. Proceedings can be more timely and less expensive in the Small Cases Division. Some of these cases can now be found on the U.S. Tax Court Internet site.

American law, following English law, is frequently made by judicial decisions. Under the doctrine of *stare decisis*, each case (except in the Small Cases Division) has precedential value for future cases with the same controlling set of facts. Judges are not required to follow judicial precedent beyond their own jurisdiction. For example, the decisions of an appellate court are binding only on the trial courts within its jurisdiction and not on other trial courts. Different appellate courts may reach different opinions about the same issue. Further, the doctrine of precedential authority requires a court to follow prior cases only where the issues and material facts of the current case are essentially the same as those involved in the prior decisions.

Most Federal and state appellate court decisions and some decisions of trial courts are published. More than 4 million judicial opinions have been published in the United States; over 130,000 cases are published each year. Published court decisions are organized by jurisdiction (Federal or state) and level of court (appellate or trial).

**Trial Courts.** The differences between the various trial courts (courts of original jurisdiction) can be summarized as follows:

- There is only one Court of Federal Claims and only one Tax Court, but there are many Federal District Courts. The taxpayer does not select the District Court that will hear the dispute but must sue in the one that has jurisdiction.
- The U.S. Court of Federal Claims has jurisdiction over any claim against the United States that is based on the Constitution, any Act of Congress, or any regulation of an executive department.
- Each District Court has only one judge, the Court of Federal Claims has 16 judges, and the Tax Court has 19 regular judges. In the case of the Tax Court, the whole court will review a case (the case is sent to court conference) only when more important or novel tax issues are involved. Many cases will be heard and decided by one of the 19 regular judges. If a case is reviewed by the full Tax Court, such an *en banc* decision has compelling authority.
- The Court of Federal Claims meets most often in Washington, D.C., while a District Court meets at a prescribed seat for the particular district. Since each state has at least one District Court and many of the populous states have more, the inconvenience and expense of traveling for the taxpayer and counsel (present with many suits in the Court of Federal Claims) are largely eliminated. The Tax Court is officially based in Washington, D.C., but the various judges travel to different parts of the country and hear cases at predetermined locations and dates. This procedure eases the distance problem for the taxpayer, but it can mean a delay before the case comes to trial and is decided.
- The Tax Court hears only tax cases; the Court of Federal Claims and District Courts hear nontax litigation as well. This difference, as well as the fact that many Tax Court justices have been appointed from IRS or Treasury

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Department positions, has led some to conclude that the Tax Court has more expertise in tax matters.

- The only court in which a taxpayer can obtain a jury trial is a District Court. Juries can decide only questions of fact and not questions of law, however. Therefore, taxpayers who choose the District Court route often do not request a jury trial. In this event, the judge will decide all issues. Note that a District Court decision is controlling only in the district in which the court has jurisdiction.

- Before the Court of Federal Claims or a District Court can have jurisdiction, the taxpayer must pay the tax deficiency assessed by the IRS and then sue for a refund. If the taxpayer wins (assuming no successful appeal by the IRS), the tax paid plus appropriate interest will be recovered. Jurisdiction in the Tax Court, however, is usually obtained without first paying the assessed tax deficiency. In the event the taxpayer loses in the Tax Court (and no appeal is taken or any appeal is unsuccessful), the deficiency must be paid with accrued interest.

- Appeals from a District Court or a Tax Court decision are to the appropriate U.S. Court of Appeals. Appeals from the Court of Federal Claims go to the Court of Appeals for the Federal Circuit.

- Special trial judges hear small tax cases and write summary opinions. The IRS’s deficiency recovery rate is higher here than in regular Tax Court decisions. Beginning in 2001, these summary opinions are now posted on the U.S. Tax Court’s Internet site; regular decisions have been posted there since 1995.

Some of the characteristics of the judicial system described above are summarized in Concept Summary 1–1.

**Appellate Courts.** An appeal from a trial court goes to the U.S. Court of Appeals of appropriate jurisdiction. Generally, a three-judge panel hears a Court of Appeals case, but occasionally the full court will decide more controversial conflicts. A jury trial is not available.

Figure 1–2 shows the geographic area within the jurisdiction of each Federal Court of Appeals.

If the IRS loses at the trial court level (District Court, Tax Court, or Court of Federal Claims), it need not (and frequently does not) appeal. The fact that an
appeal is not made, however, does not indicate that the IRS agrees with the result and will not litigate similar issues in the future.

The IRS may decide not to appeal for a number of reasons. First, the current litigation load may be heavy. As a consequence, the IRS may decide that available personnel should be assigned to other, more important cases. Second, the IRS may determine that this is not a good case to appeal. For example, the taxpayer may be in a sympathetic position, or the facts may be particularly strong in his or her favor. In such event, the IRS may wait to test the legal issues involved with a taxpayer who has a much weaker case. Third, if the appeal is from a District Court or the Tax Court, the Court of Appeals of jurisdiction could have some bearing on whether the IRS decides to pursue an appeal. Based on past experience and precedent, the IRS may conclude that the chance for success on a particular issue might be more promising in another Court of Appeals. The IRS will wait for a similar case to arise in a different jurisdiction.

**FIGURE 1–2**
The Federal Courts of Appeals

The IRS loses a tax case against a prominent citizen in the U.S. District Court of Iowa. The taxpayer, a minister, had set up three separate trusts for each of his three children (i.e., a total of nine trusts). The IRS argued that under Reg. § 1.641(a)-(c) these trusts should be consolidated and treated as three trusts to stop the taxpayer from mitigating the progressive tax structure (e.g., the 35 percent top tax bracket).
The IRS has decided to appeal a case in the multiple trust area. As one of the IRS's attorneys, you must choose between the Iowa case and a similar multiple trust conflict in the U.S. District Court of Virginia. Here the taxpayer is a CPA who has established two different trusts for her two children (i.e., a total of four trusts). [See Estelle Morris Trusts, 51 T.C. 20 (1968).] In making your decision, you note that potentially more sympathy may be associated with the minister's profession than with the CPAs. Other considerations are the facts indicating that the attempt at tax avoidance is more egregious in the Iowa case and a colleague's opinion that the Virginia case is winnable. Which case will you select? Comment on whether it is fair for the IRS to select a case to appeal in this fashion.

Gene lives in Texas and sues in the Tax Court on Issue A. The Fifth Circuit Court of Appeals, the appellate court of appropriate jurisdiction, has already decided, in a case involving similar facts but a different taxpayer, that Issue A should be resolved against the IRS. Although the Tax Court feels that the Fifth Circuit Court of Appeals is wrong, under the Golsen rule, it will render judgment for Gene. Shortly thereafter, Beth, a resident of New York, in a comparable case, sues in the Tax Court on Issue A. Assume that the Second Circuit Court of Appeals, the appellate court of appropriate jurisdiction, has never expressed itself on Issue A. Presuming the Tax Court has not reconsidered its position on Issue A, it will decide against Beth. Thus, it is entirely possible for two taxpayers suing in the same court to end up with opposite results merely because they live in different parts of the country.

Appeal to the U.S. Supreme Court is by Writ of Certiorari. If the Court agrees to hear the case, it will grant the Writ (cert. granted). Most often, it will deny jurisdiction (cert. denied). For whatever reason or reasons, the Supreme Court rarely hears tax cases. The Court usually grants certiorari to resolve a conflict among the Courts of Appeals (e.g., two or more appellate courts have assumed opposing positions on a particular issue) or when the tax issue is extremely important. The granting of a Writ of Certiorari indicates that at least four members of the Supreme Court believe that the issue is of sufficient importance to be heard by the full Court.

The role of appellate courts is limited to a review of the trial record compiled by the trial courts. Thus, the appellate process usually involves a determination of

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*Jack E. Golsen, 54 T.C. 742 (1970); see also John A. Lardas, 99 T.C. 490 (1992).*
whether the trial court applied the proper law in arriving at its decision. Usually, an appellate court will not dispute a lower court’s fact-finding determination.

An appeal can have any of a number of possible outcomes. The appellate court may approve (affirm) or disapprove (reverse) the lower court’s finding, and it may also send the case back for further consideration (remand). When many issues are involved, it is not unusual to encounter a mixed result. Thus, the lower court may be affirmed (aff’d) on Issue A and reversed (rev’d) on Issue B, while Issue C is remanded (rem’d) for additional fact finding.

When more than one judge is involved in the decision-making process, disagreement is not uncommon. In addition to the majority view, one or more judges may concur (agree with the result reached but not with some or all of the reasoning) or dissent (disagree with the result). In any one case, the majority view controls. But concurring and dissenting views can have influence on other courts or, at some subsequent date when the composition of the court has changed, even on the same court.

Judicial Citations—General. Having briefly described the judicial process, it is appropriate to consider the more practical problem of the relationship of case law to tax research. As previously noted, court decisions are an important source of tax law. The ability to cite a case and to locate it is therefore a must in working with the tax law. The usual pattern for a judicial citation is as follows: case name, volume number, reporter series, page or paragraph number, and court (where necessary).

Judicial Citations—The U.S. Tax Court. A good starting point is the U.S. Tax Court. The Tax Court issues three types of decisions: Regular decisions, Memorandum decisions, and summary opinions. They differ in both substance and form. In terms of substance, Memorandum decisions deal with situations necessitating only the application of already established principles of law. Regular decisions involve novel issues not previously resolved by the Tax Court. In actual practice, this distinction is not always preserved. Not infrequently, Memorandum decisions will be encountered that appear to warrant Regular status and vice versa. At any rate, do not conclude that Memorandum decisions possess no value as precedents. Both Memorandum and Regular decisions represent the position of the Tax Court and, as such, can be relied upon. Summary opinions, on the other hand, are issued in small tax cases and may not be used as precedent in any other case.

Regular decisions are published by the U.S. Government in a series called Tax Court of the United States Reports (T.C.). Each volume of these reports covers a six-month period (January 1 through June 30 and July 1 through December 31) and is given a succeeding volume number. But, as was true of the Cumulative Bulletin, there is usually a time lag between the date a decision is rendered and the date it appears in bound form. A temporary citation may be necessary to help the researcher locate a recent Regular decision. Consider, for example, the temporary and permanent citations for Ismat M. Abeid, a decision filed on June 29, 2004:

Temporary Citation


Explanation: Page number left blank because not yet known.

Permanent Citation


Explanation: Page number now available.
Both citations tell us that the case ultimately will appear in Volume 122 of the \emph{Tax Court of the United States Reports}. But until this volume is bound and made available to the general public, the page number must be left blank. Instead, the temporary citation identifies the case as being the 24th Regular decision issued by the Tax Court since Volume 121 ended. With this information, the decision can be easily located in either of the special Tax Court services published by Commerce Clearing House (CCH) and by Research Institute of America (RIA—formerly by Prentice-Hall [P-H]). Once Volume 122 is released, the permanent citation can be substituted and the number of the case dropped. Starting in 1995, both Regular and Memorandum decisions are issued on the U.S. Tax Court Web site (\url{http://www.ustaxcourt.gov}).

Before 1943, the Tax Court was called the Board of Tax Appeals, and its decisions were published as the \emph{United States Board of Tax Appeals Reports} (B.T.A.). These 47 volumes cover the period from 1924 to 1942. For example, the citation \emph{Karl Pauli} \textit{11 B.T.A. 784 (1928)} refers to the 11th volume of the \emph{Board of Tax Appeals Reports}, page 784, issued in 1928.

Memorandum decisions are published by CCH and by RIA (formerly by P-H). Consider, for example, the three different ways that \emph{Walter H. Johnson} can be cited:

\begin{itemize}
  \item \emph{Walter H. Johnson}, T.C.Memo. 1975–245
  \item \emph{Walter H. Johnson}, 34 TCM 1056
  \item \textit{Walter H. Johnson}, P-H T.C.Mem.Dec. ¶75,245
\end{itemize}

Paragraph 75,245 of the P-H T.C. Memorandum Decisions.

Note that the third citation contains the same information as the first. Thus, ¶75,245 indicates the following information about the case: year 1975, 245th T.C.Memo. decision.41

Summary opinions are cited as in the following example for \emph{Edward C. Jones}, issued on May 27, 2003.

\begin{itemize}
  \item \emph{Edward C. Jones}, T.C. Summary Opinion 2003–61.
\end{itemize}

Starting in 2001, summary opinions are issued on the U.S Tax Court Web site.

\textbf{Judicial Citations—The U.S. District Courts, Claims Court, and Courts of Appeals.} District Court, Claims Court (now Court of Federal Claims), Court of Appeals, and Supreme Court decisions dealing with Federal tax matters are reported in both the CCH \emph{U.S. Tax Cases} (USTC) and the RIA (formerly P-H) \emph{American Federal Tax Reports} (AFTR) series.

Federal District Court decisions, dealing with both tax and nontax issues, are also published by West Publishing Company in its \emph{Federal Supplement 2d} (F.Supp.2d) series. This series follows the \emph{Federal Supplement} (F.Supp.) series, which concluded in 1998 with Volume 999. The following examples illustrate how a District Court case can be cited in three different forms:

\begin{itemize}
  \item \textit{Explanation:} Reported in the first volume of the \emph{U.S. Tax Cases} (USTC) published by Commerce Clearing House for calendar year 1973 (73–1) and located at paragraph 9279 (¶9279).
\end{itemize}

\footnote{In this text, the Research Institute of America (RIA) citation for Memorandum decisions of the U.S. Tax Court is omitted. Thus, \emph{Walter H. Johnson} would be cited as: 34 TCM 1056, T.C.Memo. 1975–245.}
Explanation: Reported in the 31st volume of the second series of the American Federal Tax Reports (AFTR2d) published by Prentice-Hall (now RIA) and beginning on page 640. The “73” preceding the page number indicates the year the case was published but is a designation used only in recent decisions.


In all of the preceding citations, note that the name of the case is the same (Simons-Eastern Co. being the taxpayer), as is the reference to the Federal District Court of Georgia (D.Ct.Ga.,) and the year the decision was rendered (1972).42

Beginning in October of 1982, decisions of the Claims Court are reported by West Publishing Company in a series designated Federal Claims Reporter. Thus, the Claims Court decision in Recchie v. U.S. appears as follows:

Recchie v. U.S.,
83–1 USTC ¶9312 (CCH citation)
51 AFTR2d 83–1010 (P-H citation)
1 Cl.Ct. 726 (West citation)

Beginning on October 30, 1992, the Claims Court underwent a further name change. The new designation, U.S. Court of Federal Claims, began with Volume 27 of the former Cl.Ct. (West citation), now abbreviated as Fed.Cl.

Decisions of the Courts of Appeals are published in a West Publishing Company reporter designated as the Federal Third (F.3d) series, which began in October 1993, at the conclusion of the Federal Second (F.2d) series. Illustrations of the different forms follow:

Sterling Distributors, Inc. v. U.S.,
63–1 USTC ¶9288 (CCH citation)
1 AFTR2d 767 (P-H citation)
313 F.2d 803 (West citation)

Apollo Computer, Inc. v. U.S.,
95–1 USTC ¶50,015 (CCH citation)
74 AFTR2d 94–7172 (P-H citation)
32 Fed.Cl. 334 (West citation)

Note that Sterling Distributors, Inc. v. U.S. is a decision rendered by the Fifth Circuit Court of Appeals in 1963 (CA–5, 1963) while Apollo Computer, Inc. v. U.S. was rendered in 1994 by the U.S. Court of Federal Claims.

If the IRS loses in a decision, it may indicate whether it agrees or disagrees with the results reached by the court by publishing an acquiescence (“A” or “Acq.”) or nonacquiescence (“NA” or “Nonacq.”), respectively. The acquiescence or nonacquiescence is published in the Internal Revenue Bulletin and the Cumulative Bulletin as an Action on Decision. The IRS can retroactively revoke an acquiescence or nonacquiescence. Originally, acquiescences and nonacquiescences were published

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only for Regular U.S. Tax Court decisions, but since 1991 the IRS has expanded its acquiescence program to include other civil tax cases where guidance is helpful.

Judicial Citations—The U.S. Supreme Court. Like all other Federal tax cases (except those rendered by the U.S. Tax Court), Supreme Court decisions are published by Commerce Clearing House in the USTCs and by Research Institute of America (formerly P-H) in the AFTRs. The U.S. Government Printing Office also publishes these decisions in the United States Supreme Court Reports (U.S.) as does West Publishing Company in its Supreme Court Reporter (S.Ct.) and the Lawyer’s Co-operative Publishing Company in its United States Reports, Lawyer’s Edition (L.Ed.). The following illustrates the different ways the same decision can be cited:

\[
\begin{align*}
\text{U.S. v. The Donruss Co.,} & \quad \text{(USSC, 1969)} \\
69–1 \text{USTC} \ 19167 \ (\text{CCH citation}) & \quad 89 \text{S.Ct.} \ 501 \ (\text{West citation}) \\
23 \text{AFTR}2d \ 69–418 \ (\text{P-H citation}) & \quad 393 \text{U.S.} \ 297 \ (\text{U.S. Government Printing Office citation}) \\
393 \text{U.S.} \ 297 \ (\text{U.S. Government Printing Office citation}) & \quad 21 \text{L.Ed.}2d \ 495 \ (\text{Lawyer’s Co-operative Publishing Co. citation})
\end{align*}
\]

The parenthetical reference (USSC, 1969) identifies the decision as having been rendered by the U.S. Supreme Court in 1969. The citations given in this text for Supreme Court decisions will be limited to the CCH (USTC), the RIA or P-H for older volumes (AFTR), and the West (S.Ct.) versions.

Working with the Tax Law—Tax Research

Tax research is the method used to determine the best available solution to a situation that possesses tax consequences. In other words, it is the process of finding a competent and professional conclusion to a tax problem. The problem may originate from either completed or proposed transactions. In the case of a completed transaction, the objective of the research is to determine the tax result of what has already taken place. For example, is the expenditure incurred by the taxpayer deductible or not deductible for tax purposes? When dealing with proposed transactions, the tax research process is concerned with the determination of possible alternative tax consequences. To the extent that tax research leads to a choice of alternatives or otherwise influences the future actions of the taxpayer, it becomes the key to effective tax planning.

Tax research involves the following procedures:

- Identifying and refining the problem.
- Locating the appropriate tax law sources.
- Assessing the validity of the tax law sources.
- Arriving at the solution or at alternative solutions while giving due consideration to nontax factors.
- Effectively communicating the solution to the taxpayer or the taxpayer’s representative.
- Following up on the solution (where appropriate) in light of new developments.

This process is depicted schematically in Figure 1–3. The broken lines indicate steps of particular interest when tax research is directed toward proposed, rather than completed, transactions.
IDENTIFYING THE PROBLEM

Problem identification starts with a compilation of the relevant facts involved. In this regard, all of the facts that might have a bearing on the problem must be gathered as any omission could modify the solution reached. To illustrate, consider what appears to be a very simple problem.

Dana Pehrson advances $52,000 to her nephew in 1998 to enable him to attend a private college. Seven years later, she claims a bad debt deduction for $42,000 that the nephew has not repaid. The problem: Is Dana entitled to a bad debt deduction?

Refining the Problem. Before a bad debt deduction can arise, it must be established that a debt really existed. In a related-party setting (e.g., aunt and nephew), the IRS may contend that the original advance was not a loan but, in reality, a gift. Of key significance in this regard would be whether the lender (the aunt) had an honest and real expectation of payment by the borrower (the nephew). Indicative of this repayment expectation is whether the parties preserved the formalities of a loan, including the following:

- The borrower issued a written instrument evidencing the obligation.
- Interest was provided for as part of the loan arrangement.
- The note specified a set due date.
- Collateral was available to the lender in the event of default by the borrower.

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EXAMPLE 20

Dana Pehrson advances $52,000 to her nephew in 1998 to enable him to attend a private college. Seven years later, she claims a bad debt deduction for $42,000 that the nephew has not repaid. The problem: Is Dana entitled to a bad debt deduction?

Refining the Problem. Before a bad debt deduction can arise, it must be established that a debt really existed. In a related-party setting (e.g., aunt and nephew), the IRS may contend that the original advance was not a loan but, in reality, a gift. Of key significance in this regard would be whether the lender (the aunt) had an honest and real expectation of payment by the borrower (the nephew). Indicative of this repayment expectation is whether the parties preserved the formalities of a loan, including the following:

- The borrower issued a written instrument evidencing the obligation.
- Interest was provided for as part of the loan arrangement.
- The note specified a set due date.
- Collateral was available to the lender in the event of default by the borrower.

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W. Mercil, 24 T.C. 1150 (1955), and Evans Clark, 18 T.C. 780 (1952), aff’d 53-2 USTC ¶9452, 44 AFTR 70, 205 F.2d 353 (CA-2, 1953).

The presence of some or all of these formalities does not, however, guarantee that a bona fide loan will be found. By the same token, the absence of some or all of the formalities does not make the advance a gift. Applying the formalities criteria to Example 20 is not possible since key facts (e.g., the presence or absence of a written note) are not given. Nevertheless, several inferences might be made that lead to a loan interpretation:

- It appears that the nephew has repaid at least $10,000 of the $52,000 that he borrowed. If the parties intended a gift of the full amount of the loan, why was partial repayment made?
- Although one would not expect a nephew on his way to college to have assets to serve as collateral for a loan, the fact that he was obtaining additional education could reinforce any expectation of repayment. In most situations, a person with a college education will possess a higher earning potential than one without such education. This education would improve the nephew’s financial ability to repay the loan.

Further Refinement of the Problem. It may be impossible to determine whether the advance constitutes a loan or a gift with any degree of certainty. In either event, however, the tax consequences of each possibility must be ascertained.

If the advance is determined to be a gift, it is subject to the Federal gift tax.\footnote{The transfer does not come within the unlimited gift tax exclusion of § 2503(e)(2)(A) since the aunt did not pay the amount directly to an educational institution. Besides, the exclusion covers only tuition payments and not other costs attendant on going to college (e.g., room and board).}

Whether or not a gift tax results depends upon how much of the unified tax credit the aunt has available to absorb the gift tax on $42,000 \([52,000 \text{ (total gift)} − 10,000 \text{ (annual exclusion in 1998)}]\).\footnote{The tax, in turn, depends upon the amount of taxable gifts the aunt has made in the past. For a discussion of the mechanics of the Federal gift tax, see Chapter 17.} Whether the transfer results in a gift tax or not, it must be reported on Form 709 (United States Gift Tax Return) since the amount of the gift exceeds the annual exclusion.

Even if it is assumed that Dana made a gift to her nephew in 1998, does not the intervention of seven years preclude the IRS from assessing any gift tax that might be due as a result of the transfer?\footnote{Throughout the discussion of Example 20, the assumption has been made that if a gift occurred, it took place in 1998. That assumption need not be the case. Depending upon the aunt’s intent, she could have decided to make a gift of the unpaid balance anytime after the loan was made (e.g., 1999, 2000, etc.).}

To complete the picture, what are the tax consequences if the advance is treated as a loan? Aside from the bad debt deduction aspects (covered later in the chapter), the tax law provides more immediate tax ramifications:\footnote{\textsection 6501(c)(3) and the discussion of the statute of limitations in Chapter 16.}

- If interest is not provided for, it is imputed with the following effect:
  - a. The lender (the aunt) must recognize interest income as to the imputed value.
  - b. Since the lender has not received the interest, she is deemed to have made a gift of the interest to the borrower.
  - c. The borrower (nephew) may be entitled to deduct (as an itemized expense) in some tax years a portion of the amount of interest deemed paid to the lender (aunt).
- If interest is provided for but the rate is lower than market (as determined by the yield on certain U.S. government securities), the differential is treated as noted above.

\footnote{\textsection 7872.}
• For gift loans of $100,000 or less, the imputed element cannot exceed the net investment income of the borrower.

LOCATING THE APPROPRIATE TAX LAW SOURCES

Once the problem is clearly defined, what is the next step? Although the next step is a matter of individual judgment, most tax research begins with the index volume of the tax service or a keyword search on an online tax service (see subsequent discussion of Electronic Tax Research). If the problem is not complex, the researcher may bypass the tax service and turn directly to the Internal Revenue Code and the Treasury Regulations. For the beginner, this latter procedure saves time and will solve many of the more basic problems. If the researcher does not have a personal copy of the Code or Regulations, resorting to the appropriate volume(s) of a tax service or a CD-ROM may be necessary. Several of the major tax services publish paperback editions of the Code and Treasury Regulations that can be purchased at modest prices. These editions are usually revised twice each year.

Tax services are either annotated or topical. The two major annotated services are organized by Internal Revenue Code Sections, whereas most of the services are organized by major topics. The following major services are available:

- *Federal Tax Coordinator 2d*, Research Institute of America. (topical)
- *Tax Management Portfolios*, Bureau of National Affairs. (topical)
- *CCH’s Federal Tax Service*, Commerce Clearing House. (topical)
- *Analysis of Federal Taxes: Income*, Research Institute of America. (topical)

Working with the Tax Services. In this text, it is not feasible to teach the use of any particular tax service because this knowledge can be obtained only by practice. The representatives of the various tax services provide users with printed booklets and individual instruction on the use of the services. However, several important observations about the use of tax services cannot be overemphasized. First, always check for current developments. The main text of any service is revised too infrequently to permit reliance on that portion as the *latest* word on any subject. Where such current developments can be found depends on which service is being used. The CCH service contains a special volume devoted to current matters. Second, when dealing with a tax service synopsis of a Treasury Department pronouncement or a judicial decision, remember there is no substitute for the original source.

To illustrate, do not base a conclusion solely on a tax service’s commentary on *Simons-Eastern Co. v. U.S.*50 If the case is vital to the research, look it up. The facts of the decision may be distinguishable from those in the problem being researched. This is not to say that the case synopsis contained in the tax service is wrong; it might just be misleading or incomplete.

50Cited in Footnote 42.
Citators help researchers learn the history of tax decisions and Revenue Rulings and evaluate the strengths of their holdings. The three major multivolume citators are the RIA Citator 2nd Series, the CCH Citator, and Shepard’s Federal Tax Citations. Computerized citators can be found in WESTLAW (KeyCite) and LEXIS (Auto-Cite and Shepard’s). The RIA and CCH Citators are available through their computerized tax services. The last section of this chapter describes the use of the RIA Citator.

**Tax Periodicals.** The various tax periodicals provide additional sources of tax information. The easiest way to locate a journal article on a particular tax problem is through Federal Tax Articles (CCH) or Index to Federal Tax Articles (Warren, Gorham and Lamont). CCH’s six-volume service includes a subject index, a Code Section number index, and an author’s index. In addition, the RIA tax service has a topical “Index to Tax Articles” section that is organized using that service’s paragraph index system. Also, beginning in 1992, The Accounting & Tax Index is available in three quarterly issues plus a cumulative year-end volume covering all four quarters. The original Accountant’s Index started in 1921 and ended in 1991.

The following are some of the more useful tax periodicals:

- The Journal of Taxation
- Tax Law Review
- Taxation for Accountants
- Journal of Corporate Taxation
- Estate Planning
- Journal of Partnership Taxation
- Warren, Gorham and Lamont
- 395 Hudson Street
- 4th Floor
- New York, NY 10014

- The Tax Executive
- 1200 G Street NW
- Suite 300
- Washington, DC 20005

- The Practical Accountant
- One State Street Plaza
- New York, NY 10004

- Trusts and Estates
- 249 W. 17th Street
- New York, NY 10011

- TAXES—The Tax Magazine
- CCH, Inc.
- 2700 Lake Cook Road
- Riverwood, IL 60015

- National Tax Journal
- 725 15th Street NW
- Suite 600
- Washington, DC 20005

- The Tax Adviser
- Harborside Financial Center
- 201 Plaza 111
- Jersey City, NJ 07311-3881

- The Tax Lawyer
- American Bar Association
- 750 N. Lake Shore Drive
- Chicago, IL 60611

- Journal of the American Taxation
- Association
- American Accounting Association
- 5717 Bessie Drive
- Sarasota, FL 33583

- Oil, Gas & Energy Quarterly
- Matthew Bender & Co.
- 1275 Broadway
- Albany, NY 12204

- The International Tax Journal
- Aspen Publishing, Inc.
- 1185 Avenue of the Americas
- New York, NY 10036

- Tax Notes
- Tax Analysts
- 6830 Fairfax Drive
- Arlington, VA 22213

**ASSESSING THE VALIDITY OF TAX LAW SOURCES**

After a source has been located, the next step is to assess the source in light of the problem at hand. Proper assessment involves careful interpretation of the tax law and consideration of the law’s relevance and validity.
Interpreting the Internal Revenue Code. The language of the Code often is extremely difficult to comprehend. For example, a subsection [§ 341(e)] relating to collapsible corporations contains one sentence of more than 450 words (twice as many as in the Gettysburg Address). Within this same subsection is another sentence of 300 words.

The Code must be read carefully for restrictive language such as “at least 80 percent” and “more than 80 percent” or “less than 50 percent” and “exceeds 50 percent.” It also makes a great deal of difference, for example, whether two or more clauses are connected by “or” or by “and.”

If an answer is not in the Code, it may be necessary to resort to the Regulations and judicial decisions. In 1969, Congress directed the Treasury Department to promulgate Regulations under § 385 to distinguish corporate debt from corporate equity. As of yet, there are no Regulations under § 385. The researcher, therefore, must resort to past judicial decisions for a definition of debt.

Sometimes the Code directs the researcher elsewhere for the answer. For example, § 162(c) refers to the Foreign Corrupt Practices Act for purposes of determining when payments to foreign officials are deductible.

Cross-referencing between Code Sections is often poor or nonexistent. Code Sections are enacted at different times by Congresses that are operating under stringent deadlines. Consequently, a certain lack of integration within the Code is frequently apparent.

Definitions vary from one Code Section to another. For example, § 267 disallows losses between related parties and includes brothers and sisters in the definition of related parties. Not so with § 318, which deals with the definition of related parties as to certain stock redemptions.

Assessing the Validity of a Treasury Regulation. Treasury Regulations are often said to have the force and effect of law. This statement is certainly true for most Regulations, but some judicial decisions have held a Regulation or a portion thereof invalid. Usually, this is done on the grounds that the Regulation is contrary to the intent of Congress.

Keep the following observations in mind when assessing the validity of a Regulation:

• In a challenge, the burden of proof is on the taxpayer to show that the Regulation is wrong. However, a court may invalidate a Regulation that varies from the language of the statute and has no support in the Committee Reports.
• If the taxpayer loses the challenge, the negligence penalty may be imposed. This accuracy-related provision deals with the “intentional disregard of rules and regulations” on the part of the taxpayer and is explained further in Chapter 16.
• Some Regulations merely reprint or rephrase what Congress has stated in its Committee Reports issued in connection with the enactment of tax legislation. Such Regulations are “hard and solid” and almost impossible to overturn because they clearly reflect the intent of Congress.
• In some Code Sections, Congress has given to the “Secretary or his delegate” the authority to prescribe Regulations to carry out the details of administration or to otherwise complete the operating rules. Under such circumstances, it could almost be said that Congress is delegating its legislative powers to the Treasury Department. The Congressional Research Service found that Congress delegated regulatory authority to the Treasury on more than 240 occasions from 1992 through 2000, an average of more than 26 delegations per year. Regulations issued pursuant to this type of authority truly possess
the force and effect of law and are often called “legislative” Regulations. They are to be distinguished from “interpretative” Regulations, which purport to explain the meaning of a particular Code Section. Examples of legislative Regulations are those dealing with consolidated returns issued under §§ 1501 through 1505. As a further example, note the authority granted to the Treasury Department by § 385 to issue Regulations setting forth guidelines on when corporate debt can be reclassified as equity (see Chapter 3).

Assessing the Validity of Other Administrative Sources of the Tax Law.
Revenue Rulings issued by the IRS carry less weight than Treasury Department Regulations. Rulings are important, however, in that they reflect the position of the IRS on tax matters. In any dispute with the IRS on the interpretation of tax law, taxpayers should expect agents to follow the results reached in any applicable rulings.

Actions on Decisions further tell the taxpayer the IRS’s reaction to certain court decisions. Recall that the IRS follows a practice of either acquiescing (agreeing) or nonacquiescing (not agreeing) with court decisions where guidance may be helpful. This practice does not mean that a particular decision has no value if the IRS has nonacquiesced in the result. It does, however, indicate that the IRS will continue to litigate the issue involved.

The validity of individual letter rulings issued by the IRS is discussed in Chapter 16.

Assessing the Validity of Judicial Sources of the Tax Law. The judicial process as it relates to the formulation of tax law has been described. How much reliance can be placed on a particular decision depends upon the following variables:

- The level of the court. A decision rendered by a trial court (e.g., a Federal District Court) carries less weight than one issued by an appellate court (e.g., the Fifth Circuit Court of Appeals). Unless Congress changes the Code, decisions by the U.S. Supreme Court represent the last word on any tax issue.
- The legal residence of the taxpayer. If, for example, a taxpayer lives in Texas, a decision of the Fifth Circuit Court of Appeals means more than one rendered by the Second Circuit Court of Appeals. This is true because any appeal from a U.S. District Court or the U.S. Tax Court would be to the Fifth Circuit Court of Appeals and not to the Second Circuit Court of Appeals.
- Whether the decision represents the weight of authority on the issue. In other words, is it supported by the results reached by other courts?
- The outcome or status of the decision on appeal. For example, was the decision appealed and, if so, with what result?

In connection with the last two variables, the use of a manual citator or a computer search is invaluable to tax research. The use of a manual citator is described in the last section of this chapter.

Assessing the Validity of Other Sources. Primary sources of tax law include the Constitution, legislative history materials, statutes, treaties, Treasury Regulations, IRS pronouncements, and judicial decisions. The IRS regards only primary sources as substantial authority. However, reference to secondary materials such

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"The major manual citators are published by Commerce Clearing House, RIA, and Shepard’s Citations, Inc. See the prior comments under Working with the Tax Services."
as legal periodicals, treatises, legal opinions, general counsel memoranda, technical advice memoranda, and written determinations can be useful. In general, secondary sources are not authority.

Although the statement that the IRS regards only primary sources as substantial authority is generally true, there is one exception. For purposes of the accuracy-related penalty in § 6662, the IRS has expanded the list of substantial authority to include a number of secondary materials (e.g., letter rulings, general counsel and technical advice memoranda, and the “Blue Book”).52 The “Blue Book” is the general explanation of tax legislation prepared by the Joint Committee on Taxation of the U.S. Congress.

As under former § 6661, “authority” does not include conclusions reached in treatises, legal periodicals, and opinions rendered by tax professionals.

ARRIVING AT THE SOLUTION OR AT ALTERNATIVE SOLUTIONS

Returning to Example 20, assume the parties decide that the loan approach can be justified from the factual situation involved. Does this assumption lead to a bad debt deduction for the aunt? Before this question can be resolved, the loan needs to be classified as either a business or a nonbusiness debt. One of the reasons the classification is important is that a nonbusiness bad debt cannot be deducted until it becomes entirely worthless. Unlike a business debt, no deduction for partial worthlessness is allowed.53

It is very likely that the loan the aunt made in 1998 falls into the nonbusiness category. Unless exceptional circumstances exist (e.g., the lender was in the trade or business of lending money), loans in a related-party setting are treated as nonbusiness. The probability is high that the aunt would be relegated to nonbusiness bad debt status.

The aunt has the burden of proving that the remaining unpaid balance of $42,000 is entirely worthless.54 In this connection, what collection effort, if any, has the aunt made? But would any such collection effort be fruitless? Perhaps the nephew is insolvent, ill, or unemployed, or has departed for parts unknown.

Even if the debt is entirely worthless, one further issue remains to be resolved. In what year did the worthlessness occur? It could be, for example, that worthlessness took place in a year before it was claimed.55

A clear-cut answer may not be possible as to a bad debt deduction for the aunt in year 2005 (seven years after the advance was made). This uncertainty does not detract from the value of the research. Often a guarded judgment is the best possible solution to a tax problem.

COMMUNICATING TAX RESEARCH

Once the problem has been researched adequately, a memo, letter, or spoken presentation setting forth the result may be required. The form such a communication takes could depend on a number of considerations. For example, is any particular procedure or format for communicating tax research recommended by either an employer or an instructor? Are the research results to be given directly to the client, or will they first pass to the preparer’s employer? If an oral presentation is

[53] See § 166 and the discussion of Investor Losses in Chapter 3.
required, who will be the audience? How long should you talk? Whatever form it takes, a good tax research communication should contain the following elements:

- A clear statement of the issue.
- In more complex situations, a short review of the factual pattern that raises the issue.
- A review of the pertinent tax law sources (e.g., Code, Regulations, rulings, judicial authority).
- Any assumptions made in arriving at the solution.
- The solution recommended and the logic or reasoning in its support.
- The references consulted in the research process.

Figures 1–4, 1–5, and 1–6 present a sample client letter and memoranda for the tax files.

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Working with the Tax Law—Tax Planning

Tax research and tax planning are inseparable. The primary purpose of effective tax planning is to reduce the taxpayer’s total tax bill. This reduction does not mean that the course of action selected must produce the lowest possible tax under the circumstances. The minimization of tax payments must be considered in the context of the legitimate business goals of the taxpayer.

A secondary objective of effective tax planning is to reduce, defer, or eliminate the tax. Specifically, this objective aims to accomplish one or more results. Some possibilities are eradicating the tax entirely, eliminating the tax in the current year, deferring the receipt of income, and proliferating taxpayers (i.e., forming partnerships and corporations or making lifetime gifts to family members). Further examples include eluding double taxation, avoiding ordinary income, or creating, increasing, or accelerating deductions. However, this second objective should be pursued with considerable reservation. Although the maxim “A bird in the hand is worth two in the bush” has general validity, the rule frequently breaks down. For example, a tax election in one year may accomplish a current reduction in taxes, but it could saddle future years with a disadvantageous tax position.
NONTAX CONSIDERATIONS

There is a danger that tax motivations may take on a significance that does not conform to the true values involved. In other words, tax considerations can operate to impair the exercise of sound business judgment. Thus, the tax planning process can lead to ends that are socially and economically objectionable. Unfortunately, a tendency exists for planning to move toward the opposing extremes of either not enough or too much emphasis on tax considerations. The happy medium is a balance that recognizes the significance of taxes, but not beyond the point at which planning detracts from the exercise of good business judgment.

The remark is often made that a good rule to follow is to refrain from pursuing any course of action that would not be followed were it not for certain tax considerations. This statement is not entirely correct, but it does illustrate the desirability of preventing business logic from being “sacrificed at the altar of tax planning.”

TAX AVOIDANCE AND TAX EVASION

A fine line exists between legal tax planning and illegal tax planning—tax avoidance versus tax evasion. Tax avoidance is merely tax minimization through legal techniques. In this sense, tax avoidance becomes the proper objective of all tax planning. Though eliminating or reducing taxes is also a goal of tax evasion, the term implies the use of subterfuge and fraud as a means to this end. Perhaps because common goals are involved, popular usage has blurred the distinction between the two concepts. Consequently, the association of tax avoidance with tax evasion has kept some taxpayers from properly taking advantage of planning possibilities. The now-classic words of Judge Learned Hand in *Commissioner v. Newman* reflect the true values a taxpayer should have:

> Over and over again courts have said that there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced extractions, not voluntary contributions. To demand more in the name of morals is mere cant.57

FOLLOW-UP PROCEDURES

Tax planning usually involves a proposed (as opposed to a completed) transaction and is based upon the continuing validity of the advice resulting from tax research. A change in the tax law (either legislative, administrative, or judicial) could alter the original conclusion. Additional research may be necessary to test the solution in light of current developments.

Under what circumstances does a tax practitioner have an obligation to inform a client as to changes in the tax law? The legal and ethical aspects of this question are discussed in Chapter 16.

TAX PLANNING—A PRACTICAL APPLICATION

Returning to the facts in Example 20, what should be done to help protect the aunt’s bad debt deduction?

- All formalities of a loan should be present (e.g., written instrument, definite and realistic due date).

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57: 47–1 USTC ¶9175, 35 AFTR 857, 159 F.2d 848 (CA–2, 1947).
• Upon default, the lender (aunt) should make a reasonable effort to collect from the borrower (nephew). If not, the aunt should be in a position to explain why any such effort would be to no avail.
• If interest is provided for, it should be paid.
• Any interest paid (or imputed under § 7872) should be recognized as income by the aunt.
• Because of the annual exclusion of $10,000 in 1998 (now $11,000), it appears doubtful that actual (or imputed) interest would necessitate the filing of a Federal gift tax return by the aunt. But should one be due, it should be filed.
• If § 7872 applies (not enough or no interest is provided for), the nephew should keep track of his net investment income. This record keeping is important since the income the aunt must recognize may be limited by this amount.

Throughout this text, each chapter concludes with observations on Tax Planning Considerations. Such observations are not all-inclusive but are intended to illustrate some of the ways in which the material in the chapter can be effectively used to minimize taxes.

**ELECTRONIC TAX RESEARCH**

The computer is being used more frequently in the day-to-day practice of tax professionals, students, and educators. Many software vendors offer tax return software programs for individual, corporate, partnership, and fiduciary returns. The use of computers, however, is not limited to batch-processed tax returns. Computer materials for quantitative tax and problem-solving planning and calculations have added a new dimension to tax research.

Computer-based tax research tools hold a prominent position in the tax practice. Electronic tax resources allow the tax library to reflect the tax law with its dynamic and daily changes. Using electronic means to locate tax law sources is not a substitute, however, for developing and maintaining a thorough knowledge of the tax law and applying logical and analytical review in addressing open tax research issues. Accessing tax documents through electronic sources offers several important advantages over a strictly paper-based approach to the task:

• Materials are available to the practitioner more quickly through an electronic system, which eliminates delays by streamlining the composition and proofreading, production, and distribution of the new materials.
• Some tax documents, such as so-called slip opinions of trial-level courts and interviews with policymakers, are available only through electronic sources.
• Commercial subscriptions to electronic tax services are likely to provide, at little or no cost, additional tax law sources to which the researcher would not have access through stand-alone purchases of traditional material. For example, the full texts of private letter rulings are quite costly to acquire in a paper-based format, but electronic publishers may bundle the rulings with other materials for a reasonable cost.

Comparing the cost of paper and electronic tax research materials is difficult, especially when the practitioner uses hardware, including workstations and communications equipment, that is already in place and employed elsewhere in the practice. Over time, though, the convenience, cost, and reliability of electronic research tools clearly make them the dominant means of finding and analyzing tax law.
Using Electronic Services. Tax researchers often use electronic sources to find the tax law. Usually, the law is found using one of the following approaches:

- **Search** various databases using key words that are likely to be found in the underlying documents, as written by Congress, the judiciary, or administrative sources.
- **Link** to tax documents for which all or part of the proper citation is known.
- **Browse** the tax databases, examining various tables of contents and indexes in a traditional manner, or using cross-references in the documents to jump from one tax law source to another.

Virtually all of the major commercial tax publishers, and most of the primary sources of the law itself (e.g., the Supreme Court and some of the Courts of Appeals), now provide tax materials in electronic formats. Competitive pressures are forcing tax practitioners to become computer literate. Thus, the user-friendliness of the best of the tax search software is of great benefit to both the daily and the occasional user.

**CD-ROM Services.** The CD has been a major source of electronic tax data for about a decade. Every year data compression techniques allow more tax materials to fit on a single disc. CCH, RIA, WESTLAW, and others offer vast tax libraries to the practitioner. Often these resources are available in conjunction with a subscription to traditional paper-based resources and are accompanied by newsletters, training seminars, and ongoing technical support.

At its best, a CD-based tax library forms the archival data that make up the permanent, core library of tax documents. For about $300 a year, the tax CDs are updated quarterly and provide more comprehensive tax resources than the researcher is ever likely to need. In contrast, a paper-based library of a decade ago cost perhaps $20,000 to establish and $5,000 per year in perpetuity to maintain. If the library is contained on a small number of discs, portability (through use on notebook computers) becomes an additional feature of the service. Exhibit 1–1 summarizes the most popular electronic tax services on the market today.

**Online Systems.** An online research system allows a practitioner to access the computer of the service provider, giving virtually instantaneous use of tax law.
Online services employ price-per-search cost structures that average close to $200 per hour, making them significantly more expensive than paper or CD-ROM materials. Thus, unless a practitioner can pass along related costs to clients or others, online searching is limited to the most important issues and to the researchers with the most experience and training in search techniques.

Perhaps the best combination of electronic tax resources is to use a CD system for day-to-day work where the budget is known in advance and augment the CD with online access where it is deemed to be critical. Exhibit 1–2 lists the most commonly used commercial online tax services.

### The Internet

The Internet provides a wealth of tax information in several popular forms, sometimes at no direct cost to the researcher. Using so-called browser software, which is often distributed with new computer systems and their communication devices, a tax professional can access worldwide information in several popular forms that can aid the research process.

- *Home pages on the World Wide Web (WWW)* are provided by accounting firms, consulting firms, publishers, tax academics, libraries, and governmental
bodies as a means of making information widely available or soliciting subscriptions or consulting engagements. Links to other sites and direct contact to the site providers are found in the best pages. One of the most useful sites available to the tax practitioner is the IRS’s Digital Daily, illustrated in Exhibit 1–3. This site offers downloadable forms and instructions, “plain English” versions of Regulations, and news updates. Exhibit 1–4 lists some other Web sites that may be most useful to tax researchers along with their Internet addresses as of press date.

* **Newsgroups** provide a means by which information related to the tax law can be exchanged among taxpayers, tax professionals, and others who subscribe to the group’s services. Newsgroup members can read the exchanges among other members and offer replies and suggestions to inquiries as desired.
Discussions address the interpretation and application of existing law, analysis of proposals and new pronouncements, and reviews of tax software.

- **E-mail capabilities** are available to most tax professionals through an employer’s equipment or by a subscription providing Internet access at a low and usually fixed cost for the period. E-mail allows virtually instantaneous sending and receiving of messages, letters, tax returns and supporting data, spreadsheets, and other documents necessary to solve tax problems.

In many situations, solutions to research problems benefit from, or require, the use of various electronic tax research tools. The competent tax professional must become familiar and proficient with the various means of using electronic tax resources to meet the expectations of clients and the necessities of work in the modern world.58

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Use of the RIA Citator

The Federal Tax Citator is a separate multivolume service with monthly supplements that may be used to determine the status of tax decisions, Revenue Rulings, and Revenue Procedures. A similar citation process is available with the online research system. Cases that are traced by the Citator are divided into the issues involved. Since the researcher may be interested in only one issue, only those cases involving that issue need to be checked.

The volumes of the Federal Tax Citator and the period of time covered by each are as follows:

- Volume 1 (1863–1941).
- Annual and monthly cumulative paperback supplements.

Through the use of symbols, the Citator indicates whether a decision is followed, explained, criticized, questioned, or overruled by a later court decision. These symbols are reproduced in Figure 1–7.


The headnote for Adda summarizes the holding of the court and lists the two main issues involved (designated “1” and “2”) in the case. As noted previously, the issue designation procedure facilitates the use of the Citator.

Refer to Volume 3 for the AFTR Series (covering the period from October 7, 1948, through July 29, 1954) of the Federal Tax Citator. Information about the case is located in the excerpt reproduced in Figure 1–8.

Correlating the symbols in Figure 1–7 with the shaded portion of Figure 1–8 reveals the following information about Adda v. Comm.:

- Application for certiorari (appeal to the U.S. Supreme Court) filed by the taxpayer (T) on March 1, 1949.
- Certiorari was denied (x) by the U.S. Supreme Court on April 18, 1949.
- The trial court decision is reported in 10 T.C. 273 and was affirmed on appeal (sa) to the Fourth Court of Appeals.
- During the time frame of Volume 3 of the Citator (October 7, 1948, through July 29, 1954), one decision (Milner Hotels, Inc.) has agreed “on all fours with the cited case” (iv). One decision (Comm. v. Nubar) has limited the cited case to its facts (i), and two decisions (The Scottish American Investment Co., Ltd. and Zareh Nubar) have distinguished the cited case on issue 1 (g–1).

The portion of Volume 1 of the Citator Second Series (covering the period from 1954 through 1977) dealing with Adda v. Comm. is reproduced in Figure 1–9.

Correlating the symbols in Figure 1–7 with the shaded portion of Figure 1–9 reveals the following additional information about Adda v. Comm.:

- The case was cited without comment in two rulings and two decisions: Rev.Rul. 56–145 and Rev.Rul. 56–392, Balanovski and Liang.
- It was followed in Asthmanefrin Co. (f–1).
- It was distinguished in de Vegvar and Purvis (g–1).
- It was reconciled in deKrause (k–1).
CHAPTER 1 Understanding and Working with the Federal Tax Law

FIGURE 1–7
RIA Citator Symbols for Court Decisions

Judicial History of the Case

- **a** affirmed (by decision of a higher court)
- **d** dismissed (appeal to a higher court dismissed)
- **m** modified (decision modified by a higher court, or on rehearing)
- **r** reversed (by a decision of a higher court)
- **s** same case (e.g., on rehearing)
- **rc** related case (companion cases and other cases arising out of the same subject matter are so designated)
- **x** certiorari denied (by the Supreme Court of the United States)

(C or G)
The Commissioner or Solicitor General has made the appeal

(T)
Taxpayer has made the appeal

(A)
Tax Court’s decision acquiesced in by Commissioner

(NA)
Tax Court’s decision nonacquiesced in by Commissioner

- **sa** same case affirmed (by the cited case)
- **sd** same case dismissed (by the cited case)
- **sm** same case modified (by the cited case)
- **sr** same case reversed (by the cited case)
- **sx** same case—certiorari denied

Syllabus of the Cited Case

- **iv** four (on all fours with the cited case)
- **f** followed (the cited case followed)
- **e** explained (comment generally favorable, but not to a degree that indicates the cited case is followed)
- **k** reconciled (the cited case reconciled)
- **n** dissenting opinion (cited in a dissenting opinion)
- **g** distinguished (the cited case distinguished either in law or on the facts)
- **l** limited (the cited case limited to its facts. Used when an appellate court so limits a prior decision, or a lower court states that in its opinion the cited case should be so limited)
- **c** criticized (adverse comment on the cited case)
- **q** questioned (the cited case not only criticized, but its correctness questioned)
- **o** overruled

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FIGURE 1–8
Excerpt from Volume 3, First Series

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FIGURE 1–9
Excerpt from Volume 1, Second Series

Reprinted from RIA Citator 2nd Series Volume 1 © 1992, RIA, 395 Hudson St., NY, NY 10014.
Reference to the “Court Decisions” section of Volume 2, Second Series of the Citator covering the period from 1978 through 1989 shows that Adda v. Comm. was cited in Robert E. Cleveland and Judith C. Connelly, each case limited to its facts (l).

The Citator includes a cumulative supplement, and each month there is a cumulative paperback supplement. Be sure to refer to these monthly supplements, or very recent citations might be overlooked.

Except as otherwise noted, it would appear that Adda v. Comm. has withstood the test of time.

**KEY TERMS**

| Acquiescence, 1–31 | Determination letters, 1–24 | Revenue Procedures, 1–22 |
| Arm’s length concept, 1–14 | Indexation, 1–11 | Revenue Rulings, 1–22 |
| Business purpose concept, 1–15 | Letter rulings, 1–23 | Tax benefit rule, 1–15 |
| Certiorari, 1–28 | Nonacquiescence, 1–31 | Temporary Regulations, 1–21 |
| Continuity of interest concept, 1–15 | Proposed Regulations, 1–21 | Wherewithal to pay, 1–7 |
| Revenue neutrality, 1–3 | |

**PROBLEM MATERIALS**

**Discussion Questions**

1. What is revenue neutrality?
2. What is the justification for allowing the write-off of depreciation?
3. What are some provisions in the corporate area that favor or benefit small businesses?
4. Why is personal saving desirable for the U.S. economy?
5. Explain how the following tax provisions encourage small business:
   a. The nature of a shareholder’s loss on a stock investment.
   b. The tax rates applicable to corporations.
   c. Nontaxable corporate divisive reorganizations.
6. What purpose is served by allowing a refundable earned income credit?
7. What purpose is served by permitting the HOPE scholarship credit?
8. What purpose is served by the credit allowed for certain child or disabled dependent care expenses?
9. Why should the deductibility of excess political campaign expenditures be contrary to public policy?
10. In the past, Congress has considered proposals that would allow a taxpayer to claim a tax credit for tuition paid to send a dependent to a private school. Is there any justification for such a proposal?
11. Why has Congress moved toward credits rather than deductions in recent years?
12. Some states that impose a state income tax allow the taxpayer a deduction for any Federal income taxes paid. What is the justification for such an approach?
13. A provision of the Code allows a taxpayer a deduction for Federal income tax purposes for state and local income taxes paid. Does this provision eliminate the effect of multiple taxation of the same income? Why or why not? In this connection, consider the following:
a. Taxpayer, an individual, has itemized deductions that are less than the standard deduction.
b. Taxpayer is in the 10% tax bracket for Federal income tax purposes. The 33% tax bracket.

14. Yvonne operates a profitable sole proprietorship. Because the business is expanding, she would like to transfer it to a newly created corporation. Yvonne is concerned, however, over the possible tax consequences that would result from incorporating. Please comment.

15. Assume the same facts as in Question 14. Yvonne is also worried that once she incorporates, the business will be subject to the Federal corporate income tax. Any suggestions?

16. In regard to situations in which the tax law recognizes the wherewithal to pay concept, discuss the effect of the following:
   a. The basis to the transferor of property received in a nontaxable exchange.
   b. The recognition by the transferor of any realized loss on the transfer.
   c. The receipt of boot or other property by the transferor.

17. Does the wherewithal to pay concept enable a transferor to permanently avoid the recognition of any gain or loss? Give an example of the law permanently forgiving the recognition of gain or loss.

18. Brenda exchanges 600 shares of Veritex Corporation stock for a one-fourth interest in the Blue Partnership. Since this exchange is not pursuant to a nontaxable reorganization, does the wherewithal to pay concept shield Brenda from the recognition of gain or loss? Why?

19. Give some exceptions to the annual accounting period concept.

20. Mel, a calendar year cash basis taxpayer, is a participant in an H.R. 10 (Keogh) retirement plan for self-employed persons. To get the deduction for 2005, Mel makes his contribution on December 30, 2005.
   a. Why was there an element of urgency in Mel’s action?
   b. Was Mel misinformed about the tax law? Explain.

21. What is the justification for the alternative minimum tax and the imputed interest rules?

22. List the community property states. What is the effect of community property on the earnings of married taxpayers?

23. Illustrate how state laws have influenced Federal tax laws.

24. Give some examples of tax provisions that resulted from efforts by the IRS to prevent taxpayers from exploiting loopholes.

25. Describe how the IRS achieves administrative feasibility through each of the following tax provisions:
   a. The standard deduction allowed to individual taxpayers.
   b. The $345,800 unified tax credit allowed for gift tax purposes in 2005.
   c. The $11,000 annual exclusion allowed for gift tax purposes.

26. What is the arm’s length concept?

27. Explain the business purpose concept.

28. White Corporation lends $404,000 to Red Corporation with no provision for interest. White Corporation and Red Corporation are owned by the same shareholders. How might the IRS restructure this transaction with adverse tax consequences?

29. Under what circumstances can court decisions lead to changes in the Code?

30. In 1986, Congress codified the then-existing Federal tax provisions, and this compilation became the Internal Revenue Code of 1986. Discuss the validity of this statement.

31. How may a tax bill originate in the Senate?
32. What is the role of the Joint Conference Committee?
33. Determine the subparts of § 703(a)(2)(E).
34. Is § 280A(e)(2) a proper Code Section?
35. Why are certain Code Section numbers missing from the Internal Revenue Code (e.g., §§ 6, 7, 8, 9, 10)?
36. Do Temporary Regulations carry more weight than traditional Proposed Regulations?
37. Interpret each of the following citations:
38. Cy Young calls you requesting an explanation of the fact-finding determination of a Federal Court of Appeals. Prepare a letter dated October 15, 2005, to be sent to Cy answering this query. His address is 1072 Richmond Lane, Keene, NH 01720.
39. Milt Pappas calls you with respect to a tax issue. He has found a tax case in the U.S. District Court of South Carolina that is in favor of his position. The IRS lost and did not appeal the case. Over the phone, you explain to Milt the significance of the failure to appeal. Prepare a tax file memorandum dated September 13, 2005, outlining your remarks to Milt.
40. In assessing the validity of a court decision, discuss the significance of the following:
   a. The decision was rendered by the U.S. District Court of Wyoming. Taxpayer lives in Wyoming.
   b. The decision was rendered by the U.S. Court of Federal Claims. Taxpayer lives in Wyoming.
   c. The decision was rendered by the Second Circuit Court of Appeals. Taxpayer lives in California.
   d. The decision was rendered by the U.S. Supreme Court.
   e. The decision was rendered by the U.S. Tax Court. The IRS has acquiesced in the result.
   f. Same as (e) except that the IRS has issued a nonacquiescence as to the result.
41. Which court heard these decisions?
   d. Aldren H. Hale, 44 TCM 1116.
42. Refer to Figures 1–7 and 1–8 illustrating the use of the RIA Federal Tax Citator. Explain the following abbreviations:
   a. sx f. e
   b. NA g. k
   c. r h. c
   d. a i. q
   e. f j. o
43. Kenny Rogers needs to learn quickly about the personal holding company tax. How should Kenny approach his research?
44. Determine whether the following items are primary sources or secondary sources for the purpose of substantial authority.
   a. Revenue Ruling.
   b. Article written by a judge in Tax Notes.
   c. Memorandum Tax Court decision.
   d. The “Blue Book.”
   e. A letter ruling.
45. How can a citator help a researcher?
CHAPTER 1  Understanding and Working with the Federal Tax Law

Problems

46. Thelma owns some real estate (basis of $120,000 and fair market value of $65,000) that she would like to sell to her son, Sandy, for $65,000. Thelma is aware, however, that losses on sales between certain related parties are disallowed for Federal income tax purposes [§ 267(a)(1)]. Thelma therefore sells the property to Paul (an unrelated party) for $65,000. On the next day, Paul sells the property to Sandy for the same amount. Is Thelma’s realized loss of $55,000 deductible? Explain.

47. Bart exchanges some real estate (basis of $800,000 and fair market value of $1 million) for other real estate owned by Roland (basis of $1.2 million and fair market value of $900,000) and $100,000 in cash. The real estate involved is unimproved and is held by Bart and Roland, before and after the exchange, as investment property.
   a. What is Bart’s realized gain on the exchange? Recognized gain?
   b. What is Roland’s realized loss? Recognized loss?
   c. Support your results to (a) and (b) under the wherewithal to pay concept as applied to like-kind exchanges (§ 1031).

48. Using the legend provided, classify the overall objective of the particular tax provision:

<table>
<thead>
<tr>
<th>Legend</th>
</tr>
</thead>
<tbody>
<tr>
<td>CE = Control of the economy</td>
</tr>
<tr>
<td>EA = Encouragement of certain activities</td>
</tr>
<tr>
<td>EI = Encouragement of certain industries</td>
</tr>
<tr>
<td>SC = Social considerations</td>
</tr>
<tr>
<td>W = Wherewithal to pay concept</td>
</tr>
<tr>
<td>AF = Administrative feasibility</td>
</tr>
<tr>
<td>ESB = Encouragement of small business</td>
</tr>
</tbody>
</table>

   a. Like-kind exchange treatment.
   b. An increase in the individual tax rate.
   c. The S corporation election.
   d. Adoption expense credit.
   e. Percentage depletion.
   f. Unified estate tax credit.
   g. Charitable contribution deduction.

49. Determine whether the following states are community property or common law states:
   a. Louisiana.
   b. New York.
   c. New Mexico.
   d. South Carolina.
   e. Alaska.
   f. California.

50. Troy sells property (basis of $30,000) to Beige Corporation for $45,000. Based on the following conditions, how could the IRS challenge this transaction?
   a. Troy is the sole shareholder of Beige Corporation.
   b. Troy is the son of the sole shareholder of Beige Corporation.
   c. Troy is neither a shareholder in Beige Corporation nor related to any of Beige’s shareholders.

51. a. What are Treasury Decisions (TDs)?
   b. What purpose do they serve?
   c. Where are they published?


53. Using the legend provided, classify each of the following citations as to the location. There may be more than one answer for a citation.
Legend

<table>
<thead>
<tr>
<th>IRC = Internal Revenue Code</th>
<th>FR = Federal Register</th>
</tr>
</thead>
<tbody>
<tr>
<td>IRB = Internal Revenue Bulletin</td>
<td>NA = Not applicable</td>
</tr>
<tr>
<td>CB = Cumulative Bulletin</td>
<td></td>
</tr>
</tbody>
</table>

a. § 8022(3)(B).
e. Temp.Reg. § 310.6103(k)(6)–1T(c)(3).
g. Miller v. U.S., 38 F.3d 473 (CA–9, 1994).
h. Ltr.Rul. 200409001.

54. To which U.S. Court of Appeals would a person living in each of the following states appeal?
   b. Louisiana.
   c. Nevada.
   d. Pennsylvania.
   e. Ohio.

55. Using the legend provided, classify each of the following citations as to the court:

<table>
<thead>
<tr>
<th>Legend</th>
</tr>
</thead>
<tbody>
<tr>
<td>T = U.S. Tax Court</td>
</tr>
<tr>
<td>D = U.S. District Court</td>
</tr>
<tr>
<td>C = U.S. Court of Federal Claims</td>
</tr>
<tr>
<td>A = U.S. Court of Appeals</td>
</tr>
<tr>
<td>U = U.S. Supreme Court</td>
</tr>
<tr>
<td>N = None of the above</td>
</tr>
</tbody>
</table>

   b. 79 T.C. 7 (1982).
   c. 54 S.Ct. 8 (USSC, 1933).
   d. 3 B.T.A. 1042 (1926).
   e. T.C.Memo. 1954–141.
   f. 597 F.2d 760 (Ct.Cl., 1979).
   g. Ltr.Rul. 9414051.

56. Locate the following tax services in your library and indicate the name of the publisher and whether the service is organized by topic or by Code Section:
   a. United States Tax Reporter.
   c. Federal Tax Coordinator 2d.
   e. Tax Management Portfolios.
   g. CCH’s Federal Tax Service.

57. Using the legend provided, classify each of the following tax sources:

<table>
<thead>
<tr>
<th>Legend</th>
</tr>
</thead>
<tbody>
<tr>
<td>P = Primary tax source</td>
</tr>
<tr>
<td>B = Both</td>
</tr>
<tr>
<td>S = Secondary tax source</td>
</tr>
<tr>
<td>N = Neither</td>
</tr>
</tbody>
</table>
a. Sixteenth Amendment to the Constitution.
b. Tax treaty between the United States and China.
c. Proposed Regulations.
d. Revenue Procedure.
e. General Counsel Memoranda (1988).
f. Tax Court Memorandum decision.
g. Harvard Law Review article.
h. Legislative Regulations.
i. Letter ruling (before 1985).
j. District Court decision.
k. Small Cases Division of U.S. Tax Court decision.
l. Senate Finance Committee Report.

58. Rank these items according to their reliability:
a. Letter ruling.
b. Legislative Regulation.
c. Code Section.
d. Revenue Ruling.
e. Proposed Regulation.
f. Interpretive Regulation.
g. Recent Temporary Regulation.

59. Using the legend provided, classify each of the following decisions or statements in regard to the RIA Federal Tax Citator:

<table>
<thead>
<tr>
<th>Legend</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>a = affirmed</td>
<td>q = questioned</td>
</tr>
<tr>
<td>d = dismissed</td>
<td>c = criticized</td>
</tr>
<tr>
<td>r = reversed</td>
<td>f = followed</td>
</tr>
<tr>
<td>o = overruled</td>
<td>x = certiorari denied</td>
</tr>
</tbody>
</table>

a. Leroy Frantz, Jr., 83 T.C. 162 (1984), aff’d 784 F.2d 119 (CA–2, 1986), cert. den.

Research Problems

Note: Solutions to Research Problems can be prepared by using the RIA Checkpoint® Student Edition online research product, which is available to accompany this text. It is also possible to prepare solutions to the Research Problems by using tax research materials found in a standard tax library.

Research Problem 1. Locate the following cited items and give a brief description of the topic or opinion in the item:
   a. § 59A(a).
   b. § 6166(b)(8)(D)(i).
   c. Ltr.Rul. 200134022.

Research Problem 2. Determine whether the IRS agreed or disagreed with the results of these court decisions.
Research Problem 3. Determine the disposition of the following decisions at the appellate level.

Research Problem 4. Determine the disposition of the following decisions at the Supreme Court level or on rehearing:

Research Problem 5. Locate the July 2004 issue of the Journal of Taxation and find the article by Louis A. Mezzullo. What are the title and page numbers of the article? What do the designations FLP and FLLP stand for?

Research Problem 6. You have a client who collected and truthfully accounted for a tax, but failed to pay it over to the IRS. Section 7202 states:

   Any person required under this article to collect, account for, and pay over any tax imposed by this title who willfully fails to collect or truthfully account for and pay over such tax shall . . . be guilty of a felony.


Partial list of research aids:

Research Problem 7. Complete the following citations to the extent that the research materials are available to you:
   a. Omohundo v. U.S., 300 F.3d 1065 (CA–9, ____).
   e. Maranto v. Comm., T.C.Memo. 1999–____.
   g. Announcement 2003–43, 2003–1 C.B. ____.

Research Problem 8. Find Estate of Shelfer, 103 T.C. 10 (1994) and answer these questions:
   a. Who is the petitioner (plaintiff)?
   b. Who is the respondent (defendant)?
   c. What is the holding of the court?
   d. What is Rule 122(a)?
   e. Was this a reviewed decision?
   f. How many judges agreed with the majority opinion?
   g. Was this decision entered under Rule 155?

Use the tax resources of the Internet to address the following questions. Do not restrict your search to the World Wide Web, but include a review of newsgroups and general reference materials, practitioner sites and resources, primary sources of the tax law, chat rooms and discussion groups, and other opportunities.

Research Problem 9. Go to each of the following Internet locations:
   a. Several primary sources of the tax law, including the U.S. Supreme Court, a Court of Appeals, the Internal Revenue Service, the U.S. Tax Court, and final Regulations.
   b. Sources of proposed Federal tax legislation.
   c. A collection of tax rules for your state.

http://wft.swlearning.com